

Consumer Financial Capability: Empowering European Consumers

**Edited by the
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The papers collected here were presented during a 'Consumer Financial Capability Workshop' held in Brussels at CEPS on 8 November 2005 and co-sponsored by ECRI and VISA Europe. This event also included presentations of current financial literacy programmes, and of recent financial capability survey results. For more information, please consult <http://www.ecri.be/HTM/research/capability.htm>.

European Credit Research Institute, Brussels

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Besides its involvement in research projects on the different aspects of consumer credit in Europe, ECRI contributes to the public debate by making its findings available through publications, seminars, workshops and conferences. For more information, please consult our website: www.ecri.be

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1. Introduction and brief summary of the papers

Introduction

Consumers' ability to gather, compare and use relevant information is crucial for the functioning of market economies such as those of European Union countries. Well-informed consumers express their needs and preferences by making choices which, through competition, induce suppliers to produce tailored products at the best price.

Naturally, this mechanism also applies to retail financial markets. One may even argue that consumers' capacity to make well-informed choices – what we call 'consumer capability' – is particularly important in this area. Indeed, the consequences of a bad decision are likely to be quite different if the choice is about, say, a washing machine than if it is about a twenty-year mortgage product financing the family home. Moreover, European households do not tend to purchase financial products, such as loans and investment plans, on a regular basis. This gives them fewer opportunities to learn by trial and error. Most Europeans do not have many opportunities to test out their long-term financial decision-making skills, while errors can be very costly.

'Consumer financial capability' is therefore an important issue at both the aggregate and the individual level. First, it stimulates competition and innovation in retail financial markets. Second, by empowering European consumers, it gives them more control over their financial future. At a time when many European countries are reforming or are planning to reform their welfare systems and are struggling to keep state pension payments for the young generations at current levels, households will progressively be required to take even greater responsibility for their financial futures.

However, many European households seem to be struggling even with the financial decisions they are expected to take today. A 2005 OECD study entitled 'Improving Financial Literacy: Analysis of Issues and Policies'¹ revealed worryingly low levels of financial capability among European consumers. This finding is confirmed by the results of several studies presented in this volume. Thus, the question arises as to what steps could be taken to improve consumer financial capability for the benefit of individual households and financial markets as a whole.

Three basic remedies are available, which should arguably be considered as complementary: consumer education, consumer information and consumer protection. This set of papers contributes to policy research in all these three areas. The first paper, by Johanna Leskinen and Anu Raijas, prepares the ground by proposing a definition and conceptual framework for consumer financial capability. Catarina Frade and Cláudia Lopes then provide an analysis of the psychological and social factors determining consumer financial capability. Both papers offer guidelines for the design of policy initiatives in consumer education and information.

The paper by Elaine Kempson, Sharon Collard and Nick Moore deals with how to measure consumer financial capability based on an extensive UK survey run by the authors. Their methodology and preliminary results are essential references for the design and evaluation of any policy programme in the area of consumer financial capability.

¹ See http://www.oecd.org/document/28/0,2340,en_2649_15251491_35802524_1_1_1_1,00.html for more information.

Gianni Nicolini examines what aspects should be taken into account to strike the right regulatory balance between consumer information and consumer protection. He develops an innovative regulatory proposition, namely the creation of a financial capability index, to allow consumers to assess their own financial capability. Potential future legal and regulatory developments are further explored by Didier Noël. He provides a comparative analysis of the existing regulatory structures which provide the framework for the assessment of consumer credit applications at the EU level and in several individual countries.

All the papers were presented during a workshop held in Brussels on 8 November 2005. The event was co-sponsored by Visa Europe, one of the members of the European Credit Research Institute. A brief summary of the papers follows this introduction, while the summary of the presentations and interventions made during the workshop is available in Annex 2 to this volume. For any question about this event or our other activities please consult our website www.ecri.be or contact info@ecri.be.

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Brief summary of the papers

The publication starts with the article ‘**Consumer financial capability – a life cycle approach**’ by Johanna Leskinen and Anu Raijas. They explore the concept of consumer ‘financial capability’. Building on microeconomic theory and empirical findings, the authors develop a framework in which consumer financial capability depends on age, education, cultural environment and income among other factors. They conclude that financial education programmes should take those characteristics into account and provide tailored tools adapted to the background of consumers as well as to the stage in the life cycle that they have reached.

After summarising the dynamics of household economic activities, the authors explain the rationale of using the life-cycle approach for their framework. This approach takes into account the evolution of consumer needs, resources and responsibilities through the different phases of their lives. It also encompasses the role of expectations in decision-making processes and the general preference of individuals for stability in the level of consumption. Combined with a typical income development profile, where income reaches its peak around the middle of the life, this inclination to stability supports the hypothesis that individual financing needs significantly change over time. When applied to the analysis of consumer financial capability, the life-cycle approach supports the concept of different financial capabilities corresponding to different stages in life, from childhood to old age.

The authors consider financial capability as a set of personal characteristics influenced by micro- and macroeconomic factors. On this basis, they can examine the range of financial services and the depth of financial capability. Financial capability depth is then seen as including personal features organised around three axes: 1) financial knowledge and understanding; 2) skills and competence; and 3) responsibility. Financial capability (or financial literacy as North American literature tends to put it) can be understood as a process evolving along both following dimensions: the personal life cycle and the current trends in the economy.

A review of relevant empirical studies follows, which, among other points, highlights the rapid increase in the complexity of financial services. This is a challenge to consumers, particularly when they are comparing products. The authors conclude that consumer financial capability is a dynamic phenomenon worth further research and analysis. Determining a threshold of ‘sufficient’ capability might be impossible, given the relative nature of the concept that varies across time and cultures. Consumers need to update their knowledge and skills continuously. The ability to learn about new issues is a key prerequisite for financial capability. Given this flexibility, it is quite difficult to define what would be an ‘adequate’ level of financial capability.

In ‘**The fable of the grasshopper and the ant**’, Catarina Frade and Cláudia Lopes provide an empirical analysis of the psychological determinants influencing consumer financial profiles. Using data collected from a survey of two groups of Portuguese consumers, they develop a frame of reference which can be used to identify the factors that determine financial attitudes and behaviour. Importantly, their analysis encompasses the characteristics of the socio-economic context. Knowledge and skills are seen as a necessary but not sufficient first step towards the ability to make efficient decisions. Individual behaviour will also crucially depend on personal and social factors, i.e. cognitive styles and value systems.

The data that they use was collected during a series of interviews in Portugal. Aiming first to analyse the relationship between unemployment and over-indebtedness, the interviews were held with two distinct groups of individuals: factory workers who had recently lost their jobs and debtors who had sought the assistance of DECO (Associação Portuguesa Para A Defesa Do Consumidor), a Portuguese consumer protection association, in renegotiating with their creditors. The data included information about interviewees’ attitudes towards consumption,

credit and indebtedness, which allowed the authors to divide the interviewees into two distinct groups, called here the ‘grasshoppers’ and ‘the ants’.

In the group of factory workers who had recently lost their jobs, education and skill levels tended to be low. Their lifestyle was mostly rural or semi-urban, with relatively low levels of consumption; those ‘ants’ had a strong tendency to save and made very limited or virtually no use of credit. Considering the low wages they had received, unemployment benefits did not represent a significant loss of income. Their attitudes towards debt showed a marked reluctance to becoming indebted – apart from for mortgages or car loans. They said they could count on informal solidarity networks to help them through temporary financial difficulties.

In the group of debtors renegotiating with their creditors, unemployment or health problems were the two most common causes of default. Average education, skills levels and wages were higher than in the previous group, while saving levels were low. Urban lifestyle was the most common, with high levels of consumption. Credit was frequently used, while financial discipline was lower than in the previous group. Weaker informal solidarity networks meant that this group (the ‘grasshoppers’) was more vulnerable to the financial consequences of job losses. Additionally their higher incomes translated into higher gaps between earnings from work and unemployment benefits.

The authors conclude that financial capability programmes should be geared towards the consumer’s specific value system. Financial education is seen as aiming to change attitudes, whether in the area of money management, credit or consumption choices, through the establishment of new value priorities. For those changes to be sustainable, they should affect not only individuals but whole social groups.

In 2004, the UK Financial Services Authority commissioned the Personal Finance Research Centre (University of Bristol) to carry out a study on financial capability and to design an appropriate questionnaire to measure financial capability levels in the UK. Elaine Kempson, Sharon Collard and Nick Moore, describe in **‘Measuring financial capability – an exploratory study for the Financial Services Authority’** the methodology they used for the identification of components of financial capability, the design of a questionnaire to capture those components and the creation of a scale which measures financial capability.

After reviewing the research methods and definitions adopted in previous studies on financial capability, the authors developed their own conceptual model. This model was tested on eight focus groups to explore perceptions of financial capability and their correlation with personal financial circumstances. Interviewees’ perceptions of financial capability centred on behavioural elements and could be separated into four aspects: managing money, planning ahead, choosing and using financial products, and getting information and help.

Eight additional focus groups allowed for the assumptions underlying the model to be tested and for the questionnaire to be developed. This stage helped refine the information that had been collected. For instance, it provided evidence on the differences in the relative importance of financial capability elements, depending on age and income levels. Through all groups, there was the sense that money management, planning ahead, getting appropriate advice and avoiding over-borrowing were key aspects of financial capability. On some other issues such as the ability to shop around or to manage risk, answers differed among respondents according to their age and income levels.

Pilot surveys helped the research team to refine the content of the questionnaire before a national survey took place between June and September 2005.²

² Atkinson A., S. McKay, E. Kempson and S. Collard (2006), “Levels of Financial Capability in the UK: Results of a baseline survey”, prepared for the Financial Authority by the Personal Finance Research Centre, University of Bristol, FSA Consumer Research Report 47, March 2006.

In **‘A regulatory perspective on consumer financial capability’** by Gianni Nicolini, the author presents policy choices related to financial literacy as organised around two main approaches: the 'invasive approach' and the 'information approach'. Focusing on the latter, the author argues in favour of the creation of a financial capability index. This tool would help to stimulate consumers' perceptions about their own financial situation. The paper then presents a few guidelines to be followed when selecting the information to be used in the construction of such an index.

Financial capability is defined here as “the capacity, when in possession of a given set of information, to implement a decision-making process, based on which decisions are to be taken and/or modes of conduct followed, with respect to certain economic/financial situations”. Improving financial capability therefore means improving the results of such a decision-making process. This will entail increasing consumers' know-how and expertise and should be done through programmes designed to improve knowledge, skills and confidence. Besides traditional training courses, making the inputs of the decision process simpler and easier to use should be considered as a complementary measure.

The author argues that in the lender-borrower relationship, the borrower is the weaker contracting party. The reasons are that the debtor's need for credit is often stronger than the lender's need to invest and that the asymmetry of information is in favour of the lender. In order to compensate for this imbalance, two methods are considered: 1) direct intervention by limiting the range of action of the borrowers in order to protect their interests and 2) providing more information while preserving the decision-making autonomy of the borrower. Two different views support those divergent approaches. In the first view, the borrower is seen as unable to deal with the lender, which justifies invasive intervention, in the second the borrower possesses enough decision-making abilities, but lacks sufficient information in order to negotiate with the lender on an equal footing.

The present paper focuses on the second approach, which aims at improving the information level of consumers without compromising their decision-making independence. The author started his research with an analysis of the current regulatory framework in order to determine areas for intervention regarding financial capability. Consumer credit legislation in ten European countries (Belgium, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Switzerland and UK) was examined. The results showed considerable differences between the countries. Apart from Switzerland and – to a certain extent – UK legislation, financial capability was only implicitly dealt with through transparency regulations.

Information requirements, in particular at the level of financing costs, can be found in all the laws examined. Here, one could ask if the focus of the legislative action should not be expanded beyond the quantity of information made available. It could also regulate the modes of transmission for this information. The characteristics of the consumer decision-making process, which vary depending on the size of the economic commitment being considered, should be taken into account in determining efficient information requirements.

After examining the pros and cons of legislative intervention, the author develops the case for an innovative form of regulation: a financial capability index that would be made available for consumers to improve their assessment of their own situation and the potential impact of taking out a loan. This transparency-enhancing tool would have the advantage of favouring competition between operators while avoiding increases in the costs of borrowing. However, it presents the risk of excessively simplifying the situation. The index would mostly focus on current financial flows, taking into account their level of certainty and the level of possible change in both consumption habits and asset ownership over the repayment period.

Lastly, in **‘Evaluation of the consumer's financial capacity’**, Didier Noël presents a comparison of credit application assessment methodologies, as seen through legal frameworks in Switzerland, France, Belgium and at the EU level. Summarising the two successive proposals

prepared by the EU Commission for a reform of the directive on consumer credit, he points to key elements relating to consumer financial capability. Comments made by the EU Parliament and the Economic and Social Committee are also examined.

The author notes that, apart from the case of Switzerland, national law usually does not set out the assessment criteria in positive standards. In French law and Belgian common law, criteria are not imposed, but the responsibility of the lender might nevertheless be engaged. That responsibility is evaluated from the information that was available to the lender about the borrower's situation. Only in France however, has the 'public service' aspect involved in the lender's business been involved to justify a lender's duty to ensure reasonable repayment possibilities.

In contrast to Belgian common law, Belgian consumer credit law defines a clear sequencing of the pre-contractual obligations to be fulfilled by the loan applicant, the surety provider, the lending intermediary and the lender. In this case, it is not the criteria but the assessment method that is precisely defined, in advance, by the legislator.

Altogether, the papers give an overview of the recent research in the financial capabilities of consumers and possible ways to evaluate their ability to deal with financial matters. The publication concludes with the summary of interventions and the workshop programme.

Part I.

**Defining Consumer Financial Capability:
An Economic and Sociological Approach**

2. Consumer financial capability – a life cycle approach

Johanna Leskinen and Anu Raijas

Abstract

The paper discusses the concept of consumer financial capability and introduces a wider interpretative framework by discussing empirical findings in this area based on the life cycle approach. We argue that consumer financial capability is evolving. It relates to the consumers' position in the life cycle and to their education, income and life circumstances. It also depends on the culture they come from, as we will discuss. Together with other human abilities, financial capability as put into practice in the form of financial management contributes to people's well-being and to their having sound finances. Improving consumers' financial capability requires targeted education and information to an increasingly diverse range of consumers, which uses their language, considers various life cycle factors and is continuously updated via research.

1. Introduction

One of the key concerns emerging in national and EU-level consumer policies is consumers' ability to manage their finances. Overextended credit use and debt difficulties continue to be a major problem in European economies despite a number of legislative and other preventive policies introduced over the past ten years or so. 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 are increasingly susceptible to falling into debt. Consumption is driven even more by the increasing amount of free time people have and the growing number of commodities and services competing for this leisure time (Pantzar, 2005).

Consumption has always been an essential part of people's everyday life, but with increasing access to credit, it is more important than ever to manage one's personal finances because such financial resources tend to be small in relation to the needs and wants to be satisfied. Furthermore, changes in the overall macroeconomic environment challenge the financial capability of consumers. In many households there is uncertainty about permanent income due to temporary employment or unemployment. Cash has become somewhat obsolete as everything can be paid with plastic. Agreements where consumers have considerable financial responsibility have increased. Yet consumers – at least Finnish consumers – are used to trust their 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. Choices and decisions made in the financial domain have major consequences for the future financial well-being of consumers and households (Financial Capability through Personal Financial Education 2000, 4.).

The majority of households are able to live with their financial obligations and can manage their credit risks unless something unexpected happens that disrupts their income stream. 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 or bankruptcy or many simultaneous problems, can disturb the household budgetary equilibrium. Apart from insolvency due to 'external factors', new reasons for debt problems have risen to the

fore. A kind of negligence, a lack of financial management skills or excessive consumption in relation to the available income cause growing problems. Defaulting on payments and debt problems stemming from the use of loans 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 inability to predict the path of human life has 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.

Technological development offers consumers access to and use of online services, which brings opportunities as well as challenges into their personal budgeting plans. Increased telebanking (telephone and internet banking) on one hand saves people time and on the other forces them to do things for themselves and acquire computer skills. Finnish bank customers, for example, are expected to find out about loan issues on a bank homepage. Some banks encourage their customers to apply for a loan over the internet in order to save administrative costs. The homepages of banks provide a wide variety of information about different kinds of loans and offer tools such as calculators for loan applications (Lehtinen & Leskinen, 2003).

Alongside telebanking, the distance marketing of financial services poses a further challenge for 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 Commission, 2002). The directive concerning the distance marketing of financial services entered into force in Finland in January 2005 (Laki kuluttajansuojalain muuttamisesta, 2005). It remains to be seen how extensive the distance selling of financial services will be.

In today's economy consumers are expected to be active and well-informed in their financial activities and they are responsible for the consequences of their choices. Directives and regulations easily hide the fact that there is a wide diversity of consumers, families and households with different financial needs and resources according to their phase of life. The increasing diversity of consumers is posing a major challenge to all interested parties to promote their capability to manage financial affairs. An example is the growing role of children as economic actors in the market and as targets of marketing strategies. Elderly people's growing purchasing power and consumption is also expected to have an increasing impact on economic growth.

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. Several questions arise here. Who are these consumers with financial capability? What kind of a framework could be used to examine consumer financial capability? Is financial capability related to other consumer capabilities? How form does consumer financial capability take in different stages of life? And finally, how could consumers be empowered in their financial capability?

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

2. Dynamics of personal finances: Consumer financial capability in context

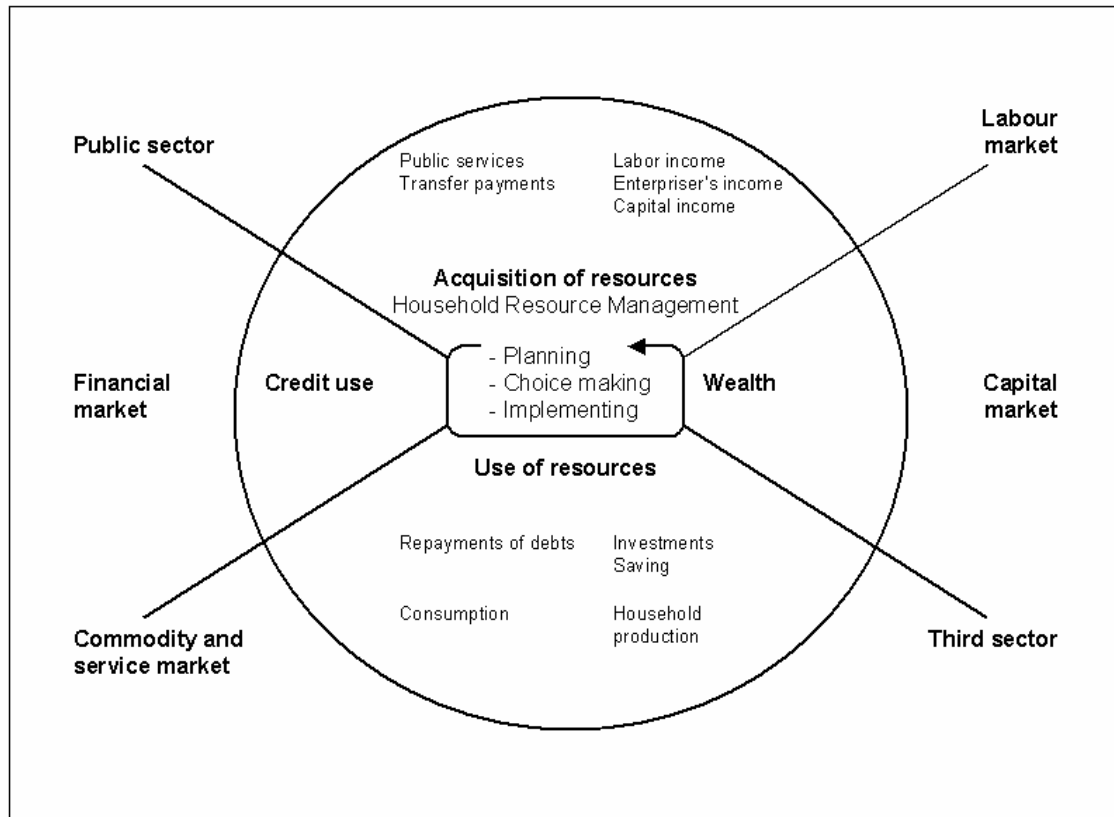
The primary goal of household activities is to provide well-being to the household members. Well-being, according to Allardt (1976), can be approached both objectively and subjectively. *Objective* well-being has material (standard of living) as well as non-material dimensions (quality of life). *Subjective* well-being refers to people's attitudes 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 interact with the economic activities of the household. It can be argued 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 (Heinonen & Raijas, 2005). In other words, production and consumption per se provide well-being (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 welfare services provided by the public sector is decreasing while welfare provision by the private sector, third sector and household sector is increasing. Technological development, digitalisation and service innovations are considered as important solutions. Households and consumers have interesting and challenging roles in this ongoing development. Households generate a whole array of services for their own use and maintain national economic growth through consumption. Furthermore, they are expected to be 'rational', reflective and responsible actors in the market in their economic activities and in their decision-making (Varjonen et al., 2005).

With this in mind we may ask: how are consumer finances and consumer financial capability related to this type of well-being? Household economic activities have to do with the acquisition and use of resources to satisfy human needs. Households interact with all other sectors of society, so their resources come from a number of sources. Wages, entrepreneurial income, capital income and transfer payments are 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 other parties, one example being their participation in the labour market. Balancing between needs and resources is the core of household resource management. Figure 1 summarises the dynamics of household economic activities and consumer finances:

Figure 1 indicates that household resource management is made up of planning, choices and decision-making, implementation, and the interaction of these activities. Consequently, it is possible to compensate for a shortage of income by planning and making the right choices in terms of credit use, increasing household production and/or increasing the liquidity of potential assets (wealth). Households also have to be aware of possible future risks and must be prepared for them. Excessive income can be used for consumption or for saving and the accumulation of wealth. Financial capability in its broadest sense is needed to operate in different markets, especially for allocating resources to consumption, credit use and investments. The need for this capability is increasing in today's global economy.

Figure 1. Dynamics of Household Economic Activities and Consumer Finances



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

3. Rationale of the life cycle approach

The life cycle approach (e.g. Deacon & 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’s life. By combining an individual’s age and family context the approach also helps to avoid the problem noted by Lea et al. (1981) that household decisions were consistent as if a household were composed of a single individual.

The ‘family life cycle’ has a special status in field of Anglo-American consumption research. People’s progress through life varies depending on their social and economic demands. The most frequently used definition of a family life cycle (according to Deacon & Firebaugh 1988) takes into account the ages of the children and their presence in the home. The authors emphasise the challenge that today’s family forms pose to the traditional model. Mainstream economic theories that focus on the effects of income, prices and interest levels on consumption and consumption expenditure introduced the life cycle hypothesis as early as the 1950s, based on Ando, Brumberg and Modigliani (e.g. Hallman, 1991). Consumption does not depend merely on the currently available income but also on income expectations in later phases of the life cycle. The hypothesis draws on the idea of ‘typical income development’, i.e. 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 with some slight increase. When young, consumers have to borrow because their consumption expenditure easily exceeds their available income. In the middle of the life cycle, people repay their loans and save and make investments for old age. However, considering today's complex economic and financial environment, such life cycle hypotheses remain 'idealistic' scenarios because the reality is often different in practice.

However, a life cycle hypothesis does make it possible to look at income and expenditure paths within certain time frames. Empirical applications indicate the relevance 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 be the most successful at increasing their consumption expenditure (Ahlqvist & Berg, 2003).

How does the life cycle approach help us to describe 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 or hobbies penetrate 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 & 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 obtain from the home or from shopping centres, leisure activities or special occasions such as birthdays. Attention has been also drawn to the role of giving presents and the potentially divergent educational models offered by grandparents and other relatives (Envall, 2005) – without forgetting the educational impact of the media.

To take another example, young consumers from their late teens through to 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 & Leskinen, 2005). When individuals reach the legal age of adulthood, they encounter financial capability issues such as the legal and other obligations of credit contracts.

What about the elderly population? Competence in the financial domain is considered a critical component because there are numerous and substantial risks involved in making financial decisions. Additionally, there is an ongoing demand for capacity assessments by individuals involved in elderly people's financial affairs, for example family caregivers and legal representatives (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 dictionaries, capability is ‘the quality of being capable in various senses’. Other definitions of capability offered by dictionaries include physical and mental power in general or legal or moral qualification. Sen (1993, 30) defines capability as a person’s ability to include valuable functioning in his/her 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 a lack 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 (see, for instance Oxford English Dictionary). A person has certain mental, social and material resources that he/she has to be aware of in order to use them as best they can. If the household has more than one member, part of the material resources will be used together with them. Sen’s definition 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. Their social environment provides the framework within which households operate 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 his/her micro and macro environment. This view allows us to examine the breadth and depth of financial capability. The breadth of financial capability refers to tasks concerning financial services (banking or borrowing) or 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 (Financial Services Authority 2005a, 7). These three aspects of capability are used in practice whenever a consumer 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 such as 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 awareness 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, towards 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 out insurance cover. An excellent example of this is a payment protection insurance 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 Capability through Personal Financial Education, 2000, 6; Financial Services Authority and Basic Skills Agency, 2002; Roy Morgan Research, 2003, 73-76). The financially responsible consumer understands that the decisions he/she 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 him/her aware of the commitments involved. If the consumer runs into disagreement with the service provider, he/she 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 use 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 aspects, we can also assume that there are various stages and expressions of financial capability. These are based on certain demographic consumer characteristics (sex, age, education, etc.) as well as values, attitudes or habits. The consumer's phase of life and the immediate environment he/she lives in shapes his/ her 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. 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 Social and Enterprise Development Innovations (SEDI) (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 is 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 (Australian Securities & Investments Commission, 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 use financial information is able to compare various alternatives concerning his/ her economy and evaluate the consequences of his/her actions. Financial competence has to do with practical activities – such as 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 synonymously 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 also some long-term activities, like saving and investment. Financial management refers to 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 achieved 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 (Timonen, 2002, 48). Furthermore, regardless of a person’s financial knowledge and competence, his/her decision-making is sometimes non-rational and based on intuitions, or irrational and motivated by compulsions and urges (see Gross, Grandall & Knoll, 1980, 236-237).

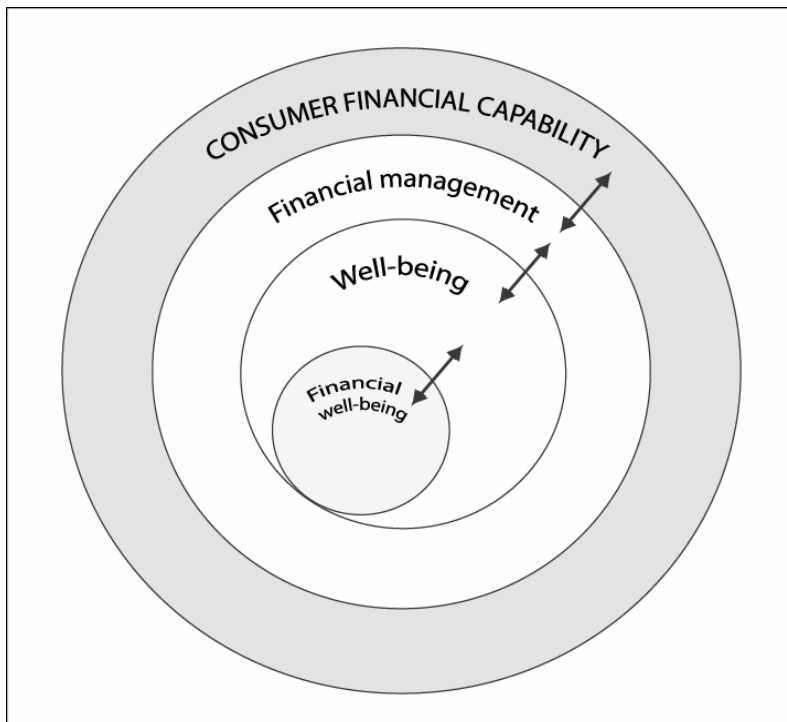
If the goal of all household activities is the well-being of the household members, what then is the household’s financial well-being? It can be examined objectively with certain measurable variables like the household’s available income and real property. Yet, this approach measures only one dimension 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 set out 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 presupposes 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 as 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 indicators of the financial situation of the household that include marital status, number of children, income, home ownership, responsibility for 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 in practice a product of perceived surplus (money left over from consumption, loan amount) and perceived adequacy of income (Porter & 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 set out 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 (see Figure 2).

Figure 2. The Relationships between Concepts in the Area of Financial Capability



Along with other consumer capabilities, financial capability, as is manifested 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 (such as sex and age) and psychological (such as values, attitudes, opinions, habits and 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 individual circumstances 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 he/she manages the household economy. A person may sometimes be unaware of his/her subjective capability and unable to measure it although it may guide his/her 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 carried out 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 US, a survey of consumers (Hilgert & Hogarth, 2003, 310-315) investigated the financial practices and knowledge of American consumers. The survey revealed that 89 percent of households had a bank account, 88 percent always paid their bills 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 & Ozanne, 2005, 104).

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 bank account on a monthly basis. Economic planning in the form of budgeting and monitoring of expenditure 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 high 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 fall. 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, such as 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 & 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 such as 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 online 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, home ownership, attitude towards credit and risk, and shopping for credit were significantly related to financial well-being among baby-boomers (Baek & DeVaney, 2004, 343). Furthermore, the ratio of debts and assets in the household was essential in determining its financial room for manoeuvre. 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 pose increasing challenges to consumer financial capability (Hogarth & 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 repay the costs of a given loan (Lehtinen & Leskinen, 2003, 11). How well can a customer understand all the costs of a housing loan when it is not possible for him/her to ask questions to a real person? Is the information on the internet reliable – reliable 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 interest 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 updating information, giving clear examples of credit costs and improvement of the sellers' professional expertise (Peura-Kapanen, 2004).

The influence of financial information providers 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 his/her 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 he/she 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 the internet) and through education. The aforementioned US survey of consumers reported that American households preferred to learn about money management through the media (Hilgert & 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 is 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 (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 higher the risk of becoming unemployed, the more guarded consumers will be with respect to their own economy.

6. Conclusions

Our focus in this paper has been 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's 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 aspects of the phenomenon.

In order to attain financial well-being, the financial capability of the household has to be put into practice in the form of financial management. Even if a consumer has the knowledge and skill needed to manage his/her finances, dissatisfaction with his/her income, savings and

investments may make financial management difficult for him/her. 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 take the 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. Furthermore, what about financial capability in the context of housing loans spanning twenty to sixty 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.

Financial capability varies from individual to individual. It is dependent both on the living circumstances and also the personal needs, values and attitudes of the consumer - on what is actually important in his/her life. Financial capability also includes an understanding of 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 with respect to 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 his/her 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 that are responsible for consumer financial capability have to communicate with each other. They have to have a clear understanding of who is responsible for what 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.

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3. The fable of the grasshopper and the ant or a short story about the psychological determinants of consumer financial profiles

Catarina Frade and Cláudia Lopes

1. Introduction

Like a magic potion that promises to cure the ills of our consumer society, which has completely succumbed to the attraction of easy credit, the expression ‘financial literacy’ has recently invaded the political, economic and academic discourse in the US, Europe, Australia, New Zealand, the EU and the OECD.

Financial literacy promises to perform the miracle of sustained reform of indebtedness; in it lie all the hopes of redemption of badly planned consumption. It is being used to try and create an individual and collective consciousness of the risks associated with the wrong use of financial products, mainly insolvency and household over-indebtedness.

But those who view it as a cure for the situation arising from the realisation of those risks, namely consumer over-indebtedness, are clearly making a mistake. Financial literacy has to do with preventive and anticipatory action, and, therefore, aims at changing attitudes towards consumption and indebtedness by individuals and society as a whole *before* these are translated into actual market behaviours.

In addition, consumer financial education should not be taken to apply only to young people. On the contrary, the idea is to promote a generalist training for children and young adults, preferably within the formal education system, which should later be combined with specific financial training programmes aimed at certain social and economic groups (people who are divorced, unemployed, single parents, low-income families) and adapted to people’s different phases of life (for example, for individuals who are becoming financially independent for the first time, for those who want to buy a house, for those who want to plan their retirement).

A vast number of programmes to improve consumer financial literacy have been designed and implemented in various countries, notably in those where there is a well-established tradition of financing consumption with credit, such as in the United States and northern Europe. Other countries, like Portugal, are notorious for a lack of such initiatives.

Nevertheless, and notwithstanding the number of programmes which have already been implemented, theoretical and scientific research on the subject is still limited. Investigation should focus on various aspects, from programme design (target audiences, trainers, contents, training techniques and methodologies) to programme application and assessment. It is important to note, however, that the reflection on the human and social dimension of this phenomenon is likely to evolve over time, which could positively or negatively affect the programme design as well as the application of the programme.

Consumers are not a homogenous group with the same needs, ambitions, and preferences. Furthermore, they are not a mere sum of individuals, whose attitudes and behaviours have no relevance for their community, the market or the society as a whole. Consumers’ different personal, social and economic characteristics determine and shape their attitudes and behaviours towards consumption, credit and indebtedness. Without knowing what motivates, influences and conditions them, it is very difficult to devise and apply truly effective financial education programmes, which promote both personal and collective interests (MacGregor, 2005).

The objective of this paper is to study the social, economic and mostly psychological factors which can positively affect initiatives aimed at increasing consumer financial literacy. To achieve this goal we shall examine a series of interviews with consumers in Portugal, which were carried out within the framework of a larger research project, conducted by the Observatory of Consumers Indebtedness (OCI) of the University of Coimbra with the purpose of analysing the relationship between unemployment and over-indebtedness.¹

We start with an overview of consumer credit development in Portugal. Indeed, this is a relatively new phenomenon that rapidly expanded since mid 1990s. The household indebtedness ratio became one of the highest in Europe (Frade, 2004).

However, the use of credit for housing and consumption is not equally distributed through socio-economic groups, being more predominant in middle and middle-high ones. There are also geographical discrepancies showing urban area residents to be more prone to use credit. We consider this point in order to establish the general socio-economic context that helps to understand the relevance of the research project.

After that, we will present a theoretical framework of human values designed to explain financial attitudes and behaviours illustrated by preliminary results from the research project cited above. We will finish by examining the possible policy implications of this values approach to financial literacy.

2. The rise of the open credit society in Portugal

In Portugal, the development of consumer credit started relatively late compared with most of the European Union's member states, especially with respect to the countries with a Protestant tradition, in the north of Europe. The expansion of the mortgage and consumer credit markets took place in the favourable social and economic climate of the 1990s, triggered by increases in household incomes on the demand side and the deregulation of the credit market on the supply side. This is a new phenomenon, with the economic, social and cultural consequences that are normally associated with it (Marques & Frade, 2003).

The rate of family indebtedness rose from 20 per cent in 1990 to 40 per cent in 1995 and 117 per cent in 2004. However the rate payment default is limited (5%, says the Bank of Portugal).

This phenomenon has had a deep effect on the way Portuguese society has come to deal with credit and consumption. The discussion that all this change has stimulated has sometimes been over-dramatised, reflecting traditional cultural values that are still strongly embedded. The demonisation of borrowing ('borrowing is usury and usury is a sin'), particularly of consumer borrowing – implicitly regarded as something that is only used to buy unnecessary goods, as opposed to credit for housing, which is a necessity – was strongly associated with the idea of running into debt.

So, a sense of taking advantage (using credit, which has become accessible and cheaper) exists alongside one of cultural rejection (consuming before saving is contrary to the cultural habits of many Portuguese) (Marques & Frade, 2003).

Although we have relatively precise statistical information on levels of indebtedness, payment default cannot be measured with the same degree of accuracy. The problems are far greater when we move on to over-indebtedness, which can only be measured in Portugal by means of very imperfect and indirect indicators.

¹ The OCI was created in 2001 in the wake of research into family credit and indebtedness that a group of lecturers in the Faculty of Economics of the University of Coimbra had been pursuing since 1998.

Until September 2004, when the new Bankruptcy Code came into force, there was no specific legal system to deal with consumers' over-indebtedness problem in Portugal, one that could provide us with some sort of statistical data for consumers' insolvency.²

OCI research on courts has shown that cases of insolvency linked to indebtedness for consumption and housing are rarely found in the judicial system. Some of the factors that help explain why Portuguese consumers very rarely file for bankruptcy are: the lengthiness of court procedures in Portugal, Portuguese people's general aversion to litigation, the personal and social stigma associated with insolvency, and the willingness to honour one's debts.³ It seems, therefore, that the court may be considered an inappropriate forum for resolving this new kind of dispute, whose specific profile is also unrecognised by the judicial system.

Typical cases of over-indebtedness are only picked up by *consumer protection associations*, notably by DECO (Associação Portuguesa Para A Defesa Do Consumidor), the largest association of that nature in Portugal. DECO's initiative is the only visible expression of any sort of debt counselling system in Portugal.

A tendency for the number of insolvency cases to increase year by year has been observed, which is partly explained by the worsening financial circumstances of some families and partly by the growing visibility of this problem and of the role of DECO in the media.

3. A research project on over-indebtedness and unemployment

A high rate of indebtedness (even though the effort rate stays at 25-26%) combined with deterioration in the labour market create conditions with the potential to lead to the financial situation of some families worsening. This state of affairs is even more marked when there is no effective system for dealing with over-indebtedness in place.

In October 2004, a one-year project was set in motion to analyse the financial sustainability of families in a situation of unemployment, especially where there are outstanding credit debts for consumption and housing.

Two basic notions gave rise to the project. First, various studies conducted in other countries have shown that unemployment is one of the causes, if not the major cause, of consumers' over-indebtedness.⁴ Second, the unemployment rate in Portugal has increased significantly since 2003.

The Bank of Portugal's annual figures for the past few years show that default on loans to individuals remained at "historically low levels". Nevertheless, the negative trend in the labour market enabled us to advance the (first) hypothesis that failure to meet debt obligations must be increasing. And if this does not occur, it will be (second hypothesis) because mechanisms have been put in place in the market and / or society to "cushion" the negative impact experienced by families when jobs are lost.

To test these hypotheses, we carried out two empirical studies, based largely on face-to-face interviews. The first study concerned interviews conducted on workers who have lost their jobs and who used to work for large companies which have closed or relocated. The second interviews were conducted on debtors who had sought the assistance of DECO to renegotiate

² Although it is still mostly concerned with companies, the new Bankruptcy Code contains a set of rules relating to the insolvency of individuals.

³ Concerning the lengthiness of court procedures and people's general aversion to litigation in Portugal, see Santos et al., 1996.

⁴ Kempson, 2002 and Ellingsen & Holden, 2002.

with creditors. In the first instance, we were looking for any over-indebted individuals among the unemployed. In the second we were trying to find from the over-indebted to what extent unemployment or job insecurity had influenced their insolvency (Frade, 2004).

Although the objective of this investigation was to clarify the possible interdependence between unemployment and over-indebtedness, the interviews also provide pertinent information on the interviewees' values and attitudes towards consumption, credit and indebtedness. On the basis of the data collected from the interviews, we traced two profiles which we termed the 'grasshopper' and the 'ant', as in the famous fable. These profiles reveal different ways of understanding and dealing with money and credit, and their origin can be found in distinct value hierarchies and social and economic situations.

Only after these structuring elements have been analysed and fully understood will it be possible to establish consumers' financial skills. Without such an analysis, the financial education programmes to be designed and applied will most probably be inefficient and unsuited to the needs of the target population.

It is important to note that the two profiles are a simplification of reality. They are generalisations or working models which provide an outline of reality, thus facilitating the understanding of a relatively homogenous group in terms of the characteristics analysed (Weiss, 1994).

The reality they typify is naturally much more complex and multidimensional. While the 'ants' usually belong to the working classes living in semi-urban and rural areas and the 'grasshoppers' to the urban middle class, our analysis shows that there are grasshoppers in the world of ants and vice versa.

4. Human values as determinants of financial attitudes and behaviours

The cornerstone of consumers' financial education is to improve consumers' working knowledge of financial concepts and their understanding of financial products so as to allow them to make the most advantageous decisions regarding their economic and financial well-being (Braunstein & Welch, 2002). This suggests that the acquisition, comprehension and retrieval of financial concepts and a good grasp of financial products are indispensable tools in helping them budget and manage their income, get credit, invest efficiently, choose a retirement plan or save for short-term and long-term goals. In the broad sense of the word, consumers' financial education produces informed and skilled consumers.

However, the knowledge and skills outlined above are just the first step towards making efficient decisions (i.e. decisions that maximise financial benefits) since these are influenced by a variety of personal and social factors which go beyond the objective benefits obtained. In other words, consumers' information is a necessary but not sufficient condition for making efficient decisions.

From the perspective of cognitive science, financial behaviour can be understood in a context where the individual has the motivation and capacity to engage in active thinking about available alternatives. The perception of risk encompasses the evaluation of alternatives, since virtually all choices include a more or less probable chance of negative consequences. Therefore, a consumer's perception of the risk associated with financial choices is a central aspect in the understanding and modification of financial behaviour, as emphasised by the OECD definition of financial education (OECD, 2005).

Although there is quite a lot of disagreement as to the conceptual definition of risk, an operational definition could be the sum of the likelihood of negative consequences of a (negative) event multiplied by the negative value or utility of those consequences (Plight, 1999).

Nevertheless, evidence shows that people balance their risk-behaviour by pursuing an optimal risk strategy which does not maximise their benefits but assures a satisfactory pay-off and avoidance of major disasters (Renn, 1992).

From this standpoint, the utility of a financial choice should be understood from a subjective perspective, and the risk that an individual is likely to take when faced with a financial choice depends on personal and social determinants such as personality traits and the human values the person believes in. There are some general aspects of human behaviour and specific differences between individuals that help us explain different behavioural choices in the presence of comparable skills and working knowledge.

On the one hand, a new and more advantageous financial behaviour may meet with some resistance on the part of an individual for the very reason that it is a new type of behaviour and has never been experienced before. This tendency will be even more marked if that individual's current financial behaviour does not pose any problem.

On the other hand, individuals process probabilities in a biased way. Prospect theory (Kahneman & Tversky, 1979) postulates a universal pattern of reasoning about decisions under uncertainty with clear applicability to financial choices. As outlined by the theory, there is a tendency to give excessive weight to outcomes that are considered certain, as compared to outcomes that are merely probable (certainty effect). Thus, most people prefer a sure win of 300 euros as compared to an 80% chance of winning 400 euros. If the same 'dilemma' is applied to a loss context, the preference will be reversed: most people prefer a 50% chance of losing 400 euros than a sure loss of 200 euros (reflection effect). The reasoning is determined partly by the presentation of the dilemma: a gain frame will lead to a risk-avoiding preference and a loss frame will result in a risk-seeking preference (Kahneman & Tversky, 2000). Despite these systematic ways of information processing, there are individual differences in traits like over-confidence (individuals more prone to risk) and loss aversion that can also account for variability in financial choices.

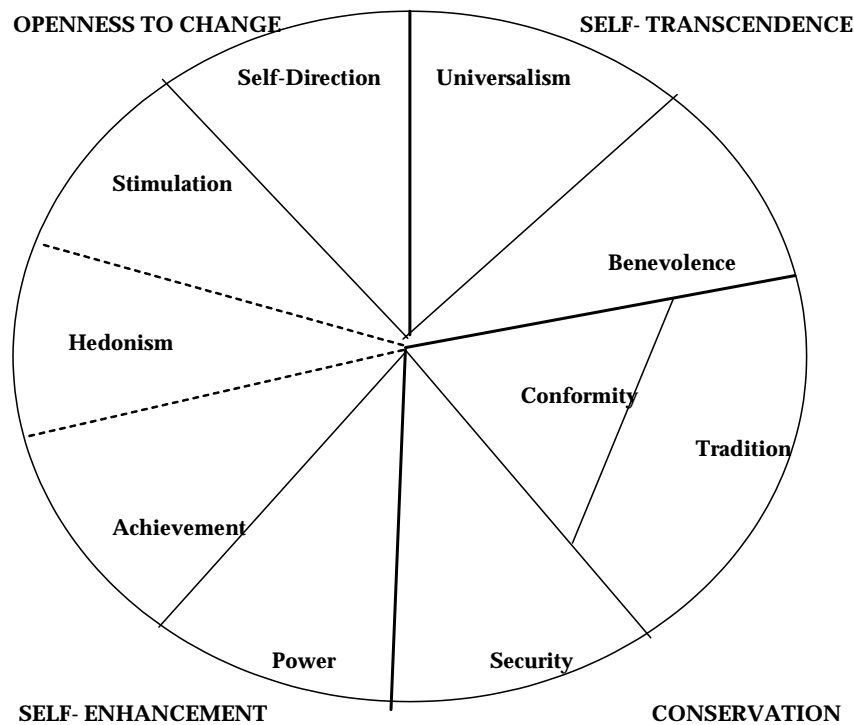
By the same token, individual differences in information processing can influence the way individuals think about financial products. Cognitive styles are vehicles for choosing relevant information and for building our value systems (Broeck et al., 2003). Some individuals prefer to think in an analytical, deductive, rigorously formal and convergent way (analytic style), whereas others prefer to think in a holistic, inductive, informal and creative way (holistic style). The analytical processing mode can result in attention to the details of financial products and budget plans, whereas a holistic style is characterised by risky behaviours and impulsiveness. Cognitive styles are related to the values individuals endorse about the ultimate meaning of life. Broeck et al. (2003) found that the analytical style is more associated to ideas of conservation of social order, customs and traditions, whereas the holistic style is associated to openness to change and the search for stimulation and new experiences.

Values are a key concept to explain decisions and behaviours at individual and societal level, since individuals in the same society are likely to differ in the relative importance they assign to a particular value. Values have been broadly defined as enduring beliefs about life-goals which transcend specific situations and are used by individuals both as general standards that guide behaviour and as the ultimate rationale that justifies their actions and judgments. Schwartz (1992) describes values as a way of articulating universal requirements of human existence (like social, interpersonal and biological demands) into cognitive representations. Rokeach (1973), on his part, considers them as "enduring beliefs that a specific mode of conduct or end-state of existence is personally and socially preferable to an opposite or converse mode of conduct or end-state of existence".

A recent formulation of values system (Schwartz, 1992, 2003) comprises ten core values aggregated in four higher-order dimensions as represented in Figure 1. The values content was developed in former studies and improved from instruments developed in different cultures, examinations of texts on comparative religions and suggestions of scholars and tested in 210 samples from 67 countries (Schwartz, 2003). The universality of values is assumed since they apply to a wider range of cultures and languages and allow a successful prediction of behaviours and discriminations among groups.

The values system can be illustrated by a circular structure representing a motivational continuum and postulating the pattern of relations expected among values: adjacent values are compatible and opposed values are antagonistic. Two axes arise: self-transcendence vs. self-enhancement and openness to change vs. conservation.

Figure 1. Theoretical model of the relations among ten motivational types of values



Source: Schwartz (1992, 2003).

The axis *self-transcendence vs. self-enhancement* emphasises the concern with the welfare and interest of others (universalism, benevolence) contrasted with the pursuit of self-interests (achievement, power). *Universalism* is expressed by understanding, appreciation, tolerance and protection for the welfare of all people and for nature, assuming that the world is everyone's home. *Benevolence* is related to the preservation and enhancement of the welfare of people with whom one is in frequent personal contact. *Achievement* is defined by personal success through demonstrating competence according to social standards. *Power* is endorsed by social status and prestige, control or dominance over people and resources.

The axis *openness to change vs. conservation* opposes independent action, thought and feeling and readiness for new experience (stimulation, self-direction) with order and resistance to change (security, conformity and traditional values). *Hedonism*, i.e., pleasure and sensuous

gratification for oneself shares elements of both openness and self-enhancement. *Stimulation* is related with excitement, novelty and challenge in life. *Self-direction* is expressed with independent thought and action - choosing, creating, exploring. *Security* encompasses safety, harmony and stability of society, of relationships and of self. *Tradition* is defined as associated with respect, commitment and acceptance of the customs and ideas that traditional culture or religion provides the self with, and *Conformity* implies restraint of actions, inclinations, and impulses likely to upset or harm others and violate social expectations or norms (Schwartz, 1992, 2003).

Despite the abstractness of the concept, values are assumed to have an individual and social existence as shared beliefs that are available and can be discussed through communicative processes. At a personal level, values allow individuals to regulate impulses that could otherwise conflict with the needs of the groups and structures within which they live. At a group level, values allow for a distinction to be made between different social systems defined by the cultural ideals held by group members (such as, for instance, social consensus about what is right, good, or to be cherished) and underlying the sanctions for some behavioural choices and the rewards for others (Oyserman, 2001).

From this perspective, Schwartz's Theory of Values offers a compelling frame of reference to understand financial behaviours in the sense that they should be read in the light of the specific value system in which the behaviour takes place and acquires meaning. Indeed, the way consumers regard money and credit is associated with specific values in as much as the possession of material resources is an end in itself or just a way to achieve an ultimate life goal.

In a very rough sense, the axis *openness to change vs. conservation* in a whole meets an instrumental way of dealing with money and financial products. In the *conservation* slice of the circular diagram, a security feeling can be attained through financial behaviours and products that guarantee a safe and comfortable future and invulnerability to financial crisis. For example, long-term savings for education or health plans, mortgage credit or retirement products, as well as spending plans meet these requirements; risky investments do not and therefore would not take place. Endorsement of tradition and conformity can lead to responsible financial behaviours like paying all the bills on time or paying credit cards in full. On the contrary, in the openness-to-change part of the circular diagram, money and credit are just ways to attain enjoyment and new experiences, resulting in the acquisition of credit for non-durable products (e.g., credit for holiday travel) and possibly in a lack of concern about financial aspects.

Self-enhancement values, especially *power*, fall within the consumption attitude which views wealth and ostentation of material goods as a way to achieve social success and to define oneself and other people. These values imply a higher motivation to take part in financial opportunities (including risky investments) as well as a wider range of financial products (e.g. several credit cards and more than one type of investment).

Although not so obvious, *self-transcendence* values can be expressed by an alternative financial awareness. A marked concern for social justice and welfare will give rise to a holistic responsible citizenship attitude. From this perspective, financial decisions are not regarded merely as individual decisions, but rather as having a significant impact on an entire economic system. The social benefits achieved by the smooth functioning of financial markets will then surpass the personal benefits resulting from a particular financial decision. This attitude requires a clear understanding of the social impact of a financial choice, along with a basic knowledge of the way in which the global economy works. The ethic of financial behaviour which stems from self-transcendence values, namely universalism, is present in MacGregor's (2005) approach to consumer education. This author considers that the aim of consumer education is to "create learners who see themselves as citizens in a consumer role, holding profound responsibility for

the future of the planet and others". In short, consumers' empowerment is seen as a way of helping people to find their inner power to change the status quo (MacGregor, 2005).

In the next section, we will present some empirical evidence, bearing on a qualitative methodology, aimed at disclosing the value hierarchies and identifying financial behaviours and attitudes in two distinct Portuguese consumer groups defined by different socio-economic backgrounds. We consider that the financial choices performed by individuals and their consequent financial behaviours reflect the value priorities they endorse, not only from an individual perspective, but also from a perspective of the socio-economic group they belong to.

5. Two financial profiles: The grasshoppers and the ants

The two aforementioned empirical studies have revealed the existence of different patterns of consumption and indebtedness which arise from distinct socio-economic lifestyles and mostly distinct value hierarchies. It should be noted that the interviews conducted resulted from a convenience sampling procedure and the conclusions drawn from them cannot be further extrapolated for the universe of the families (Frade, 2004).

First empirical study: interviews of the unemployed

In the first study, workers from various industrial plants (textiles, ceramics, food industry) that have closed were interviewed to find out if they had managed to continue paying their debts (and if so how), or if they had failed to do so.

The interviewees were factory workers whose average age was forty with low levels of education and few professional skills (especially know-how), although some had reached middle grade positions. Salaries were relatively low, almost always less than €600 a month (without overtime). As these companies had been established in the market for many years, some workers had been working for them for over thirty years. Some had started at the age of 12 and had never worked anywhere else.

The firms had closed at the beginning of this decade and in no case was closure due to lack of orders. The reason was almost always relocation or a change in company strategy.

All the workers were receiving unemployment benefit, which was now coming to an end for some of them. Hardly any had found new jobs. Their relative advanced age, poor qualifications, a crisis in the sector where they had worked and the long-term unemployment benefit were some of the reasons mentioned for this.

Although the companies were in large towns or cities, or just outside them, the workers had continued to keep a strongly rural or semi-urban lifestyle, in line with their socio-economic origins. Their consumption was neither as intense nor as diversified as that found in the second study. There was a strong tendency to save even though wages were low.

The relationship with credit was nil or extremely limited (buying a house and, in some cases, a car). A feeling of great mistrust, to the point of refusing credit, predominated. This feeling was bolstered by the loss of their job, and very few of the interviewees admitted they would be likely to resort to credit in the future. Credit cards were not used, and in many cases it was a totally unknown means of payment.

Low levels of consumption, low indebtedness and the existence of own savings still do not entirely explain the almost complete absence of their defaulting on credit commitments. Other factors are also involved.

In the first place, given the low wages of this group, there is very little difference between what they earned when they were working and what they are now receiving in unemployment benefit.

In addition, they have tried to top up their income by taking on small informal jobs (domestic cleaning, for instance) or by their spouse working more overtime, when possible.

These people try to restrict their family expenditure as far as possible. Their priorities are feeding their children and paying the banks. They have almost all given up personal spending (clothes, hairdressers, leisure, holidays and sometimes even medicines).

In spite of the hardships they are facing, these people maintain a very strong ethical attitude in relation to their debts: *honour the commitment made*. To this ethical aspect is added the sense of preventing at all costs the loss of what they have achieved with their labours (e.g. their home) and they will make untold sacrifices for this. Losing these assets would be like losing twice: first the job and then what they have achieved thanks to it.

There is another important feature in the life of these interviewees. They enjoy quite strong informal solidarity networks. Friends, but families, above all, help to keep these individuals integrated and they are the ones who sometimes stop them from defaulting on their payments. Although the support may take the form of money, it is much more likely to be in kind (e.g. food, clothes).

The pattern of behaviour found makes it possible to classify these interviewees, symbolically, as the ‘ants’ of society.

It might be said that the greatest vulnerability of these people - the ants - stemming from job loss is not felt at the financial level but at the psychological one. Loneliness, lack of prospects for the future, no plans and projects, low self-esteem (too old to get another job, too young to retire) are the aspects observed in these ants, which in some cases have already led to depression and even alcoholism.

A careful analysis of the interviews of unemployed consumers showed *Security* to be the most important value, with employment and savings as major sources of security. People manage to save thanks to a very thrifty management of their family budget, sacrificing leisure and taking advantage of all opportunities to make some extra money (by working overtime or having an additional job). Some interview excerpts follow – with the thrifty behaviour of interviewees revealing a great concern with security

Not having a job is very bad for me, very bad, very bad; I am sorry that I don't have a job because I would feel more secure (Interview 18).

Well, we always managed to save. I mean, I might buy a few things if I thought they were cheap. Instead of buying only one, we'd buy two or three. When employment happened, my pantry was full. Of course the fact that I started eating at my mother's also helped for a little while (Interview 12).

Some years ago we managed to put some money by. Because my husband is very thrifty, we never go anywhere, he's very thrifty. (...) Then he lost his job, but my wages at the factory were pretty good, I always managed to get bonuses, I always managed bonuses of around 50Euros, and I would work long hours, I worked a lot, making 500 Euros, sometimes even more. (...) We lived on little money, we never went on holiday because we couldn't afford it, we lived as we could (Interview 5).

We have to think twice. From one day to the next my husband can lose his job, something can happen to him, something can happen to me, and then we won't have the money... We always have to think ahead (Interview 23).

I think that if I was late with one of my instalment payments, first I would ask someone that could help me and then, well, going to the bank would be the last thing I would do (Interview 2).

Concerning credit ... only mortgage credit. Nothing else! I get too worried, I feel frightened (Interview 14).

Second empirical study: interviews of the over-indebted

In the second study, as mentioned earlier, interviews were conducted on individuals who had sought help from DECO to renegotiate deals with creditors.

Nearly all the interviewees lived in or around the capital city of Lisbon. Their ages varied, but the 25-40 age groups were dominant.

Not all were unemployed, but unemployment was the main cause of their defaulting, followed by health problems and excessive debt combined with bad management of the family budget.

A great many of the interviewees have, or have had, insecure jobs. Short-term contracts and high job turnover were common. In some cases we found what Sullivan et al. (2000: 88) called 'job skidding': the interviewees were finding work, but always with less professional responsibility and lower pay. Nevertheless, some of the interviewees did have a longer-lasting job, which was lost for various reasons.

Most of the interviewees had schooling to the middle or higher level, though there were a few with low educational levels.

Wages were between €750 and €1,000. This sum was almost doubled when a couple was involved. The level of saving was low.

The prevailing lifestyle was urban; consumption was intense and varied. Credit was commonly used, and not only for buying a house, but also for consumption (car, household appliances and even trips and holidays). The credit card was a familiar means of payment. Credit facilities and a lifestyle where having goods of a particular kind and personal image are of considerable social importance encourage a certain temptation to consume and to use credit.

When unemployment strikes there is more of a tendency for there to be a gap between earnings from work and unemployment benefit. This means that informal jobs are often resorted to.

These people may be symbolically termed 'grasshoppers'. They find it hard to keep up with the payments associated with a high level of indebtedness and to establish financial priorities, especially when they lose their jobs or suffer 'job skidding'.

From the ethical point of view, grasshoppers still consistently manifest an intention to pay their debts. However, their willingness to make sacrifices in consumption and exert considerable financial discipline does not seem to be as strong as that shown by the ants. This situation is made worse by the fact that their informal solidarity networks are more fragile and less active.

It may thus be concluded that the grasshoppers are more vulnerable to the financial consequences of job loss even though they generally have a higher disposable income. This vulnerability is expressed in more frequent defaulting on debts due to a more intense consumption pattern and higher indebtedness.

A close analysis of the discourse contained in the DECO interviews showed *Power and Hedonism* to be the most relevant values. Some excerpts to illustrate this point follow.

My mortgage credit was already eight months in arrears. And we don't want to lower our living standards and our comforts ... And you can't stretch money, can you? (Interview 26)

My credit card is like a piggy bank which I can count on if something unforeseen comes up ... but I keep using my credit and I leave payment in the hands of fate [word unclear but may be fate] (Interview 32)

I'm totally obsessed with my house (...) I fit another lamp, then take it down, make a hole, remove the tiles... it was my obsession with finishing up the house that got me into this predicament (...) because I want things done ... and when you want things done you get bogged down ... (Interview 40)

I like to enjoy life... so saving is not my main concern... if I made 50,000 Euros per month, well, that would be good! (Interview 27)

6. Discussion and conclusions

While consumers are confronted with an ever growing availability and complexity of goods and services, as well as risks, consumer information and counselling is becoming progressively more inadequate. Consumers need to be equipped with basic and structuring skills which will allow them to choose and fully understand the information and suggestions they are given. As Ritters (2003) points, out “... consumer education equips people with the skills to make discerning choices, to resolve problems effectively and to seek further information and help appropriately”.

Sue MacGregor (2005) goes a step further when she suggests that consumer education should be directed both at the individual and at the whole community level. Consumer education is not simply a way of promoting consumers’ personal interests, making them aware of their rights and obligations as regards producers and distributors and giving them access to the information that will help them make rational choices. According to MacGregor, consumer education must also be a process of assertion of common rights stemming from the critical awareness of the social and environmental impact caused by individual consumers’ decisions. Consumer education must result in an emancipated attitude on the part of individuals, as well as contribute to introducing positive changes in the very structure of the consumer society (*‘inner power and inner voice as global citizen’* – see MacGregor, 2005). Thus, educated consumers are, above all, fully aware citizens empowered to determine the global effects of their consumption choices and, consequently, able to act in a socially and environmentally responsible way. Education shall give consumers permanent power not “over” but “along with” other consumers and economic players. Thus, the broad scope of financial education might be to modify a group’s attitudes towards money management, credit and consumption through re-establishing value priorities directing them to a *Universalism* way of regarding financial issues.

Financial education is an essential component of the vaster field of consumer education. Its specific sphere of action is consumers’ relation with money and the financial market. Just as has been the case for other types of goods and services, financial products have become more diversified, complex, and difficult to manage by people who are not specifically trained for this purpose.

The financial market, with its operations and contracts, is characterised by a special language as well as by technical, legal and mathematical procedures which are not readily accessible to the majority of people. If, on the one hand, it is true that nowadays people have to deal with financial institutions much more frequently than ever before, on the other hand, it is also true that options and decision-making processes have never been so complex and filled with risk.

A wide variety of credit and investment products are available on a very competitive market. Deciding for one of the multiple options on offer, or even deciding whether we truly want to be part of this market is not simply a question of economic efficiency. This is what emerges from the empirical studies and the analysis of the values and the socio-economic context of the two profiles set out above.

Braunstein and Welch (2002) maintain that, although financial education is an effective tool to improve consumers’ financial behaviour, “the assumption that the presence of information will lead to improved behaviour is faulty”. Informed consumers who can access reliable information do not necessarily act in their best financial interest (in terms of economic efficiency). This does not mean that their decisions are irrational, but simply that there are multiple motivations and states of mind which influence the decision-making process. A good knowledge of people’s

value systems and their social and economic environment helps us to understand what factors guide their decisions and in what direction.

However, long-lasting changes in financial attitudes and behaviours should be regarded as a social change given that financial behaviour is anchored in the relation between the individual and certain group standards and values (Lewin, 1947). At first, we could expect some individuals to show inner resistance to changes partly because of their desire to meet the standards of the group they belong to or wish to belong to. When the new attitudes and behaviours are established, they could be maintained as long as they correspond to a change in the group standards. Otherwise, individuals will return to the old behaviour. Indeed, a rule of thumb in changing attitudes, which could apply to financial education, is that it is easier to change individuals collectively, especially in face-to-face groups, than to change any one of them separately.

The grasshoppers – who live in the big cities with a wider range of goods on offer and where the social value of consumption is clearly positive – tend to show less aversion to the risks of the credit market. For this reason, they use various financial products, from more traditional and less risky ones, such as mortgage loans, to more modern and risky ones, such as credit cards. They take advantage of the different market offers to keep feeding their intense consumption of both essential and ‘situational’ goods, with the second category reflecting the social and economic context in which the grasshoppers live. The grasshoppers, more than the ants, view consumption (and the credit associated) as playing an important role in social integration and in camouflaging social stratification. Hence, they are sometimes unable to establish priorities when they need to reduce consumption or to save money on a regular basis.

For their part, the ants show almost an aversion to credit. They regard credit in a negative way and many of them consider that resorting to credit is a morally unacceptable way of living above one's real means. Only mortgage loans and, sometimes, car loans are seen as acceptable.

This group follows considerably restrained consumption patterns, probably due to low income levels and a less urban life style, and maintains strong saving habits. Generally, their wariness of the financial market makes them opt for more traditional and less risky investment solutions, such as fixed deposit accounts. Even retirement schemes are not viewed as a reliable alternative. Thus, the ants are not willing to take the risk of contracting a loan, but at the same time they do not maximise the market advantages concerning their savings.

These two profiles allow us to show, very superficially, two distinct perceptions of the financial market and, consequently, two different relationships with it. We cannot expect, therefore, that grasshoppers and ants react equally to the same financial education programmes, changing their financial behaviour in the same way. Indeed, their position in the values system (Figure 1) is clearly not the same. Thus, training programmes will have to be tailored to suit their specific hierarchy of values.

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Part II.

Measurement and Scaling Methods

4. Measuring financial capability: An exploratory study for the Financial Services Authority

Elaine Kempson, Sharon Collard and Nick Moore

1. Introduction

It is now widely recognised in the UK that consumer financial capability goes hand-in-hand with regulation and competition in ensuring that we have an efficient financial services market.

Indeed, a recent report by the National Association of Citizens Advice Bureaux shows the consumer detriment that can arise through low levels of consumer financial capability (NACAB, 2001). Financially incapable consumers find it difficult to identify products and services that are appropriate to their needs, they are unsure about how best to access and evaluate independent advice, they make inappropriate financial decisions and they fall victim to abusive practices and mis-selling.

The establishment of the Financial Services Authority marked the first time a financial services regulator was given a statutory responsibility to promote public understanding of the financial system in the UK. From the outset, the FSA has played an active role in the area of financial capability, issuing a consultation paper on how it should undertake this role soon after it was set up. Since then the FSA has commissioned a large body of research and developed a framework for adult financial capability that draws on earlier work in schools (FSA, 2002b).

In 2003, the FSA launched a new initiative to develop and implement a national strategy for financial capability (FSA, 2003a). This included the establishment of a Financial Capability Steering Group, which identified seven priorities that are being explored by specially convened working groups. These priorities cover: schools, young adults, families, work, retirement, borrowing and advice (FSA, 2004a). In the 2004 progress report, it was noted that the FSA would commission a “comprehensive baseline survey to establish the current state of financial capability in the UK”, which would also be used to inform the evaluation of individual pilot projects that will be set up within the strategy (FSA, 2004a).

The FSA subsequently commissioned the Personal Finance Research Centre to carry out an exploratory qualitative study and to design a baseline questionnaire to measure levels of financial capability in the UK. Within this overall aim, the study had three specific objectives:

- To identify the components of financial capability using input from both consumers and experts, and explore whether the components vary in different circumstances
- To design a questionnaire that can capture these components of financial capability in a large-scale quantitative survey
- To design a scale against which individuals’ financial capability can be measured, taking into account their circumstances and ‘need to know’.

1.1 Previous research measuring levels of financial capability in the UK

A number of research studies have identified relatively low levels of financial capability among consumers in the UK and show that they encounter difficulties in dealing with the growing complexity and diversity of financial services provision. Some of these studies are quantitative, others are qualitative, and between them they have used a variety of methods to capture this

information. We give an overview of a selection of the key studies below, drawing out some lessons in terms of methodology.

The 'Better informed consumers' quantitative survey undertaken for the FSA in 2000 used an administered questionnaire to capture consumer reports of their behaviour and information needs when they bought products they had acquired in the past five years. This looked particularly at where people had gone for information or advice as well as their willingness to use different sources of information and advice. It also covered a number of attitude statements that were used to assess the level of interest in financial matters; consumers' own assessments of their skills in selecting the right financial product and approaches to money management and saving. There was a parallel qualitative study as well.

This survey found that around nine in ten consumers who had considered or taken out a financial product in the past five years said they felt confident that they had enough information and that they had made the right decision. But related qualitative research showed that this confidence was often misplaced. (In fact, one in eight had bought a financial product in past five years that they had later regretted.) It also found that about eight in ten consumers said that they tended to shop around, but in practice hardly any of them had actually done so (FSA, 2000a).

A broadly similar approach was adopted by the Financial Services Consumer Panel Survey. Here, though, consumers were asked about the most recent savings or investment product they had bought. They were also asked whether this had been bought in the past 12 months, one to five years ago or more than five years ago. This survey asked a number of questions designed to capture consumer attitudes and reported behaviour, which were used to develop scores of levels of financial literacy, confidence and risk aversion. The Personal Finance Research Centre undertook this analysis, but had not been involved in the design of the original questionnaire. We consider that it offers a starting point but that the questionnaire could be greatly improved, especially with regard to the measure of financial literacy.

The Consumer Panel survey showed that around four in ten consumers reported feeling confident about making their own financial decisions and a third that they had a clear idea of the sorts of products they need. But these were rather different types of people: the first group were more likely to be people with limited holdings of financial products than the second. Around half of the people surveyed were judged to be risk averse and these people held below-average numbers of financial products. Around a third said they reviewed their finances regularly. The extent to which people did so differed according to life-stage, economic well-being, level of product holding and confidence about financial decisions. Turning to information and advice, seeking pre-purchase advice was considered important for all products, but especially so for 'investment products', pensions and mortgages. About half of those who had bought pensions, life assurance policies or investment products said that they found it difficult to understand the charges levied on them and six in ten of those who had taken out a mortgage said that it was difficult to compare the costs of different products (Financial Services Consumer Panel, 2001).

Follow-up qualitative research for the Financial Services Consumer Panel in 2003, however, showed that regardless of age and social class, people were generally prepared to admit to being fairly uninformed and unsophisticated with regard to financial products. Only a minority regarded themselves as 'financially astute' and prepared to shop around. These spanned all social classes, although there was evidence that some people in social classes D and E might be particularly vulnerable. That research identified 'customer relations concerns' – with consumers saying that providers fail to give them the full picture. In particular, they identified a failure to draw attention to key terms and conditions, to advise on performance of long-term products and to notify changes in savings account interest rates. The study also identified 'product-related concerns' – small print, problems comparing like-for-like, and limited understanding of life assurance pensions and investment products (Financial Services Consumer Panel, 2003a).

Other qualitative research undertaken for the Consumer Panel at much the same time explored the way that consumers manage their own finances, as well as their overall understanding and interpretation of the financial world around them. This showed that most consumers undertook little long-term planning or budgeting. Most decisions were reactive rather than pro-active. There was a general misunderstanding of the so-called ‘more sophisticated’ financial products – although many could identify ones they considered risky, they could not say why they thought this was the case. Like many other studies it also found that when people want advice they turn first to their family and friends (Financial Services Consumer Panel, 2003b).

A study of young people aged 15-18 showed that parents were the main source of information about financial matters. It was, however, parental behaviour rather than their advice which had the greatest impact on young people’s decisions. Levels of shopping around for financial products were very low, in contrast to their behaviour when buying clothing or mobile phones (FSA, 2004b).

To inform its investigation into changes that might be made to liberalise the regulation of the selling of life policies, pension policies, collective investment schemes and investment trust savings schemes (i.e. the polarisation regime), the FSA commissioned six independent consumer studies - some quantitative, others qualitative. These showed that over a quarter of consumers had obtained financial advice in the past 12 months; around one in five people had sought advice from a bank, building society or insurance company; one in eight had consulted an independent financial adviser. Most had done so because they felt that they lacked the knowledge they needed to make a financial decision. Regardless of their financial sophistication, consumers clearly differentiate between ‘information’ and ‘advice’, which they saw as guidance on the most suitable product given their needs and circumstances. Advisers tied to particular companies tended to be selected on the basis of trust; independent advisers on their status. However, consumers in general were sceptical about whether there is such a thing as independent advice (FSA, 2002a).

Drawing this together, it seems that the qualitative research elicited a more realistic picture of people’s financial capability than most of the quantitative studies have done to date. And, within the quantitative surveys, different approaches have been used to assess financial capability, with varying degrees of success. Some rely on consumers’ own assessments of their knowledge and confidence, and how they tend to manage their finances and make decisions about financial products (this approach was used in a recent Australian survey of financial literacy (Roy Morgan Research, 2003)).

Others try to obtain more objective measures through questions designed to assess consumer knowledge and consumer accounts of their behaviour when they last purchased a financial product. Overall, this approach seems to be more fruitful.

None of the research studies that have been carried out to date, however, provides a robust means of measuring and monitoring levels of financial capability in the population as a whole. The FSA, therefore, commissioned the Personal Finance Research Centre to undertake this exploratory, methodological study to design a baseline questionnaire that could be used to measure levels of financial capability in the UK.

1.2 Research methods

The study was carried out in five stages:

- A literature and research review, to help develop a model of financial capability and to review questions used in other surveys

- Eight focus groups held in three different areas to explore people's perceptions of financial capability and to identify ways of capturing financial capability in a survey
- A first wave of depth interviews with people who had participated in the focus groups to develop the content of the questionnaire
- A second wave of semi-structured interviews, to provide a cognitive test of the questionnaire
- Two pilot interview surveys to test the questionnaire

Further testing was undertaken with people from black and ethnic minority communities in a separate, but linked study, undertaken by Ethnos Research and Consultancy.

1.2.1 Literature and research review

The first stage of the qualitative study was to develop a detailed conceptual model of financial capability in order to provide a basis for measurement in a quantitative survey. This involved a wide-ranging review of existing literature and research, the findings of which are reported in Chapter 2.

At the same time, we reviewed a large number of earlier studies that sought to assess levels of financial capability. This included studies carried out in the UK (many of which are described above), but also extended to work carried out in the US, Australia and other parts of the world. These studies are listed in the bibliography. They were reviewed in detail to identify the most appropriate and accurate ways of capturing the level of financial capability of consumers.

In total, we reviewed the methods used in 37 surveys from eight countries. The main areas covered by these surveys were knowledge of financial products, behaviour and attitudes. Hardly any of them attempted to capture skills or experience.

In terms of the topics included in these surveys, most asked questions about the financial products that people had (currently and/or in the past). Some included questions about money management behaviour, knowledge of sources of information and advice, and people's behaviour in terms of seeking information and advice.

There was little or no coverage in these surveys of people's attitudes, knowledge or skills in relation to money management. Financial planning was rarely touched upon and very few asked about people's skills and attitudes with respect to seeking information and advice.

Moreover, none of the studies we looked at attempted to relate financial capability to consumers' circumstances. This is something we tried to address in the fieldwork. In particular, we aimed to assess the impact on financial capability of the financial world in which people operate and how this changes over the life-cycle.

1.2.2 Focus groups

Eight focus groups were held in three different areas and with people in different age groups. Two groups took place in a low-income neighbourhood, one with people aged 18 to 39, the other with people aged 40 or over. Three groups were held in a middle-income neighbourhood and three in a high-income neighbourhood. In each of these neighbourhoods, one group was held with young people aged 18 to 24, the second with people aged between 25 and 39, and the third with people aged 40 or over.

The aim of these focus groups was to find out what people considered to be the main elements of financial capability in order to test the conceptual model and to provide a basis for the development of a questionnaire. The findings are reported in detail in Chapter 3.

1.2.3 Interviews

In order to develop the questionnaire, two waves of interviews were held, involving 33 people in total. The first wave of depth interviews was used to develop the content of the questionnaire. A second wave of cognitive testing interviews was then held, using a more structured questionnaire. The interviews comprised a balanced mix of people at different income levels and from different age groups.

All but four of the people who were interviewed in waves one and two had taken part in the focus groups. It was decided to interview the focus group participants because they already had a clear idea of what the survey was trying to achieve and, as a consequence, we could discuss with them at the end of the interview how successfully they felt we had captured their own financial capability. In addition, four extra people were recruited, who were living on social security benefits with low levels of financial product-holding.

The more structured questionnaire was also tested for ethnic sensitivity. Fifteen interviews were conducted with people who had detailed knowledge and understanding of the different ethnic communities in the UK and who could provide information about the religious, cultural and social factors likely to impinge on their financial capability. The experts represented local voluntary sector organisations, Citizens Advice Bureaux, as well as financial institutions and financial advisors working specifically with ethnic minority clients. This was followed by 17 interviews with Indian (four), Pakistani (five), Bangladeshi (four) and Black Caribbean (four) respondents. Within each ethnic group, individuals were selected to represent those factors identified in the literature review and through expert interviews, as likely to impact on people's financial capability.

Finally, this qualitative research was followed by two pilot surveys, involving 200 respondents in total. Members of the research team accompanied interviewers during the pilots, and there was a full de-brief of interviewers at each stage. These pilots also contributed to the development of the questionnaire.

The development of the questionnaire is discussed in detail in Chapter 4.

2. A conceptual approach to financial capability

Financial capability is a relatively new concept and we lack a strong, established consensus about what it entails. Much valuable work has, however, been undertaken recently, not least in the development, by the Basic Skills Agency and the Financial Services Authority, of the Adult financial capability framework (Basic Skills Agency, 2004).

The framework was designed 'to support the creation of learning programmes and resources around adult financial capability'. Its essentially pedagogic basis, however, means that it is not necessarily a suitable tool for measuring the extent of financial capability within the adult population. We therefore sought to develop a conceptual approach that would provide a more appropriate starting point for the development of a questionnaire.

We began with a review of existing definitions and concepts. The results gave us the basis for the initial discussions in the focus groups, after which we were able to develop and refine questionnaires that were consistent with the conceptual model but which used approaches that were rooted in people's understanding of what financial capability is all about.

2.1 Defining financial capability

At first, attention focused on the need to define financial capability, or financial *literacy* as it was initially conceived. The National Foundation for Educational Research, for example,

defined financial literacy as ‘*the ability to make informed judgements and take effective decisions regarding the use and management of money*’ (Noctor et al, 1992). This succinct definition has been widely accepted and built on in the context of personal finance education in schools.

The draft guidance on personal finance within personal, social and health education in schools expanded the National Foundation for Educational Research definition to spell out more precisely the types of judgements and decisions a financially capable person should be able to undertake:

Financially capable people are able to make informed financial decisions. They are numerate and can budget and manage money effectively. They understand how to manage credit and debt. They are able to assess needs for insurance and protection. They can assess the different risks and returns involved in different saving and investment options. They have an understanding of the wider ethical, social, political and environmental dimensions of finances.

These two definitions were considered to provide a ‘base starting point for a broader definition of adult financial capability’ by the Adult Financial Literacy Advisory Group (AdFLAG), which reported in December 2000.

At much the same time, Carolynne Mason and Richard Wilson from the Business School at Loughborough University reviewed a substantial body of literature in their attempt to conceptualise financial literacy. They concluded that it was a *process* leading to desired *outcomes*:

Financial literacy could therefore be defined as an individual’s ability to obtain, understand and evaluate the relevant information necessary to make decisions with an awareness of the likely financial consequences. (Mason and Wilson, 2000)

2.2 From definition to concept

The Adult Financial Capability Framework, which was developed by the Basic Skills Agency and the Financial Services Authority, reflects the process model outlined by Mason and Wilson. It identifies three broad elements of financial capability and, in so doing, begins to specify what it is that financial capability enables individuals to do:

- *Financial knowledge and understanding.* This is the ability to make sense of and manipulate money in its different forms, uses and functions. Financial knowledge and understanding allow people to acquire the skills they need to deal with everyday financial matters and make the right choices for their needs.
- *Financial skills and competence.* This is the ability to apply knowledge and understanding across a range of contexts including both predictable and unexpected situations. Financial skills and competence makes available to people the necessary skills to allow them to plan, monitor, manage and resolve any financial problems or opportunities.
- *Financial responsibility.* This is the ability to appreciate the wider impact of financial decisions on personal circumstances, the family and the broader community, and to consider the social and ethical issues. Financial responsibility enables people to understand and appreciate their rights and responsibilities. They understand the need and have the right skills and attitudes to plan, analyse, decide, evaluate and monitor financial decisions and choices. They understand the various sources of advice and guidance available (Basic Skills Agency, 2004).

The framework goes on to specify three levels of capability:

- *Basic understanding and developing confidence.* Aimed at those adults who have a low level of understanding and who require the skills to make informed judgements concerning their finances and the ability to use appropriate financial services.
- *Developing competence and confidence.* Aimed at those adults who have a basic understanding and competence in handling financial services and require more knowledge and skills to meet their needs.
- *Extending competence and confidence.* Aimed at adults who require the skills and knowledge to understand the wider range of services and the ability to make informed decisions regarding their own personal circumstances. (Basic Skills Agency, 2004).

The clear implication is that an individual can progress from the basic to the extended level through formal or informal learning or, possibly, through experience, if that met their needs.

The framework is, essentially, a curriculum document, and does not explicitly address the fact that consumers are a heterogeneous group. The nature of the capability required will be determined, to a great extent, by the individual's financial circumstances: the knowledge and skills required by a young lone parent living on a low income, for example, will be very different from those required by a high-income professional who is nearing retirement.

People also differ in the extent to which they choose to use financial products and need advice to do so. Moreover, an individual's use of financial services and their need for advice will almost certainly change over their life-time.

It is, therefore, necessary to take into account the wider context within which the individual is operating, in particular the individual's circumstances and needs. Here we can draw on work on information literacy and citizenship that was undertaken by Ana Maria Correia on behalf of UNESCO (the United Nations Educational, Scientific and Cultural Organisation). She emphasised both the need to take account of context and the role of information providers when assessing an individual's information literacy:

If the citizen stays within his or her sphere of expertise, then there should be no problem with [basic information literacy skills]. Once outside that sphere, the average citizen should not be expected to have the knowledge required to understand the information ... unless the information is given in a form which is designed for general consumption. Here it is the responsibility of the information provider to ensure that the information provided is suitable for the average citizen, whatever his or her calling. (Correia, 2002)

This suggests that, to understand financial capability fully, one needs to take account of the *context* within which the individual is operating or, in Correia's terms, the individual's sphere of understanding.

The context will be determined, to a great extent, by the individual's financial circumstances: as we noted above, the capability required by a poor person will be very different from that needed by a rich person.

The context might also be determined by the individual's age and its combination with the triggers determining the need for financial products (Financial Services Authority, not yet published).

Other factors that might need to be taken into account include the degree to which an individual interacts with the financial services sector and an individual's ethnicity or faith and possible limitations that these might place on their use of financial services.

Ana Maria Correia also points to the importance of the information environment – the availability and quality of information and the providers’ consequent responsibility to provide information that can easily be used. We also need to include information made available through other channels, such as the mass media.

Further, the role of intermediaries, such as independent financial advisers or friends and family, is important as they can play a key role in the decision-making process.

The nature of this information and advice environment is important as it will condition the level of financial capability required at any one time: if information or advice is generally misleading or not readily available, individuals will need a higher level of skill to gather and interpret the information they need for effective decision-making.

In terms of a conceptual approach to financial capability, the information and advice environment can be considered to be an exogenous factor, in the sense that it is fixed – it does not vary from individual to individual, although of course each individual will choose which parts of the information environment they use. The information environment may well change over time, however, and it will also vary geographically, some areas being better provided with sources of advice than others.

2.3 Our conceptual model

The first point to be made is that financial capability is a relative, not an absolute concept.

It might be possible to define a basic level of financial capability that is required by everyone in a given society. Beyond that level, the degree and nature of the financial capability required by any given individual will depend on their circumstances.

We, thus, have a universal basic level, or floor, which all individuals need in order to survive and to develop the capability which corresponds to their needs and circumstances. In an ideal world, 100 per cent of the population would attain this basic level of capability.

Beyond this basic level, the nature of the financial capability required by any individual will be determined by their financial circumstances.

With this proviso, we initially felt that financial capability consisted of three inter-related elements: knowledge, skills and attitude. This approach was consistent with the results of our literature review.

2.3.1 Knowledge

People require a basic body of knowledge and understanding, upon which they can draw when managing their financial affairs. This knowledge will be acquired in different ways: through experience, through education and training and through passive receipt of information from different sources such as family and friends, the media and information materials produced by the financial sector.

This basic knowledge and understanding will be supplemented from time to time by information gathered for specific purposes. The additional information will be assimilated and understood in the context of an individual’s existing body of knowledge. Some of the information will be forgotten - what is not forgotten will add to the individual’s knowledge and understanding.

It follows, therefore, that the body of knowledge will tend to increase through a person’s life. Parts of it, however, can become redundant or inaccurate as circumstances change.

The Adult Financial Capability Framework identifies three areas of knowledge and understanding:

- Different types of money or payments
- Income generation
- Income disposal

To this could be added knowledge and understanding of:

- Concepts, such as risk, interest, inflation and probability
- Financial products
- Institutions, including sources of information, advice and redress.

2.3.2 Skills

People also need the ability to apply their knowledge and understanding in order to manage their money and to make appropriate financial decisions. This calls for a range of specific skills, which need to be underpinned by basic levels of literacy and numeracy. The framework identifies two sets of skills:

- Gathering financial information and record-keeping
- Financial planning – saving, spending and budgeting.

The framework lists a third set of skills – risk and return – but this concerns understanding the concept of risk and should, we felt, be included as an element of knowledge and understanding rather than an element of skills.

There is, however, another set of skills that should be included. These are the skills required to evaluate information and to make comparisons between different products or courses of action.

2.3.3 Attitudes

Knowledge and skill alone are not enough to ensure that people manage their financial affairs appropriately. They must be prepared to take whatever steps are necessary to apply their knowledge and to exercise their skill. This is largely a question of attitude.

It is possible to identify three elements of a person's attitude towards financial capability. They must be:

- Willing to invest the time and other resources required to apply their knowledge and to exercise their skill
- Able to gain access to information, advice and other resources
- Confident enough to exercise their skills and to act on the results

The strength of these attitudes can be measured by assessing the extent to which the willingness, ability and confidence is reflected in a person's behaviour.

It might also be useful to take account of people's attitudes towards things, such as their attitude towards salesmen, towards risk or towards mutually-owned providers.

We began, therefore, with a conceptual model that was built around three elements: knowledge, skills and attitudes. The validity of this model was first tested at a seminar held by the Financial Services Authority on 4 November 2004. At the seminar, a speaker identified nine factors that influenced financial capability:

- Knowledge
- Understanding
- Basic skills
- Behaviour
- Experience
- Attitudes
- Confidence
- Circumstances
- Personality

Each of these can be further sub-divided. Equally, a case can be made for grouping some together. In our thinking, for example, we had tended to group knowledge and understanding. It also seemed possible to group experience and circumstances, as well as confidence and attitudes. Approached this way, we were able to specify a rather more manageable group of factors:

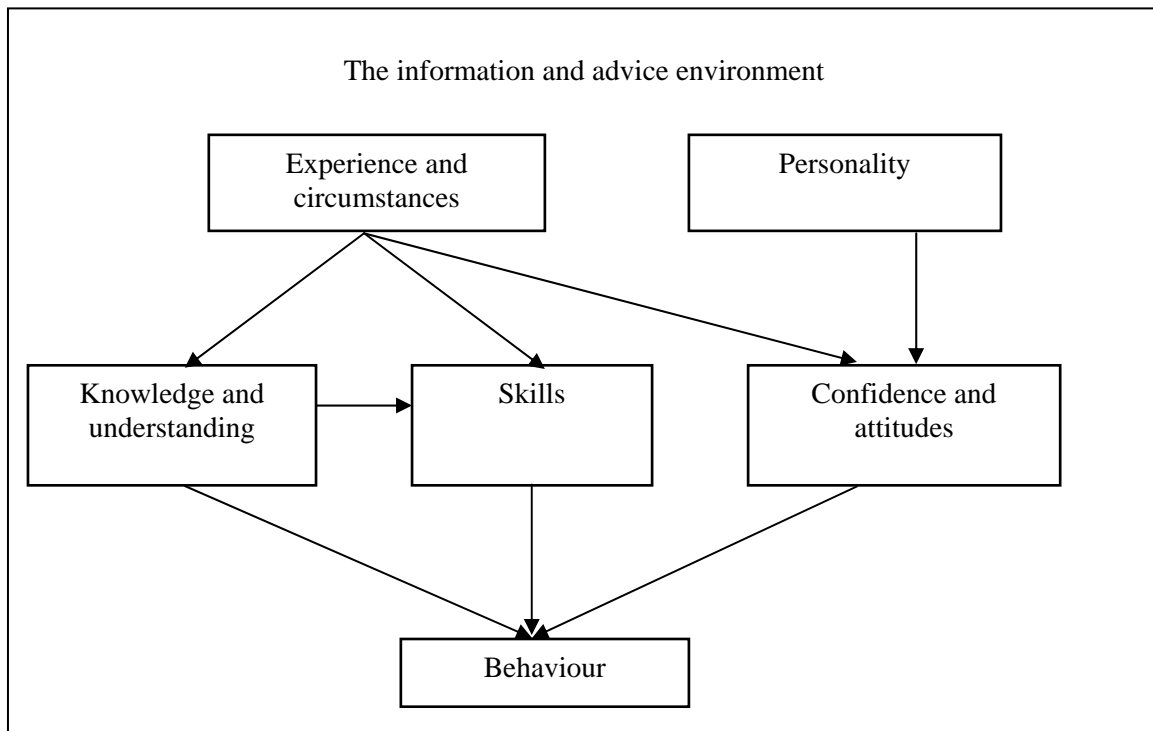
- Knowledge and understanding
- Skills
- Experience and circumstances
- Confidence and attitudes
- Personality
- Behaviour

It now became easier to chart the inter-relationships between these factors. Thus:

- Knowledge and understanding are influenced by experience and circumstances.
- Skills are also influenced by experience and circumstances. In turn, basic financial skills are shaped, or at least, constrained by knowledge and understanding.
- Confidence and attitudes are influenced by experience and circumstances. They are also influenced by personality.
- Patterns of behaviour are influenced by all the above factors, indeed, behaviour can be perceived as evidence of financial capability.

All these factors operate within an information and advice environment that is effectively fixed at any one time.

In diagrammatic form, these relationships look something like this:



In essence, this was the conceptual model that we tested in the focus groups.

2.4 Lessons from the focus groups

We held eight focus groups to explore consumers' own perceptions of what financial capability means and whether these perceptions varied according to their circumstances. The detailed results of these focus groups are discussed in the next chapter. For now it is sufficient to outline the main conclusions.

It became clear in all of the groups that people's perceptions of financial capability were rather different from our conceptual model. Perhaps most significant was the fact that they found it very difficult to distinguish between knowledge and understanding and skills.

Indeed, members of the focus groups perceived financial capability in behavioural terms. They were able to specify quite clearly the characteristics of financially capable people, although the actual specifications varied slightly from group to group. Overall, they felt that financial capability had four discrete aspects:

- Managing money
- Planning ahead
- Making choices
- Getting help

People discussed the issues about knowledge, understanding, skills, attitudes, confidence and personality in the context of their behaviour in relation to these four activities. They felt that personality, confidence and attitudes were inextricably bound up with knowledge and skills, with the outcomes reflected in behaviour.

Managing money was primarily concerned with being able to live within one's means. Financially capable people needed to be well-organised, particularly when it came to paying bills and keeping and using financial records. Staying within one's means involved developing strategies to make ends meet and resisting pressures to spend or to borrow money. It also involved accepting responsibility for one's actions. Financially capable people budgeted for lumpy or unexpected expenditure.

Planning ahead is required for two purposes: to cope with unexpected events and to make provision for the long-term. Unexpected events can upset budgets and financial plans. Financially capable people are able to deal with a large fall in income. They have a plan for meeting expenditure in such circumstances; they have a clear idea of the help that they can expect from the state and from others, such as employers, and they know about, and understand, insurance. They also know how to cope with large, unforeseen expenses. They have made some provision for such unexpected events and they are aware of possible sources of financial help.

Planning for the long-term is also important. Here discussion focussed on retirement and pensions, possibly because the issue was very topical at the time. They felt that a financially capable person would have made adequate provision or have firm plans to do so; they would know what sort of help would be forthcoming from the state; they would know about appropriate financial products, and they would know how and where to seek advice.

Making choices. Given the array of financial products available, being aware of what was on offer and being able to choose those that were most appropriate to an individual's circumstances were important aspects of financial capability. People needed a good general awareness of the types of product that were available but a constant pre-occupation with financial matters was 'sad' and did not indicate confidence.

They should be able to choose the products that were right for them. This required an ability to compare costs and returns; an ability to assess risk and to identify risky products, and an ability to look at products holistically. The financially capable person was also able, and confident enough, to say 'no' in the face of assertive selling or seductive advertising. Some felt that a financially capable person would be able to work the system, getting, for example, the most advantageous interest rates by switching between products. They would certainly know the key features of the products that they had bought, even though they might have struggled with the small print to understand the terms and conditions.

Getting help had two dimensions: self-reliance and using third parties. First, people should be able to gather information for themselves. This involved both general scanning, which kept them up-to-date with what was going on, as well as the ability to find and compare information about different products. Secondly, a financially capable person would know where, and when, to turn for advice and help from a third party. They would be able to judge how much trust to place in the information and advice provided.

Interestingly, the ability to complain and to seek redress was not seen as being an important aspect of financial capability. In this context, there was a high degree of fatalism.

2.5 The model and reality

Superficially, there does not seem to be a close correspondence between the conceptual model of financial capability and the reality, as perceived by the focus groups. A closer examination, however, shows that the differences are not marked.

The most striking difference was the fact that the focus groups thought about financial capability in behavioural terms. They related it to the four activities described above.

Within each activity, however, they could identify requirements for the conceptual model's three key elements: knowledge and understanding, skills and confidence and attitudes. More particularly they were quite sure about the importance of individuals' experience and circumstances. There was a clear recognition that income, in particular, and life stage, more generally, shaped and constrained financial capability. They emphasised the fact that you cannot judge everyone by the same yardstick.

Personality was also seen to be an important factor. It had a bearing on confidence, shaping people's ability to say 'no' and their propensity to take action. It also conditioned the way they behaved: whether or not, for example, they were well-organised.

In essence, they took our conceptual model and applied it to the four different, but related, sets of activity.

While we, and others who have gone before us, found it relatively easy to distinguish between knowledge and skills, it is clear that consumers do not make the distinction so readily. They perceive financial capability in terms of behaviour: what people do and what they should be capable of doing. This behaviour, however, involves knowledge, understanding, skills of various kinds and the confidence to use them as and when required.

We feel, therefore, that the focus groups did not invalidate the basic model, indeed, they served to endorse it. The groups did, however, provide a clear indication of how best to ask members of the public meaningful questions that would measure financial capability as we have conceptualised it.

3. Developing the framework for the questionnaire

Having developed our conceptual model of financial capability, we held a series of focus groups to test the assumptions underlying the model and to provide a basis for the development of the questionnaire.

3.1 The focus groups

We held eight focus groups that were attended by a total of 68 people. The groups were selected to provide a good spread of both ages and financial circumstances.

Two groups were drawn from a low-income neighbourhood: one with people aged 18 to 39, the other with people aged 40 or over. These people held a relatively low level of financial products. We held three groups in a middle-income neighbourhood, one with young people aged between 18 and 24, the second with people aged 25 to 39 and the third with people aged 40 or over. These participants held a wider range of products, including some investments. The final three groups were in a high-income neighbourhood, the first with young people aged 18 to 24, the second with people aged 25 to 39 and the third with people aged 40 or over. Participants in these groups held a wide range of financial products, including a number of investment products.

Each focus group lasted between one hour and an hour and three-quarters. The discussions were recorded and transcribed in full for analysis using thematic grids.

To provide a structure for the discussions, we developed a topic guide which was deliberately kept very open. The topic guide began by asking participants to describe the characteristics of a person who is *not* financially capable, and then to describe someone who is. It then sought to open up the discussion to consider the knowledge, understanding and skills that people require. Participants were asked to identify other factors that might influence financial capability. The

groups finished by considering three different scenarios to explore whether they considered the people concerned to be capable or not.

It became apparent early on that the focus group participants found it difficult to discuss the concepts of knowledge, skills, understanding, personality, confidence and attitudes in the abstract. They were much more comfortable discussing these concepts in relation to different kinds of activity or behaviour. Four particular activities emerged: money management, planning ahead, choosing and using products, and seeking information and advice. Within each of the different activities, participants were able to identify the knowledge, skills and understanding that were required and were able to consider the ways in which factors like personality, confidence and attitudes would affect behaviour.

3.2 Financial capability

We began each discussion by asking participants to describe the characteristics of someone who they would consider to be financially incapable and, conversely, those of someone who was capable.

All the groups agreed that the key characteristic of a financially capable person was that they were able to manage their money. This enabled them to live within their means and ‘keep their head above water’. Money management involved being well-organised and keeping control over financial resources. A financially capable person budgeted so that they were able to balance their income and expenditure.

These characteristics were identified by all the groups: young and old, rich and poor. Beyond this, there was some variation by age and by income in what people thought financial capability encompassed – we discuss these variations below.

Most people agreed that planning ahead was an important characteristic. A financially capable person would make long-term provision for expected events and for their retirement. They would also have a strategy for coping with the unexpected.

Financially capable people would be aware of the range of products that were available to them and would take care to shop around and select the ones that were most suitable. Finally, a financially capable person would make sure that they were generally well-informed and would know where to go for further information and advice. Their financial capability would be influenced by their personality, upbringing and experience.

It seemed, therefore, that financial capability was a function of money management; planning ahead; choosing and using financial products, and accessing and using information and advice. Within this broad framework, however, there were some differences according to age and income level.

For poor people, capability did not extend much beyond day-to-day money management. Their ability to plan for the future was constrained by their lack of spare cash. They used a limited range of products, mostly those involving borrowing and they used a limited range of sources of information and advice. Young people had very similar views and patterns of behaviour.

Better-off people, on the other hand, faced fewer money management problems and, because they generally had spare cash, they often did not find it necessary to plan for expected or unexpected events. They did, however, use a much wider range of financial products and drew on a wider range of information and advice.

Young people, as we have noted, had a fairly constrained view of financial capability. In contrast, middle-aged people, while retaining the emphasis on money management, identified a

greater need for forward planning, and for pensions in particular. They chose and used a fairly wide range of products, drawing on a range of sources of information and advice.

Older people reflected generational differences in attitudes towards money and, particularly, the use of credit. They arguably had the most balanced view of financial capability, although the emphasis on money management remained.

3.3 *Managing money*

All the groups thought that managing one's money was really important, indeed, there was a strong sense that this held the key to financial capability: if a person was not able to manage their money from day to day then, no matter how good they were at planning ahead, choosing and using products, or seeking advice, they would not be able to make best use of their financial resources.

3.3.1 *Budgeting*

For most people, money management involved being in control of one's financial resources, monitoring income and keeping some kind of record of expenditure. Critically, it required someone to be aware of regular outgoings and to ensure that they would always be able to meet these commitments. To do this successfully required someone to be quite organised and to be prepared to spend some time working out budgets, keeping records and checking statements.

'Lumpy' expenditure, or commitments that fell outside the normal weekly or monthly pattern, presented a particular difficulty that had to be taken into account when budgeting. This highlighted the differences between people on different incomes. People on low incomes found that 'lumpy' expenditure caused them real problems and they sometimes had to borrow in order to meet the commitment. In contrast, people in the high-income focus groups said that they were able to meet such expenditure out of their regular surplus income.

The purpose of all this budgeting and control activity was to enable people to live within their means or, as many people put it, to 'keep their heads above water'. There was a general recognition that inadequate or low incomes made the process of money management more difficult. This view was emphasised, unsurprisingly, by those on low incomes: they commented that some of the most skilful money managers were the people who had to exist on social security benefits. It was also a view that was stressed by the younger people, many of whom had incomes that they felt were low relative to their requirements. That said, a minority of older people on higher incomes recognised that people living on social security benefits long-term should not be judged incapable if they sometimes failed to make ends meet.

3.3.2 *Pressure to spend or to borrow*

People were very conscious of the ways that money management and budgets could be upset by pressures encouraging people to spend. These pressures were thought to be growing and came from advertising, the desire to keep up with one's peers and, particularly, from children. Resisting such pressures was considered to be a mark of capability. Young people seemed to find it hardest to resist such enticements to spend.

People also felt that they were being tempted to borrow money. They felt that they were constantly being offered credit, particularly through direct mail advertising, and that getting credit, or extending credit limits was easy – some said it was too easy.

The ability to resist the pressure to spend and the temptation to borrow was seen by all groups as a characteristic of a financially capable person.

3.3.3 *Borrowing and credit*

There was a general wariness of credit. Most of the participants, particularly in the younger and middle-aged groups, were using credit of some kind. They felt, however, that a financially capable person would avoid using credit if they could or, if they could not, that they would make sure that they were able to repay what they owed. Reckless use of credit was regarded as a mark of financial incapability.

The people on middle incomes felt that the use of credit should be kept under control and that a financially capable person would not ‘over-borrow’ to the extent that they found it difficult to keep up with the payments. They also felt that a financially capable person would not borrow to meet regular commitments or to buy things like food. The experience of poor people was different. They felt that it was sometimes necessary to borrow in order to cover lumpy expenditure, pressing commitments and unforeseen events.

The people with high incomes used credit quite extensively. This group felt that a capable person would be able to borrow cheaply and to ‘play the system’.

Younger people had the most relaxed views on the use of credit. Many had, or were contemplating taking out, loans to cover major expenditure like the purchase of a car. For this kind of borrowing, the important thing for them was to ensure that they would be able to meet the repayments. Most also used credit cards quite extensively but they were critical of people who built up large credit card balances and who only made the minimum repayments each month.

People in the middle-aged groups drew a similar distinction between types of credit. Mortgages and loans to buy cars were accepted as necessary and it was a matter of simply making sure that the repayments could be managed within the family budget. There was, however, a wariness of credit cards and a feeling that their use should be restrained.

The older people were more likely to comment on the over-use of credit and were particularly wary of the over-use of credit cards. These attitudes seem to be associated with the view that financially capable people were those who were able to defer gratification and so put off a purchase until it could be afforded.

3.3.4 *Group characteristics*

Somewhat alarmingly, people on high incomes appeared almost automatically to associate a lack of financial capability with broad social groups. The 18 to 24 year-olds among them thought that unemployed people and students were financially incapable; the 25 to 39 year-olds thought that young people, lone mothers and people on social security benefits were incapable, while those aged 40 or over identified benefit-recipients and ‘artistic people’ as incapable. In each case, the criterion seemed simply to be the level of income that the groups were assumed to receive. In their minds, someone was financially incapable if they lived on a low income, as a more capable person would make sure that they earned more. These did not, however, seem to be strongly-held views.

3.3.5 *Enjoyment*

Interestingly, only the older groups commented on the need to balance the management of one’s financial affairs with the need to enjoy one’s money, suggesting that excessive amounts of time spent gathering information or shopping around indicated a person who was ‘sad’ rather than financially capable. The younger groups also seemed to think that the enjoyment of money came with spending it but they were aware that unrestricted spending carried with it the

consequence of losing control and over-commitment and excessive borrowing, all things that a financially capable person would avoid.

3.4 Planning ahead

Making financial provision for the future was something that everyone thought was important. There were two aspects to this: making long-term provision for expected commitments and requirements and providing what some described as a safety net, to cover the unexpected.

3.4.1 Saving

The ability to save was strongly associated with planning ahead. This could involve saving money for expected events and for specific purposes: many of the young people mentioned the need to save for a car or for a deposit on a house. Or it involved saving for emergencies: the middle-aged and older people, in particular, saved in order to build up a safety net to cover emergencies or unexpected expenditure – in other words, they were saving for a rainy day.

Saving behaviour clearly differed with income. For people on low incomes, saving was difficult. Indeed, for some it seemed a hopeless aspiration and, consequently, they did not spontaneously identify saving with financial capability. For people on high incomes, though, saving was an aspect of regular budgeting, suggesting that a financially capable person would budget for regular expenditure and would then decide how much of their surplus income to save.

3.4.2 Planning for the long-term

Everyone thought that making long-term provision for expected events was an important part of financial capability. There was a considerable range of things that people were planning for, including buying a car, buying a home, helping children to buy a home, paying for children's higher education, pensions and long-term care. The older that people were, the more conscious they seemed to be of the need to make such provision early in life.

Both age and income level seemed to have a bearing on people's views about planning for the long-term. Young people recognised the importance of making provision but few were actually doing so. Poor people were in a similar position.

Middle-aged people were aware that they could use a range of financial products in order to make long-term provision. They were also most aware of some of the complexities: some, for example, were conscious of the fact that having savings might mean the loss of entitlement to some means-tested benefits. There were also some who were content to leave matters to the government, believing that, at the end of the day, the state would provide. A number of the middle-aged people stressed the importance of getting the balance right between saving for the future and using one's money to enjoy life.

Older people were more likely to say that they had little incentive to save for the long-term, many because they were already retired and, for them, the long-term had arrived.

The lack of incentives to save was also mentioned by the people on high incomes, although here the lack of incentive was more closely associated with low interest rates and investment returns.

Pensions

Much of the discussion focused on pensions¹. The majority of people recognised that they had to make some provision over and above their entitlement to a state pension. There was,

¹ In part this might be a reflection of the fact that pension reform was a very topical issue at the time the focus groups were held.

however, little agreement on what was the best strategy. Some people, as we have noted, were prepared to leave things to the government, believing that the state would provide them with an adequate pension. There seemed, however, to be a generally low level of trust in the government, in pension providers or in firms that ran their own pension schemes. Perhaps as a consequence, a number of people were exploring alternatives to conventional pensions. Some were investing in stocks and shares. A larger number, particularly among those who were better off, were investing in property. Indeed, there seemed to be a fairly widespread belief in the long-term value of property.

3.4.3 Planning for the unexpected

People recognised that they might face the need to cope with unexpected events like a sudden drop in income, a significant increase in expenditure, a major one-off expense or the loss of possessions or damage to one's dwelling.

The extent to which people made provision for these possible events varied considerably according to their income. People with low incomes faced the biggest problems. They lacked the spare cash that would be needed to build up a safety net and they found it difficult to justify expenditure on insurance. In contrast, for people with high incomes, unexpected events of this kind presented less of a problem as many of the unexpected expenses could be managed within existing budgets. Even the loss of income did not seem to be a concern as most of the people on high incomes believed that they would simply get another well-paid job.

Insurance clearly provides for events of this kind. People with low incomes were more likely to mention taking out payment protection insurance to guard against financial difficulties arising from the loss of income. There was, however, a degree of scepticism about other forms of insurance, particularly insurance against the breakdown of things like white goods. People generally seemed to balance the cost of insurance against the risk of being uninsured.

The other safety net is provided by the benefits system. Knowledge of the way the system works varied considerably, although nearly all people commented on its complexity and the difficulties one faced if claiming for the first time. Among the middle- and high-income groups there were considerable misconceptions about eligibility and the amounts that one would receive if one were eligible. The people on high incomes, in particular, over-estimated the amounts that people would receive and under-estimated their entitlement: they seemed to believe that people who were dependant on social security benefits lived on comfortable incomes, while they themselves would not be entitled.

3.5 Making choices

The types of financial products that people held varied according to their age. Middle-aged people tended to have the widest range. Young people most commonly just had credit, in the form of credit cards, loans and overdrafts, while older people tended to have pensions and investments.

3.5.1 Shopping around

With the exception of the older groups, people thought that a financially capable person would take the trouble to shop around to get the best value – both generally and in relation to financial products. They would also be concerned to get the products that were most suitable for them. This required three things: a good general understanding of what was available; shopping around before purchase and monitoring during the life of the product.

Attitudes towards background knowledge differed. Some people felt that it was best to build up a general understanding regardless of whether one had an immediate need. Others felt that it was better only to gather such information in response to need. This dichotomy arose in all the groups.

Most people, however, admitted that, when they were planning to buy a product, they did not shop around as assiduously as they felt they should. The main reason for this seemed to be that people found it difficult to compare products. They found the products themselves complex and were not at all sure what criteria they should use to compare one against another. In this context, there was a widespread lack of understanding of interest rates in general and APR (Annual Percentage Rate) in particular. Faced with this, many people seemed either simply to choose the lowest-priced products, or they chose products offered by big firms on the grounds that they felt that they were more likely to be trustworthy.

They also did not monitor their products once purchased, so that they could switch to others that offered more favourable terms. The exceptions here were credit cards and mortgages: people seemed ready to switch providers of these products to take advantage of more favourable offers.

3.5.2 Risk

People's attitudes towards the risk associated with financial products seemed to vary considerably. The younger people did not associate the ability to assess risk with financial capability, indeed many participants did not fully understand the concept of risk. The middle-aged thought that a capable person would be prepared to take risks in order to make money. The older people, however, seemed a little more cautious and emphasised the importance of taking risks within one's limits.

A similar variation seemed to apply to the different income groups. Some people in the low-income groups perceived risk almost exclusively in terms of being able to keep up with commitments. The middle-income people tended to associate risk with making money, while those on high incomes took a rather more measured view and said that a financially capable person would assess risk in relation to the amount they could afford to lose.

3.5.3 Small print

Choice and comparison were made more difficult by the fact that people perceived that the products' terms and conditions were usually set out in small print. People usually did not read these terms and conditions (although they felt they should). This was felt to be particularly critical when buying things like equity-based products that carried a degree of risk. Awareness of such risks appeared to be low, particularly among young people and those with low incomes. Most people said that they would like to see the terms and conditions expressed in simple, clear, easily understood language and printed with a type size that was easy to read.

3.6 Getting help

People considered that information and advice were important aspects of financial capability. A financially capable person would, they felt, get help from passive information sources, such as newspapers, the broadcast media and the internet. This would help them to become well-informed. They would also know where to go for specific advice and assistance from third parties. They would know their rights and would be able to seek redress when things went wrong.

3.6.1 Background information

As we noted above, people were divided over when it was useful to gather background information. There was, however, much more agreement on the sources of information they used. They gathered information from broadcast media – television and radio – and from newspapers and magazines. The internet was used for background information by some, but people more commonly turned to the internet when seeking information about a specific product.

People sought information on a wide variety of topics, ranging from general issues like the state of the economy or the housing market, through to new product developments and special offers.

While nearly everyone felt that it was important to keep up to date in this way, there was a recognition that it could be taken too far – people who spent all their time reading the money pages of the Sunday newspapers were, generally, considered to be rather sad.

3.6.2 Specific issues

Everyone agreed that the important thing was to know where to go for advice. When people needed information or advice on specific issues they, unsurprisingly, turned to a different range of sources. Some relied on family and friends. Young people, in particular, said that they would turn first to their parents. Other potential sources of advice were the internet, banks, which were popular with young people and those on low incomes, and employers, which were used mostly by low-income, middle-aged people. Independent financial advisers were used by everyone other than people with low incomes. They were used most heavily by people on high incomes, one of whom suggested consulting three and comparing the results.

The choice of which source of advice to use clearly depended on the degree to which they were trusted. People recognised that family and friends might not know very much but they felt that they could be trusted. In contrast, independent financial advisers were regarded with a considerable degree of scepticism as people felt that they would be inclined to advise someone to have the product that generated the largest commission for the adviser rather than one that best suited the consumer. There was also a belief that if a person sought advice it was almost inevitable that they would be put under pressure to buy a financial product.

Notwithstanding people's scepticism about the objectivity of the advice provided by professionals, there was a clear feeling that being mis-sold a product by a professional adviser did not necessarily mean that a person was financially incapable.

3.6.3 Rights, complaints and redress

People generally felt that it was important to know about one's rights and how to assert them. Most people, however, were aware that their knowledge was patchy. Perhaps because of this, people were fatalistic about their rights and their ability to complain successfully. In part, this related to the terms and conditions embedded in the small print on contracts. People seemed to feel that when things went wrong the firms would be able to point to something in the small print that exonerated them. Even if right was on the side of the consumer, people felt that embarking on a complaint was tantamount to starting a 'war of attrition' in which the firm would continue to make life difficult in an attempt to force the consumer to drop the complaint. Faced with this gloomy prognosis, it is perhaps not surprising that many people seemed happy to call upon the local citizens advice bureau to help them get redress.

3.7 The X-factors

Throughout the discussions people referred to a range of additional factors that would determine the extent of a person's financial capability. The key was the individual's personality: whether they were organised, able to resist temptation, likely to plan for the future, prepared to shop around, likely to keep themselves well-informed and prepared to assert their rights. Knowledge, understanding and skills alone were not enough – one had to be prepared to act on them.

People differed in their views about what it was that determined one's personality. Many mentioned up-bringing and parental example but in nearly every group someone was able to point to siblings they knew who differed widely in their financial capability. One participant also pointed out that her parents provided dreadful role models. Despite this there was a general feeling, particularly among older people, that parents should do more to instil a sense of financial capability in their children.

Experience was felt by many to be important, particularly as one learned from one's mistakes, and there was a general view that a person became more financially capable as they got older.

3.8 Important issues

A number of other issues arose during the focus group discussions that are important when developing a framework to measure financial capability.

The first is the need to take levels of income into account. Managing money was clearly felt to be more difficult when financial resources were tight. The scope for planning ahead and the strategies that could be used were largely determined by a person's income. The range of financial products that a person would use was also, to a great extent, determined by income level. And, to a lesser extent, the range of sources of advice was constrained by a person's disposable income.

The effect is most marked at the extremes. A poor person could still be considered to be financially capable even though they were unable to make ends meet on an inadequate income. Equally, the simple fact of being rich should not be equated to financial capability.

It is also clear that different generations have different attitudes towards things like the use of credit. Just as the needs of older generations differ from those of younger people, and the range of products used differ so, too, do people's attitudes. Behaviour that is considered to be uncontentious by a twenty-year-old might appear reckless to someone in their sixties.

People in most of the groups commented that financial capability meant more than simply knowing what to do – if a person knew what was the right course of action but failed to do it (shopping around for products was a frequently-mentioned example), then they could not be considered to be financially capable.

Related to this, the older people and those on high incomes thought that leaving one's financial affairs to others, whether another family member or a professional adviser, was a mark of financial incapability.

This also has a bearing on the need to test financial, or applied, literacy and numeracy. Basic literacy and numeracy skills are required for financial capability and for almost all other human endeavours in a modern society. We considered, therefore, whether we should include questions to test literacy and numeracy. What is important, however, is not whether a person has the skill but whether they use it. Someone who lacks literacy and numeracy skills, or who has not developed coping strategies to overcome their deficiency, would not be able to manage money, to plan ahead, to make choices or, probably, to get help when they need it. By measuring their behaviour we are, therefore, implicitly, testing their literacy and numeracy.

Finally, being canny should not be confused with financial capability. People thought that someone who, for example, constantly switched between credit card companies to take advantage of zero per cent interest on balance transfers while failing to reduce the level of the balances was more likely to be reckless than capable.

The literature review and our initial discussions enabled us to develop a conceptual approach to financial capability. We tested the model in the focus groups and found that the model itself was sound. However, people found it easier to discuss financial capability in behavioural as distinct from conceptual terms. We therefore needed to use a pragmatic approach when designing a questionnaire to test. This instrument, which is discussed in detail in the next chapter, is grounded in the four behavioural domains of: managing money, planning ahead, making choices and getting help.

4. Designing and testing the questionnaire

The questionnaire was developed through two waves of interviews with 33 people: a wave of depth interviews to refine the content of the questionnaire and a wave of cognitive testing interviews using a more structured questionnaire. All but four of the participants had taken part in the focus groups, and were drawn in equal numbers from people of different income levels and ages. Four additional people were recruited, all of whom were living on social security benefits with minimal levels of financial product holding (eg a basic bank account and a Social Fund Budgeting Loan²) because people in these circumstances present a particular challenge for the survey (as we describe below) and we needed a booster sample.

The managing money and planning ahead sections of the structured questionnaire were also tested to identify any cultural or religious factors specific to certain ethnic or religious groups that needed to be taken into account. This included seventeen interviews with: four Indian, five Pakistani, four Bangladeshi and four Black Caribbean respondents. In addition, 15 interviews were conducted with ‘experts’ who could provide information about the religious, cultural and social factors likely to have an impact on financial capability.

Following the initial qualitative stage of the research, two pilot surveys were conducted to fine-tune the questionnaire. A total of 200 respondents were interviewed during these pilots.

4.1 General points

Without doubt, it was easier to capture individuals’ level of financial capability in the depth interviews: translating this into a questionnaire for a quantitative survey was much less straightforward. This is in keeping with previous research, as we have noted in Chapter 1.

It became clear very early in the interviews that assessing financial capability is a complex process, which needs to be tailored to specific circumstances and cannot be captured in a short interview. None of the early exploratory interviews lasted less than an hour, while a number took more than two hours to complete.

As we have discussed in Chapters 2 and 3, financial capability is considered, by both experts and the general public, to encompass a wide range of factors that are not amenable to simple measures. To assess these in more than a superficial way requires a fairly lengthy interview. As we go on to note in Chapter 5, the average interview length in the full national survey was 44 minutes. Some interviews lasted well over an hour.

² The Social Fund Budgeting Loan scheme is run by the Government and offers interest-free loans to people on certain social security benefits to cover lumpy expenditure they may be unable to meet from their income, such as a washing machine, furniture or carpets.

4.1.1 *Inappropriateness of a 'one-size-fits-all' approach*

It was also apparent that a 'one-size-fits-all' approach would be inappropriate. At one extreme people living on very low incomes, who have little or no opportunity to save or plan for the future and limited engagement with financial service products, need to be assessed primarily in terms of their ability to manage their finances day-to-day. They need to be asked about plans that are realistic in their circumstances and products that they have experienced.

At the other extreme, someone with an income far in excess of their needs, who has money to invest and experience of a wide range of financial products, including some complex investments, needs to be assessed quite differently. In this case, greater weight has to be given to their ability to plan for the future and choose and use appropriate products wisely.

Failure to modify the interview in this way could lead to the false conclusion that poor people are financially incapable and capability increases with income. This proved to be a considerable challenge. Designing a questionnaire for the majority of people was relatively straightforward. Ensuring that it was capable of distinguishing levels of capability at the income extremes was far more difficult.

Another key challenge was to capture the financial capability of people who rely on someone else to make the financial decisions for them. This includes people who rely on their partner to manage the household finances and people who rely on a financial adviser for most of their financial planning and choice of financial products. It is particularly acute in some ethnic groups as we discuss below. This, too, has proved very difficult as, ideally, we need to find out what they would be capable of if they had to do it themselves. At the very least one needs to know if they are wise to leave everything to someone else and whether or not they are able to judge whether that person is handling their affairs in a capable way.

Throughout the questionnaire we have, therefore, asked questions to ascertain who is mainly responsible for different aspects of the household finances – including managing money, planning ahead and making choices about financial products. And, although most questions relate to the individual's behaviour, questions on income, saving and borrowing and ability to make ends meet are asked about the family as a whole. Couples tend to pool resources and often hold savings, investments, mortgages and consumer credit commitments in their joint names. For this reason it is usual to assess these in relation to the family income to arrive at estimates of people's gearing. Moreover, for individuals who rely on their partner to manage the family budget or make financial provision for the future it is important to assess the outcome at the family level to assess whether or not they are wise to rely on their partner in this way.

A third challenge was to make the questionnaire culturally sensitive. In particular, it needs to take account of ways that specific ethnic groups might handle their affairs that differ from others at their age or income level. The most obvious example is that of Muslims whose religion could influence the ways in which they make provision both for the future and for unexpected events, and the types of products they would find acceptable. But there are other areas of cultural sensitivity too. These include language and literacy difficulties, the extent to which there is gender segmentation in financial responsibilities, and the need to take account of the complexities of money management and planning ahead in extended families. As noted above, the questionnaire was tested separately for these cultural differences.

Many of these points are returned to in the sections below, which discuss the design and testing of specific sections of the questionnaire in more detail. It is, however, important to note that strong gender divisions of responsibility in some South Asian and Black African cultures mean that women may be unable to answer large sections of the questionnaire.

4.1.2 *Format of questions*

The topic guide and questionnaire included a mix of questions covering the individuals' circumstances, their behaviour, attitudes, knowledge and 'applied financial numeracy'. Wherever possible, questions used and tested in previous surveys were deployed in the draft questionnaire. At key points in the interview, participants were asked for their views of the questions they had been asked and how well they felt these had captured their financial capability. They were also asked to identify any areas they felt had been omitted, or ones that they felt should not have been included. No radical suggestions of this kind were made, although participants did make valuable comments on the detail of the interview and questions they had been asked.

Attitude statements

The attitude questions proved especially valuable and participants often commented that, taken together, the statements in the individual sections of the interview gave a fairly accurate picture of their capability. That said, questions in the first wave of interviews that related to the individual such as 'I am impulsive and tend to buy things even though I can't really afford them' worked far better than those that were more general – for example 'Most financial firms treat their customers fairly'. The non-personalised questions more often elicited equivocal responses like 'Well, it depends'. As a result, only personalised statements were included in the questionnaire for the second wave of interviews.

Incomes, saving and borrowing

It was decided that accurate information should be obtained about incomes, amounts held in savings and investments, equity in properties owned and amounts borrowed. A number of people queried why this level of detail was required and would have preferred to assign their reply to a banded amount. Most were, however, willing to provide the information when the interviewer explained why it was needed, how it would be used (ie in aggregate for groups of people) and the confidentiality of the information they gave. It will clearly not be possible to collect this information at the level of detail of, for example, the Family Resources Survey. At the same time, figures are needed to calculate ratios of, say, borrowing to income so banding has to be avoided.

The testing for ethnic sensitivity identified two particular problems in relation to information about incomes. Many people from South Asian and Chinese communities work in small family businesses, alongside other members of their family. The amounts withdrawn from the business vary from week to week and are often taken out to meet the needs of the extended family rather than individual needs. Capturing income from self-employment is complex in any survey and this adds a further level of complexity. It was decided, therefore, to use the full set of harmonised questions used on all UK Government surveys to capture income from self-employment.

The second problem arises where people in receipt of social security benefits also have jobs. Experts suggested that it is relatively common for Bangladeshis, Pakistanis and refugees to work informally in this way. This had two implications for this survey: the need to try and record these informal earnings and the low level of engagement with the financial services sector that can ensue. Both have been taken into account in the design of the survey.

Testing and past experience have shown that respondents often do not know how much their partner has in savings or how much they owe on mortgages or credit commitments when these are in their own name only. Because we required fairly accurate information for the family as a whole, we decided to ask respondents for details of commitments held in their own name or in

joint names and to use a statistical technique, known as ‘hot-decking’ to impute values for their partner’s saving and borrowing.

Language and literacy

The ethnic sensitivity testing showed that some people (and South Asians in particular) found parts of the questionnaire difficult because of a combination of:

- lack of ease with conversing in the English language
- literacy problems
- lack of familiarity with financial services and financial services terminology

This was especially the case with older people and more recent migrants. It should also be noted that the second and third problems were also identified in relation to some people on low incomes among the general population. Where possible the questionnaire has been simplified to remove technical language. In addition, the interview relies on the use of show cards and show screens, some of which are quite long. In cases where respondents cannot cope with show cards or show screens, it is standard practice for the interviewer to read them out.

For people who have difficulty conversing in English, conducting an interview using a family member as an interpreter is not appropriate in a survey that aims to assess an individual’s financial capability. In the full national survey, therefore, interviews were only conducted with people who spoke English.

Applied financial numeracy

The applied financial numeracy questions were designed by staff at the Financial Services Authority. They included questions intended to show whether people could extract information from bank statements, tables or graphs and those that sought to capture their ability to make calculations, such as working out the monthly instalments on a Council Tax bill paid over 10 months rather than 12 months. On the whole, the first group of questions worked better than the second.

A number of participants commented that ‘calculation’ questions altered the tone of the interview and made them feel like they were being tested by a school teacher. Some objected quite strongly to this, especially those younger people who were daunted by these calculations. These questions could also take some time to administer and people were torn between giving a quick response and working out an accurate reply. Many people needed to have the questions read out to them several times – or were given them to read on paper. This suggested that a self-completion format might be preferable, although if people had limited literacy skills it would not be clear what was being tested. In real life, people would have access to pens and paper or calculators and arguably this should be the same in any interview. In the light of these difficulties, the FSA decided to drop the calculation questions from the questionnaire.

For the final rounds of testing the remaining applied financial numeracy questions were placed towards the end of the interview and introduced as ‘a money quiz’. This format was carried forward into the national survey.

We also tested the applied financial numeracy questions by asking first for a free response and then giving people a multiple choice response. In both formats a number of people were clearly guessing with no attempt to work out the response. This was more apparent with the free responses than with the multiple choice ones, where they usually had a one in three chance of being right. It would be possible to ask people how they arrived at their answer although this would complicate the analysis. Undoubtedly, quicker responses are elicited by multiple choice

questions, but at the cost of lack of accuracy of measurement. The final questionnaire uses a free-response format.

4.1.3 Structure of the interview

The topic guide used in the first wave of interviews was divided into four sections, one for each of the four domains being studied – managing money, planning ahead, making choices and getting help.

Testing showed however, that this was not always the most helpful structure for respondents. For example, information about levels of saving and borrowing (needed to assess ability to manage money) are better asked in a section dealing with product-holding. Likewise questions on information seeking and use of financial advisers (part of the ‘getting help’ domain) are better dealt with when asking about recent product purchases. As a consequence, although the final questionnaire is still broadly structured around the four domains, these are no longer as self-contained as they were originally. In the sections that follow on the four main domains, we describe not only what information is being collected, but also indicate where in the final questionnaire it is located.

4.2 Managing money

This section, more than any other, illustrated the general issues highlighted in the ‘one-size-fits all’ approach (section 4.1.1 above). Considerable time was spent to ensure that it included questions that were appropriate to people at the income extremes; identified and accommodated people with limited responsibility for money management; and, as far as possible, took account of the complexities of money management in extended families that are common in some South Asian communities.

In the first wave of depth interviews, most people had no difficulty at all in talking through how they managed their day-to-day finances and, with some probing and prompting, it was possible to elicit details of the strategies they deployed. This generally gave a clear picture of the things that distinguished both very capable and less capable people from the rest. These included keeping account of money spent, knowing fairly accurately how much money is available to cover future spending, planning to deal with ‘lumpy’ expenditure and living within one’s means.

Capturing the same information in a structured questionnaire was much more of a challenge.

4.2.1 Record-keeping and knowing where you are with your finances

Individuals differed in the extent to which they kept an eye on their finances. Regardless of income, some knew accurately to within a pound or two how much money they had at any one time, others had only the vaguest idea. Some checked to make sure sufficient money was in their account before withdrawing cash or making a big payment. Others did not. Some kept records and checked statements on their bank accounts to make sure that no errors had been made by the bank and to make sure that all payments had been processed. Others merely skimmed statements or did not look at them at all.

On the whole, the questions in the questionnaire for the second wave of interviews gave an accurate picture of the extent to which people had control over their finances. Further refinement was, however, needed to ensure that this was also the case where people made little use of banking facilities or relied on another member of the family to manage the money.

4.2.2 *Planning for 'lumpy' expenditure*

This area, too, clearly marked out the more capable people – who tended to plan and budget to ensure that they always had enough to cover regular expenses that were normally billed quarterly, annually or half yearly. The strategies used were varied and this needed to be captured in a question with pre-coded responses. The least capable strategies involved borrowing (including using credit cards and overdrafts) and falling into arrears with regular commitments.

A complication arose with people who had high incomes and did not need to plan ahead as they could absorb large occasional expenses, perhaps with a little pruning of non-essential spending. This was addressed by adding extra pre-codes.

As before, we have included a question to ascertain the extent to which the respondent is responsible for ensuring that money is available to meet this type of expenditure.

4.2.3 *Living within one's means*

As we have noted, the focus groups indicated clearly that someone should be judged capable if they balanced the books and incapable if they did not and either fell into arrears or routinely borrowed to make ends meet. But the focus groups also recognised that this needed a caveat - that people living on social security benefits for extended periods of time may well have insufficient income to cover their basic needs.

Previous surveys have included a variety of questions to capture people's ability to live within their means and all worked well. It was decided to approach this in a variety of ways, asking people about overdrawing, running short of money and the strategies used to manage when this happens, as well as the total amounts owed in relation to income. It also included questions (in the 'making choices' section) about using credit cards to buy food and pay bills but not settling the balance in full.

Again people on higher incomes posed a challenge as they should be able to meet all essential expenditure with a large margin. The distinction here was more subtle, with the least capable people regularly spending all their income and having none left over at the end of the month. In this context it was also important to identify if people had taken on heavy expenditure on mortgages and discretionary commitments such as school fees. A question has been included to capture this type of expenditure.

Information is also collected in the 'making choices' section to allow calculations to be made of total borrowing in relation to both annual income and to savings and investments, and also of repayments on mortgages and other credit commitments in relation to monthly income. Finally, information is collected in the 'making choices' section on amounts saved, invested or paid off the capital on mortgages in the past 12 months.

4.2.4 *Areas dropped following the depth interviews*

A number of other areas were covered in the initial depth interviews but subsequently dropped from the questionnaire.

The initial interviews included questions about spending priorities and methods of bill payment – but the wide use of direct debits meant that this approach was not particularly useful. People were unable to assign a priority to bills paid on direct debit. And while a conscious decision to pay by direct debit could indicate a careful approach to money management, in other circumstances it was imposed by creditors after someone had fallen behind with bills. A further complication was the fact that direct debits were deliberately avoided by careful money managers who had low incomes, who preferred the greater control offered by cash payments.

And among cash budgeters, the use of prepayment tools or direct debits, resulted both from careful money management and from past financial difficulties.

The timing of bill payment (soon after receipt of income) was generally a good indicator of careful money management, but individual idiosyncrasies meant that it was difficult to capture in a quantitative survey. In any case, the timing was much less important for people who routinely had a large surplus income. It was therefore excluded.

The initial interviews also asked people how often they reviewed their levels of saving and borrowing. But neither question elicited responses that added usefully to the assessment of their capability. The people interviewed did not operate their finances in this way and found the questions too abstract. For example, people were either minded to save and did so when they could, or they did not. Many avoided borrowing altogether and others considered their level of borrowing in an *ad hoc* way when a purchase or house move was contemplated.

4.2.5 People with limited responsibility for finances

People who lived with a partner and relied on them to manage the joint finances posed a particular problem. As we have already noted, this was most acute in South Asian and Black African families where women often played no role at all in managing finances. It was possible to include questions to identify who these people were and the extent to which they relied on their partner. It was, however, more difficult to assess how capable they were personally, the less financial responsibility they had. To some extent, the attitude statements helped to make this assessment.

4.3 Planning ahead

The initial depth interviews asked about a range of situations for which people might be expected to make financial provision. These included:

- Unexpected events (how people dealt with any they had experienced; and how they would deal with any in the future):
 - An unexpected drop in income
 - An unexpected rise in expenditure (tailored to their circumstances)
 - An unexpected major expense (also tailored to their circumstances)
 - Lost or damaged possessions
 - Anticipated events or major expenditure
 - Retirement

This proved to be too long and repetitive and for the second wave of interviews this section was reduced to the four areas that provided the most useful information:

- An unexpected drop in income
- An unexpected expense of £1,000 or more
- Any areas of major expenditure they anticipate
- Retirement

4.3.1 *General points*

Both waves of interviews demonstrated the importance of distinguishing between better-off people who have planned for such eventualities and those who have adequate provision by default rather than by design. Likewise they showed the importance of being able to identify people on low incomes who would plan if they had enough money and those who would not (and not penalise the first group for failing to make adequate provision). The questionnaire for the second wave of interviews needed further revision to capture this information more fully.

It was also clear from the replies people gave that it is important to check whether the same provision has been earmarked for a number of purposes and whether or not it would be adequate to cover them all. Consequently, the final questionnaire includes a number of questions to capture the adequacy of any provision people have made.

The ethnic sensitivity testing confirmed the need to take account of the fact that in some ethnic groups (and especially those where extended family households are common) the cultural norm is for families to support one another, obviating the need for specific financial provision for retirement or a drop in income. It is important that this is captured in the replies to questions and just as important that it is taken into account in the analysis.

4.3.2 *Unexpected drop in income*

On the whole, few people had consciously considered what they might do if they had a large fall in income. More people could relate to becoming unable to work through ill-health or disability than through redundancy. People with higher levels of qualifications or who worked in jobs where there was a skills shortage could not envisage being out of work for long, except through ill-health. In the final questionnaire, therefore, people are asked how they would make ends meet if the chief income earner were unable to work for three months or more due to ill-health or an accident.

With the general caveats already noted, it was possible to capture what provision people had made or considered and, if they had none, how they would manage to make ends meet. To assess its adequacy, we added a question asking people how long they think they would be able to manage to make ends meet on the provision they have made.

4.3.3 *Unexpected expense*

In the first wave of interviews we tried to tailor the unexpected expense to people's circumstances, asking home owners about needing to replace the roof on their home, and tenants about needing to replace a washing machine and fridge at the same time. Non-householders were asked about needing to set up home at short notice. In the second wave of interviews we tried a different approach, asking instead about an unexpected expense of £1,000 or more. On the whole, the second approach worked better, but would be better still if the sum were adjusted to take people's incomes into account. Accordingly, we have amended the question to ask about an expense 'equivalent to their whole income for a month, or more'.

Because the second wave interviews took a good deal more than an hour to complete, we decided to reduce this section quite considerably and merely ask how people would manage to cover an expense of this amount.

4.3.4 *Anticipated expense*

The questionnaire captured expenses that people anticipated and any plans they had for meeting these. In the first two waves of interviews, the questions were, however, more open-ended than

those asked about other areas of financial planning. The information collected has enabled us to design pre-coded questions.

Questions were included following the second wave that identify whether the provision made will cover all the cost and, if not, how any shortfall will be met. The ethnic sensitivity testing identified the need to include within the anticipated expenses those related to travel overseas for an extended period of time.

To reduce the length of the interview it was decided only to ask about the provision that had been made for the expense that was likely to occur first.

4.3.5 Retirement

People were asked a different set of questions depending on whether they were retired or had yet to retire. For most participants this routing was unproblematic. It was, however, less clear-cut when people had either retired early or passed retirement age but continued to work. Where people had continued in the same job after the age of retirement they generally described themselves as still working and for these the section for people who had yet to retire worked best. On the other hand, people who had retired (sometimes early) but had found another job variously described themselves as either ‘working’, ‘retired’ or ‘retired but still working’. Generally speaking, the section for people who had retired worked best in these circumstances. The questionnaire needed to identify and route these people appropriately.

People who had already retired were asked about the sources and adequacy of their income and, if inadequate, the reasons for this and how they had managed.

Those yet to retire were asked about private and occupational pensions and other potential retirement income from investments, property etc. They were asked how confident they were that these would give them the standard of living they would like, although it was clear that a question in this format needed a lower age limit – we decided to set this at 50.

The second wave of interviews identified the need to include questions on the number of years people had paid into personal pensions and any additional contributions they had made.

Women who relied on their husband’s provision for retirement also presented a problem. We have decided to concentrate on the provision they have made personally, but to include questions to ascertain whether their partner has any pension provision and the role this has played in their own decision about pensions. We have also added a question to ascertain who, in the family, has mainly been responsible for ensuring they have an adequate income in retirement.

4.4 Making choices

This part of the questionnaire begins with a general section, to assess people’s basic knowledge about financial products, their attitudes to risk, how confident they feel about selecting appropriate financial products and the extent to which they trust financial advisers. This section has remained largely unchanged from wave one. The second wave of interviews also included a module of questions on applied financial numeracy, many of which have since been dropped following the testing. As discussed earlier, the remainder have been moved to the end of the questionnaire.

It was decided early in the design that the bulk of this section needed to be tailored to the extent of people’s involvement with the financial services market. For example, it would be inappropriate to ask someone on a very low income about complex investment products or strict Muslims about credit or insurance. At the same time, it became clear that the interview could be

very lengthy indeed for people who held a large number of products and we would need to find some way of restricting the ones that they were asked about.

Most previous surveys have solved this dilemma by asking people either about the product they took out most recently or about any they have taken out in the past 12 months. However, these surveys tended to concentrate on savings and investment products (including pensions and mortgages), whereas the present survey covers products of all kinds. Widening the coverage in this way meant that a high proportion of people would be asked about general insurance policies that were renewed annually. Moreover, we generally wanted to collect some information about each type of product held, as well as asking about purchases in some detail.

In the first two waves of interviews, the range of products held by respondents was assessed and respondents were routed to the sections of the questionnaire for the types of product they actually held, namely:

- Current (including basic) bank accounts (but only if they had no other financial products)
- Credit and store cards
- Loans and other fixed term credit agreements
- Insurance
- Mortgages
- Investments and savings

In each section they were asked a small number of questions about the products they held and rather more about the most recent one they had purchased.

4.4.1 Monitoring products held

It became clear in the first wave of interviews that more searching questions were required about complex products such as investments, mortgages and protection insurance as it was in this area that people on higher incomes would be likely to demonstrate their financial capability – or lack of it. The questionnaire for the second wave of interviews therefore asked people holding these more complex products some more detailed questions: people with interest-only mortgages were asked what provision they had made for repaying the capital. Those with protection insurance were asked whether and how often they assessed the adequacy of cover. People with investments were asked how often they monitored their performance, whether they were likely to produce the return they wanted and, if not, whether they had increased the amount they had invested in the past three years. People who had invested in second properties were asked about their possible liability for Capital Gains Tax.

4.4.2 Choosing products

The early interviews showed that questions on purchases did not work for people who had not played an active role in selecting the product. This included people whose partners had taken a product out in joint names, young people whose parents had opened a savings account for them, people who had been given or inherited investments and people whose employer had provided medical insurance. Consequently, the questionnaire was amended so that, in the second wave, people were only asked about purchases where they personally played a role in the decision-making. No time limit was placed on purchases for the first wave in order to assess the most appropriate one to use. A five year limit was subsequently used.

This was, however, one of the longest and most repetitive sections of the questionnaire and at each wave of interviews ways were sought to reduce its length. So, in the second wave people

were not asked about the purchase of savings products if they had bought an investment. Nor were they asked about the purchase of general insurance if they had bought some form of income or payment protection. Following the second wave of interviews it was decided to make further cuts and ask only about two purchases made in the past five years, and to ask about the most complex products people held. The order of priority used in the questionnaire is:

- 1) Investments
- 2) Mortgages
- 3) Payment or income protection
- 4) Credit cards
- 5) Unsecured credit
- 6) General insurance
- 7) Savings accounts
- 8) Current accounts

For each product taken out recently, people were asked whether they had got any information or advice before selecting it and the source of that information. This will almost certainly form part of the ‘getting help’ domain in the analysis.

They were asked who influenced their choice of product and what features made them choose the particular one they did. They were also asked if they read the terms and conditions carefully before signing the agreement and, if they did not, whether someone else read them on their behalf. Questions were included in both of the first two waves of interviews to assess respondents’ knowledge of key terms and conditions of products they had bought. There was some concern that we would not be able to verify the answers they gave to the questions on terms and conditions. However, the exploratory interviews indicated that people either knew the answer or (in the majority of cases) said they did not know. This was tested further, but the need to cut the length of the questionnaire meant that most of these questions were removed. Those remaining include questions about the interest rate on mortgages, unsecured credit and credit cards; whether, and how long, people would need to wait before claiming on protection insurance, and their assessment of the risk associated with investments (which will be compared with their earlier reply on the level of risk they are prepared to accept).

4.4.3 Managing money

This section also collected information about the amounts owed on credit cards, loans and other credit agreements, and mortgages; the monthly repayments on these borrowing commitments; the amounts saved and invested; and the equity people had in any property they owned. These will be used to assess individuals’ gearing and form part of the ‘managing money’ domain.

4.5 Getting help

Although the focus groups generally discussed information, advice, complaints and redress in the context of money management, planning ahead and choosing financial products, it was decided to create a separate domain that would bring this together. For short-hand this is called ‘getting help’.

In the first wave of interviews this was included as a separate section at the end of the interview which covered:

- Keeping an eye on changes in the economy and the financial services sector: how important this was considered to be, what was monitored and how, and any impact this information had on financial decisions.
- Whether people had ever taken out a product and regretted it.
- What they would do if they made an unsuccessful claim on insurance, whether this had happened and what they did.
- What they would do if they were mis-sold a product, whether this had happened and what they did.
- Who they would contact for advice if their income fell and they got into financial difficulties.

4.5.1 Keeping abreast of changes

The section on keeping an eye on changes in the economy and the financial services sector has remained largely unchanged other than to turn open-ended questions into pre-coded ones. Respondents were asked how important they thought it was for people like them to keep up with financial matters generally, what they monitored personally, how they did this and how often. A question on any impact this information had had on their financial decision-making was dropped as it proved to be too complex for a structured questionnaire.

This sub-section worked reasonably well, and showed that people monitored rather different things depending on their income and circumstances. This has been reflected in the pre-codes in the final questionnaire and needs to be taken into account in the scaling of replies.

4.5.2 Using information and advice

The first wave of interviews showed that some people on higher incomes had relied entirely on financial advisers and had not really made some of the decisions about their finances themselves. The topic guide had not captured this adequately and questions were added to the 'getting help' section of the questionnaire for the second wave of interviews. When tested these were found to be repetitive and needed to be revised alongside questions on advice-seeking in earlier parts of the questionnaire.

The questions used in the first two waves of interviews also failed to capture adequately the continuing relationships some people had with financial advisers, for example where they had an annual meeting which was initiated by the adviser. Nor did the questionnaire as a whole capture adequately people who relied on an adviser to manage their finances for them and played little active role in this.

Subsequently a small number of questions was added to the beginning of the 'making choices' section on more general use of financial advisers, supplemented by further questions on information-seeking and use of financial advisers linked to particular purchases.

4.5.3 Dealing with complaints

In the second wave of interviews, we were also asked to test a new set of questions on how people would deal with an error on a bank or credit card statement. This replaced the earlier questions on unsuccessful insurance claims.

So, the questionnaire for this second wave covered the following areas relating to complaints:

- Whether respondents had ever taken out a product and regretted it.

- What they would do if there was an error on a bank or credit card statement, whether this had happened and what they did.
- What they would do if they were mis-sold a product, whether this had happened and what they did.

These were rather repetitive and the second wave of interviews indicated that they needed further revision and testing. Moreover, while the questions on what people did if they had experienced any of these problems worked, the more hypothetical ones on what they would do *if* they happened (or happened again) did not. Most people said that they would be willing to complain and to take things further if needed, while interviewers were left in some doubt that they would actually have done so.

The questions have, therefore, been revised to cover a wider range of situations that people may have experienced over a longer time period. They now form a single section identifying whether, in the past five years, respondents have:

- Discovered that they have been sold a financial product that is clearly unsuitable for their needs
- Had a dispute with a financial company that involved £50 or more, that could not be resolved with one phone call
- Had a dispute with a shop or supplier about the quality of goods or services costing £50 or more, that they were unable to resolve straightaway
- Experienced an error involving £50 or more on any social security benefits they receive, that could not be resolved with one phone call
- Experienced an error involving £50 or more on any pension they receive, that could not be resolved with one phone call

They are then asked about the first situation on the list they have experienced and how they handled it. This includes questions on whether they complained to the firm, whether they managed to resolve it with the firm and, if not, whether they took the complaint further and who they contacted.

In addition, in the ‘managing money’ section, respondents are asked if they have experienced any financial difficulties in the past five years and, if so, whether and from whom they sought advice.

5. The survey and developing a scoring system

The full national survey to measure levels of financial capability in the UK was conducted between June and September 2005. A total of 5,328 people were interviewed. 4,905 of these were a general population survey (with booster samples in Wales, Scotland and Northern Ireland to allow separate analysis in each of the countries in the UK). In addition there was a booster sample of 423 ethnic minorities. The sampling method used was a random location sample with tight quotas of 8 people at each location.

Interviews lasted on average 44 minutes. But, as expected, there was a wide range of times from a minimum of 15 minutes to 1 hour and 40 minutes. Shorter interviews tended to be with single people with only minimal engagement with financial services. Longer ones with people living with a partner whose financial arrangements were complex. Both the pilots and the main survey showed there was little resistance to the subject of the survey – indeed many respondents said they had found the interview both interesting and illuminating.

5.1 Dealing with missing information

The pilot surveys identified a high level of non-response to questions regarding partner's income and financial commitments. As a consequence, the interviews in the main survey only collected information about the respondent's personal income and any financial commitments they had in their own name or jointly with someone else. They identified the sources of income of partners and the types of commitments partners held in their own name only. An imputation method known as 'hot decking' was used to calculate the sums of money involved. As might be expected, questions about the value of investments elicited a large number of genuine 'don't knows' and people who 'refused'. Here regression analysis was used to impute missing values. Indeed this approach was used wherever 3 per cent or more of respondents had missing values. Below this cut-off we used simple median values in the imputation. All cases with imputed values were also flagged.

5.2 Developing a scoring system

At the time of writing (November 2005), work associated with developing a scoring system is just about to begin. We can, however, set out the broad approach that will be adopted and the range of potential approaches that will be tested.

First, it is clear from the development work that there cannot be an overall scale across the whole questionnaire. When people discussed their self-assessment of their financial capability it was apparent that they did so in terms of the four main domains we have used. So people might think they were quite capable with regard to managing money but less so about choosing products. In view of this it seems appropriate to develop separate scores for each of the four domains.

Secondly, it would be inappropriate to have a 'pass-mark', above which people are considered capable and below which they are not. This survey is not amenable to that sort of precise measurement as it is based on patterns of behaviour not individual questions with right and wrong answers. Moreover, the majority of people will almost certainly be judged to have very similar levels of capability, with only a small number of outliers - in particular at the least capable end of the spectrum. With such a 'flat' distribution of replies the differences between the mass of people who are clustered together are far too small to assess some as capable while others are not.

In determining the most appropriate approaches to test, we have adopted five broad criteria for the scoring system:

- *Reliability* – it should produce accurate output and have internal consistency
- *Validity* – it should measure what it is intended to measure
- *Relevance* – it should relate to the outcome being evaluated, with no bias for different income or ethnic groups
- *Comprehensible* – it should be possible to explain the outcomes to a non-technical audience
- *Longitudinal* – it should be possible to repeat the process in future surveys and compare the outcomes

Turning now to the methods one might use to develop a score, three broad approaches have been used in other circumstances. The first approach would involve assigning a score to each question and adding these up to give an overall score for each respondent, which can be converted to percentages from 0 (worst financial capability) to 100 (best financial capability). This is the approach used in the UK Skills for Life survey of literacy and numeracy. It has the

advantage that it is simple and easily understood, but would be very difficult to apply to a questionnaire where the questions are mainly behavioural and few of them have a ‘correct’ answer. For this reason, we do not anticipate using this approach.

The second approach is more complex and similar to that used for predicting longevity of individuals, or for credit scoring to predict individuals’ likelihood of falling into arrears. It would involve building models using regression analysis of the data to predict key outcomes, such as the ability to live within ones means, which would be used to develop a score measuring the risk of an individual failing to live within their means. This is a tried and tested approach and one where the outcomes are well understood. Moreover it would be able to handle the behavioural questions used in the questionnaire. It would work well for some areas, where it is possible to identify an outcome that can be assessed – for example living within one’s means. It is, however, more difficult to apply to other areas, such as information seeking, where it is difficult to identify a clear outcome that can be measured.

The third approach is similar to that used for the Index of Multiple Deprivation and Health indices. This method, like the other two, is robust and well-tested. It is, however, complex and rather less easy to explain. It is based on factor analysis of the data with the results for each domain transformed to a normal distribution. The scores are then ranked from lowest to highest. At this stage, this approach seems best suited to the types of inter-related questions that are being used to assess financial capability in the survey. Building on this approach, further analysis can be undertaken to combine the assessments of the four separate domains for individuals. In this way it will be possible to build a typology of consumer financial capability that describes individuals’ strengths and weaknesses. This could then be used to inform policy and practice for raising levels of financial capability. At present, this seems likely to be the main approach that will be used.

The full report of the national survey, including the scoring system, is due to be published by the FSA in March 2006.

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Part III.

Related Policy and Regulatory Issues

5. A regulatory perspective on Consumer Financial Capability

Gianni Nicolini

Abstract

The increasing level of complexity of financial products means that there is a need for a higher level of consumer financial capability. A market able to reduce the current gap in information and financial expertise between financial intermediaries and consumers would have the effect of reducing the risk of over-indebtedness, default or bankruptcy). This would also generate more competition between lenders and thus raise the overall efficiency of the market.

This paper analyses the topic from a regulatory perspective based upon the different approaches that the main European countries currently take towards financial literacy. The analysis shows a choice between an 'invasive approach' and an 'information approach'.

The objective of this paper is to evaluate whether or not a regulatory initiative designed to stimulate debtors' perception of their own financial capabilities would be advisable. The proposal for a financial capability index is addressed. In addition, guidelines for selecting the information to be used in the index are discussed.

The financial capability index is meant to help the consumer estimate his/ her financial situation and to evaluate the impact that a (new) load would have on his/her current financial situation. This paper is meant to be a preliminary study, preparing the way for a more elaborate proposal for a financial capability index.

1. Introduction

The development of consumer self-evaluation of their own financial situation is in its infancy. For consumers it is important that the current gap in information and financial expertise between financial intermediaries and themselves is reduced. This could contribute to reducing instances of over-indebtedness and bankruptcy. At the same time, it might make it easier for consumers to compare products and hence increase the level of competition between lenders.

The need to support consumers by providing them with information instruments capable of facilitating the decision-making process thus takes the form of a request for an intervention based on a regulatory approach of fair play. Such a regulatory initiative would be intended to guarantee parity in relations between lenders and debtors through transparency rather than modifying relations between the parties through invasive activity involving sanctions.

The objective of this paper is to evaluate whether or not a regulatory initiative designed to stimulate debtors' awareness of their own financial capabilities is advisable. I propose the development of a financial capability index. This is addressed by a discussion of guidelines to help determine which information could be used in the index. The present discussion is only exploratory. Further research would be needed to address the information should be included in the index as well as the procedures for constructing the index.

2. Financial capability as a problem with many solutions

By analysing the different contributions in the literature, it is possible to summarise the concept of ‘financial capability’ (or financial literacy) as the capacity of the consumer to implement a decision making process given a specific set of information regarding his/her financial situation. Improving financial capability means improving the results of a decision-making process.

The objective of improving financial conduct entails increasing the individual’s capacity to be aware of issues and to work out appropriate actions. This objective is pursued by improving knowledge, skills and confidence. Everything which may help increase these three elements is valued in a positive way.¹ For example, holding training courses and putting in place less traditional solutions.² Although such responses have the potential to improve the financial capabilities of individuals, they are not the only way to improve financial capability.

The key concepts underlying the concept of ‘financial capability’ are know-how and expertise, with both geared towards developing the capacity to understand financial affairs. Improving financial knowledge includes raising consumers’ level of knowledge, but also working on the inputs of the decision-making process (the information) in order to increase its suitability for their use.

The awareness of individuals can certainly be improved with regard to the increasing complexity of financial products. In particular, the information used by individuals in their decision-making process could be simplified in order to make its use more effective.

The topic of financial capability therefore presents itself as a problem with a number of solutions that, rather than being mutually exclusive alternatives, may be put in place simultaneously. This would amplify the effectiveness of each measure. The different solutions are distinguished from each other by the assumptions regarding the financial capabilities of the individuals. When training is used as a tool, it is assumed that there is room for improvement in the individual’s capacity to work out appropriate actions. When efforts focus on the information, on the other hand, the quality of the process of working out appropriate actions is taken as a given, while the quality of the information input is deemed to play a critical role. In the first case, any initiative designed to improve financial capability focuses on the individual and his or her capabilities, while the second approach focuses on the set of information available.

3. The role of legislation: ‘invasive approach’ vs. ‘information approach’

Before taking time to consider the topic of financial capability, it is best to examine the relationship between creditor and borrower. Specific consideration should be given to the status of the weaker contracting party which is in general the borrower. There are two main arguments for this assumption. The first stresses the fact that the borrower’s need to obtain credit is often greater than the lenders need to provide it.

The second is the little amount of information possessed by the borrower when it comes to making decisions.³ This asymmetry of information is often made worse by the borrower’s

¹ For a detailed analysis of the factors influencing the conduct of consumers of financial products and services, see Kempson & al. (2006).

² The reference is to the use of training tools not based on an explicit teaching process, but which draw on alternative learning processes, such as television shows where common financial situations are analysed in order to provide the audience with knowledge based upon indirect experience.

³ Lenders, in carrying out their professional activities, gain skills and have greater information at their disposal regarding the conditions, current and future, of the credit market, for instance.

inability to interpret the information available correctly, a condition that hampers his/her capacity to evaluate the lender's credit offer.

Having taken note of the different inherent conditions of the lender and borrower, it must be determined whether, in order to place the relationship on a more balanced footing, it is necessary to: 1) intervene directly in the transaction with a third party limiting the range of action for the debtors or 2) if there is a form of intervention that would preserve the decision-making autonomy of the borrower.

In the first case, intervention in the lender-borrower relationship would be justified by the acknowledgement that the latter is structurally incapable of dealing on an equal footing with a lender. This means that, in order to improve the role of the weaker contracting party, the borrower would need an 'invasive intervention' geared towards safeguarding the interests of the debtor. The intervention in the financing relationship would take the form of a series of limitations that affect the decision-making freedom of both parties.

By contrast, the second scenario holds that the consumer possesses adequate decision-making capabilities, identifying the different levels of information as the cause of the gap in the relationship between the lender and the borrower. By adjusting the level of information available to the debtor, therefore, the contractual relationship can be returned to a more balanced relationship without restricting the parties' freedom to negotiate.

Should it be deemed impossible for the debtor to deal with the lender on an equal footing, then the state would be called upon to safeguard the interests of the borrower. In contrast, should it be held that the debtor, when adequately informed, is able to deal independently with the lender, then state intervention is not the only option. Nevertheless, the use of legislation to guarantee adequate information remains an advisable course.⁴

Given that, in both cases, legislative intervention is needed to offset the weakness of the debtor, under the first scenario state intervention is structural and inhibitory in nature while the approach taken in the second case is closer to the logic of 'fair-play regulation', meaning that it is based on transparency of information. Thus the judgement as to whether the debtor is capable or incapable of acting in an independent and fully aware manner becomes a crucial point. The consequences of an approach stressing invasive intervention as opposed to one focusing on transparency of information becomes relevant with regard to the topic of financial capability as well.

The definition of financial capability as the capacity to evaluate the consequences of one's own financial decisions ties this concept directly to the capacity to estimate one's own capacity for indebtedness. Viewed from a practical perspective, the level of financial capability can be defined as the degree of precision with which a subject is capable of evaluating its own level of sustainable indebtedness. The latter means the level of debt for which the borrower is still able to pay back the loan(s) without having to resort to extra financing. The invasive approach gives rise to a demand for regulations designed to inhibit any forms of conduct on the part of debtors held to be incompatible with their levels of sustainable indebtedness. The information approach, on the other hand, which is based on the assumption that consumers are capable of making decisions, is designed to improve the level of information. In this scenario, debtors, who draw on an external information support, succeed in independently evaluating the consequences of their financial conduct and in interacting with the lender with a greater degree of freedom.

Looking at the credit market as a whole, the first type of approach holds that the differences between the demand and the supply of credit are fundamental and prevent the establishment of a

⁴ The arguments that lead to the conclusion that a legislative intervention is necessary are presented in the subsequent paragraphs of this paper.

situation of balance. The argument is that this will remain the case unless a corrective intervention is carried out on the basis of legislation introducing remedial measures. In contrast, the second type of approach views the scope of application of any legislation as being limited to considerations of transparency. The market, in and of itself, is considered to be potentially efficient, and, following an adequate corrective intervention in the area of information, is viewed as being able to improve competition and efficiency. In fact, a higher level of information leads to increased competition among the creditors, driving out less efficient ones.

In other words, the topic of financial capability is not focussed on safeguarding the debtor in individual credit relations, but has macro-economic implications regarding the level of efficiency of the market. The proposal for an approach based on a fair-play regulation emphasises how an improved supply of information to consumers allows them to improve their financial capabilities and to arrive at more accurate estimates of their financial capacities. This could reach a point where they are able to foresee situations of potential difficulty (excessive indebtedness, default etc.) and thus select from the credit options on offer in a more precise manner.

While the alternative stances regarding the decision-making autonomy of consumers are fundamental assumptions in any analysis of financial capability, the approach that this paper adopts is the second one. It is the approach geared towards improving the level of information of consumers without compromising their decision-making independence.

4. The current regulatory framework in Europe

An analysis of the regulatory framework currently in force in European countries is of great help in identifying possible areas of intervention regarding financial capability. It is especially worthwhile examining how legislation in Europe (at both the Community and national levels) addresses the issue.

To this end, I conducted an analysis of legislation in the main European countries (Belgium, France, Germany, Ireland, Italy, Holland, Portugal, Spain, Switzerland and the UK), paying particular attention to the legislation on consumer credit. This is an area in which safeguards for the debtor as the weaker party in the credit relationship have already been put in place. Consumer credit is an area in which the legislative intervention of the EU has contributed to placing the different national laws on a uniform footing, guaranteeing a minimum level of homogeneity.

The topic of financial capability is given explicit consideration only under Swiss legislation, while English laws contain measures which, although they do not deal with financial capability per se, pay close attention to the subject of defending consumers. In the other countries considered, the theme of financial capability was found to be dealt with only implicitly, with regard to the obligations of transparency that must be observed by creditors. In other words, the attention paid to the level of information and to the level of consumer understanding of the information is not especially high.

In all the countries examined, the legislation appears to be designed to provide the consumer with an adequate level of information. This is pursued by placing obligations to communicate on the creditor. Particular attention is focussed on the cost of credit. In the case of consumer credit, the European Community directive on the subject⁵ can be credited with having introduced the annual percentage rate of interest (APR) as a simplified cost indicator. As part of an analysis meant to determine the procedures under which the level of information to the

⁵ European Communities (Consumer Credit) Regulations, 2000.

consumer is increased, the APR represents an example of how (by using an information tool) the legislation has made an improvement for the consumer's decision-making capabilities. The strengths of the APR are the standardisation, simplification and comparability it ensures. The APR provides consumers with a measurement that makes possible immediate comparison of different credit offers. In addition to being a standardised information tool, the APR provides consumers with the benefit of information that has been subjected to a process of selection, focussing attention on one of the main decision-making variables - cost.

The attention paid to transparency in the creditor-borrower relationship is not limited to the APR, but takes the form of a series of further procedures that must be fulfilled by the creditor. The assumption underlying the current European regulatory framework appears to be that, by increasing the quantity of information available to the client and standardising the procedures through which this information must be communicated, the consumer is provided with the means to evaluate the characteristics of a credit offer. If the availability of information is an indispensable precondition for making an informed decision, then the question must be raised as to whether it really is sufficient for guaranteeing rational decisions on the part of the consumer. Another related question would be if the focus of attention must be expanded to include not only the quantity of the information supplied but also the modes of information communication.

However, there could be an error in the assumption that an increase in the information available to the client automatically results in an increase in the information possessed by the client. In fact, the information collected by a borrower for decision making tends to change, depending on the nature and importance of the financial product or service being purchased. In the case of higher amounts of credit such as mortgages, the decision-making process of the borrowers might follow non-compensatory rules.⁶ This process demands a large quantity of information. In the case of loans of a smaller amount (i.e. consumer credit), the use of compensatory rules means that the borrower bases his or her decision on a restricted set of information that are considered to be most meaningful. In this second case, the assumption that an increased quantity of information leads to an improvement in the level of information (and thus an increase in the decision-making capability of the debtor) is not an absolute one.

In the case of consumer credit, it is highly likely that the decision-making process follows non-compensatory rules. However, a high quantity of information could be perceived as excessive information with the countermeasure being a process of selection designed to identify the most relevant information concerning a credit offer. A legislative measure that focuses on the quantity of information therefore guarantees *neither* an adequate level of safeguards for the consumer *nor* an increase in the transparency of the system as a whole, thus compromising the levels of efficiency as well.

To return to the legislation, features commonly found at the European level include the need for a clear indication of the price agreed, plus the requirement that the client be presented with a copy of the contract at the moment that it is concluded.

⁶ "Non-compensatory rules" refers to a decision-making process under which a subject tends to analyse every single piece of information available, establishing an especially accurate decision-making process. In contrast, a process follows "compensatory rules" when it includes an initial phase of information selection designed to simplify the decision-making procedure, with the end goal of reducing the time needed for its performance. For a more in-depth consideration of the topic, see M. Caratelli, "Fabbisogni informativi ed intervento pubblico nella trasparenza dei rapporti negoziali tra banca e clienti" [Information needs and public role in the transparency of bank-client relationships], in "Il comportamento degli operatori nei mercati finanziari ed assicurativi – Atti del Convegno" [The behaviour of financial market operators – Workshop papers], Ancona (Italy), 28 October 2005

Although the values described are common to the different legislative acts, there are also specific national measures that provide safeguards for the consumer. Belgian legislation,⁷ in the same way as Italian law, provides the consumer with the possibility of obtaining a copy of the contract even before it is signed. The reason is also to enable the consumer to evaluate the contents in detail, especially with regard to any clauses that could prove disadvantageous to him/her. Another positive side-effect is that it is an explicit reminder for creditors of the need for clarity and correctness in communications with their clientele.

Belgian legislators go even further by preventing the creditor from forwarding a credit application from a consumer which, in the opinion of the creditor, formulated on the basis of the available information, is not or will not be able to honour the obligations stipulated in the contract.⁸ This measure, unmistakably consumer-oriented, is a clear example of the invasive approach.

The intention to safeguard the position of the consumer to such an extent can also be found in Portuguese legislation. In this case, under Law No. 24/1996 (31 July 1996), consumers are assigned the right to training and education as well as the right to information. Although the act makes reference to a general principle, it appears to acknowledge the need to move beyond mere measurement of the quantity of information supplied in line with the principle of shifting attention to the consumer rather than focusing exclusively on the creditors.

Although the underlying intentions are the same, Spanish legislation takes a different approach.⁹ There is a possibility under Spanish law of bringing a class action suit, an option that backs up the role played by consumer associations in protecting consumers. Such associations are able to go to court in the name of their members or in order to defend the public interest.

While the measures referred to are at risk of remaining nothing more than mere principles, English legislation appears to address the need to select the information or at least to recognise that different types of information are of greater or lesser importance.¹⁰ Of particular interest is the measure that requires the use of a differentiated layout in order to draw the attention of the contracting parties to the consequences of signing the contract. The following phrases are examples of warnings meant to alert the debtor:

“Your home may be repossessed if you do not keep up repayments on a mortgage or any other debt secured on it.”

“Think carefully before securing other debts. THINK CAREFULLY BEFORE SECURING OTHER DEBTS AGAINST YOUR HOME.”

“CHECK THAT THIS MORTGAGE WILL MEET YOUR NEEDS IF YOU WANT TO MOVE OR SELL YOUR HOME OR YOU WANT YOUR FAMILY TO INHERIT IT. IF YOU ARE IN ANY DOUBT, SEEK INDEPENDENT ADVICE.”

The regulatory concern in question is part of a legislative framework (the British one) generally constructed around transparency criteria.

⁷ Loi relative au crédit à la consommation du 12 Juin 1991.

⁸ Loi relative au crédit à la consommation du 12 Juin 1991 art. 64 «*L'intermédiaire de crédit ne peut introduire de demande de crédit pour un consommateur si, compte tenu des informations dont il dispose ou devrait disposer, notamment sur base des renseignements visés à l'article 10, il estime que le consommateur ne sera manifestement pas à même de respecter les obligations découlant du contrat de crédit.*».

⁹ Law 26/1984, 19 July 1984 “General para la Defensa de Consumidores y Usuarios”.

¹⁰ The Consumer Credit (Advertisements) Regulations 2004.

English legislation also provides an example of how, by establishing a system designed to guarantee an adequate level of attention to consumers, the level of external intervention by regulatory authorities can be reduced, to the point of implementing the principle of responsibility, under which consumers are obliged to take responsibility for the decisions they make.¹¹

The situations in the other countries of the EU do not present peculiarities deserving particular reflection. French, Italian and German legislation is in line with European Community standards, ensuring transparency but delegating responsibility for interpreting and processing the information to the consumer. In other words, there is no intervention in the decision-making process of the debtor.¹²

The Swiss FLCC (Federal Law on Consumer Credit),¹³ on the other hand, is an example of a highly invasive measure. Art. 28, which contains provisions on the capability of consumers to obtain credit,¹⁴ states that consumers are deemed to possess the financial capacity to enter into a credit relationship if they are able to repay the credit without drawing on the portion of their income meant to satisfy basic needs. The capacity to engage in a credit relationship is evaluated by assuming that the duration of the credit is greater than 36 months even if the contract stipulates a longer duration. If the applicant has already been found in default in the past, then this information must be taken into consideration.

The objective of the law is made explicit in art. 22, which states that “*the evaluation of the consumer’s capacity to enter a credit agreement is aimed at preventing excessive indebtedness a credit agreement could cause*”.¹⁵

An analysis of the articles clearly points to the conclusion that consumers are, regardless of the level of information they possess, subjects whose conduct must be guided. The idea of legally establishing criteria to be used by consumers in evaluating their financial capability is definitely a positive development. However, the fact that this evaluation must be carried out by the creditor denies consumers recognition of their capacity for self-evaluation, and, by asking the lender to safeguard the interests of the party being financed, creates a potential conflict of interest.

5. Legislative intervention: Pros and cons

Given that the topic of consumer financial capability involves the supply of credit in the retail sector, it touches on a finely balanced relationship of noteworthy social relevance. This means

¹¹ Financial Services and Markets Act 2000, art.5 (2-d) “*the general principle that consumers should take responsibility for their decisions*”.

¹² An admirable proposal was made, however, by the Verbraucherzentrale Bundesverband e. V. (vzbv) (Federation of German Consumer Associations), which, in a proposal to the European Parliament for modification of the legislation on consumer credit, holds that a legislative effort should be made to prevent situations of excessive indebtedness: “*The Directive should at least uphold standards set by the previous Directive. It should incorporate consumer protection and the prevention of overindebtedness into its goals [see Article 1], reinsert the minimum harmonisation clause and the article concerning circumvention [see Article 30] applicable to legal constructs achieving the same economic goals as those regulated by the Directive.*” - Verbraucherzentrale Bundesverband e. V. “Reifner Proposal Consumer Credit Directive 2002 – Report”, 2002.

¹³ Federal Law on Consumer Credit (FLCC) of 23 March 2001.

¹⁴ FLCC – art. 28 “Evaluation of the consumer’s capacity to enter a credit agreement”.

¹⁵ FLCC – art.22 “Capacity to enter a credit agreement”.

that the prospect of legislative intervention risks creating situations of imbalance, making an attentive evaluation of the possible consequences necessary.

To supporting legislative intervention, there is, first and foremost, a need to establish a uniform set of rules capable of standardising the evaluation process. The results obtained with the APR in the consumer-credit sector are typical of this. Had nothing more than general principles been indicated rather than specific instructions on the calculation procedures, the effectiveness of the index as an information tool would not have been the same. In the same way, a piece of legislative intervention would result in the definition of uniform criteria, thus guaranteeing, through standardisation, the effectiveness of the result.

Legislative intervention is also justified by the coercive nature of the measure in question. Standards for procedures used to calculate financial capability could also be established without legislative intervention. They could be allowed to develop through the progressive and spontaneous ‘sedimentation’ or ‘stratification’¹⁶ of operating practices, with the legislators providing varying levels of stimulus to move the operators in this direction. On the other hand, the coercive approach has the advantage of shortening the necessary period of time while guiding the process under which financial capability is adopted as information of use in evaluating financing proposals.

Legislative intervention is also advisable in those financial systems where the use of credit is part of a process of change whereby consumption patterns based on an advance accumulation of savings are being replaced with conduct geared towards financing purchase through the activation of financing arrangements, leading to repayment plans of varying length. In such systems, the risk that consumers will learn the correct procedures for the use of credit through negative experiences (excessive indebtedness, default, legal proceedings etc.) is high. Legislative intervention meant to manage the change would make it possible to avoid (or at least reduce) the associated social costs.

But there are also elements that give rise to potential confusion over the future use of the legislative instrument. An initial point which, though it may not be confusing, gives cause for concern all the same, is the possibility that consumers will view the estimate of their own financial capabilities, carried out using parameters and indexes introduced under the legislation, as a type of rating. They may then mistake positive evaluations generated by the indices for a right to financing that they can pressurise financial intermediaries for. In this context, it is of fundamental importance that the criteria set for the measurement of financial capability be clearly distinguishable from the scoring models used to arrive at credit ratings. Legislative intervention that gives rise to erroneous interpretations of the concept of financial capability, linking it to a ‘right to obtain credit’, would run the risk of damaging the fundamental principle of contractual independence as well as the intermediaries’ freedom of choice in terms of the subjects they wish to finance.

We have noted the risk that subjects held to be unreliable by the credit system could demand that they be given credit ‘under the law’. In addition, stipulating the use of financial capability indices might drive those borderline subjects away from official channels of credit who would indeed find intermediaries willing to finance them, but who, in light of a less than positive evaluation of their capacity to make repayments, forgo applying for credit and do business with illegal credit providers. Apart from the importance of constructing an index that cannot be traced to an estimate of credit worth, there is no mistaking the need to implement an information campaign designed to create an underlying culture of interest in the topic of financial capability.

¹⁶ The concept is that an indicator concerning financial capability could be reached by the market itself (without legislative intervention). In this case people understand how to evaluate the financial capability level of a consumer step by step (probably mistake by mistake).

A third element to be taken into consideration is the cost of adjusting to the legislation. Should a cost-benefit analysis indicate that the benefit for the system is not sufficient to cover the costs of the change, then measurement of financial capability would have to be left to the discretion of the more attentive consumers.

6. Guidelines for legislative intervention

The use of legislation to attempt to reduce the differences that inherently keep the relationship between the lender and the borrower from developing on an equal footing gives rise to a number of risks, although, at the same time, it creates a series of opportunities. The writer of this paper believes that the advantages that can be obtained through legislative intervention justify the attendant risks. In particular, it is held that the introduction through legislation of a parameter capable of improving the level of consumer information on financial products can make a concrete contribution to improving the relationship between lenders and the parties financed. This conviction is further reinforced by analysis of European legislation, which points to a fairly heterogeneous framework that does not always represent the optimal situation.

Before drawing up an intervention proposal designed to modify the current regulatory framework, a number of guidelines for the formulation of the change must be identified.

Holding that the gap between the lender and the borrower can be traced primarily to the information gap that penalises the borrower, the ideal legislative intervention on financial capability would be one that remains within the realm of transparency. The contribution of the measure should specifically focus on defining an index of financial capability. This index should be conceived of as an information tool available to the consumer and used by the latter to evaluate his/her financial capacity in a more informed manner. The decision to focus on transparency and to act on the demand side of credit (the consumer) is based on two sets of reasons.

Intervention meant to improve the cognitive capacity of the consumer has the primary advantage of avoiding intervention from outside the credit market, thus favouring competition among the operators. In fact, a better informed consumer is capable of distinguishing between different financing proposals and selecting the one closest to his/her needs. In this way, the decision-making independence of the consumer is protected, while the information tool both allows consumers to deal more effectively with intermediaries and stimulates supply-side competition, given that lenders will be dealing with an average consumer who is better informed and thus better able to tell the more efficient operators from the less efficient ones. Legislative intervention aimed at market transparency also presents the advantage of streamlining the operating procedures for the supply of credit and avoiding regulatory costs that would otherwise be present. These costs would inevitably affect the cost of the financing service as well the efficiency of the market in general.

As has already been noted, in many cases the current regulatory framework regarding transparency already guarantees a large quantity of information. The introduction of a financial capability index would thus be in keeping with the approach followed to date in many European countries. The task of the index would be to select the information and organise it in such a way as to optimise its use by consumers.

The danger in the current regulatory framework is of a potential excess of information not being filtered by the consumer. This may undermine the consumers' level of understanding, thus limiting their decision-making capability.

The decision to intervene on the supply side is supported by the need to avoid potential conflicts of interest. Were the lenders to be assigned the task of disclosing full information to the

consumers, lenders would become stakeholders wearing two hats. While they operate as the main suppliers of information on the supply side, the demand side would also have to rely on them. To remedy this situation, a considerably more elaborate regulatory framework would have to be drawn up. This framework should be able to define in detail the information which the creditors are required to supply and, at the same time, establish a system of controls for and penalties against the creditors to act as incentives encouraging legal behaviour.

However, steps should be taken to avoid an increase in regulation, both by working on the level of transparency of the market and by stipulating prohibitions¹⁷ of various types. It should be noted that, in modifying the legislation, the objectives of consumer protection and market efficiency are not necessarily alternatives. An improvement in consumers' capacity to evaluate their own financial capabilities also leads to higher consumer protection and improved market efficiency.

7. A preliminary approach to a financial capability index

There are three different stages in the construction of a financial capability index. The first is to identify the information to be included in the financial capability index. The next stage is designed to evaluate the procedures used to group together and process the information considered. The last step consists of selecting the ways to communicate the result. There are two alternatives – a monetary index (for example, an amount in euro allocated to the monthly repayment of a loan) and a discrete index (that is an index based on different levels, each of which identifies a greater or lesser financial capacity). The creation of a financial capability index must not be the same as a credit rating.

The idea of using a simplified financial capability index stems from the assumption that information overload, as well as the use of relatively inefficient methods of communication, drastically reduces the information content for the consumer. The use of technical language with frequent references to legislative articles or the use of small print are only some examples of the communication barriers that can emerge in terms of the content of the information. To overcome these barriers, specific skills must be supported, such as learning the technical terms or studying the legislative article cited. An index that includes relevant information and maximises the information content for the consumer would be advantageous. It would remove the obstacles that separate the consumer from the information needed for wise financial decisions.

The purpose of a parametric measurement is to simplify the content and to make it easily understandable to less educated consumers. However in the simplification process carried out to produce the index, a wealth of information is lost. The risk of over-simplification is that it will make the input for a parameter used in a decision-making process insignificant where, in reality, that input is very significant.

In addition to the risk of reducing the quality of the information content, the use of a simplified index also might distort the information content. Consumers that are not capable of evaluating the structure of the model in depth are at risk of erroneously interpreting the index.

In proposing an index which is difficult to understand by those who will be using it, the risk is that the decision-making process will be distorted, leading to decisions that would otherwise not be made. The use of a simplified index to make decisions means choosing not to analyse the information in depth, but rather to place trust in the choices made by the creators of the index. In

¹⁷ By prohibitions is meant the possibility that the legislator has to indicate that some behaviour or contract note is “not legal”. For instance, a contract that does not clearly say that “if you don't pay the bank can sell your house” will be invalid.

proposing an index, there is a risk of replacing the user in the decision-making process, causing them to bear the consequences of the choices implicit in the structure of the index.

The pitfalls in the process of creating a simplified index are not, therefore, reason enough not to present a proposal for a financial capability index. The latter can be understood as the capability to repay loans.

It is now time to turn to the first phase of the construction of the index (analysis of the information considered) by contemplating a number of preliminary considerations that lead to a proposal for an index that estimates financial capability.

In terms of the selection of the information to be included in the index, it should be remembered that the objective of the index is to increase the consumer's perception of his or her repayment capacity. The index must enable the consumer to evaluate how taking out a given loan would affect his or her financial situation. In particular, the index must evaluate the consumer's repayment capacity in terms of a specific offer of credit.

In selecting what information to include and what not to include, it is best to focus on the current financial flows of the consumer given that income elements are more directly tied to the repayment of credit. Extraordinary events such as the sale of real estate or the sale of assets in general are factors that deserve only marginal consideration. Underlying this assumption is the fact that the repayment plan for a loan is usually a periodic repayment of predetermined instalments. If, therefore, taking out a loan leads to recurrent expenditure, the regular income of the consumer represent the immediate benchmark for comparison.

For the evaluation of a consumer's financial capability, it must be possible to identify the financial flows generated by wage and by other periodic revenues (rents for real estate owned, royalties or other sources). The estimation of periodic revenues is the first step in the process of evaluation. After examining the periodic revenues, consideration must be given to the outlays that are also certain to occur and that reduce the amount of the income that can be allocated to the repayment of the debt. This would include expenses related to food, clothing and housing.

With regard to the expenditure to be included in the financial capability index, some doubts may arise. While it is plausible to include expenditure regarding food, clothing and housing, there is a question as to whether other outlays should be considered indispensable. Expenses for transport and communications are examples of cost items which some individuals cannot do without. The greater or lesser willingness of the consumer to modify his or her habits of consumption after taking out a loan is a factor to be taken into consideration in determining the relevant financial flows.

The financial capability index may not, therefore, consist of an exhaustive and detailed list of entries regarding current revenues and outlays. But it must cover the criteria under which the consumer would evaluate (taking into account his or her own preferences and habits) which financial flows to include and which to exclude from the calculation of his or her financial capability. The margin of discretion left to the consumer for identification of the relevant financial flows is consistent with the assumption of the decision-making independence of the consumer.

Identification of the information to be included in the calculation of the index also calls for an evaluation of the potential role of the consumer's assets. The evaluation of the financial capability of an individual should be based primarily on income and on the capacity to have enough income over time to sustain repayment of the debt. However, some consideration should also be given to his or her assets. As a rule, the financial capability of an individual should be considered as adequate if the person can meet the loan commitments without having to take extraordinary steps to ensure the financing of debt. While the sale of the home would certainly

be regarded as an example of an extraordinary operation, it is open to question whether one should exclude securities or real estate not used as the primary residence. If the consumer is willing to include such assets, they should be used in the calculation of the index. This means that a consumer with limited income and major real estate wealth should be evaluated just like somebody with limited funds, if the person is not willing to sell the estate. Likewise, somebody who is willing to sell securities to reimburse their debt should be evaluated just like an individual with high financial capability.

In addition to identifying the information to be included in the evaluation, the stability of the flows evaluated must also be examined. For instance, in terms of income assessment, a worker's wage can be considered over the short term as being almost certain.

If the income of the consumer varies over time (e.g. in the case of a commission-based wage), then the current wage level cannot be considered a reliable forecast of its future level. In this case, the evaluation of financial capability must take into account the range of possible future wage levels and their respective probabilities.

The question that must be addressed in establishing a financial capability index is whether or not the index needs to consider the fact that certain income flows cannot be precisely predetermined because they are unstable.

One further point is if there are any guarantees capable of expanding the credit capacity of the consumer. There are two reasons for excluding guarantees. These are that the purpose of such an index is that it is different from a credit rating and that the assumption that financial capability should estimate the 'individual' financial capacity of the consumer.

In addition to the analysis of the nature of the flows being evaluated, the establishment of the indicator also requires that a timeframe be set. This is necessary to identify the (future) financial flows being evaluated. In general, the financial capability to be evaluated should encompass the duration of the whole credit agreement timeframe.

The estimation of an individual's financial capability is not an absolute but an estimate of sustainability that depends on the duration and the commitments laid down in a credit contract. The evaluation of a subject's financial capability will thus be higher or lower depending on the consequences that the specific loan could have on his/her overall financial situation.

Once the criteria for the selection of the (financial) information have been identified, the income amounts have been identified and a timeframe has been set, it would then be possible to consider the procedures for pooling this information. By comparing financial capability with the commitments implicit in the repayment of the loan, it will thus be possible to express a judgment on the sustainability of the debt. A detailed analysis of the factors to be considered as well as the calculation method of the index, however, must be subject to further scrutiny.

8. Conclusions

Starting from possible approaches to the topic of consumer financial capability, we have analysed the current regulatory framework to evaluate the advisability of legislative intervention in the borrower-lender relationship. The analysis demonstrated that legislative intervention would mean using information tools such as the financial capability index. This would represent an opportunity both to increase the protection of the consumer and improve the performance of the credit market. Backing this position is the assumption that legislation capable of improving the level of information possessed by consumers would make it possible, on the demand side of credit, to avoid 'out-of-control' situations such as over-indebtedness. At the same time, in a market where the debtors are able to evaluate different offers of credit, the level of competition on the supply side would also rise, leading to increased efficiency of the market as a whole.

In constructing a financial capability index, however, care must be taken to avoid the risk of the index being interpreted as a credit rating. Unlike a credit rating, the financial capability index should not abstractly evaluate the capacity of the borrower to repay the capital and the interest. Instead, the index should evaluate the borrower's capacity to meet his or her commitments without having to resort to extraordinary operations. The role of guarantees as well as the question of the borrower's assets are considered to be of secondary importance, while the periodic financial flows (current income and outlays) play a leading role in the estimation of financial capability. The financial capability index is therefore meant to help consumers to estimate their financial situation, and specifically to evaluate the impact that a (new) loan would have on their situation.

This paper is only a preliminary work. There is a need for further research on financial capability. Having evaluated the consequences of an approach based on a simplified index and having identified the guidelines to be followed in establishing such an index, further research must tackle the selection and pooling of the information.

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6. Evaluation of the consumer's financial capacity

Didier Noël

1. Introduction

Financial capability presupposes that the consumer is informed and educated to make optimal decisions that guarantee a sustainable financial household budget in the long run. However, it does not relieve creditors from the task of assessing the consumer's creditworthiness and repayment capability. In the past, different countries have introduced regulations on the assessment of creditworthiness and only recently the principle of 'responsible lending' was introduced at the European level. Under this doctrine, the lender is obliged to only grant credit to consumers that are objectively deemed to be able to repay their loans.

This paper focuses on the legal aspects of the assessment of a consumer's creditworthiness with regard to credit applications. I will refer first of all to the recent work of the European Commission and the European Parliament on the subject and then describe possible assessment criteria established in national law or case law in the various member states of the European Economic Area. In different examples I discuss how the regulator may or may not define criteria for judging creditworthiness.

The topic of assessing creditworthiness is important because it complements the discussion on financial capability. It underlines the point that it should not only be consumers who judge their repayment capability but that creditors also have a responsibility and the obligation to judge the consumer's capability.

2. The European approach to assessing consumer financial capability

2.1 *The first proposed reform of the Directive on Consumer Credit*¹

For some time, the European Commission's ambition has been to harmonise national laws on consumer credit. This was one of the main intentions behind the proposal for a directive intended to replace directive "87/102/EEC for the Approximation of the Laws, Regulations and Administrative Provisions of the Member States concerning Consumer Credit".²

The European Commission had noted that the aforementioned directive was no longer appropriate given the development of new forms of credit and that, as the directive in question laid down only minimal standards, the relevant national legal systems had developed in very different ways, which implied competitive distortions between creditors established in different member states and was an obstacle to the creation of a common market in the area of credit and growth in cross-border credit.³

¹ COM (2002) 443 final, 2002/0222 (COD), O.J., n° C 331 E, 31 December 2002, p. 200 to 248 ; <http://www.europa.eu/eur-lex>.

² O.J.E.C., No. L 42, 12 February 1987, p. 48. It was amended by directive 90/88/EEC of the Council of 22 February 1990 (O.J.E.C., No. L 61, 10 March 1990, p. 14 to 18) itself amended by directive 98/7/EEC of the European Parliament and of the Council of 16 February 1998 (O.J.E.C., No. L 101, 1st April 1998, p. 17 to 23).

³ Article 30.1, p. 58; explanatory memorandum, p. 1-8, 28. According to the explanatory memorandum, the Member States had not simply restricted themselves to transposing directive 87/102/EEC because they considered that the level of consumer protection it provided as insufficient.

With its proposal for a directive, the European Commission intended to introduce into the European legal framework the principle of ‘responsible lending’, worded as follows:

“Where the creditor concludes a credit agreement or surety agreement or increases the total amount of credit or the amount guaranteed, he is assumed to have previously assessed, by any means at his disposal, whether the consumer and, where appropriate, the guarantor can reasonably be expected to discharge their obligations under the agreement.”⁴

The explanatory memorandum specified that it was an obligation for the creditor and that any infringement of that obligation, if proved, could result in the creditor being held legally liable for lending to a consumer who is not able to repay debt.⁵ The aim was to avoid the creditworthiness of borrowers being undermined, to their detriment and that of their current or future contracting parties. The explanatory memorandum also indicated that this obligation would be achieved “(...) in particular by consulting centralised databases and examining the replies provided by the consumer or the guarantor, to request the provision of sureties, to check the data supplied by credit intermediaries and to select the type of credit to be offered”. Member states were invited to make clear “the link between the conclusion of the credit agreement and the preliminary assessment”. At the same time they retained their competence to determine the penalty applicable for creditors failing to comply with their obligations provided that such a penalty was effective, proportionate and constituted a deterrent. It could, for example, include a loss of interest and/or penalties and the reimbursement of costs – the consumer would still benefit from the agreed capital repayment terms. In extreme cases it could also lead to the withdrawal of their credit authorisation or licence.⁶

The creditor’s duty to assess the borrower’s creditworthiness was intrinsically linked to a series of other preliminary measures intended, prior to granting loans and putting in place guarantees, to provide the creditor with full and reliable information on the borrower’s financial situation. For instance, the lender had to consult a central databank, possibly in the form of a network of databases, in which late payment by borrowers or guarantors would be recorded. These credit reporting agencies (as well as public credit registries) exist across European countries and are already used by creditors for the purpose of estimating credit risk.

The member states had to ensure that such a privately or publicly operated central database was put in place and could record, if applicable, all consumer commitments relating to credit, irrespective of whether payment defaults had been noted. In such a case, each creditor would have access to an even more reliable instrument for checking whether a consumer or a guarantor had concluded other credit or surety agreements that had not been the subject of litigation but where the associated total financial burden would rule out any further credit being made available to the consumer. This, of course, only works if the databases are complete in terms of information and cover all the current credit taken out by each consumer.

Free access to the central databases of the member states was guaranteed to creditors in other member states on conditions that had to be satisfied by creditors in the member state where the database was operated. In addition, to avoid any abuses, it was stipulated that:

⁴ Article 9, p. 41; explanatory memorandum, p. 16.

⁵ Which implies that, if it is not respected by the creditor, it is the borrower’s responsibility to prove that. However, the same proposal for a directive stipulates that “Any term in an agreement which provides that the burden of proof in respect of compliance by the creditor and, where applicable, the credit intermediary with all or part of the obligations incumbent on them pursuant to this directive should lie with the consumer and, where applicable, the guarantor, shall be an unfair term within the meaning of Directive 93/13/EEC.”

⁶ Article 31, p. 58; preamble n° 29, p. 35; explanatory memorandum, p. 29.

- Lenders could only consult the database on a case-by-case basis
- The data released by the database could be used only for assessing the risk of the non-performance of the credit or surety agreement and any marketing or sales application was prohibited⁷
- Credit applicants and guarantors could request the lender to inform them of the results of the consultations of the latter so that, if applicable, they could exercise their right to have any erroneous or out-of-date data corrected or deleted⁸
- After the credit had been granted or refused, the lender must destroy the data communicated to it, while being authorised to keep a record of the consultations and, if necessary, make it available, if he/she was subsequently accused of having been irresponsible in granting the credit⁹

The creditor and, if applicable, the credit intermediary, could only ask the credit applicant or guarantor to provide information that is appropriate, relevant and does not exceed that which is required to assess their financial situations and their ability to repay the credit.¹⁰ The credit applicant and the guarantor were required to provide complete answers, meaning to answer the questions honestly.¹¹ The creditor (or the credit intermediary) had a general duty to provide advice, that is to say to select among the products which they usually offer the most appropriate type and total amount of credit taking into account the borrower's financial situation and ability to make repayment.¹² While performing this duty of advice, the creditor (or the credit intermediary) also had to take into account the purpose for which the credit was being sought or used and the advantages and drawbacks of the products proposed by them. This entailed in particular the existence of planned recurrent repayments and the scope for withdrawing amounts of credit.

Credit intermediaries, on the other hand, had to inform each of the credit institutions that they had contacted of the credit applications that they had submitted to other credit institutions or credit offers that they had obtained from the latter in favour of the same consumer during the two months preceding the conclusion of the credit agreement. The aim was to avoid an amount of credit which no financial institution would have granted (with regard to the borrower's financial situation) being split into several applications, each for an "acceptable" amount, being submitted at the same time to several credit institutions, thereby misleading them and circumventing their credit monitoring procedures.¹³

⁷ Article 7 and 8.3, p.14; explanatory memorandum p. 14. This obligation also applied to debt recovery agencies and credit insurers with regard to data collected during the management of the credit or surety agreement.

⁸ Article 8.1, indent 3, p. 40; explanatory memorandum, p. 15.

⁹ Article 8, p. 40; explanatory memorandum, p. 15.

¹⁰ Article 6.1, indent 1, p. 38; explanatory memorandum, p. 13.

¹¹ Article 6.1, indent 2, p. 38; explanatory memorandum, p. 13.

¹² Article 6.3, p. 39; preamble n° 15, p. 33; explanatory memorandum, p. 14.

¹³ Article 29, b), p. 57; explanatory memorandum, p. 27.

2.2 The Economic and Social Committee¹⁴ and European Parliament positions

In 2003, the European Economic and Social Committee reacted positively to the proposal to introduce standards with regard to checks on the financial situation of consumers into European legislation on consumer credit. This drew attention to the need to define, among other things, the reversal of the burden of proof and penalties in the event of non-compliance with the obligations laid down in the proposed directive, rather than leaving the member states free to resolve these questions.

The European Economic and Social Committee also wanted greater account to be taken of existing European legislation and, simultaneously, wanted standard rules to be drawn up for operating the central database and for consumer protection with regard to the data recorded in it, together with penalties in the event of non-compliance with such rules.

The committee feared that national laws would continue to differ fundamentally, which was what the proposed directive sought to remedy. It noted that certain consumer protection formulas set out in the proposal offered less protection than already provided in some member states. In addition the adoption of the proposal aimed at maximum harmonisation did not opt for the highest possible level of consumer protection. A side effect would be that it would lead to less consumer guarantees. Consequently, it recommended that in certain aspects the ‘minimal clause’ should be maintained, that is to say that in some areas the member states could still adopt stricter standards than those set out in the proposal.

The European Parliament also opted for that approach (under the banner of “optimal harmonisation” instead of “total harmonisation”) when it adopted its position on 20 April 2004. While not calling into question the principle of responsible lending, the European Parliament has nevertheless modified it fundamentally. It differed in relation to the proposal drawn up by the European Commission.

Firstly, creditors and, if applicable, credit intermediaries, are obliged to check only the creditworthiness of the credit applicant and not the ability of the credit applicant and any guarantor to satisfy their contractual obligations. The necessary checks no longer have to be made by all means available to the creditors. This check did not have to be made from the information provided by a central database that they should consult and data that they should collect from the credit applicant and, if applicable, the guarantor. It only had to be made on the basis of the information provided (spontaneously?) by the credit applicant and, possibly, by consulting a database.

Secondly, member states are no longer obliged to ensure the existence of a credit registry. The member states still have an obligation to ensure that borrowers from other member states can access the databases located on their territories but this obligation now concerns only cross-border credit. There is no express obligation for credit intermediaries to avoid a loan application being spread over several applications submitted simultaneously to different creditors, but member states are required to ensure that the “(...) the provisions that they adopt in implementation of this directive cannot be circumvented as a result of the way in which agreements are formulated (...)” and that “spreading the amount of credit over several credit contracts” is mentioned as one of these specific ways. The position does not mention the penalties that should, if applicable, accompany any failure by the creditors and, if applicable, credit intermediaries, to fulfil their obligations.

¹⁴ EESC, 2003/918, O.J., n° C 234, 30 September 2003, p. 1 to 10; <http://www.esc.eu.int>.

On the other hand, where a ‘revolving credit’ is concerned, the European Parliament maintains the obligation for the creditor to update the information it has about the borrower’s creditworthiness before any amendment is made to the terms of the credit agreement. In addition, it leaves in place the general duty of advice, based in particular on the analysis of the loan applicant’s financial situation, as it was drafted by the European Commission.

2.3 The amended Consumer Credit Directive reform proposals

Having published a first amended proposal on 28 October 2004, the European Commission published a second amended proposal on 7 October 2005.¹⁵ In the latest proposal, the Commission maintains its objective of achieving maximum harmonisation, but points out that “(...) only those elements explicitly dealt with in the text are fully harmonised”. This prohibits the member states from introducing or maintaining provisions other than those provided for in the directive in the areas that it regulates. However, other aspects that are not regulated in the directive are left to the member states, while setting a principle of mutual recognition in certain areas covered by the directive.¹⁶ The Commission specifies in the preamble of its amended proposal that the principle of mutual recognition implies that “(...) the rules of the law of the member state in which the consumer has his habitual residence are set aside if its application to a given situation constitutes a restriction of the free circulation of services (...)”. In the explanatory memorandum, it considers that either the law is chosen by the contracting parties or that, in the absence of this choice, the requirements of the creditor’s home country law continue to apply. It justifies the application of this principle with the fact that in some harmonised areas, national implementing rules could still differ and make it more burdensome for creditors to provide their services across borders. In those cases the creditors should not have to comply with rules that go beyond those of the Member State where they are established.

The Commission has integrated the principle of “responsible lending” and the reworded text of the European Parliament.¹⁷ It states that “(...) against the background of broad consultation of the banking sector, the Commission does not perceive that this gives rise to any additional costs for banks as it corresponds to good banking practice (...)” but adds that, “(...) in response to a request from the banking sector and some member states, it was clarified that the consumer is always responsible for his final decision to conclude a credit agreement (...)” and that “he should also act with prudence”.¹⁸

In addition, in accordance with the principle of mutual recognition, member states are required to not restrict the activities of creditors established in another member state (and who operate within their territory). The application of this principle is nevertheless complicated since the member states may take “(...) necessary and proportionate measures on grounds of public policy (...)”.¹⁹

As the European Parliament had suggested, the Commission no longer demands the creation of a central database in each member state. Instead, in the case of cross-border credit, creditors may access, on non-discriminatory terms, private and public databases relating to consumers of a member state different from the one where the creditors are established.²⁰ It also makes it

¹⁵ COM (2004) 747 final, 2002/0222 (COD), O.J., n° C 50/10, 26 February 2005, n° C 86/11, 8 April 2005; COM (2005) 483 final, 2002/0222 (COD), <http://europa.eu.int/eur-lex>.

¹⁶ Article 21.1 and 2, p. 51; preamble n° 9, p. 12.

¹⁷ Article 5.1, indent 1, p. 26; explanatory memorandum, p. 6.

¹⁸ Explanatory memorandum, n° 5.4., p. 6; preamble n° 19, p. 15.

¹⁹ Article 21.2, p. 51.

²⁰ Article 8, p. 31; preamble n° 21, p. 15; explanatory memorandum, n° 5.6., p. 7.

compulsory for creditors to update credit information that they store with regard to the borrower where the credit agreement allows the creditor to change the total amount of credit after the date of conclusion of the credit agreement. In addition, the Commission supported the practice of assessing the consumer's creditworthiness before any significant increases in the total amount of credit are granted.²¹

However, contrary to the European Parliament's decision, it changed the nature of the concept of duty of advice. It is an in-depth (and if applicable) personalised duty of information taking account of the complexity of the products that are proposed to the would-be borrower and intended to enable him to assess the advantages and drawbacks of the products and decide which of them is the most appropriate in the light of his/her needs and financial situation.

The member states can determine the arrangements for granting credit and the scope of this assistance as well as the person who will provide it, depending on the specific context of the credit offer.²² The Commission makes it compulsory for member states to lay down rules on penalties applicable in the case of infringement of the national provisions adopted pursuant to the directive and to implement them. Such penalties must be effective, proportionate and dissuasive.²³

3. Criteria defined by the national legislator

It is rare for criteria for the determination of a consumer's financial capacity to borrow to be set out in positive standards. An example can be found in Articles 28 to 30 of the Swiss federal law of 23 March 2001 on consumer credit²⁴. In accordance with these provisions, the consumer is deemed to have the capacity to take out a loan when the repayment terms are *lower than the portion of his income which is subject for attachment*, or where property leasing is concerned, when the financial assets belonging to the consumer guarantee the repayment of the instalments. The 'portion of income which is subject for attachment' is determined in accordance with the standards in force at the consumer's domicile and those used to calculate the minimum required for living and, in all cases, takes account of the various rental and taxation charges (communicated by the consumer) and financial commitments (recorded in the Swiss central register of loans which the lender must consult).^{25 26}

As some academics have pointed out, due diligence can only be judged by a court if it has a precise content²⁷ and there should be flexibility to avoid situations whereby some consumers are

²¹ Article 5.1, indent 2, p. 26.

²² Article 5.5, p. 28; preamble n° 19, p. 15; explanatory memorandum, n° 5.4, p. 6.

²³ Article 22, p. 52; preamble n° 33, p. 18.

²⁴ <http://admin.ch>, RS 221.214.1. It was completed by a decree of 6 November 2002 (RS 221.214.11).

²⁵ It is called the "Consumer Credit Information Centre" and is a federal body created by lenders. It records both loans granted (positive database) and payment defaults (negative database).

²⁶ In the event of a loan that can be drawn using a card, whether or not it is linked to an account or by way of an overdraft, the borrower's financial capacity should be re-assessed when the lender has information that the consumer's financial situation has deteriorated.

²⁷ B. STAUDER, « La consécration légale d'un devoir de diligence du donneur de crédit – réflexions à partir du droit suisse actuel et en préparation », in « La responsabilité du donneur de crédit aux particuliers », The Observatory on Credit and Debt, Charleroi, 1996, p. 61. Professor STAUDER emphasised that the canton of Neuchâtel had already adopted in law the proportion of the consumer's income which is subject for attachment as the measure of the consumer's borrowing capacity, while the canton of Berne had fixed the maximum amount that could be borrowed at three gross salaries. Moreover, the laws of the two cantons prohibited lenders from renewing or granting a loan while a previously

refused a loan even though there is no danger of over-indebtedness in their specific situation. On the other hand, a judge checking that these practices were applied would be led to intervene in a field that should be protected from this, i.e. each lender's definition of its commercial policy.

Swiss federal legislation also stipulates that the ability to borrow must be assessed on the basis that the amount borrowed should be repaid in 36 months even if the loan contract provides for a longer repayment period. It is also important to take into account sums that are not repaid in the context of loans that have already been granted.

The implementation of a quantitative criterion in the exercise of due diligence actually creates the risk of leading the consumer to opt for a loan with a longer repayment period so that the instalments would match the budget that the consumer can afford. But it is exactly this long repayment period that might cause over-indebtedness, "notably because the risk exists that unforeseen events likely to disturb the household will be correspondingly more frequent the longer the period subject to repayment commitments".²⁸

If the lender does not fulfil measures to assess the borrower's capacity to take out a loan, it is severely penalised. In the event of minor negligence, the lender loses the right to claim the payment of interest and expenses, which means the borrower can continue to repay the borrowed amount according to the agreed instalments. However, in the event of gross negligence, the lender also loses the amount borrowed to the consumer and will have to repay the amounts that it has already received from the consumer.²⁹

4. Criteria not defined by the national legislator

In French law and in Belgian common law, it was the citing of the lender's responsibility that evoked the evaluation of the borrower's financial capacity in jurisprudence. This first occurred in the context of financing professional activities and the lender's responsibility to the curator in the event of the borrower's insolvency. It then also arose in the context of financing consumption and the lender's responsibility to the consumer.

The principle of lender responsibility for having granted a loan negligently was raised in France in the 1960s in view of the growing corporate demand for capital, increased technical skills required by the credit business and in parallel, increasingly greater demands from the public. It was claimed that as result of imprudently granted loans, a company that is in reality not viable could be sustained (on credit) and cause loss to creditors who are deceived by the artificial prosperity of that company.³⁰

This was all the more the case insofar as, in French and Belgian law,³¹ a fault (whose existence is the first of the conditions for which responsibility can be shown) is not solely restricted to a violation of a legal or regulatory standard. It also entails a slight intentional or non-intentional deviation from behaviour normally exhibited by a prudent person placed in the same

contracted loan had not been repaid. The author denounced this situation which impeded the activity of lenders within a "single Swiss market" and did not ensure the market transparency needed by consumers.

²⁸ B. STAUDER, *op. cit.*, p. 67.

²⁹ Article 32 of this law. B. STAUDER, "Réforme du droit relatif au crédit à la consommation – projet de loi fédérale", R.E.D.C., 1999/3, p. 315 and 316.

³⁰ C. GAVALDA and J. STOUFFLET, "Droit de la banque", Collection Thémis, P.U.F., Paris, 1975, p. 584.

³¹ Articles 1382 and 1383 of the French and Belgian Civil Codes.

circumstances and with the same capacity³². With regard to the lender, the degree of prudence and vigilance expected is high considering the greater technical skills that its business requires.

In France, a justification for these requirements was sometimes sought in the nature of the public service involved in the lender's business.³³ This thesis never held sway in Belgium, even if some jurisprudence decisions observed that bankers had a special responsibility that put them under an obligation to act in a prudent and professional way. Based upon this, they must take account of the repercussions of their behaviour on their customers, depositors and third parties, including their customers' creditors.³⁴

The lender's responsibility emerged in connection with questions of finance provided for its client's illegal activities³⁵ and or not having acquired minimum information relating to it at the start of their relationship and later if worrying signs appeared. But, apart from financing an illegal activity, the lender was also judged as responsible for the borrower's insolvency if the granting or maintenance of loans allowed the borrower to continue its activities while having stopped making repayments. This was especially the case if the lender knew the state of affairs or would have been aware of it if it had not neglected to obtain information on its customer's profitability and/or accounting situation.³⁶ The same applies if the borrower had been able to supply the lender with sufficient guarantees.

³² It is not necessary, as in other laws, to demonstrate that the standard infringed (legal or behavioural) was introduced to protect the victim of the infringement or that the victim has suffered a prejudice in a specific subjective law (theory of relative unlawfulness).

³³ This thesis can lead to other conclusions: "required to take more risks in the general interest, they should be treated with greater indulgence if they have badly assessed the risks" (J. STOUFFLET, French report, in "La responsabilité extra-contractuelle du donneur de crédit en droit comparé", FEDUCI, Brussels, 1984, p. 25.

³⁴ P. VAN OMMESLAGHE, Belgian report, in "La responsabilité extra-contractuelle du donneur de crédit en droit comparé", FEDUCI, p. 36.

³⁵ For example, when the borrower has issued "accommodation" cheques, even if the lender (banker) is not a party to these operations by the borrower.

³⁶ Which would have inevitably led to the deduction that the borrower was desperate or that such a result was certain and unavoidable. By the way of examples of French case-law Cass, 23 February 1982, Bull. Civ., 1982, IV, n° 67; more recently:

-Cass. (civ.), 8 June 1994, RTD com., 1995, p. 170 : the Court has rejected an appeal by the lender which had been held liable for having acting with "culpable neglect" in granting a business loan to a farmer to finance the purchase of a new tractor, because the annual interest on the loan exceeded the farming income of the borrower : "the borrower's responsibility for the investment does not exclude the bank's duty to check, if not the profitability of the borrower, but at least his ability to repay the loan, which duty is all the more relevant for the credit institution ... because it is its own interest" ; the lender was ordered to pay to the borrower part of the capital loss incurred in the resale of the tractor. "This duty has been established by the legislator in another area, that of civil redress; when he invites the courts to "check that the loan was granted with the seriousness required by banking practise" (L. of 31 December 1989, art. 12, indent 5), this clearly refers among other things to the borrowers capacity to repay the loan".

- Cass. (civ.), 2 July 1987, Les Petites Affiches, 1997, n° 120, p. 9, note de D.R. MARTIN : a loan had been granted to borrowers already in debt and in default – which the lender knew – in order to finance the purchase of flat on a co-ownership basis ; the flat had been sold and the proceeds of the sale had been totally absorbed by the repayment of the loan ; the property manager, whose charges had not been paid, invoked the lender's liability for having been at fault in making the loan ; the Court considered that there had been a direct causal connection between the granting of the loan and the default in the payment of the co-ownership charges. The annotator emphasises that the lender is at fault "when the amount lent results in repayment costs, by way of principal and related amounts, that are reasonably incompatible, from the

But this responsibility was not absolute. It was often mitigated by the fact that account was taken of:

- The principle whereby the borrower was the main party responsible for poor financial management
- The principle whereby the lender could not become mixed up in managing its customer's business³⁷
- The fact that granting a loan always implies a risk and if a lender were not to take any risk it would never grant a loan³⁸
- The fact of refusing to grant or to maintain the loan could in certain cases prevent the re-establishment of companies justified by general interest and which the public authorities encourage³⁹
- The marginal appreciation to which the judge must confine himself and which prohibits him from retroactively substituting his own view of the commercial policy that the lender should have followed

This means that only gross negligence relating to information and verification (determining factors) could be considered as a fault by the lender.

Recognition of possible lender responsibility by the borrower itself in the context of a loan granted for private purposes (not professional ones) has evolved in the same way in French and Belgian jurisprudences.⁴⁰

In Belgium, the following conditions for the lender's responsibility were considered: 1) proof of a mistake by the lender; 2) loss suffered by the borrower; and 3) causal link between both. The first doctrine considered that the third of these conditions (the link of causality between the fault and loss) could never be verified.⁴¹ It then adopted the view that this causality link was broken

outset, with the borrower's existing and foreseeable financial resources". The lender was ordered to pay the co-ownership charges.

See also Cass. (com.), 18 February 1997, JCP, 1997, ed. E, p. 944, note LEGEAIS; Cass. (com.), 7 October 1997, RTD com., 1998, p. 188.

³⁷ By way of an example of Belgian case-law: Comm. Ghent, 10 February 1987, R.D.C., 1989, p. 84; Mons, 20 September 1999, J.L.M.B., 2000, p. 1688: "it is not the banker's role to supervise the customer"; Mons, 7 March 1994, J.L.M.B., 1996, p. 1201.

³⁸ By way of an example of Belgian case-law : Brussels, 27 June 1997 (G.R. n° 1992/3421), quoted by D. BLOMMAERT, "Aansprakelijkheid van de bank en de bemiddelaar bij de kredietverlening herbezocht", in *Liber Amicorum Yvette MERCHERS*, p. 359, note 31, and 360, note 34.

³⁹ Brussels, 28 September 1989, R.D.C., 1990, p. 1054; Liège, 28 April 1994, R.D.C., 1995, p. 1032: the Court of Appeal did not hold the lender liable with regard to the borrower for having wrongly assessed the viability of the borrower as a business, considering that the risk that it had taken was not unreasonable.

⁴⁰ On the other hand, in the Netherlands, case-law on the basis of common law has systematically taken a strong position against the lender's liability being invoked with regard to borrowers on the grounds of the absolute principles of freedom to contract and the balance between the positions of the two parties. See D. BLOMMAERT, *op. cit.*, p. 358 and 359, citing J.M. BARENDRECHT and E.J. VAN DEN AKKER, "Aansprakelijkheid van de bank wegens het schenden van een informatieplicht", in *Bancaire aansprakelijkheid*, Schoordijk Instituut, 1996, p. 45 and following ; S.O.H. BAKKERUS, *Bancaire aansprakelijkheid*, Tjeenk Willink, 2000, p. 61 and 68 and M. PH. VAN SINT TRUIDEN, "Bancaire aansprakelijkheid bij kredietverlening", in *Bancaire aansprakelijkheid*, Schoordijk Instituut, 1996, p. 21.

⁴¹ A. ZENNER and L.M. HENRION, "La responsabilité du banquier dispensateur de crédit en droit belge", *J.T.*, 1984, n° 10, p. 472.

by the consent given by the borrower at the time the loan was granted and that this consent also entailed it agreeing that the lender would be relieved of all responsibility and that possible loss suffered by the borrower would not be remedied.⁴²

Another reason is that in contrast to a loan for professional purposes, the situation of the borrower in the context of a loan for private purposes is often less complex. The degree of the lender's responsibility is thus assessed with less severity.

In France, the jurisprudence of the Court of Cassation has developed as follows. In its ruling of 27 June 1995, it confirmed that responsibility had been acknowledged for granting a consumer a loan whose charges were excessive relative to the consumer's income (they represented 30% of the person's monthly income): "(...) while the preliminary offer (of credit) is such that it informs the borrower sufficiently, it does not protect him from the vertigo of deferred payment purchasing. It therefore cannot form a substitute for the general duty borne by the banker, whatever the purpose of the lending, of ensuring a reasonable possibility of repayment".⁴³

Thus, while the responsibility borne by the consumer arising from the loan contract does not disappear, the lender cannot remain passive. His responsibility may arise not only when the lender induces the consumer to take out a loan with an unbearable burden without ascertaining his financial capacity (the lender is obliged to make inquiries and to obtain the relevant information)⁴⁴ and secondly when the lender does not warn an inexperienced consumer who is facing ruin. If the warnings are ineffective and the lender does not refuse the requested loans (the lender is obliged to provide advice), the same situation would arise.⁴⁵

In Belgium, jurisprudence no longer systematically dismisses the lender's pre-contractual responsibility relating to the borrower, but cases of enforcing responsibility of this type are rare.⁴⁶ A 26 September 1994 ruling by the Mons Court of Appeal can be cited. The lender had endorsed the obviously excessively high valuation of the borrowers' building issued by the architect, who had been appointed by the lender (this building was to act as a mortgage surety

⁴² L. CORNELIS, "De aansprakelijkheid van de bankier bij kredietverlening", T.P.R., 1986, n° 16, p. 366, who cites M. KRUIHOF, "De betekenis van het cassatiearrest van 9 maart 1984 in de discussie omtrent de doorbraak van causaal verband door eigen juridische oorzaak", R.W., 1983-84, p. 2807, and M. VANQUICKENBORNE, "Oorzakelijk verband en vergoedbare schade", note under Cass., 15 March 1985, R.W., 1984-85, p. 2619. The author evokes case-law of the Court of Cassation and emphasises that the provisions of the Civil Code related to liability are not public order provisions.

For an example of concurring Belgian case-law: Com. Hasselt, 15 December 1998, R.D.C., 1999, p. 721.

See also B. DEMONTY, "Derniers développements en matière de responsabilité du banquier et actualité législative en matière bancaire et cambiaire", in "Droits bancaire, cambiaire et financier", edition Formation Permanente CUP, Liège, May 1998, volume XXIV, p. 81 : the author notes that the exemption from liability granted by the borrower to the lender is valid only on condition that the borrower has been correctly informed beforehand by the said lender of the risks of the loan with regard to his financial situation.

⁴³ Cass. (civ.), 27 June 1995, RTD com., 1996, p. 100: the commentator emphasises that the duty of the lender which was, initially, to advise and warn the consumer, "in reality masks here the duty not to grant a loan which the applicant will clearly not be able to repay (an evaluation which is fairly easy to make in the case of a consumer credit application from an applicant with employee status)".

⁴⁴ It has been considered as encouraging over-indebtedness.

⁴⁵ M.-C. BARRET-BARNAY, "Le contrôle de l'octroi du crédit dans les Etats membres de l'Union européenne", R.E.D.C., 2002/3, p. 191 to 194.

⁴⁶ This contribution does not address the hypotheses where the lender's liability has been invoked on the basis of the lack of clarity of the information provided by the lender to loan applicants or on the basis of apparent inconsistencies between various contractual documents regarding the said information (see, for example the references cited by D. BLOMMAERT, op. cit., p. 361, notes 41 and 42).

for the loan). However, a judicial expert assessment revealed that the value of this building was significantly lower than the valuation, which meant that the mortgage surety was inadequate to cover the amounts owed by the borrowers.⁴⁷

In the two member states, invoking the lender's responsibility for not evaluating or poorly evaluating the borrower's capacity depends on the information available to the lender about the borrower's situation. Experience shows that borrowers sometimes ignore information that is useful to the lender or are encouraged to hide it by a credit intermediary that is more concerned about 'collecting' contracts than avoiding financial problems among its customers. The value of compulsory consultation of a credit registry makes a great deal of sense at this point.⁴⁸

5. Methods defined in advance by the national legislator

In contrast to common law, Belgian consumer credit law defines a clear breakdown and sequencing of the pre-contractual obligations that the loan applicant and lender must enter into.⁴⁹ For instance, the lender must consult the Consumer Lending Centre on consumer credit and mortgage credit contracts already taken out by the loan applicant and his defaults on payments of these contracts.⁵⁰ This consultation is not sufficient. It is up to the lender to take the initiative to question the loan applicant and identify the information they require to determine the loan applicant's financial situation, solvency and repayment capacities and relating to a possible surety.⁵¹ The loan applicant does not have to provide information on this subject

⁴⁷ Mons, 26 September 1994, R.D.C., 1995, p. 1032. See also the references cited by D. BLOMMAERT, *op. cit.*, p. 360 and 361, notes 38, 39 and 40.

⁴⁸ M.-C. BARRET-BARNAY, *op. cit.*, p. 194.

⁴⁹ Articles 10, 11 and 15 of the law of 12 June 1991 on consumer credit (Belgian Official Journal of 9 July 1991, p. 15203), amended by the laws of 6 July 1992 (Belgian Official Journal of 9 July 1992), 4 August 1992 (Belgian Official Journal of 19 August 1992), 8 December 1992 (Belgian Official Journal of 18 March 1993), 11 February 1994 (Belgian Official Journal of 16 March 1994), 5 July 1998 (Belgian Official Journal of 31 July 1998), 11 December 1998 (Belgian Official Journal of 3 February 1999), 11 April 1999 (Belgian Official Journal of 30 April 1999), 7 January 2001 (Belgian Official Journal of 25 January 2001), 10 August 2001 (Belgian Official Journal of 25 September 2001), 17 July 2002 (Belgian Official Journal of 17 August 2002) and 24 March 2003 (Belgian Official Journal of 2 May 2003), <http://www.just.fgov.be>; <http://www.mineco.fgov.be>.

These provisions have given rise to an important volume of case-law, which readers can consult in the "Annuaire juridique du crédit et du règlement collectif de dettes – Jaarboek kredietrecht en collectieve schuldenregeling" (published by the Observatory on Credit and Indebtedness) as well as an excellent description by F. de PATOUL, "La responsabilité du prêteur et de l'intermédiaire de crédit dans la phase pré-contractuelle" in "Le crédit à la consommation", under the supervision of C. BIQUET-MATHIEU, Formation Permanente CUP, Liège, 2004, volume 75, n° 23 and following, p. 25 and following.

The Dutch law of 4 July 1990 on consumer credit includes an article 28 which stipulates that lenders can only grant loans if they have sufficient, written information on the solvency of the loan applicant, <http://www.wetten.overheid.nl>

⁵⁰ Article 9 of the law of 10 August 2001 on the Consumer Lending Centre on Consumer Credit and Mortgage Credit Contracts (Belgian Official Journal of 25 September 2001, p. 32027), <http://www.just.fgov.be>.

It is an obligation of results. The consultation must be made within 20 days before the conclusion of the loan contract. The lender must prove that it has carried out the said consultation in due time; it is not sufficient to indicate the consultation date in the loan contract. It is not compulsory to consult the Consumer Lending Centre for the surety provider, but such a consultation is recommended.

⁵¹ The lender and the lending intermediary cannot be exempted from this obligation on the grounds that they have already accomplished it when they granted an earlier loan to the same consumer or because the latter is a good customer.

spontaneously.⁵² At the minimum, this information must include the loan applicant's name⁵³, his family situation, income, expenses, debts, the borrowings he/she has already incurred which are currently being repaid⁵⁴ and the purpose of the loan.⁵⁵

The lender must ensure that the information communicated is supported by the appropriate supporting documents.⁵⁶ The loan applicant and the surety provider must meet the demands for information from the lender and lending intermediary in a faithful and precise way. This obligation must be executed in good faith. Consumers can be induced to communicate unsolicited information if they know or must be aware that it will have an impact on the granting of the loan.

The lender must check and analyse the information received. If they note that some of the information is incomplete,⁵⁷ ambiguous or contradictory,⁵⁸ they are obliged to request clarification from consumers and if the latter remain silent the lender must refuse to grant the requested loan. This obligation must be executed in a reasonable way. Lending professionals are not expected to turn themselves into private detectives⁵⁹ or to become excessively suspicious.

The lending intermediary must notify the lender of all the information that it has collected. Moreover, in order to avoid the 'splitting' of a loan into several smaller amounts which form the subject of loan applications to several different lenders, the intermediary must notify all the lenders that it has approached on behalf of the same consumer of all the loan contracts that it has requested or received in the two months preceding the submission of each new loan application. The lender and the intermediary have to make a statement on the appropriateness of the loan sought and recommend the most suitable loan type and amount in view of the loan applicant's financial situation and the purpose of the loan.⁶⁰ If doubt exists relating to the appropriateness of

⁵² And neither the lender nor the lending intermediary can offload the responsibility for the accomplishment of their obligations onto the loan applicant. The clause whereby the loan applicant certifies that the replies that he has given are complete and accurate has no effect.

⁵³ This is an obligation of results.

⁵⁴ Not all loans were recorded with the Consumer Lending Centre on Consumer Credit and Mortgage Credit Contracts.

⁵⁵ This information is essential so that the lender and lending intermediary can perform correctly their duty of advice. The lender and lending intermediary have an active role: they cannot satisfy themselves with vague formulas and must, in necessary, ask the loan applicant more questions. To obtain this information, the lender and credit intermediary frequently ask the loan applicant and surety to complete a standard questionnaire. The information which must be obtained to assess the financial situation of a surety provider and his capacity to make repayment will focus mainly his assets and savings, rather than his current income.

⁵⁶ For example, a recent pay slip, a lease, the last tax notice, etc.

⁵⁷ Such as the reference "other private purposes".

⁵⁸ Such as the reference "home improvements", when the loan applicant does not own any property and pays a modest rent.

⁵⁹ He is not obliged either to go over the loan applicant's current amount or deposit account statements with a fine-tooth comb, or to examine which of the applicant's assets can be seized if necessary.

⁶⁰ There is no obligation to provide advice to a guarantor. Lenders are not prohibited from granting a loan that is intended to be used to repay one or more previously contracted loans (loan consolidation), but the fact that the loan applicant informs the lender of such an intention should make the lender more prudent :

- that is particularly true if the loan applicant has difficulties repaying the earlier loans ; in addition, the lender and lending intermediary would be failing in their obligation to provide advice if the loan applicant did not benefit in any way from such a loan consolidation operation and if the operation his debt burden ;
- on the other hand, the liability of the lender and the lending intermediary would not be invoked if the repayment of earlier loans was only part of the aim of the loan application or if the operation reduced the

the loan, the lending intermediary shall refrain from seeking the loan and the lender from granting it.⁶¹

The lender and intermediary are jointly liable for performing their obligations in many areas. Provided consumers have correctly fulfilled their obligations, the lender's responsibility can be invoked if the lender or the lending intermediary did not respect their duties. It is not necessary for the loan applicant to demonstrate a mistake on their part, a loss he/she may have suffered and a causality link between the fault and the loss. As such, the penalty, administrative or civil penalties stipulated by law on consumer credit can be applied.

In terms of civil sanctions, the judge has the option of cancelling the loan contract or of releasing the borrower from the cost of the loan. In the latter case, the borrower has the option to repay the borrowed capital in accordance with the agreed schedule.

6. Conclusions

Running in parallel with the notion of the consumer's financial capability, which presupposes that he/she becomes more informed about credit matters, is a trend towards demanding creditworthiness assessments from lenders. It is a fact that the assessment of the consumer's financial capacity is now not only debated in the actuarial profession, and among economists and sociologists, but has also gradually found its place in European law and in certain national laws.

In the relations between creditors, intermediaries, borrowers and guarantors, the assessment of the consumer's capacity to conclude a credit agreement is no longer simply the concern of one party, but now concerns all the parties. This does not mean limiting the responsibilities of one of the parties, but is more a question of new responsibilities shared between all the parties. The assessment of the debtor's future creditworthiness, which is an essential stage in the credit process, does not represent a drawback for any party. The contrary is the case. It is the source of renewed confidence and new benefits for each of the actors.

amount of the loan applicant's repayments in the case of an applicant whose income has recently been reduced.

⁶¹ The existence of sureties or the possibility to dispose of assets cannot be taken into account when assessing the applicant's creditworthiness. What is decisive in this regard is the comparison between the income, overheads and debts of the loan applicant.

Annexes

1. About the Contributors

Sharon Collard, Research Fellow at the Personal Finance Research Centre, University of Bristol, UK. Member of the DTI advisory group on face-to-face debt advice, UK. Member of the management committee of the Bristol Debt Advice Centre, UK.

Almudena de la Mata, Legal and Regulatory Counsel, Genworth Financial, Belgium. Lecturer in Law, Humboldt University, Berlin, and University of Hamburg, Germany. Member of the Scientific Committee of the European Credit Research Institute (ECRI), Belgium.

Catarina Ferreira Frade, Researcher and Executive Coordinator of the Observatory of Consumer Indebtedness, University of Coimbra, Portugal. Assistant Professor (Faculty of Economics) and Permanent Researcher (Centre for Social Studies) at the University of Coimbra, Portugal. Member of Consumer Debtnet and the International Consumer Law Association.

Elaine Kempson, Director and Professorial Research Fellow of the Personal Finance Research Centre at the University of Bristol, UK. Member of the DTI Advisory Group on Over-indebtedness, the HM Treasury Financial Inclusion Taskforce and the Social Security Advisory Committee, UK.

Johanna Leskinen, Head of the Research program “Households as producers and users of services”, National Consumer Research Centre, Finland. Member of the Scientific Committee of the European Credit Research Institute (ECRI), Belgium.

Cláudia Abreu Lopes, Researcher at the Observatory of Consumer Indebtedness, University of Coimbra, Portugal. Assistant Professor, Faculty of Psychology, University of Coimbra, Portugal. Member of the Survey Centre and Opinion Studies, University of Coimbra, Portugal.

Nick Moore, Visiting Fellow, Bristol University, UK, and Visiting Professor, University of Brighton, UK. Managing Director, Acumen, Taunton, UK.

Gianni Nicolini, Researcher in Banking and Finance at the University of Rome “Tor Vergata”, Italy.

Didier Noël, Legal Advisor, Observatory of Credit and Indebtedness, Charleroi, Belgium.

Anu Raijas, Senior Lecturer in Consumer Economics, University of Helsinki, Finland.

2. Summary of the workshop interventions

Consumer Financial Capability Workshop, 8 November 2005

Almudena de la Mata, (Chair of the Workshop and former ECRI Research Fellow), introduced the event by underlining the importance of ‘consumer financial capability’ in the context of the ongoing regulatory process in retail financial services.

Elaine Kempson and **Sharon Collard** (Personal Finance Research Centre, University of Bristol, UK) presented the research methods they followed for an exploratory study (co-authored with Nick Moore) carried out for the Financial Services Authority. This study had three objectives: identifying the components of ‘financial capability’ and their sensitivity to various factors; designing an adequate survey questionnaire and designing a scale against which individuals’ financial capability can be measured. A literature review, which helped in the development of the conceptual model, also showed that none of the previous research studies had provided robust means of measuring and monitoring levels of financial capability in the population. Focus groups and interviews were then held in order to develop and test the draft questionnaires.

The conceptual model used here was based on the interrelation of the following main factors: knowledge/understanding, skills, experience/circumstances, confidence and attitudes, personality, behaviour. The focus groups showed that financial capability was perceived in behavioural terms by the respondents – it was seen as encompassing the three aspects of knowledge, behaviour and attitudes. Individual interviews confirmed that measuring financial capability is complex and lengthy, partly because of the necessity to adapt to individual specificities (e.g. income level, cultural environment, level of engagement with financial services). None of those interviews lasted less than an hour. A number of them, in particular those involving financially sophisticated people, took more than two hours to complete. Four domains were defined for the appraisal of the financial competency of consumers: money management, financial planning, the choice and use of financial products and lastly, the area of “information, advice, complaints and redress” which included the use of financial advisers.

A national survey was then undertaken all over the UK between June and September 2005, using the questionnaire developed during the previous phases. After two pilot surveys covering about 100 persons each, 5,328 persons were interviewed in the full survey, which included representatives of regional and minority groups. Many participants declared that they had found the process of answering those questions on financial issues both interesting and illuminating.

The next step, namely the design of a scoring system, is about to begin. Consequently, we can only present a broad overview of the chosen approach. First, the building of an overall, one-size-fits-all scale for the whole questionnaire is clearly not possible. The appropriate approach seems to be to develop separate scores for each of the four domains identified above. Secondly, it would be inappropriate to designate a clear-cut “pass-mark” under which people would be considered not capable. This survey, based on behavioural patterns, is anyway not compatible with that sort of approach. Five criteria have been adopted for the scoring system: reliability, validity, relevance, comprehensibility (to non-technical audiences) and longitudinality (should be replicable in the future). At the moment, it is likely that the method of choice for the scoring system will be similar to that used for the Index of Multiple Deprivation and Health indices. In this type of approach, factor analysis is applied to the results for each domain before ranking the scores from lowest to highest. This methodology seems best suited to this type of analysis, as it

would allow for the building of a consumer financial capability typology describing individuals' strengths and weaknesses. It is also a robust, well-tested approach.

Catarina Frade and Cláudia Lopes (Observatory of Consumers' Indebtedness, University of Coimbra, Portugal) based their study of the social and psychological factors affecting consumer financial literacy on a series of face-to-face interviews with Portuguese consumers. The first aim of those interviews was for the Observatory of Consumers' Indebtedness to analyse the relationship between unemployment and over-indebtedness. For the present study, the preliminary results obtained during the interviews illustrate the theoretical framework of values developed by the authors, as well as its implications for financial literacy.

In Portugal, consumer credit is a relatively new phenomenon that took off in the favourable socio-economic climate of the 1990s and rapidly developed. Nowadays, the Portuguese household indebtedness ratio is one of the highest in Europe (117% of disposable income in 2004), with the use of credit varying along socio-economic categories as well as from one geographic area to another. This swift evolution has challenged the local cultural values that often demonised borrowing.

Two groups of interviews were held: one with unemployed workers and the other with debtors who had sought the assistance of DECO (Associação Portuguesa Para A Defesa Do Consumidor Portugal's largest consumer protection association). Besides the main investigation goal of clarifying the unemployment/over-indebtedness interdependence, those interviews also provided information about the interviewees' values and attitudes towards consumption, credit and indebtedness which provides a useful basis for the design of financial education programmes.

A recent formulation of human values system (Schwartz 1992, 2003) comprises ten core values aggregated in the following four dimensions: openness to change as opposed to conservation; and self-transcendence as opposed to self-enhancement. This system can be used to identify the determinants of financial attitudes and behaviours.

From the data collected during interviews it is possible to draw the general profile of each interviewed group, the unemployed being characterised as 'the ants' and the over-indebted as 'the grasshoppers'. The ants were mainly factory workers, aged 40 on average, with low levels of education, low salary levels and strong informal solidarity networks. They had a rural or semi-urban lifestyle and tended to have longstanding employment relations. The grasshoppers had a wider range of occupations, often in services industries. They were younger (25-35 years old mostly) and switched jobs more often. They had higher qualification and income levels. The relation to debt and consumption was very different from one group to the other: the ants had a strong personal ethic regarding credit payments, while the grasshoppers, albeit intending to pay or repay, were less willing to make sacrifices and found it hard to establish financial priorities. Their financial behaviour also varied: the ants saved money on a regular basis (although through unsophisticated products) and showed an aversion to credit while the grasshoppers almost never saved and used credit products intensively, whether for housing or consumption purposes.

Financial education is an essential component of the vast field of consumer education. As is the case with many other types of good, financial products have become more diversified and complex: consumers need to be equipped with the basic skills that will allow them to make discerning choices and seek information/help appropriately. Although the results developed here cannot be extrapolated to social groups (due to the convenience sampling procedure used for the interviews), they give an indication of how divergent the value systems and the socio-economic environments can be between groups of consumers. Consumer financial education should take into account those specificities. Given that financial behaviour is related to certain group standards and values, it should be directed at both the individual and the whole community levels.

Johanna Leskinen (National Consumer Research Centre, University of Helsinki, Finland) presented a paper co-authored with Anu Raijas on the concept of ‘consumer financial capability’. They based their approach on the economic role of consumers and consumption, using the life cycle approach (Deacon and Firebaugh, 1988) as a cornerstone for their interpretative framework. The most frequently used version of the family life cycle takes into account the ages of the children and their presence at home. The life cycle hypothesis then considers consumption as depending not only on the present income but also on the income expectations in later phases of life. This hypothesis draws on the idea that there is a “typical income development”: minimum income at the beginning and end of life and maximum at the middle. At the same time it assumes a relatively stable level of consumption. In this case, credit is used mostly when consumers are young (and their consumption expenditures exceed their income) while in middle age people repay their loans and save for old age.

Empirical applications show a ‘Gaussian type’ of curve for the development of income and consumption in life, which provides support for this framework. For this paper, the suggestion of the authors is that different financial capabilities are related to different life stages, as the decisions to be made by consumers differ along their life cycle.

The definition of financial capability given by the FSA (Financial Services Authority) is widely used and very useful. It is articulated around three dimensions related to individual characteristics: financial knowledge/understanding, skills/competence and financial responsibility. Consumers then need to be able to apply, in practice, the capabilities they have in each of those dimensions. Building on this definition, we can assume that there are various stages and expressions of consumer financial capability, varying with individual (i.e. sex, age, education, values and habits), household (i.e. phase of life, employment status) and with environmental characteristics. Those variables are in constant interaction with each other. Therefore, financial capability can be understood as a process evolving over a person’s lifecycle and influenced by social trends and circumstances. It can be considered a synonym of financial literacy, an equivalent concept more prevalent in US literature. Financial literacy can be then considered as a subset of consumer literacy.

Should we define what is “good” or “best” in terms of consumer financial capability? It may be impossible to define what kind of financial capability is sufficient and what is not. As we just saw, this concept is volatile, depending on situational factors that are difficult to observe or forecast. The scope of the present paper did not allow for the underlying questions (i.e. about the definition of “good” or “adequate” financial capability) to be fully explored. Empirical studies help us reach at least some first practical conclusions. Prof. Leskinen presented here a short summary of the relevant empirical studies and surveys. She listed conclusions directly applicable to consumer policy, particularly underlining that information targeting consumers should be practical, understandable, connected to consumers’ lives as well as that it should be adapted to their environment and tailored to the phase of life they are going through.

Further empirical research is needed in order to understand the many dimensions of the complex, dynamic phenomenon of consumer financial capability. This research should also examine the cases of households that seem to have high levels of financial capability (comparative studies).

During the question and answer session that followed, **Rosa-Maria Gelpi** (Cetelem, France) asked if, in the study presented by Catarina Frade and Cláudia Lopes, some results would suggest that some of the ‘grasshoppers’ become ‘ants’ later in life. **Catarina Frade** answered that the ‘grasshoppers’ were often the children of ‘ants’ but that most of them already had families and so were likely to keep the same financial behaviour throughout their lives. They used credit to take part in the predominant economic lifestyle. **Laura Rinaldi** (Centre of Economic Studies, University of Leuven, Belgium) asked Elaine Kempson and Sharon Collard

about the validity of their conclusions for other countries. **Sharon Collard** explained that, even if the very distinct structure of the UK financial services sector had to be taken into account, she expected fundamental results to be similar for other EU countries. **Arianna Mellini-Sforza** (European Banking Federation, Belgium) addressed a question to all speakers: how did they see the categorisation of consumers along their financial capability levels? In Portugal in particular, were there intermediary groups, people who were both ‘ants’ and ‘grasshoppers’? **Sharon Collard** said that she expected categories to emerge through differences in the four domains examined, when the analysis of the results had been completed. **Catarina Frade** summarised the differences between the two types examined in Portugal for her study. **Elaine Kempson** argued that those characteristics were not necessarily clearly good or bad. For instance, the ‘grasshoppers’ might use credit more readily during a period of unemployment because they know that they will quickly find a job again, given their relatively higher level of qualification. **Barbara Smith** (Financial Affairs Division, OECD) explained that in the US, her team found 3 categories while examining the saving behaviour of consumers: the dedicated savers, those knowing that they should save, and those who do not save at all (the majority). Those three attitudes were not necessarily correlated with age or income groups. **Elaine Kempson** added that saving habits are usually built in early childhood (age 7-8). In the UK, most people save, at least over short periods. **David Rees** (Provident Financial, UK) brought the topic of the impact of welfare systems into the discussion. **Catarina Frade** said that in Portugal, people receive help in rural areas, often in kind. The informal solidarity networks are significant. **Almudena de la Mata** mentioned to the audience that the ECRI Consumer Finance Network had recently examined the topic of over-indebtedness.

Gianni Nicolini (Università di Roma ‘Tor Vergata’) presented a regulatory perspective on consumer financial capability. The focus here is whether we can help consumers to understand their financial capability through law. Consumers are a weak part in the financial market transactions, first because their need to borrow is greater than banks’ need to lend, and secondly because of asymmetric information: the consumer does not have enough information. The regulator intervenes at this latter level: can we fill the information gap and therefore prevent asymmetric information from appearing? If we consider that we can, then we would adopt what will be called here an “information approach”, part of which consists in setting up a consumer financial capability indicator. In the opposite case, an “invading approach” will be adopted, where we would try to control the relationship between credit institutions and consumers.

The current regulatory approach varies from one EU country to another. To give an example, in Switzerland, financial capability is directly mentioned in regulation. The problem is more about the quality and adequacy of the information than about its quantity. Consumers will be able to reach the right level of financial capability only if they receive the right information at the right moment. It will have an impact not only on the consumers themselves but also on the whole economy because it will allow for a higher competition level between credit institutions. Informed consumers will select providers more carefully.

At the moment, the study is not finished, so the financial capability indicator being developed cannot be presented yet. This indicator would help consumers to have a clear overview of their financial situation, which would in turn allow them to take better informed decisions regarding financial products. It should take into account periodical cash-flows (i.e. income, costs) and household assets. In its present state it would not consider the household situation in the area of mortgages and guarantees. Credit history would not be considered either.

Rosa-Maria Gelpi (Cetelem, France) expressed her disagreement with the view that consumers are the weak part in the retail financial markets for the reasons developed above. She underlined that lack of information available for consumers was not a current problem in that area. **Gianni Nicolini** insisted on his focus on the quality of information provided. He argued that we could

do better, in terms of information, than what was offered by the new Consumer Credit Directive proposal. In particular, we should consider the option of giving the consumer the possibility of choosing what information they need. **Rosa-Maria Gelpi** agreed with that opinion. **Kate Taylor** (Policy Division, Citizens' Advice International, UK) asked if Gianni Nicolini would conclude that providers should have more obligations to provide information. **Gianni Nicolini** answered that in his view, it was the consumer who needed to know more about his/her own financial situation. The banks have access to information from credit bureaus. **Michel Van Lierde** (Eurofinas and Leaseurope, Belgium) advised Gianni Nicolini to examine the new draft Consumer Credit Directive in detail. The industry thinks that the wording of the regulation is quite complex, in particular in the requirements for pre-contractual and contractual information. It would be useful to examine if some of those requirements are not redundant.

Didier Noël (Observatory of Credit and Indebtedness, Belgium) presented a comparison of the responsibilities and obligations of lenders and borrowers in several EU legislative systems. In rare cases, it is possible to find a criterion for a consumer's financial capacity to borrow based on positive standards. An example can be found in the Swiss federal legislation, which stipulates in particular that the ability to borrow must be assessed on the basis of a repayment period of 36 months even if the loan contract provides for a longer repayment period.

In French and Belgian law, the criteria are not defined in advance by the legislator, but the responsibility of the lender might be engaged. The principle of lender responsibility for having granted a loan 'lightly' was raised in France for the first time in the 1960s. In France, a justification for these requirements was sometimes sought in the nature of the public service involved in the lender's business. This thesis never held sway in Belgium, even if some jurisprudence decisions observed that bankers, through the exercise of their profession, fit into economic and social life and hold powerful resources that put them under an obligation to act in a perceptive, prudent way in their professional business.

Recognition of possible lender responsibility by the borrower itself in the context of a loan granted for non-professional purposes has evolved in the same way in French and Belgian jurisprudences, albeit at different rhythms. Belgian law has moved from assuming that the link of causality between a fault of the lender and a loss encountered by the borrower could never be proved to considering the causality link as broken by the consent of the borrower at the signature of the loan. Recent jurisprudence no longer systematically dismisses the lender's pre-contractual responsibility relating to the borrower; however, cases of enforcing responsibility of this type are rare. In France, the jurisprudence of the Court of Cassation has evolved: in its ruling of 27 June 1995, it confirmed the general duty borne by the banker, whatever the purpose of the lending, to ensure a reasonable possibility of repayment.

In contrast to common law, Belgian consumer credit law defines a clear breakdown and sequencing of the pre-contractual obligations that the candidate borrower and lender must fulfil in the context of assessing the capacity to borrow, e.g. consulting the Consumer Lending Centre for the lender or answering faithfully the information demands presented by the lender, for the borrower. The lender and intermediary are jointly and severally liable for performing their obligations. It is not necessary for the candidate borrower to demonstrate a fault on their part, a loss he may have suffered and a causality link between the fault and the loss.

Włodzimierz Szpringer (Warsaw Business School and University of Warsaw, Poland) presented the institutional perspective on consumer financial capability.

Information obligations, related to the ex ante protection of consumers, have a crucial role in the prevention of over-indebtedness and in the concept of responsible lending and borrowing. However, it is difficult to decide the level and method of appropriate disclosure. In fact, excessive information levels may be particularly ineffective in protecting the most vulnerable

consumers: as consumers' rationality is limited, more is not always better in this area. Information overflow of consumer is not in the interest of any party. Information needs to be proportionate.

Opinions concerning the optimal set of information requirements or the calculation and presentation of the annual percentage rate of charge vary from one country to another. When considering the issue of informational requirements we should take into account that people borrow either to finance the acquisition of consumer durables (higher income borrowers) or to make ends meet (lower income borrowers). It might be useful to examine the possibility of a targeted disclosure, which would be adapted to the type of borrower and its overall situation. This issue becomes more important as consumer credit markets develop, the range of available products widens and more consumers have access to credit.

Avoiding the extremes of over-regulation and non-regulation, the 'third way' approach to consumer credit regulation would be to empower individual consumers and protect their autonomy, recognising the importance of access to affordable credit for all households, while at the same time taking preventive and regulatory measures against over-indebtedness and draft regulations influencing (facilitating) market interactions rather than merely policing infractions. Regulation should focus on problem areas and take into account the insights brought by behavioural economics.

Protective legislation has to be effective. It must cover any form of credit that is linked directly to the lives of borrowers. Credit relations have to be transparent and understandable. Consumers should have access to both a standardised mathematically correct form of 'one price' disclosure (the Annual Percentage Rate of Charge) and a standardised pre-contractual payment plan. Providing consumers with the right information at the right time, so they can make informed decisions, is the main regulatory and competitive issue in this area.

Prof. Szpringer then examined the issues of contractual and pre-contractual information from the consumer and the creditor sides. He observed the impact of the development of sophisticated credit scoring techniques and credit bureaus on the informational asymmetry characterising the lender-borrower relationship. Insisting on the role of trust in this relationship, he underlined the importance of the implementation of the 'responsible lending and borrowing' principle. He then examined and compared the two successive drafts of the Consumer Credit Directive with the perspectives adopted for the Unfair Business Practices Directive, the Misleading Advertising Directive and the Distance Selling Directive. He pursued with an overview of Consumer Credit Legislation in Central and Eastern Europe.

After the lunch break, **Barbara Smith** (Financial Affairs Division, OECD) presented good practices and institutional insights drawn from the first results of the OECD Financial Education Project. This project, established in 2003 with funding by Prudential plc, aims to describe existing financial education programmes, analyse their effectiveness and develop good practices. As part of it, a 'Recommendation on Principles and Good Practices for Financial Education and Awareness' has been developed and is now available on the OECD website. Another major achievement has been the undertaking of the first major international study of financial education, 'Improving Financial Literacy: Analysis of Issues and Policies', to be published at the end of November 2005.

The interest of the OECD in the issue derives from the observation of parallel increases in credit product complexity, their use by individuals and the number of personal bankruptcies. The international study led to the conclusion that financial literacy is generally low among consumers. Furthermore, many consumers overestimate their knowledge. Consequently, consumers find financial information difficult to understand and discouraging. They make financial decisions based on inadequate understanding.

Financial programmes examined during the study have been shown to be generally effective. There are, however, lessons or ‘good practices’ to infer from comparing them. First, it is very important to recognise the diversity of consumers and to adapt to their characteristics. This is probably a reason why one-to-one counselling and modular course schedules seem to be particularly effective. Consumers vary not only in their approach to financial decisions but also in their preferred media to receive information (i.e. internet for the young people). The mere availability of information is not enough. It is also important to take into account all the factors, apart from information, that will affect consumers’ financial decisions.

Ms Smith presented examples of financial education programmes in various countries. She added that benchmarks should be established to measure change, and that communication and coordination between financial education providers was a key issue. Financial education programmes will bring benefits not only to consumers but to supervisors, employers and governments.

Erich Paetz (Consumer Finance Department, Federal Ministry of Consumer Protection, Food and Agriculture, Germany) started by introducing his Ministry Division. In Germany, financial education is regarded as a task for society as a whole, and the responsibility for it is shared between the state, the economy, the family and the associative sector. The state provides financial support to consumer information measures, to the Federation of German Consumer Organisation, to Germany’s premier product-testing organisation, to research projects and to various one-off projects related to financial education. Reforms are planned for the distribution of competences between the Federal State and Länder regarding financial education.

Consumer information is the basis of well-functioning financial markets and is therefore of considerable interest for the banking industry. Generally speaking, it will be easier for banks to fulfil their obligations in terms of ‘responsible lending’ if consumers are well informed. In Germany there are examples showing that the industry has taken its responsibility in this area seriously. The responsibilities of families should not be forgotten, especially among children and teenagers.

In general, financial literacy levels are not high, with consumers often making expensive mistakes because of their poor knowledge. At the same time, both household financial needs and the available financial services have become more complex. However, adequately reaching the different groups of consumers is often an issue.

Brenda Gibson (Financial Capability Department, Financial Services Authority, UK) presented the FSA’s action in the area of consumer financial capability. The scope of the financial capability programmes in the UK is quite wide ranging and covers much more than credit and borrowing. In October 2005, the FSA proceeded to stocktaking in that area, which helped not only to evaluate current accomplishments but also to evaluate future funding needs. Two of the four FSA objectives are related to financial capability, namely: increasing consumers’ awareness and ensuring adequate consumer protection. The goal of FSA’s action in that area is to make a difference for consumers, who are then more likely to make better informed choices. This would lead to less need for regulatory intervention by encouraging better product design and better providers’ practices.

Seven working groups are active in that area, focusing respectively on Schools, Young adults, Work, Families, Retirement, Borrowing and Advice. They develop action plan proposals, run pilot projects, develop implementation plans and oversee the roll-out of the projects. Until now, some of their main findings are that ‘one-size-fits-all’ approaches do not work; promising results have been obtained by reaching people through the workplace and through supermarkets; focusing on youth means that results take time to appear; there is a need for resource banks of educational/informational material. For the next phase, the FSA will focus on the following

areas: Schools. Higher education. Workplace (public and private). Maternity leaver resources. Debt test (e.g. an interactive financial health check) and a Quality Assurance Scheme for generic advice. The FSA will also launch campaigns on financial capability issues.

Helga Springeneer (Federation of German Consumer Organisations -Verbraucherzentrale Bundesverband, Germany) asked why the FSA had developed this stocktaking and new initiative given that financial literacy programmes already existed in the UK fifteen years ago. **Brenda Gibson** answered that a point had been reached where step-change, and not more incremental change, was needed. **Kate Taylor** (Policy Division, Citizens' Advice International, UK) added that her organisation had asked for the development of a new national strategy in this area, and that this change was generally seen as good. **Michael Green** (University of Wales, Bangor) mentioned the household debt level in the UK as a reason for national institutions being interested in financial capability. Answering a question from **Carolyn H. Welch** (Division of Consumer and Community Affairs, Federal Reserve Board of Governors, USA), **Brenda Gibson** explained that the FSA spent 8 million pounds per year on financial capability. More funding is expected soon. The FSA is considering the creation of a 'financial capability brand'. **Rosa-Maria Gelpi** (Cetelem) mentioned a project in financial education developed by Cetelem in association with other professionals and consumer organisations. **Elaine Kempson** mentioned the work of the UK association PFEG which specifically targets schools. **Karel Lannoo** (ECRI) asked all government representatives about the way they assessed the impact of their actions and what the implications were for issues regarding housing markets. **Brenda Gibson** explained the difficulties related to such measurement due to the interrelations of the variables considered. However, the FSA tries to operate individual impact assessments when possible. **Javier Arias** (Banco Bilbao Vizcaya Argentaria) reminded participants of the importance of pre-regulatory impact assessment, which prevents the adoption of over-reactive measures. **Brenda Gibson** said that the FSA saw its action in financial capability as separate from its regulatory activities. **Rosa-Maria Gelpi** argued that the development of financial capability could be a way to avoid over-regulation. **Almudena de la Mata** asked about the cooperation between national regulators. **Jane Rooney** (Financial Consumer Agency, Canada) answered that the International Association of Financial Educators and Regulators was a useful platform for the exchange of information.

John Rossi and **Jane Rooney** (Financial Sector Policy Branch, Department of Finance and Financial Consumer Agency, Canada) presented the Canadian perspective on enhancing 'consumer financial capability'. They first presented an overview of state level activity in terms of consumer protection, regulation and education. In Canada, financial consumer protection, which includes consumer capability enhancing in all financial areas, is the responsibility of the Federal Department of Finance. In this context, they ensure that consumers receive enough information about products as well as related rights and obligations to feel secure and make informed choices. The Financial sector consumer regulator is the Financial Consumer Agency of Canada (FCAC), which among other tasks is assigned a broad consumer education mandate. Consumers can also contact FCAC if they are encountering problems. Issues can then be raised by the FCAC to policy-makers when necessary.

The FCAC developed innovative programmes and user-friendly products to help consumers: for instance, their website contains an interactive tool helping consumers to shop around by allowing them to find the cheapest banking package adapted to their situation. Plain language publications are also available. All consumers are targeted by FCAC projects, with an emphasis on low-income, low-literacy Canadians. The institution has developed partnerships with organisations having access to lower-literacy groups - one example is its collaboration with Credit Counselling Canada. FCAC staff also established direct contact with such groups through a presence at various events and direct mail operations. The goal is then to inform those consumers about their rights.

The Financial Capability Symposium, held in June 2005 with national and international participants, explored the concept of financial capability while identifying existing projects and future needs. On this occasion, the following definition was elaborated: “Develop the skills and confidence to be aware of financial opportunities, to know where to go for help, to make informed choices and to take effective action to improve financial well-being”. FCAC plans, among other projects, to do further research, build more partnerships, and create a database of existing programmes and organisations in the area.

Carolyn H. Welch (Division of Consumer and Community Affairs, Federal Reserve Board of Governors, USA) presented the USA perspective on the improvement of consumer financial capability. She gave an overview of the consumer credit market in the USA, which is vast and highly complex. From 2000 to present, consumer debt has increased by 26%, with bankruptcy filings doubling over the last 10 years. Technology developments have allowed for increased lender capacity and efficiency while the deregulation of the financial services industry has resulted in an increased number of non-bank lenders, as well as increased levels of competition and a very large range of products, terms and features. Until now, Federal disclosure laws and regulations aiming at reducing the information asymmetries inherent to this market have been the primary policy responses adopted. Currently, consumer advocates seek a reform that would provide more information in plain English instead of legal jargon while the creditors seek a reduction of the regulatory burden linked with disclosure obligations.

Research done in 1975 on disclosures in credit contracts showed that they did not generally increase consumers’ ‘shopping around’ behaviour, while actually benefiting high-income/high-education consumers the most. Research led by the Federal Reserve showed more encouraging results, with disclosures increasing consumer confidence and their awareness of APR in credit card pricing, increasing competition and decreasing consumer loyalty. However, the advantages of the disclosure-based approach to consumer education are balanced by the risk of information overload, the need for frequent amendments and the inability to protect consumers against fraudulent practices.

Ms Welch also developed the benefits and limitations linked to a complex regulatory structure. In the US, there are regulatory bodies at several levels: federal, state, and local. However their action seems insufficient to prevent unfair practices. Furthermore, the complexity of the system makes it difficult to understand for consumers – co-ordination among supervisors can be challenging and non-bank lenders are often excluded from the regulations, which creates a competitive advantage for them. Given the limits of the disclosure and the regulatory approaches, consumer capability and consumer financial education have a critical role. One big challenge in this area is to provide information to people when they need it.

The research on the effectiveness of consumer financial education is limited, but some studies have demonstrated that financial education can improve consumer credit behaviour. One-to-one counselling was found to have a particularly positive impact. Financial education should be seen as a public good and a long term goal.

Elaine Kempson asked participants about their views regarding the concept of ‘financial education replacing financial regulation’ that she perceived as emerging from the debates. Should financial capability be regarded as a bonus or a replacement? **Carolyn H. Welch** said she definitely saw it as a complement. **John Rossi** added that this type of argument did not seem, from his point of view, to significantly influence the current debate. **Brenda Gibson** expressed the view that the optimal level of consumer protection has to depend on the actual level of financial capability. **Karel Lannoo** (ECRI) asked if the frictions between the national and federal levels in Canada were comparable to those between the Union and the national level in Europe, as it is a real issue for consumer protection in the EU. **John Rossi** answered that Canadian institutions have one advantage: they have a federal jurisdiction for financial services.

Regulation in this area is therefore created at the federal level. But they allow for local legislation to be developed within that framework. There is strong collaboration with the provincial institutions. **Hans W. Grohs** (Debtor advice organisation ASB Schuldnerberatungen GmbH, Austria) asked about the issue of consumers who did not use any banking services at all. **Jane Rooney** indicated that approximately 3% of Canadians were in that situation.

Kate Taylor (Policy Division, Citizens' Advice International, UK) presented the Citizens' Advice perspective for England and Wales. Citizens' Advice is the largest independent charity in the UK. It reaches many communities, including prisons and house care centres. It works with sister organisations in various countries. Relying on volunteers for its functioning, it provides free advice and information on legal, financial and other problems and plays an advisory role towards policy-makers.

At the moment, evidence points towards a growth in debt problems and requests for debt advice; the organisation's bureaux are being asked to deliver programmes to the community. It also receives many requests for advice in the general financial area: e.g. banking, social state benefits and insurance. Therefore it sees a need for action in the area of financial capability. Interest in the same area has also been expressed by external agents such as the FSA and the general government.

In the context of its community programmes, Citizens' Advice organises small group sessions with young people and adults at key lifecycle stages (young people leaving home, for instance). They observed that one-to-one programmes were very effective, especially with people with low literacy or low English language skills. In other situations, those groups lack the necessary confidence to participate efficiently. In general, community programmes are built by adopting a bottom-up approach and operated through partnerships.

In 2002, Citizens' Advice launched its National Financial Capability Project in partnership with Prudential. This programme supported local bureau programmes and piloted a range of face-to-face programmes in order to establish best practices. An external evaluation of those pilots will be published in early 2006. In general, the following lessons emerged: effectiveness of partnerships; reaching people at the right moment is key; it is better to stress the benefits of the programmes and to keep it practical, building on existing knowledge and skills; trust is crucial in this process.

Carolyn H. Welch asked if Citizens' Advice would exchange information with providers about unsuitable products. **Kate Taylor** answered that her institution participated in the collection of information by public bodies and that a separate department dealt with product issues. **Almudena de la Mata** proposed starting a debate on the border between financial capability and regulation. **Elaine Kempson** started by saying that regulation could help make it easier for consumers to understand financial products. **Almudena de la Mata** asked if it was possible to simplify financial products. **Carolyn H. Welch** asked if it was desirable to simplify them at the probable expense of choice. **Jane Rooney** said that the consumer and industry side were complementary. Consumers need to receive adequate information and the industry players should provide it, preferably in plain language. There is a project ongoing in Canada with a credit card provider about the issue of the language used when providing information to consumers. **Rosa-Maria Gelpi** reminded the audience that better protection against risk necessarily involved higher sophistication levels for financial products, taking the example of mortgages.

The debate then turned towards regulation issues. **Jane Rooney** emphasised the role played by codes of conduct. **Rosa-Maria Gelpi** explained that on average, regulation increased costs and reduced the access to credit, which made it often a disadvantage for consumers as a group, even if a subset of them benefited from it. **Brenda Gibson** underlined the importance of cost-benefit

analysis for regulation. **Almudena de la Mata** intervened to redirect the discussion towards the concept of the ‘average consumer’, which is important in the current regulatory context. **Jane Rooney** explained that in Canada, the approach is to look first at average consumers, then to establish comparisons with disadvantaged groups. **Rosa-Maria Gelpi** argued that it is not possible to regulate the market at the margins. **Elaine Kempson** acknowledged that financial exclusion is often caused by well-intentioned legislation which increases regulatory requirements for the industry, thus resulting in the companies which were dealing with vulnerable consumers being driven out of the market (an example being the insurance-selling policies that requested insurance products to be sold by trained people). **Almudena de la Mata** wondered what combination of protection and inclusion or exclusion was better. **Elaine Kempson** said the regulation that would work best for the average consumer could make the marginal ones worse off. **Kate Taylor** mentioned that the choice between educating or regulating often appeared in the work of Citizens’ Advice, when it had to decide whether to raise some issues to policy-makers or not.

Almudena de la Mata presented a wrap-up of the presentations and discussions. She thanked the participants for their presence and interest. **Daphne Luchtenberg** (Corporate Communication, Visa Europe, Co-Sponsor of the workshop) thanked the participants and said that the workshop had been a welcome opportunity for dialogue between academics, industry players, consumer representatives, policy-makers and government agencies.