

# Rethinking Financial Capability

Lessons from economic psychology and behavioural finance

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# Summary

Improving the UK's 'financial capability' is not an easy task. Nor is it a small one. In early 2006, although 17 million adults in the UK were successfully making ends meet, keeping track, planning ahead, choosing products and staying informed about financial products, as many as 10.5 million experienced considerable difficulty in one of these areas, 3.8 million faced severe problems in two, 6.2 million lacked capability in three areas, 8.6 million in four, and 1.4 million were succeeding in none.

This has serious consequences for people's well-being, the British economy, the financial services industry and future prosperity. Looking ahead, it is clear that deep-seated economic, demographic, cultural, policy and political trends will make financial capability increasingly important in the future.

Despite the substantial progress achieved over the last few years, the current National Strategy for Financial

Capability is too limited in scope to achieve its ambition of significant change. A substantial increase in resources is needed. But a revitalised policy approach is also needed that makes better use of emerging thinking from academia, and experiences from other countries and policy areas.

There is also a clear need to determine priorities. Over the long term the best solution to financial capability is to engender a profound cultural change, in terms of attitudes to personal responsibility, behaviour, consumption, sustainability and debt. If our society has moved from a 'thrift ethic', where people limited their consumption of goods to what they could afford at the time, to a 'consumption ethic', where people buy now and pay later, we now need to move towards a 'sustainability ethic', where both saving and borrowing are appropriate, but within the context of overall financial sustainability. But in the shorter term, it is unrealistic to think that

policy can improve all elements of financial capability for everyone.

The key question is where and how UK citizens' low levels of financial capability are creating, and will continue to create, the greatest problems for society at large and, specifically, where – and to what extent – they affect the financial services industry. This report argues that policy should prioritise efforts to improve people's ability to plan ahead, as this has most serious repercussions for individuals, business, the economy and the financial services industry.

This report also sets out a case for seeing financial capability as more of a central social welfare issue. This would suggest moving responsibility for the National Strategy from the FSA to the government, through the Department for Work and Pensions (DWP) and the Department for Education and Skills (DfES). There are several key motivations for this. The first is that the DWP and DfES have considerably better access to many practical delivery channels, through social services offices and education providers, than the FSA. They also have more experience in delivering large-

scale programmes, and the evaluative and research capacity to assess these. Also the Government has greater expertise in dealing with financial issues that affect ordinary people's lives and there are strong links between the rest of its core business and financial capability issues.

### Closing the motivation gap

A central challenge identified in this report is closing the motivation gap between what people say is important and their actual behaviour. More than 80 per cent of people under retirement age think that the state pension will not be enough to give them the standard of living they would like, but just 37 per cent have made some provision for their old age (Atkinson *et al*, 2006).

There are two main ways to close this gap: providing the best kind of advice and guidance to those who want it, when they want it; and providing the best possible structures to make it easier for people to act in more financially capable ways, thereby becoming more engaged and interested in improving their financial capability.

Policy has too often focused almost exclusively on the first of these strands, although there have been considerable successes. For example, research from the US suggests that introducing compulsory financial education into the curriculum could increase the wealth of UK citizens substantially by their late 40s: the average couple with no children could be better off by about £22,000, the average single person with no children could have £13,000 more, and the average couple with two children aged five and 11 could be £32,000 richer, as a result of having taken better financial decisions throughout their lives. But a real challenge remains in ensuring that the financial education is delivered in an engaging way and teaches the right skills.

### New strategies for financial capability

A further key finding of this report is that economic psychology, behavioural economics and behaviour change theory can help develop the second approach to improving people's financial capability – providing the best possible structures to make it easier for people to act in more financially capable ways, thereby

becoming more engaged and interested in improving their financial capability. Given the right support and structures, and a significant stake in financial products, people do take steps to become more financially capable. Below are some practical suggestions in which policy can empower them to do so.

#### ***Improved communication***

Improving the way government, the financial services industry, the voluntary sector and other stakeholders talk about financial capability, and the way these communicate with people about this topic, is important. There are a range of easy, practical solutions that can be undertaken, including opening up contracts to a wider, more creative set of agencies, taking greater risks in communication, and setting up competitions with generous remuneration for the best work.

#### ***Simplified products and benefits***

A clear lesson from behavioural economics is that people are put off making decisions by complexity and a wide range of options. This means that, for many consumers, it may be more appropriate to offer them a smaller range of products initially, rather than a wide

portfolio, even if this means that they may not have immediate access to the most tailored and suitable products. A related challenge is in simplifying the tax and benefits system. There is a difficult balance to be made here between effective targeting and simplicity, and there are no easy answers.

### ***Responding to critical moments***

Policy needs to identify better the key critical moments when people are most receptive to efforts to improve their financial capability and, at these times, to direct them towards appropriate guidance. These critical moments are sometimes related to life stages, such as becoming a new parent, but are often unrelated, for example, starting a new job, moving to a new city, deciding to go on an expensive holiday or to start saving for a house.

But government, the financial services industry and other stakeholders also need to ensure that advice and guidance is available to people when they need it, in a form that does not impose any formal commitment or informal pressure to buy specific products as a result. We support the Resolution Foundation's call for a step

change in funding to deliver a new national financial advice resource.

### ***Challenging established wisdom: rethinking savings hierarchies***

The traditional model of savings hierarchies needs to be rethought: for many people it will be more effective to pay off debt regularly at a slightly slower rate and to build up a savings habit and asset at the same time, as this could lead to better financial management and cost savings over the long term. One clear advantage to this approach is that it would leave people with an asset at the end of their debt clearance, with all the benefits that asset-holding entails (Bynner and Paxton, 2001). Another advantage is that it provides more tangible rewards for good financial management. It would also help people to develop regular savings habits.

### ***A new model for debt management***

The Government should offer people with debt problems the option of having debt repayments deducted automatically from benefit payments (up to a small set maximum), including Working Tax Credits.

This would effectively reduce the risk of default to zero, reducing administrative costs for both the public and private sector considerably. If this were combined with a plan to provide participants with the opportunity to save for a small asset at the end of the debt-repayment period – perhaps conditional on attending financial capability training – this could have a significant impact on the UK’s financial capability, with substantial savings for both the public and private sector.

### ***Empowerment through commitment***

One of the clearest lessons from behaviour change research is that commitment plays a crucial role in changing behaviour. This is because it helps to mitigate against hyperbolic discounting – the tendency to postpone and prevaricate indefinitely, acting against one’s own stated long-term interests. Helping people to make and keep commitments is therefore an important way of tackling the motivation gap.

There are some simple changes to current policy that can make better use of commitment effects. Some obvious examples include encouraging and helping people to sign forms or book appointments during education seminars,

and to encourage setting small, specific and achievable financial behaviour goals as part of employment programmes or generically provided financial advice.

### ***Save More Tomorrow accounts***

A new kind of current account service could be developed that makes it easier for people to commit in advance to greater saving levels in the future. This would allow people to choose to save more of any pay rises that they receive. Any sustained payroll increase from an employer paid into the nominated account would automatically trigger an increased direct debit to a dedicated savings account (which could include a Child Trust Fund account). This would be up to a set maximum, with a notification letter being sent to the account holder. Offering consumers the opportunity to start a direct debit into a savings account – starting if and when the customer received a pay rise – to be paid on the same day as customers receive their automated pay cheque from their employer, would be a useful way to encourage greater financially capable behaviour, at little administrative cost.

***Extending default approaches***

There is wide consensus that automatic enrolment into company pension schemes should be the norm. But there may also be considerable scope for extending this use of defaults into wider realms of policy.

***Creating new 'mental accounts' to encourage certain kinds of spending or saving***

There seems to be potential for offering savings accounts with small deposits to customers who open a new basic bank account for the first time, to encourage saving. Another possible way forward would be that for all schoolchildren (and perhaps adults) who take up work experience, a small contribution could be made to a pension fund, linking paid work to pensions saving and creating an initial pension investment for children.

***Harnessing social norms and networks***

The importance of social norms and networks is key, and holds numerous implications for efforts to promote financial capability. It shows the importance of promoting financial capability to the most influential figures in communities with low levels of financial capability. Word of mouth is a powerful force in disseminating ideas and behaviour.

**Conclusion**

This short report has attempted an ambitious task and as such can only make a start. But it is hoped that the ideas set out here will help others to move forward with their thinking, in developing policy approaches that focus on empowering people to improve their financial capability.