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The Emerging Role of Financial Literacy Financial Planning

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Abstract

Economic and financial sector reforms have placed higher disposable incomes with the public. Availability of a variety of new financial products on both, credit and investment sides, which are provided by a host of financial intermediaries has necessitated that the investing public understands the degree of each product and product supplier, and takes an informed decision about where s(he) should invest. At the same time, those who are not part of the formal financial system need to be educated about banking and why they should have a relationship with banks. Financial literacy is considered an important element for promoting financial inclusion and ultimately financial stability. Financial literacy would benefit the financially-excluded by enabling them to understand the benefits and the ways to join the formal financial system. It could also benefit the financially included by helping them make informed choices about the products and services available in the market to their best advantage. This paper stresses the importance of financial literacy and the opportunities for research in this area.

Keywords: Financial Inclusion, Financial Literacy

Introduction

It is aptly said that give a man a fish and you will take care of his one meal but teach him how to fish and that takes care of rest of his life. For economic progress, it is not enough for an individual to earn an income; he also needs to make informed and wise decisions about what to do with the money once it reaches his hands. Failure to utilize the money prudently leads to growing debt, misuse of credit facilities and in the long run slows down economic growth. On the other hand financial literacy fosters improved standard of living and a confidence about the future. It assists in sound financial planning – in accumulation of assets, in funding of education of and also in planning for retirement – which in turn help build economy.

Financial decisions can be difficult. Comparing savings or borrowing options with different interest rates and term structures can be difficult for those who are not finance savvy—and even a knowledgeable individual may need to rely on calculators or spreadsheets to make truly informed decisions. Yet, many households are not knowledgeable, and often receive little assistance when making these decisions. Moreover, unlike the decision to visit a restaurant or purchase a particular car, customers may not receive useful feedback on the value of the financial product they have purchased, making the typical learning process even more difficult.

So, Financial literacy—the ability to process financial information and make informed decisions about personal finance has received growing attention in the developed markets and, emerging markets as a potentially important determinant of household well-being.

Meaning of Financial Literacy

Financial literacy is the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being. Financial Literacy is the process by which individuals gain an understanding of their financial situation and learn how to strengthen it over a period of time by inculcating the financial habits of savings, budgeting, planning and hence making the right financial decisions.

What do we understand by Financial Literacy, Education and Knowledge in India?

In India, where a majority of the poor earn less than $2* a day1, the primary aim of the Central Government, Regulatory Authorities and Financial Institutions is to include the poor and the marginalized in the financial system by providing them access to banking and other financial products and services at a low cost. So, the process of financial inclusion has begun, but the supplementary process of financial literacy (Figure 1) has not yet received the desired attention. In a country as large and diverse as India, spreading financial awareness across the length and breadth of India would require the regulatory authorities, stock exchanges and financial institutions to come together and make joint implementation efforts; however this is not being done. Much needs to be achieved in terms of making the common man financially secure thus giving him life-long financial empowerment; and this cannot be achieved only through financial inclusion but has to go beyond and incorporate financial literacy, awareness and knowledge sharing.

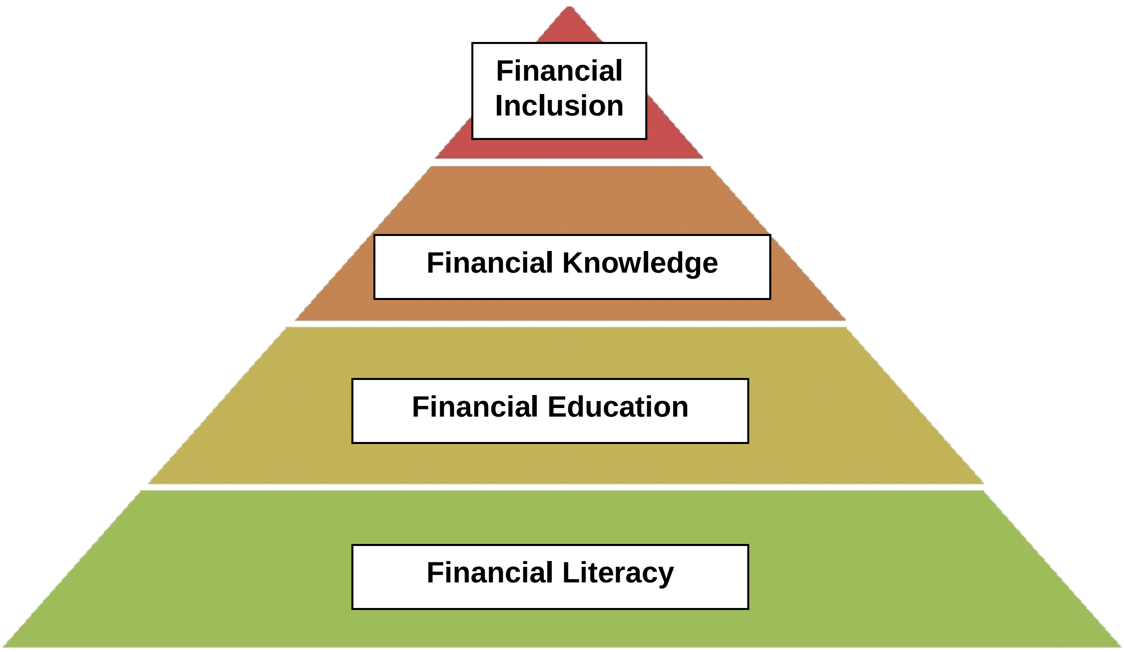


Figure 1- Financial Empowerment Pyramid

* 1 $ = Rs.50

Necessity of Financial Education for Different segments

Although the necessity of financial education can be undeniably established the need for different segment of population for the same varies. It is critical for the population that has been traditionally under-served by our financial system. This strata is more vulnerable to the traps local money lenders and often fall prey due to lack of basic education and financial education may come secondary. The lack of basic financial intelligence is evident even in most educated class of society. The personal financial well being of most individuals increases when the economy is strong and the collective wealth creation strengthens the economy. Financially strong households have higher consumption and are willing to make major purchases. They are also able to invest more into the banking system and are better equipped to make use of credit to start the small household businesses/cottage industries that provide jobs and incomes to thousands. This generates flow of fund and lot of economical activity and in turn contributes to facilitate the growth and fortification of the economy.

Consequences of Low Levels of Financial Literacy

One of the most straightforward consequences of limited financial literacy may be limited financial market participation. Households that are not familiar with the workings of a bank, for example, are unlikely to open a bank account, and may instead choose to store cash at home or invest in other stores of value (such as gold), which may offer unattractive returns. Declining to participate in financial markets may well be the optimal decision for an individual with limited financial literacy: if she were to choose the wrong savings product at a bank, for example, she may end up with an illiquid instrument which charges substantial fees to withdraw. A borrower unable to truly understand the terms of a loan may borrow too much, exposing herself to risk of missing a payment, and potentially incurring substantial penalties.

Problems faced by Financial Market are:

1. Right needs wrong solutions.
2. Excessive dependence on own wisdom.
3. Complex nature of instrument and jargon.
4. Influence of smart agents, consultants, publicity.

However, such wrong practices affect the financial organizations in a big way. Established financial institutions look for long-term relationships with customers and they think that short-term measures are not the solution for sustainable growth of both the customer and the institution, hence financial institutions have great significance in educating customers regarding the complexities of financial instruments and the market.

Hence, it is imperative to increase the spread of the financial literacy by persuading customers that they need financial education, to take control of their financial situation, to improve spending habits, to increase their savings/investments for future requirements, for children’s higher education, to ensure prudent use of credit facilities and contribute towards growth and stability of the economy.

Financial Literacy Influences Savings and Investment Decisions

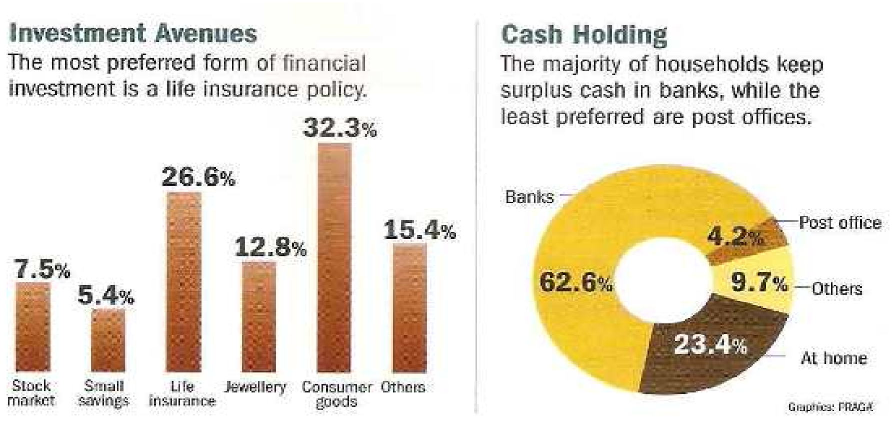
As many developing countries have a large number of their population engaged in agriculture, such communities are especially vulnerable to income shocks which result from weather risk and price volatility in the goods they produce. As such, savings can be critical in allowing households to smooth consumption and support longer-term investments in human and physical capital. While research connecting financial literacy to household savings decisions remains limited in developing countries, a rich strand of research exists for developed countries.

The ability to understand the degree of different investments can dramatically change the financial well-being of an individual. Inflation risk is often substantial, and financial literacy is required to understand which assets provide protection against inflation. Similarly, a nuanced understanding of the importance of how the value of various assets correlates with each other can help households diversify risk efficiently.

How India Earns, Saves and Spends?

A research study reveals that a major chunk of money of urban Indians, around 45% is spent on food. Transportation and education comes second and third place with 11% and 8.7% approximately. On the non-routine expenditure, ceremonies take a huge cut while medical emergencies come second. It explains why investors should pay importance on budgeting to curb the spend on food and transportation and also plan for a emergency fund these are the three top areas where money is being spent most. Food, transportation and education are non discretionary expenses and cannot be skipped; hence it makes sense to reduce the outgo by careful budgeting.
From the Figure 3 it is clear that the most preferred investment of the people is insurance and 62% of the households keep surplus cash in banks.

Figure 3



Source: How India Earns, Saves and Spends **b**y The Wealth Wisher, October 4th, 2010

Indians are wise savers but poor investors

A recent nationwide survey of over 60,000 households by National Council of Applied Economic Research (NCAER), New Delhi and Max New York Life has revealed that people in India do not plan for long-term future and keep away from investing in long-term instruments though they save for long-term goals such as emergencies, education and old age. It reveals that this phenomena is not just confined to just poor or middleclass households, but is prevalent in rich households too. The survey reveals the following results:

1. Most Indians prefer keeping 65 percent of their savings in liquid assets like bank or post office deposits and cash at home, while investing 23 percent in physical investments like real estate and gold and only 12 percent in financial instruments.

For getting secure return on their earning, 51 percent of Indians put their savings in the banks while 36 percent of households still prefer to keep cash at home.

2. The investment in post offices and other guaranteed return schemes and plans gets minor part of total savings. Only 5 percent of family put their money in post offices, while 2 percent buy insurance policies and 0.5 percent invests in equities.

3. Life insurance is among the most popular financial instruments (about 78 percent of the households are aware of life insurance), only 24 percent of households have a life insurance policy.

4. It suggests that Indian households have a strong saving habit. While income level is an important factor in influencing the saving patterns of households, variations in savings behavior are equally decided by education level and occupation, According to the study, 83 percent of the households surveyed saved for emergency, while children's education (81 percent) was the other key priority. While only 69 percent households saved for old-age financial security, 63 percent households said they kept aside money to meet future expenses like marriage, births and other social ceremonies.

5. The study also notes that nearly 47 percent households saved to buy or build a house and a similar percentage saved to improve or enlarge their business. Only 22 percent households saved to buy consumer durable and 18 percent for meeting expenses towards gifts, donation or pilgrimage.

6. The two main factors responsible for higher savings with growing age, according to the survey, are motivation to save and the need to meet old-age requirements.

7. The survey also suggests a direct link between the education and savings by pointing out that households headed by graduates had highest level of savings in both absolute terms and as a percentage of income.

8. The survey reveals the he habit of savings is good, but the way of savings are not good enough as only a meager part of total savings come under the government account that is not enough to conduct various plans properly.

9. The survey also reveals that 96 percent of the households cannot survive beyond a year on their current savings in case of loss of income due to some eventuality such as death or disability of the chief earner. However, a majority of those surveyed expressed confidence in their financial well-being. Lack of awareness of their financial preparedness for income loss predicated their ignorance of the more viable channels for long-term investment.

Emerging Role of Financial literacy

Financial Literacy is the ability to grow, monitor, and effectively use financial resources to enhance the well-being and economic security of oneself, one's family, and one's business. Recognizing the need for financial education, many countries, both developed and developing, have launched financial education or financial literacy programmes for their people. The OECD has brought out "Recommendations on Principles and Good Practices for Financial Education and Awareness", which is furnished below:

i) Governments and all stakeholders concerned should promote unbiased, fair and coordinated financial education.

ii) Financial education should start at school, for people to be educated as early as possible.

iii) Financial education should be part of the good governance of financial institutions whose accountability and responsibility should be encouraged.

iv) Financial education should be clearly distinguished from commercial advice; codes of conduct for the staff of financial institutions should be developed.

v) Financial institutions should be encouraged to check that clients read and understand information, especially when related to long-term commitments or financial services with

potentially significant financial consequences; small print and abstruse documentation should be discouraged.

vi) Financial education programmes should focus particularly on important life-planning aspects, such as, basic savings, debt, insurance and pensions.

vii)Programmes should be oriented towards financial capacity building, appropriately targeted on specific groups, and made as personalized as possible.

viii) Future retirees should be made aware of the need to assess the financial adequacy of their current public and private pension schemes.

ix) National campaigns, specific websites, free information services, and warning systems on high-risk issues for financial consumers (such as fraud) should be promoted.

Present Financial Literacy situation in India

With the advent of the global economic crisis, the need for financial literacy has become more evident. Globally, many countries defaulted in debt payments and hundreds of thousands of common individuals faced critical financial problems in their life. In India too, many individuals who had taken debts or made bad financial decisions in the boom period faced enormous difficulties and challenges in their financial life. Therefore, Financial Literacy is not an option anymore!

So, the government is in the process of setting up the "Financial Stability and Development Council (FSDC)" which will focus on financial inclusion and financial literacy. Presently, there are only a few organizations in India working in the field of financial literacy. These are as follows:

1. **RBI** – The Reserve Bank of India is quite active in the field of financial literacy in India. RBI has designed comics on money and banking which can be downloaded for free on the website ww.rbi.org.in/Financial Education. RBI's main focus remains on financial inclusion and financial literacy is one of the areas which it is trying to spread awareness about. RBI has directed that public and private banks take up the cause of financial inclusion aggressively while not giving the same attention towards financial literacy. Therefore much needs to be achieved by RBI in terms of making financial literacy and education a mass movement in India.

2. **SEBI** – Many investor associations focused on the stock markets are registered with SEBI. SEBI undertakes investor awareness programs through its department of National Institute of Securities Markets (NISM). www.nism.ac.in

3.**MCA** (IEPF) **–** The Ministry of Corporate Affairs is spreading financial and investor awareness through the Investor Education and Protection Fund. The focus of MCA is however more geared towards adult programs primarily comprising of investor awareness camps. www.iepf.gov.in

4.□**ICAI, ICSI, ICWAI** – These organizations have their own financial literacy and investor awareness programs and also get support from the MCA and other government departments for spreading financial literacy. These institutions are focused on creating investor awareness among the middle income segment and their own member communities, rather than programs for the general public.

5.**Stock Exchanges –** NSE, BSE, MCX, and others also have programs on investor awareness and regularly release articles and propaganda related to financial literacy. These organizations are not really focused on financial literacy but on increasing the public participation in the stock markets.

Research Opportunities in Financial literacy

Being financially literate is essential for both avoiding and solving financial problems, and, are vital to living a prosperous, healthy and happy life. So, financial literacy has become a prominent research topic and it is expected that the focus will lean towards the implementation and evaluation of strategies to improve the financial literacy levels of certain cohorts of populations where a lack of financial knowledge and skill has been identified Further, the high number of people with low levels of financial literacy presents a serious problem for both the economic well-being of nations and the personal well-being of such individuals Thus research is required to determine appropriate and accurate benchmarks for the ongoing measurement of financial literacy. In addition, continuing changes and advancements in technology, as well as requirements regarding saving, borrowing, investing, retirement, medical and insurance will provide further impetus for financial literacy research.

Conclusion

Financial literacy has become increasingly important for the economic wellbeing of the nation's future it is important that it can be explicitly linked with financial behaviour, and hence financial success and sustainability. No financial literacy study has yet achieved this. Another area of research is the focus on the components of financial literacy and determining which are most and least critical to financial success and sustainability. Several studies reveal that personal financial skills and knowledge are acquired mostly through 'trial and error', but no research to date has actually attempted to investigate what types of financial experiences and characteristics have the most influence on an individual's personal financial literacy or competence. Another area of research is the focus on gathering extensive details of financial experience and characteristics, which may prove to be important influential variables in modeling financial literacy among general populations.

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S.No	Title of the Paper	Author	Variable Studied	Methodology	Objectives of the Study	Sample Studied	Findings of the study
1	Financial Literacy and Investment decisions of Indian Investors – A case of Delhi and NCR	Pallavi Seth G.N.Patel K.K.Krishnas	Financial Literacy Demographic Variables	Questionnaire	1. Financial Literacy among the samples 2. Relationship between age, Income and Education 3. The preferred investment instrument	140 Middle Class and Lower Middle Class People	1. High income respondents have high financial literacy score than low income people. 2. LIC is the most effective financial instrument.
2.	Assessing the importance of Financial Literacy	Shawn Cole Nilesh Fernando	Financial literacy Savings	Descriptive Study	1.Importance of Financial Literacy 2. Relationship between Financial literacy and savings	NA	Financial literacy Influences Savings and Investments.
3.	Financial Literacy and Financial Planning: Evidence From India.	Sumit Agarwal Gene Amromen	Financial Literacy Investment Behaviour	Questionnaire	The study examines the investment behavior, liability choice, risk tolerance and insurance usage of program participants by conducting a financial advisory program.	Clients of Investment Yogi Financial Advisory Services in Hyderabad.	Majority of the respondents are financially literate. The study implies that there exist significant variations across demographic groups and reveals that there exist relationships between literacy and socioeconomic variables
4.	Prices (or) Knowledge? What drives demand for financial services in emerging markets?	Shawn Cole	Financial Literacy and Household behavior Demand for Financial Services	Surveys, Field experiment	To prove two theories: 1. The financial services are expensive that low income does informal savings 2. Financial literacy serves as a important barrier to demand for services.	Households in India. Through stratified sampling 112 villages and 3,360 households was selected for the study.	1. Financial literacy has no impact on the probability of opening bank accounts. 2. Modest subsidies have large effect.

5	The ABC's of financial literacy – Experimental evidence on attitudes, behavior and cognitive biases	Fenella Carpena Shawn Cole	Financial literacy and Financial behavior	Experiments	Which channel of financial literacy education is effective?	Urban households	Financial Literacy training increase individual's awareness of financial products and services.
6	Indians have better financial management skills. Is it so?	ING Group	Financial Literacy Attitude	Survey	To find the way Financial literacy affects his attitudes and behavior on buying financial products or simply making financial decisions.	Survey of 10 countries 5000 Sample across 10 countries.	Financial literacy percentage in India is 55%. Attitude of Indians is to keep the cash safe as a bank balance.
7	Consumer behavior in financial markets. Financial crisis and policy implications.	Sumit Agarwal	Financial Mistakes Financial Decisions Financial education and counseling	Questionnaire	(i) Do consumers make mistakes in choosing credit Contracts? (ii) If yes, do they learn from their mistakes? (iii) Do financial mistakes vary by age? Is financial decision making related to cognitive abilities? Does financial counselling and education help them make better financial decisions?	Households	Consumers (old and the young) are more prone to making financial mistakes and these mistakes are correlated with cognitive abilities. The research concludes that the role of financial counseling and education and they finds mixed evidence.