

# FINANCIAL LITERACY AND FINANCIAL WELLBEING – A LITERATURE REVIEW

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## *Abstract*

The concept financial literacy has assumed significance all over the globe ever since the 2008 global crisis where investors suffered huge losses on account of market failure. The market failure has eroded the wealth of the investors especially the wealth of those who invest in equity markets. The crisis has brought few lessons as forewarning to the investors and this paper looks into the various aspects in which financial literacy can safeguard the interest of investors and lead them to financial wellbeing. The methodology of the paper is to scan the existing literature on financial literacy and financial wellbeing. The scope of the paper is justified as research scholars, policy makers and practitioners may find it as a contribution to the existing literature on the domain financial literacy and wellbeing.

Key words: financial literacy, financial education, financial wellbeing, financial wellness

JEL Classification: D14, G01, G53, I31

## **Introduction**

Financial wellness is the ultimate goal of every individual and households and towards this end, all efforts are taken to ensure that individuals are not misguided in managing their personal finance. Quite often, owing to lack of literacy or poor knowledge on managing the savings and investments, individuals land in trouble either as a victim to scamsters or forced to pay high interest and charges for borrowings etc. Hence a basic level of financial literacy or education is required for everybody. To get the youngsters prepared for the future, learnings on financial literacy is often preferred at high school levels so that the concepts and processes in making the people to pursue savings and investments are well imparted. The subject matter of financial literacy involves savings, investment, borrowing, insurance, pension etc. The habit of savings is to be imparted to all segments of the population and a savings culture is to be carved out. Savings is to be treated as a compulsory habit and to be followed by households on pay day. Once savings are accumulated to a reasonable sum, the same is parked in investment. The investment is to be for a particular duration, say, one year, two years etc. and the same would carry a particular return. The determinants of savings are liquidity, safety and return. Liquidity implies capacity to convert into cash or demand to encash the investment when need arises. Safety is the situation that the principal and interest on an investment are safe in the hands of the service provider and there is no chance of failure of the scheme. Return means the interest income that is accrued on the investment. Thus, based on these three criteria, often called as holy trinity in investment, investors park their savings in investment. A fair level of financial literacy is required to make people manage their personal finance. Personal finance means the income and expenditure of the households as well as the assets and liabilities. The income, expenditure, assets and liabilities of the households are to be managed in such a way that the net worth of the family or households witnesses a steady increase over the years. It is the increase in financial net worth of the families along with the confidence and satisfaction in managing their personal finance determine the financial wellbeing.

## Financial Literacy

The subject financial literacy has been viewed by researchers in different ways. The International Network on Financial Education (INFE) of OECD defined financial literacy as ‘a combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and ultimately achieve individual financial wellbeing.’ The definition illustrates certain attributes for individuals to arrive at decision making and these attributes are knowledge, skills, attitude and behaviour. Knowledge about the products and processes in financial transactions are absolutely required to arrive at any decision to save or invest. The skills relate to the experiential learning of financial transactions. Learning by doing the transactions is important as repetitive transactions by individuals make them habituated with the processes and remain confident. The attitude of individuals towards managing the personal finance is to be positive and ready to take up activities that enhance the financial literacy. Once an individual is literate on various aspects of personal finance, the same is to be shown in behaviour. Thus, decision making becomes quite easy and pertinent if the requirements – knowledge, skills, attitude and behaviour are fine-tuned and result in better financial literacy. National Financial Educators Council (NFEC) defines financial literacy as ‘possessing the skills and knowledge on financial matters to confidently take effective actions that best fulfils an individual’s personal, family, and global community goals’. Here the financial literacy is linked to achieving financial goals and to meet goals, individuals are required to get the confidence, knowledge and skills to arrive at the decisions that make the goals materialise within a time frame. [Remund \(2010\)](#) views financial literacy in two aspects – conceptual definition and operational definition. The conceptual definition relates financial literacy in acquiring certain competencies in managing personal finance. These attributes are classified into five – knowledge, skills, aptitude, confidence and ability to communicate. The operational definition of financial literacy is related to the factors that can be expressed in objective assessment in one’s personal finance management. These are classified into four segments – budgeting, savings, borrowing and investing. A sound understanding about the concepts and operations in personal finance management is required to make the desired effect of financial literacy on financial wellbeing. [Huston \(2010\)](#) makes a scientific conceptualization of financial literacy and views financial literacy in two dimensions – understanding and use. Understanding personal financial knowledge and application of this knowledge through financial transactions are important in financial literacy. Thus, measurement of financial literacy is to be made by assessing how well an individual can understand and use personal finance related information. The application dimensions of financial literacy is stressed here as an individual should have the ability and confidence to make use the financial knowledge to arrive at financial decisions, The author views financial literacy as human capital and financial education is an input to enhance an individual’s human capital.

[Cohen \(2010\)](#) cites the importance of financial education as it provides a foundation for effective money management which is an indispensable skill in the deregulated environment. By bringing the topics budget, savings, and borrowing to the table of less educated, financial education leads to behavioural change and financial empowerment. This is evidenced through findings from a randomized impact evaluation conducted at SEWA clients in Ahmedabad. [Shuttleworth \(2011\)](#) considers financial literacy as the consumer’s ability to understand financial information and use it to make responsible financial decisions. [Mundy and Moseke \(2011\)](#) stress the need for more knowledge on financial concepts and such knowledge should be translated into skills. [Sebstad et al. \(2006\)](#) argues for enhancing knowledge through understanding financial concepts and financial products. [Potgieter \(2013\)](#) on the other hand focuses on financial attitudes that determined how to spend and resultant financial behaviour.

## Financial Wellbeing

The ultimate goal of financial literacy is to achieve financial wellbeing. Financial wellbeing is a situation in which individuals feel comfort in managing their personal finance, their materialization of financial goals in tune with the financial planning. Consumer Financial Protection Bureau, U.S, has given a standard

definition of financial wellbeing. It defines financial wellbeing in terms of financial security and financial freedom of choice in the present and future. It is a state when individuals have control over day to day finances, have the capacity to absorb financial shock, have the financial freedom to make choices and are on track in meeting financial goals. This comprehensive definition makes financial wellbeing meaningful as people with same level of income and financial experiences feel different levels of financial wellbeing.

Various research studies have been conducted in the domain – financial wellbeing. Financial wellbeing is a composite concept of objective and subjective dimensions. The indicators of the objective measure of financial wellbeing are income level, debt level, net worth position, adequacy of emergency fund, liability level etc. [Hong and Swanson \(1995\)](#) provide three indicators of financial wellbeing and these are household income, emergency fund adequacy and total debt to income ratio. The adequacy of emergency fund is an important requirement of financial wellbeing and this has been examined by [Johnson & Widdows \(1995\)](#), and [Hanna, Chang, Fan & Bae \(1993\)](#). Net worth as an indicator of financial wellbeing is examined by [Greenwood & Wolff \(1988\)](#), [Radner \(1989\)](#) and [Hurd \(1990\)](#). Researchers [Winger & Frasca \(1993\)](#) suggest three to five months take home salary as emergency fund. Debt to income ratio is another indicator, the same looked into by [Garman & Fogue \(1991\)](#). The subjective dimension of financial wellbeing is explored by researchers [Hayhoe \(1990\)](#) and [Porter \(1990\)](#) and they are of the view that subjective aspects also matter in assessing the financial wellbeing. Most research studies use a composite concept of financial wellbeing, taking into account objective measures as well as subjective measures to arrive at financial wellbeing. This is supported by [Joo \(1998\)](#) and [Porter and Garman \(1993\)](#).

[Parker et al. \(2016\)](#) has advocated for four components of financial health and these are Spend, Save, Borrow and Plan. One is considered financially healthy when the expenditure is less than income and resorts to payment of bills on time and in full. On saving, one must have sufficient living expenses in liquid savings and possesses sufficient long term savings or assets. On borrowing, one must have sustainable liability load and should possess a prime credit score. On plan, one should have appropriate protection plan or insurance scheme and has the practice of financially planning. These four components are converted into measurement metrics. The spending is measured through identifying the difference between income and expenses and arriving at the percentage of bills that are paid on time and in full. Saving is assessed through arriving at the number of months of living expenses kept in savings account balances and calculating the amount of one's long term saving and investments. Borrowing is measured through calculating debt to income ratio and the ruling credit score. Planning is assessed through ascertaining the type and extent of insurance coverage and the behaviours that exhibit future financial orientation.

[Kempson et al. \(2017\)](#) discuss financial wellbeing as the situation in which a household is able to meet all their commitments and needs and has the resilience to maintain the situation throughout the life. The authors developed a model in which financial literacy is influenced by the socio economic environment and depends on knowledge, skills and experience. This is expected to exhibit in positive behaviours leading to financial wellbeing which is measured by financial resilience, a feeling of comfort and satisfaction on meeting the commitments.

Based on a survey, the Federal Reserve System, the central bank of the United States of America, prepared a report on the economic wellbeing of US households in 2018. The objective of the survey was to share the financial challenges and opportunities that households in U.S face. The questions posed on the survey were on the extent of savings in proportion to income, preparedness for emergency, availability of credit facility and savings for retirement, among others. The findings of the survey revealed that many households in U.S. are financially vulnerable and difficult to manage an emergency fund. Volatile income and low savings made them vulnerable. The survey observed that financial wellbeing increases with education.

## Financial Literacy and Financial Wellbeing – Inter relationship

Taft et al. (2013) examined the relationship between financial literacy and financial wellbeing and concluded that financial literacy leads to enhanced financial wellbeing. The authors viewed financial literacy as the ability to understand and interpret financial options for decision making, plan carefully to meet financial goals, and face appropriately the life events. Financial literacy helps reducing social and psychological pressures and enhancing the welfare of the family. It reduces stress, disputes, illness, abuse of children and conflict in families. The study revealed that a higher level of financial wellbeing is followed by financial literacy and a higher financial literacy leads to reduced financial concerns. Higher financial wellbeing reduced financial concerns.

Mokhtar and Husniyah (2017) define financial wellbeing as satisfaction or dissatisfaction towards financial situation in managing finances among individuals. An empirical analysis conducted by the authors indicated that work environment, financial stress, locus of control and financial behaviour were associated with financial wellbeing. On work environment the respondents consider their financial wellbeing as an outcome of their work place environment that affects their commitment, self-esteem, and efficiency. Financial stress is the self-perception about stress in meeting the commitments. Locus of control is the extent of control of their destiny as respondents reflect their financial wellbeing as the outcome of their actions or influences from others. Financial behaviour reflects the habits of managing personal finance. The study concluded that lower financial stress, good financial behaviour and positive work environment would enhance employees' financial wellbeing. Financial stress was the largest factor affecting wellbeing followed by work environment. Financial education at workplace can enhance the understanding of employees' financial behaviour.

In December 2018, a national financial literacy and wellbeing survey was conducted in Ukraine. The survey assessed financial wellbeing of 2007 respondents in the age bracket 18-79 years in Ukraine. The survey observed that over 60 per cent of Ukrainians feel negative about their financial wellbeing. Wellbeing is found much lower for people aged over 60, and also for people with less income. Women are found to be better in financial wellbeing compared to men. Resilience, the most important aspect of financial wellbeing is one dimension assessed among the respondents. About 70 per cent of the respondents were concerned about facing an unexpected expense. For the whole sample, the average wellbeing index was 33 per cent, for low income people the average score was 13 per cent and for the highest income group the average wellbeing score was 41 per cent.

Mehwish Zulfiqar and Muhammed Bilal (2016) highlighted the importance of financial literacy and financial wellbeing for working women and studied the impact of financial literacy and financial attitude on financial wellbeing. The sample consisted of 300 women working in the non-financial sector in Pakistan. The study found that more than 70% of the women answered questions on financial literacy correctly implying that working women can understand and comprehend financial concepts correctly. Financial literacy and financial attitude were found to be positively and significantly associated with financial wellbeing of working women. With respect to demographics, age was the most influencing factor followed by their marital status with regards to financial wellbeing.

Adam et al. (2017) examined how financial literacy and behaviour influenced the financial wellbeing of retirees in Cape Coast Metropolis of Ghana. The results indicated that financial literacy, retirement planning and family support significantly made impact on financial wellbeing of retirees. It is the retirement planning and family support that influenced financial wellbeing of retirees than the financial literacy. The study findings imply that retirement planning and financial literacy should be promoted among the employees as every step towards retirement planning can bring wellbeing in the post retirement life.

## Conclusion

The literature review reveals that financial literacy as a public policy plays a vibrant role in educating the public on the prudent management of personal finance of an individual or household. Financial market transactions are often influenced by the demand and supply forces and hence market may witness fluctuations in the yield of investment products. An educated investor can understand the market mechanism better and can play safe. Financial education should be promoted at all levels, right from student education to education of the elderly. Financial literacy should be part of curriculum in schools so that the upcoming generation understand the significance of money and its management. Financial education at workplace is another suggestion as it is revealed in many studies that workplace productivity is disturbed with poor financial wellbeing. Employers need to educate its workforce regarding the sound principles of savings, investment, protection plans, retirement planning etc. Literacy on retirement planning is to be given due importance as assured benefit plans are replaced by contributory plans. Financial concepts viz. power of compounding, time value of money, risk reward relationship, asset allocation, risk diversification etc. are to be imparted to the young investors to make them understand the management of personal finance and invest prudently. Homemakers are another segment that requires learning on savings and financial planning. Financial literacy to the marginalized and underprivileged is to be carried out duly incorporating adult learning principles in the content and delivery of financial education.

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