TACKLING THE FINANCIAL CAPABILITY DEFICIT

Summary

The ability to make sound financial decisions has always been an essential life skill, enabling people to manage their day-to-day expenditure, cope with unforeseen emergencies and plan for their retirement. This is becoming even more important as financial decisions become more complex, consumer attitudes change and the emphasis on individuals to take personal responsibility for their financial welfare increases.

However, evidence from a new poll commissioned by the Resolution Foundation from *YouGov*[1] suggests that people in the UK are in a poor state of financial health, with parents in particular concerned about how their children will cope with the financial decisions they will face and large numbers of people regularly worrying about their finances.

- Nearly 70 per cent of parents worry about how their children will deal with the financial decisions they will face during their lifetime
- Almost 80 per cent of people admit to worrying about their personal finances at least 'sometimes', with one in ten of them worrying 'all the time' and over one in four worrying 'often'
- Nearly 60 per cent of people believe that the average UK person is in a poor state of financial health

The Financial Services Authority (FSA) has made good progress in recent years in leading efforts to improve 'financial capability'.[2] There are also welcome indications that the Government is giving increasing priority to improving the UK's financial health, with a financial capability action plan due later in the year and a review, led by the Chief Executive of AEGON UK, Otto Thoresen, currently taking place to determine how to deliver 'generic' financial advice on a national basis.[3]

As managing personal finances becomes a more complex task, our poll reveals strong support for these initiatives.

- Over 60 per cent think that people find managing their personal finances more challenging than they did 10 years ago
- Nearly three-quarters of people said they support the development of a national service to provide generic financial advice
- Over half of people said they would be likely to use such a service at least once a year, with over a third likely to use it at least every few months and only one in ten saying they would not use it

In light of these findings, the Foundation is underlining the opportunity for the Government to earmark funding in the forthcoming Comprehensive Spending Review to deliver a national generic financial advice service, following the publication of the Thoresen Review's recommendations in the new year. This could be part of a public-private funding agreement between the Government and the financial services industry, which our poll suggests would be the most popular way of delivering the service.

Background

People are increasingly reliant on financial services. 98 per cent of us hold at least one type of financial product.[4] Excluding debt and mortgage repayments, the average household spends £43.90 a week, nearly 10 per cent of their income on financial products and services.[5] An effective interface between consumers and the financial services industry is therefore essential. However, this interface is often undermined by complex products, poor communication between the industry and its customers, problems in accessing basic financial products for people on low incomes and mistrust of the industry among consumers.

Young people in particular face a more complex environment than their predecessors. Previous polling has suggested that 90 per cent of teenagers worry about their money and spending, two-thirds think about money every day and more than half of them have been or are in debt by the time they are 17.[6] Young people also now have to bear more of the cost of further education and are therefore borrowing increasingly large sums of money. Nearly two-thirds of graduates leave university with debts of over

[1] The sample size for the survey was 2,010 adults. Fieldwork was undertaken from 25-27 July 2007. The survey was carried out online. The results have been weighted are representative of all GB adults (aged 18+).
[2] Financial capability can be defined as people's financial knowledge and skills, understanding of their financial circumstances and motivation to take action.
[3] Generic financial advice is advice and guidance given in light of people's individual circumstances which helps them understand their financial needs, identify their options and take appropriate action. As it stops short of making recommendations about particular products and providers, it does not fall under the FSA's regulatory regime.
[4] *Financial capability in the UK*: establishing a baseline; FSA, 2006
[5] *Family spending 2006 edition*; Office for National Statistics, 2007
[6] pfeg press release, 13 February 2007

£10,000, with the average graduate debt now standing at £13,252.[7] However, these problems are not confined to young people. The Consumer Credit Counselling Service reports that money worries are growing faster among people over the age of 60 than among any other age group.[8]

Against this background, growing concern has been voiced about the financial health of people in the UK. Two issues in particular have fuelled this concern; rising levels of consumer debt and the failure of people to save enough for their retirement.

Debt

The increase in consumer debt, which has more than doubled since 2000, has been well documented. The UK is the most indebted country in Western Europe. Although over-indebtedness remains a serious problem for only a small proportion of the population, it has taken a significant toll in recent years, with services such as National Debtline, the Consumer Credit Counselling Service and Citizens Advice all reporting a significant increase in demand for their services. Fuelled by the growth of Individual Voluntary Arrangements (IVAs), the number of individual insolvencies has also increased dramatically.

- Total consumer debt in the UK stood at £1,345 billion at the end of June 2007, with the average household debt, excluding mortgages, now £8,816[9]
- The average person has unsecured debts of £6,739, nearly 40 per cent of their income[10]
- Recent research published by debt consultancy firm Thomas Charles suggested that over 8 million Britons have unsecured debts of more than £10,000, with around a quarter regularly struggling to meet repayments[11]
- It has been estimated that the leading high street banks are expected to write off around £6.5 billion in bad debts in 2007, a 20 per cent increase on last year[12]
- 114,439 individual insolvencies were recorded in the year up to June 2007, a rise of 28 per cent on the previous year (although increases appear to be levelling off)[13]

Up to now, rising house prices and the strength of the economy have meant that the concerns expressed by many commentators about the consequences of the rising debt burden have not so far been realised. However, recent rises in interest rates and concern about a possible slowdown in the housing market are once again fuelling these fears. 25,900 homes were repossessed in the year to June 2007.[14] Although recent years have seen historically low levels of mortgage repossessions, this represents an increase of 40 per cent on the previous year.

Pensions

Pensions decisions are among the most complex and important financial choices people make during their lifetime. The dramatic decline in the number of 'defined benefit' pension schemes has placed more onus on people to take responsibility for their pensions. However, understanding of the pensions system is low and many people are failing to plan adequately for their retirement.

- The number of people of State Pension Age and above will increase from 11.25 million in 2005 to over 18 million by 2055[15]
- The Government estimates that at least 7 million people are currently under-saving for their retirement[16]
- While 81 per cent of people feel that the State Pension will not provide enough to live on in retirement, only 37 per cent of them have made any additional provision for later life[17]
- Outside the public sector, defined benefit schemes now cover only 11 per cent of the workforce[18]

To address this, and to ensure that people take personal responsibility for saving for their retirement, the Government plans to introduce a national system of 'personal accounts' from 2012. The aim is to provide a simple, low cost way of saving for people on low to moderate incomes, who will be automatically enrolled into the scheme if they do not have access to a suitable occupational scheme through their employer. The Foundation has argued strongly that personal accounts should be accompanied by generic financial advice to ensure that people understand the choices available to them and make the right decisions in light of their individual circumstances.

The financial capability deficit

Experts agree that, as financial decisions have become more complex, people's knowledge and skills have failed to keep pace, creating a significant deficit in financial capability which fuels poor decision-making. The full extent of the financial capability deficit was highlighted by the FSA when it published the results of its 'baseline survey' of financial capability in March 2006.[19]

7 *Debt facts and figures*; Creditaction, August 2007 (quoted from a Natwest Bank survey)
8 *2006 Statistics Yearbook*; Consumer Credit Counselling Service, 2007
9 *Debt facts and figures*; Creditaction, August 2007
10 Official Report, 19 June 2007, col 1641 W
11 www.telegraph.co.uk, 2 August 2007
12 www.nortonfinance.co.uk, 23 February 2007
13 Insolvency Service quarterly statistics, August 2007
14 Mortgage possession statistics; CML, August 2007
15 *Pension facts*; Pensions Policy Institute, July 2007
16 *Security in retirement; towards a new pension system*; DWP, December 2006
17 *Financial capability in the UK: establishing a baseline*; FSA, 2006
18 *The state of the nation's savings 2006/07*; ABI, 2007
19 *Financial capability in the UK: establishing a baseline*; FSA, 2006

- Almost three million people find it a constant struggle to keep up with their financial commitments
- 1.5 million people are falling behind with bills and credit commitments, around 500,000 of whom say they have real financial problems
- 39 per cent of people say that they tend to live for today and let tomorrow take care of itself
- 70 per cent of people have made no provision for a drop in income, yet 28 per cent say they have experienced a large unexpected fall in income in the last three years and 21 per cent have faced a large unplanned expense
- 40 per cent of people who own an equity ISA are not aware that its value fluctuates with stock market performance, while 15 per cent of people who own a cash ISA think its worth does vary in line with the stock market
- When purchasing financial products, 42 per cent of people rely on product information and/or advice from family and friends, while one in five do not seek any advice at all

The Resolution Foundation's poll supports the FSA's analysis. Although it suggests that many people think they are sufficiently informed and confident enough to be able to deal with their personal finances, in reality the majority of people worry about their financial situation, are concerned about the financial health of people in the UK and are anxious about how their children will deal with the financial decisions they will face.

- 63 per cent of people agree that they feel sufficiently informed and confident enough to deal with and plan their personal finances, while 36 per cent disagreed or did not express a view
- 42 per cent of people admit to worrying about their personal finances 'sometimes', with a further 27 per cent worrying 'often' and 10 per cent worrying 'all the time'
- Only 16 per cent of people worry about their finances 'rarely' and just 4 per cent 'never'
- 68 per cent of parents worry about how their children will deal with the financial decisions they will face during their lifetime
- 59 per cent of people believe that the financial health of the average UK person is 'very' or 'fairly' bad
- Only 11 per cent of people think that the financial health of the average UK person is 'very' or 'fairly' good
- 62 per cent believe that people find managing their personal finances more challenging than they did 10 years ago

People most at risk from the financial capability deficit

Although the financial capability deficit is a problem that spans incomes and generations, previous research undertaken by the Foundation has shown that people on low to moderate incomes, a group comprising around 15 million adults,[20] are more vulnerable to its consequences. Unlike those on higher incomes, they do not have the cushion of wealth to offset the consequences of poor financial decision-making. This leaves them particularly vulnerable to falling into debt and poverty should their incomes fall or their circumstances change.

- Only 53 per cent of people on low to moderate incomes are members of an available employers' pension scheme, compared to 81 per cent of those on higher incomes
- 17 per cent have personal pensions compared to 27 per cent of those on higher incomes
- Only 40 per cent have life assurance compared to 58 per cent of higher earners, while less than half as many have income protection products
- Analysis carried out for the Foundation shows that nearly one-third of this income group display 'chronic' or 'acute' signs of financial stress[21]
- Although they make up nearly 90 per cent of the population, people earning under £30,000 a year account for less than half of the customer base for independent financial advisers[22]

In addition, those on the lowest incomes often find themselves 'financially excluded', lacking access to the basic financial services most people take for granted, and incurring significant costs as a result. For example, having a bank account is a pre-requisite for many jobs and not having one means paying more for basic transactions such as cashing cheques. Exclusion from mainstream credit forces people to rely on expensive sources of credit such as doorstep lenders and loan sharks. Those without insurance or savings are vulnerable to risks such as theft or unexpected costs.

- 4 per cent of UK households do not have a bank account of any kind and 1 in 10 do not have a current account
- People without direct debit facilities pay an extra £70 a year for their energy bills[24]
- 7.8 million people in the UK are unable to access mainstream credit[25]
- In 2002, 57 per cent of over-indebted households had annual incomes of less than £7,500[26]
- 3 million households in social housing lack contents insurance, while they are twice as likely to be burgled as people living in privately owned properties[27]

[20] Defined as receiving no more than 20 per cent of income from benefits but being on below median income
[21] *Closing the advice gap: Providing financial advice to people on low incomes*; Resolution Foundation, 2006
[22] *Financial capability*: the Government's long term approach, HM Treasury, 2007
[23] *Family Resources Survey 2004/05*; Office of National Statistics, 2006
[24] Fuel Poverty Advisory Group memorandum to the Treasury Select Committee inquiry into financial inclusion, 2006
[25] *Home credit: examining whether doorstep credit works well for consumers on low incomes*; National Consumer Council, 2006
[26] *Financial capability*: the Government's long term approach, HM Treasury, 2007
[27] *Widening the safety net*; Demos, 2005

The benefits of improved financial capability

Experts agree that improved financial capability will deliver significant long term benefits to the consumer, the Government and the financial services industry.

For consumers, it would lead them to make better product choices, saving them money in the short term and, in the long term, offering the opportunity to improve their income in retirement. By enabling people to purchase products that are appropriate to their needs, it would reduce the likelihood that they will fall into debt, minimise the stress and anxiety associated with financial problems and ensure that they have the means to cope with unexpected events.

It would also deliver significant benefits to the Government by promoting personal responsibility, reducing welfare dependency and supporting a range of policies including efforts to reduce over-indebtedness, encourage people to save for their retirement and tackle financial exclusion.

By creating more informed and confident consumers, improved financial capability would help promote a more efficient financial services market, potentially reducing the very high sales and distribution costs currently incurred by financial services companies (for example, the industry as a whole currently spends £1.5 billion a year on advertising).[28] It would also increase take up of certain types of products and improve the industry's reputation as a more effective interface with consumers increases trust and reduces complaints, potentially leading to a reduction in regulation over the long term.

- Research by the FSA showed that the typical consumer can save between £70 and £710 a year by making better financial product choices[29]
- Evidence from the United States suggests that receiving financial education as a child can result in people being up to £32,000 better off between the ages of 35-49[30]
- Research for the Resolution Foundation showed that increased access to financial advice could leave people on low to moderate incomes £60,000 better off by the time they reach 60 years of age[31]
- This research also showed that this could deliver potential savings in welfare expenditure of up to £100 million a year within 10 years, as better financial decision-making lifts people clear of the threshold for receiving Pension Credit[32]
- The Foundation's research has also suggested that increased access to financial advice would lead to people investing much more in savings, pensions and life assurance, while reducing their spending on credit cards and other unsecured debt products[33]

Progress

With responsibility for financial well-being increasingly shifting to the individual, it is becoming more important than ever to close the financial capability deficit. In recent years, efforts to improve financial capability have been led by the FSA, which has a statutory duty to promote public understanding of the financial services system. Funded by a general levy on regulated financial services companies, it oversees a National Strategy for Financial Capability, focusing mainly on increasing the availability of financial education and improving the quality of financial information.

The National Strategy for Financial Capability consists of a seven point programme.

- Promoting financial education through the National Curriculum, with a target of reaching 1.8 million children in 4,000 schools by 2010/11
- Working with partner organisations to promote financial education among young people, with the aim of reaching 2.3 million students and 1.1 million young people not in education, employment or training by 2010/11
- Rolling out a programme of work-based seminars which aim to provide financial education to over 4 million adults by 2010/11
- Improving the FSA's range of information materials and launching a new *Moneymadeclear* website to provide basic financial information to as many people as possible
- Promoting the *Financial healthcheck* and *Debt test* online tools to help people understand their financial situation and take appropriate action
- Providing a *Parent's guide to money*, with the aim of reaching over 1.5 million new parents by 2010/11
- Continuing to explore the most appropriate options for delivering generic financial advice

There are also encouraging signs that the Government is giving a much higher priority to promoting financial capability. In January 2007, the Treasury published a strategy document setting out its long term aspirations to ensure that:

- All adults in the UK have access to high-quality generic financial advice to help them to engage with their financial affairs and make effective decisions about their money
- All children and young people have access to a planned and coherent programme of personal finance education, so that they leave school with the skills and confidence to manage their money well

28 Nielsen Media research, 2006
29 *Losing interest: how much can consumers save by shopping around for financial products?* FSA occasional paper series 19, 2002
30 ippr press release, 23 August 2006
31 *A national dividend: The economic impact of financial advice*; Resolution Foundation, 2006
32 Ibid
33 *The advice gain: The impact of generic financial advice on the financial services industry*; Resolution Foundation, 2007

- A range of Government programmes are focused on improving financial capability, particularly to help those who are most vulnerable to the consequences of poor financial decisions

To achieve its aspirations, the document anticipates a more active role for the Government. A range of policies and programmes with a role to play in improving financial capability are currently being reviewed, with a view to publishing an action plan before the end of the year.

At the same time, the Government has launched a number of initiatives to address financial exclusion, backed by a £120 million Financial Inclusion Fund and overseen by a Financial Inclusion Taskforce. These initiatives have mainly focused on working with the banks to increase access to basic banking services, increasing the supply of debt advice, and expanding the number of credit unions and other third sector lenders. Ministers are committed to maintaining 'the current intensity of action', with funding due to be extended for another three years and a new action plan published later in the year.

A 'national financial health service'

The Foundation's poll suggests that financial decisions are becoming increasingly complex, that the majority of people worry about their personal finances and that parents are anxious about how their children will cope with the financial decisions they will have to make. This suggests that it is more important than ever to address the financial capability deficit.

Looking to the future, the Foundation advocates an approach based on a 'national financial health service' to promote financial capability, comprising three main elements:

- Preventative services: financial education to build people's financial awareness and skills
- Primary services: information and advice to help them make the right financial decisions
- Acute services: debt advice and other specialist services to help those in financial crisis

Recent years have seen a welcome increase in the availability of 'preventative' and 'acute' services. The FSA is leading work to promote financial education in schools, among young people and to employees through a programme of work-based seminars. The Basic Skills Agency is also developing ways of using financial literacy to teach basic literacy, language and numeracy skills. It was also recently announced that personal finance education will be explicitly included in the national curriculum for secondary schools.

The supply of debt advice and credit counselling has also increased, with over £50 million provided through the Government's Financial Inclusion Fund to increase the supply of face-to-face debt advice. Services such as National Debtline and the Consumer Credit Counselling Service have also significantly expanded their capacity in recent years.

- 48 per cent of primary schools and 91 per cent of secondary schools currently say they are delivering personal finance education, although in over 70 per cent of cases, this only takes the form of occasional lessons[34]
- By 2010, National Debtline will have the capacity to assist 230,000 clients a year, compared to 90,000 in 2006[35]
- In 2006, the Consumer Credit Counselling Service answered over 293,000 counselling calls on its helpline compared to 167,000 in 2004[36]

However, the Foundation's work has shown that people on low to moderate incomes in particular currently lack access to 'primary' services, especially affordable, impartial financial advice. Their advice needs are not met by the financial services industry, which packages advice as part of the product sales process, or independent financial advisers, who tend to target higher income groups, with voluntary sector services mainly focusing on the poorest or those with debt problems. This means that many people in this income group are only able to access financial advice if they are in debt ie when they have already reached crisis point.

The Foundation's poll shows that although many people say they are able to obtain the financial advice they need, around half are only 'sometimes', 'often' or 'never' able to access it. The poll also revealed mixed perceptions about the availability of affordable, impartial advice. Although 41 per cent of people agreed that enough advice is available, 24 per cent disagreed and 36 per cent did not express a view, suggesting a general lack of awareness about the extent of current advice provision.

The most common source of advice is family and friends, closely followed by banks and building societies. Far fewer people said they use independent sources of advice such as independent financial advisers (IFAs) or citizens advice bureaux. The poll also revealed that people on low to moderate incomes are nearly 40 per cent less likely than those on higher incomes to use an IFA, confirming the Foundation's previous findings about the barriers faced by this income group in accessing advice.

- Although 39 per cent of people say that they are able to access the financial advice they need, 37 per cent say that they are only 'sometimes' able to get this advice and 12 per cent are 'often' or 'never' able to access it
- The main sources of financial advice used by people who need it are friends and family (48 per cent) and banks and building societies (45 per cent)
- The other main sources of advice for people who need it are IFAs (32 per cent) and citizens advice bureaux (11 per cent)

[34] *Financial capability in the UK*: creating a step change in schools; FSA, 2006
[35] Money Advice Trust response to the Thoresen Review's call for evidence
[36] *2006 Statistics Yearbook*; Consumer Credit Counselling Service, 2007

Bridging the advice gap

Tackling this ‘advice gap’ is critical; the goal must be to encourage people to make active, informed decisions by ensuring that they understand the financial products available to them and are able to make the right financial decisions. The key to this is to increase the supply of generic financial advice - impartial information, advice and guidance, given in light of people’s personal circumstances, that enables them to understand their financial needs and take appropriate action as a result. This goes further than providing information but stops short of making recommendations about specific products or providers, which would be subject to the regulatory regime that applies to advice linked to product sales.

The Foundation has outlined proposals for a new national service to provide this advice via a combination of the telephone, internet and face-to-face advisers. We have put forward a range of costed delivery options, depending on the scale and type of service offered, but estimate that a national service based on telephone advice, augmented by the internet and face-to-face advisers, could be provided for an annual cost of around £50 million a year.

The need for a service of this type is supported by a wide range of financial, consumer and voluntary organisations, and has been strongly endorsed by MPs on the Treasury Select Committee. In March 2007, the Government announced the establishment of a review, headed by the Chief Executive of AEGON UK, Otto Thoresen, to design a national approach to providing generic financial advice. The Thoresen Review is expected to report around the turn of the year.

The Foundation’s poll shows strong support for the aims of the Thoresen Review, confirming our previous research that a generic financial advice service would be popular among consumers.

- 72 per cent of people said they would support the development of a service to provide generic financial advice, with only 7 per cent opposing this
- 53 per cent of people said they would use such a service once a year or more, with 35 per cent of people likely to use it at least every few months
- Only 11 per cent of people said they would never use such a service

As set out above, the Foundation’s previous research highlighted the benefits to consumers, the Government and the financial services industry of increased access to financial advice. On this basis, we have suggested that funding for a new service should be provided via a public-private funding agreement between the Government and the financial services industry.

Our poll supports this analysis, also suggesting that people would prefer generic financial advice to be provided by an independent organisation.

- 42 per cent of people (49 per cent of those who expressed a view) think that an independent organisation should be responsible for providing a new generic financial advice service
- Only 24 per cent of people think that it should be run by the Government and 17 per cent by the financial services industry
- 45 per cent of people (49 per cent of those who expressed a view) agree that a generic financial advice service should be funded by a combination of the Government and the financial services industry
- Only 25 per cent of people think it should be funded solely by the Government and 16 per cent by the financial services industry

Conclusion

Our poll provides further evidence of the extent of people’s concerns about their financial health. In doing so, it provides strong backing for the efforts of the Government, the FSA and others in promoting financial capability. However, it also highlights the need to build on this work by giving people access to the impartial advice they need to help them make the right financial decisions.

By confirming strong public support for a national generic financial advice service, the poll provides a clear endorsement for the work of the Thoresen Review. It also indicates that the most popular way of delivering such a service would be via an independent organisation, funded by a combination of the Government and the financial services industry. The Foundation therefore believes there is an opportunity for ministers to earmark funding in the Comprehensive Spending Review to deliver this as part of a public-private funding agreement, following the publication of the Review’s recommendations in the new year.

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