Rethinking Financial Capability

Lessons from economic psychology and behavioural finance

Mike Dixon

ippr

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NORWICH UNION

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About Norwich Union

Improving financial literacy is an important precondition for solving the long-term financial challenges facing the UK. As a leading financial services provider and consistently one of the most trusted brands, we recognise our responsibility to support the work of the regulator and government to improve financial capability in the UK.

However, it is crucial that programmes designed to improve financial skills actually deliver positive changes to people's financial behaviour and decision making rather than merely improving their awareness and understanding.

Delivering this behaviour change requires a greater understanding of economic psychology. The debate on financial education must evolve in a way that ensures the approach brings about the required change.

We are proud to have sponsored a report that has deepened our understanding of how people's financial decision making is formed and influenced, and can therefore help us create the right products and services for more informed, financially capable consumers.

Key facts

- Norwich Union is the UK's largest provider of life, pensions and investment products and has £102 billion assets under management.
- Norwich Union is the UK's largest insurer, insuring one in seven motor vehicles with a market share of around 14 per cent.
- Norwich Union is part of the pan-European insurance group Aviva, the largest life and pension provider in Europe and the world's sixth-largest insurer. Its main activities are long-term savings, fund management and general insurance. It has 59,000 employees and 30 million customers worldwide.

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Foreword

We are living in a consumer-driven society. From a very early age, children are exposed to many different messages from an increasing range of media. Everyday, in all areas of our lives, people are making very sophisticated decisions about what to buy and how to spend their money by reaching informed and rational decisions based on brand, quality and price.

Indeed, anyone with children will be only too familiar with the detailed knowledge they absorb and analyse regarding the pros and cons of mobile phones, MP3 players or games consoles - making decisions baffling to many adults.

However, despite becoming increasingly savvy about what we buy on the high street and in the supermarket, this informed decision making has not extended to how people manage their personal finances. When confronted with what can be equally complex decisions about how to manage their money, people often take actions that are not obviously rational and yet to them can make perfect sense. For example, people may keep large amounts of cash liquid in a current account rather than investing it in short- or medium-term savings, or they may not save for retirement even when they can afford to and know they should.

A better understanding of why people act as they do is crucial if the financial services industry and the Government are to successfully engage consumers and enable them to take greater personal responsibility in areas such as saving, protection and insurance. The state is increasingly reigning back in areas where it has previously accepted responsibility, and Norwich Union feels it is important that we debate the implications of this for our society.

It is widely acknowledged that financial education has a role to play in helping people take better informed financial decisions but it should not be assumed that simply having a more financially educated society will automatically translate into people taking appropriate action to manage their financial situation better.

There have been important and significant steps made over the last ten years to better understand the psychology behind the decision making process and Norwich Union is pleased to work with the Institute for Public Policy Research to bring this analysis to a new audience beyond the academic world.

We hope that the ideas raised in this report make a useful contribution to the wider debate being led by the Government and Financial Services Authority to create a more financially capable society. This is a common goal, which if achieved successfully will reward society, government and the financial services industry alike.

Mark Hodges
Chief Executive, Norwich Union Life

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 to 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.

Introduction

Ten years ago, almost no one had heard of the term 'financial capability'. Today, the UK is in the second phase of its dedicated National Strategy for Financial Capability with combined support from the financial services industry, the voluntary sector, the Government, much of the media and more than £10 million in annual funding (FSA, 2006b). The aim is to improve people in the UK's financial capability in making ends meet, keeping track, planning ahead, choosing products and staying informed (Atkinson *et al*, 2006). But will the strategy work?

This report argues that despite the substantial progress achieved over the last few years, the current approach is too limited in scope to achieve its ambition of significant change. The UK now needs a substantial increase in resources and a revitalised policy approach that makes better use of emerging thinking from academia and experiences from other countries and policy areas.

Mid 2006 is a good time to take stock. Financial capability is still fresh on the agenda and the National Strategy is in its relatively early stages. But there is now a good opportunity to undertake a paradigm shift in approach, in terms of both scale and content. Perhaps the most important advance so far has been the development of the concept of financial capability itself, one that is unique to the UK and internationally admired (SEDI, 2004; 2005).

Most other countries, including much of the US – where efforts to improve financial awareness are most prevalent – are still working with a narrower concept of 'financial literacy' (Vitt *et al*, 2000; 2005). So why is thinking about financial capability a step forward?

The simple answer is that financial capability is a broader concept, comprising five related strands that focus on behaviour, decision making and practical skills as well as the more traditional foci of knowledge and understanding. This is a more realistic encapsulation of the way people think about money in their everyday lives (SEDI, 2004). It is also a better focus for policy efforts because it highlights the importance of helping people to change their behaviour.

If the concept of financial capability is a relatively recent development, so too is the emergence of real political appetite for tackling it. Before the late 1990s politicians and policymakers remained relatively sanguine about the ability of UK citizens to navigate the financial landscape (FSA, 2000). Financial capability was not a political priority compared to recurrent crises over Europe, year-on-year increases in crime, and an economy that appeared to swing inevitably from boom to bust and back again with near-catastrophic implications for interest rates. But then two influential reports - building on a groundswell of academic research (Ford and Rowlingson, 1996; Kempson and Whyley, 1999) - the first by the Social Exclusion Unit (SEU) in 1998 (SEU, 1998) and the second in 1999 by Policy Action Team 14 (HM Treasury, 1999), helped change the terms of political debate.

Both of these reports focused on financial inclusion - an issue that remains central to policy debate today, with an ongoing Treasury Select Committee inquiry and a dedicated government taskforce (Financial Inclusion Taskforce, 2006).

This resurgence in political appetite was welcomed by much of the voluntary sector and the financial services industry: both have long recognised the importance of people's financial well-being in its own right, as well as its salience for broader social policy and business goals. It is an issue that has remained central to much of the work of the Institute for Public Policy Research (ippr), notably by Sue Regan and Will Paxton (Regan and Paxton, 2003). It is also an issue that has evolved considerably over the past five years.

Financial inclusion was often originally thought about in a polarised way (Kempson and Whyley, 1999): you were either in or you were out. But as understanding has deepened, there is growing consensus that this view is overly simplistic: financial exclusion is a continuum, with people more or less excluded across a range of different products and skills (Atkinson *et al*, 2006; FSA, 2006b).

This realisation has led naturally to the development of the financial capability agenda, which incorporates many of the original concerns raised in the late 1990s but sees them as relevant to a wider audience (FSA, 2003).

A wider audience – and considerable effort – has led to the creation of a 'grand coalition' for the promotion of financial capability. In 2003 the Financial Services Authority (FSA), under the auspices of its new Chief Executive, John Tiner, convened a partnership of leading thinkers, organisations and practitioners to establish a 'road map for delivering a step change in the financial capability of the UK population' (FSA, 2003; 2006b). Three years and seven working groups later, we now have the results of a first set of pilots, data from a comprehensive survey assessing the state of UK citizens' financial capability, and a range of specially commissioned reports covering topics as (relatively) diverse as the financial needs of young adults (FSA, 2005) and the best way of delivering advice (Wallis, 2005).

The evidence base has never been better: there is now a firmer grasp than ever of what works in promoting financial capability. The FSA has also recently published its plans for the next phase of the National Strategy for Financial Capability (FSA, 2006b). It is a good time to take stock and ask whether there are new approaches and ideas to try, and to assess the strategy against the evidence.

The time is also right to be thinking about the role of government in influencing behaviour. The business of government has always been the business of behaviour change: from the moment the Babylonian king, Hammurabi, ordered his 282 laws to be inscribed on an eight-foot stone slab nearly four thousand years ago, government officials have prescribed and proscribed in the interests of the common good. Regulations, taxes and subsidies, laws and punishments, information and persuasion, the provision of public services – all have been employed for centuries.

But in the last decade, policymakers have been spurred on by new findings in behavioural sciences and genetics, results from longitudinal studies tracking the impact of various kinds of behaviour on people's later lives, and – perhaps most importantly – a growing realisation that many of the most intractable social problems in the UK today are the result of entrenched behaviour that is resistant to traditional incentives. These policymakers have now become more interested in whether the Government should become more involved in trying to influence behaviour. Proponents of this approach variously point to the need to engage citizens in policy efforts in a more interactive way, rather than as merely passive recipients of services; the potential for greater cost effectiveness in achieving policy outcomes; and the moral and political case for greater personal responsibility (Halpern *et al*, 2004).

Revealingly, this shift has not been confined to one corner of Whitehall. Across the board politicians, researchers, practitioners and academics have simultaneously begun to talk about these new approaches to traditional policy questions (Halpern *et al*, 2004), encouraged by the deep entrenchment of evidence-based policymaking and piloting, which has revealed the inadequacy of much traditional wisdom. It is no longer enough to rely on ideas alone: rightly, proof is needed of whether they work (Pearce and Paxton, 2005). From tackling obesity to encouraging recycling, from reducing antisocial behaviour to promoting education, and from discouraging smoking to facilitating entrepreneurship, new strategies are needed. As David Miliband MP, then Minister of Communities and Local Government, noted earlier this year:

> *'Across government, there is growing recognition that if we are to move to the next stage of economic and social reform, we need more than 'more of the same'. To build on the foundations so far laid, we need new relationships between different public services and new relationships between public services and local people.' (Miliband, 2006)*

It is no coincidence that these questions have increasing resonance as our understanding of behavioural sciences grows. Economic psychology, behavioural economics, neuroscience, behavioural genetics, social norm theory, sociology and traditional economics (to name but a few) have seen significant advances in recent decades, partly spurred on by technological advances that have enabled us to assess, collate and compare information faster than ever before. We also now know more than ever before about how and why people make the decisions they do, and what affects behaviour (Kahneman, 2002). These developments will fundamentally change the way policy is created (Dixon, 2005; Pearce and Paxton, 2005), not least in relation to financial capability.

But these developments will also change our perspective on the financial capability challenge, seeing it not as an isolated issue, but as one aspect of a much broader challenge that is deeply rooted in fundamental cultural shifts – a challenge that will increasingly require government to work harder and more effectively to empower people in changing their behaviour. Over the long term, improving financial capability almost certainly requires a profound cultural shift, in terms of attitudes to personal responsibility, behaviour, consumption, sustainability and debt (Webley, 2006). This is an enormous challenge, which will not be met in the next decade. But without longer-term aims that set the direction for policy efforts, lasting cultural change is unlikely.

This report aims to set out this new direction for the financial capability agenda, complementing and developing the existing approach, and building on the understanding gleaned and progress made so far. It recommends two main shifts: increasing resources and improving the integration of academic theory and experiences from other areas into policy.

The central focus of this new agenda should be to empower people in becoming more financially capable, by using the best available theories and evidence about human behaviour. The agenda must apply the latest developments in economic psychology and behavioural economics (the study of how people really make decisions about money in their everyday lives) to the most rigorously evaluated evidence of what really works in promoting financial capability. This should be combined with the best theory about how people change behaviour, drawn from a burgeoning specialist literature, in order to draw out lessons for future policy development.

This is an ambitious task, one in which this short report can only make a start. But we hope that the ideas set forward here will help others to develop their thinking further and contribute towards a more financially capable Britain.

The structure of this report

The report is structured as follows. Section 1 sets out the economic, demographic, cultural and political context for financial capability in the 21st century. Section 2 reviews the state of the nation's financial capability in 2006. Section 3 considers priorities for action and future funding requirements and responsibilities. Section 4 sets out principles for action and identifies the motivation gap and the appropriate role of advice. Section 5 provides an overview of the latest theories from economic psychology and behavioural economics. Section 6 considers lessons from other policy areas, and strategies that empower people to change their behaviour. Section 7 benchmarks current domestic and international policy success against this theory. Section 8 sets out new strategies for financial capability, based on this analysis.

1: Financial capability in the 21st century

The need for a more financially capable Britain is clear: deep-rooted social, economic, cultural and political trends are changing how we live in ways that make financial acumen ever more important. Any policy response needs to be based on a firm analysis of how the world is evolving and what this means for priorities. In this section we therefore provide a brief overview of some of the most important economic, demographic, cultural, policy and political trends shaping the UK in the 21st century, and assess their implications for the financial capability of UK citizens.

Economic trends

The UK has famously experienced the longest period of economic growth on record (HM Treasury, 2006). Following inflation targeting (and the subsequent transfer of responsibility for interest rates to the Bank of England), interest rates and inflation have remained consistently low, with long-term inflationary expectations stable at two per cent and long-term interest rates at a 40-year low of four per cent (HM Treasury, 2006). In turn, mortgage rates, which averaged 11.5 per cent between 1979 and 1997, have averaged 6 per cent over the last eight years (HM Treasury, 2006). Employment is historically high, unemployment low and inactivity falling (HM Treasury, 2006).

This stable economic framework has provided a backdrop to ongoing structural shifts in the labour market, partly driven by technological change and differential productivity growth, partly by 'globalisation' and international competition, and partly by changing patterns of consumer demand (Dixon and Pearce, 2005; Wilson *et al*, 2006). As people have become richer, they have tended to spend more of their income on services, such as haircuts, cinemas and financial advice, and less on goods, such as videos, TVs, washing machines and even computers, as most manufactured goods have become more affordable so less needs to be spent on them (Hills, 2004).

In combination with rising female employment, which has brought many jobs that women used to do unpaid into the formal labour market, this has led to more people being employed in service industries and fewer in manufacturing. The statistics are compelling: in 1982, 33.6 per cent of total employment was in the manufacturing, construction and utilities sectors and 65.4 per cent was in the service sector; by 1992 the figures were 27.1 per cent and 72.8 per cent respectively; and by 2004 they were 20.6 per cent and 79.4 per cent. This trend is expected to continue over the next decade at least: by 2014 service-sector employment is projected to be 82 per cent of all employment, with manufacturing, construction and utilities having shrunk to 18 per cent, nearly half of its 1982 share (Dixon and Pearce, 2005; Wilson *et al*, 2006).

The implications of this shift for financial capability remain relatively unclear, although it is likely that service sector employees will require higher levels of financial capability in their jobs. Most indicators point to continued growth in demand for financial services (Wilson *et al*, 2006), a trend that will exacerbate the need for consumers to be able to make the right decisions in choosing appropriate products.

More speculatively, others (FSA, 2003) have pointed to trends that make financial capability more important: a purported decline in 'jobs for life' and greater flexibility in people's careers, alternating periods of learning or caring with paid employment. Twenty-eight per cent of people have experienced a large unexpected drop in income in the last three years while nearly half have no savings (Atkinson *et al*, 2006). As people live more complex lives in which it is harder to plan for the long term, their need for personalised, tailored products to meet increasingly complex demands becomes more pressing.

Other trends are also important. Owner occupation has increased rapidly – by 46 per cent between 1981 and 2004, to 17.8 million dwellings (Babb *et al*, 2006). This has resulted in a greater need for financial capability, as people have to take on greater financial and other responsibilities than when renting, and be better at planning ahead for large, irregular expenditure, such as repairs or other improvements.

These trends have been reflected in the rapidly changing nature of the financial services industry. Following the deregulatory 'big bang' of 1986 and subsequent reforms, which vastly increased competition in financial markets, there was a huge expansion in the scale, scope and range of financial services offered to consumers. Building societies demutualised and raised finance through share offerings, increasing the range of providers, and financial service institutions began to offer a much wider range of products than before. Total lending more than doubled from £531 billion in 1993 to £1,077 billion in 2005 (prices indexed to 2004) and consumer credit expanded even faster, by 167 per cent over the same period (Babb *et al*, 2006).

The changes to people's financial holdings have been rapid, particularly in an historical context. For much of the twentieth century, (predominantly male) workers took home their cash in a weekly pay packet; relatively few had need of bank accounts. As living standards increased and people's disposable income grew – partly due to women entering the labour market, creating dual-earner households – people began to turn to intermediaries to help secure and manage their money. But even by the standards of this unprecedented development, the last few decades have seen a large shift in people's financial portfolios (FSA, 2003; Kempson and Whyley, 1999).

These trends in product offerings look set to continue. And if they do, it will become increasingly important that people can manage and understand the portfolio of products available to them, as many of these new products are relatively complex and require a greater degree of financial capability.

The developments have not all been on the supply side of the financial services industry. The huge inflationary pressures seen in the housing market, with people taking up 100 per cent mortgages on properties – often relying on continued house price growth – also places much greater reliance on UK citizens' financial capability.

Many people in the UK have been slow to realise this growing salience, perhaps due to the relatively benign economic conditions of the past decade: strong economic conditions can hide low levels of financial capability. Widespread negative equity is a relatively distant memory, although still a painful one. But it is vital to remember that economic conditions change; it is unlikely that the prosperity of the last ten years will continue indefinitely. When things do start to shift, the brunt is likely to fall hardest on those who are least financially capable.

There are already some worrying signs. The level of individual insolvencies is rising rapidly: one person declared insolvency every 11 minutes in 2004, nearly twice the rate of seven years before, and £4.2 billion of bad debts was written off by banks, nearly double the total of four years previously (DTI, 2005). Credit card debt write-offs have risen to £1.6 billion from £0.28 billion in 1993 (Babb *et al*, 2006). And six per cent of people - ten per cent of those aged over 85 - do not have bank accounts (DWP, 2005a), despite considerable efforts to eradicate the most extreme forms of financial exclusion. All these trends suggest that we should not slip into sanguinity: financial capability will become ever more crucial over the coming decade.

The demographic context

Looking even further ahead, it is clear that the UK faces serious fiscal challenges that will have an important bearing on the personal finances of its citizens. Perhaps the most important of these is the inevitable ageing of the population over the next half century (Dixon and Margo, 2006). Life expectancy in the UK is longer than ever before (Dixon and Margo, 2006): there were 9.5 million people aged 65 or over in the UK in 2001 but this is projected to rise to 12.8 million by 2021, and to 16.7 million by 2044 - when there will be more than twice as many octogenarians (GAD, 2005). The picture is radically different to that of 30 years ago and will only become more so. In 2001 there were 21 per cent fewer children under the age of 16, and 23 per cent more people aged 65 or older than in 1971; by 2044 these figures will have spiralled to 31 per cent and 56 per cent respectively (Dixon and Margo, 2006).

These shifts in the age structure are familiar and have some well-rehearsed implications. The number of people of working age for every 'dependent' rose from 1.6 in 1971 to 1.8 in 2001 as the 'baby boom' generations of the late 1940s and mid 1960s entered the labour force, but it will fall to 1.4 by 2044 as these cohorts enter retirement (Dixon and Margo, 2006). This will have a profound knock-on effect on government spending on a range of areas, including pensions provision, health spending and long-term care financing. Modelling by ippr earlier this year estimated that total public spending would have to rise by 2.6 per cent of gross domestic product (GDP) by 2051 and a further 1.6 per cent by 2074, to keep per capita spending levels at their current rate (Dixon and Margo, 2006).

The implications for financial capability are obvious: if people in the UK do not save for their retirement, they will face a considerable risk of poverty later in life. Similar implications hold true for long-term care provision: too few people are saving for retirement (Atkinson *et al*, 2006; Pensions Commission, 2005). One reason is that people simply do not believe the official statistics: few people in the UK think that they will live longer than the generation before – most expect their health to decline from the age of 70 – which partly explains why there has been such strong resistance to raising the state pension age (Robinson *et al*, 2005).

Promoting financial capability must be an integral part of the response to an ageing population. But ageing is not the only relevant demographic trend for this agenda: the recent rise in solo living, increasingly diverse family structures and divergent fertility trends all mean that navigating the financial marketplace will continue to be an ever more important skill (Dixon and Margo, 2006). To take one example, people who live alone are less able to rely on someone to support them in a time of financial crisis or redundancy, which means that assets, insurance and savings are more important for this group than many others (Bennet and Dixon, 2006; Dixon and Margo, 2006).

The cultural context

These demographic shifts cannot be seen in isolation from the changing cultural milieu of modern Britain.

Public attitudes have inevitably evolved over a wide range of areas in the last few decades, and will continue to do so in the future. These changing expectations have partly driven demographic change and have been partly influenced in their turn by the changing structure of the population. But they also hold enormous importance for financial capability.

Perhaps the most profoundly relevant cultural shift of the past century has been a shift from a 'thrift ethic', where people limit their consumption of goods to what they can afford at the time, to a 'consumption ethic', where people buy now and pay later (Tucker, 1991; Webley, 2006). People are more willing than ever before to take on debt and use credit in return for more immediate gratification, and less willing to think for the long term. Although it is difficult to disentangle cause and effect here, public policy, much business practice and economic trends have arguably all contributed towards this shift, as well as responded to it. For example, credit has become easier to get and use; policy has often, understandably, focused on short-term outcomes, such as getting people into a job rather than prioritising progression in the labour market, and has made debt a more inevitable part of life through the introduction of student loans in place of grants; and many companies have focused on children and adolescents as an important retail market, effectively 'commercialising' childhood (Schor, 2004).

Some parts of the media have also played an important role here. Although the last decade has seen a rise in personal finance, 'Money Matters' or 'Money' sections of regional and national newspapers – often providing excellent analysis and advice – these stand in marked contrast to coverage that normalises the idea of low financial capability and high debt levels. Commentators have coined new terms such as 'homeowner debt', 'newlywed debt', 'student debt', and 'pensioner debt' – and characterised financial problems as trivial or even glamorous. One recent example is the former BBC correspondent Rosie Millard, writing in the *Sunday Times* in 2005, proudly detailing her private financial problems alongside large pictures of her two plush homes and four children. Her serious debt problems were reported as somehow irrelevant to her happy, successful, rich life.

'Am I curtailing my lifestyle? Well, I have dramatically curbed my addiction to black cabs, but can't live without a decent haircut every eight weeks, vaguely designery suits, Stila makeup and The New Yorker. *As I say to my bank manager (whose mobile number is naturally on my direct dial), if you want to keep working, you have to keep looking the part.' (Millard, 2005)*

Welfare state retrenchment

Policy changes over the last two decades, particularly under the previous government, have made it more important for UK citizens to be financially capable, although this has been partly masked in recent years by the strength of the economy. The scaling back of national insurance benefits, such as unemployment benefit and incapacity benefit, the breaking of the link between the basic state pension and earnings (Hills, 2004), and reductions in support for homeowners (Burrows and Wilcox, 2000) have meant that many more people now have to protect themselves against ill health, disability, unemployment and old age through financial products. This places much greater importance on people's ability to plan ahead and to choose appropriate products for their needs.

Political context

These economic, demographic, cultural and policy trends have shifted the political context in many areas. Pensions policy is a matter of urgent national debate, for example (Pensions Commission, 2005). But looking deeper, there are signs of a wholesale shift towards the importance of personal responsibility across many areas of the Government (Halpern *et al*, 2004), prompted by moral and political arguments as much as fiscal concerns. New Public Management and subsequent shifts in thinking have led to a conception of citizens as active consumers of public services, in which personal 'choice' is ever more important, as both a delivery mechanism and a valuable end in itself (Byrne *et al*, 2006; Pearce and Paxton, 2005). Also the 'empowerment agenda' that is steadily gaining ground across the Government similarly sees more active citizens as crucial to more effective governance (Miliband, 2006).

The political concern for financial capability can be understood as part of this overall shift in thinking, which sees the state as playing an enabling role in providing people with the opportunities to achieve their aspirations. This thinking places personal responsibility to the fore, but without shirking the very real responsibility that the Government must take in helping them to do so. But how far do we have to go? How financially capable is the UK? This question is explored in the following section.

2: Financial capability in 2006

The UK now leads the world in its understanding of how its citizens use and think about money (SEDI, 2004). The initial analysis of the groundbreaking Financial Capability Baseline Survey (FSA, 2006a), carried out by researchers at the University of Bristol (Atkinson *et al*, 2006), reveals for the first time the true extent and levels of financial acumen in the UK. As the data is analysed further, a more detailed picture will emerge, providing policymakers with a wealth of detail on which to base initiatives and develop strategies. So what does it show?

Financial capability measures a broad range of skills, behaviour and knowledge, but can broadly be understood as consisting of five separate strands (Atkinson *et al*, 2006): making ends meet, keeping track, planning ahead, choosing products and staying informed. It is crucial to realise that financial capability is an amorphous concept with many levels and components: this means that we cannot simply say that someone is financially capable or that they are not – people are often very capable in some areas but not in others. For example, people on low incomes are often better at keeping track of their money than those on higher incomes, but are not as good at choosing products.

Unfortunately it is not currently possible to assess levels of financial capability in an international context. Most other countries use measures of financial literacy that do not capture the crucial behavioural element central to financial capability. This section therefore focuses on overall levels of financial capability in the UK in isolation, summarising recent work by Elaine Kempson, Adele Atkinson, Stephen McKay and Sharon Collard at the Personal Finance Research Centre, University of Bristol (Atkinson *et al*, 2006).

Section 3 below uses this analysis to identify priority groups and key factors in determining financial capability, and explores the 'motivation barrier' behind seeking financial advice and changing behaviour.

Overall levels of financial capability

People in the UK are storing up trouble for the future (FSA, 2006c). Too many are failing to plan ahead for retirement or for an unexpected drop in income, despite the fact that most can afford to do so. Around two million households are living in a precarious financial position and could be pushed into difficulties by a small change in their circumstances – a common experience. Although only a small proportion of people have severe debt problems, those who do are often very seriously affected. Too many people take on inappropriate risks – either protecting themselves against risks they do not face, or failing to insure themselves against those they do. Also too many simply choose the first financial product that appears to roughly suit their needs, needlessly wasting substantial sums of money (Atkinson *et al*, 2006).

If the current situation is troubling, the prospects looking ahead are worrying. Younger people are less likely to be financially capable than previous generations, even allowing for their relative inexperience in dealing with financial products and institutions. This suggests that as these groups move into later life, the UK will become less financially capable than it is today unless action is taken. This is particularly worrying, given the analysis in Section 1, which shows that these generations are likely to have a greater need for financial capability than their parents and grandparents.

Of course, many people have a good grasp of their finances and experience few difficulties, particularly in making ends meet and keeping track of their money.

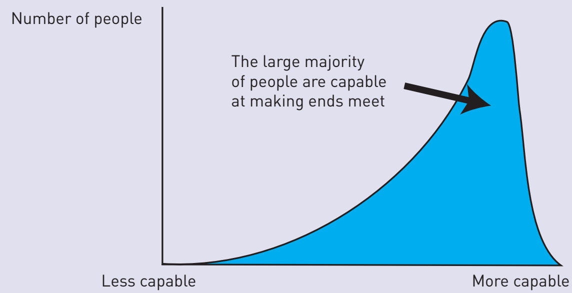
Making ends meet

Making ends meet is about how well people live within their means. Someone who is good at making ends meet would rarely be overdrawn or run short of money, and would tend to pay off their credit card bill at the end of every month. As a nation, the UK is pretty good at making ends meet. For example, 65 per cent of people keep up with their bills and other commitments without any difficulties and another 26 per cent do so with only relatively minor problems. But for nine per cent of the population, making ends meet is either a constant struggle or worse, with three per cent falling behind on bills and other payments, sometimes severely (Atkinson *et al*, 2006).

Statistics like these are revealing. But focusing on narrow indicators tends to distort the overall picture. For example, people tend to prioritise paying bills over other kinds of spending, which means that research focusing on whether people pay bills will produce a more optimistic picture than research that focuses on whether they run out of money: 31 per cent of people say they sometimes run out of money at the end of the week or month, and 9 per cent of people always run out (Atkinson *et al*, 2006). A better measure of how well people make ends meet is through a technique known as 'cluster analysis', which essentially combines scores on a range of questions to produce one composite measure (Atkinson *et al*, 2006). What does this approach reveal?

Figure 2.1 shows the distribution of financial capability (using a cluster analysis measure) in making ends meet. The left-hand side of the figure shows the number of people who are less capable in this area; the right-hand side shows the number of people who are more capable. The strong skew to the right shows that the majority of people can make ends meet – but it is important to note that a substantial number of people face real difficulty here, even though the majority are doing well.

Figure 2.1: Making ends meet



Source: FSA, 2006c

But what differentiates those who are good at making ends meet from those who have real difficulties? Regression analysis, a statistical technique that allows important factors to be isolated, reveals that older people are much better at making ends meet, as are those who own their own home, and those with higher educational qualifications (after controlling for all other factors). Perhaps surprisingly, income makes relatively little difference – those in the highest income group are only a little more likely to say that they make ends meet than those in the lowest (Atkinson *et al*, 2006). This backs up the idea that behaviour and attitudes are much more important than levels of affluence in financial capability.

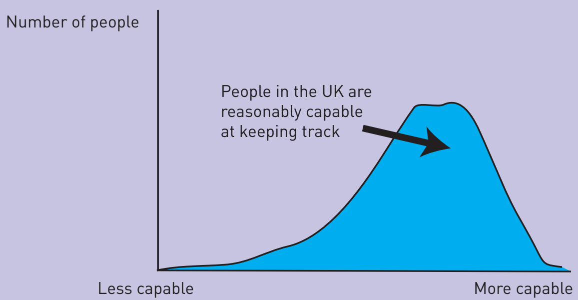
Keeping track of finances

For some people, keeping track of finances is of paramount importance: it can be essential to know how much money they have available to the nearest pound. For others, particularly those on higher incomes or with easier access to credit and savings, keeping track is much less important – a general idea of how much money they have is all they need. Seven per cent of people could not place their current account balance to within £500 while 21 per cent can pinpoint it to a pound or two (Atkinson *et al*, 2006). This makes it difficult to say how important keeping track is in determining a person's overall financial capability, and reinforces the idea that financial capability is best understood as a complex concept composed of discrete, but related elements.

Someone who is good at keeping track of their finances will typically: know the amount in their account to a degree that is appropriate for their income and outgoings, with those on higher incomes needing to know the balance less precisely; check the amount in their current account (or in hand for cash budgeters) frequently – 38 per cent of people do this each time they withdraw money while 14 per cent never check; budget to cover uneven expenditure, such as utility bills, council tax or TV licence.

Figure 2.2 shows the distribution of people in the UK's ability to keep track of their finances, also using cluster analysis to produce a single measure (Atkinson *et al*, 2006). Once again, there is a relatively strong skew to the right, although this is less pronounced than for 'making ends meet', suggesting a greater variation in people's ability to keep track. More worryingly, there are a far greater number of people who are poor in this area: 10 per cent of people make no provision for quarterly or annual bills, and six per cent ignore bank statements completely.

Figure 2.2: Keeping track



Source: FSA, 2006c

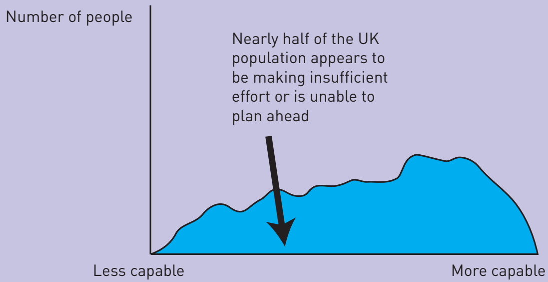
Regression analysis shows that people who have difficulty in making ends meet tend to be better than average at keeping track of their finances. This makes sense: it is more important to know exactly how much money you have at any one time if you are on a tight budget. This means that lone parents, people without a current account, and the unemployed tend to be particularly capable in this area. Women are also better than men on average. Interestingly, age seems to make little difference to people's tendency to keep track, suggesting that this is not a behaviour learned over time, but one related to necessity (Atkinson *et al*, 2006).

Planning ahead

People who are good at planning ahead tend to have made sufficient provision for an unexpected drop in income, would be able to make ends meet for a year or more if their income dropped unexpectedly, tend to buy insurance and contribute to a pension (FSA, 2003). These attributes are crucial determinants of people's future well-being, particularly given the economic, demographic, cultural and political trends outlined in Section 1; this component of financial capability is arguably the most important for a progressive government.

Yet worryingly, although perhaps not surprising, the statistics show that many people in the UK are very bad at planning ahead. Thirty-nine per cent of people in the UK said that they 'live for today and let tomorrow take care of itself' and just 42 per cent of those under retirement age said they had a personal pension (Atkinson *et al*, 2006). Looking at the distribution of scores in Figure 2.3 below shows this clearly: a substantial proportion of the population do not adequately plan ahead.

Figure 2.3: Planning ahead



Source: FSA, 2006c

Looking in detail at the numbers behind this figure reveals that older people are much better at planning ahead than younger people, taking all other factors such as income and education levels into account, as are those who perform better in making ends meet. People who do not have a current account are much worse, as are those who live in deprived areas. Those who are better off are more likely to plan ahead, but income by no means determines behaviour in this domain: plenty of those on very high incomes make no provision for the future. One particularly interesting finding from regression analysis is that people who receive free financial products from work tend to be much better at planning ahead, even when other factors are taken into account (Atkinson *et al*, 2006). This suggests that once people make a start in planning ahead, this can trigger further efforts – an idea discussed in more detail in Sections 5 and 6.

Crucially, this is an area where people's stated intentions and views do not match their behaviour. To take two examples, three-quarters of people say they always make sure they have some money saved for a rainy day, but in reality 70 per cent have made no provision to face a drop in income and nearly half have no savings; and while 81 per cent of the pre-retired think that the state pension will not be enough to give them the standard of living they would like, 37 per cent have made no provision for themselves (Atkinson *et al*, 2006).

Choosing financial products

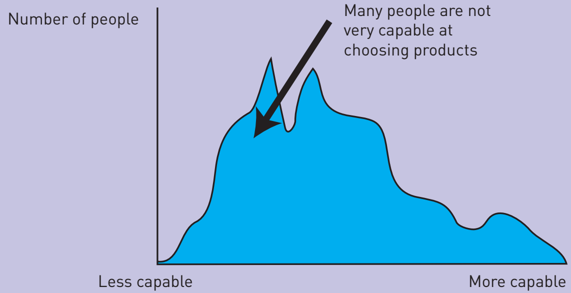
Many people find financial products confusing. Early research by the Financial Services Authority (FSA) revealed that two-thirds of consumers think that financial matters are 'too complicated for them' and that they do not know enough to choose suitable financial products (FSA, 2003). To take one example, forty per cent of those who own an equity Individual Savings Account (ISA) did not know that the cash value of their investment depends on stock market performance, and 15 per cent of those who own a cash ISA wrongly think that it does (Atkinson *et al*, 2006). This often results in people buying inappropriate or unnecessary products and missing out on ones that could meet their needs. For example, nine per cent of people renting from a private landlord hold buildings insurance, at significant expense, when they will never see a return on their policy; and ten per cent of homeowners do not have buildings insurance, exposing them to enormous potential loss (Atkinson *et al*, 2006).

This lack of understanding means that people in the UK tend to buy financial products in a very different way to other goods. Although many financial products are expensive and represent a substantial outlay, people are often reluctant to shop around for the best deal or take advice: 21 per cent of people take no advice at all and 42 per cent rely on friends, product information, relatives or sales staff, rather than consulting a professional advisor or making an active effort to find out what the best buy is. This is despite there being a wealth of available information in newspapers and online (Atkinson *et al*, 2006).

People also appear to pay remarkably little attention to the price of financial products: 51 per cent of savings account holders can estimate the current level of interest, and only 49 per cent of people choose a credit card based on the interest rate, with 11 per cent simply opting for the one that came with their current account (Atkinson *et al*, 2006). People are also reluctant to change products once they have bought one, often sticking with the same insurance policy, or even the same mortgage, for years – even though other, more suitable products may be available. This finding still holds true in extremely competitive markets, such as car insurance, where 52 per cent of policy holders have not even considered switching in the last five years. The figure for mortgages is 58 per cent (Atkinson *et al*, 2006) – a surprisingly high figure considering the enormous sums of money usually involved.

It is hard to imagine people treating other purchases, even for small items such as clothes or cameras, in a similar fashion. Yet these three traits – a reluctance to shop around and seek advice, a high degree of price insensitivity, and considerable inertia – are widespread, meaning that UK citizens score particularly badly in terms of their capability in choosing products. This can be seen in Figure 2.4 below, which covers the 74 per cent of people who have bought a financial product in the last five years (Atkinson *et al*, 2006).

Figure 2.4: Choosing products



Source: FSA, 2006c

What distinguishes those who are most capable? Perhaps unsurprisingly, experience counts for a lot; by far the most important determinant is how many products people hold – those with more are better at choosing. Interestingly, younger and older people both perform significantly worse in this domain than those in their 30s, 40s and 50s. Income levels also make some difference, with the better off more likely to be more capable in this area. People who perform better at planning ahead are also more likely to be better at choosing products (Atkinson *et al*, 2006).

Staying informed

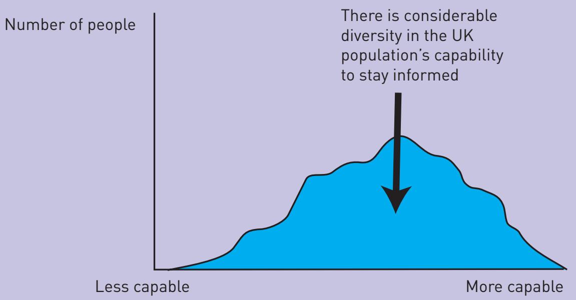
The fifth component of financial capability concerns whether people stay informed about financial matters. This includes monitoring changes in key financial indicators, such as interest rates, stock market fluctuations or the housing market; having a good level of applied financial literacy; and thinking it is reasonably important to keep up with financial matters (FSA, 2006c).

Most people (72 per cent of people in the UK) think that staying informed is important and 78 per cent keep up with at least one financial indicator. But a sizeable minority are less engaged, with around a fifth of people saying they do not keep track of any financial indicators at all. Perhaps unsurprisingly, people are most likely to follow the big macroeconomic indicators – such as interest rates, changes in the state pension or the housing market; whereas only about one in ten people claim to keep up with the best buys in financial products (Atkinson *et al*, 2006). But what sources of information do people rely on?

Despite the growth of online financial advice sites, newspapers remain the most common source of financial information for most UK citizens with 41 per cent relying on these to stay informed. Around 39 per cent glean their information from television and radio programmes, although 7 per cent watch or listen to dedicated programmes such as Radio 4's *Moneybox*. This suggests that most people tend to absorb financial information without making a dedicated effort to do so – they pick it up from the media they come across as part of their everyday lives (Atkinson *et al*, 2006).

Although 72 per cent of people think that staying informed is important, the cluster analysis undertaken by researchers at Bristol University suggests that far fewer live up to their expectations. Twelve per cent of those who think it is important openly admit that they do not really keep up to date. But the results of the Financial Capability Baseline Survey, shown in Figure 2.5, suggest that a far greater proportion do not stay informed to any great degree: there is clearly considerable diversity in UK citizens' ability to stay informed (Atkinson *et al*, 2006).

Figure 2.5: Staying informed



Source: FSA, 2006c

As might be expected, there are considerable differences between groups in terms of staying informed. People on higher incomes, older people, people with degrees and homeowners are significantly more likely to stay informed, as are people who perform better at choosing products and planning ahead.

Using the data

This analysis of the UK's financial capability is revealing: for the first time we have a comprehensive assessment of the state of UK citizens' financial acumen, based on more detailed evidence than telephone polling, the diffuse experiences of voluntary sector organisations and ill-suited government surveys. The enormity of the task is also becoming clearer: financial capability covers an enormous range and depth of skills, knowledge and behaviour across an extremely large and diverse sector of the population. Very few people are fully financially capable in all domains. But the analysis so far does little to pin down the specifics of the financial capability challenge. This issue is considered in Sections 3 and 4, which look at target groups, key factors in promoting financial capability and the motivation gap.

3: Priorities for action and future funding

Policy is often most effective when it responds to specific, detailed needs. This makes improving the UK's financial capability a particularly daunting task for two main reasons. The first is the scale and diversity of the target group: just 36 per cent of people are fully financial capable (Atkinson *et al*, 2006), which means that more than 30 million adults in the UK experience difficulties in managing their finances (GAD, 2005). The second is the sheer breadth of the concept of financial capability: it is a deliberately inclusive and wide-ranging idea that covers a plethora of skills, behaviours, and generic and product-specific knowledge over several distinct domains. How should policy respond?

There is a clear need to determine priorities. It is unrealistic to think that policy can improve all elements of financial capability for everyone. The key issue is where and how UK citizens' low levels of financial capability are creating, and will continue to create, the greatest problems for society in general and, specifically, where and to what extent they affect the financial services industry. Resolving this issue would set policy priorities. It would also help determine the appropriate balance of responsibility between government, the financial services industry and other stakeholders for funding and delivering the financial capability agenda in the future.

The impact of low financial capability

In an ideal world we would be able to determine the cost of current levels of financial capability, revealing where and how these affect the UK and the gains to be made from policy efforts to improve them. Unfortunately this depth of analysis remains beyond us for the immediate future, although efforts, led by the Resolution Foundation, are ongoing to develop a working model. What should we expect this to show?

Impact on individuals

Low levels of financial capability clearly harm individuals, who are not protected against the risks they face, experience higher costs and miss out on opportunities to save and benefit from financial products. Although a lack of financial capability in all the areas explored above can have negative repercussions for individuals, perhaps the most worrying area is people's tendency not to plan ahead adequately, particularly for retirement but also for unanticipated income changes. Lack of financial capability can have a considerable effect on people's well-being: we know that financial concerns are a major cause of stress and even ill health (FSA, 2003). Yet despite these benefits it is clear that leaving it up to individuals to improve their financial capability without appropriate support will not be enough.

Impact on the voluntary sector

The voluntary sector as a whole would also benefit from improved financial capability (FSA, 2003): charities focusing on financial matters would be able to prioritise their preventative work - which is often more cost-effective than palliative efforts - enabling them to make more effective use of often scarce resources. Also charities working with other client groups, whose problems are often exacerbated by financial difficulties, would see a reduction in the complexity of issues faced by their clients, enabling them to provide a more effective response.

Impact on the financial services industry

Low financial capability has clear costs for the financial services industry, particularly in terms of planning ahead and choosing products. A more capable Britain would result in greater consumer confidence in markets and firms, and a subsequent increase in demand for financial products. Consumer vulnerability to mis-selling would be lower with a subsequent reduction in costs due to handling complaints and less regulatory intervention (FSA, 2003).

There is also the possibility of growing new markets and creating greater value from existing customers. Research by the Resolution Foundation suggests there is a large group of people on low to median incomes who have the capacity to save for a pension but are not currently doing so, representing a large under-tapped market (Resolution Foundation, 2006b).

These considerations suggest that the financial services industry has a sizeable stake in improving the UK's financial capability, and there are significant gains to be made from a successful strategy. The industry, taken as a whole, also seems well placed to increase funding, given recent record profits made by many financial institutions, totalling £30 billion last year – although much of this was derived from overseas activities (*The Guardian*, 2006).

Impact on government and society more broadly

From the perspective of government, there is also a clear rationale for tackling financial capability issues. From an economic point of view, improving people in the UK's ability to manage their money would have a significant impact on government revenue and spending. From the revenue side, a flourishing financial services industry is an important contributor to the public purse and it is in the Government's interest to ensure that people have confidence in financial products.

In terms of public spending, perhaps the most important issue is in terms of future pension commitments – linked to the planning ahead aspect of financial capability. Quite simply, if people in the UK do not start saving more or working later, the Government will have to accept much higher levels of pensioner poverty or face soaring public expenditure (Pensions Commission, 2005). This should be a compelling argument in itself. But there are many others. For example, there is the potential to reduce some forms of welfare spending, as people would be less likely to fall into serious debt problems and more likely to have taken out insurance against the risks they face, with subsequently less reliance on the state. There is also the potential for existing benefit payments to have more impact on people's lives – reducing the extent to which these payments go towards servicing existing debt rather than improving standards of living. There would be cost savings in other areas too, in terms of freeing up resources to focus on more effective preventative services rather than palliative ones.

Economic arguments such as these are important considerations for the Government. But there is also a compelling social case for the Government to prioritise this agenda. Lower levels of financial capability - including the likelihood of saving for a pension - are broadly correlated with disadvantage. The worst off are also likely to be more profoundly affected by the underlying socio-economic, cultural and political shifts outlined in Section 1.

Competing priorities?

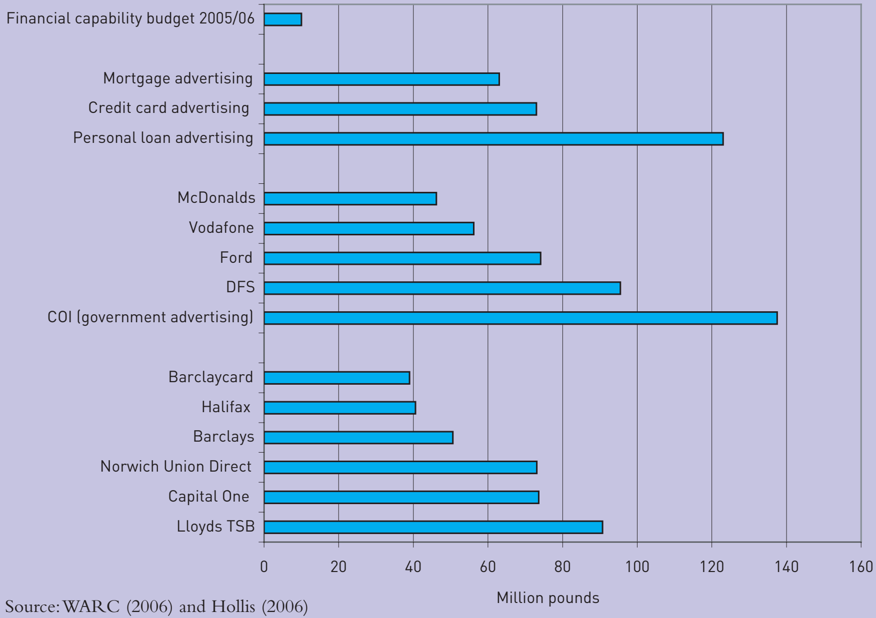
There should be no surprise that different stakeholders are interested in different aspects of financial capability. For example, for charities that focus on social exclusion, people's capacity to make ends meet is of greater concern than their ability to choose between financial products; whereas for a firm specialising in mortgage broking or devising niche insurance products, people's capacity to choose between financial products is of paramount importance. While government needs to focus on the social and moral case for financial capability, the private sector must see it through the lens of a business case. But do these really differ as much as might be thought?

There are some good reasons to think so. Many people in the UK do not represent a particularly profitable opportunity for the financial services industry, certainly in terms of providing financial advice (Resolution Foundation, 2006b). Those on low to median incomes are often proportionately more expensive for banks and other institutions to service, for example, because they make smaller deposits and withdrawals at counters, and are consequently less profitable. They also have less to invest in financial products. Yet this simple analysis overlooks considerable harmony between the aims of the government and the financial services industry. One good example is the financial behaviour of people on moderate to low incomes who already use some financial services. This is a key target group for the Government in terms of pension saving but also represents a substantial growth market for the financial services industry, if suitable and cost-effective delivery mechanisms can be developed.

Future funding

It is clear that individuals, the private sector and particularly the financial services industry, the voluntary sector and the Government all have much to gain from improving the UK's financial capability. But it is less clear where responsibility should sit most fully. The current National Strategy for Financial Capability is based on a partnership between the Government and the private sector, largely funded by a levy on the financial services industry, with the Government committed to funding delivery in schools (FSA, 2006b). So far, this approach has worked well. But the sums involved are relatively tiny: just over £10 million will be spent by the FSA in 2006. Figure 3.1 puts this into perspective by comparing it to advertising

Figure 3.1: The financial capability budget in perspective. 2005/06 budgets and advertising spends



Source: WARC (2006) and Hollis (2006)
Figures for sectoral advertising spend are from 2003 due to data limitations

spending by the financial services industry, other companies and the Government.

The enormous discrepancy between the funding available to deliver a National Strategy and the annual advertising spent on credit cards, personal loans and mortgages is clear. For every pound spent on promoting financial capability, £7.30 is spent advertising credit take-up and £12.30 on promoting personal loans (FSA, 2006a; Hollis, 2006; WARC, 2006).

A broader comparison with other areas is revealing. Ford Motor Company spends £7.41 for every pound in the Financial Capability budget (Hollis, 2006), predominantly aiming to shift improve public perceptions of the 'quality' of Ford cars. DFS spends £9.55 trying to alter people's furniture-buying habits. The financial services industry as a whole spends £204 on advertising for every pound spent on promoting financial capability - although of course much of this advertising is aimed at encouraging saving and other beneficial financial behaviours (Hollis, 2006).

This gives a clear perspective on the scale of the challenge facing the National Strategy and the adequacy of current resources. Looking ahead, it seems clear that a fundamental paradigm shift in the scale of the approach is needed if we are to meet the challenges posed by the UK's current levels and future prospects of financial capability.

Analysis by the Resolution Foundation shows that a step change in funding would be needed to deliver a new national financial advice resource - just one component of a truly national, adequate response. The Foundation estimates that a telephone-based advice service, supported by web-based information, could be delivered for approximately £25-£35 million per year (not including start-up costs). This could possibly be funded by a partnership between the Government and the financial services industry. Including provision for face-to-face advice would add to this cost (Resolution Foundation, 2006a).

It is apparent from the analysis above that the Government and financial services both have clear gains to be made from improving the UK's financial capability, and that the scale of the funding required is likely to be beyond the remit of the voluntary sector to raise. There are difficult political issues to be resolved here and it is beyond the scope of this report to go into funding models in more detail. But it is worth noting that a budget of £100 million would equate to half of one per cent of the advertising spend for the financial services industry in 2004/05, or nearly two-thirds of the Government's communications spending (Hollis, 2006).

Funding is of course only one part of a National Strategy for Financial Capability. Questions of delivery are just as important. Regardless of where the budget comes from, the analysis above also suggests that there is a pressing need to rethink the administration of the National Strategy.

Financial capability as a welfare issue

There could be a strong 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 than the FSA, through social services offices and education providers. They also have more experience in delivering large-scale programmes, and have the evaluative and research capacity to assess these. The Government also 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.

This kind of shift would be particularly appropriate if the scale of the financial capability strategy is to undergo a paradigm shift – as it arguably must do if it is to meet the challenge outlined above – as this would radically alter the balance of the FSA's business model.

But there is a more philosophical issue in favour of this shift too. A central theme of this report is that financial capability should be seen as a central welfare issue, not as a set of peripheral life skills. People's financial acumen is increasingly important in determining the quality of their lives. Conceptualising financial capability as a welfare issue in this way would lead naturally to greater government involvement in delivery - albeit with considerable and ongoing contribution and partnership from the financial services industry, the voluntary sector and other key stakeholders.

The voluntary sector arguably enjoys greater public confidence than either the public or private sectors, particularly among the most disadvantaged groups, but has less scope and reach. The public sector has extensive reach and considerable expertise in delivering education programmes, but has less contact with higher-earning consumers, who are in greater contact with the private sector. The private sector, in conjunction with the FSA, also has the capacity to determine much of the detail of the supply side of the financial services market, both in terms of products and advice. Again, it seems clear that a differentiated but co-ordinated common approach is needed. But what principles should the strategy be based on? This question is considered in Section 4.

4: Principles for action

So far, the National Strategy for Financial Capability has focused largely on education as the best way to change behaviour and improve the nation's financial acumen. It has tried a range of approaches, including delivering seminars in the workplace, providing online communications and information, ensuring the centrality of personal financial education in the curriculum and improving the range of materials available to teachers and others involved in promoting financial capability (FSA, 2003; 2006b). These initiatives have met with varying degrees of success: some appear to have worked well; others less so. None have yet been evaluated to show whether they have in fact had an impact on people's financial capability.

The previous section argues that we need a paradigm shift in the scale of the strategy and a greater focus on specific priorities, particularly around people's ability to plan ahead. In this section we assess how the policy approach should be changed to make best use of limited resources and focus on a tighter set of priorities.

Demographic and socio-economic targeting

One way of focusing policy efforts is to try to identify detailed target groups with specific needs, and distinctive demographic and socio-economic profiles. Unfortunately, this approach appears relatively unhelpful in the context of financial capability. Work by researchers at the University of Bristol has aimed to identify distinct groups of people sharing financial capability and other characteristics, using advanced statistical 'cluster analysis' techniques (Atkinson *et al*, 2006). Their analysis, which divides the UK population into 11 distinct groups on the basis of their likelihood to have certain demographic and socio-economic characteristics, is summarised in Table 4.1.

Table 4.1: Eleven distinctive financial capability groups

	Number of weak areas	*Percentage of sample*	*People in this group are more likely to be...*
Ai	0	36	Well-off, older couples, without children, homeowners, retired, higher education level, own many financial products. Good at making ends meet, planning ahead, staying informed and choosing products.
Bi	1	13	Poorer, older people, women, without children, homeowners, often retired, few financial products, less likely to use current account. Good at making ends meet, keeping track and planning ahead; poor at staying informed.
Bii	1	9	Well-off, middle aged couples, mortgaged, higher education level, many financial products. Good at staying informed, poor at keeping track.
Ci	2	4	Well-off, younger couples, with children, mortgaged, higher education level, few financial products. Good at planning ahead, poor at making ends meet and keeping track.
Cii	2	4	Average income, younger people with children, equally likely to have a mortgage or rent, likely to be working full time, often sick or disabled. Good at keeping track and staying informed, poor at making ends meet and planning ahead.
Di	3	3	Average income, older couples without children, likely to own home, often retired, lower education level. Good at keeping track, staying informed and choosing products. Poor at making ends meet and planning ahead.
Dii	3	3	Poorer, middle-aged, single people without children, likely to live in social housing, often retired, lower education level, few products, often without current account. Poor at planning ahead, staying informed and choosing products.
Diii	3	7	Poorer, younger, single people with children, likely to rent privately or live in social housing, likely to be unemployed, lower education level, few products. Poor at making ends meet, planning ahead and choosing products.
Ei	4	16	Poorer, younger, single people, often women, with children, likely to live in social housing, likely to be unemployed, often looking after the home, lower education level, few products, often without current account. Good at keeping track. Poor at making ends meet, planning ahead, staying informed and choosing products.
Eii	4	2	Average income, younger women with children, likely to own home or live in social housing, lower education level, few products, less likely to use current account. Poor at making ends meet, planning ahead, staying informed and choosing products.
Fi	5	3	Poorer, younger, single people with children, likely to own home or live in social housing, lower education level, few products. Poor at making ends meet, keeping track, planning ahead, staying informed and choosing products.

Source: Adapted from Atkinson *et al*, 2006

Table 4.2: Policy-susceptible factors correlated with high or low financial capability

Financial capability strand	*Positive factors*	*Strength of effect*	*Negative factors*	*Strength of effect*
Making ends meet	Owns home outright	4.4	No current account	-5.0
	Gets free financial products from work	1.8	Unemployed	-3.5
	Higher/post-graduate degree	1.7	Has current account but does not use it	-3.2
	First degree	1.6		
Keeping track	No current account	12.8		
	Has current account but does not use it	10.6		
	Part-time work	1.7		
Planning ahead	Gets free financial products from work	6.9	No current account	-8.1
	Owns home outright	5.9	Unemployed	-4.3
	Higher/post-graduate degree	5.7	No qualifications	-3.4
	Diplomas in HE/HNC	3.5	Highest qualification O Level/GCSE grades D-G	-1.5
	First degree	3.4	High level of borrowing	-0.1
	A/AS levels	2.4		
	Trade apprenticeship	2.4		
	Bought more financial products	0.9		
	High level of saving	0.003		
Choosing products	Higher/post-graduate degree	5.7	No current account	-3.3
	Diplomas in HE/HNC	2.7	No qualifications	-2.9
	First degree	4.2	Trade apprenticeship	-0.1
	A/AS levels	2.3		
	Bought more financial products in last five years	1.6		
	High level of saving	0.1		
Staying informed	First degree	6.3	No current account	-4.8
	Diplomas in HE/HNC	3.9	Has current account but does not use it	-2.2
	Full-time education	3.4	No qualifications	-7.1
	A/AS levels	3.1		
	Gets free financial products from work	1.7		
	Bought more financial products in last five years	1.0		
	High level of borrowing	0.1		

Source: Atkinson *et al*, 2006

Note: Strength of effect scores reflect statistically significant (at five per cent) deviation from constant coefficient. See Atkinson *et al*, 2006 for more detail.

Looking at Table 4.1 in detail suggests an important lesson: there is no quick, targeted fix to financial capability. Groups that are otherwise fairly dissimilar, such as Bi (more likely to be poorer, older people, often women, without children) and Fi (more likely to be poorer, younger, single people with children), often share weak areas in terms of financial capability (for example, staying informed). A similar picture emerges from regression analysis that considers the factors most strongly correlated with high levels of financial capability (Atkinson *et al*, 2006). In Table 4.2 we narrow these down to the statistically significant factors over which policy may conceivably have some influence.

This analysis holds two important lessons for policy. The first is the more obvious point that policy and circumstances do matter for financial capability: the more disadvantaged are less likely to have high levels of financial capability. The second is the crucial finding that there is a strong, statistically significant correlation between people's financial stake - in terms of holding products, buying products or having savings - and their financial capability.

Two approaches to financial capability

This suggests that efforts to improve financial capability can take two forms: a direct approach that aims to respond to people's interests and concerns, and build interest and motivation through the provision of education and advice; and a more indirect approach that aims to help people build up a financial stake and thereby promote interest and engagement in financial capability. The National Strategy for Financial Capability has focused almost exclusively on the first of these (FSA, 2003; 2006b). But has it done so as effectively as it could?

Critical moments

In an effort to isolate what really matters in determining an individual's behaviour over the longer term, many theorists have turned to the idea of critical moments (Thomson *et al*, 2002). This points to key 'turning points' or 'tipping points' to explain changes in behaviour, rather than focusing on innate or environmental explanations of behaviour, such as demographic or socio-economic status.

Critical moments are particular life events that act as a catalyst for further change, such as getting married, parental separation, episodes of ill health, moving house or neighbourhood, experiencing the death of a close family member or making new friends. These critical moments are sometimes related to life stages, such as becoming a new parent, but are often unrelated, for example taking on a new job, moving to a new city or deciding to go on an expensive holiday or start saving for a house. The key idea behind critical moments theory is that individuals may be more subject to chance, choice and contingency than was previously thought. The social and psychological consequences of a serious life event can play out over a long period and have implications for future behaviour that are not obvious at the time of the event itself. But what are the implications of this theory for financial capability?

Perhaps the most important lesson is that policy needs to identify better the key critical moments that make people most receptive to efforts to improve their financial capability and to direct them towards appropriate guidance at these times. Viewed from this perspective, the current National Strategy for Financial Capability is a marked improvement over the first stage of promoting financial capability as it has shifted away from targeting particular demographic groups (FSA, 2003) towards a more differentiated focus (FSA, 2006b). But it still has a considerable way to go in terms of grasping the importance of critical moments. With the exception of the 'New Parents: Money Box' strand of policy (FSA, 2006b), the strategy remains too focused on broadly conceived life stages. We need better ways of identifying when and how policy can target these more diverse and specific critical moments. But policy also needs 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.

Financial advice and the motivation gap

One of the most striking things about financial information is that there is plenty of it, freely available to most people. The Money Advice Trust offers a range of tools and services that people can use to help plan their finances. Most newspapers have dedicated financial sections or pages offering non-partisan advice on a range of issues – a good example is the *Daily Mail*'s financial section, and its online offering (www.thisismoney.co.uk), which provides a plethora of generic and specific product information. Even a cursory search of the internet throws up countless information sites, online financial planners and automated assessment tools – such as the BBC's Cashwise (www.bbc.co.uk/cashwise) and the Financial Service Authority's online Financial Healthcheck (www.fsa.gov.uk/consumer/healthcheck). So why do people seem unable or unwilling to improve their own financial capability?

One problem here is the motivation gap between people's stated assessment of the importance of financial capability and their actual behaviour. For example, 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). For many people, sorting out their finances is something that comes later rather than sooner.

But this does not mean that people are complacent about their finances. Research commissioned by the Resolution Foundation reveals that more than half of all middle-aged workers worry 'a lot' about not having enough income in retirement, and that the proportion is even higher among those on lower incomes who do not receive benefit support (Resolution Foundation, 2006b). So what lies behind the motivation gap?

One problem is the relative complexity of financial products, particularly around pensions and the benefits system, which can often deter people from taking practical steps to identify and buy suitable financial products for their needs. This is particularly the case for older people who release wealth from their homes, as they are often unable to access suitable financial advice (Maxwell and Sodha, 2006).

This problem is relatively widespread. Financial information is easily available but generic, independent low-cost – or free – financial advice is not. Many high-street banks – and even some Independent Financial Advisors – offer free financial consultations to prospective customers, but both of these are often focused on, and almost always perceived as, selling specific products rather than providing generic advice. The freephone National Debtline can help with budgeting and debt enquiries but not general financial advice. Also, although free courses are available through many voluntary sector organisations, such as SAFE at Toynbee Hall, these are not convenient or appropriate for many people.

Generic advice is important because it can help people 'convert' a desire into practical action. Work by the Resolution Foundation has shown that even a relatively short consultation with an advisor can spur people into making a financial purchase or finding out more on their own (Resolution Foundation, 2006a). But this is not the only way of tackling the motivation gap. As outlined above, helping people to develop a financial stake, even through changing their behaviour to act in more financially capable ways by default, can lead to changes in attitudes that result in greater engagement in improving financial capability. But should a government attempt to change people's behaviour in this way or is this too paternalistic an approach?

The role of government in changing behaviour

There have always been concerns about the role of government in changing behaviour. Seatbelts, which were made compulsory in 1983, caused considerable controversy in the 1970s, as MPs railed against the 'act of a "nanny state" restricting "freedom of choice" for drivers' (Jochelson, 2005). Successive advertising campaigns softened public opinion in favour of legislation but had little real impact on behaviour. It was only after legislation was passed that public attitudes shifted in support of seatbelts, once the benefits became clear. Similar shifts in public opinion can be seen around recent moves to ban smoking in public places, such as in Ireland and New York, where legislation has arguably led opinion faster than other measures would have.

This suggests that a government can lead public opinion in support of measures aimed at influencing behaviour and that legislation can be the most effective way to catalyse changes. But we should be wary of legislating too easily or imposing conditionality unnecessarily. For the foreseeable future, a softer approach to financial capability is undoubtedly the right approach. But this is not to say that government cannot be more sophisticated.

A central argument of this report is that better use of economic psychology and behavioural economics can help policymakers to anticipate better how people react to policy, and how policy can better fulfil its aims. These theories provide a clearer insight into how policy can respond to and meet people's needs – they do not represent a paradigm shift in the tools of government. But what are the most important ideas in these fields and how do they explain policy success and failure? These questions are considered in the following sections.

5: Lessons from psychology

In October 2002, Daniel Kahneman, a behavioural psychologist, won the Nobel Prize for Economics. This cross-disciplinary award was the final confirmation of a fundamental shift in the way we think about human behaviour and decision-making. Although many of the seminal figures in the development of modern economics saw psychological principles as integral to their theories (Bentham, 1781; Smith, 1759), by the late 1970s psychology had largely disappeared from economic discussions with the dominance of rational expectations economics.

The vast majority of professional economists had begun to simply assume that people act as if they are almost entirely 'rational'[1]: that they weigh up the full pros and cons of their actions over the long and short term and come to a considered decision before committing to a business deal, moving house, changing job, taking a shower in the morning or even eating biscuits (Mullainathan and Thaler, 2001). There are many benefits to this rational approach: it is simple, makes calculations cleaner, and avoids much of the messiness of everyday life. And it seems to work: *en masse*, most of the time, people do tend to act in ways that are fairly rational.

Daniel Kahneman won his Nobel prize for his work on prospect theory (Kahneman and Tversky, 1979), part of a cross-disciplinary shift towards systematically reintegrating psychological principles into mainstream economics (Kahneman, 2002). This shift has provided unprecedented insight into why people behave how they do, and when they are likely to behave in ways that more traditional economists consider irrational (Kahneman, 2002). As the economist Richard Thaler and the sociologist Cass Sunstein have described it:

1 The technical definition of 'economic rationality' is that preferences are 'complete' and 'transitive'. That is, that the decision-maker can compare all of the alternatives, and that these comparisons are consistent across decisions. They should also be consistent over time.

> *'People fail to make forecasts that are consistent with Bayes' rule [which shows how we should update our beliefs in the light of new evidence], use heuristics that lead them to make systematic blunders, exhibit preference reversals (that is, they prefer A to B and B to A), suffer from problems of self-control, and make different choices depending on the wording of the problem.' (Sunstein and Thaler, 2003)*

If we fast-forward to the UK in mid 2006, the impact of Kahneman's ideas can be seen in a range of policy areas (Halpern *et al*, 2004), from environmental sustainability (DEFRA, 2005; Jackson, 2005) to pensions (DWP, 2004; Horack and Wood, 2005).

These ideas are one strand of an enormous academic literature focusing on human behaviour, a literature that aims to assess why people behave as they do and discern the strategies people can use to change their behaviour. This is a literature that policymakers have yet to fully grasp; too often policy relies on outdated or unsophisticated assumptions and fails to be as effective as it could. Of course, integrating this body of academic work into policy development is no easy task, and it is no coincidence that efforts so far have been relatively tentative. But it is an attempt worth making: the pay-off for social policy could be enormous. In this section we focus on lessons from economic psychology and behavioural economics, before turning to general strategies to change behaviour in Section 6.

Financial capability and broader notions of empowerment

The crucial lesson for policymakers focusing on financial capability is that the problems they are grappling with are one example of a much larger set of issues, all stemming from the issue of empowerment. People have trouble managing their finances because they have trouble managing a much wider set of behaviours; all of us tend to procrastinate, delay, act irrationally and prioritise short-term gains over long-term losses. The key challenge for government is to empower people to be able to better understand and control their behaviour in general; this is why there are such similar efforts and strategies employed across the full range of policy, from healthcare to sustainability to crime to financial capability. Giving people the tools and support necessary to change their behaviour – 'empowering' them to take action – is often more effective than trying to influence them in other ways.

These ideas of empowerment are gaining ground fast across government. They are also particularly applicable to the financial capability agenda, an area in which people's personal responsibility is paramount.

In this section we draw from three strands of academic literature: the first provides an overview of biases in how people make decisions in general, the second focuses on specifically financial decision-making and the third concerns general strategies to change behaviour. We discuss these in turn, before asking in Section 6 how these ideas can illuminate our understanding of policy related to financial capability.

Behavioural economics: bias and heuristics

For the past few million years it has been much more important to think fast than it has been to think accurately (Craig, 1990). Our brains, shaped by evolutionary pressure, have never needed to process information to the last decimal point: our ancestors needed quick, rough, practical solutions that worked, far more than they needed to pinpoint the perfect way of doing things (Craig, 1990; Dawkins, 1995; 1996). People do not have time to carefully weigh up the pros and cons of every decision they make – most of the time they need an answer that will take them in roughly the right direction. If they are obviously going wrong then it usually becomes apparent and they can make a more considered decision. Making decisions using rules of thumb means that people can react much faster than they would otherwise be able to. Over the millennia, this evolutionary pressure has fundamentally shaped the way people's brains work. The result has been that people take mental 'short cuts', most of the time. But where do these short cuts come from?

Most of the time, these mental short cuts – or 'heuristics' – are based on previous experiences, what other people are doing, what people have said or on intuitive guesswork. Most of the time they work well.

For example, when deciding whether it is safe to cross the road, people will often look to see if other people are crossing. People waiting to cross is a bad sign; people crossing is a good sign, and most of the time this is a reliable way to judge. We all recognise that it feels much more risky to be the first person to cross a road when lots of other people are waiting on the side, regardless of how much traffic there is.

In the psychological literature this use of mental short cuts is known as 'attribute substitution'. The idea is that:

> *'A judgement is said to be mediated by a heuristic when the individual assesses a specified target attribute of a judgement object by substituting a related heuristic attribute that comes more readily to mind.' (Kahneman, 2002)*

Or more prosaically, if people have to choose how to behave in an unfamiliar situation, or in one where the likely outcome is difficult to calculate, they tend to think about it in a way that makes it easier to analyse, swapping one feature for another that is more familiar to them (Rundmo, 2002). This has proved incredibly useful in our evolutionary history and in much of our everyday life. But this approach has also led us to make irrational decisions on a regular and systematic basis – decisions that often lead us to act against our own interests (Tversky and Kahneman, 1974). The short cut can sometimes lead to the wrong place.

The past three decades has seen a significant advance in our understanding of how heuristics work, and where they most often lead to systematic conceptual errors and behavioural idiosyncrasies (Benjamin and Shapiro, 2005; Kahneman, 2002; Webley, 2006). They explain much of the failing in standard economic models, and why policy often fails to anticipate how people will react to incentives, persuasion, sanctions and other strategies (Mullainathan and Thaler, 2001). This has fundamentally changed economics and even radically altered accounts of knowledge in philosophy (Craig, 1990). It also has two profound implications for policymakers. The first is that policy can make use of heuristics to encourage people to behave in certain ways. A simple example of this is that we tend to judge how fast we are driving by the amount of time it takes to pass regular road markings. On the approach to a roundabout, if the distance between lines crossing the road are decreased, this makes people feel like they're speeding up, and so encourages them to slow down further.

The second implication is that heuristics can explain why people systematically appear to behave in apparently irrational ways, and predict when they will do so. This can help policymakers design policies that help people avoid these systematic errors, empowering them to make better-informed decisions. But what are the most important behavioural biases for policymakers?

Inertia, default and status quo bias

People tend not to take decisions if they do not have to. If they do have to make a decision, they are often happy to stick with the status quo if they can. This is the case across a wide range of fields. For example, when tort law was reformed in the US, people were offered a choice of two types of car insurance: an expensive option that gave the full right to sue, and a less expensive option with restricted rights to sue. New Jersey and Pennsylvania implemented similar systems with one crucial difference: the default option. In New Jersey, where the more expensive option was the default, 75 per cent of people chose this option. But in Pennsylvania, where the cheaper option was the default, only 20 per cent chose the more expensive option – a difference of 55 per cent (Johnson *et al*, 1993).

Similar results have been shown in relation to a diverse range of issues, including organ donation. In Belgium, after the introduction of legislation in 1986, the city of Leuwen adopted a presumed consent model whereas Antwerp and Brussels did not. Donation rates rose sharply in Leuwen, but remained static in the other two cities (BMA, 2005).

Hyperbolic discounting

A related phenomenon is that people tend to choose short-term gratification over longer-term reward, even if the benefits over the long term are much larger (Kahneman, 2002; Mahdon and Webley, 2004; O'Donoghue and Rabin, 2000a; 2000b). Importantly, the rate at which we 'discount' future consumption varies, depending on how far away the decision is – putting something off until tomorrow is almost always the preferred option. As the Pensions Commission explains:

> *'In trading-off consumption today versus consumption in the near future, [people] use a far higher discount rate that when trading-off consumption today versus in, say, 20 years time. Over a 20 year period they are willing to sacrifice current consumption (i.e. to save), but as between this year and next they strongly prefer consumption today. Therefore the decision is always to start saving 'next year', but when next year arrives, the preference is to start saving the year thereafter.' (Pensions Commission, 2004)*

Salience

People tend to overestimate the probability of events that they can easily imagine – either because they are particularly memorable, recent or relevant – or those that have given a short-lived but extreme experience (Kahneman, 2002). Things that arouse strong emotions also seem more likely to happen than they are (Mahdon and Webley, 2004). A famous example is that if floods have not occurred in the immediate past, people who live on flood plains are far less likely to buy insurance. Similarly, in the aftermath of an earthquake, the level of insurance for earthquakes rises sharply, but declines steadily from that point as vivid memories recede (Slovic, 1987).

Other well-known (but largely apocryphal) examples include the tendency of people to assume that more people are killed by sharks than by parts falling from aeroplanes, when being killed by a shark is around 30 times less likely. This is because it is much easier to imagine being killed by a shark. A further example is people's tendency to assume that they are more likely to win the lottery than they are, because it is easy to imagine having virtually limitless money and because there are frequent newspaper reports about ordinary people who have won the lottery.

Trust

One of the most important mental short cuts is based on trust (Kahneman, 2002). If you have good reasons to trust someone, you have good reasons to rely on what they tell you without having to check for yourself.

Almost all modern advertising relies on this basic heuristic. Before about 1960, most advertising was product based and aimed to communicate the rational advantages of a particular product over its competitors (Ogilvy, 1995). This was based on a model of consumer behaviour that saw shoppers as making calculated decisions over each purchase, based on its relative strengths and weaknesses. Of course, this is not how people really make decisions. They rely on brands as short cuts to quality, price and other characteristics. Once advertisers realised that brands could effectively piggyback on the heuristic of 'trust' in consumer behaviour, advertising underwent a paradigm shift in approach, focusing on higher-level issues of corporate branding, rather than the details of product specifics.

In policy terms, this explains why the voluntary and community sectors are often better placed to deliver services to socially excluded people than either the public or private sectors, as they often enjoy higher levels of trust among this group. It also explains why many people are reluctant to seek financial advice from banks, which are often perceived as having a specific sales agenda (Consumers' Association, 2002).

Option and time pressure

If people are evaluating a range of options in a hurry, they tend to focus on a superficial overview of all the options, rather than an in-depth analysis of a few. If they are severely time pressured they will focus on the negative aspects of each option, rather than the positive ones (Bettman *et al*, 1998). This means that giving people a smaller range of options can encourage them to make a decision; an overwhelming range often puts people off.

Over-confidence

People tend to overestimate their own luck, skills and knowledge in many areas. For example, most people think they are better-than-average drivers, less likely to be injured by consumer goods and more likely to live to 80 than other people (Slovic, 1987). This tends to lead to people thinking 'it wouldn't happen to me', which may partly explain why people are often reluctant to take out insurance or save for a pension (Mahdon and Webley, 2004).

Commitment

People feel uncomfortable when they experience a clash between their strongly held beliefs or commitments and their behaviour (Harmon-Jones and

Mills, 1999; Sherman and Gorkin, 1980). This means that making public commitments to do things makes people much more likely to do them, and can even shift people's attitudes in favour of what they have committed to do (Morris, forthcoming).

Framing effects

How things are presented makes an enormous difference to people's decisions and behaviour. There are several different processes here: two of the most important are loss aversion and anchoring.

Loss aversion ('prospect theory')

People are loss averse – they tend to be more concerned with preventing a loss than in winning a gain (Kahneman, 2002; Kahneman and Tversky, 1979; Mahdon and Webley, 2004; Webley, 2006). The classic illustration of this is known as the Asian disease experiment, which runs as follows (Tversky and Kahneman, 1981):

> *'Imagine that the United States is preparing for the outbreak of an unusual Asian disease, which is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimates of the consequences of the programs are as follows:*
>
> - *If Program A is adopted, 200 people will be saved*
> - *If Program B is adopted, there is a one-third probability that 600 people will be saved and a two-thirds probability that no people will be saved*
>
> *Which of the two programs would you favour?'*

In this version of the problem, a substantial majority of respondents opt for Programme A, indicating risk aversion. Other respondents, selected at random, receive a question in which the same cover story is followed by a different description of the options:

> *'If Program A is adopted, 400 people will die*
>
> *If Program B is adopted, there is a one-third probability that nobody will die and a two-thirds probability that 600 people will die'*

In this 'framing' of the options, a clear majority of respondents opt for Programme B, the risk-seeking option. Although there is no substantive difference between the versions, they clearly evoke different associations and evaluations.

Another famous example comes from work that considers the preferences of patients choosing cancer treatments. This shows that the treatment that patients (and indeed experienced physicians) choose depends to a huge extent on whether the likely outcome is described in terms of survival rates or mortality rates. If surgery was described as having a 10 per cent immediate mortality rate, far fewer patients and physicians chose it than if it was described as having a 90 per cent short-term survival rate (McNeil *et al*, 1982).

Interestingly, this seems to be a deep-seated evolutionary trait. In one experiment capuchin monkeys, which are close evolutionary neighbours to humans, were given tokens that they could insert into one of two slot machines in exchange for fruit. One machine had two pieces of fruit on display; the other had one piece of fruit. Apart from that the machines were identical: both paid out one piece of fruit half the time, and two pieces of fruit the other half of the time. So the choice of machine should not make any difference: both paid out the same amount of fruit. But the monkeys thought it did, vastly preferring the first machine, which sometimes seemed to give an extra piece of fruit, rather than the second machine, which often seemed to take away a piece of fruit (Chen *et al*, 2005).

Things become slightly more complicated if the options involve only gains or only losses. If the choice involves only gains, people tend to try and minimise their risk (Kahneman, 2002). But in the face of potential losses, people are more likely to take risks, even in the face of quite severe losses, if the likelihood of the loss occurring is small. For example, 'even if property owners are aware of possible severe losses that they could suffer after a flood, they are willing to take that risk in place of purchasing the insurance and loosing some money for sure' (Zaleskiewicz *et al*, 2000).

Anchoring and reference bias
People tend to base their decisions on 'anchors' or other reference points that are often arbitrarily chosen.

For example, if an audience is asked first to memorise the last four digits of their social security number and then to estimate the number of doctors in New York, the correlation between the two numbers is around 0.4 – a much higher correlation than would be expected by chance (Kahneman, 2002). It seems that thinking of the first number strongly influences the second, even though there is no logical connection between them.

This idea explains much human behaviour. Another simple example is the powerful influence that sale-price reductions – such as from £100 to £25 – have on people's desire to buy products. Another example is that people often focus too much on one factor when buying a second-hand car, giving undue prominence to the mileage or condition of the tyres when making their decision.

One way to shape people's behaviour is to try and set the reference that they choose. Experiments have shown that this can have a surprisingly powerful effect. For example, when asked to guess the proportion of African countries that belong to the United Nations, people who were first asked whether it was more or less than 45 per cent tended to guess lower values than people who had been asked if it was more or less than 65 per cent (Tversky and Kahneman, 1974).

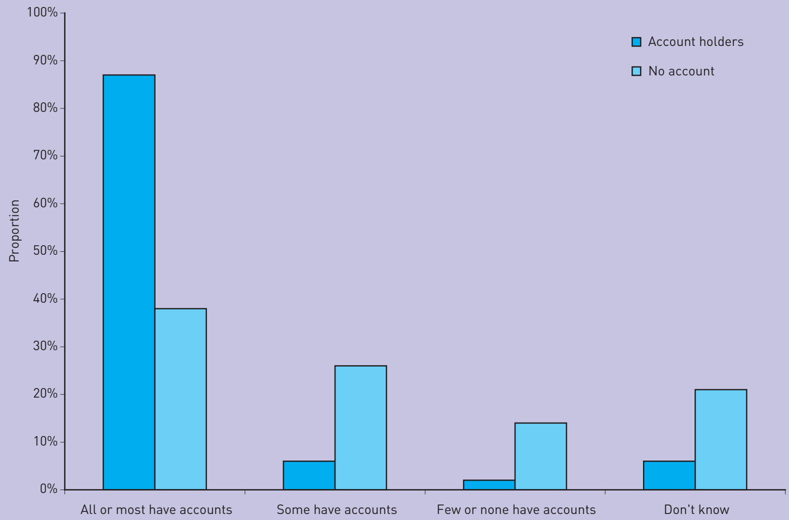
Social norms, peers and networks

The behavioural biases outlined so far focus on how people make decisions about their finances as individuals. But there is good reason to think that people's social context matters enormously. A good example is the issue of basic bank accounts. In 2004/05, around six per cent of people did not have a bank account (DWP, 2005a). Almost all of these people were not employed: many were past pension age while many others were disabled or otherwise economically inactive. Apart from this unifying factor, there appear to be very few systematic differences between people in work who do and do not have bank accounts. The main exception is social networks.

Research has shown that social networks go a long way towards explaining why people do not have bank accounts. People without accounts tend to know and socialise with far more people who also do not have bank accounts (Ormerod and Smith, 2001). As Figure 5.1 shows, only 38 per cent of people who did not have bank accounts in 2000 said that most or all of their family and friends had accounts, compared to 87 per cent of those with accounts themselves.

In some ways this finding is hardly surprising. We know that social networks and prevailing 'norms' – ways of behaving and thinking that are common across groups – are extremely important in determining behaviour (Bearman and Bruckner, 1999; 2001; Sunstein and Thaler, 2003). This desire to fit in is particularly important for young people entering adolescence. But it also spans adult life and partly explains the clustering of financial behaviour in small groups.

Figure 5.1: Use of bank accounts by friends and family



Source: Ormerod and Smith (2001)

Using economic psychology

These behavioural biases go a long way towards explaining why people behave as they do. They also suggest ways we can empower people to change by helping them to avoid mental short cuts that lead to counterproductive behaviour. But these lessons need to be complemented by experiences in other areas that have focused on changing behaviour.

6: Empowering people to change behaviour

Helping people change their behaviour is big business. Last year alone, people in the UK bought hundreds of thousands of self-help books, spent millions on nicotine patches and other stop-smoking products, and tens of millions more on diet plans, pills and classes. It is no surprise that a mountain of literature has tried to tap into this market, with authors ranging from ex-basketball players – for example, *I Can't Accept Not Trying: Michael Jordan on the pursuit of excellence* (Jordan, 1994) – to distinguished academics, each with their own take on the most effective strategies and techniques. Yet, despite minor disputes over the details, it is easy to be struck by the degree of consensus between authors who have little else in common. It seems that we really do know the basic principles of how people can change their behaviour.

Almost all the experts agree that the most important factor is the motivation to change: people have to genuinely want to alter their behaviour. This is so important that most recommend a strategy that places strong emphasis on building up the motivation to change. One of the most influential theories behind this emphasis is the Transtheoretical Model of Change – more commonly known as Stages of Change Theory. This was originally used in developing approaches to healthcare policy (Prochaska, 1979; Prochaska *et al*, 1994) but has been successfully extended to deal with approaches towards child abuse, domestic violence, consumer spending, organisational change and, crucially, personal finance (Lawson, 2001; Shirer and Tobe, 2005; Xiao *et al*, 2001).

This theory proposes that people undergo five distinct phases in changing their behaviour, three of which occur before the person tries to substantively alter their behaviour. It emphasises that behaviour change is a process rather than an event and that the key to successful behaviour change is to understand what stage a person is at and then decide what strategies are most appropriate to move forward. The theory also recognises that people will often move back before taking another step forward. In the early stages, the most important processes are conscious and cognitive, while in later stages the important processes tend to be more heavily behavioural, such as conditioning and environmental controls (Prochaska *et al*, 1996). The phases are:

1. *Precontemplation. Not intending to take action within six months.* A shift to the next phase is achieved through finding and learning new facts, ideas and tips; experiencing negative emotions as a result of the behaviour; and realising that it has a negative effect on their own life and on other people's.
2. *Contemplation. Intending to take action within six months.* A shift to the next phase is achieved by realising that they would feel better, and be better off, if they changed their behaviour.
3. *Preparation. Intending to take action within 30 days.* A shift to the next phase is achieved by making a firm commitment to change.
4. *Action. Made overt changes less than a month ago.* A shift to the next phase is achieved by actively substituting positive behaviours for negative ones, increasing the rewards for having changed behaviour, removing reminders or cues that make relapse more likely, and seeking and using social support for the changed behaviour.
5. *Maintenance. Made overt changes more than six months ago.*

This theory has radically altered the way that policymakers approach many questions of behaviour change, particularly in the US, and in a health context in the UK. For example, instead of trying to persuade people to give up smoking, doctors are now advised to help people move on one step in the process leading to giving up smoking, taking a more incremental and, in the long term, effective approach.

The theory also suggests how policymakers can start to address the motivation gap identified in Section 4. It is important to recognise that for many people, improving financial capability is a gradual process, one that takes time to build up to. We also need to take on board lessons learned in other policy areas about what works in empowering people to change their behaviour – over the long term, before a change, during a change, and after a change. These strategies can play a crucial role in behaviour change: three per cent of smokers manage to give up by willpower alone, but more than 12 million people in the UK have given up using a range of support methods and techniques (QUIT, 2006). Fortunately there is a wealth of experience to learn from.

In the rest of this section we outline practical steps that empower people to change behaviour. These come in three stages: preparing to change, undergoing change, and maintaining new behaviour. The focus here is on individuals rather than policy. (See Section 7 for an assessment of how these lessons can explain recent policy success and failure.)

Empowering people to change: preparation

Preparation is key. A range of research shows that people are much more likely to successfully alter their behaviour if they take preparatory steps to make any planned changes easier (Tucker-Ladd, 2004). One of the most important of these is altering the environment so that old patterns can be avoided – a modern version of the old maxim that 'out of sight is out of mind'.

Research shows that people's environment is an extremely powerful determinant of behaviour. This makes sense: it is much harder to avoid eating chocolate cake if it is on a plate in front of you. One seminal research study in the 1970s showed that obese people respond much more strongly to external cues, such as the sight or smell of food or someone telling them that it is lunch time, than they do to physiological messages from an empty stomach (Schachter, 1971).

There are several steps involved in changing the environment: the first is to identify specific situations that make it difficult to behave in the desired way. For people who find it hard to manage their money, this might include wandering around shops on a lunch break or going shopping with certain friends who encourage them to spend more than they can afford. It is often useful to try and work out 'chains' of behaviour in this context, identifying what actions typically lead to undesirable ones. For example, getting up late might make someone less likely to make sandwiches in the morning. This means they have to go to the local shopping centre to buy their lunch, prompting them to be tempted by sale offers. Avoiding these kinds of situations can make it much easier to change behaviour.

A corollary to this approach is identifying situations that make it easier to act in the desired way, such as taking a packed lunch to work or buying a magazine to read over lunch (Hodgson and Miller, 1982).

Setting goals

These kinds of environmental changes are much easier to implement if they are worked out in advance and are specific. It is much more effective to focus on one or two particular situations than it is to stick to a general but vague aim. When setting goals, people should aim to: be very specific, detailing time, place, and exact behaviour; focus on the near future; prioritise learning desired behaviours rather than evaluating how well they are doing overall; focus on positive outcomes rather than reducing negative behaviours (Tucker-Ladd, 2004).

These approaches are more effective because they reduce the need for people to think about their overall goal when making decisions. They help people to develop new mental short cuts to the desired behaviour, rather than having to work out what they should do in each situation (Gollwitzer, 1999; Orbell, 2005). Research has shown that working out in advance specific ways of implementing intentions can more than double the chances of success (Tucker-Ladd, 2004).

In one study looking at patients with heart disease, researchers found that expanding an existing education programme - which focused on general messages around building self-confidence, reducing vulnerability and the importance of exercise - by developing explicit implementation intentions for each patient, increased the proportion of patients following their doctors' advice from 39 per cent to 91 per cent (Sheeran *et al*, 1999).

Building motivation

A third common strategy is to use techniques that help build the motivation to change. There are hundreds of different approaches, but some of the most common include: writing lists of the positive and negative aspects of the target behaviour; telling other people about the plan to change, and asking to be reminded, thereby creating 'peer effects' in favour of the desired behaviour; acting out role plays of difficult situations; and trying to imagine what it would be like to have changed (Tucker-Ladd, 2004).

Empowering people in changing

Building motivation and preparing techniques and responses can make the practicalities of changing behaviour much more manageable. But there are a range of other complementary strategies that can make it easier to continue with a changed behaviour. One of the most common is to adopt artificial rules that disrupt old habits. For example, many diet plans recommend pausing for 10 seconds between each mouthful – this prolongs the time it takes to eat a meal, giving more time for the stomach to send chemical messages to the brain signalling that it is full. In terms of managing money, this could involve doing a weekly food shop, rather than a daily one, only buying one item of clothing at a time, or setting money aside at the beginning of every month to cover bills.

Another common strategy is to monitor and check progress, by making a mental checklist, talking to someone about what has been achieved so far, or keeping a written record (Tucker-Ladd, 2004). Whatever technique people choose, it is again important that they focus on details and specifics, rather than general measures of how well they are doing, and that people assess how well they are doing on a daily basis. This is one reason why many psychologists tend to recommend keeping written records over other techniques, as these can be used to chart progress over time, reminding people about their goals and providing an objective and demonstrable measure of success. After even a short period of time, people can see that they are heading in the right direction – this is much more effective in maintaining motivation than focusing on a final, distant ambition, which can be seen overwhelmingly far away (Chapman and Jeffrey, 1978).

Of course, most people will experience setbacks in their efforts to change. But these should not be regarded as failures, rather as opportunities to improve their strategy for changing behaviour. Recognising and analysing why someone has slipped in their behaviour, and focusing in particular on external cues, can help them to develop new, specific targets. To continue the example used above, the person who struggles to manage their money may need to go to the local shopping centre at lunch time for some other legitimate reason, perhaps to visit the doctor on a regular basis or pick up prescriptions. In this case, they could alter their target to one that ensures they leave their debit or credit card behind at the office when they do go to the shops (Tucker-Ladd, 2004).

A further strategy is to build in rewards for having successfully reached targets. These need to be relatively small: it is important that the rewards themselves do not become the reason for changing behaviour, overshadowing the original motivation (Cameron *et al*, 2001).

Empowering people after change

Old habits die hard and new ones are easily forgotten. All the evidence from behaviour change research shows that it is vital to continue to adopt strategies to promote the positive behaviour until it has become routine, even well after the event. There are a range of techniques for doing this, including support, rewards and reminding people of previous behaviour. In many drink-drive rehabilitation programmes, participants are encouraged to write themselves a letter at the end of the course, explaining what they have learned, identifying situations where they are likely to face temptation to drink and drive again, and the steps they need to take to avoid this behaviour. These letters are then kept for several months by the course administrators and sent to participants as a reminder of the decisions they have made. For individuals, a similar approach can involve making notes in future pages of a diary.

Financial capability and 'consciously' changing behaviour

For policymakers concerned with financial capability, there is clearly a great deal to take on board from experiences in other areas. It is appropriate to see financial capability as one example of a more general policy challenge that places changing behaviour at its core. Yet it is striking that the approaches outlined so far focus on methods that require people to be actively involved in changing their behaviour. Where possible, this is clearly the right approach: policy is more effective when it actively empowers people, building on their motivation to change behaviour.

But there are also other options. A variety of research shows that the relationship between attitudes, motivation and behaviour does not run in one direction. One way to improve people's motivation to change is by helping them to change their behaviour first, showing that they have the capacity to change. According to this approach, we need to think about ways to help people become more financially capable first, then focus on changing attitudes and motivation second. This approach requires a more detailed understanding of people's specific financial behaviour. We outline this below, before turning to its power in explaining policy in Section 6.

Financial capability and mental accounting

Perhaps the most widely accepted theory about how people think about their finances is Richard Thaler's idea of 'mental accounting' (Thaler, 1985). The basic idea is that people have separate 'mental accounts' or 'psychological purses' for different categories of expenditure (Thaler, 1999; Webley, 2006). These can either be related to specific categories - such as food, clothing, going out and holidays, or be more abstract terms. The theory proposes that at the beginning of each month, for example, we assign a certain budget to each of these accounts and then, crucially, hardly ever transfer funds between these mental accounts. The theory explains why people often tend not to shift spending from one kind of item to another. For example, if someone spends more on clothes in January than they had in their clothes-related mental account, rather than transfer money from their 'food' mental account for January into their 'clothes' account, they will tend to spend less on clothes in the next month. One easy way to demonstrate this idea is by an anecdote, such as this from Richard Thaler himself:

> *'A few years ago I gave a talk to a group of executives in Switzerland. After the conference my wife and I spent a week visiting the area. At that time the Swiss franc was at an all-time high relative to the US dollar, so the usual high prices in Switzerland were astronomical. My wife and I comforted ourselves that I had received a fee for the talk that would easily cover the outrageous prices for hotels and meals. Had I received the same fee a week earlier for a talk in New York though, the vacation would have been much less enjoyable.' (Thaler, 1999)*

Thaler explains that:

> *'The vacation in Switzerland was made less painful because of the possibility of setting up a Swiss lecture mental account, from which the expenditures could be deducted.' (Thaler, 1999)*

This is important because it shows that people's mental accounts are 'non-fungible' – that people are reluctant to transfer spending from one account to another (Thaler, 1999). This idea seems to explain much human behaviour, particularly that related to people's finances. A classic example comes from a study of New York taxi drivers in the late 1990s.

Many taxi drivers in New York pay a fixed fee to rent their cab for 12 hours, and can then keep any takings they make. This gives them the freedom to work for as long or as little time each day as they like. According to traditional economics, drivers should work longer on 'good' days – when it is raining, there is a subway strike, a big convention or a major sports game – than on a 'bad' day. This strategy would mean they could take home a bigger monthly pay packet. But in fact they do the opposite, leaving early on good days and working longer on bad ones (Camerer *et al*, 1997). Why? It seems that these taxi drivers approach each day at a time, setting a 'mental account' target for each day, and treat any shortfalls in their daily earnings as a loss – meaning they work longer when they are less likely to meet their daily target.

There are many other examples of how mental accounting can help explain people's financial behaviour, suggesting that this theory may have profound implications for policy. If policy can shape or create mental accounts for specific purposes, then it could help people to make certain kinds of financial decisions or behave in certain ways (Heath and Soll, 1996) – for example, by spending more on fruit and vegetables (Walker and Zhu, 2005), or even certain kinds of financial products (Mahdon and Webley, 2004). But is this a step too far for government?

Shades of Machiavelli?

Taxes and subsidies, rules and regulations, laws and punishments, information and persuasion, and the provision of public services are all legitimate means for government to influence behaviour. But we need to ask whether policies based on, and aiming to harness, deeper understanding of the subconscious workings of human decision-making mark a fundamentally new, and morally problematic, approach.

Of course, as is argued in the introduction, the business of government is largely the business of behaviour change. But just because there is a clear popular mandate for considerable interventions aimed at tackling some problems, for example, in response to crime and antisocial behaviour, this does not give the Government a *carte blanche* across the board. Anti-Social Behaviour Orders (ASBOs), Parenting Orders and prison sentences are democratically acceptable, partly because crime has such a profound effect on people's lives, often over the long term (Dixon *et al*, 2006). By way of contrast, policy efforts aimed at increasing environmentally sustainable behaviour, by promoting recycling, reduced energy use and better-insulated homes, and discouraging private transport for short or unnecessary journeys, do not have a mandate for such strong deterrents and incentives. What underpins this difference?

One factor is the extent and acceptability of the negative externalities of any given kind of behaviour. A government arguably has the strongest case for intervention in behaviour when it negatively affects other people in ways that are unacceptable. The more negative the externality and the more innocent the victim, the more legitimate is any government action. Crime and antisocial behaviour have an immediate and easily discernible effect. Environmental sustainability has a longer-term impact that is not so easy to see immediately - it will be interesting to note whether popular views around the appropriate role of government in promoting sustainable behaviour start to shift as the implications of climate change become more apparent in our everyday lives.

If this intuition is partly right, then it might leave government in something of a quandary about changing people's behaviour to promote financial capability. There are significant externalities to UK citizens' low financial capability, as outlined in Section 3. But it is important to recognise that one of the key drivers behind the financial capability strategy is that being more financially capable improves your own life (as well of that of your immediate associates and family), a motivation that does not apply as immediately to behaving in environmentally sustainable ways.

This may be one reason why policymakers have taken a fairly hands-off approach in their efforts to promote financial capability, offering opportunities for people to become engaged or receive education or information with no threat of sanction or compulsion. For the foreseeable future, this is undoubtedly the right approach: imposing widespread conditions would not be an appropriate response to low levels of financial capability. For a start, it would almost certainly bite hardest on those who need the most support (Stanley *et al*, 2004). But this is not to say that the Government cannot take a more sophisticated approach.

Using economic psychology to better anticipate how people react to policy, and how policy can better fulfil its aims, is far from Machiavellian. These theories simply provide a better insight into how policy can respond to and meet people's needs; they do not represent a paradigm shift in the tools of government. The question is how much insight they provide into the success and failure of policy so far. This issue is considered in Section 7.

7: Explaining policy failure and success

The last decade has seen a radical transformation in the way public policy is developed and implemented in the UK. Extensive piloting and evaluation has moved from the periphery to become a standard part of most major policy initiatives. One implication has been to make policy debate a more technocratic affair, in which ideology takes second place to evidence. A second has been to highlight areas where our knowledge base is resoundingly poor. Unfortunately, despite substantial recent gains, financial capability is a classic example of this: there is a dearth of rigorous, systematic longitudinal data and analysis proving what works, particularly in a UK (and European) context. But why?

One reason is that the financial capability agenda is still quite new. Another is that much previous work on the ground has been done by voluntary sector agencies, with considerable duplication and without the capacity or resources to evaluate results in detail. A third reason is that until recently overarching principles have been lacking to develop policy approaches and consistent evaluation techniques (Fox *et al*, 2005). So what do we know?

In this section we focus on a limited number of financial capability initiatives, drawn from around the world, that have been properly evaluated, to show how the theories and strategies outlined in Sections 5 and 6 can help explain success and failure. We start by looking at approaches that place education centre stage, before considering strategies that use incentives to change behaviour. We then turn to programmes and products that are designed to make it easier to change behaviour.

Does financial education really change behaviour?

Education can change even the most entrenched attitudes, even late on in life. Participating in some form of adult education has been shown to make people less racist, authoritarian and politically cynical, and more concerned for the environment (Preston and Feinstein, 2004). It can certainly improve people's knowledge and understanding, particularly in relation to financial matters (ECOTEC, 2006; Fox *et al*, 2005; Todd, 2002). This should give cause for optimism: we know that financial behaviour and knowledge are intimately connected (Hilgert, *et al*, 2003). But can education feed through into improved financial capability and behaviour in the long term?

School-based financial education can change behaviour

Perhaps the most compelling evidence in favour of financial education comes from studies of school-based initiatives. This is hardly surprising: young people are much more receptive to information and often have yet to form strong financial habits. Two pieces of evidence stand out from the rest, both derived from research in the US.

The first tracks the behaviour of people who grew up in states where some form of universal consumer education at high school was imposed through legislation, comparing them to students who grew up in states where there was no such mandate. Over the past 40 years, more than 28 states have adopted this kind of legislation, starting as far back as 1957. (Policy in the UK in this area appears to have lagged decades behind.) In 14 of these states, legislation specifically required teachers to cover topics relevant to household decision-making, including budgeting, credit management, balancing chequebooks, compound interest and other investment principles (Bernheim *et al*, 2001).

The impact of financial education at high school is impressive. Controlling for other factors, those who received financial education at this stage had significantly better financial outcomes and behaviour by age 35 to 49, compared to those who did not: they were better off (in terms of higher net worth) by about a year's worth of earnings and tended to save about 1.5 per cent more of their income each year (Bernheim *et al*, 2001). Transposing these results to the UK suggests that similar financial education could make people much better off 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 (DWP (2005b).

The second piece of evidence concerns the National Endowment for Financial Education High School Financial Planning Programme, set up in the late 1990s in the US. This is a comprehensive, seven-unit curriculum, designed primarily for high schools, reaching nearly 400,000 students each year (NEFE, 2006). The course lasts about 10 hours and covers the basic concepts of financial planning and how they apply to young people. An evaluation in 1999 revealed that this has a demonstrable impact on the knowledge and behaviour of participants. Even after three months, 47 per cent knew more about credit costs than they did before the programme and 38 per cent knew more about investments. Importantly, 37 per cent improved their skills for tracking spending, and 45 per cent started saving or began saving more (Danes *et al*, 1999).

This analysis strongly supports the British National Strategy's current focus on integrating financial education into the curriculum (FSA, 2006a). But it also cautions against expecting immediate results and highlights the importance of getting the delivery, curriculum and teaching methods right. There is a real challenge in terms of ensuring that the financial education is delivered in an engaging way and teaches the appropriate skills. Current proposals are for financial education to be integrated into the functional maths curriculum, which raises serious concerns about whether the content of lessons will be too close to outdated concepts of financial literacy. There are also concerns that these plans will miss the opportunity to teach young people about the behavioural skills they need to identify problems and take practical steps to resolve them.

In the US, state mandates often took years to feed into the curriculum – Illinois, for example, was still running teacher workshops for several years after it passed legislation and did not issue guidelines until more than a year after its adoption. Establishing and disseminating best practice has taken even longer (Bernheim *et al*, 2001), with many programmes failing to live up to expectations.

Education in the workplace

A second key element of the National Strategy in the UK so far has been to deliver financial advice through the workplace (FSA, 2003; 2006a). There are good reasons for this: it is an effective way to reach large numbers of people at any one time, and some important financial behaviours, such as saving for a pension, can often be catalysed through workplace provision of financial products. The Financial Capability Baseline Survey also reveals that where employers offer free financial products, this is highly correlated with improved individual financial capability (Atkinson *et al*, 2006). But does advice delivered in this way change behaviour?

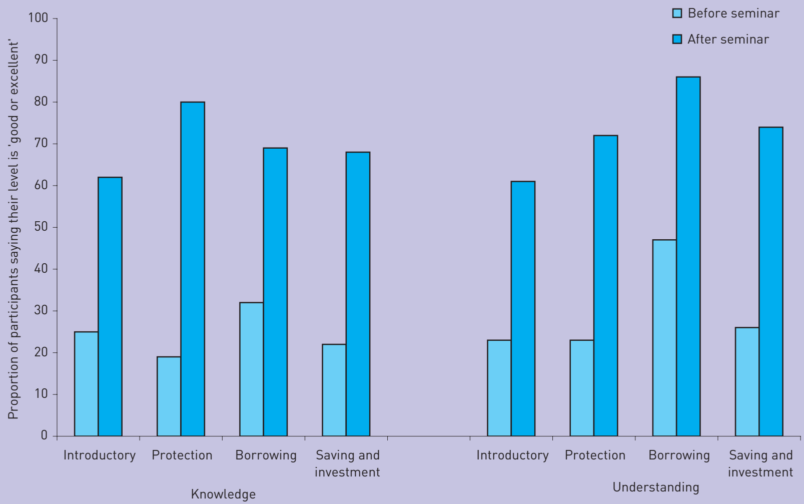
US research suggests that it does (Vitt *et al*, 2000). Improved savings rates are common results of workplace financial education (Bernheim and Garrett, 2003; Todd, 2002), particularly for lower-paid workers (Bayer *et al*, 1996). One study shows that median savings rates are 22 per cent higher for individuals whose employers offer financial education, after controlling for other factors (Bernheim and Garrett, 2003), a finding that is supported (less specifically) in a British context by the Baseline Survey (Atkinson *et al*, 2006). Another study, focusing on a specific programme designed in-house by UPS – which helps employees to budget, reduce debt, calculate benefits from the company's retirement plan, and plan for specific goals – shows impressive results: by the end of its first six months, 40 per cent of employees had attended workshops – of which 70.5 per cent said they planned to prepare a budget, 57.3 per cent planned to increase the deferral amount in their UPS Savings Advantage accounts, and 65 percent planned to prepare a will (Braunstein and Welch, 2002).

In a British context, the 2005 Make the Most of Your Money pilot (MMYOM), funded and developed by the FSA and its partners, has been one of the largest and best evaluated schemes in this area (ECOTEC, 2006). It tested several models of delivery, including organised seminars within the workplace, one-to-one information and guidance sessions, and web-based financial information tools.

The immediate feedback on MMOYM from participants was largely positive, with between 72 and 84 per cent of seminar attendees saying it was 'very or fairly useful', depending on the topics covered. As Figure 7.1 shows, many more people rated their financial knowledge and understanding as being 'good or excellent' immediately after the seminar.

MMOYM seems to have undoubtedly affected people's confidence, knowledge and understanding, at least in the short term. But did it change their behaviour too? Unfortunately, it has not been possible to rigorously assess whether participants changed their behaviour following the

Figure 7.1: Impact of MMOYM on self reported levels of financial knowledge and understanding



Source: ECOTEC (2006)

seminars, nor has it been possible to determine how permanent the impact of the programme has been. The post-pilot follow-up survey had extremely low response rates and subsequent interviews were unable to provide quantitative results. But there are some indicators suggesting that around 40 per cent of seminar attendees had been prompted to think about planning ahead or managing their money more effectively and to reflect on how they planned their finances, and around 25 per cent had made some change to the way they saved or managed their money. But there seemed to be little impact on attitudes to credit and choosing products, or on other financial behaviour (ECOTEC, 2006).

It would be unrealistic to expect attendance at one or two seminars to fundamentally alter people's financial capability; as is highlighted in Section 6, changing behaviour has many stages, and the seminars may have helped move people along the path towards improving their financial capability, even if no specific behaviours have changed. But there are considerable concerns about whether the MMOYM scheme will achieve even this. Research from the US shows that many people procrastinate and delay considerably, even if they originally intend to take action. Studies show that even if all participants say they will sign up to a company pension plan, if asked immediately after the seminar, very few of them will sign up even after six months (Choi *et al*, 2001a; Sunstein and Thaler, 2003). These findings reinforce the need for longer-term evaluation of changes in behaviour following seminars in this programme.

There are almost certainly ways in which the approach could be improved, drawing on lessons from the analysis in Sections 5 and 6. There are two main points here. First, the seminars should focus on practical ways of changing behaviour as much as on technical knowledge; knowledge is clearly only one element in improving financial capability. This would require rethinking the delivery structure and materials for these seminars, as current providers may lack expertise in this area or require further training. Second, there is strong evidence that the seminars should be linked to encouraging people to take specific actions immediately following the seminar. Research findings suggest that this would encourage people to move along the stages of change towards improving their financial capability, and could even dramatically improve their savings levels, as discussed below (Thaler and Benartzi, 2001).

Community- and voluntary-sector-based financial education

A separate strand of financial education is delivered through the voluntary sector and other agencies located in the community, such as housing, credit unions and Citizens Advice. Many of these focus on the provision of tailored financial help, dealing with fairly severe financial problems after they have occurred, rather than preventative financial education aimed at pre-emptively changing behaviour (although Citizens Advice has recently piloted the provision of more generic financial advice with some success [FSA, 2006b]). This is partly a question of client need, as many voluntary sector organisations routinely deal with more excluded sectors of the population, and partly a result of the motivation gap identified in Section 4. Few people turn to the voluntary sector for advice before they have serious financial problems.

Much remedial work undertaken by community-based and voluntary sector organisations has a profound effect on people's lives, often helping to rescue them from dire circumstances. But this approach has less relevance for building financial capability in an attempt to pre-empt problems occurring in the first place.

There are good reasons to think the voluntary sector is well placed to deliver financial education. A major advantage is the trust that people place in it; the research outlined in Section 5 shows that this is a major factor in influencing people's decisions and behaviour. There is also a range of evidence to show that when the voluntary sector does become involved in more generic financial education - often in combination with support and guidance - it can have a profound effect.

Perhaps the most compelling evaluation evidence comes from an initiative originally developed in New Jersey in 1996, called Money 2000 (now named Money 2020). This was the first savings programme in the US to incorporate a longitudinal behavioural monitoring system, a feature that has made it a model for programmes throughout the world.

Participants are asked to set financial goals and are then provided with educational services, – such as quarterly newsletters, classes, state conferences, computer analyses, home-study courses, and websites – and are surveyed about changes in their asset and debt level every six months. Importantly, participants are only asked about changes in their financial status, rather than the amount of their income, assets or debt. This approach clearly makes use of several insights from behavioural economics and behaviour change theory, outlined in Sections 5 and 6. Goals are specific, there is consistent monitoring, and tools are tailored to people's needs. Regular monitoring and tailored provision also ensures that people are supported in moving through the different stages of change. The results of the programme are compelling.

In New Jersey, where the programme was initiated, 1,840 participants had enrolled by June 2000 and reported US$5.8 million of aggregated savings and debt reduction. In the 32 states that reported programme participation, there were 13,093 participants and a total saving impact of US$15.2 million reported in 16 states (O'Neill *et al*, 2000).

Peer-based education

The analysis in Section 5 suggests that peer networks are powerful influences on behaviour, and that these can be harnessed in efforts to promote financial capability. Although there is limited evidence as to whether it has in fact changed financial behaviour, the recent Roehampton University Money Doctors pilot – which delivered education, one-to-one surgeries and extensive publicity about financial issues to students, with more than 1,000 attending talks or training sessions – appears to support this idea, as many students acted as volunteer 'peer educators' to bring the benefits to fellow students.

Experiences from the Saving Gateway pilot project, a matched savings scheme, also highlight the importance of making use of peer networks. Thirty-four per cent of people who participated in the programme found out about it by word of mouth, compared to 32 per cent who found out through a local project, 12 per cent via a leaflet and 12 per cent through a local newspaper (Kempson *et al*, 2005). The evaluation suggested that word of mouth might be particularly important for building trust, as one participant explained:

> *'I read the stuff first and I was a bit… it seemed too good to be true at first. When they say the government will double your money, it seems too good to be true. I was looking for the small print.' (Kempson et al, 2005)*

Once people were signed up, however, they were keen to tell other people. Nearly half of participants knew someone else with a Saving Gateway account, and 83 per cent said they had told someone else.

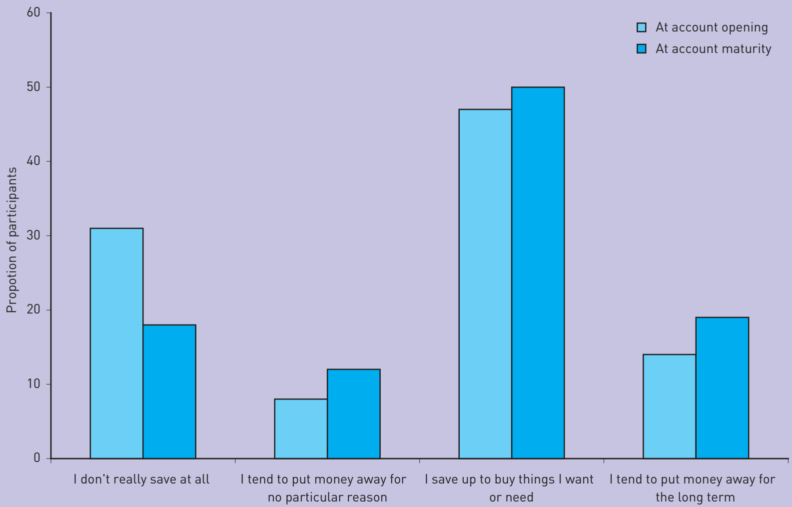
Incentives

The Saving Gateway project also reveals how important incentives are in encouraging financial capability. This is relatively unsurprising: almost all behaviour change theory stresses the importance of rewards, as outlined in Sections 5 and 6. The central idea behind Saving Gateway is to provide a saving account to low-income households, with a much higher rate of return than anything available through the private sector. Over 18 months, the return could be as much as 60 per cent per year, on a maximum saving of £25 a month (Kempson *et al*, 2005).

The evaluation results for the Saving Gateway pilot are generally very positive. As Figure 7.2 shows, it had a significant impact on people's attitudes towards saving, with participants being more likely to save in general, more likely to save up for specific goods, and more likely to put money away for the long term.

The pilot also seems to have shifted people's attitudes towards their finances in general, with 32 per cent of those who said that debt was inevitable at the beginning of the programme having changed their minds by the end. Furthermore, 39 per cent of participants said they felt more in control of their lives and 32 per cent said they were more likely to plan for their retirement as a direct result of their involvement. But did it change behavioural measures of financial capability too?

Figure 7.2: Impact of the Saving Gateway on attitudes to saving



Source: Kempson *et al* (2005)

The evidence suggests that it did. Compared to a reference group of otherwise similar people, Saving Gateway participants were less likely to have taken out a loan in the previous 18 months (16 per cent compared to 24 per cent), with a noticeably marked reduction in taking up doorstep loans (one per cent compared to seven per cent). They were considerably more likely to have a positive balance in their savings account and to use a more diverse range of financial products and services (Kempson *et al*, 2005).

A second pilot is now underway in Cambridgeshire, Cumbria and North Lancashire, East Yorkshire, Manchester, East London and South Yorkshire. This will test alternative match rates, different monthly contribution limits, the effect of an initial endowment, and the support of a wider range of community financial education bodies. It will also be made available to a wider range of income groups than the first pilot (HM Treasury, 2005).

In common with much British policy surrounding financial capability, Saving Gateway is based on US experience, primarily involving Individual Development Accounts. These are matched savings accounts funded from national, local and charitable sector contributions. In the largest and most well-known scheme, the American Dream Demonstration, there were clear signs that matching helped people to save - even those living on very low incomes. Participants averaged monthly net deposits of US$19.07, making deposits in about six of every 12 months and accumulating approximately US$700 per year (Schreiner *et al*, 2002).

One of the most important differences between the American Dream Demonstration, with its use of Individual Development Accounts, and Saving Gateway is that matching contributions in the US must be spent on one of a limited number of asset acquisition purchases, including buying a house, setting up in business, or getting education or training, whereas Saving Gateway participants are free to spend their savings as they choose (Kempson *et al*, 2005).

There are clearly advantages to both approaches, but it is clear from the behaviour change literature that setting clear goals, backed up by spending restrictions, can not only encourage people to change their behaviour in the short term, but can also result in longer-term habit formation and more fundamental behavioural shifts. Qualitative research by ippr suggests that these kind of restrictions can be popular, particularly with Child Trust Funds (Paxton *et al*, 2006). The next stage of Saving Gateway pilots should aim to test how goal-setting can be incorporated most effectively into the scheme.

Policy underpinned by economic psychology and behavioural economics

A great deal of the success of the approaches outlined so far can be explained by referring to the behaviour change literature explored in Section 6, which empowers people to alter their behaviour. These approaches make much less use of the economic psychology and behavioural economics outlined in Section 5. This might raise questions about whether the latter can be incorporated meaningfully into policy approaches.

Developing policy that is underpinned by economic psychology and behavioural economics is far from simple. But there are at least four examples of current policy approaches that employ these theories to a greater or lesser extent, however consciously. Two of these concern pension saving, one concerns child-related saving and a fourth concerns heating bills. We discuss these in turn.

Economic psychology, behavioural economics and pension saving

One of the most consistent findings from behavioural economics is people's tendency to stick with the default option. This has important implications for pensions policy (Pensions Commission, 2005), because in companies in which employees are automatically enrolled into the company pension scheme, contributions tend to be much higher (Sunstein and Thaler, 2003). For example, in a study of three US companies that switched to automatic enrolment, researchers found that 401 (k) pension participation rates exceeded 85 per cent, regardless of the tenure of the employee. (A 401 (k) plan – named after a section of the US federal tax code – is an employer established pension saving plan generally funded with before-tax salary contributions and matched employer contributions.) Before the switch, participation rates had ranged from 26 to 43 per cent after six months of tenure at the three firms and 57 to 69 per cent after three years. Importantly, the research showed that participation increases were most significant for those least likely to participate in standard retirement savings plans: the young, lower-paid, black and Hispanic employees (Choi *et al*, 2001b).

Similar results have been seen in the UK, with 80 to 100 per cent of new employees joining pension schemes evaluated by the DWP (Horack and Wood, 2005). Indeed, the evidence is so compelling that there is now wide consensus that automatic enrolment needs to be implemented nationally through the National

Pension Savings Scheme (NPSS) (Pensions Commission, 2006). As the final report of the Pensions Commission argued:

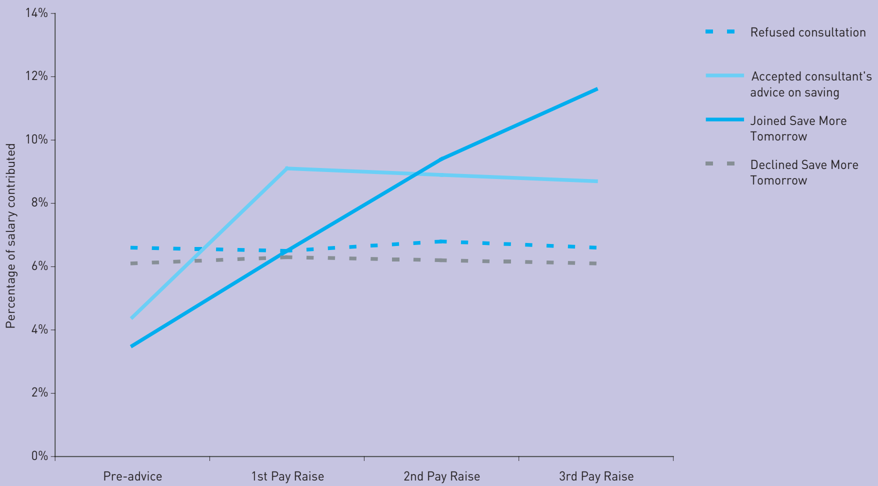
> *'We recommended the application of automatic enrolment at a national level to overcome the behavioural barriers to long-term saving, while leaving people ultimately free to make their own decisions. Debate … has revealed a wide-ranging consensus in favour of this approach … [and] there is general agreement that without automatic enrolment it will be impossible to increase pension participation rates significantly or to reduce the costs of pension saving via the elimination of regulated advice costs.' (Pensions Commission, 2006)*

A second example of pension-related policy underpinned by economic psychology and behavioural economics is the Save More Tomorrow scheme, developed by the American economists Richard Thaler and Shlomo Benartzi. This shows how hyperbolic discounting – the tendency for people to put things off – can be overcome by encouraging people to make a formal commitment to decisions in the future, and how people can make use of their tendency towards inertia to increase their savings (Thaler and Benartzi, 2001). This scheme is perhaps the clearest example of how behavioural economics has been used to develop and test new policy ideas, and has justifiably become internationally renowned; it has certainly influenced recent thinking in the Department for Work and Pensions (Horack and Wood, 2005).

The Save More Tomorrow scheme recognises that people are usually reluctant to reduce their current income, but happy, in principle at least, to forgo future income if it means they will be better off in the long term. There are five main features to the scheme:

1. Employees are approached as early as possible before a potential pay rise about increasing their pension contribution rates. This takes advantage of hyperbolic discounting.
2. Employees commit to increasing their contribution to their pension plan when they next receive a pay rise. This takes advantage of commitment effects.
3. With each pay rise, employees' contributions are increased. This avoids loss aversion.
4. With each pay rise, the contribution rate increases up to a set maximum (reached after several rises).

Figure 7.3: The impact of the Save More Tomorrow scheme on contributions to 401(k) plans



Source: Thaler and Benartzi (2001)

This takes advantage of inertia and default bias.

5. The employee can opt out of the scheme at any time. This encourages employees to join.

The Save More Tomorrow scheme was trialled in the US in 1998 in a mid-size manufacturing company that had low participation rates in pension saving, as well as low contribution rates. The results of the scheme are compelling: on average, those who joined more than tripled their savings rates by their third pay rise (after 28 months), as Figure 7.3 shows.

There are obvious implications here for the structuring of British pension schemes: where possible, employees should be encouraged to join up on a Save More Tomorrow basis. But there are more general lessons that can also be drawn. It is clear that asking people to commit to financial behaviours in the future, and then automating the process as much as possible, is an extremely effective route to behaviour change, as it makes use of a variety of heuristics at once.

It seems likely that similar processes can be used to encourage people to seek financial advice, perhaps by asking them to commit to seeing a financial advisor after their next pay rise or starting a new job – which could be tracked using HM Revenue and Customs receipt of P45 forms – and sending them a voucher for a free consultation linked to this change in circumstance. Similarly, for people who are receiving support in finding employment or training, advisors should encourage participants to commit to reviewing their finances once they gain permanent employment.

Economic psychology, behavioural economics, children and heating bills

Pensions policy is perhaps an obvious candidate for economic psychology to make its mark. But there are many other candidates too. Mental accounting theory is a particularly promising example. Perhaps the most interesting case study concerns Child Trust Funds (CTFs). These are an endowment paid to children at birth, placed in trust until the age of 18, and topped up by the government (and possibly family and friends) at various ages throughout their lives.

Some economists have argued that CTFs may create a new mental account for child-related saving that would not have existed previously, encouraging families to save for their children. Standard models of rational agents would assume that people would save less for their children if the government contributed towards a saving for them – they would simply divert expenditure from saving for their children to other kinds of consumption. But because mental accounts are non-fungible, starting a new mental account, or contributing to a small but existing one, means that people may be more likely to save more in a CTF than they would have done without one. Research by ippr next year will examine this effect in more detail; at the moment it is simply too early to tell whether CTFs have in fact worked in this way.

Using mental accounts to help shape financial behaviour is a plausible policy strategy. But it is by no means inevitable that policies will have the desired effect. A good example here is the Winter Fuel Payment – a policy that costs more than £1.6 billion each year (Walker and Zhu, 2005). This is a payment of more than £100 to pensioners before Christmas to try to combat fuel poverty and the estimated 40,000 excess winter deaths that are caused in part by people being unable to pay to heat their homes (Wilkinson *et al*, 2001). Pensioners receive it automatically after their first claim and take-up is extremely high.

Standard economic theory would predict that a payment delivered in this way would not be spent entirely, or even largely, on fuel – recipients would treat it as extra general income and would spend it on a range of goods, perhaps including a little extra on fuel. But mental accounting would suggest that, if the fuel payments can be delivered in such a way as to be firmly linked to people's 'fuel' mental account, then it would be spent largely on fuel. So what does the data show?

There is evidence of a small mental accounting effect. People are 21 per cent more likely to spend money from their Winter Fuel Payments on fuel than they would be to spend a similar payment that was not presented as being linked to fuel payments (Walker and Zhu, 2005). This suggests that hypothecated payments can work – but that it is important to understand when and how policy initiatives that affect mental accounts work most effectively. Child Trust Funds seem plausible candidates here because they create a physical account that matches a mental account. The Winter Fuel Payment has a less direct link – and it may turn out that physical accounts are particularly important.

Taking stock

These examples prove how important theories of behaviour change, economic psychology, behavioural economics, social norm theory and sociology are for the financial capability agenda. But how should they be used to shape policy going forwards?

8: New strategies for financial capability

This report aims to set out a new direction for the financial capability agenda, one that complements the existing approach and builds on the understanding gleaned and progress made so far. The central focus of this new agenda should be to empower people to become more financially capable, by using the best available theories and evidence about human behaviour. Our recommendations touch on seven central themes: rethinking the challenge; tackling the motivation gap; responding to critical moments; challenging accepted wisdom, particularly in relation to savings hierarchies; developing a new model for debt management; empowerment through commitment, including new Save More Tomorrow accounts; extending default approaches; using mental accounting; and harnessing social norms and networks. These ideas are developed below.

Rethinking the challenge

Improving the UK's financial capability is not an easy task. Nor is it a small one. In 2006, 17 million adults in the UK are successfully making ends meet, keeping track, planning ahead, choosing products and staying informed about financial products. As many as 10.5 million are experiencing considerable difficulty in one of these areas, 3.8 million face severe problems in two, 6.2 million lack capability in three areas, 8.6 million in four, and 1.4 million are succeeding in none (Atkinson *et al*, 2006; GAD, 2005), with serious consequences for their own well-being, the British economy and future prosperity.

The shift towards a financial capability agenda from one that prioritises narrow notions of financial literacy or financial inclusion is a move in the right direction in its emphasis on behaviour. We have a much better grasp of the problem than ever before. But policy has only recently begun to mirror this conceptual shift in attempting to affect behavioural outcomes, rather than merely outputs. The measure of success should not be the number of people who attend seminars: there is a need to continue evaluating policy in terms of its impact on behaviour, practical skills and attitudes.

If policy now has a much better grasp of the nature of the problem, we are still underestimating its scale. The financial capability challenge should not be seen in isolation from other challenges facing the UK. It is one aspect of a much broader shift in society, deeply rooted in cultural changes – a shift that requires government to work harder and more effectively to empower people to change their behaviour. Over the long term, the best solution to financial capability is to engender a profound cultural change, in terms of attitudes to personal responsibility and behaviour, and in terms of attitudes to consumption, sustainability and debt. If we have moved from a 'thrift ethic', where people limit their consumption of goods to what they can afford at the time, to a 'consumption ethic', where people buy now and pay later (Johnson, 1985; Tucker, 1991), we now need to move towards a 'sustainability ethic', where both saving and borrowing are appropriate, but within the context of overall financial sustainability (Webley, 2006).

A budget of £10 million is nowhere near enough. If the National Strategy for Financial Capability is to be a truly national strategy in practice as well as in name, much more funding is needed. Analysis by the Resolution Foundation shows that a step change in funding would be needed to deliver a new national financial advice resource – just one component of a truly national, adequate response. The Foundation estimates that a telephone-based advice service, supported by web-based information, could be delivered for approximately £25–£35 million per year (not including start-up costs). This could possibly be funded by a partnership between the Government and the financial services industry. Including provision for face-to-face advice would add to this cost (Resolution Foundation, 2006a).

This is likely to require substantial additional funding from both government and the financial services industry. But it also suggests that lead responsibility for delivering financial capability should be moved from the Financial Services Authority (FSA) to 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 than the FSA, through social services offices and education providers. They also have more experience in delivering large-scale programmes and the evaluative and research capacity to assess these.

But there is also a more philosophical issue in favour of this shift. A central theme of this report is that financial capability should be seen as a central welfare issue, not as a set of peripheral life skills. People's financial acumen is increasingly important in determining the quality of their lives. Conceptualising financial capability as a welfare issue in this way would lead naturally to greater government involvement in delivery - albeit with considerable and ongoing contribution and partnership from the financial services industry, the voluntary sector and other key stakeholders.

This is not to say that the government and other stakeholders should spend indiscriminately. There is a careful balance to be found between piloting approaches and being caught in a 'piloting trap', which delays real action for years. Where we can draw on experiences in other policy areas, such as telephone advice delivery through NHS Direct, it may be sensible to invest substantial sums early.

Tackling 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 only 37 per cent have made some provision for their old age (Atkinson *et al*, 2006).

The challenge is to find more effective ways to empower people to change their behaviour, working with their aspirations and with a degree of realism about the difficulty in engaging them. There needs to be more thought put into how policy can make best use of the latest developments in economic psychology and behavioural economics. This should be combined with the best theory about how people change behaviour, drawn from a burgeoning specialist literature, in order to draw out lessons for future policy development. We also need to learn lessons from what works in other policy areas. There is the potential for much more effective policy.

The evidence outlined in this report shows that there is a two-way relationship between people's interest in improving financial capability and their financial behaviour: greater engagement leads to greater capability, but having a greater stake in financial products can also lead naturally to greater interest in improving financial capability. This suggests that policy needs to take a two-pronged approach: providing the most appropriate 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. This will help to engage them and make them interested in improving their financial capability.

Policy has too often focused almost exclusively on the first of these strands. A key finding of this report is that economic psychology and behaviour change theory can help develop the second. Given the right support and structures, and a significant stake in financial capability, people do take steps to become more financially capable. Below we suggest some practical ways in which policy can empower them to do so.

Improved communication

Improving the way we talk about financial capability, and the way we communicate with people about this topic, is important. The FSA should be congratulated for its recent revision of the way it advertises and presents this issue. But there is an opportunity to be far more innovative than it has been so far. Compared to the best private sector advertising and public sector communications – particularly concerning other issues around behaviour change, such as smoking and literacy – there is considerable work to be done. 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

Communicating the importance of financial capability is clearly important. But so too is communication around financial products in general. Even relatively financially capable consumers can find financial terms confusing. 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 a smaller initial range of products, rather than a wide portfolio, even if this means that people may not have immediate access to the most tailored and suitable products.

A related challenge is in simplifying the tax and benefits system. Means testing has been successful in reducing disincentives to work and has lifted many families out of poverty through Working Tax Credits (Hills, 2004; Pearce and Paxton, 2005). But it has also created considerable complexity in the benefits system that can put people off engaging with financial products, and particularly saving in a private pension (Pensions Commission, 2004). 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 make 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.

With the exception of the New Parents: Money Box strand of policy (FSA, 2006b), the current strategy remains too focused on broadly conceived life stages. Better ways of identifying when and how policy can target these more diverse and specific critical moments are needed.

But policymakers 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. The Foundation estimates that a telephone-based advice service, supported by web-based information, could be delivered for approximately £25-£35 million per year (not including start-up costs). This could possibly be funded by a partnership between the Government and the financial services industry. Including provision for face-to-face advice would add to this cost (Resolution Foundation, 2006a).

Challenging established wisdom: rethinking savings hierarchies

Some debts are more expensive than others. Typically, credit card or hire purchase loans have higher interest than overdrafts, which in turn have higher interest rates than loans. All of these tend to have higher interest rates than current or savings accounts. This simple fact has given rise to the notion of 'savings hierarchies': the idea that people should prioritise paying off their most expensive debt first, before moving on to the next most expensive.

If people were completely rational then this would be good advice: it is the best way to save money over the long term. But people are far from rational. They have different mental accounts, tend to stick with the status quo, and are profoundly affected by perceptions of how well they are doing. This suggests that policymakers should rethink the traditional model of savings hierarchies (Maxwell and Paxton, 2004). 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.

This idea has obvious implications for a very broad range of stakeholders, from Independent Financial

Advisors to frontline agency staff, to those in the voluntary sector. But it also has considerable implications for the way that the public sector responds to individual debt, prompted by new evidence on the capacity of poor households to save: even those on very low incomes can save if provided with the right structures, goals and incentives (Atkinson *et al*, 2006; Kempson *et al*, 2005; Schreiner *et al*, 2002).

A new model for debt management

Many poor households have substantial debt problems, spending a considerable proportion of their income servicing interest payments or loan repayments (Atkinson *et al*, 2006; DWP, 2005a). Recovering this debt is expensive: it costs the public and private sector a substantial sum, running into several million pounds each year. This pushes up the cost of loans and reduces credit availability to low-income households, as they are regarded as higher risk.

Since the evidence suggests that even poor households can save, 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, because this helps to mitigate against hyperbolic discounting – people's tendency to postpone and prevaricate indefinitely, acting against their 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 – as recommended in the Save More Tomorrow plan. (Thaler and Benartzi, 2001) – and to encourage setting small, specific and achievable financial behaviour goals as part of employment programmes, such as the New Deal, or as part of generically provided financial advice.

Save More Tomorrow accounts

Encouraging commitment should not be the exclusive preserve of the public and voluntary sectors. It may also have implications for the range and scope of products offered by many financial services providers. A new kind of current account service could be developed that mirrors the structure of the Save More Tomorrow plan, in making it easier for people to pre-commit to greater savings levels in the future.

This would allow people to choose to save more of any pay rises that they received. 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. Such a scheme would allow people to commit to saving more in the future, making use of the same heuristics and behaviour change strategies as the Save More Tomorrow plan.

Currently, few, if any, providers offer the option of setting up transfers between accounts in advance. The technical and legal issues around this need further exploration, but in theory this should allow people greater opportunities to determine their financial futures.

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 check 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.

Using mental accounting

Mental accounting appears to be a relatively underexploited idea in public policy, particularly given its potential power in empowering more financially capable behaviour. For a start, the analysis in this report suggests that the Child Trust Fund may be more important than previously recognised in promoting financial capability. One of the most commonly cited reasons in favour of Child Trust Funds is that they can be used to promote financial education, both in schools through maths lessons linked to each child's Child Trust Fund, and to parents through programmes such as Sure Start. But mental accounting suggests that Child Trust Funds may also help to promote saving through an alternative non-educative means too. But there may also be other implications.

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

More research is needed into whether this is a cost-effective way of changing behaviour in terms of financial capability. But 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.

Encouraging people to review some mental accounts more often

It may be that it is easier to persuade people to review one particular account more often or in greater depth than to take a holistic look at their finances (Thaler, 1999). This would suggest that efforts to improve people's financial capability might be best focused on one particular aspect of their finances. It is well-known that courses aimed at improving budgeting skills are often more popular if they are presented in terms of saving for a particular event, such as budgeting for Christmas. Many credit unions take this factor into account in offering Christmas-orientated programmes, such as Portsmouth Savers' Christmas Savers Club.

Harnessing social norms and networks

The importance of social norms and networks is key, and holds numerous implications for efforts to promote financial capability. First, 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. Second, it shows the importance of building 'bridging social capital' in neighbourhoods with low levels of financial capability. 'Social capital' is a measure of the connections between people. 'Bridging social capital' extends across communities and groups to link people who live very different lives. This contrasts with 'bonding social capital', which exists within communities and reinforces existing ties (Halpern, 2005). Bridging social capital is important for financial capability because it connects individuals to other people who may have higher financial capability, and would therefore influence people, for example, towards having bank accounts.

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 help others to develop their thinking further, in developing policy approaches that focus on empowering people to improve their financial capability.

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