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THE EFFICACY OF PERSONAL FINANCIAL PRUDENCE: A LITERATURE REVIEW

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ABSTRACT:

Over the last decade, world has witnessed rapid growth and expansion in financial markets through liberalization, globalisation and privatisation. This gave birth to new and innovative financial products as an investment choices and loan options. In a situation where the range and complexity of financial products is continuously increasing, financial illiteracy stops individuals from making prudent choices or prudent decisions giving them positive return. It has increased their fear about money management and insecurity about their financial future. The purpose of this literature review is to recognise, measure, and understand the existing body of work on financial prudence and the benefits of being financially prudent.

Keywords: *Financial Prudence, Financial Literacy, Financial Education, Financial Well-being.*

Introduction:

Due to changing structure of our economy, financial knowledge has become not just a convenience but an essential survival tool. A lack of financial knowledge leads to the making of incorrect financial selections that can be harmful to both people and communities. Without proper understanding of money concepts and consideration of financial options, people are likely to pay more than they have for financial services, fall into debt, damage their credit records and over-invest in some financial products while under-investing in others.

The economies around the world have increasingly considered financial prudence as a key pillar for the development of financial system of a country. As financial markets become more complicated and families assume a growing share of the responsibility and risk for financial decisions, financial education is necessary to ensure sufficient levels of investors and protection to consumer as wells as the high level of effectiveness of the financial markets. Creating financial literacy can play significant role in providing the consumers with the information, necessary knowledge, and abilities to evaluate their options and allows them to understand the implications of alternative financial decisions.

What is Prudence?

The word prudence comes from the old French prudence (14^{th} century), from Latin prudential (foresight). The word is always associated with wisdom, insight and knowledge. In recent past prudent is called as practical intelligence, practical soundness, or sensible choice. Quality decision or perception grown from experience and knowledge, indicated in a truthful and careful attitude. Prudenceis in avoiding redundant deliberations and in the preparedness to sacrifice present indulgences for better future.

Oxford dictionary has specified meaning of prudent as being sensible and careful when making judgements and decisions; avoiding unnecessary risk. And the quality of being prudent; cautiousness is termed as Prudence (Oxford dictionary).

What is Prudence in Economics and Finance?

The book, “inner world of money” has interpreted financial prudence as follows: Saving Money, living within own income, paying bills on time, recognizing that some of debts are the result of unwise decisions and behaviours (Dr.Marty Martin, 2012).

“Financial prudence is rooted in how one thinks and then behaves relative to use of money”. In this book author has provided spectrum of behaviours for describing people’s use of money. A prudent individual spends money in a knowledgeable way. Prudent is the exercise of sound judgment in practical affairs. Prudent is synonymous with term rational choice. Prudent behaviour applies foresight, forethought, temperance and moderation. Prudent people think about the management of money, resulting in economical spending and the avoidance of waste. Prudent spender seeks high value from expenditures and investments. Prudence is classically considered to be a virtue- a characteristic or trait valued as being good (Redinius D. L, (2010).

The RBI publication has expressed gratitude to several facets of financial literacy and their effects on our lives as it holds a key to prudent financial planning and welfare expansion at individual level and for the society as a whole as well. It further stated that educating people on key savings, protection and investment related products can empower them to take prudent decisions.

Discussion:

The study carries the literature review in two major parts:

- ❖ Financial Prudence
- ❖ Benefits of Financial Education/ Literacy/ Prudence

1.1 Literature Review on Financial Prudence:

Financial prudence helps young adults nurture debt avoidance behaviours and develop a tendency to resist credit card misuse and these together keep them away from unnecessary financial strain at a prime age itself. The paper on influence of parental financial prudence on the attitude and behaviours of their children towards their finances has underlined the importance of family atmosphere to inculcate the necessity of being sensible in personal financial management from the very early life of a person. Five hypotheses were tested empirically to establish the relationships among financial prudence, debt avoidance, credit card misuse and financial strain. In this study they have associated four habits with financial prudence: living within their income, paying their bills on time, avoiding unnecessary debt, consistently saving.In this paper main focus is given on family atmosphere. Paper has ignored importance of numeracy, knowledge concepts and financial products (J.R.Hibbert, I. F.Beutler, & T.M.Martin, 2004).

High level of financial prudence can be achieved by increasing level of financial literacy through practical financial education.A study on financial prudence among youth has focused on graduated young adults within the age group of 20 to 30 years. In this study financial prudence was measured on the basis of questions related to financial literacy, savings and spending habits, credit card usage and borrowing, and financial planning. This study found that though many of respondents have financial knowledge they don't know practical application of such knowledge to real life situations. According to them one of the most common problems faced by Asian young adults today is spending in excess of their earnings **(**Pillai, K., Karlo, R., & D'Souza, R., 2010).

Prudence is correlated with educational attainment.The paper on experimental study on higher order risk attitude frequency of prudence with large demographically representative sample of 109 student participants made pairwise choices that distinguish prudent from imprudent. This study correlated individual's demographic profiles and financial decisions to their prudence level, temperance level and risk aversion. The findings show that prudence is widespread and positively correlated with financial well-being. Findings also suggested that the more prudent an individual, the greater is his wealth, the more likely he is to have a saving account, and the less likely he is to have credit card debt (Noussair C., Stefan T, & Gijs Van De Kuilen, 2013).

In the paper on the link between personal and relational characteristics with financial attitude, knowledge and capabilities and financial well-being, data was collected from 584 married individuals. Basic financial skills such as living within one's means, paying bills on time, budgeting, and debt reduction and proportion of income to saving for retirement are the items considered for financial prudence measurement. The study provided empirical support for the benefits of being prudent in financial matters. Study found that the more financially prudent individual has saved higher percentage of their income for retirement (Payne S., 2014).

Financial literacy is the capacity to apply ideas and skills to manage financial resources effectively in order to achieve a long lasting financial soundness. It increases ability of a person to manage finances efficiently to make prudent financial decisions in an attempt to achieve financial well-being. Financial literacy empowers consumers to become better shoppers, allowing them to obtain goods and services at lowest price. This helps in optimizing their family budgets, providing more opportunity to consume and save or invest. It also teaches them to initiate savings plans, manage debt, and make prudent investment decisions for their retirement (US Financial Literacy and Educational Commission,2006).

In the presence of future income risk, agents who are prudent save more and invest very small part of these savings in risky assets, than those who are imprudent (Eeckhoudt and Schlesinger; 2008; Kimball, 1996; Gollier and Pratt, 1992; Leland, 1968; Sandmo, 1970). Besides the importance for their saving and investment behaviour, the amount of prudence and temperance that individual's demonstrate has effects in a wide range of other economic participation such as auction bidding (Eso and White, 2004), negotiating (White, 2008) , rent seeking (Treich, 2010) and tax compliance (Snow and Warren, 2005).

Thesis submitted on an in-depth analysis of investors in Gujarat stateispresented in five chapters and it is mainly divided into two sections. The first section dealt with literature review and second section covered in-depth research analysis. Population consisted individuals above the age of 18 years. Detailed 50 item performance test and questionnaire were prepared. Data collected by 385 investors. Data analysis was done by employing univariate, bivariate and multivariate techniques. The study found that all the investors do not understand the basics of investments and its calculation, majority investors are less financially literate and some of them don't even understand the important concepts. It was also found that investors on the two extremes of age 18 to 35 years and 56 years above possess lower level of financial literacy. Study concluded that financial literacy leads to controlled spending behaviour and encourages saving behaviour and also have significant impact on investment decisions (Jariwala H., 2013).

1.2 Literature Review on Benefits of Financial Education / Literacy:

Financial literacy leading prudent financial behaviour is beneficial for individuals, families and whole economy.It expands individuals' chances for saving and investing, getting out of debt, spending less than they earn, and living on a budget. It also helps in decreasing their chances for bankruptcy, receiving government assistance (Bauer et al. 2000; Huston et al. 2003; Blalock et al., 2004) , and making poor consumer decisions (Grable & Joo, 1998; Hayhoe, Leach, Turner, Bruin and Lawrence, 2000).It helps to increase financial efficiency which in turn results in saving money and an improved ability to set realistic goals and select suitable investments to achieve those goals. Financially illiterate people's savings are always low (Jappelli, 2010).

There are three types of savers: regular savers termed as rainy day savers, purposive savers termed as instrumental savers and non-savers. Right education can convert non savers into instrumental savers and instrumental savers into rainy day savers (Kempson E., & Finney A. (2009).

There is positive correlation between higher level of financial knowledge and higher and consistent source of income as well as higher savings rate (Dane S., 1994).Generally students tend to carry on their financial habits into their later life which they acquire in college. They may have fewer financial hardships if they leave college with better financial literacy. Financial education levels the playing field in regards to gender differences and is effective in changing knowledge, attitudes and behaviours. Education can increase financial knowledge which is positively associated with financial attitudes, risk tolerance, and saving and investing behavior (Grable & Joo, 1998).

There is strong relationship between financial knowledge and planning. It showed that those with financial knowledge were more likely to plan and to succeed in their planning whereas the least literate are also the least likely to plan and save for retirement (Lusardi A., & Mitchell O., Oct 2006).

Higher level of financial literacy is associated with successful life and success in business. Financially literate people plan and implement long term savings and investments. Their long term vision makes their future safe and happy (Cude, 2010).

Financial education influences financial knowledge, attitude and behaviours (Ajzen and Fishbein, 1980; Garble and Joo; Varcoe and Write, 1991). Financial education helps in increasing financial knowledge which changes financial attitudes (Gorham, Bechman, DeVaney and Haldeman, 1996; Grable and Joo; Boyce, L., Danes, S. M., Huddleston-Casas, C., Nakamoto, M., & Fisher, A. B., 1998).

In the pre and post assessment study of financial behaviour, knowledge and attitudes of participants of Iowa State's personal finance workshops, it was found that participants had improved knowledge, attitudes, and behaviours (Fletcher C.N., Beebout G., & Mendenhall S., 1997).

Increased financial knowledge influences students' attitudes positively towards business in general and their ability to be wise consumer in society (Langrehr F., 1979).

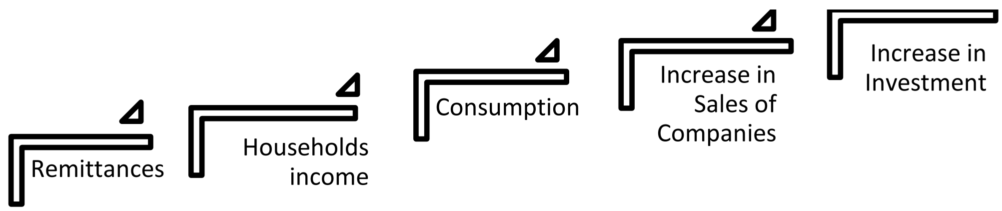
There are numerous specific benefits of financial literacy. Increasing financial literacy is a way to increase empowerment and improve quality of life. Students with more knowledge and optimistic attitudes about money can take better decisions, which in turn help them to save more and improve their financial state. Consumers are participating more in financial market when they feel that their finances are in control (Knapp J. P., 1991;Voydanoff P., 1990).

Financial education assures that people have a practical view of their own knowledge while making investment choices or taking financial decisions. It is most disappointing truth that the literate people are victims of frauds, cheating and miss-selling. Most people are over confident about their financial knowledge. They are not aware about their financial illiteracy. (JumpStart, 2008; ANZ, 2008; Kuzina, 2010).Financial education provides consumers with greater bargaining power through enhancing their skills and understanding about finance and terms used by financial service providers. As a result consumers can get better deals and demand more. A skillful and knowledgeable youth with positive behaviour and attitude about money will plan spending. An ability to understand financial products and financial institutions is an important benefit of financial education (European, C., 2007).

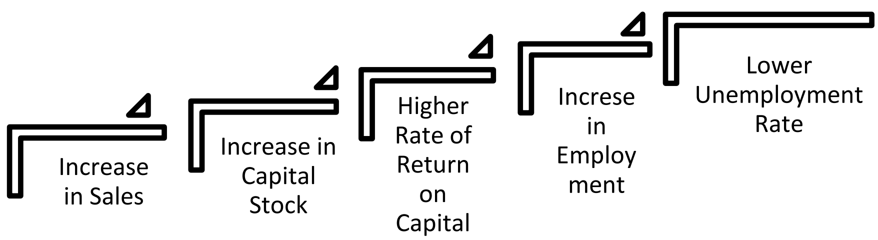
Financial education should be seen as capability building path over person's lifetime which helps in improving financial literacy and security. Financial literacy realistically guarantees economic and financial growth. Financial education leads to prudent financial allocation decisions of persons/ households related to savings and borrowings, which affects large as well as small companies. More financially literate person saves more and increases domestic saving rates which ultimately reduces dependence on foreign capital, thus it helps foster speedy economic growth. It helps in enhancing overall financial development and application of more systematic financial structure. It also can help in fulfilling long-term financial requirement for development fund in Asia. Financial educated person plans well for retirement. Financially literate person is ready to take long-term view with regard to pension fund and life insurance. This will improve the retirement life of an individual. All these progresses lead enhancing economic growth(N. Yoshino, P. Morgan, and G. Wignaraja., 2015).

Macroeconomic Impacts of Financial Education

Aggregate Demand Effect: Output = Consumption + Government Spending + Investment + Export – Import



Aggregate Supply Effect: Output = A x F (Labour, Capital Stock)



Increase in Capital Inflow from Abroad by Remittances: Current Account deficit will be reduced.

Current Account = (Exports-Imports) + Capital Flows+ Remittances

Source: ADBI working paper 534

Students with less financial knowledge have to face bigger financial problems that affected elderly life (Danes & Hira, 1987; Hibbert & Beutler, 2001; Hira, 2002). Students with higher financial knowledge can plan and live their elderly life happily. Students' financial behaviour is correlated to their future earning capacity (Danes & Hira, 1987). Financial prudence will help young adults nurture debt avoidance behaviours and develop a tendency to resist credit card misuse and these together will help keep them away from avoidable financial tensions at a main prime age itself (J.R.Hibbert, I. F.Beutler, & T.M.Martin, 2004).

Adverse feelings about finances are correlated with lower financial knowledge of students. These students ended with more incorrect financial decisions. Having a low level of financial knowledge limits students' ability to make informed decisions (Chen, H. & Volpe, R. P., 1998).

Financial literacy increases self-confidence, independence and control. This comes by feeling in control and knowing how to face a complex financial market (Allen M., Edwards R., R. Hayhoe C., & Leach L., 2007).

Another benefit of financial literacy is it increases physical, emotional, and psychological well-being.

Perceived financial well-being in college students appeared to be related to psychological well-being, a skill to control their lives, and having less unhealthy characteristics (Norvilitis J. M., Szablicki P B, & Wilson S D., 2003). Economic stress is associated with depression, anxiety, and psychological distress (Voydanoff, 1990).Economic hardship negatively affects the parent-teen relationship, student's educational attainment, and student's earned income (Sobolewski J. M., & Amato P. R., 2005). Increased financial literacy has a positive impact on people's personal and business life. The financial knowledge helps reducing psychological and social burdens and improving the well-being of the family in the personal life. Financial knowledge reduces stress, illness, financial disputes, abuse of children and conflict among the families. People grown up in families with the higher financial knowledge and well-being are less depressed, show less aggressive and anti-social behaviour and have more self-confidence (Fox J., Bartholomae S., & Lee J., 2005).

The greatest advantage of financial literacy education is reducing employees' financial problems and encouraging them to be responsible for their own financing; which will ultimately help to increase the efficiency of the organization (Vitt et al., 2000).Rajat Nagindicated that financial education not only increases ability to manage earning but it also provides knowledge to youth about how to increase income levels. This in turns helps to better manage life requirements like education, health, job and retirement. People are getting more confused with the increasing complex financial products and services in the market. Financial education helps then select best value products at lower price efficiently (Nag R, 2007). Financial education ensures lifetime financial wellbeing. Financial wellbeing means increase in wealth, accumulating retirement savings and perfect investment portfolio that reflects the needs of individual (Tatom, J. (2010). Financially literate individuals actively participate in financial market. They owned more financial products. On the other hand financially illiterate individuals have shown less participation in financial markets (Shawn C., & Fernando N., 2008).

People with less financial literacy level less likely participate in financial markets. Financial education leads to financial stability by guiding people to select right products and services. This helps to increase savings and investment (Holzmann, 2010; Rooij, 2007; Jappelli, 2010).Financially literate person is less likely to borrow just because credit is easily and cheaply available. As a result there are far better chances that they will repay their debts without defaulting, which in turn minimizes bad debt experience of financial institutions. This leads to boost stability of the financial system (Keith Hall, 2008).

Conclusion:

Though personal financial prudence is very important topic from individual point of view no major studies are done on the topic. Review has shown that highly financial literate person can take prudent financial decisions and person with low financial literacy takes imprudent decisions. Financial prudence can be achieved through financial education. Financial prudence and financial wellbeing are mutually related. Financial wellbeing is the capacity to have our financial decisions to serve our life, to have the financial earnings, to strongly reach whatever personal goals a person has, to enjoy a pleasing lifestyle. Financial Wellbeing can be easily achieved through financial prudence. The opportunity given to people to engage with the formal financial system and how well they manage their money will impact their quality of living and the standard of living of dependents for which they are responsible. This leads to improve community's standard and quality of life as well as financial system, which ultimately improves country's economy.

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