Valuing Financial Literacy with special reference to Personal Financial Planning

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Financial literacy the term is strongly associated with the concept saving, investment, financial services and retirement planning in most of the countries of the globe and the urge for financial literacy has gained the attention of wide range of entities like financial services, organization, community interest groups and education institutes in recent years in developed as well as developing countries after the global financial crisis. As India continues to remain one of the highest savers among the emerging market economies and Gross Domestic Savings (GDS) of the nation constitutes 33.7% of total National Gross Domestic Product (GDP) and the major contributor of this GDS is Household savings but the Capital formation from household saving is not at par with the saving contribution of GDP. The developments during the crisis have confirmed that financial literacy is not a substitute for households' wealth protection but a key element of a consumer protection framework and the tool to fill the gap of saving and capital formation in the nation.

Financial literacy has led to the need of personal financial planning. The process of Personal financial planning encompasses all the money activities during the planner's life. The understanding of financial needs leads to create the awareness and realization that the structure of reasoning and explanation, necessary and sufficient to analyze the crux of the issues pertaining to financial literacy at various stages of life. The paper will focus on constituents of personal

Introduction

It is recognized that high domestic saving and that convert to investments are crucial for sustainable high rates of growth of the economy. India is considered as one of the highest savers among the developing countries. The Indian economy consistently growing at 8 percent Gross Domestic Product (GDP) annually and with more and more investment and finance companies are coming in public and private sector. The Indian finance sector is becoming one of the best and preferred investment options globally. The financial facts of the country India has also proved favorable for reforms in financial markets. Per capita of income in India which had taken four decades to double by 1991, has been doubled in 15 years and likely to double again in 10 years. The saving rate also showed a substantial increase from 23 percent of GDP in 1990 to about 30 percent in the 2000 with the peak saving rate of over 33 percent achieved during recent years. But the global financial crisis has relocated interest on the vulnerability of global markets, systematic risk and need of concrete solutions that will minimize the impact of future aftershocks. There are number of causes and reasons associated with global crisis but financial literacy also been considered as the key reason for this crisis and worsen the impact of that. Whether it was US mortgage subprime crisis 2008 or EU crisis; lack of financial education and behavioral biases of individual decision maker were considered as main reason. Although India suffered only the indirect impact from the global financial crisis as its policies are different from other East Asian countries which are heavily dependent on external demand from US for their growth perspective. But at the same time financial crisis of 2008 has forced us to rewrite the rules of personal financial management and redefine the term financial literacy over next few years. Changes in financial markets and pensions landscape have also led these changes.

Increased riskiness of financial markets that has impacted understanding of personal finances

- o Increased riskiness of financial products once considered risk free – deteriorating fiscal debt of governments all over the world implies that long term government bonds can no longer be treated as riskless securities.
- o Low real returns across financial products and markets – European Union crisis and low economic growth in developed countries means that the returns from equity markets are low and volatile.

Changes in pension landscape

- o Freezing Defined benefit pension plans all over the world that shifts the burden of providing financial

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security from employers to employees. As a result employees are required to make complex decisions related to savings portfolio and draw down strategy in retirement.

Financial Literacy and Personal finance

"The processes, by which financial consumers/investors improve their understanding of financial products and concepts and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well being". OECD, (2005, 13)

Financial literacy is the ability to make informed judgment and to take effective decisions defined as financial knowledge in general terms and it is strongly correlated with the use of financial services, savings and retirement planning. It has portrayed panacea for recent global financial ills. It is umbrella program designed to encapsulate, coordinate and raise awareness of many ways in which financial planners and advisors help to improve the financial understanding of people. Financial literacy has not been fully articulated and recognized by the international development community or by policy makers and practitioners in developing countries but measures to promote and improve financial education are becoming more frequent. The diversity of financial products available in developed and developing countries has increased rapidly in the past decades for example thousands of mutual funds, mortgage options, expansion of microfinance, micro insurances and number of saving plans has vastly increased and a household may have the choice of a loan product from several different institutes as well as insurance products of life, health and properties and even index based derivatives and funds. Many of these products are complex and a growing body of evidence suggests that low levels of financial literacy may prevent consumers from making good decisions about financial products. The ability to understand these nuances can dramatically change the financial well- being of an individual, similarly the understanding of the importance of how the value of various assets correlate with each-other can help households diversify risk effectively. Having financial literacy skills is an essential basis for both avoiding and solving financial problems which in turn are vital to living prosperous life. Considering this, in recent years the need for personal financial literacy has gained the attention of wide range of entities like financial services, organizations, community interest groups, education institutes.

The factors contributed to global financial crisis highlight the need to rethink the scope and nature of financial literacy with context to personal finance. From the individual and household perspective how the working model can be created, the components of the personal finance are interrelated what options are available to them and how the model would help to in wealth creation, retention and maximization.

Objective

- To develop the concept of personal financial planning.
- To define the components of personal finance
- To establish the conceptual working model for the personal financial planning

Working on conceptual model for personal financial planning, first step is to understand 'What is Personal finance?' Over the period of time number of definition and contribution has been given for Personal Finance.

Definition of Personal finance and financial planning

Personal financial planning denotes the process of determining whether and how an individual can meet life goals through the proper management of financial sources (CFP Board, 2005).

'Financial Planning is the process that takes into account client's personality, financial status and the socio economic and legal environment and leads to the adoption of strategies and use of financial tools that are expected to aid in achieving the client's financial goals' (Warschauer, 2001). Personal financial planning is associated with the personal financial goals not only long term goals but the basic routine financial requirements. Life goals can be buying home, children education or retirement planning. Financial planning provides direction and meaning to financial decisions.

Around four decades ago Personal financial planning was only associated with the terms of saving and insurance. But from early 1970s through 1980s, 1990s boom period to 2000 number of financial association began to create new era. Personal financial planning is fairly a new growing concept in India over the past quarter century. The Indian population is experiencing demographic, economic and cultural changes that may create demand for the personal finance management in the current decade. Numerous forces of technology, market innovation and competition has made number of financial services offering various complex financial products hence led to the structured financial model and program to create knowledge.

Literature review

An American Economist quoted "No matter who you are, making informed decisions about what to do with your money will help build a more stable financial future for you and your family" the quote emphasized on the financial literacy and awareness. Financially educated person can make right decisions that generate positive long term cash flows.

In consumer financial market the main players are traditional financial institutes, banks, mutual funds, insurance companies and brokerage companies but the role of the each players have significantly changed with keeping core functions as constant. (Andrea, Gunnar and Peter, 2001) These changes are not resultant of changes in household demographic factors but the liberalization of the financial sector in India from 1970s and 1980s. The state dominated development paradigm has shifted sharply towards a more market determined strategy of development paradigm and that has led to a change in the perception of the role of financial system in development. Liberalization can be viewed as a set of operational reforms and policy measures designed to deregulate and transform the financial system with a view to achieving a liberalized market oriented system within an appropriate regulatory framework (Johnson and Sundararaja, 1999).

With the changing platform of financial market, the need of financial literacy and awareness has been arisen. Financial literacy plays an important role in financial reforms across the world. With the liberalization and new technology have created new financial products and services widely available, much of the households remains ill equipped to make informed financial decisions or can evaluate complex financial products (Lusardi and Mitchell, 2007).

The cognitive components of financial literacy include knowledge of the individual, education and ability of making decisions related to banking, credit, insurance, investments and taxes along with the basic conceptual knowledge of interest rates, time value of money and risk association (Jeanne M. Hogarth, 2002). Translating this literacy into positive actions requires some level of confidence (Brad and Terrance, 2000).

The term Personal Financial Planning (PFP) is the result of financial literacy. Personal financial planning (PFP) is developed with the growing profession centered on Certified Financial Planner (CFP). Consumer perception about what exactly PFP and related professionals do. Personal financial planning is the process of managing your money to achieve personal economic satisfaction (Kapoor et al, 2004; Lai M and Tan W., 2009). Individual needs and goals change when he or she moves through different stages of life, therefore, making financial planning is a dynamic process (Gitman and Joehnk, 2005; Lai M. and Tan W., 2009). Lewis Altfest (2004) suggested the personal financial planning should be developed as separate study with its base of economics and finance theories. Personal finance incorporates economics, finance, management, general principles of decision making and management of financial resources of households. He proposed the steps to give rise to the prestige of personal financial planning discipline and personal financial planning should be recognized as separate academic professional along with medicine, law and accounting.

With the change in time the role of financial planner has also changed from financial analyst to coaching and life planning (David and Lyle, 2009). Basically the financial planning process is a structured approach to planning one's financial needs. It is like a journey. Before one starts the journey, one must know where one is now and where one wants to go. Then one will plan the route and start the journey. The 5-step-trip of personal financial planning involves taking stock of one's current financial resources, setting one's financial goals, developing financial plans, implementing the financial plans, and reviewing financial progress (Fong W.M. & Koh S. K. 2001). Financial planners also need to have various skills from the fields of accounting, demography, economics, financial institutions, financial mathematics, insurance, investment analysis, law, marketing, psychology, sociology, statistics, strategic management and most important taxation with good communication and counseling skills to provide the better solution to their clients (Keith Redhead, 2009).

Personal finance is the dynamic process which is influenced by various factors both in external and internal environments including financial markets and institutions, government agencies, economic, demographics and social trends, and personal and family factors (Tahira Hira, 2009). Personal financial planning process and each dimension of this structural process is affected by various significant demographic variables like age, education, income, wealth, gender, marital status and number of dependent in family which are closely associated with life stages (Moreschi, 2005). Many researchers from different fields have created different divisions of life cycle stages considering age, marital status, child's presence and age and retirement status (Gilly and Enis, 1982; Jing Xiao, 1996). Based on these factors the risk tolerance level is measured of each individual. It might be related to gender differences (Yuh and Hanna, 1997; Patti Fisher, 2010). Personal financial planning starts from prudent goal setting followed by step of budgeting money management. Ming Lie and Wei Tan (2009) in one of their survey in emerging country Malaysia examined the attitude of people towards financial planning which encompasses money management, insurance planning, investment planning and estate planning. Three measures viz. attitude towards personal financial planning, factors affecting various aspects of personal financial planning and frequency of managing personal finance were associated with personal financial planning process and concluded job status and profession is the primary factor whereas some other demographic factors such as race, marital status, gender, education.

Many individuals are not able to secure their retirement life from failure to set aside sufficient savings during their working years (Lusardi, Skinner and Venti, 2003). It is essential to understand why households fail to plan and save aggressively when they know there is direct relationship between financial independent and quality of life (Kim and Moen, 2001), why people fails to make over correct credit decisions. Unfortunately, a significant number of financial education providers still do not have in place the evaluation capacity and resources to conduct more effective and rigorous evaluations, especially smaller, non-profit organizations (Lyons, Palmer, Jayaratne and Scherpf, 2006). In the personal finance lack of rational economic judgement and financial awareness may lead to excessive debt, high risk of investing or inadequate saving for retirement and long term financial goals. The education of financial planning benefit the students, academics, dealers, consumers, clients, regulators and professional bodies to make the financial sector strong and face the financial turmoil.

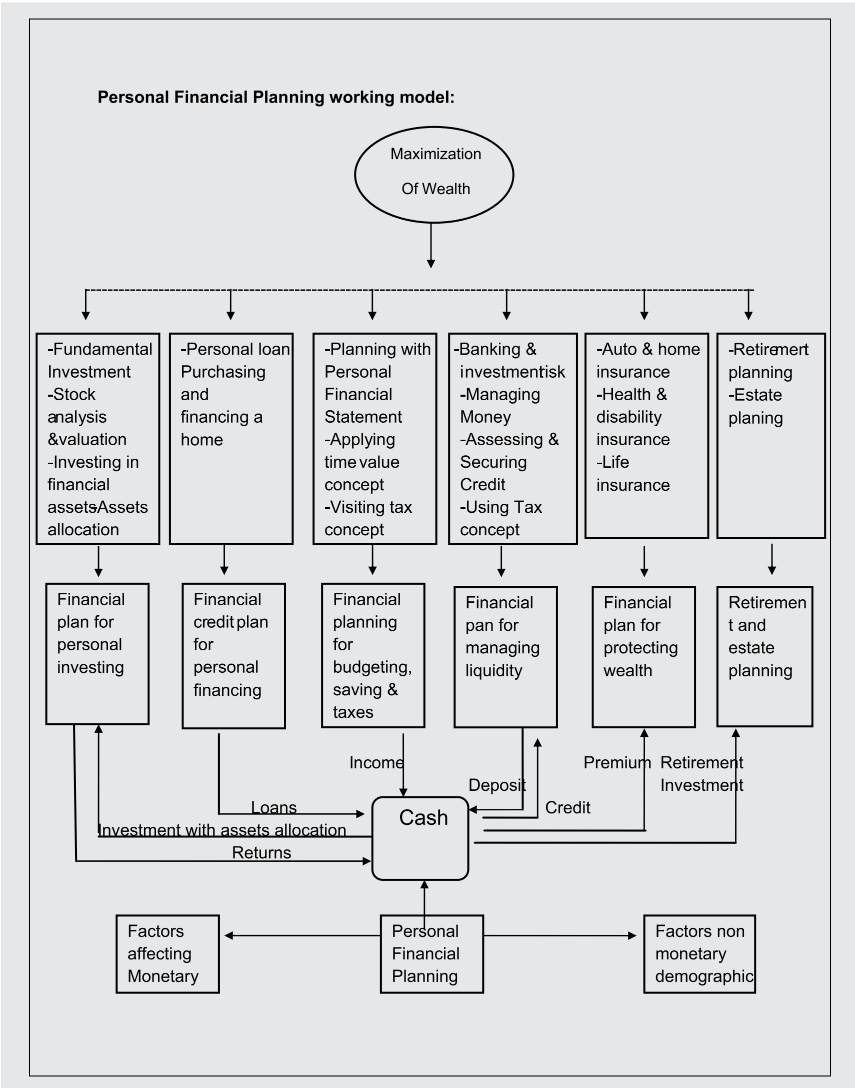
Based on the literature review there is a need for the individual to have personal financial plan and to understand what the steps to be are followed what are the components associated with the personal financial planning process and how that helps in wealth creation, wealth retention and wealth maximization.

Personal financial planning conceptual model

The working model of Personal Financial planning incorporates the goal setting of an individual influenced from various monetary factors as well as the non monetary goals or demographic factors. In model all the basic personal finance components are incorporated and also indicated the money circulation i.e. cash flows (cash inflow/ cash outflow) related to each component. Each component consist some dimensions with it some related exercise has been figured out. The whole exercise of this consumer finance tools resulting in to the prime goal of maximization of wealth.

Steps involved in Personal Financial Planning process

Personal financial planning process carries step procedure to achieve the financial goals successfully. The major steps of this process are determining the current financial position regarding incomes, saving, spending and liabilities. This information is needed to match the short term as well as long term goals with the current income and potential future earnings considered as second step of process. To achieve the desired goals there required developing alternate course of actions although various monetary and non monetary factors would impact on the alternatives to opt. Apart from the factors each alternate carries some amount of risk and uncertainties associated with it. An individual need to trade off between the alternates by evaluating the opportunity cost analysis. After the in depth analysis one can make the concrete action plan to execute and revise the plan over the period of time.



In this working model all the major areas of financial planning have been covered related to household finance.

(1) Financial planning for budgeting, saving and taxes

(2) Financial planning for managing liquidity

(3) Financial credit plan for personal financing

(4) Financial planning for protecting wealth

(5) Financial planning for personal investments

(6) Retirement and estate planning

These components are very different and decisions concerning each component are captured in separate plans that, taken together, form the overall financial plan.

Financial planning for budgeting, saving and taxes

The main base of the financial planning process and components is associated with the regular income of an individual or household. Budget planning is the process of forecasting future expenses and saving related to the decision process of spending and saving money. The relationship between income received, spending and saving bifurcate the individuals in two parts; *big spender* and *big saver.* The difference between two is related with their saving and spending habits. Big spender focuses their budget decision on how to spend their income and left a little for saving whereas big saver consider spending after allocating a portion of income towards saving. The budget process involves the income-expenses and assets-liabilities. One can value his/her Net worth by assets and liabilities as the businesses do. There always have positive relation of net worth with increased income and assets portion. The budget decisions are influenced by the factors like education and career decisions. Mostly the financial decisions are affected by tax regulations so the decisions of the alternatives chosen are evaluated with the tax treatments. So tax planning is essential part to be focused while preparing financial plan.

Financial planning for managing liquidity

Planning for managing liquidity emphasizes on Money management and credit management. Money management involves decision process regarding the emergency fund liquidity and short term liquidity requirements. This helps in avoiding cash shortages because of unanticipated expenses. Credit management is about amount of credit needed to support spending and the sources available for credit. By proper balance between the money and credit management one can identify the areas to invest and level of investment required.

Financial credit plan for personal financing

The amount of financing is the short fall between the purchase amount and the amount of money available. Many people seek credit for major purchases such as home, car, education or businesses. Managing debt is the ability to identify the most effective sources and forms of debt to get long time benefits with informed decisions. One need to understand the true cost of credit i.e. APR (Annual Percentage Rate) and tenure of the debt while obtaining any debt.

Financial planning for protecting wealth

Adequate insurance coverage is another component of personal finance and also called managing risk. In particular automobile insurance, home insurance or property insurance to protect assets while health insurance to limit medical expenses and disability or life insurance for self and dependents to protect the income. Deciding the amount of insurance and right policy needs one's time, research and careful thought.

Financial planning for personal investments

The amount beyond the required money liquidity management should be invested in different financial avenues. The main objective for this short term and long term investments is to earn return in terms of interest income and capital appreciation on them. The areas are not restricted to only financial assets only in the developed market one can also invest in real estate, precious metals, art and collectibles. As per the asset allocation with considering the life cycle stage an individual can invest his/her money in different investment stream. A thorough analysis of factors like safety of investments, risk return trade off and awareness of the products is essential while selecting the investments.

Retirement and estate planning

Retirement planning involves determining how much money one should set aside at each time interval for retirement needs. The retirement planning not start at the life stage of retirement years it begins well in advance stage where a person having current income inflows. Accumulated sufficient money would support an individual and dependent to maintain the same life style. Estate planning is the activity of distribution of wealth before or upon the death of an individual. Effective estate planning protects against unnecessary taxes.

Conclusion

The global financial crisis has highlighted the issues related to retail investors to exposure to financial risk. Complex financial products originated from financial reengineering in the financial markets where the retail consumers are financial not educated has raised the issue of financial literacy for the retail investors. Financial literacy is the only key element for global financial instability. There is a need to develop a financial education program with keeping personal finance in the center. With the changes in technology, the global economy and social trends have changed the financial planning environment. In recent times apart from finance many disciplines like economics, sociology and psychology are applied to study household financial behavior. Keeping these in mind, financial literacy programs need to focus on helping people make better risk management of their savings through portfolio allocation, retirement timing, purchase of annuities and drawdown strategies. Most importantly financial literacy programs need to ensure that participants become informed consumer of financial information.

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