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FINANCIAL LITERACY AMONG INVESTORS: THEORY AND CRITICAL REVIEW OF LITERATURE

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ABSTRACT

Financial Literacy means knowledge of basic economic and financial concepts, as well as the ability to use that knowledge and other financial skills to manage financial resources effectively for a lifetime of financial comfort. In this paper, an attempt is made to examine the burning issue of "financial literacy among investors," from multiple perspectives. Accordingly the existing literature on the subject has been reviewed and critically analyzed on various bases i.e., definitions developed, importance elucidated, determinants identified, demographics studied, impact of financial education and various geographical locations covered. To conclude, it can be said that the eminent area of financial literacy holds many unexplored dimensions which researchers can take up in future.

JEL CLASSIFICATION
D14, G02, G20, P46.

KEYWORDS
Financial Literacy, Financial Education, Investors, Cognitive Ability.

1. INTRODUCTION

Financial literacy has become a major area of research in recent years, both in the investment and retirement literature with respect to the increasing complexity of financial products and more frequent need to save for retirement. Studies find individuals are generally financially uninformed and lacking in basic financial principles. Also in the last few decades, financial markets around the world have become increasingly accessible to the "small investor" as new products and financial services have come on the market Nonetheless, many of these products are complex and difficult to grasp, especially for financially unsophisticated investors. At the same time, changes in the pension landscape are encouraging increased reliance on the individual. Now there is greater responsibility on an individual regarding investment of his saving which provides them both security and return for the future.

Over the recent years, also in our country financial landscape has been changed considerably. Financial landscape has become complex over the past few years with the introduction of many new financial products. In order to understand risk and return of these products, there must be a minimum level of financial literacy. Financially literate individuals can make effective use of financial products and services and there will be less chances of cheat by people selling financial products which are not suitable for them. Financial literacy also helps in improving the quality of financial services and contributes to economic growth and development of a country (Bhushan and Medury 2013).

India is among the world's most efficient financial markets in terms of technology, regulation and systems. It also has one of the highest savings rate in the world. In spite of the same, India is still one of the poorest countries in the world. While savings are more in India, where the savings are invested is a cause for concern. Wealth creation for the investor and the economy will remain a distant dream, unless the common man becomes a wiser investor and is protected from wrong doings.

In layman words, financial literacy is nothing but knowledge about personal management of finances. It gives you the twin benefit of protecting you from financial frauds as well as planning for financially secure future (Kumari & Viz 2012). Financial literacy gives consumers the knowledge and skill required to assess the suitability of various financial products and investments available in the financial market. This benefits the consumers by translating itself in benefits to the economy as a whole. Financial literacy is first and foremost about empowering and educating consumers so that they are knowledgeable about finance in a way that is relevant to their lives and enables them to use this knowledge to evaluate products and make informed decisions.

From the regulatory perspective, financial literacy empowers the common person and thus reduces the burden of protecting the common person from the elements of market failure, attributable to, de facto, information asymmetries (Ramakrishnan 2012). Financial literacy is also an integral component of customer protection. Despite concerted efforts, the current state of transparency coupled with the difficulty of consumers in identifying and understanding the fine print from the large volume of convoluted information, leads to an information asymmetry between the financial intermediary and the customer.

From decision making perspective, financial literacy refers to the ability to make informed judgments and to take powerful choices in regards to the utilization and administration of cash. It is viewed as a vital prerequisite for working viably in current society (Atkinson and Messy 2011). It empowers an individual to comprehend the vitality of investment funds. Financial literacy is progressively critical for household's decisions about on how to invest wealth and how much to borrow in financial markets. Mounting proof demonstrates that the individuals who are less financially educated are more inclined to have issues with debt, are more averse to save, are more prone to take part in high-cost credit, and are less liable to plan for future.

The rest of the paper is framed as follows. Section 2 lays the objectives of the study. Literature review is presented in Section 3. Critical analysis of extant studies constitutes Section 4 of the paper. Section 5 discusses scope for future research. Summary and conclusions of the present work are provided in Section 6.

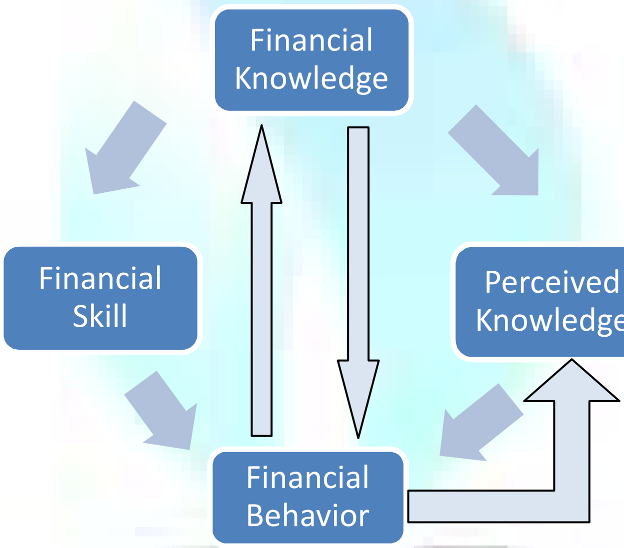
2. OBJECTIVES OF THE STUDY
The present work has multiple objectives which are listed below.
1. To develop a consensus on definition of financial literacy.
2. To highlight the importance of financial literacy.
3. To enumerate major determinants of financial literacy.
4. To examine the extant studies on the basis of demographics studied.
5. To investigate the literature that measured the impact of financial education on financial literacy.
6. To probe whether financial literacy levels significantly differs across geographical regions.

3. LITERATURE REVIEW
This section of literature review has been segregated on the basis of meaning, importance, determinants, demographics, the impact of education and various geographic locations.

3.1 MEANING OF FINANCIAL LITERACY
In order to enhance comparability and consistency across the evidence base, core concepts must be clearly defined. However, as happens in many research areas, different researchers and organizations have defined financial literacy in different ways. This section examines the breadth of existing conceptual and operational financial literacy definitions, compares financial which financial literacy applies.

It is tempting to accept the **PACFL (2008)** (Presidents Advisory Council on Financial Literacy) definition. However, that definition largely rests on the ability to use knowledge and skills towards achieving financial well-being, and is hence quite behaviorally based. While practically relevant, such a focus limits insight into mechanisms for impacting financial literacy. We would argue that financial knowledge, skills, and behavior, as well as their mutual relationships, should all be considered in an overarching conceptualization of financial literacy. In particular, financial knowledge represents a particularly basic form of financial literacy. Financial knowledge, in turn, is reflected in perceived financial knowledge and influences financial skills that depend on knowledge. Actual financial behavior, in turn, depends on all three (actual knowledge, perceived knowledge, and skills). Finally, the experience gained through financial behavior feeds back to both actual and perceived financial knowledge. Still, the relationships are likely to be imperfect, as each also depends on other factors internal and external to the individual (e.g., attitudes, resources). Figure (1) presents these logical relationships among financial literacy components.

FIGURE 1: CONCEPTUAL MODEL OF FINANCIAL LITERACY



Accordingly, a composite definition of financial literacy that builds off of those given by PACFL (2008) and various researchers is:

Financial Literacy means knowledge of basic economic and financial concepts, as well as the ability to use that knowledge and other financial skills to manage financial resources effectively for a lifetime of financial well-being. Being precise about what is meant by financial literacy, including which components are being considered, will help clarify research and ultimately lead more fluidly to practical interventions. For example, lessons learned through a focus on financial knowledge will help inform knowledge-based financial education, but be only one factor to designing behavioral interventions. Those are more likely to depend on other financial skills, perceptions of knowledge, attitudes, and environmental factors. Similarly, measures should accurately reflect conceptual definitions, and conclusions should be restricted to financial-literacy components that are actually measured.

Still others, like **Moore (2003)** elaborated that individuals are considered financially literate if they are competent and can demonstrate the knowledge which they have learned. Financial literacy cannot be measured directly so proxies must be used. Literacy is obtained through practical experience and active integration of knowledge. As people become more literate they become increasingly more financially sophisticated and it is conjectured that this may also mean that an individual may be more competent.

Mandell (2007) described financial literacy as the ability to evaluate the new and complex financial instruments and make informed judgments in both choice of instruments and extent of use that would be in their own best long-run interests.

Lusardi (2008a, 2008b) explained the financial literacy as knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification while Lusardi and Tufano (2008) focused on debt literacy, a component of financial literacy, defining it as "the ability to make simple decisions regarding debt contracts, in particular how one applies basic knowledge about interest compounding, measured in the context of everyday financial choices.

Hung et al. (2009) tried to provide a composite definition of financial literacy and approach for measurement of financial literacy. They found that financial literacy consistently predicting the financial behavior. However, financial literacy is not consistently predictive of total savings measures. The results of their study suggested that the less financially literate may be less likely to engage in recommended financial practices, such as planning for retirement.

3.2 IMPORTANCE OF FINANCIAL LITERACY

Financial literacy is important for several reasons. Financially literate consumers are able to sail through tough financial times because of the fact that they might have accumulated savings, purchased insurance and diversified their investments.

"Financial literacy is also directly correlated with positive financial behaviour such as timely payment of bills and loan installments, saving before spending and using credit card judiciously." (Atkinson and Messy, 2011) Financial education is increasingly important, and not just for investors. It is becoming essential for the average family trying to decide how to balance its budget, buy a home, fund the children's education and ensure an income when the people retire. Of course people have always been responsible for managing their own finances on a day to day basis – spend on a holiday or save for new furniture; how much to put aside for a child's education or to set them up in life – but recent developments have made financial education and awareness increasingly important for financial well-being. Now a days, consumers are not just choosing between interest rates on two different bank loans or savings plans, but are rather being offered a variety of complex financial instruments for borrowing and saving, with a large range of options. At the same time, the responsibility and risk for financial decisions that will have a major impact on an individual's future life, notably pensions are being shifted increasingly to workers and away from government and employers.

As life expectancy is increasing, the pension question is particularly important as individuals will be enjoying longer periods of retirement (Thilakam, 2012). Individuals will not be able to choose the right savings or investments for themselves, and may be at risk of fraud, if they are not financially literate. But if individuals do become financially educated, they will be more likely to save and to challenge financial service providers to develop products that truly respond to their needs, and that should have positive effects on both investment levels and economic growth.

3.3 DETERMINANTS OF FINANCIAL LITERACY

Determinants are the indicators or the predictors of the financial literacy. So before measuring the financial literacy it is necessary to find out the factors which affect the financial literacy. The financial behaviour assesses how the individual deals with continuous saving habits etc. Financial attitude influences the behaviour of the individual. Financial attitude is the opinion of the individual about the belief in planning, their propensity to save and consume. So, the combination of financial knowledge, attitude and behaviour determines the level of financial literacy of an individual. There are also other factors of the financial literacy which are discussed by various researchers as follows.

Lusardi et al. (2009) found that both educational attainment and cognitive ability are important determinants of financial literacy, but they are not the sole determinants. In fact, many variables continued to be important predictors of financial literacy, even after accounting for education and cognitive ability. Moreover, education and cognitive ability alone fail to account for the wide variation in financial knowledge among the young. They also found that financial knowledge among the young is strongly influenced by family background.

Jappelli (2010) used the panel data to offer a comprehensive assessment of literacy across the world based on a survey of executives in 55 countries, in 1995-2008. The advantage of the dataset is strict international comparability, which allows financial literacy to be related to the quantity and quality of human capital, technological infrastructure, economic, and financial development. The drawback to it is that the survey respondents are a selected group of managers and country-experts, and that data are only available in aggregate form, preventing analysis of specific socioeconomic groups. The descriptive analysis shows that literacy varies quite substantially among countries, and the regression analysis shows that its level depends on educational achievement, social interactions (as proxies by the share of urban population), and mandated savings in the form of social security contributions.

Mahdavi & Horton (2014) focused on measuring the degree and determinants of financial literacy among educated women in a sample of alumnae of a highly selective women's college. They used descriptive statistics and multiple regressions to analyze effects of HHI (house hold income), degree types, marital status, having children, employment status, parents' education, sources of financial information, and influences on money attitudes. They found that the FKI score increased with higher HHI. In terms of degrees obtained, they found that women with MBA degrees had the highest FKI score.

3.4 DEMOGRAPHICS

In this sub-section only those studies are included which examined the Financial Literacy across various demographic factors like age, income, gender, etc.

Volpe et al. (2002) examined investment literacy of 530 online investors. They found that level of investment literacy varied with people's education, experience, age, income and gender. Women had much lower investment literacy than men and older participants performed better than young participants.

Worthington (2006) used the logit regression models to predict financial literacy of Australian adults. Their findings suggests that financial literacy is found to be highest for persons aged between 50 and 60 years, professionals, business and farm owners. Financial literacy is lowest for unemployed, females and those from non-English speaking background.

Al-Tamimi and Kalli (2009) assessed the financial literacy of the UAE investors. The results indicate that the financial literacy of UAE investors is far from the needed level. The financial literacy is found to be effected by income level, education level and workplace activity.

Agarwal et al. (2010) evaluated financial literacy of online Indian investors of Hyderabad city. The findings suggest that participants are generally financially literate. Variations in financial literacy level were observed across demographic and socio-economic groups.

Almenberg and Soderbergh (2011) examined the relationship between financial literacy and retirement planning of Swedish adults. They found significant differences in financial literacy between planners and non-planners. Financial literacy levels were found lower among older people, women and those with low education or earnings.

Lusardi (2012) found that both in USA & other countries there is low level of financial literacy among adult population and especially very low level of financial literacy among particular group of population like old age persons, women, and those with low educational attainment. This is problematic because numeracy has been found to be linked to financial decision making, and many governments and employers around the world are increasingly shifting the responsibility for saving, investing, and borrowing onto individuals.

Bhusan & Medury (2013) showed that in India people are still not much aware about their finance related issues. The results suggest that level of financial literacy varies significantly among respondents based on various demographic and socio-economic factors. It can be concluded that financial literacy level gets affected by gender, education, income, nature of employment and place of work whereas it does not get affected by age and geographic region.

3.5 FINANCIAL EDUCATION IMPACT ON FINANCIAL LITERACY

In this subsection the impact of financial education on financial literacy as propagated by different researcher has been described.

Walstad (2006) utilizing National Council on Economic Education standardized tests, such as the BET (Basic Economic Test) for elementary students have shown economic literacy gains as demonstrated in pre and post test data in comparison to control groups. The most effective educational means have generally been shown to be 'practice oriented' in student learning outcome measures.

Sanders et al. (2007) tried to examine the financial education impact on financial literacy. A total of 67 survivors completed a pre-test and a post-test two weeks following the implementation of the curriculum. They found that survivors who participated in REAP showed greater and significant differences in their knowledge when compared to survivors who did not participate in REAP (Redevelopment Opportunities for Women's Economic Action Program)

Sprenger (2007) showed that future-oriented people are the most likely to agree to attend financial education. Since future-oriented individuals are already more likely to manage their personal finances better, the authors conclude that selection into financial education contributes to an overestimation of positive impacts.

Walstad et al. (2010) tried to investigate in what ways the financial knowledge of high school student is affected by a financial education program. They observed that there is an increase in level of financial literacy because of financial education irrespective of student's characteristics and the course in which the curriculum was used.

Xio et al. (2010) examined the association between financial knowledge, financial education and risk credit behavior. Their findings suggest that both high school and college personal finance courses may contribute student's subjective finance knowledge but does not show a direct impact on objective credit knowledge.

Fonseca et al. (2012) studied the effects of household financial decision making on women's financial literacy. According to the latter, the division of labor in financial decision making is not based on gender, but rather on the level of educational attainment, with the level of education positively linked to knowledge of finance and financial decision making.

Postmus et al. (2014) examined the effect of financial education curriculum using a longitudinal randomized control study, with data collected over four time periods spanning 14 months. Study participants were recruited from 14 different advocacy organizations located in seven different states and Puerto Rico. They found that group had an average improvement a half point to over a full point on self-reported financial knowledge, financial intentions, and financial behavior and a decrease in financial strain.

Singh and Sehrawat (2014) found high degree of positive correlation between education and financial literacy. They reported that people do not implement their own decisions because of the lack of confidence. The benefit of various financial literacy programs is of long term nature. In short term one can cross check their decisions by taking advice from financial experts and boost their confidence.

3.6 GEOGRAPHICAL LOCATIONS

Many researchers examine the financial literacy across various geographical regions and they found that financial literacy level is higher in urban area as compare to rural area. Some of them are discussed below.

Fornero and Monticone (2011) showed that financial literacy varies widely among Italian regions. While there is a distinct North-South divide in terms of financial literacy—with Southern regions showing much lower levels of financial knowledge than the Northern regions—there are also sharp differences in financial literacy among the regions in the North of Italy.

Klapper and Panos (2011) also documented large differences in financial literacy in Russia. According to their work, these differences seem to be explained by living in rural versus urban areas. This is consistent with the evidence provided in other papers that, in the absence of formal education, people acquire financial literacy via interactions with others.

Bumcrot et al. (2011) constructed a hierarchical regression model in which demographic variables – age, gender, ethnicity, income, education, and marital status – were entered in the first block, and state was entered in the second block for understanding the degree to which geographical variations in financial literacy are attributable to variations in the demographic characteristics of the states. They found a significant effect of geography. Their study highlighted two main findings- financial literacy is rather low in the population and most Americans are not familiar with fundamental concepts that should form a basis for financial decision-making.

Thilakam (2012) made an empirical analysis of rural investors, level of awareness towards modern savings/investment avenues and their perception towards availability of various financial services among the people who are living in Coimbatore district of Tamilnadu in India. It has been found out that investors' perceptions towards feasibility of financial services offered by various agencies in rural areas significantly differ from one another.

4. CRITICAL ANALYSIS

Financially literacy is pivotal for positive financial behavior, rational financial decision making, overall financial welfare and sailing through tough financial times. This is because financially literate investors are more likely to make choices and decisions which would lead them to make optimal financial decisions, thus maximizing their financial well-being.

Major factors which determine financial literacy among investors are financial education, cognitive ability, maturity and family background. Relative importance of these determinants will vary from investor to investor.

Since financial literacy is a very subjective term, various researchers have defined it differently. The most widely accepted of financial literacy in literature is provided by Lusardi. Lusardi defines the financial literacy as knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification.

A plethora of studies have incorporated demographics as part of their framework. Different researchers have analyzed financial literacy for investors belonging to different age category, income groups and gender. They have thus arrived at varying results which are not directly comparable.

Various researches on the subject have confirmed the notion that financial education significantly enhances financial literacy among investors and it is perhaps the most significant factor influencing financial literacy. This is significant as it indicates that concerted efforts in imparting financial education would make valuable increments to an investor's level of financial literacy, irrespective of their general education level, age, income, gender and family background.

Previous studies which attempted to measure financial literacy among investors, encountered several problem in achieving their objective. The main issues where lack of a common construct, lack of uniform questionnaire, over or underestimation of their financial knowledge by investors while replying, incorrect responses, inherent inability of questions in capturing cognitive ability, possibility of measurement errors and that individual answers might incorrectly measure their true financial knowledge. They have applied regression analysis, chi-square test, factor analysis, non parametric tests and various other inferential statistics techniques on their data sets to draw meaningful conclusions regarding financial literacy of their study subjects. Due to problems mentioned above and application of varied statistical techniques, financial literacy as measured by different researches cannot be generalized and directly compared.

Researchers in their attempt to capture financial literacy have surveyed investors transcending national boundaries. They have studied investors in countries as diverse as Italy, India, Australia, USA, Russia and several others. They reported different levels of financial literacy across different geographical regions and nationalities.

5. SCOPE FOR FUTURE RESEARCH

- Probing the level of financial literacy amongst developing or emerging markets.
- Analyzing the impact of financial literacy on investor behaviour.
- Scrutinize whether financial literacy level significantly varies across different geographical regions.
- Developing a comprehensive set of factors which can determine, measure and explain financial literacy.
- Investigate whether financial literacy varies across countries with different levels of economic and social development.
- Examine financial literacy among young entrepreneurs, finance managers and proprietors of medium, small and micro enterprises (MSMEs).

6. SUMMARY AND CONCLUSION

In this paper, an attempt has been made to study various facets of financial literacy among investors. The literature on financial literacy has been analyzed by segregating extant studies on multiple bases such as meaning, importance, various determinants, demographics, impact of financial education, measurement, geographical locations covered and those which incorporate investor protection in their research.

Financial Literacy means knowledge of basic economic and financial concepts, as well as the ability to use that knowledge and other financial skills to manage financial resources effectively for a lifetime of financial comfort.

To conclude, it can be said that the area of financial literacy holds promising prospects for future researches as it has many facets which are still unexplored or underexplored. Study of financial literacy grows in significance with growing importance of financial matters in our lives and increasing complexity of financial products and services. Financial literacy of investors is particularly un-probed in developing or emerging markets where a growing middle class of investors, present themselves as a group whose financial knowledge must be examined.

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