



The link between financial confidence and financial outcomes among working-aged Canadians

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Executive Summary

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Executive Summary

In an environment where people are required to be increasingly responsible for their own personal financial management, working-aged Canadians face numerous challenges. They are at a stage of life where they need to not only manage their day-to-day finances but also plan for future life events, such as buying a first home or saving for retirement. With a multitude of financial products, services, and offers to consider, making the right decision is not always an easy task.

Financial literacy is defined as the knowledge, skills, and confidence a person needs in order to make responsible financial decisions. “Knowledge” refers to an understanding of personal and broader financial matters; “skills” refer to the ability to apply that financial knowledge in everyday life; and “confidence” means having the self-assurance to make important decisions. Findings show that many people lack the financial literacy to make sound financial decisions. This points to an urgent need to improve the delivery of financial literacy programs and enhance the financial well-being of Canadians. We define financial well-being as “a state of being wherein a person can fully meet current and ongoing financial obligations, can feel secure in their financial future, and is able to make choices that allow enjoyment of life” (CFPB, 2015).

Knowledge is certainly a critical aspect of the financial literacy equation. However, interventions may under-deliver when they target only financial knowledge and neglect to consider other factors in people’s ability to apply knowledge appropriately in decision-making.

While knowledge is clearly important, emerging evidence from behavioural economics shows that an array of interconnected psychological factors frequently result in systematic errors in financial decision-making, in which people act contrary to their own knowledge and intentions. These kinds of self-defeating decisions may in turn reduce confidence in people’s ability to manage their own finances.

In an effort to add to the existing literature and begin to more clearly understand these psychological underpinnings of financial behaviour, this study makes use of microdata from the 2014 Canadian Financial Capability Survey to examine the links between an objective measure of financial knowledge, a subjective measure of financial confidence, and a range of financial outcomes among working-aged (25- to 64-year-old) Canadians.

The results highlight the central importance of confidence in financial decision-making, behaviours, and outcomes of working-aged Canadians.

Key Findings

- **Many Canadians have low scores in either an objective assessment of financial knowledge or a subjective assessment of financial confidence, or both.**

This suggests that there are substantial gaps to be filled in financial confidence, as well as in financial knowledge. Besides youth, other groups at risk for low knowledge, low confidence or both include women, those without a partner, those living in low-income households and those with lower levels of educational attainment.

- **Financial confidence is a better predictor than financial knowledge when it comes to outcomes associated with day-to-day money and debt management.**

In fact, those with high levels of knowledge are likely to experience relatively poor outcomes in areas such as meeting financial commitments, making bill payments, budgeting, and managing debt, if they also have low levels of confidence. Conversely, those who have relatively low levels of knowledge achieve good outcomes in these areas if they have high levels of confidence. Confidence may be an indicator of good day-to-day financial practices requiring simple self-control-based “rules of thumb” (e.g. don’t spend more than I make; pay off debt before spending more) rather than complex information processing.

The conceptual and empirical findings suggest that learning-by-doing may be the key in this behavioural domain, as people who are successful in handling their daily money matters may be effectively learning from their own experience. Identifying best practices from people with high confidence may be a way to inform the design of interventions.

- **Financial confidence is also important in understanding many planning and saving outcomes.**

Those who are knowledgeable, but have low levels of confidence are likely to experience poor outcomes in areas such as investing, saving for major purchases (such as a new home), knowing how much they need for retirement, and saving adequate amounts for retirement.

- **However, high financial confidence does not appear to “shield” those with low knowledge from relatively poor planning and saving outcomes.**

Unlike with day-to-day money and debt management, those with high confidence and low knowledge tend to have poor planning and saving outcomes. It may be that good planning and saving practices require more complex information processing (e.g. which savings vehicles to choose; within these savings vehicles, which products are most suitable to choose; when to consult a financial advisor), and that sound practice in this area may in some cases be undermined by overconfidence.

Implications

These key findings suggest several implications for research, policy and interventions.

- **Interventions designed to enhance Canadians’ financial well-being can be informed by a better understanding of the psychological underpinnings of financial choices.**

Generally, our findings confirm that psychological factors associated with confidence are critically important when it comes to financial decision-making. Indeed, this research reveals a complex relationship between self-perceived skills and financial knowledge that varies based on confidence levels and is indicative of underlying psychological factors influencing behaviour.

- **Effective program design requires a better understanding of cognitive biases and their prevalence among different groups of working-aged Canadians.**

Low confidence despite high knowledge (i.e. under-confidence) may be an indicator of poor financial practices stemming from a susceptibility to various kinds of cognitive biases in decision-making. This paper has reviewed several such biases, a number of which are associated with low confidence. An especially important bias in this context is likely to be the present bias—i.e., acting contrary to one’s intentions with regard to future costs and benefits because of a tendency, when it comes time to act, to give more weight to immediate costs and benefits. Other important departures from rational decision-making related to the present bias include inertia and procrastination, and a tendency to weigh losses higher than equivalent gains.

Designing strategies to address these biases may in many cases require more than simple knowledge-based interventions. In particular, interventions need to account for the specific biases of those who lack confidence in managing their finances and the decision-making processes that underlie their low levels of confidence.

- **Interventions related to planning and savings need to address the potential negative effects of overconfidence on financial outcomes.**

Poor planning and saving outcomes among those with high levels of confidence but low levels of knowledge (i.e. the overconfident) may stem from a series of related but distinct biases.

In contrast, the poor financial choices and outcomes of the overconfident may relate to their failure to see the need for change or to recognize their need for advice, because of tendencies to distort information through the lens of prior beliefs, and thus to attribute poor outcomes to bad luck rather than their own decisions. In this context, confidence built through ongoing success in day-to-day money and debt management may actually undermine planning and saving, since practices developed in the context of managing current financial needs may be unrelated to the information-processing demands associated with planning future needs.

Designing interventions to target the potentially detrimental effects of overconfidence on financial decision-making would also require more detailed and direct measures of investing and saving behaviour, and investigation into how the presentation and framing of new information may influence changes in behaviour.

- **Carefully designed studies in controlled laboratory settings would allow for *direct measurement* of these potentially important biases and provide important insights into their role in financial decision-making.**

Though currently available data do not allow for rigorous measurement or investigation of different kinds of cognitive bias, controlled laboratory experiments have been used successfully to measure similar constructs. These kinds of measures, in conjunction with existing indicators from the Canadian Financial Capability Survey, would help identify the specific needs and biases in decision-making associated with low and high confidence, and assess the extent to which such biases impact financial choices and behaviour.

Summary

In general, this research highlights several ways in which confidence and knowledge may be linked with financial decision-making, and suggests that a one-size-fits-all approach to intervention is unlikely to reap dividends. Instead, interventions need to be informed by a better understanding of the mechanisms through which gaps in confidence and knowledge lead to poor outcomes, and tailored to the specific needs of those with different kinds of gaps.

This research is intended to contribute to the existing empirical literature on the links between financial confidence, knowledge and outcomes. It also aims to set the stage for more detailed investigation into the psychological underpinnings of financial decision-making and how such investigations could inform the design and delivery of effective financial training interventions.