

# FINANCIAL LITERACY AND CREDIT CHOICE OF CONSUMER CREDIT USERS IN SRI LANKA

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## Abstract

*Financial literacy of individuals matters in credit decisions specially when choosing among different credit alternatives. This study investigates the financial literacy level of consumer credit users in Sri Lanka and their credit choice. For this purpose primary data was collected from 445 individuals using a survey instrument. Individuals have displayed a moderate level of financial literacy and it is found that there is no significant difference between the financial literacy levels of males and females. Despite the financial literacy level, most individuals have resorted to high cost credit cards compared to low cost bank borrowings. This may imply a behavior that deviate from the rationality. It demands further research to determine the possible factors affecting the deviation from rationality. Further this research finds that individuals below the age of 25 have lower financial literacy level. It may imply that they are susceptible to higher credit related risks.*

**Keywords:** Consumer credit, Financial literacy, Credit choice, Rationality

## 1 INTRODUCTION

Consumers could resort to diverse sources of consumer credit at present such as credit card, personal loans, hire purchases etc. Pattarin & Cosma (2012) defined consumer credit as a monetary request made by a household from an institution and subsequent lending made by the institution considering the solvency. Different consumer credit products entail different financial costs. Some are costlier such as credit cards. For example US national average of credit card rate stood at 15.06% while consumer loan rate was at 3.53% at the mid of September 2014 (US Consumer Interest Rates, 2014; Credit card interest rates, 2014). For the same period credit card rate was 24% and personal loan rate was 14% in Sri Lanka (Sampath.lk, 2014).

Consumers need to understand the financial cost of the credit that they use (Disney & Gathergood, 2013). Thus financial literacy of consumer has important role in choosing consumer credit products. Hilgert, Hogarth, & Beverly (2003) found that the relationship between credit management knowledge and credit behavior is statistically significant. Accordingly the present study investigates the financial literacy level of consumer credit users in Sri Lanka and their choice among different credit alternatives. Moreover the research is carried out in a developing country context, thus it contributes to the body of knowledge pertaining to the consumer credit behaviour in developing countries as there is dearth of researches in developing countries (Ahmed, et al., 2010)

The rest of the paper is structured with a brief literature review on consumer credit, financial literacy and relevant theories. This is followed by the discussion data and methodology of the study. Next section presents the findings and discussion. Finally the concluding remarks of the study are presented.

## **2. LITERATURE REVIEW**

It is observed that a broad variety of consumer credit products are offered in credit markets such as consumer loans, credit cards, hire purchase loans, point of sale lending, salary loans and etc. Definition of consumer credit exclude the credit taken for property (Guardia, 2002).

Credit users need to choose among different form of credit alternatives which is known as the credit choice (Kamleitner, Hoelzl, & Kirchler, 2012). Credit choice is a decision made at the credit take up process (Kamleitner & Kirchler, 2007). Expected utility theory suggests individuals make rational choices to maximize their utility (Bernoulli, 1954). Accordingly one may expect that an individual with fair level of financial literacy may choose low cost credit alternatives.

Gathergood (2012, p.591) defines financial literacy as the “consumer understanding of financial concepts and ability to correctly interpret financial data”. According to Lusardi & Mitchell (2007) financial literacy has a relationship with economic behavior of individuals. Thus financial literacy matters in consumer credit related behavior of individuals. Consumer credit products usually demand knowledge on interest rates, credit terms, time value of money, etc. As a result the consumer needs to have an understanding on such aspects in order to properly use the consumer credit products. There is a statistical relationship between the credit management knowledge and credit behavior. (Hilgert, Hogarth, & Beverly, 2003)

It is intuitive that an individual with higher financial literacy would opt for low cost bearing credit alternatives. In contrary, individuals with poor financial literacy may choose credit alternatives at higher interest rate. Disney & Gathergood (2013) studied the behaviour of UK households to identify the relationship between finance literacy and consumer credit portfolios and found that consumers with poor financial literacy hold high cost credit products compared to the consumers with higher literacy. Moreover Norvilitis et.al (2006) found that credit card debt is associated with lack of financial knowledge.

## **3. METHODOLOGY**

Current study focuses on the behavior of consumers pertaining to the use of consumer credit. Pattarin & Cosma (2012) has defined a credit user as an individual that was either using consumer credit when interviewed or had used consumer credit during the previous 24 month. The current study has also adopted the same definition. Further this study is carried out within the geographical limits of Sri Lanka. Given the resource and time limitation, the study has used the convenience sampling approach. According to Roscoe (1975) as cited in Sekaran & Bougie (2009) sample sizes of greater than 30 and less than 500 are appropriate for most research. Accordingly this study limits its sample size to 445 individuals.

Even though there are two methods of collecting the data from a given sample, the present study engages the cross sectional data collection. Considering the time limitation the data were collected from the respondents only once during the period of December 2014 to the end of February 2015.

The survey instrument used in this study is a questionnaire. A pilot study has been carried out for a sample of 20 respondents prior to finalising the survey instrument. The survey instrument carries scales to measure the financial literacy and demographical factors of credit

users. Financial literacy scale developed by Perry (2008) has been adapted in the current study.

## 4. FINDINGS AND DISCUSSION

Respondents of the sample consist of individuals who have actually used the consumer credit during last 2 years (credit users) as well as credit non users. Accordingly the sample comprises of 328 individuals who are actual credit users which account for 74% of the total. The balance respondents have not used the consumer credit during last 24 months.

### 4.1 Credit financed goods & services

Consumer credit users have used consumer credit to purchase different types of consumer goods and services. These are illustrated in table 1.

**Table 1: Consumer financed goods and services**

Type	Frequency	Percent
Electronics	100	30
Furniture	24	7
Appliances	31	9
Hotel bills	34	10
Education fees	38	12
Travelling	17	5
Other	77	23
Missing	7	2
Total	328	100

*Source:* Research data

Most of the credit users have used consumer credit to purchase electronics which accounts for 30% of the sample. Second largest category is other types which consist of day to day goods, medical bills and etc. Respondents have also used consumer credit to finance education fees.

### 4.2 Credit choice

Respondents were required to rank different forms of credit according to their preference where 1 being the most preferred and 6 being the lowest preferred. Credit forms with highest preference (ranked 1) is considered as the choice which is known as the first choice rule (Elrod, Louviere, & Davey, 1992). Accordingly credit choice of respondents are presented in the table 2.

**Table 2. Credit choice**

Credit forms	Statistics	
	Frequency	Percent
Bank loan	97	21.8
Credit Card	227	51.0
Salary loan	69	15.5
Hire Purchase	39	8.8
Pawning	11	2.5
Other types	2	0.4
Total	445	100

*Source:* Research data

According to the table 2, it can be observed that 51% of individuals prefer credit card most and preference for bank loan is 22%. The study has also observed the actual forms of credit used by the respondents. Credit users have declared what form of credit that they have actually used to finance goods and services. Credit non users were requested to declare what form credit that would choose if they had resorted to consumer credit (Pattarin & Cosma, (2012). This is presented in table 3.

**Table 3. Actual Credit Use**

Credit forms	Frequency	Percent
Bank loan	75	16.9
Credit Card	267	60.0
Salary loan	42	9.4
Hire Purchase	47	10.6
Pawning	10	2.2
Other types	4	.9
Total	445	100.0

*Source:* Research data

A chi-square test has been carried out to identify whether the credit choice of consumers is significantly independent from the credit alternatives that they have actually used. Results of the test is presented in table 4. According to the table 4, Pearson chi-square is less than 0.05. As results it rejects the null hypothesis that actual credit choice is independent from the preferred credit choice. Accordingly it can be concluded that preferred credit choice is dependent on the actual credit choice. This is increases the validity of credit choice declared by consumers according to their preferences.

**Table 4. Chi square test on credit choice vs. actual credit use**

Description	Value	Df	Asymp. Sig. (2-sided)
Pearson Chi-Square	210.131	4	.000
Likelihood Ratio	192.752	4	.000
Linear-by-Linear Association	77.201	1	.000
N of Valid Cases	445		

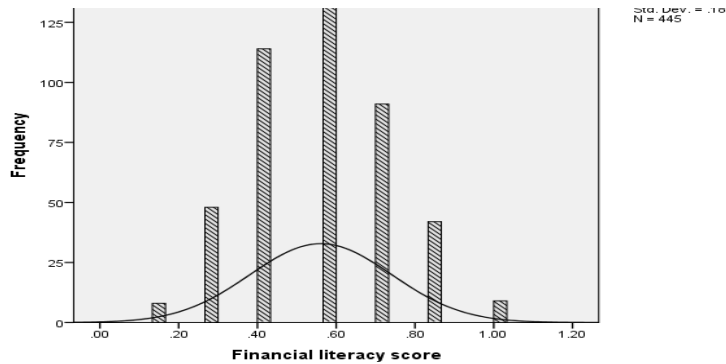
*Source:* Research data

Preceding sections discussed the nature of consumer credit choice. Financial literacy of individuals matters on the choice of consumer credit that they make. The following section analyses the financial literacy levels of individuals.

### 4.3 Financial literacy

The questionnaire carries 7 multiple choice questions on interest rate, credit and investment to measure the financial literacy of individuals. A final score is developed based on number of correct answers to total number of questions which ranges from 0 to 1. Figure 1 represents the financial literacy distribution of the respondents. Mean score of the individuals stood at 0.56. Accordingly an individual could accurately answer more than half of the questions thus represents fair level of financial literacy. Further 75% of individuals could score above 0.46.

**Figure 1. Financial literacy**



A chi square test has been carried out identify whether there is a gender differences on financial literacy. Results of chi square statistic test for the gender differences is presented in table 5.

**Table 5. Chi square test of financial literacy on gender differences**

Description	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	3.956	6	.683
Likelihood Ratio	4.586	6	.598
Linear-by-Linear Association	.556	1	.456
N of Valid Cases	445		

Source: Research data

Pearson chi square statistic is greater than 0.05. Accordingly it can be concluded that there is no significant difference between financial literacy of males and females.

**Table 6. Financial literacy by age group**

Age	Financial literacy (Mean Score)
16-24	0.49
25-34	0.58
35-44	0.54
45-54	0.54
Above 55	0.49

Source: Research data

Table 6 presents the financial literacy of individuals in different age groups. Accordingly it can be observed that financial literacy of individuals below the age of 25 is lower compared to the literacy levels of individuals who in between 25 to 54 years of age. Financial literacy level of the individuals above the age of 55 also found to be lower. Lower financial literacy may imply that they susceptible to higher credit related risks.

## 5. CONCLUSION

Financial literacy of individuals found to be moderate where an individual in average could score more than 50% of the questions. Further there is no significant difference between the financial literacy of males and females. However when analysing the credit choice of individuals it could be found that more than 50% individuals choose high cost credit card to finance the consumption. Less than 22% of individuals choose low cost bank loans to finance the consumption. This suggests that individuals despite their financial literacy resort to high cost credit cards thus displayed a behavior that may deviate from the rationality. Deviation from rationality is suggested in prospect theory (Tversky & Kahneman, 1986) and different psychological factors may have an influence. Thus it demands further research to determine possible factors that deviate individuals from rationality.

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