

Eighth Issue
(8/2024)
December 2024

بنك الكويت المركزي
CENTRAL BANK OF KUWAIT



Financial Literacy and Personal Finance: Basics of Budget Management



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Introduction

Complementing the Central Bank of Kuwait's series of quarterly reports since November 2022, the 8th edition (December 2024) titled **“Financial Literacy and Personal Finance: Basics of Budget Management”** addresses the importance of financial literacy and personal budget management, including income, spending, saving, investing, debt management and insurance. Financial literacy and personal finance are basic skills that everyone should acquire in this modern era in order to achieve financial stability at both individual and family levels, avoid debt accumulation, and seize investment opportunities.

The G20 countries pointed out the significance of financial literacy at a global level as a core life skill in the 21st century, one that is essential for the empowerment of individuals, and for supporting individual and societies' financial well-being¹. In addition, financial experts advise that an individual should acquire money management skills, otherwise the lack of such skills would control them. A study shows that² “only one in three adults worldwide has basic knowledge of financial concepts”. This means that around 70% of adults globally lack the knowledge needed to make effective financial decisions, therefore, they face difficulties with decisions related to spending, saving, debt management and investment.

It is important to know that a personal financial planning process does not require deep research, instead it requires use of common sense and discipline. If an individual takes sound personal financial decisions, they would spend their money wisely, which increases their savings and reduces their borrowing, thus boosting their wealth and ability to purchase products or services in the future, or hedge contingencies more easily. Conversely, poor personal financial decisions could lead to excessive borrowing resulting in repayment difficulties.

¹ G20 (2021), “Italian G20 Presidency Third Finance Ministers and Central Bank Governors Meeting Communiqué”, <http://www.g20italy.org/wp-content/uploads/2021/07/Communique-Third-G20-FMDBG-meeting-9-10-July-2021.pdf>

² “The S&P Global Financial Literacy Survey” published in 2015. It is considered the world's largest and most comprehensive measure of financial literacy. The survey assessed the financial literacy of 150000 adults across 140 countries.

Financial Literacy and Personal Finance

Financial Literacy

is a combination of awareness, knowledge, skills, attitudes and behaviors necessary to make sound and effective financial decisions and ultimately achieve financial well-being.

As for Personal Finance

it is the practical application of financial literacy, such as planning, managing personal budget including income, spending, investments, insurance and debt management, in order to improve an individual's current financial status, achieve future financial goals, and ensure long-term financial security.

Figure: Components of Personal Finance



Income

Income is a source of cash inflow that an individual receives and then uses to support themselves and their families. There are different sources of income: most importantly salaries, rewards/bonuses, pensions, profits and dividends.

Table: Sources of Income

Sources of Income	Definition
1 Earned income	Money received from an entity as payment for work, such as salaries, wages and bonuses, as well as profits of small and medium enterprises that are directly run by an individual.
2 Unearned income	Money received without engaging in active daily work or direct labor, such as profits resulting from investing in stocks and bonds (capital gains), companies' dividends distributed to shareholders, interests from banks' deposits and savings accounts, pensions, and unemployment allowance.

Factors Affecting Personal Income:

Education Level\ Specialization:

1

Higher level of education usually leads to higher salaries. Moreover, skilled jobs often require specialized and higher skill levels, and those usually provide higher salaries than those requiring general skills. Also, the demand for particular skills or specializations can influence personal income.

Individual's Career Path (Experience Gained):

2

The stage reached in an individual's career path affects their level of income. At the early stages of a career, individuals receive relatively low cash inflow which increases as they gain experience and advance in their profession.

Economic Conditions:

3

Economic conditions influence the type of jobs available and the income level for each type. For example, Covid-19 pandemic and the financial crisis in 2008 affected individuals' financial status in many ways, causing fewer new job opportunities, eliminating some jobs, and reducing the wages of some existing jobs.

Social Safety Net:

4

Includes subsidies provided by social welfare programs such as housing, healthcare and food subsidies which reduce the financial burden on families and indirectly increase an individual's income, in addition to direct transfer programs that include unemployment benefits, children's allowances, and pensions which provide direct financial support for individuals' income.

Highlight:

Diversifying an individual's sources of income contributes to financial stability and security during crises, and paves the way for wealth building, while relying on a single source of income can be risky, especially in emergency situations such as job loss or economic slowdown.

Spending

Personal Spending is the amount of money an individual or family spends on necessary goods and services to fulfil everyday needs, entertainment, personal wants and desires. Managing personal spending effectively is crucial to personal finance, as it affects a person's ability to save, invest and achieve long-term financial goals. Balanced personal spending enables individuals to maintain financial security and avoid excessive debts, ensuring that resources are allocated in a way that supports immediate needs as well as future stability.

Personal spending includes:

Essential Spending

on life necessities (food, housing and transport)

Discretionary Spending

on luxuries (entertainment and hobbies)

Factors Affecting Spending:

Personal spending is affected by a number of factors, a key factor of which is an individual level of income. An individual tends to spend more money on housing, transport, and entertainment when income increases. Also, spending increase as a family size grows, especially those related to essential expenses. Moreover, psychological factors influence individuals' behaviors and ability to make sound financial decisions and planning, leading some to seek instant gratification, while others focus on the future, as follows:



1. Instant gratification and response to social environment pressure:

Some individuals build their financial decisions on the desire to feel immediate satisfaction and their tendency to imitate others, which makes them want to spend excessively thus dragged into what is known as 'impulsive buying', which is the act of making unnecessary purchases based on instant decisions.

2. Focusing on the future:

Some individuals have more discipline when making spending decisions, their decisions are affected by their desire to avoid debts, as they realize that rational spending provides them with more surplus money to improve their future financial well-being.

Highlight:

Diversifying an individual's sources of income contributes to financial stability and security during crises, and paves the way for wealth building, while relying on a single source of income can be risky, especially in emergency situations such as job loss or economic slowdown.

Saving

Saving is the surplus of income that is held for future spending. It is income minus expenses. The importance of saving is summarized as follows:

- 1. Achieving financial independence:** Saving helps to overcome crises without borrowing from banks, credit card, or parents and friends, and be truly financially independence.
- 2. Enhancing ability to handle emergencies:** Savings serves as a safety net during unforeseen events, enhances ability to deal with emergency expenses such as medical expenses, or emergency auto and home repairs and maintenance, etc.. It also provides flexibility in responding to financial needs in the event of a job loss.
- 3. Achieving goals and covering future needs:** Achieving financial goals in the short, medium and long term, such as purchasing a mean of transportation, a down payment for buying a house, or retirement.
- 4. Building wealth:** Regular saving and savings investment provide an opportunity to gradually build personal wealth.
- 5. Promoting mental health:** Money saving promotes individual's health. Studies indicate that individuals with savings enjoy a better mental health due to their sense of financial security and stability, compared to those with no savings.

Key Steps to Build a Savings Plan:

Government support in the State of Kuwait covers a number of basic services, nevertheless, personal savings provide a safety net, and contribute to achieving financial ambitions such as owning a house, or covering education expenses or retirement. An effective savings plan is based on setting clear goals, regular contributing, and choosing the appropriate tools, as follows:

1. Setting goals:

Financial goals must be set in the short, medium and long term.

- **Short-term:**

Building an emergency fund (to cover 3-6 months of expenses).

- **Medium-term:**

Saving a down payment for buying a house or a personal mean of transportation.

- **long-term:**

Funding children's education or retirement.

2. Assessment of current financial status:

Includes assessment of income, expenses, and current savings.

3. Determining monthly saving capacity:

It is recommended to allocate between 20% and 30% of a monthly income to savings.

4. Choosing the appropriate saving tool:

Choosing between high-yield saving accounts, deposits or other financial tools.

Table: Savings Plan Form

Goal	Target Amount (KWD)	Period (Months)	Monthly Savings (KWD)	Saving Tool
Emergency savings	6,000	12	500	High-yield saving account
Travel savings (entertainment)	1,500	6	250	Regular saving account
Education savings	20,000	60	333	Deposits (deposits certificates)

● Available Savings Tools in the State of Kuwait:

1. High-yield saving accounts:

Provide liquidity and competitive returns (1.5%-2.5% annually) with easy access to funds.

2. Deposits:

Suitable for medium-term goals with higher returns, but with a mandatory freezing of funds for a specific period of time.

3. Automatic savings plans:

Banks offer to automatically transfer funds monthly to saving accounts, thus facilitating financial discipline.

An individual must save a fixed portion of their income (not less than 20% of their income) immediately upon receipt of the monthly salary, and before spending on anything else. Progressively, saving will bring financial stability and security to an individual, ensuring that they are ready for emergencies, and allowing them to achieve some or all of their objectives without the need to borrow.

Highlight:

Investment

Investment on its broad sense implies allocating part of the personal income for buying different assets -such as shares, bonds and investment portfolios- aiming for financial returns. Investment's returns play a vital role in personal income diversification, wealth growth and long-term goals accomplishment. In order to support one's investment decisions, the following concepts are crucial to understand:

1. Diversification:

The distribution of investments on a variety of assets' classes such as shares, bonds, real states and mutual funds in order to minimize the risk and maintain portfolio stability. For example, real state stable returns would compensate for shares market fluctuations.

2. Risk assessment:

Investor's knowledge of the risk level of each investment is crucial where risk durability varies from one another. Some investors seek high risk assets for higher returns, others lean to safer choices with lower returns.

3. Compound returns:

Long term investments allow investors to benefit from the compound interest over a lifetime of investing, where investment returns turn to an added value to the capital (asset+ previous returns) which significantly increases the capital. For instance, investing KWD 10,000 with 5% annual return would approximately grow to KWD 16,000 over the course of 10 years.

Highlight:

Starting with straightforward low-risk investment choices such as mutual funds or fixed deposits to build up the fundamentals of investment knowledge is crucial in the beginnings.

Insurance

Insurance is a contract (insurance policy) between the person (insuree) and the insurance company where the insuree pays regular installments in return of financial coverage against certain risks or circumstances (such as car accidents, diseases, fire, etc.). It aims to transfer the risks of such circumstances to the insurance company which will compensate the insuree of any financial losses due to any circumstances stated on the insurance policy in compliance with the terms and conditions. Insurance plays a vital role in personal finance planning; it acts as a safety net in reducing any financial losses of such circumstances. It also, if used efficiently, contribute on the long run to financial stability accomplishment. Personal insurance categories vary, below are some examples:

Health insurance:

It covers the medical expenses such as doctor appointments, hospital admissions and medicines. It also eases the financial burden of medical emergency and chronic diseases.

Car insurance:

It covers the losses or liabilities occurring from car accidents or car theft.

Pension insurance:

An insurance certificate designed to provide a steady income after retirement, which increases financial security and maintains the living standards after retirement.

Highlight:

The Public Institution for Social Security is entitled of providing sustainable insurance and social services ensuring a decent living for citizens working in the State of Kuwait and abroad after retirement. In Kuwait, pension insurance is a systematic savings plan regulated by laws where the PIFSS deduct a proportion of its subscribers' salaries for the duration of their service and employs it in conservative low risk investments on the long run. This will ensure a decent life for the subscribers and their families after retirement or work stoppage due to illness, disability or death. Hence, insurance is an advanced protective measure that ensure society prosperity and personal living standards stability.

Loans

Loan is an amount of money given to someone over a period of time to be paid back with interests. People take loans for big purchases or emergencies then facilitate the payment in installments over a period of time. Loans are categorized as good or bad debts in relevance to its use, usefulness and loan conditions.

Good loan:



When the loan is used to accomplish personal goals or financial long-term returns (such as housing, education or business loans).

Bad loan:



When the loan is used on optional unnecessary spending (such as entertainment expenses on credit cards).

Although loans could be used wisely for good purposes, however, overborrowing has serious risky consequences taking in consideration that it is also a trigger for unnecessary overspending. Additionally, interest rates of purchased goods get higher with time and the borrower gets frustrated financially and mentally with low income and inaccessibility to credit for emergencies.

Loans categories provided by banks in the State of Kuwait:



Consumer Loan

It is a medium-term personal loan, maximum of five years, extended to customers for financing personal consumption needs, where the amount does not exceed twenty-five times the customer's net monthly salary and up to a maximum of KWD 25,000



Housing Loan

It is a long-term personal loan of maximum KWD 70,000 over a period not exceeding fifteen years, for purchase, building or renovation of private housing.



Credit Cards

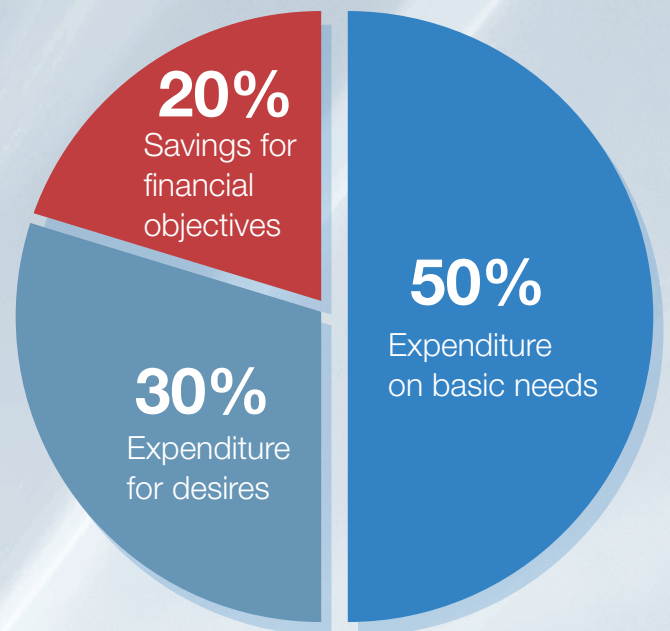
Credit cards offers bank customers a credit line that enable them to buy through the card or withdraw cash money and repay that credit later, mostly with interests if the payment is overdue. Unlike traditional loans, credit card interest rates and installments are variable.

Highlight:

It is worth noting CBK's role in regulating the terms and conditions of banks' loans, where the maximum allowed ratio of monthly installments shall not exceed 40% of an employee salary or 30% of a retiree salary. This will ensure individual's ability to pay for the loan and other necessary needs simultaneously with the limitation of any financial distress risks and ensuring financial stability.

Proposed plan towards a balance in personal finance

There are many methods towards a balance in personal finance depending on one's needs, desires and future goals³. The most common method is the (20%30%50%)⁴ plan, which is a well-known method to manage one's budget and redeploy it across groups of expenditures. This method encourages one's financial discipline while leaving a window open to entertainment and flexibility, as well supporting the accomplishment of long-term goals. The aforementioned percentages could vary relatively to one's financial status, lifestyle and personal goals. This plan helps people to divide their income into three main categories:



1. Allocating 50% of income for basic needs:

This category shall cover basic needs such as rent, electricity, water, internet, food, transportation expenses such as gas and car service, along with repayment of credit card installments.

2. Allocating 30% of income for desires spending:

This category shall cover one's discretionary spending like hobbies and entertainment. This category is optional and variable from one another, however, it must be limited and does not extend to taking loans or covering its expenses by credit cards.

³ Assessment on Effectiveness of Using 50-30-20 Rule in Improving Budgeting Skills of Grade 12 ABM Students.

⁴ "All Your Worth: The Ultimate Lifetime Money Plan", Elizabeth Warren, 2005.

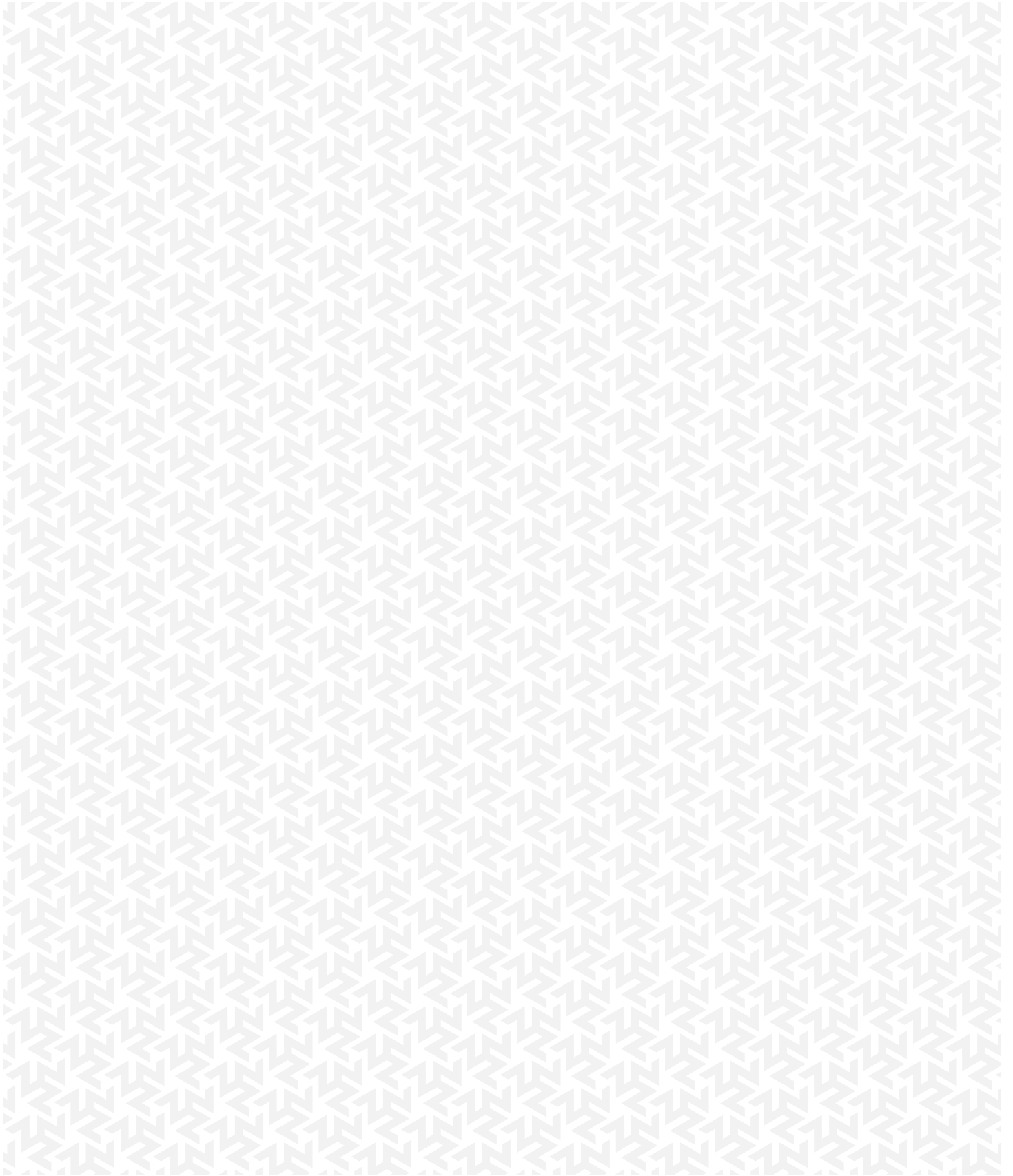
2. Allocating 20% of income for financial objectives:

This category shall cover savings and investment which strengthen one's financial stability. It includes emergency savings, investing in bonds and shares, and bank deposits.

AI applications have revolutionized personal finance management and individual budget automation, providing tools to analyze income, spending, savings and investment patterns, and making dedicated recommendations to help individuals achieve specific financial goals, such as saving to finance purchases or debt repayments. For example, AI applications can automatically allocate income based on specific rules, such as a 50%, 30%, and 20% plan, or offer suggestions suitable to an individual's lifestyle. Many local banks have adopted AI-enabled solutions within their digital platforms, offering features such as automatic savings transfers, real-time spending analysis, and target tracking.

Conclusion

Financial literacy and personal finance are basic needs nowadays, each person has to acquire the knowledge and skills on how to manage personal budget efficiently in order to make sound decisions about income, spending, saving, investments, debt management and insurance. Therefore, a person becomes more flexible in facing crises and emergencies and able to accomplish specific goals on the long run. Thus, financial knowledge is a lifestyle that should be adopted by everyone seeking financial stability. The importance of financial literacy increases nowadays and the positive impact of it does not reflect on the financial status of the individual alone, it extends efficiently to enhance the financial and economic stability on national level.



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