Dejan Šoškić: Financial literacy and financial stability

Keynote speech by Mr Dejan Šoškić, Governor of the National Bank of Serbia, at the Bank of Albania 9th International Conference "Building our future through financial literacy", Tirana, 15 September 2011.

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Honorable Governor Fullani, Excellencies, distinguished participants and guests,

It is my great pleasure to greet you all at the 9th International Conference on Financial Literacy, here in Albania, on behalf of the National Bank of Serbia. I would like to thank our host for giving me the opportunity to be the keynote speaker on such an important issue, not only for the region of Southeast Europe but worldwide.

Although financial literacy has been a concern and policy priority for some years now in many countries, it was the financial crisis that additionally propelled the issue into the limelight. With the rapid credit expansion experienced throughout the global financial system and to a certain extent in Southeast Europe (SEE) over the past decade, it is hardly surprising that the importance of financial literacy has become exposed and painfully vivid. The increased availability and complexity of financial products have highlighted the worryingly low levels of financial literacy of the general public. In order to provide efficient, stable and sound financial markets that offer quality financial services, we have to offer and ensure financial education for all financial market participants on various levels and in various points in their personal and professional development.

It is not by chance that teaching experts know that by learning early we know better, and that by knowing deeper we know forever.

Financial literacy is the ability to understand finance. More specifically, it refers to the acquired financial skills and knowledge that allow us to make informed and effective decisions through our understanding of finance. Such an approach extends this concept beyond households and corporates to existing and potential investors. Although the expanding financial crisis does not stem from a single cause, the role of financial literacy, or rather lack of it, has been evident. Yes, the crisis was to a large extent caused by the combination of the risky and less than proper actions and decisions by various stakeholders; including financial institutions, experts and sometimes regulators who unquestionably carry most of the responsibility. But the lack of understanding of households on financial issues and, in particular, on credit and investment, has also played a major role. As a result, individuals have accepted (sometimes unknowingly) to support more financial risks than they could afford.

That is precisely why it is never too early to start learning basic concepts in finance and why it is never too late to revisit the fundamentals and increase and deepen the body of knowledge in finance.

We should never neglect the importance of basic individual level of understanding financial issues, knowledge on how to appropriately manage one's budget and personal/households' wealth. This is important in the short and medium but especially in the long term, and has become an essential asset for financial stability.

Greed needs to be contained by understanding.
Financial industry professionals need to be aware of the risks the products carry and be able to explain their services to the customers. Financial literacy is being increasingly acknowledged as an important pillar of a sound financial regulatory and supervisory framework on the global scene and a critical component of economic and financial stability and development. Additionally, in order for the financial products on offer to be fully utilized and sustainably increase the wealth of a society it is essential that both professionals in the

industry and consumers (corporate and households) have full knowledge and understanding about financial products they consume and potential risks they can be submitted to.

Basic financial literacy is a key component of rational decision making in finance. The fundamental concepts need to be widely understood, like: time value of money, flexibility of annuities payments design, importance of maturity in calculating the overall cost of credit… to name just a few. In addition, it is important to have clear understanding of a bit more complex matters, like: flexible and fixed interest rates and the importance of interest rate risk, what an FX clause means for an unhedged borrower and what the importance of FX risk is, what EURIBOR/LIBOR and other reference rates are and how they can move through time… again to name just a few. If we provide wide understanding of these concepts and combine them with legislation on consumer protection of financial products, we have done a lot in preventing future excessive credit growth, potential asset price bubbles and undesirable movement in nonperforming loans. And this is in the interest not just to the regulators and consumers of financial products, but to the banking industry and sustainable economic growth of our economies.

It is also important to underline that financial literacy can support the overall efforts to decrease tax evasion and legalize most of the economic activities in the country. This is an important issue not just for the SEE countries but elsewhere as well, especially in the context of increasing budget deficits and diminishing growth rates in many countries.

What is sometimes forgotten in SEE is that a solid basis for loan qualification is and should be exclusively past and expected fully declared net-income both for companies and for individuals. This can be vital information for loan approval and interest rate pricing. By increasing financial literacy of potential financial products consumers in this area, we can significantly influence the decrease of so called “gray economy” with a positive impact on tax collection, budget deficit and accuracy of economic data in the system, and therefore, future efficiency of economic policies. That is why it is very important in this respect as well, to increase financial literacy so as to make people fully understand and realize that fully declared and legal cash-flow is a primary prerequisite for individuals and companies to successfully qualify for banking loans.

Another, similar aspect is making people fully understand the role and significance of credit bureaus. By obtaining information from credit bureaus on total borrowing and bill paying habits for corporate and individuals, lenders can obviously better assess credit worthiness of a potential borrower. This can in turn influence the decision to lend or not to lend, and can affect the interest rate and other terms of a loan. Consumers must be aware that interest rates are not the same for everyone, and are, as a rule, determined by risk-based pricing. Obviously, highly leveraged consumers with poor credit repayment histories will pay a higher annual interest rate than consumers with lower overall debt and good payment habits. Full awareness of these simple rules in finance and maintenance of good credit profile in a credit bureau can potentially decrease the overall leverage in the economy, keep the NPLs under control, help avoid the creation of asset bubbles and avoid unnecessary overdue payments court procedures. Again, financial literacy in this domain can protect both the lenders and the consumers, avoiding unnecessary shocks to the financial systems as a whole.

Closely related is understanding the importance of full legalization and registration of real estate properties as a common collateral for mortgage lending. Again, this is an area that should be very important for financial literacy and education providers. The task is particularly vital in SEE and other transition and post-transition countries where public awareness of the importance of registering real estate is not so developed in comparison to the rest of Europe and developed world economies.

Lack of understanding and the significance of real-estate registration, can have serious economic repercussions; most importantly, the inability to guarantee any obligations with one’s property. This would pose a particular problem for enterprises as loans are, in most cases, one of the most crucial sources of financing. The existence of a means of guarantee would put the enterprises into a better negotiating position, when considering credit contract conditions, as they can offer concrete collateral. In circumstances where there are no means or possibilities of land registration, or a way for creditors to register their mortgage rights, credit becomes a very risky transaction in which the lender claims much higher interest rates if he decides to lend at all. Developed land registry systems should provide for "cheaper" credit for enterprises and consumers. Real estate registration also has consequences with regards to financial reporting. If one enterprise has registered real estate property, its balance sheet will improve and so will their chances to provide adequate financing. From a historical perspective, it was not by chance that successful empires throughout history often had well-developed land registry systems. A sophisticated land registry system improves legal security of property rights and thus improves the basis for finance and market economy.

If we consider the relevant publications that take into account assessments of the South-East European region, we can see that one of the most exploited subjects lately has been the region's exposure to foreign currency lending. As interest rate differentials across currencies during the last decade have been considerable, and the region is mostly export-oriented towards the Euro zone, it may appear that efforts of market participants' education on such issues as risks linked to currency mismatch and existence of hedging instruments are long overdue. This is especially important for the corporate and small business sectors that have the ability to access a wide range of instruments (such as futures, forwards, options and swap contracts) that may serve as protective tools, especially during these turbulent times with rapid changes in international markets. Furthermore, our corporate sector needs to know that FX hedging instruments serve to insure oneself against exchange rate volatility in either direction. Just as importers may use forwards to buy foreign exchange, exporters may use them to buy their own currency. Indirect consequences have given us a signal that these efforts need to be focused towards banking sector as well. Although with the introduction of Basel II we should be aware that sometimes it can be pro-cyclical and short-sighted. The harm to financial stability of the systems that may arise from such behaviour of market participants especially during "downturn" phases of the business cycle, if not properly communicated and managed, may instigate systemic risk that could to a certain extent potentially backfire on financial institutions.

Even if we look at the United States, we can say that the sub-prime mortgage crisis was primarily the result of poor risk management and misled selling practices by lenders and financial institutions, in a context of real estate overvaluation and lax monetary policy and regulatory oversight in the financial sector. However, the development of a speculative bubble and its subsequent shattering happened also due to the reckless financial behaviour of households, including the most vulnerable ones who contracted mortgages they should not have subscribed to, considering their financial circumstances. In fact, individuals were often not aware of the risks they were exposed to and did not understand the terms and conditions of the mortgages they purchased, which often resulted in significant increases in their monthly payments over time. They either relied on the limited and incomplete financial advice from relatives or sometimes less than honest lenders in the form of mortgage brokers, or even sheepishly followed the less than responsible behaviour of others. In this respect, higher levels of understanding of financial products may have helped these individuals consider more accurately the risks and conditions of the credit products they were buying. Additionally, this process was further emphasized by the loosened and remote link between households and banks, or poorly regulated financial institutions. Concerned financial providers did not price appropriately and assess the risks of default, partly owing to the possibility of transferring this risk to other institutions through various types of securitization: mortgage backed securities, collateralized debt obligations and other kinds of securitized products.

Credit rating agencies played an important role at various stages in the sub-prime crisis. They have been highly criticized for understating the risk involved with new, complex securities that fuelled the United States housing bubble such as mortgage-backed securities

(MBS) and collateralized debt obligations (CDO).The Financial Crisis Inquiry Commission reported in January 2011 that: "The three credit rating agencies were key enablers of the financial meltdown." The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, and regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.

Only if there was a wide-spread understanding that credit rating is just a professional opinion which can be, and sometimes is, wrong!

Learning from the bad experiences of the large-scale crisis, our main job as central banks and educators will be to explain to the investors that the primary role of the credit rating agencies is to give an opinion and direction on the creditworthiness of a debt issued or issuer. The rating does not provide complete guidance on other aspects essential for investment decisions, such as market liquidity or price volatility. Accordingly, as we are all aware, bonds with the same rating may have very different market prices. Despite this fact, and even though each rating agency has its own rating methodologies and scales, market participants have often treated similarly rated securities as generally the same. Our job is also to underline the responsibility of the investors in estimating the risk exposure of the debt issue. Furthermore, we should direct and highlight to the professional investors the importance of developing their own risk management function, not solely taking into account the opinion of the rating agency, but going deeper and fully understanding underlying assets and risks.

Long periods of rapid economic growth worldwide resulted in the narrowing of focus towards high financial gains – circumstances which gave the potential to constantly create new types of hybrid financial instruments that majority of the market did not fully understand – in some cases, not even the sophisticated financial analysts and not even the regulators themselves. More importantly, the instruments were sometimes not completely and clearly understood by the institutions that we have all looked to for proper interpretation – the rating agencies. The primary lesson of this crisis is that we can no longer rely on other market participants, and we must both individually and on national level invest significantly in financial education. In an increasingly globalized world, the possibility for localized problem solving becomes more and more difficult and we must put additional effort on taking pre-emptive action in the future. The experience has taught us that efficiency and effectiveness of measures that are justified by future possible outcomes is only productive when communicated with well-informed and properly educated market participants.

Financial institutions should have a responsibility to provide clients with information that clearly and accurately represents the terms and conditions associated with the products they offer. For example, effective interest rate (EIR) should allow consumers of financial services to find out the actual cost of a financial product. On macroeconomic level effective interest rate is important to provide efficient allocation of money and capital. The task of a loan officer has to be to explain to the consumer that EIR includes all the credit payments and costs payable by the financial services consumer (e.g. interest, fees, taxes) and/or benefits to be received by the consumer (interest and other unconditional benefits) and costs relating to ancillary services which are prerequisite for the use of financial service or for its use in a specific manner (e.g. costs of life assurance, property and personal insurance). Thus, financial education can serve to augment and strengthen consumer protection but also to enable more effective allocation of money and capital on macroeconomic level. Financially educated consumers are in a better position to protect themselves on their own and to report possible misconducts by financial institutions to the authorities. Consumer protection and financial education share many of the same goals but each takes a somewhat different approach. Both financial education and consumer protection have as aims to ensure the well-being of consumers and to shield them from misconduct.

The National Bank of Serbia has been addressing the need to expand activities in the field of financial education and financial consumer protection since 2005. At the beginning of 2011 the NBS introduced the Law on Financial Consumers Protection. This Law is prescribed not only in line with EU Directive 48/2008 relating to Consumer Credit, but includes a wider range of financial products, because our intention was to cover all kind of banking services: loans including mortgages, deposits, accounts, debit and credit cards etc. The purpose was to ensure maximum protection of financial consumers in Serbia.

The NBS has been actively promoting consumer education and financial literacy training and programmes over the years. We are now in the process of introducing a Financial Education Strategy of the NBS (2011–2015) not only in order to improve our activities in this field, but also to provide a more adequate way for our citizens, entrepreneurs, farmers, schoolchildren, and students to obtain information that are of significance for them both currently and in the future. Bearing in mind that consumer protection has a reactive function – the actual problem has already taken place when the consumer is asking for help – we are aiming to place the main emphasis on financial education, especially of schoolchildren, with the aim of having a financially literate population in 5, 10 or 15 years. Our overall aim however remains the need for all the participants in the financial market to be financially literate. We intend to initiate the creation of a National Strategy for Financial Education as a necessary complement to a sound financial regulatory and supervisory framework. In doing so, we should favour and promote the establishment of coordinated public-private partnerships. All stakeholders should be encouraged to consider and implement international principles, guidelines and good practices developed by the OECD and the International Network for Financial Education (INFE) in the financial education field.

It is not possible to overestimate the importance of financial literacy and financial education. Literacy and education are the essence of building confidence. Without confidence there is no financial stability. Persistence, systematical and inclusive approach, innovative, user-friendly and technologically advanced methods used – all of these should be the properties of a far-reaching, effective and long run effort in financial literacy and education. As some wise people rightfully noted: it might be costly but undoubtedly priceless.