Briefing

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Improving the financial literacy of European consumers

SUMMARY

The 2008 financial crisis highlighted consumers' low level of understanding of financial products, which they often deemed too complex. It therefore exposed the lack of financial literacy among consumers, financial literacy being a combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and achieve financial wellbeing.

Earlier this year, the Swiss National Bank decision to discontinue its currency ceiling, leading to the sudden leap in value of the Swiss franc (CHF) – with a direct impact on all CHF-denominated loans in the European Union – again revealed a persistent lack of financial literacy among certain consumers, as they were unable to predict this financial risk and consequently to fulfil their loan obligations. A 2012 Eurobarometer survey showed that many consumers do not receive advice when purchasing financial product or services and that 52% of them tend to opt for the first product they see when obtaining a current bank account or a credit card.

Major hurdles to financially sound behaviour appear to lie in individuals' psychological habits, culture, social and economic background. Levels of financial literacy can be improved directly through financial education, as well as indirectly by ensuring a good level of consumer protection in the financial sector and enabling consumers to make informed choices with appropriate advice, standardised information and comparison tools for financial products. Research shows that most people seem to learn through experience (or even more through adverse experience), but consumers also have a tendency to forget fast, making it necessary to repeat lessons in various forms.

In this briefing:

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Glossary

Consumer credit: Credit obtained to finance any purchase other than property.

Compound interest: Compound interest – as opposed to simple interest – is the interest added to the principal sum of a deposit (or loan). In this way the accumulated amount earns interest from that point onwards. This addition of interest to the principal sum is called compounding.

Risk diversification: In finance, this refers to reducing non-systematic risk by investing in a variety of assets. The rationale behind is that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio.

Financial education: According to the OECD, this is defined as the process by which financial consumers/investors improve their understanding of financial products, concepts and risks. Through information, instruction and/or objective advice, they also develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial wellbeing.

Definition, benefits and limitations of financial literacy

Definition

According to the OECD, financial literacy is a combination of awareness, knowledge, skill, attitude and the behaviour necessary to make sound financial decisions and ultimately achieve individual financial wellbeing. Similar to literacy, it can be viewed as an expanding set of knowledge, skills and strategies, which individuals build on throughout life, rather than as a fixed quantity. Consumer understanding of financial concepts and ability to correctly interpret financial data is what is generally referred to as financial literacy in the field of consumer finance.

Other definitions add that financial literacy is mainly used in connection with personal finance matters (e.g. real estate, insurance, investing, saving, tax planning and retirement), including the understanding of financial concepts like compound interest, risk diversification, advantageous savings methods, and consumer rights.

Studies related to financial literacy in general measure three specific concepts: 1) knowledge of fundamental financial concepts, 2) awareness of products and services offered by different financial service providers and an understanding of the risks associated with using these products and services, and 3) understanding how to manage personal finances or use financial services.

According to the World Bank, the terms financial literacy and financial capability[1] are often used interchangeably. The term financial literacy is associated with financial knowledge, while financial capability is a broader term encompassing behaviour and the interaction of knowledge, skills and attitudes.

Benefits of financial literacy

Financial literacy clearly benefits individual consumers and their households, since they are able to make better and more informed decisions when it comes to saving for their pension, studies or ensuring that they contract a mortgage for their home which they are able to repay within a reasonable period. There are other benefits that society can reap from financially literate consumers. Studies show that a financially savvy individual will be more willing to participate in the financial market and invest in stocks and shares. They also show that stock market participation rates vary with demographic characteristics, e.g. stock market participation increases with income, age, and wealth, and men are more likely to participate than women.[2]

The causality between financial literacy and participation in financial activity may be more difficult to prove. Do financially literate people engage in more financial activity or do people learn from their financial experiences and therefore become financially more literate? Both seem possible, as studies show that financial experience can make people more receptive to financial education.[3]

People who make good financial decisions are more likely to achieve their financial goals, making them more likely to hedge against financial risks and negative shocks and support economic growth. Several empirical studies have shown that limited participation in the stock market, as well as limited financial preparation for retirement, is associated with lower levels of financial literacy.[4] Financial illiteracy (together with lack of self-control) is also positively associated with non-payment of consumer credit and excessive debt burden.

According to a 2009 OECD policy paper, **lack of financial education** and **consumer awareness may cause individuals to react in an unexpected and irrational way**, but can also loosen the relationship between households and financial institutions, reinforcing information asymmetry.[5] The ability to take appropriate financial decisions can also make a person a more reliable party in interactions with banks and other financial institutions, contributing to the stability of the whole economic and financial system. Similarly, on a global scale, inappropriate consumer financial decisions (among other factors) can have ripple effects on the stability of the financial market, as was the case with the subprime mortgage crisis in the United States. Poor financial literacy is shown to affect the macroeconomic situation of a country, contributing to greater inequality in wealth distribution, as the financially illiterate tend to save less, have lower provisions for retirement savings, make more use of expensive debts like credit cards and predatory lenders and have greater overall reliance on debt as a means of financing their needs.

As stated in the OECD policy paper, the recent financial crisis exposed a consumer tendency to panic, mainly related to a lack of financial information and public awareness of deposit insurance and guaranteed schemes. This was particularly the case in emerging economies, where people withdrew deposits and savings from banks on a large scale (e.g. Poland, Hungary, Serbia and Russia). In fact, consumer trust in financial institutions was severely shaken by the financial crisis of 2008,[6] as well as recent scandals and market abuses, including the manipulation of interest rate benchmarks (LIBOR and EURIBOR). The OECD policy paper also states that greater financial literacy and consumer confidence could lead to more balanced consumer behaviour, preventing households from overreacting in times of crisis. It also mentions that one of the few positive aspects of the financial crisis is that it provides a 'teachable moment' when households seem to be more willing to learn about the long-term complex risks and financial issues than they would have been in normal circumstances.

Limitations through the lens of behavioural economics and behavioural finance

Certain limitations to financial literacy should be considered.[7] One strand of literature on consumer finance focuses on behavioural biases such as (lack of) consumer self-control and levels of consumer impatience, and how these are related to good decision-making. A 2010 study[8] discovered a positive relationship between high levels of impatience and credit card use. A 2012 study revealed that over-indebtedness (measured as repayment delinquency, as well as self-reported financial distress), occurs disproportionately among individuals who report self-control problems. The results of this latter study demonstrate a stronger role for a lack of self-control than for financial illiteracy in explaining consumer over-indebtedness.

EU action

EU legislation in the area of consumer protection related to financial services

Two directives have recently been adopted by the Council and the Parliament.[9] Directive 2014/92/EU 'on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features' (to be transposed by the Member States by 18 September 2016)[10] and Directive 2014/17/EU 'on credit agreements for consumers relating to residential immovable property' (to be transposed by the Member States by 21 March 2016). Regulation (EU) No 1286/2014 'on key information documents for packaged retail and insurance-based investment products' was also adopted recently, but will apply only from 31 December 2016.

Among the legislation still to be adopted in this area is the Commission proposal for regulation on key information documents for investment products which was already approved with amendments by the Parliament during its first reading in April 2014.

European Commission financial education initiatives

According to Article 165 of the Treaty on the Functioning of the European Union, EU Member States are responsible for legislating on education. Therefore, actions in the field of financial education at EU level can only take the form of incentive measures. In 2007, the Commission published a Communication on financial education giving eight basic principles for the provision of high-quality financial education schemes, and mentioning some of its financial education initiatives (e.g. Dolceta online education tool – see box).

In 2008, the Commission established the Expert Group on Financial Education composed of financial education practitioners, with the aim of obtaining policy advice in the area. In 2010, the Commission also set up a group of experts representing the interests of consumers and retail investors – the Financial Services User Group – to feed into its policy work in this area.

Dolceta

The Dolceta online education tool was available online until July 2013. It provided consumer information to adults, with one of the modules dedicated to financial services, including budgeting, consumer credit and home loans, means of payment and investments. The content is now available on the consumer education website, Consumer Classroom.

European Parliament

In its 2014 legislative resolution on payment accounts, the Parliament stressed that Member States should promote measures that support the education of the most **vulnerable customers**, providing them with guidance and assistance in the responsible management of their finances, adding that guidance from consumer organisations and national authorities to consumers is also necessary.

In its 2013 legislative resolution on credit agreements relating to residential property, the Parliament stated that the directive in question should promote **sustainable lending and borrowing and financial inclusion**, and the importance of preventing practices such as tying of certain products, which may induce consumers to enter into credit agreements that are not in their best interest. It called on the Commission to identify examples of **best practices** to facilitate the further development of measures for

enhancing consumer financial awareness. It also stated that creditors, credit intermediaries and appointed representatives should not design their remuneration policies to incentivise their staff to conclude a given number or type of credit agreement, or to offer particular ancillary services to consumers with no explicit consideration of their interests and needs. It also mentioned that **Member State out-of-court complaint and redress bodies** should be encouraged to participate in FIN-NET, a financial dispute resolution network of national out-of-court schemes, responsible for handling disputes between consumers and financial services providers.

In its legislative resolution on key information documents for investment products, the Parliament also insisted (and later ensured) that investors receive, where necessary, the following notice: 'You are about to purchase a product that is not simple and which may be difficult to understand'.

Previously, in its resolution of 2012, the Parliament stated that, in a time of severe financial crisis, the EU needs to step up its efforts to eliminate barriers to the smooth functioning of the Single Market, particularly in sectors which can act as drivers for sustainable growth, such as cross-border business and entrepreneurial activities, service provision, mobility, **access to finance** and **financial literacy**.

The Parliament's 2010 resolution on gender aspects of the economic downturn and financial crisis mentioned that women are under-represented in financial decision-making and adversely affected by financial risk, expressing the need to promote financial literacy for **girls and women**.

In its earlier 2008 resolution on improving consumer education and awareness on credit and finance, the Parliament noted that **raising the level of financial literacy of consumers** should be a priority for policy-makers**,** both at Member State and European level, not only because of the benefits for individuals, but also because of the benefits for society and the economy (e.g. reducing the level of problem debt, increasing savings, increasing competition, making appropriate use of insurance products and making adequate provision for retirement). It also suggested **increasing budget line 17 02 02** (chapter 17 02 relating to consumer policy) to finance activities at EU level aimed at improving consumers' financial education and financial literacy, asking the Commission to contribute to raising awareness at EU level by supporting the organisation of national and regional conferences, seminars, media and awareness campaigns, as well as educational programmes with cross-border participation (particularly in the field of retail financial services and household credit/debt management).

Parliament's 2008 resolution on retail financial services called on the Member States and stakeholders to take measures to **raise financial literacy among citizens** (including children, young people, employees and retired people). The aim was to empower consumers to seek better, cheaper and more appropriate products and services, enhance competition, quality and innovation within the industry, and build up **financially literate consumer** organisations able to counterbalance the role of business in the process of preparing regulation, recalling that citizens who are confident investors can provide additional liquidity to capital markets. It also recognised the tension between information overload and providing consumers with sufficient information, by favouring quality over quantity, underlining that a clear distinction should be drawn between information and advice.

Improving financial literacy among consumers

Earlier this year, the Swiss National Bank decision to discontinue its currency ceiling, leading to the sudden leap in value of the Swiss franc (CHF) – with a direct impact on all CHF-denominated loans in the European Union – again revealed a persistent lack of financial literacy among certain consumers, as they were unable to predict this financial risk and consequently to fulfil their loan obligations. Even before, the financial crisis highlighted consumers' low level of understanding of financial products and services, with a 2009 survey showing that more than **50% of EU citizens would like to be offered simpler financial products and services**.[11] The financial crisis also revealed that financial services providers do not always respect the rules or recommend suitable products to consumers. A 2011 study for the European Commission revealed that, when recommending financial products, financial advisors appeared to be more interested in the amount that the consumer was able to invest, than their ability to finance the investment.

Consumer advice and loyalty

A 2012 Eurobarometer survey on retail financial services demonstrated that many consumers do not receive advice when purchasing financial products or services, but when they do, they tend to rely on the product provider.

According to the results of the same study, **52% of consumers** tend to take the **first product** they see when obtaining a current bank account or a credit card and **over 80% of consumers never try to switch providers** after having chosen their personal loan, a credit card, a current account or a mortgage provider.[12]

In its working document Knowledge-enhancing aspects of consumer empowerment (2012-2014), the Commission identified three actions in this area to strengthen financial advice:

- special **training programme for non-profit organisations** providing financial advice to consumers,
- financial literacy **educational materials** to be part of the new community website for teachers financed by the European Commission (Consumer Classroom),
- European Consumer Centres to give **advice and assistance to consumers** who have cross-border problems with credit and online payments.

Stakeholders

Other stakeholders have also proposed possible solutions to improve financial literacy among consumers and strengthen consumer protection in the area of financial services.

The **European Economic and Social Committee** called for compulsory financial education on the school curriculum. It also proposed the organisation of a European day for financial education,[13] as well as setting up a European agency to protect consumers of financial products, supervise banking practices and combat fraud.

The European Consumer organisation (**BEUC)** proposed several policy actions[14] to remedy the vulnerable situation of consumers in the financial services' market and fight financial product complexity, tying of products or conflicts of interest posed by payment of commission and remuneration schemes. BEUC recommended banning tying and commissions. It also advocated consumer access to independent financial advice, better product governance and intervention. BEUC also stressed the need to further promote comparison sites for financial products or standardised information documents, calling for access to independent financial advice (to help consumers choose a more suitable product) – together with the creation of national registers of independent advisors to ensure transparency – as well as access to effective redress mechanisms.

The **European Banking Federation** agrees that financial literacy is an essential component of consumer empowerment and that financial education and information requirements are different but complementary issues. One of the recent initiatives of the federation and its members to promote financial literacy and financial education for young people was the launch of the first European Money Week in March 2015.

OECD recommendations

In 2005 the OECD published a recommendation on principles and good practices for financial education and awareness, where it proposes that its member countries promote financial education and argues that financial education programmes[15] should be designed to meet the needs and the financial literacy level of their target audience. It also mentions relevant best practices, such as **national campaigns** to raise awareness of financial risks through adequate savings, insurance and financial education, specifying that financial education should start at school (or as early as possible), and that it could be included in state welfare assistance programmes. OECD also states that specific **websites** should be promoted to provide relevant, user-friendly financial information to the public and that **free information services** should be developed. The development of **warning systems** on high-risk issues that may be detrimental to consumer financial interests (including cases of fraud) should also be promoted. OECD also specifies that the diversity of investor/consumer backgrounds should be taken into account to create different programmes for specific sub-groups of investors/consumers (i.e. young people, the less educated, disadvantaged groups), to relate financial education to individual circumstances, through financial education seminars and personalised financial counselling programmes.

Further reading

High-level principles on national strategies for financial education, OECD, 2012.

Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool, World Bank, 2010.

Good Practices for Financial Consumer Protection, World Bank, 2012.

Good Practices on Financial Education, OECD website.

Financial Education - National Strategies in Europe – Good Practices Report, European Banking Federation, 2015.

P. Muller, S. Devnani, R. Heyz, J. Suter, Consumer Protection Aspects of Financial services, EPRS, European Parliament, 2014.

Endnotes

1 'Financial capability is the internal capacity to act in one's best financial interest, given socio-economic environmental conditions. It encompasses the knowledge (literacy), attitudes, skills and behaviours of consumers with regard to managing their resources, and understanding, selecting, and making use of financial services that fit their needs.' Financial Capability Surveys Around the World. Why Financial Capability is important, World Bank, 2013.

2 See J. R. Brown, Z. Ivković, P. A. Smith, S. Weisbenner: The Geography of Stock Market Participation. The influence of Communities and Local Firms, 2004 as well as J. M. Poterba and A. Samwick, Taxation and Household Portfolio Composition: U.S. Evidence from the 1980s and 1990s, 1999. See also Women and Financial Education: Evidence, Policy Responses and Guidance, OECD, 2013.

3 A difficult financial experience, as well as financial education programmes aimed at helping people that experienced bankruptcy, have been found to be a major source of learning.

[4] Banks et al., 2010, Bernheim, 1995, Bernheim, 1998, Clark et al., 2011, Guiso and Jappelli, in press, Hastings et al., 2011, Lusardi and Mitchell, 2007, McHugh et al., 2011, Van Rooji et al., 2011b, Van Rooji et al., 2011a and Yoong, 2011. See Self-control, financial literacy and consumer over-indebtedness, J. Gathergood, 2012, page 591.

[5] Consumer protection policy aims principally to correct the informational imbalance between consumers and sellers by regulating the information that is provided to consumers.

[6] When we compare consumer trust in banks in the United States (US) and United Kingdom (UK), we can observe that from 2007 to 2009 this plummeted from 68% to 36% in the US, and from 39% to 27% in the UK. According to the 2014 Edelman Trust barometer that surveyed an informed public in US, China and 200 other countries financial services are considered to be the least trustworthy industry globally.

[7] Behavioural economics is challenging neo-classical economics by introducing a stronger consideration about some irrational aspects of human behaviour. Behavioural finance is the study of how psychology impacts financial decisions in households, markets and organizations. See: W. De Bondt, G. Muradoglu, H. Shefrin and S.K. Staikouras, Behavioral finance: quo vadis?, 2008.

[8] S. Meier and C. Sprenger, Present-based preferences and credit card borrowing, American Economic Journal: Applied Economics, 2010.

[9] Older legislation in this area: Directive 2002/65/EC concerning distance marketing of consumer financial services, and Directive 2008/48/EC on credit agreements for consumers, are already in force.

[10] In 2011, the Commission issued a Recommendation on access to a basic payment account, where it presented general principles regarding access to basic payment accounts by European consumers in all European Union countries, stating that access should not be made conditional on the purchase of additional services.

[11] Pensions were most frequently mentioned as the financial product needing simplification. See Flash Eurobarometer 282, Attitudes towards crossborder sales and consumer protection, 2010, page 53.

[12] New banking relationships (i.e. relationships with people who are either new to banking or switch primary relationship from another bank) are generally rare. According to a 2013 Bain & Company Customer Loyalty in Retail Banking Survey, only 2.5% of respondents switched their primary bank in the developed world. The average rate of customers who switched primary bank, combined with customers completely new to banking in 2013, amounted to only around 3% in developed markets and 6% in developing ones.

[13] Similar initiatives already exist, the National Financial Literacy Month in the United States, Financial Literacy Month in Canada, National Week of Financial Education in Mexico and the Global Money Week organised under the patronage of the European Parliament this year. In March 2015 a European Money Week initiative was launched for the first time.

[14] See Emerging challenges in retail finance and consumer policy, European Commission and EESC, 2014, page 44.

[15] Some EU Member States have already developed public financial education programmes: Austria, Belgium, Croatia, Estonia, Germany, Hungary, Ireland, Italy, Poland, Slovak Republic. Others have developed coordinated national strategies (involving the coordination of several public bodies and ministries and the development of a structured roadmap), namely the Czech Republic, the Netherlands and the United Kingdom. See Financial education and the crisis - Policy paper and guidance, OECD, 2009, page 10.

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