Financial Education and Literacy: Strengthening the Stability and Resilience of Financial Systems

Speaker:

Pedro Duarte Neves
Advisor, Board of Directors, Banco de Portugal

Host:

Demet Çanakçı
Senior Program Director, Toronto Centre

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Demet Çanakçı:

Hello everyone. I'm Demet Çanakçı, a Senior Program Director at Toronto Centre. My guest today is Pedro Duarte Neves, and we are diving into a crucial topic - Financial Education and Literacy: Strengthening the Stability and Resilience of Financial Systems. We'll explore why financial literacy matters, its impact on financial stability, and what can be done to improve it at all levels, from individuals to policymakers and supervisors.

Pedro is Advisor for the Board of Directors of Banco de Portugal and has chaired many EU committees on consumer protection and financial innovation in the scope of the European Banking Authority and the Joint Committee of the European Supervisory Authorities. Pedro is Professor of Economics at Católica Lisbon Business and Economics, Associate at the Systemic Risk Centre (at London School of Economics), Affiliated Fellow with the Qatar Centre for Global Banking and Finance (King's College London), and a member of the Advisory Board of the European Banking Institute. He has extensive experience operating internationally in the main high-level supervisory and regulatory fora. He was the elected Alternate Chairperson of the European Banking Authority for five years. Pedro served as Vice-Governor of Banco de Portugal from June 2006 to September 2017. Throughout this 11-year period, he was successively in charge of prudential and market conduct supervision, resolution, economic research, statistics, macroprudential supervision, and legal services. Pedro, thank you for taking the time to talk with us today.

Pedro Duarte Neves:

Thanks to you, Demet, and to the Toronto Centre for having me here. It's really a privilege to be exchanging views with you on financial literacy and to discuss how it is so relevant for financial

stability. Just before progressing, let me make the usual disclaimer that the views and opinions expressed are mine and do not necessarily reflect those of Banco de Portugal or the Eurosystem. Thanks Demet.

Demet Çanakçı:

Alright, Pedro, let's start with the basics. Why does financial literacy matter so much for the stability of financial systems? It's something we hear about a lot, but what is the real impact when people don't have it?

Pedro Duarte Neves:

Maybe we should start by recalling the OECD definition of financial literacy, which is "a combination of financial awareness, knowledge, skill, attitude, and behavior necessary to make sound financial decisions and ultimately achieve individual financial wellbeing". What is the real impact of that? It is that citizens make more informed decisions that better match their risk profiles. Examples are managing the family budget, taking the best saving decisions, planning for retirement, using credit in a responsible way, avoiding excessive indebtedness levels, protecting themselves from fraud, and so on.

> Higher financial literacy strengthens the resilience of the financial system, contributing to macroeconomic and financial stability. Moreover, financial stability and financial inclusion are essential for strengthening social capital.
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There are four fundamental concepts that are essential for adequate financial decisions. Basic numeracy, understanding inflation, understanding interest compounding, and risk diversification. The empirical research — and here I would like to draw your attention to research, for instance, by Annamaria Lusardi and colleagues — Financial literacy differs markedly across the population by gender, by educational level, by age, and by ethnicity. It also differs between advanced economies and emerging economies.

Why is it so important? Higher financial literacy strengthens the resilience of the financial system, contributing to macroeconomic and financial stability. Moreover, financial stability and financial inclusion are essential for strengthening social capital. Let me just conclude by recalling that there are financial competence frameworks, — like the ones developed, for instance, by the OECD or the European Commission —, which identify the financial knowledge, attitudes, and behaviors that support informed decisions.

Demet Çanakçı:

Thank you, Pedro. We have seen how financial crises can shake economies and often individuals are caught off guard. Do you think a higher level of literacy could have changed the course of past crises like the 2008 Financial Crisis? What role did financial knowledge, or lack of it, play?

Pedro Duarte Neves:

Well, before the Great Financial Crisis (GFC), there was an extremely limited focus in both conduct supervision and financial literacy. I would say that in many advanced economies, there was no specific authority in charge of those. For instance, in what concern financial inclusion, which is a related topic, the financial access survey of the IMF was launched in 2009 and the Global FinTech Survey by the World Bank in 2011.

Answering to your question, a stronger financial knowledge could have avoided, for instance, investments in risky financial products, in many times, they were perceived as similar to deposits when they weren't; or they could have avoided unsustainable levels of indebtedness by both household and firms; or could have encouraged higher precautionary savings to deal with difficult times, I mean unemployment, for instance.

Development of conduct supervision and financial literacy took off only some 15 years ago. For instance, national financial literacy surveys, which were extremely rare before the GFC, started to be launched on a regular basis by then, and the same with the creation of national authorities in charge of conduct supervision. It's very important at this stage to make clear that conduct supervision involves regulation, then supervision, and enforcement. So, all of this which corresponds to conduct supervision works on the supply side, that is the financial institutions. Whereas financial literacy works on the demand side - that is the clients of financial services. As such, conduct supervision and financial literacy are complementary, they are both essentially for reinforcing trust and efficiency in the functioning of financial markets.

Demet Çanakçı:

As you just mentioned, financial literacy initiatives started some 15 years ago, where are we today in terms of financial literacy and what is the current situation in advance and in emerging economies?

Pedro Duarte Neves:

Thanks, Demet, for asking that. I will start with some evidence from OECD reports. So, one of those reports released in June of last year concludes that levels of financial literacy of 15-year-old students in OECD economies remained too low, so let's start with the youngsters. Nearly one fifth of students did not achieve baseline proficiency levels in financial literacy. They find it difficult, for instance, to calculate percentages. Around two thirds of the youngsters were not confident when reading bank statements, and only one 10th of 15-year-old students could understand properly the difference in types of investments. This is, of course, worrisome, as more than two thirds of students use, on a regular basis, financial products and services.

Adults, unfortunately, do not perform better. OECD surveys conclude that only one third of adults reach minimum standards on financial literacy. Only two thirds can apply the concept of time value of money to their own savings. One sixth of them have been a victim of financial

fraud, and for all types of agents, risk diversification is the most difficult concept to understand.

Financial inclusion is also externally important. It means that individuals and businesses have access to, and effectively use, affordable financial services that meet their needs. Just to understand the relevance of financial inclusion, the United Nations defines 17 Sustainable Development Goals, and state that financial inclusion is a catalyst for achieving seven of them: Reducing Poverty and Equality, Supporting Employment and Economic Growth, Promoting Gender Equality, just to mention some of them. So, at a more global level, recent 2023 studies by the World Bank, using data from the Global Findex 2021 survey, concluded that around 1.4 billion adults are unbanked. That means that they do not have a financial account. This unfortunately corresponds to almost one quarter of adults on the planet, and this proportion is even higher for subgroups, I mean for women, for poor adults, for rural adults. The survey identifies the main barriers as being lack of money, too expensive, "family has one", and lack of trust, and understanding this is really very important for design of targeted financial education alternatives.

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Demet Çanakçı:

Thank you very much, Pedro. A lot of organizations invest in financial literacy programs, but how do we know if they actually work? Is there a way to measure whether financial education leads to real behavioral change?

Pedro Duarte Neves:

Well, let me just start by saying that there are complementary financial literacy initiatives that, by the way, should coexist, and I'll mention three: inancial literacy surveys, which basically responds to the question "where we are", definition of national competence frameworks, which corresponds to the answer to the question "where we would like to be," and national plans for financial education, "what are we going to do to achieve the competence levels that we want"

So, trying to answer your question of the assessment — how to assess — I will identify the following steps. It is necessary to monitor and to measure financial literacy and financial knowledge indicators. Then, to set concrete financial literacy targets. Then, to develop the necessary initiatives focused on the main insufficiencies identified in literacy service, and then to assess, ex-post, if the objectives were achieved or not at the national level through regular literacy surveys, which means to assess if financial literacy indicators have improved and how they have improved. On a more technical tone, the effectiveness of financial education initiatives should be assessed as well by adequate statistical procedures— namely by

randomized experiments—identifying how vulnerable populations benefit from those initiatives. And of course, finally, it's very important to benchmark national position through international rankings.

In what concerns the cooperation between authorities, it's really essential to exchange experience on financial literacy initiatives. In Europe, for instance, the European Supervisory Authorities — the financial supervisors — release and make public repository on national initiatives on financial education and good practices identified, and it is of course also essential that financial supervisors share their literacy initiatives on a continuous basis and assess the benefits and costs of them.

Demet Çanakçı:

Perhaps a follow up question on that. What is the role of national financial literacy plans? How should they be developed and implemented to achieve effectiveness?

Pedro Duarte Neves:

Thanks Demet. As you just mentioned, national plans for financial education play an essential role as they set out the general principles and actions to address the most relevant vulnerabilities. So, on general principles, first, national plans should be developed in full cooperation between governments, financial regulators, consumers, and financial firms' association, then eventually more relevant stakeholders.

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Second, national plans should address, in a comprehensive way, all the segments of the financial market, this is really very important. Banking, investment funds, insurance companies, and pension funds, as well, as possible, unregulated financial services like crypto assets, and activities like social media channels and the role of influencers. Media and awareness raising campaigns are essential in national plans, which in the more recent past, have been focused more and more on digitalization. Just the final reference here, the OECD recommendations on financial literacy, released some four or five years ago, constitute possibly the most relevant global set of recommendations to design, implement, and evaluate financial literacy programs.

Demet Çanakçı:

Thank you, Pedro. We often talk about financial literacy in broad terms, but it's not a one-size-fits-all issue. For example, women and low-income communities face unique challenges. In your experience, what is the most effective way to tailor financial education for these groups?

Pedro Duarte Neves:

Yeah, that's clearly the main message on financial literacy initiatives: one size does not fit all. I could probably identify three key aspects when tailoring financial education. So first, we need to identify the most vulnerable segments. That could be youngsters, financially illiterate adults, senior citizens, the digitally illiterate, unemployed, minorities —migrants, for instance — digitally illiterate citizens in general. To identify these segments is very important to conduct national financial surveys and benchmark them at an international level.

Then, when addressing these vulnerabilities, it's necessary to identify target groups. That could be schools, adults, business, the overall population, whatever. Initiatives are mostly at school, but they could also be at workplaces and other places. A tailored approach — as one size does not fit all, as you mentioned — a tailored approach requires fine-tuned choice on aspects like the following: selection of strategic partners, identification of stakeholders to participate in financial literacy initiatives, definition of core competencies to achieve, how to train the trainers, and the selection of the support materials. All these aspects that I've just mentioned too should be defined, having in mind a target group.

> There are, as you said, fast expanding trends in the financial sector are the increasing use of artificial intelligence, cross-border payments, and the role of social media channels and influencers. This comes in parallel with the risks of scams, fraud, and heavy losses in financial instruments that are not understood by clients.
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Demet Çanakçı:

Thank you, Pedro. Technology is making finance more accessible but also more complex. Just think about crypto, digital payments and all these FinTech apps. Do you think digital finance is making people more financially literate, or is it actually making things more confusing?

Pedro Duarte Neves:

Well, that's a very good point. There are, as you said, fast expanding trends in the financial sector as the increasing use of artificial intelligence, cross-border payments, and the role of social media channels and influencers. This comes in parallel with the risks of scams, fraud, and heavy losses in financial instruments that are not understood by clients. Financial literacy campaigns should adapt swiftly to these emerging trends. It is necessary, first, to monitor these market developments — a continuous and real-time monitoring — and then to adapt communication tools to the age of social media. Once again, one size does not fit all. Young people, say 18 to 30 years old, tend to use more frequently digital channels as they tend to be more digitally literate. However, most of the surveys show that they have relevant insufficiencies in what concerns financial literacy, which of course is different than digital literacy. So, for them, there is a risk of overconfidence resulting in suboptimal financial decisions in additional to vulnerabilities to online fraud.

The focus probably should be on ensuring that these citizens are well informed and aware of the

possible impacts of their decisions and not on discouraging their participation in the financial market. Digitalization brings also the risk of digital exclusion for seniors, poverty groups, migrants, and this should be actively fought by public authorities.

For seniors, for instance, it is important to encourage home online access, relying on family support. For other groups, poverty groups and migrants — I mean for them, it is very important, the issue of digital remittance for migrants — for those groups, more traditional materials like leaflets could be more effective. To benefit from synergies could be relevant for minority groups, to involve additional partners as municipalities, nonprofit organizations, and universities in financial literacy initiatives.

Sorry for taking so long to answer this question, but I'd like to draw your attention to a thematic report released by the European Supervisory Authorities in January 2023, that identified a set of good practices on national financial education initiatives on digitalization, (at that time with a focus on cybersecurity scams and frauds); and I'll mention some of them: provide warnings about scams and frauds in an accessible and timely matter, to foster the inclusion of tech-adverse parts of the population by strengthening their digital skills, work closely with teachers to understand their specific educational needs, to include, where appropriate, fun and entertaining elements in the financial education campaigns, and to achieve good searchability of the initiative's websites, so that it comes up as one of the first search results in a search engine.

Demet Çanakçı:

Thank you. Thank you, Pedro. This is actually very relevant to my next question. What about financial supervisors with markets evolving rapidly and artificial intelligence, FinTech, and digital assets - are supervisors themselves well equipped to participate and contribute effectively to financial literacy campaigns? How can they ensure they're making informed decisions when supervising complex financial systems?

> It is necessary to bring the experience and knowledge of data scientists, behavioral economists, communication experts, and psychologists. This very broad range of perspectives and skills is necessary for strengthening supervision, but also for the effectiveness of financial literacy initiatives.
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> Banco de Portugal

Pedro Duarte Neves:

Yeah, thanks Demet. That's really an extremely relevant aspect. Having in mind all the emerging trends that we have discussed, the first key aspect is identification of required skills for effective conduct, supervision, and promotion of financial literacy. What I would say is that — in addition to the most common profiles of lawyers and economists — it is necessary to bring the experience and knowledge of data scientists, behavioral economists, communication experts, and psychologists. This very broad range of perspectives and skills is necessary for strengthening supervision, but also for the effectiveness of financial literacy initiatives. Efficient teams require all these skills.

Old-fashioned supervision, I mean, old-fashioned conduct supervision will not deal properly with these new technological trends because it should develop additional capacities like artificial intelligence, tools for supervisory monitoring and automation of routine activities, real-time identification of consumer sentiment, more generally, randomized controlled trials, focus groups, service and use of behavioral economics are very useful for policymaking supervision, and for design of financial literacy initiatives. If NCAs [National Competent Authorities] should develop these techniques in-house or outsource them to external elections, that's debatable. But what is really important is that all of these tools should be available for financial authorities. And once again, on the specific topic of behavioral economics, I'd like to draw your attention to a report released one year ago by the Joint Committee of European Supervisory Authorities on how supervisors are using and could use behavioral economics in their day-to-day activities.

Demet Çanakçı:

Thank you, Pedro. Let's wrap up with something practical. If you could give just one piece of advice for authorities to promote financial literacy, what would it be?

Pedro Duarte Neves:

Well, that's not an easy question, but to my mind, there are two main messages. So first, I would suggest to the authorities to seriously consider mandatory financial education at schools; by authorities, I mean governments, this time. This would create equal opportunities across the population in what concerns reaching adequate standards of financial literacy. This is very important from a social point of view, as financial literacy differs markedly across the population, and this contributes to both income and wealth inequality. For instance, in Europe, the Council of the European Union recently, just one year ago encouraged the member states to consider integrating financial education into the school curriculum.

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Secondly, I'll possibly recommend an enhanced role in the assessment of financial literacy performance on the examinations of robustness and resilience of countries' financial sectors. I'm speaking about exercises like the IMF's FSAPs, for instance. This could contribute to recognition of the relevance of financial literacy for the preservation of financial stability.

So these are my two suggestions, and just to conclude, let me say that the financial reforms over the last 15 years, I mean they were substantial and successful, they have been decisive to rebuild social capital by restoring trust in market mechanisms and institutions. The promotion of financial literacy and financial inclusion is essential for achieving more effective and fairer economic outcomes.

Demet Çanakçı:

This has been a fascinating conversation. I learned a lot and many thanks for your time, Pedro. Much appreciated.

Pedro Duarte Neves:

Many thanks to you, Demet and to Toronto Centre. I enjoyed very much exchanging views with you. Thank you very much.

Demet Çanakçı:

I'm here today with Pedro Duarte Neves. Thank you for joining us today. Stay tuned for the next episodes.