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FINANCIAL LITERACY IN THE CONTEXTS OF THREATS RELATED TO SHADOW BANKING SYSTEM

Introduction

Global shadow banking system grew rapidly before the crisis, rising from \$26 trillion in 2002 to \$62 trillion in 2007. This amount declined slightly in 2008 but increased subsequently to reach \$67 trillion in 2011. The shadow banking system share in total financial system has remained at the same level – around 25% – in the years 2009-2011 (reaching at 27% in 2007) and constituted the half of banking system assets[1].

Growing importance of shadow banking system results from perceiving it as source of fast and easy credit. However, it can bring many benefits but constitute also the significant threat for stability and safety of global financial system. These risks can emerge as threats of financial, social and market nature. Materialization of these risks can endanger financial customers safety especially in conditions of low level of financial literacy in the society. The events on financial markets show that abusing and deceptive practices in connection with financial illiteracy and weak customer protection can lead in some cases to severe financial turbulences. Taking into account potential danger connected with shadow banking sector for individuals, society and the whole economy, the aim of the article is to identify the threats connected with the activity of shadow banking institutions in Poland and to present financial literacy as the way of mitigating some of these risks.

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1 FSB, *Global Shadow Banking Monitoring Report 2012*. 18.11.2012, p. 3.

1. The nature and the role of shadow banking

The shadow banking term has been used for the first time by an economist Paul McCulley in 2007 in his speech at the annual financial symposium hosted by the Kansas City Federal Reserve Bank in Jackson Hole, Wyoming, relating mainly to nonbank financial institutions which perform operations connected with maturity transformation[2].

The understanding of this term was extended in the Financial Stability Board (FSB) Report, where it was defined as "the system of credit intermediation that involves entities and activities outside the regular banking system"[3]. According to this definition, apart from maturity transformation, entities operating outside the regular banking system are engaged in one of the following activities:
- accepting funding with deposit-like characteristics,
- performing liquidity transformation,
- undergoing credit risk transfer,
- using direct or indirect financial leverage.

In accordance with FSB interpretation the term "entities and activities outside regular banking system" implies focusing on credit intermediation that takes place in an environment where prudential regulatory standards and supervisory oversight are either not applied or are applied to a materially lesser or different degree than is the case for regular banks engaged in similar activities[4].

The FSB definition reflects the broad approach to this problem and constitutes the trial of supranational attitude which allows to emphasize its universal character going beyond the specificity of domestic financial systems.

In Green Paper document[5] European Commission is focusing its analysis of shadow banking phenomenon on the following types of entities:

1. Special Purpose Entities which perform liquidity and/or maturity transformation, e.g. securitization vehicles such as Special Investment Vehicles and other Special Purpose Vehicles.

2. Money Market Funds and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("runs").

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[2] L.E. Kodres: *What Is Shadow Banking?* „Finance & Development" 2013, Vol. 50, No. 2.
[3] FSB, *Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board*. 27.10.2011, p. 3.
[4] FSB, *Shadow Banking...,* op. cit., p. 3.
[5] European Commission, *Green Paper. Shadow Banking*, Brussels, 19.3.2012, COM(2012) 102 final, p. 4.

3. Investment funds, including Exchange Traded Funds, that provide credit or are leveraged.

4. Finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank.

5. Insurance and reinsurance undertakings which issue or guarantee credit products.

Such diversity of entities which belong to shadow banking system was not common for every European country, e.g. in Poland shadow banking system is created mainly by loan companies.

Significant increase of shadow banking share in financial system assets results from potential benefits which they create for market participants. First of all, shadow banking institutions meet the demand of both individuals and economic entities for an alternative source of financing and liquidity, offering credit in fast and easy way. What is more, as indicated in Green Paper, shadow banking institutions can channel resources towards specific needs more efficiently due to increased specialization. It is particularly important, when traditional banking or market channels become temporarily impaired[6]. Apart from meeting the demand for sources of financing, shadow banking system also provides investment products, becoming an alternative for investing money through the banking system thus creating the opportunity of risk diversification.

2. The idea financial literacy

The great significance of financial literacy and its crucial role in ensuring individuals financial well-being results in perceiving it as a key life skill. This grow of financial literacy importance derived from many phenomena, which have emerged and intensified in recent years:

- the risk shift from governments and employers to individuals,
- the increase of individual impact on the market and the economy,
- the increased supply of a wide range of more complex financial products and services,
- the necessity of use of financial products which requires extensive knowledge and proficient acquaint in this area in order to do right assessment of benefits and costs make an appropriate choice[7].

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[6] Ibid., p. 5.

[7] PISA, *PISA 2012 Financial Literacy Assessment Framework*, April 2012, p. 7-8.

According to European Commission "financial literacy refers to one's ability to be aware of financial risks and opportunities and to make informed decisions in their choices of financial services"[8]. Its crucial role for financial consumer is highlighted in the World Bank's Good Practices which indicate that financial education, information and guidance can help consumers to budget and manage their income, to save, invest and protect themselves against risks, and to avoid becoming victims of financial fraud and scams[9].

OECD understands financial literacy as a combination of awareness, knowledge, skill, attitude and behavior necessary to make sound financial decisions and ultimately achieve individual financial well-being[10].

Being financially literate can bring some benefits. The OECD research indicates that financially literate consumers make more informed decisions and are more likely to:
- save and plan for retirement,
- manage their money in an effective way – participate in the stock market and perform better on their portfolio choice, choosing mutual funds with lower fees,
- accumulate higher amounts of wealth,
- effective debt manage – opting for less costly mortgages and avoiding high interest payments and additional fees[11].

The specific objectives of the financial literacy include improved awareness, confidence, knowledge and understanding of consumers and investors on financial issues to making savvier financial decisions[12]. Owing to the fact that consumers become well-informed, they can use necessary abilities to financial planning and basing on it, make responsible choices allowing to protect themselves and their relatives against unforeseeable negative events and prevent from decreasing of life quality in the future. In consequence, behaviors of financially literate consumers affect more competitive, innovative and efficient financial market.

[8] Commission of the European Communities, *Communication from the Commission. Financial Education*, Brussels, 18.12.2007, Com(2007) 808 Final.
[9] World Bank, *Good Practices for Financial Consumer Protection, June 2012*. Washington 2012, p. 29.
[10] A. Atkinson, F. Messy: *Measuring Financial Literacy: Results of the OECD / International Network on Financial Education (INFE) Pilot Study*. OECD Working Papers on Finance, Insurance and Private Pensions, No. 15, OECD Publishing, 2012, p. 14.
[11] PISA: Op. cit., p. 8.
[12] OECD, *OECD/INFE High-Level Principles On National Strategies For Financial Education*, Paris, August 2012, p. 8.

3. Shadow banking in Poland – the role of financial literacy in limiting threats

The impulse to shadow banking system development was the enforcement of the T Recommendation in the banking system by the Polish central bank – National Bank of Poland (NBP) – on 23 of February 2010 This recommendation was establish as a rule of conducts concerning the process of granting credit for individuals, directed to the trustworthy examination of consumers creditworthiness. According to the Polish Financial Supervision Authority (KNF) assumptions this document has been created in order to improve the quality of credit risk management in banks. However, credit risk improvement goes along with sharpening the assessment of consumer's creditworthiness resulting in decreasing the consumer and mortgage credit availability. This situation affects the decisions of many bank clients about changing regulated banking system to unregulated and unsupervised shadow banking institutions.

In the light of the NBP Report on Financial System Stability (July 2012) the shadow banking sector in Poland embraces mainly loan institutions which offer the same or similar products like banks and act on the basis of Civil Law and Consumer Credit Act[13]. There can be distinguished two types of these firms:

- the institutions which provide loans using the own resources,
- the subjects which provide loans using the funds raised from consumers.

Relating to the first type of loan institutions the crucial threat for financial stability is created by the firms which offer products named as "payday loans" ("chwilówki"), aimed to individuals without creditworthiness.

According to Polish law the second type of loan institutions doesn't operate in conformity with the regulations. Article 5 of Banking Act indicates that "acceptance of deposits payable on demand or at a specified maturity and the operation of such deposit accounts" is the operation reserved for banks and credit unions only. This fact diversifies approaches to applying "parabank" term. Some definitions (e.g. proposed by The Ministry of Finance[14]) reflects the standpoint according to which only the institutions providing loans using the own resources can be named "parabank", but the common use of this expression is based, however, on a broad approach, including both kinds of loan institutions.

[13] Consumer Credit Act (Dz.U. 2011, nr 126, poz. 715).
[14] Ministry of Finance. www.mf.gov.pl (5.10.2013).

The entities, in respect of which there are some suspicions, that they perform banking activity without license, are placed on the list of public warnings published by Polish Financial Supervision Authority.

The activity of loan institutions is not recorded and supervised, which results in difficulties in precise indicating the size of this market in Poland. However, the analytics from Deloitte assess that the value of Polish market of loan institutions is about 2 billion zl, which constitutes 0,4% of banking system assets[15].

Consumers can come across many threats connected with using financial products offered by shadow banking institutions. There can be distinguished threats of financial, social and market nature.

First group of risks include risks for financial well-being of consumers. The main problem connected with shadow banking products is high costs of capital in case of credits and inflexible contract conditions in deposit-like products.

The main source of high credit cost is credit fees and commissions. Relatively low share of interest payment in an overall cost of credit results from statutory limit[16] according to which the maximum level of interest rate cannot exceed four times the Lombard rate published by National Bank of Poland. In the light of the report published by Office of Competition and Consumer Protection (UOKiK)[17] in majority of analyzing contracts, interest rates comprise in Civil Code limits but the other costs (fees and commissions) many times go beyond the amount of interest payment of credit.

Other kind of financial risk for consumers is a practice of many shadow banking institution of collecting high fee before granting credit (front-end fee) and not paying the amount of credit, which was explained by lack of clients creditworthiness or lack of possibility to offer required credit collateral.

The most important infringements within the financial risk of consumer interests indicated in UOKiK report are:

- presentation of weekly or monthly interest rate instead of annual interest rate, which results in consumer' misleading,
- lack of information in information formulary about the following credit costs: service in home (Euro Providus) or/and cost of insurance (Optima) or/and cost of interest rate (Provident).

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15 Deloitte. www.deloitte.com (5.10.2013).
16 Civil Code (Dz.U. 1964, nr 16, poz. 93).
17 UOKiK, *Opłaty stosowane przez instytucje parabankowe*. *Raport*. Warszawa, czerwiec 2013, p. 14.

A separate issue linked with consumer interests infringement is advertising policy of financial products. Report published by Office of Competition and Consumer Protection in May 2013[18] concerning the advertising policy of shadow banking institutions, indicates two main types of consumer interests' violation. First type is an active deceiving of consumer which can be perceived as active behavior of entrepreneur consisting in diffusing of false information or even true, but in a way which can result in false imagination about product features, while second one is passive deceiving of consumer which consists in abandoning of providing consumers information required by law.

Cited report indicates infringements in case of three-quarters of analyzing entities. The examples of such behaviors are:

– using information about offer's exceptionality (e.g. "the lowest interest rate on the market") without comparison analysis of the market,
– providing false information about credit conditions (e.g. "fast loan without additional costs"),
– providing information suggesting that shadow banking institutions act on the basis of Banking Law[19], which can lead to the wrong belief that they have bank status,
– providing incomplete information about credit costs.

The above mentioned unfair market practices, used by shadow banking institutions can distort market behaviors of consumers influencing on the process of their decision-making, exposing them to high, unnecessary costs.

The main kind of shadow banking clients are people, who have problems with gaining credit from bank, or are interested in fast receiving money. They are usually clients with low level of income, over-indebted or with illegal income source which constitutes the roots of social risk. Irresponsible lending, which can lead to debt spiral, resulting in worsening of the quality of life, which in turn may cause social exclusion.

The main areas of market risks are as follows:

– financing activities shadow banking entities by deposit-like, short-term funding may lead to "runs",
– build-up of high, hidden leverage can increase the fragility of the financial sector and be a source of a systemic risk,
– shadow banking system gives the opportunity to circumvention of rules and regulatory arbitrage,

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[18] UOKiK, *Reklama parabanków. Raport z kontroli reklam pozabankowych instytucji finansowych oferujących pożyczki konsumentom*. Poznań, maj 2013.

[19] Banking Law (Dz.U. 2012, poz. 1376).

- connections between banks and shadow banking institutions make the regular banking system vulnerable to contagion risk and spill-over effects,
- granting credits to clients with illegal source of income supports shadow economy[20].

The occurrence of identified threats is the more dangerous, the lower the level of financial literacy is within the population. In polish society, financial literacy is dissatisfying. According to research conducted by TNS Poland for Office of Competition and Consumer Protection[21], the Polish population's level of knowledge about shadow banking is low. In the light of conducted survey, 54% of respondents were not be able to answer the question "what is parabank?" (Polish loan institution which represents shadow banking system). One for ten, incorrectly believes that it is a bank, which grants credits in an easy and fast way, while one for thirteen, claims that it is an institution supervised by supervision authority, which grants loans and accepts deposits.

The policy of financial literacy strengthening can mitigate the financial threats occurring in shadow banking system and thereby reduce also the social risks. Relating to market threats, this strategy has limited usage because limiting this risk would require enhancing regulation and implementing financial supervision.

Referring to financial and social risks it could be noted that, creating financially literate consumers requires developing their knowledge, skills and understanding, referring to financial products and services. It gives them an opportunity to better understand their rights and responsibilities, and assess the real benefits and costs connected with a given offer. Well-informed consumer is able to analyze and compare the financial and non-financial contract conditions and choose the offer that best meets their preferences.

In order to appropriate evaluation of information presented in products offer, clients should be aware of unfair practices applied by institution of shadow banking sector. This knowledge lets them understand the importance of threats linked with shadow banking system and becoming aware of the advantage of regular banking system (e.g. existence of deposit insurance system, provided by Bank Guarantee Fund – BFG). Well-educated and aware consumer realizes where to find the important information and gain help or advice. It should be underlined that being financially literate allows individuals to understand the negative consequences arising from using products offered by shadow banking institutions.

[20] European Commission: Op. cit., p. 5-6.
[21] Raport TNS Polska dla UOKiK, *Konsument na rynku usług finansowych*. TNS 2012.

Conclusions

The largely unregulated nature of the sector brings with risks, that are not present or are regulated in the regulated financials sector[22], so the financial literacy is extremely essential for consumers financial well-being. The activities directed to improving the financial consumers' awareness should constitute the element, not a separated operation, in the strategy of their financial safety strengthening.

Recognizing the scale of potential threats connected with shadow banking system in Poland, several institutions (NBP, KNF, UOKiK, BFG) within its competences undertake educational activity directed to increasing financial literacy of Polish society. One should pay a particular attention to inter-institutional initiative called "Before you sign", which aims at increasing consumer's awareness connected with loan and deposit products, especially the ones offered by financial institutions, excluded from financial supervision. This social information campaign involves radio and television programs as well as special website (www.zanim-podpiszesz.pl), where consumers can learn what they should know and check before signing the agreement.

The latest initiative oriented toward the goal of improving the consumer protection is the project of amendment to Act on Financial Market Supervision, which was presented to the President for approval on 25 October 2013. The project puts emphasis on the educating, informing and warning of financial consumers with respect to risks connected with functioning of financial market and its participants. The proposed crucial changes include among other things:
– the expanding the scope of educational and informational actions throughout indicating financial market functioning, its threats as well as entities existing on it as the essential element to protect justified interests of financial market participants,
– the necessity of providing the information on being under financial supervision authority,
– the free publishing of warnings in the mass media.

The financial literacy is now universally recognized as an important part of economic and financial stability and development, which is reflected in the recent G20 endorsement of the OECD/INFE High-level Principles on National Strategies for Financial Education[23], in order to develop efficient national strategies for increasing financial awareness.

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[22] Freshfields Bruckhaus Deringer, *Bank of the Future. EU Green Paper on Shadow Banking: March 2012*, p. 2.

[23] OECD, *OECD/INFE High-Level Principles On National Strategies For Financial Education*. Paris, August 2012.

Improved consumer protection and financial literacy cannot be a "magic bullet" to solve all problems in consumer finance but they can identify preventive measures to help to avoid some of the worst financial consumer abuses[24].

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[24] S.L. Rutledge: *Consumer Protection and Financial Literacy. Lessons from Nine Country Studies*. Policy Research Working Paper 5326, World Bank, 2010, p. 8.

ŚWIADOMOŚĆ FINANSOWA W KONTEKŚCIE ZAGROŻEŃ ZWIĄZANYCH Z RÓWNOLEGŁYM SYSTEMEM BANKOWYM

Streszczenie

Shadow banking może dostarczać wielu korzyści, jednak stanowi również poważne zagrożenie dla globalnego systemu finansowego. W obliczu rosnącego znaczenia bankowości równoległej, celem artykułu stała się identyfikacja zagrożeń związanych z działalnością tego sektora w Polsce oraz ukazanie świadomości finansowej jako sposobu ograniczania niektórych z tych ryzyk.