

Bank Management and Financial Literacy

Doc. Ing. Martin Svoboda, Ph.D., svoboda@econ.muni.cz, Masaryk University, Faculty of Economics and Administration, Department of Finance, Lipová 41 a, 602 00 Brno

Ing. Jan Krajíček, Ph.D., krajicek@econ.muni.cz, Masaryk University, Faculty of Economics and Administration, Department of Finance, Lipová 41 a, 602 00 Brno

Mgr. Bc. Bohuslava Doláková, 175975@mail.muni.cz, Masaryk University, Faculty of Economics and Administration, Department of Finance, Lipová 41 a, 602 00 Brno

Abstract

The paper focuses on the analysis of the relationship between the financial literacy and the risk management in banks. To increase the financial literacy is the interest not only for government organizations, notably the Ministry of Finance and the Ministry of Labor and Social Affairs, but also for banks. Increasing of the financial literacy will be reflected in improving of the portfolio on the one hand and on the other hand there can be expected lower profit.

Key words

Financial Literacy, Management, Bank, Profit, Risk.

JEL Classification:

G23 – Non-bank Financial Institutions; Financial Instruments; Institutional Investors.

G21 – Banks; Depository Institutions; Micro Finance Institutions; Mortgages.

I21 – Analysis of Education.

I22 – Educational Finance.

1. Introduction

Question of the financial literacy in general becomes very frequent, both in commerce, media, as well as the academic field. Academics and government workers want financial literacy measure and analyze general population it wants to increase and traders of which want to make a profit.

The government sector works on detection the real level of financial literacy of the population of the Czech Republic. There were several series of projects that mapped the area, such as exclusive research of the Ministry of Finance and the Czech National Bank, which was done in 2010, and the results of government are based on the creation of his other projects. These projects are created in collaboration with commercial entities such as Citibank and Citi Foundation - which works with the Ministry of Finance in the new project "Increasing Financial Literacy of Socially Weak Citizens of the Czech Republic", focused on those most in need of financial education. Similar character of help have the projects specialized on children's homes (2010).

European Union puts strong emphasis on financial literacy. EU financially supports a large number of projects, especially projects of the European Social Fund or European Commission.

Commercial entities also seek the way to increase the financial literacy of the population. There are various courses which are free of charge and open to the public, but there can also be some hidden advertisement for specific financial products.

On the other hand, there are banks that take many risks in their business activities. The environment in which they operate is characterized by uncertainty. The main and most significant risk in the banking business is a credit risk. Generally, credit risk is the risk of loss of the bank if the other side fails to meet its obligations.

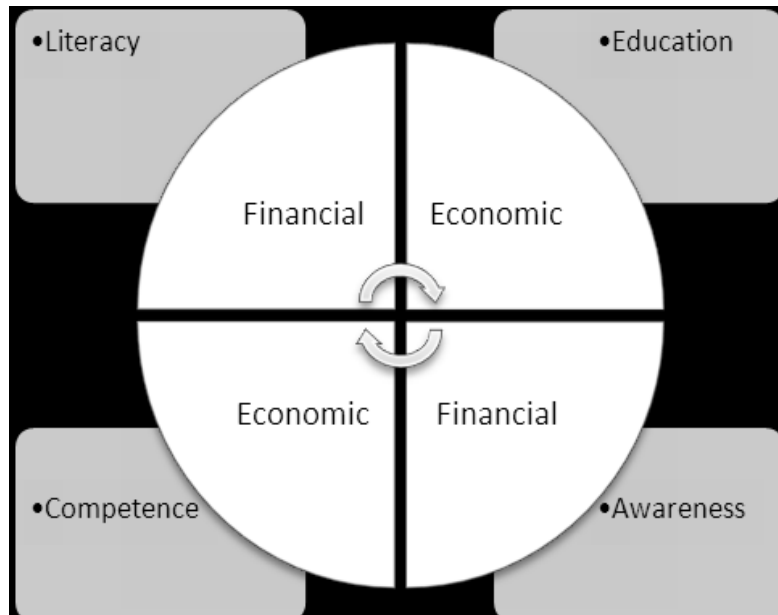
The aim of this paper is to analyze the impact of financial literacy on the banks.

2. Goal of the Financial Literacy

2.1 Financial Literacy

Financial Literacy (FG) is defined inconsistently, often, the individual subjects that are concerned with, they have different definitions. Also across the Anglo-American world is no uniform approach to the FL, the United States used the term "financial literacy," i.e. financial literacy (2009), while in the UK are more likely to encounter the phrase "financial capability", or rather financial competence (2005). Both terms are translated into Czech the same way, but their meaning is slightly different, the financial competence of financial literacy are closely linked, but cannot be used as interchangeable terms. Financial literacy refers in particular to the knowledge, financial skills refers rather to the ability of adequately usage of these acquired skills and knowledge. The concepts (including the previously mentioned financial literacy and competence) are interconnected, as it is evident in the Figure 1.

Figure 1: Interpenetration of the concepts related with Financial Literacy (2013)



Issues of the financial education and financial literacy in the Czech Republic are in the framework of consumer protection in the financial market. The Ministry of Finance began to deal with these issues and defined financial literacy in the "National Strategy for Financial Education" (2007, updated 2010), which became the central document for financial education in the Czech Republic. *"Financial literacy is a set of knowledge, skills and abilities that are necessary for the citizen to financially secure him/herself and his/her family in contemporary society and can be active in the market of financial products and services. Citizen financially*

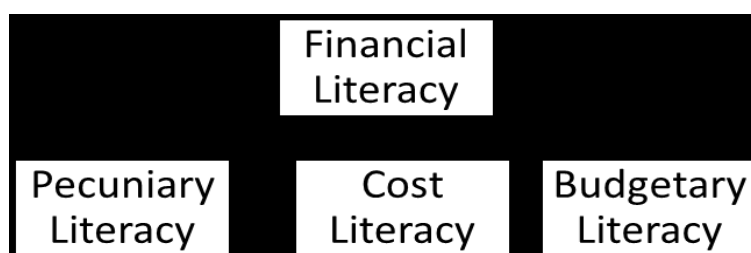
literate in the issue of money and prices is able to responsibly manage personal and family budget, including the management of financial assets and financial liabilities with respect to the changing situation." (2010)

As the main motto financial literacy Ministry states: *"Citizens are not financial experts, but they should be able to consider what is offered to them - the final solution is their responsibility."*

Financial Literacy Ministry structured into three components:

- Financial literacy,
- Cost literacy,
- Budgetary literacy.

Figure 2: The basic scheme of Financial Literacy (2013)



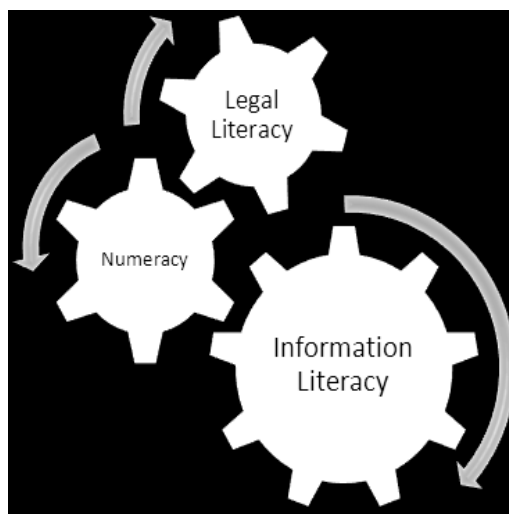
Where:

- *Pecuniary literacy skills are required to manage cash and non-cash money and transactions with them as well as management tools for this purpose (e.g. current account, payment instruments, etc.).*
- *Cost literacy skills are essential for understanding of the price mechanisms and inflation.*
- *Budget literacy skills are required to manage personal / family budget (e.g., the ability to manage a budget, set financial goals and make decisions about the allocation of financial resources), and includes the ability to manage different situations in life from a financial point of view. Budget literacy includes not only the above-described general components also two specialized components: the management of financial assets (e.g. deposits, investments and insurance) and the management of financial liabilities (such as credits or leases).*

An integral part of the financial literacy is the macroeconomic policy, i.e. focusing on the fundamental relationships between different sectors of the economy along with understanding of the basic macroeconomic indicators (such as inflation, GDP and interest rates). Necessary are also a basic awareness of the tax system and the role of taxation in society, so the basic knowledge in the field of taxation.

The financial literacy is associated with the numeracy, which is the ability to obtain, use and interpret mathematical information and ideas in order to cope actively with the mathematical demands that the life of an adult present. It is the ability to handle numerical financial operations in the context of real life and work with numbers, graphs, tables, etc. Very important is also the information literacy - the ability to look, understand, use and evaluate relevant information in the context. Also important is the legal literacy - the orientation in the legal system knowledge of rights, obligations and opportunities. Complementarity of the three additional literacies is illustrated in the Figure 3.

Figure 3: Continuity of additional literacy (2013)



2.2 Manifestations of Financial Literacy

Modernization Theory (authors Blau, Duncan) argues that with advancing industrialization there is a declining influence of social origin on education. The main causes of this state are increasing educational opportunities and changes in principle of the allocation of education. Great attention sparked the "Theory of the Bell Curve", authored by Murray and Herrnstein. It lies in the fact that intelligence is not distributed evenly in the population and those ones who have more intelligence, become elites and stay in this position. (1994)

The Theory of Cultural Capital, designed by Pierre Bourdieu, argues that children from higher status groups have over others access to specific "cultural capital", which denotes familiarity and orientation in the dominant cultural codes and practices (such as a way of speaking, aesthetic preferences, modes of social interaction)(1998). This capital is positively sanctioned by majority of social institutions for the selection of individuals (school, employment system). In childhood, during early socialization, acquired cultural capital is a permanent advantage, which cannot be gain by those who did not keep it at the beginning of their educational careers. Children, who enter the educational process with cultural capital, are able to gain another one much faster and easier and there is created barrier between children from different social backgrounds. Early cultural socialization is thus the result of the accumulation of cultural capital. It thus contributes to intergenerational continuity status (reproduces it) legitimizes power and also gives it the appearance of meritocracy. These input differences are not really eliminated, but they are even more increased.

Similar recourse is in *The Theory of Educational Reproduction*, which assumes that educational inequalities remain stable over time, reproduced from generation to generation.(2011) A more radical approach to this theory, the term "maximally maintained inequality" (authors Raftery and Hout) working with the thesis that the privileged ones have the potential, through which they retain access to tertiary education. Only in the case of saturation of demand of these groups there are given opportunities for the groups with lower status. His analysis confirmed that the expansion of educational opportunities gives a better chance of learning for disadvantaged social groups.

Latest attempt to explain existing class inequalities of opportunity to achieve higher education is a *Theory of Rational Behavior* (authors Breen and Goldthorpe). It is based on "the concept of rationality" - social actors have goals and alternative means to achieve them. A selection from them is determined by the costs, risks and benefits of various options. The theory distinguishes between "primary" factors (skills, school performance) and "secondary" effects (operating phase branching education system). With the higher levels of education weakens the effect of the primary factors (performance selectivity decreases with each other transitions). Differences between classes to achieve increasingly ambitious goals remain.

3. Management of Bank Risk

The banking business has been and will remain an integral part of the overall business environment. This kind of business activity significantly affects the allocation of capital. For the banking business, in comparison to other business activities it is characteristic that the foundation of this business is the management of the property, which is owned by the bank. The banking business is able to significantly influence both business and the public sector. Core business of banks is accepting deposits and lending. Originally, the profits of banks consist mainly of those operations. At present, however, resources of the bank profits are much wider. The main sources are currently fees for bank transactions. The great advantage of banks is that the current payment system in a developed market economy is mostly noncash, conducting of charged bank transactions (2005).

Banks operate with funds received as primary deposits, and these resources are assigned to banks only temporarily. For this reason it is very important for the banks, when creating its assets (in this case, in particular credit, even if the bank debts may have originated from the guarantees, etc.) act the way that the quality of these assets is the greatest. The peculiarity of the banking business generated social demand for the control of risks associated with the asset quality of banks. This regulation is done by the special subjects, mostly by the central banks of each country. One can certainly argue that for common business subject is equally important that its receivables will be paid or not. From the point of view of any business entity without distinction it is obvious that the quality of receivables is important to the company's ability to continue to operate and develop the business. Non-bank entrepreneurs are willingly in business with a certain degree of risk. Therefore, if they enter into business relations, these relations must also calculate with the risk that counterparty fails to meet its obligations and the quality of the resulting contract will not be as the quality that was expected. On the other hand, the majority of bank customers entrusted their funds to banks rather than as part of their business activities, but mostly as a decision about the safe storage of excess funds. Sure, I can already hear the objections that anyone who decides to impose their available funds to the bank must base take into account also the business risk, because the funds are placed in a bank depositor according to the yield from the bank for temporary provision of free funds available offers. There are proceedings created for the safe operation of the bank sector and particularly for the regulation of the bad loans. These proceedings are significant to one side for the average client, who reduces the risk of loss of funds provided by the bank, and on the other hand, they have a direct impact on the management of the bank mainly due to the creation adjustments and provisions for receivables. In this regard, the bank is inconvenienced compared to conventional businesses, where making adjustments to receivables is not the subject to such strict regulations and thus directly affect the financial results of the subject, which does not mean that these bad debts do not cause problems, especially in the area of Cash Flow.

4. Inclusion Financial Literacy in Bank Risk

The goal must be to apprise the public with the mechanism of the bank management, especially their risks. However, it is imperative to realize that the loans do not provide only banks but also non-bank institutions (leasing and various non-banking companies providing loans - Home Credit, Cetelem, Provident Financial, etc.) and credit practices are very general and in particular individuals and even corporation loan, so their financial literacy to enable them proper access to loans is simply necessary.(2004)

The basis is the lending process, which can be decomposed into several successive operations:

- initial communication with the client and applying for a loan,
- interview with the client and collecting information from different areas,
- evaluation of the client and the credit application (credit analysis),
- determine the detailed conditions of the loan proposal,
- approval and signature of the loan agreement,
- drawing on the loan,
- tracking and monitoring of credit,
- the adoption of certain measures in case that the situation changed or problems were originated.

Loan process officially begins applying for a loan, which must precede the analysis of the client (regardless of whether they are natural or legal persons):

- need a loan,
- what is necessary loan amount,
- I am able to pay it off,
- what can I offer to the bank as collateral as it may require,
- what will follow if they cannot repay the loan.

The loan process will discuss the client with the bank's expectations and requirements of the loan, especially its amount, an idea of the amount of payment or the time of repayment, the purpose of the loan, the currency of the loan, etc.

For individuals there are especially basic personal information and other data about the household and employers.

For legal persons there is relevant information such as information about the company, the key persons in the company, etc. They are also required basic financial statements for the past several years. Bank checks and searches provided additional information from other sources. These sources can be internet, credit registers and other client information¹, credit ratings, previous experience with client banks themselves, or information from the media and from third parties.

After obtaining the necessary data and information the bank employee assesses the situation and determines the client's level of credibility and client's creditworthiness. This assessment is based on the bank assembled evaluation models containing both quantitative and qualitative criteria, which are the assessment of the employee. The output of the model is in most cases creditworthiness, determining the probability of default during the term of the contract. In addition, a bank employee assesses the application for a loan from the bank's viewpoint, its policies, and its credit limits, etc. The assessment may also contribute more bank employees that have a function to verify the accuracy of evaluation and assess of the client as objectively as possible. If the result is negative assessment, employee of the bank

¹ In particular, it is a business record, criminal record, bank and non-bank register client information CBCB - Czech Banking Credit Bureau (information about individuals citizens) LLCB - Leasing and Loan Credit Bureau), the Central Credit Register (data on legal persons and natural persons entrepreneur), etc.

rejects the loan application. In the case of a negative result due to the credit application bank employee may propose a change to the client credit application and start the whole process again.

If the process of client assessment is positive, the results of the credit proposal, subject to approval, which sets out all the necessary conditions:

- Information on the contracting parties,
- the type of loan product,
- the amount of the loan,
- price terms (interest and other charges),
- the method of disbursement.
- security and insurance,
- monitoring of credit,
- the amount and timing of payments,
- the procedure for the recovery of claims for the client in the event of default.

5. Conclusion and discussion

Financial literacy is the sum of pecuniary, cost and budget literacies. Their knowledge is reflected in the general public's knowledge and subsequently into an approach of the institutions providing loans and borrowings. Increasing financial literacy has the impact on the business of the institutions that provide them. With increasing financial literacy there can be expected the impact on the credit demands.

Reduction of applications for loans due to higher financial literacy of applicants will be reflected in the banks' balance sheets in two ways. On the one hand, there will be the decline in total loans and associated decrease in total assets and profits. On the other hand, there will be a decrease in provisions and write-off of bad debts and the associated increase in profit.

As a final result of the increase of the financial literacy, it can be expected the increase of the profit for banks - it is also one of the reasons that led the banks to focus on increasing of the financial literacy.

References

- [1] Atkinson, A., (2005) *Introducing financial capability skills - A pilot study with Fairbridge West, Bristol*, http://www.pfrc.bris.ac.uk/Reports/introducing_financial.pdf
- [2] Bourdieu, P., (1998). *Teorie jednání*. Vyd. 1. Praha: Karolinum, 1998, 179 s. ISBN 8071845183.
- [3] ČNB (2010) http://www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/spotrebitel/financni_gramotnost/mereni_fg_tk_20101213/financni_gramotnost_20101213_stemmark.pdf
- [4] Doláková, B., (2013) *Vzdělání a finanční gramotnost*. Brno, 2013, Bakalářská práce, Masarykova univerzita. Ekonomicko-správní fakulta, Katedra financí, Vedoucí disertační práce Ing. Jan Krajíček, Ph.D., 49 s.
- [5] Herrnstein, J., Murray, Ch., (1994). *The bell curve: intelligence and class structure in american life*. New York: Free Press Paperbacks Book, c1994, xxvi, 872 s. ISBN 0684824299.

- [6] Krajíček, J., (2005) *Struktura úvěrů a jejich význam*, Evropské finanční systémy. 1. vydání. Brno: Katedra financí, Ekonomicko-správní fakulta, Masarykova univerzita v Brně, 2005, ISBN 80-210-3753-9. od s. 109-112, 272 s. *Sborník z konference*
- [7] Krajíček, J., (2004) *Význam subjektivních kritérií při hodnocení kreditních rizik*. Řízení a modelování finančních rizik. Ostrava: Vysoká škola báňská – technická univerzita Ostrava, Ekonomická fakulta, katedra financí, 2004, ISBN 80-248-0618-05. od s. 199-204, 368 s. *Sborník z konference*
- [8] MFČR (2010)
http://www.mfcr.cz/cps/rde/xbcr/mfcr/Narodni_strategie_Financniho_vzdelavani_MF2010.pdf, str. 11
- [9] Roulet, M., (2009). *Financial Literacy and Low-Income Noncustodial Parents*. Center for Family Policy and Practice. June 2009. [cit. 2013-02-19]. Dostupné na WWW: http://www.cffpp.org/publications/Policy_finance.pdf
- [10] Simonová, N., (2011). *Vzdělanostní nerovnosti v české společnosti: vývoj od počátku 20. století do současnosti*. Vyd. 1. Praha: Sociologické nakladatelství (SLON), 2011, 179 s. ISBN 9788074190704.