Consumer Financial Services

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My lecture is titled ‘Consumer Financial Services’ and my hope in delivering it is that CUTS will be convinced to also include financial services as a significant part of their future work.

Ladies and Gentlemen, we are in the midst of yet another financial services scandal. The manipulation of the London Inter-Bank Offered Rate (LIBOR) has adversely impacted consumers in every country.

Tracy McDermott, who led the Investigation Team, stated that “what Barclays did was extremely serious. But Barclays were not involved in this on their own. And while they were certainly not the best of the bunch, there are other firms at a similar level of seriousness”. *The Guardian* newspaper pointed out that the scandal “goes to the culture and the structure of banks: the excessive compensation, the shoddy treatment of customers, the deceitful manipulation, a key interest rate and today, news of yet another…mis-selling scandal” (Pettifor, 2012).

The UK leaders, who regulate the banks which determine the Libor, have expressed their shock. Vince Cable, the UK Business Secretary said, “The industry is a massive cesspit” and Ken Clarke, UK Justice Secretary said that “Financial crime is easier to get away with in this country than practically any other sort of crime” (Pettifor, 2012).

In retrospect, it appears incredibly naïve that bankers were allowed to by themselves determine the rate that they will charge their customers and not foresee that they would fix the rate to their advantage. Fines have been imposed, but let us make no mistake; the fines will be passed on to consumers. The regulators who so grossly failed will not be called on to account for their failure. Even more devastating is that the root cause of the problem will remain unaddressed. Banks will be permitted to continue fixing the rate. There has been regulatory capture in financial services regulation. Unless this is addressed, the shock and dismay that has been caused by the Libor scandal will not result in any change for the better.

We need to impose on the financial services sector a model of co-regulation or embedded self-regulation that requires industry players to spread amongst themselves the risk incurred by the failure of their measures of self-regulation. Demarcating areas of self-regulation without sharing risk failure transfers the cost of such regulatory failure to consumers (Omarova, 2010).

My presentation will focus on consumer protection in the financial services sector. I shall first deal with the:

- economics of consumer financial services that permits the providers of the services to treat individual consumers with disdain;
- lack of coherence in consumer financial services regulation; and
- misguided tendency to present financial literacy as a substitute for regulation.

With these as the backdrop, I shall argue that we need to adopt a consumer focus in financial services regulation. We can only do this if we go back to the basics and begin by recognising the:

- purposes for which consumers actually access the financial services sector; and the
- problems faced by different categories of consumers in their relations with the financial services sector.

In my conclusion, entitled 'The Way Forward', I will call for a change in the regulatory architecture for consumer financial services.

Economics of Consumer Financial Markets

Collectively, consumers are by far the greater users of financial services. However, the atomised nature of their individual transactions circumscribes their power.

Campbell, *et al* (2010) provide US data for 2009 - US households held US$68.2tn in assets and US$14.0tn in liabilities (mostly mortgage – US$10.3tn and consumer credit US$2.5tn). By comparison, the corporate debt in the US was only US$7.2tn. However, this very high level of consumer liabilities involved a staggering number of transactions.

Visa and MasterCard had a combined annual transaction volume of US$6tn comprised of 70 billion transactions. The Mutual Fund industry assets exceeded US$10tn, but the median investor has US$100,000 spread over four accounts. The pattern of participation of consumers in the financial markets of other countries is not unlikely to be markedly different. The atomized nature of consumer transactions means that the individual consumer is by herself insignificant to her financial service provider. It is not surprising that financial services top the list of consumer complaints in almost all countries (Collins, 2012).

Incoherent Consumer Financial Services Regulation

Consumer finance regulation in many countries is characterised by a lack of a coherent policy and institutional structure. There is an emphasis on classification by form, lack of distinction between consumer and commercial transactions, excessive technicalities, unregulated consumer products, and the absence of a coherent policy for sanctions.

Few countries regulate consumer financial services in a comprehensive manner. The regulatory schemes tend to focus on the provider of services (institution type) and/or the principal category of the services provided – banking, finance, insurance, etc. Even in the area of credit regulation, the focus may be on the type of product provided – money lending, pawn broking, hire purchase, credit cards, etc. Also, not all financial services (for instance, in the credit industry) are subject to regulation. The regulation that exists is spread across a range of statutes in a piecemeal fashion, each often stipulating very different rights and duties.

Financial services statutes may permit the regulator to control the conduct of service providers through the issue of regulations, directives or guidelines. Such powers are often not exercised, and where they are, a great variation in the nature and extent of the regulation occur. Exemptions from even the very limited regulatory control specified in statutes and other forms of regulatory control are the norm in many jurisdictions. Where this is the case, the regulatory framework tends to be complex and disorderly and by their piecemeal approach, fail to adequately provide for many categories of consumer finance.

Credit can be and is a boon to individual consumers and their families. It enables consumers to avail themselves of goods and services without first having to save for the purchases. It permits a higher standard of living than consumers can immediately pay for. Consumer credit is central to the welfare of individuals and families, and it has been argued that access to it should be made a human right (Yunus, 2006). Credit can also be a bane to many individuals and families. Individuals are often lured into excessive credit and costly debt with dire consequences for the borrower and his family. The need to save prior to purchasing a product calls for a deferment of gratification; easy credit tempts consumers into impulse gratification.

There is ample evidence that consumers are subject to unfair credit related practices. Time prohibits an examination of the practices in a variety of credit forms. Let me just focus on the credit card industry and for this I shall rely on the landmark cross-national study entitled ‘Charging Ahead’ by Ronald Mann (2010). It details the manner in which credit cards (as opposed to debit cards) have been promoted. Mann describes the “spending more, borrowing more and failing more” of credit card use and evidences a marked correlation between credit card debt and consumer bankruptcy filings. The “sweatbox” model of credit card lending has become a dominant strategy for the large debt-holding card issuers – the trick is to make borrowers pay minimum payments for long periods before defaulting. There has to regulation of the terms on which credit cards are marketed. Larger mandatory minimum payments to amortise credit card balances have to be required and there has to be a ban on marketing and issue of credit cards to youth and college students.

Financial Information, Education, Literacy and Capability

Greater financial education and information to engender consumer literacy and capability has been given much lip service as part of the ‘liberalisation’ of financial services. Financial education has to be seen as complementary to regulation for consumer protection; certainly not as a substitute for such regulation.

It is important not to confuse ‘information’ for ‘education’ - education is to develop the capacity to process the information provided and cannot be achieved by simply increasing the amount of information. Financial services regulators have to ensure that disguised product marketing that exacerbates the behavioural biases of consumers is not passed off as financial education. There also needs to be recognition that many new financial products cannot be understood by consumers even with financial education.

Adopting a Consumer Focus

Regulation of consumer financial services needs a consumer focus. And for this, it is necessary to go back to basics and understand the use of financial services by consumers. Consumers use financial services to perform five very different functions (adapted from Campbell, *et al*, 2010; Tufano, 2009):

- *Payment:* as a mechanism for the transfer of money and payment for goods and services. For this they use cash, cheques, payment cards, postal and money orders, wire transfers, remittances, online fund transfer tools like PayPal, Automated Clearing House, etc.
- *Borrowing:* as a means to use future funds now. This includes credit that is secured and unsecured - credit cards, overdrafts, payday loans, student loans, auto loans, mortgage loans, margin loans, and pawn broking. It is now common for implicit borrowing to be built into various derivative products, including options and forwards, as well as through commercial structures, (for example, hire purchase).
- *Saving:* as a means to store funds for future use. Saving accounts, fixed deposits, variable annuities and provident funds are the usual means used by consumers for this purpose.
- *Investment:* as a means to increase future funds. At first it was mutual funds of ever increasing variety. Of late, a plethora of investment products have been offered by financial institutions, such as Initial Public Offerings, government bonds, gold and silver, futures and options and derivatives.
- *Management of Risk:* to mitigate financial risks, principally by way of insurance, but also other financial products (for example, put options to protect portfolio declines).

Financial services providers tend to package their offer to consumers such as to draw them away from savings into investments without adequately revealing the cost of their borrowing or the risks involved in their investments. They take every opportunity to convert what is in savings into risky investments with heavy upfront charges and transfer all risks to the consumer with none borne by the financial institution. There has been a range of new products, which claim to perform a mix of the above mentioned five functions that consumers seek from financial service providers. The products offered are mislabelled such as to confuse consumers. Regulation has failed to keep pace with the changes that have occurred in the interaction between financial service providers and consumers.

Consumer Status *vis-a-vis* Financial Services

Much of the popular and even academic literature relating to consumer use of financial services tends to not deal with all categories of consumers *vis-à-vis* financial services. There are actually four categories of consumers in relation to financial services. The four categories are those:

1. Not included

2. Typical users of services

3. Financially distressed users of services

4. Excluded (those declared bankrupt)

I shall here focus on categories 1 and 4 because they are not traditionally emphasised in discussions of consumer protection in financial services.

Financial Services Inclusion

Half of the world's consumers do not have access to any formal financial services (Demirguc-Kunt, *et al*, 2012). As is to be expected, the deficit occurs in the developing world with a particularly emphasised gender bias. The data for the use of formal accounts is indicative. Fifty per cent of the world's adults (2.5 billion) do not have a formal account. In the higher income economies 89 per cent have an account compared to only 41 per cent in the developing economies. Whilst 46 per cent of men have formal accounts, only 37 per cent of women do. However, there is a consistent 6-9 per cent gender gap in all economies.

Similar patterns are to be noted for use of electronic transactions (ATM, debit cards, cheques and electronic payments).

It is, therefore, not surprising that formal borrowing and insurance are also relatively rare in the developing world. More than 11 per cent have an outstanding loan for emergencies or health-care needs, but more than 80 per cent use only informal sources of credit. Of adults in developing countries working in farming, forestry or fishing, only 6 per cent have crop, rainfall or livestock insurance. It is a sad fact that 65 per cent of those without formal accounts list that they do not have a formal account due to lack of money.

The other reasons given are instructive and can be more readily addressed. The lack of use due to banks and accounts being too expensive (25 per cent), banks being too far away (20 per cent), missing documentation, no trust in banks, excessive paperwork and the use of accounts of others (cited more by women).

Some countries have already begun addressing the problem of non-inclusion in a systematic fashion. The recent Indian experience is noteworthy. In 2011, India had a total of 85,000 bank branches but only 32,000 catered for the rural population which comprises 70 per cent of the population. There were a total of 73,000 unbanked villages with a population of more than 2000. Only 17 per cent of the population held a bank account. The *Swabhimaan* initiative – a nationwide financial inclusion programme launched in February 2011 by the Government of India and the Indian Banks Association aims to bring banking services to 73,000 unbanked villages by March 2012 (Press Information Bureau, 2011). A declared objective and incentive of the programme is that government subsidies for the poor would be channelled through the newly established bank accounts thus reducing the substantial leakages that occur due to inefficiencies and corruption. The 65 per cent who do not have money to open formal accounts would now have a reason to do so.

Governments (with support from international agencies, service providers and educators) should remove physical, bureaucratic and financial barriers needed to extend use of financial services to the poor.

The Financially Excluded

Bankruptcy law is often treated as separate from credit law and its regulation, the purview of separate regulators. Yet, bankruptcy is really the negative consequence of the use of financial services. The study of Robert Mann (2010) cited earlier is evidence of this.

Another landmark study also focusing on the US situation is that by Katherine Porter (2008) entitled 'Bank Profits: The Credit Industry's Business Model for Post bankruptcy Lending'. The study evidences how distressed borrowers are highly lucrative for lenders and how bankruptcy law itself facilitates this business model. Creditors repeatedly solicit debtors to borrow after bankruptcy, and they use bankruptcy itself as an advertising lure. The same lenders that the families could not repay before bankruptcy offer them credit. Debtors report more difficulty in obtaining secured loans than unsecured loans and persons who had opted for Chapter 13 (repayment) bankruptcy instead of Chapter 7 (liquidation) bankruptcy have fewer opportunities to borrow. Lenders stimulate and profit from financial distress.

In most countries, severe restrictions are imposed on bankrupts. These may include:

• being barred from holding certain judicial and political and even administrative or civil service appointments;

• being incompetent to maintain any action (other than personal injury) without sanction of the bankruptcy regulator;

• not to, without permission of a court or the bankruptcy regulator, leave the country, operate a business, become a director or be involved in the management of a company, nor be involved, manage or be employed in business belonging to the spouse or relative;

• not to borrow more than a minimum sum specified by law without informing that he is bankrupt; and

• not to own assets exceeding a specified sum in value except wearing apparels for himself and his family.

The penalty for non-compliance of such already punitive measures may be dealt with as contempt of court!

Bankruptcy regulation impacts both borrower and lender behaviour and has to be treated as a part of consumer finance.

Credit Bureaus

The financial services industry maintains and/or relies on credit bureaus operated by the public or private sector. In all countries the operation of the bureaus may not be equitable to consumers, especially since in many countries they are exempt from data protection law. There may not be a statutory duty or effective control of data collection, and of accuracy and responsibility to notify the subject of the data collected and maintained. Also there may be no specification of the limitation period that will apply when data prejudicial to the subject is maintained. In such circumstances, unauthorised access, errors in entry and sanctions for incorrect information are not provided for at all or are inadequately provided for. Credit bureaus have to be regulated to ensure equitable treatment of consumers.

The Way Forward

Consumer organisations have focused on the problems relating to consumer credit and banking and insurance services. They have emphasised the need to focus on transparency (prices, terms, conditions, and risks), fair treatment (including rules to prohibit harmful products and services) and effective redress (errors, complaints and abuses).

My contention is that our current focus will not in itself help address the systemic flaws in the system. The current institutional structure for financial services regulation itself needs to be reformed.

As noted earlier, regulation and supervision of financial services in most countries does not serve the consumer interest. Few developing countries have a Financial Services Authority distinct from the central bank. Regulation of financial services may be shared by a host of other regulators including specialised insurance regulators, ministries of domestic trade and even local government given oversight of particular financial services, particularly of providers of credit such as moneylenders and pawnbrokers. Nonetheless, the central bank dominance is the norm.

Central banks act as the government's banker and lender of last resort. They also carry out a host of other functions, including implementation of monetary policy, control of the nation's money supply, management of its foreign exchange and gold reserves and the government's stock register. A principal objective of central banks is to maintain monetary and credit conditions conducive to a high level of employment and production (Eijffinger *et al*2012).

In many countries, central banks are also responsible for the regulation and supervision of banking and other financial institutions. Given the wide ranging functions that central banks are required to perform; it is questionable whether they should also undertake the protection of consumers of financial services.

The recent financial crisis has led to a re-examination of the financial services regulatory architecture in several countries. In others, this has come from recognition of the changing nature of the financial services sector, especially with many financial institutions moving across traditional boundaries and financial activities.

An important consideration in the restructuring exercise is whether a single agency can balance the role of prudential supervision with consumer protection without trade-offs that serve the interest of financial service providers at the expense of consumers. Several countries have, therefore, moved towards what has been referred to as a "twin peaks" system. As noted by the

Group of Thirty (2008), there is a growing interest in and support for "regulation by objective" of the Twin Peaks Approach to supervision. The Twin Peaks Approach is designed to garner many of the benefits and efficiencies of the Integrated Approach, while at the same time addressing the inherent conflicts that may arise from time to time between the objectives of safety and soundness of regulation and consumer protection and transparency. When prudential concerns appear to conflict with consumer protection issues, the prudential supervisor in the twin peaks system may give precedence to safety and soundness mandates, because these are closely intertwined with financial stability. The Twin Peaks Approach may help to force a resolution to this conflict.

The article entitled 'Unsafe at Any Speed' by Elizabeth Warren (2007) is very persuasive as to why there needs to be a specialised Consumer Financial Services Agency. In it Warren deals with the US situation as regards credit and points out that reckless and predatory lending by credit providers is designed to deliberately ensnare lenders. For this, credit providers build tricks and traps into credit products to ensnare families in a cycle of high-cost debt. Warren indicates the excessive technicality and misleading information in consumer credit contracts and the increased intermediation and conflicts of interest that occur in the consumer credit industry. The situation in many countries is similar.

We need to move away from the current regulatory structure that subsumes consumer protection within prudential regulation. We need to create a Consumer Financial Services Agency that has the consumer interest and will help focus on the systemic flaws that result in the exploitation of consumers.

Mr. Chairman, Ladies and Gentlemen, thank you for this opportunity to speak to you.

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