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Consumer Protection and Financial Literacy

Lessons from Nine Country Studies

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Abstract

The recent turmoil in financial markets worldwide has emphasized the need for adequate consumer protection and financial literacy for long-term stability of the financial sector. This Working Paper aims to summarize key lessons from reviews of consumer protection and financial literacy in nine middle-income countries of Europe and Central Asia (Azerbaijan, Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, Romania, the Russian Federation and Slovakia). All the country assessments used a systematic common approach, based on a set of Good Practices for Consumer Protection and Financial Literacy developed by the World Bank's Europe and Central Asia Region. The objective of the Working Paper is to contribute to the international dialog on strengthening financial consumer protection and financial literacy in emerging markets.

A financial consumer protection regime should meet three objectives. First, consumers should receive accurate, simple, comparable information of a financial service or product, before and after buying it. Second, consumers should have access to expedient, inexpensive and efficient mechanisms for dispute resolution with financial institutions. Third, consumers should be able to receive financial education when and how they want it. A common challenge among the nine countries is the need of an adequate institutional structure for financial consumer protection. However independent of the specific institutional structures, financial consumers should have one single agency where to submit complaints and inquiries. Financial institutions should be required to apply fair, non-coercive and reasonable practices when selling and advertising financial products and services to consumers. Personal data should also be carefully protected.

This paper—a product of the 5193—is part of a larger effort in the department to enhance the quality of its financial sector development work, and its contributions to the international financial regulatory dialogue. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at srutledge@worldbank.org.

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

Produced by the Research Support Team

Consumer Protection and Financial Literacy

Lessons from Nine Country Studies

Susan L. Rutledge

Foreword

Until the global financial crisis of 2007-09, the global economy was adding an estimated 150 million new consumers of financial services each year. Rates of increase have since slowed but growth continues apace. Most new consumers are in developing countries, where consumer protection and financial literacy are still in their infancy. Particularly in countries that have moved from central planning to market economies, empowering consumers has become a prerequisite for efficient and transparent financial markets and a necessary base to ensure that new consumers have the requisite confidence in the formal financial system. In addition, technological innovation and increased competition for financial services worldwide have created a wide array of financial services available to consumers—all with new risks and rewards. Particularly over the last year, the global financial crisis has highlighted the need for strong consumer protection and financial literacy. As a result, government authorities worldwide are looking at practical and effective ways of improving consumer protection in financial services and promoting financial literacy.

Consumer protection ensures that consumers receive information ex ante that will allow them to make informed decisions, are not subject to unfair and deceptive practices, have access to recourse mechanisms to resolve disputes when transactions go awry, and are able to maintain privacy of their personal information. Financial literacy initiatives give consumers the knowledge, skills and confidence to understand the information they receive and evaluate the risks and rewards inherent in each type of financial service and product.

We are pleased to provide this Working Paper on Consumer Protection and Financial Literacy: Lessons from Nine Country Studies. This Working Paper is being published by the Finance and Private Sector Department of the Europe and Central Asia Region of the World Bank in order to stimulate discussion on what needs to be done to improve consumer protection and financial literacy worldwide. Comments and feedback would be appreciated and should be sent to Sue Rutledge (srutledge@worldbank.org).

Abbreviations & Acronyms

APR	Annual percentage rate of change
ATM	Automatic Teller Machine
AZN	Azerbaijani Manat
B2C	Business to consumer
BGN	Bulgarian Leva
CGAP	Consultative Group to Assist the Poor
CPSS	Committee on Payment and Settlement Systems
DFID	Department for International Development
ECA	Europe and Central Asia
ECSPF	Finance and Private Sector Department of the Europe and Central Asia Region
EU	European Union
FCAC	Financial Consumer Agency of Canada
FinCoNet	International Financial Consumer Protection Network
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNI	Gross National Income
HRK	Croatian Kuna
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LIBOR	London Inter-bank Offered Rate
LVL	Latvian Lat
MTPL	Motor Third Party Liability (Insurance)
NGO	Non-government Organization
OECD	Organisation for Economic Co-operation and Development
PIN	Personal Identification Number
RUB	Russian Ruble
SECO	State Secretariat for Economic Affairs
SRO	Self-regulatory organization
UK	United Kingdom
US	United States of America

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Above all, the project team is grateful to the government authorities and members of civil society of Azerbaijan, Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, Romania, the Russian Federation, and Slovakia for their valuable collaboration and assistance. They have generously supported preparation of Diagnostic Reviews of Consumer Protection and Financial Literacy for their countries, offered detailed written comments on the draft reports, co-hosted dissemination workshops, and worked to develop action plans to implement the recommendations.

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Executive Summary

Until the financial crisis of 2007-09, the global economy was adding an estimated 150 million new consumers of financial services each year. Rates of increase have since slowed but growth continues apace. Most new consumers are in developing countries, where consumer protection and financial literacy are still in their infancy. Particularly in countries that have moved from central planning to market economies, protecting consumers has become a prerequisite for sound, stable and competitive financial markets—and protection is needed to give new consumers confidence in the formal financial system. It is also in the interest of financial institutions to have an informed and confident clientele.

Households worldwide have taken on debt to buy housing, repair cars, educate their children and just pay the bills. Bank loans to households have dramatically risen in many countries. For example in Russia, household lending has increased from negligible levels to 20 percent of total bank assets in just over five years. Yet many still lie outside the formal financial sector. More than 40 percent of the Russian population still lacks access to any form of financial services, even a basic current bank account. In most developing countries, less than one percent of the population invests in securities, investment funds or insurance. Households are also heavy users of payment services and remittances.

Despite the increase in retail financial services, consumer protection and financial literacy remain weak in developed and developing countries alike. For many in the emerging markets, financial service contracts are difficult to understand. It may be the first time that someone among their friends or extended family has signed a long-term financial contract and none has sufficient financial literacy to negotiate with a financial institution. In addition the services, or the consumer disclosure for the services, may be difficult to comprehend—and impossible to compare among service providers. If a consumer has a complaint about a financial service, no agency is clearly responsible for addressing the problems: the consumer is left to fight in a court system that may be slow and inefficient at best and subject to undue influences and additional costs at worst.

The global financial crisis has highlighted the importance of consumer protection and financial literacy for stability of the financial sector. In the US, the rapid growth of complex residential mortgage products (for example, interest-only mortgages), combined with securitization of debt into instruments (such as collateralized debt obligations) which were sold to poorly informed parties, has caused much turmoil. Financial institutions worldwide have been obliged to write off trillions of dollars of assets. In Central and Eastern Europe, the damage to the financial sector was also serious. It is not clear how many borrowers understood the risks inherent in taking long-term debt in foreign currencies and at variable interest rates. Strong financial consumer protection is needed for public confidence in the financial system worldwide.

The objective of this Working Paper is to take the lessons from the nine country studies and to lay out a broad framework for reviewing consumer protection and financial literacy in emerging markets. Starting in 2005, the Europe and Central Asia Region of the World Bank initiated a pilot program, conducting country reviews in Azerbaijan, Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, Romania, the Russian Federation and Slovakia. All are considered to be “middle-income” countries and six are members of the European Union. For each, a detailed analysis was provided of financial consumer protection in banking, non-bank credit institutions, insurance, securities, private pensions and for selected Diagnostic Reviews, also microfinance institutions and credit reporting systems. In addition, the World Bank developed a set of Good Practices in Consumer Protection and Financial Literacy based on successful international practices in improving consumer protection and financial literacy. While this Working Paper summarizes key lessons from reviews in middle-income countries, the findings may also be useful for low-income countries.

In the country reviews, the most difficult issue is the institutional structure for financial consumer protection. In some countries, the financial supervisory agencies view consumer protection as part of their mandate for financial stability. In others, it is a general consumer protection agency that takes on the responsibility of dealing with financial services. This Working Paper suggests that whatever institutional structure is chosen, financial consumers should have just one agency for complaints and inquiries.

Several institutional models are available to achieve the desired outcomes. As one option, financial supervisory agencies may adopt consumer protection as part of their mandate (preferably as part of legislation). However in this case, they need to address the inevitable conflicts of interest that arise between prudential and business conduct supervision—and ensure that consumer protection receives sufficient focus. As a second option, economy-wide consumer protection agencies may take on financial services. However the agencies need to find a way to build the expertise—and confidence—to handle the complex technical issues related to financial services. In the US, the current administration has proposed a third approach, creating a special purpose Consumer Financial Protection Agency, such as that established in Canada. Whatever structure is chosen, financial consumer protection authorities could benefit from participation in an international network, such as FinCoNet, that promotes the exchange of information on supervisory and regulatory issues as well as market developments.

Simple and easy-to-understand consumer disclosure lies at the heart of robust consumer protection. One way of achieving such disclosure is through the use of a Key Facts Statement, providing all key terms and conditions in simple and plain language, for all retail financial products and services. Standard contracts for retail financial services—or at least standard basic contract provisions—would also help consumers understand their legal obligations.

At the same time, abusive business practices should be prohibited. All financial institutions that deal with the public should be registered with a financial supervisory agency. All who solicit funds from the public for investment (or speculative) purposes should be licensed—and those who engage in pyramid schemes and financial fraud should be prosecuted by experts in financial services. All sellers of retail financial services should be qualified and certified to ensure that they understand the products and services that they sell to the public. Ex-ante review by regulators of all financial products sold to the public could be required, similar to the Federal Drug Administration's approvals for all medications sold in the US. Unfair or deceptive practices should be explicitly prohibited. Personal data should be carefully protected so that consumers are aware when their personal data has been shared with outside institutions.

Special attention should be paid to consumer complaints. Where complaints are not addressed effectively, consumers will become cynical and shy away from using financial services. Each financial institution should have a customer complaint department. Complaints about financial services should be consolidated in one location and statistics published about the number and type of complaints. The analysis of complaints should differentiate between inquiries (for which consumers should receive financial education) and disputes (for which a court process, mediation or arbitration is needed to resolve the issue at hand.) A fast and inexpensive out-of-court mechanism—such as a financial ombudsman—is needed to resolve legal disputes about consumer financial services.

Financial education can potentially be an effective form of consumer protection (but cannot substitute for regulation). Building financial literacy is a long-term investment, whose effectiveness should be carefully measured and evaluated. Focus should be placed on "teachable moments" such as the first time a consumer takes a mortgage or starts to plan for retirement. Children should be taught that financial health is important to their long-term well-being. Interactive stock market computer games and investment clubs are also effective in teaching high-school students about financial investments.

Middle- and high-income countries should develop national strategies for financial education, starting with national financial literacy surveys. The surveys should review not just the ability of consumers to evaluate different financial products but also how consumers spend their paychecks (or set

aside savings) and how much confidence they have that disputes with financial institutions will be resolved quickly and efficiently. The surveys should be broken down by age, gender, geographic area, socio-economic levels and years of formal schooling. Updated surveys can later determine if the financial education program has been effective and what additional consumer protection measures may be needed.

Future work should include further analysis and financing of programs. Global surveys of consumer protection and financial literacy would be helpful as would diagnostic reviews of countries in other regions, such as Latin America and Asia. Detailed analysis of specific issues would also be useful. Consideration should also be given to ways in which international financial institutions could finance development—and execution—of national programs of consumer protection and financial literacy.

Key Recommendations

Institutional Structures

- It would be best if consumers could go to a single agency to obtain help related to financial services.
- If a consumer protection agency is responsible for financial services, a specialized department for financial services should be created with adequate resources and expertise in financial sector issues.
- If a consumer protection agency is responsible for consumer protection in basic financial services such as consumer credits, the agency should become responsible for all retail financial services.
- Creating a financial consumer protection agency could also be an alternative.
- Financial consumer protection authorities should participate in international networks such as FinCoNet.

Consumer Disclosure

- Simple and standard consumer disclosure would help consumers with complex financial products—and allow them to compare offers by different providers.
- Key Facts Statements should be prepared in order to give consumers a simple summary of the important terms and conditions of the financial contract. For each generic product class, it is best to use a standardized format written in plain language in a page or two.
- The Key Facts Statements should be developed by the professional associations, which should recommend their use by member financial institutions.
- Consumers have almost no ability to amend a financial institution's contract. For high-volume core retail financial products, the use of standard provisions in retail financial contracts (developed by the professional associations) is desirable.

Business Practices

- All financial institutions dealing with the public should be registered with a financial supervisory agency.

- Those who sell financial services and products should be qualified and certified. The level of training and qualification required will depend on the nature of the services or products being sold.
- Unfair or deceptive practices should be explicitly prohibited and sanctioned.
- Financial institutions should be obliged to ensure that they (and their registered agents) provide accurate and complete information and are held accountable for the information they provide to consumers.
- Financial products offered under high-pressure sales tactics, and those with long-term savings components, should be subject to a cooling-off period where the consumer can cancel, without penalty, any signed contract for 14 days following receipt of the contract.
- Consumers should be allowed to choose the provider of any financial product supplementing or complementing a primary financial product.
- Credit institutions should be required to file annual audited financial statements. The supervisory agency should verify that the significant owners (and those who control ownership), as well as the senior managers, satisfy fit and proper requirements, including no history of bankruptcy or criminal conviction.
- Anyone who solicits funds from the public for the purpose of investment or speculation should be required to obtain a license from the securities supervisory agency, or the insurance supervisor as appropriate.
- The securities supervisory agency should have broad powers to investigate Ponzi and other pyramid schemes and then assist the criminal authorities in prosecution.
- The law should identify a multi-level sales scheme as a pyramid scheme if: (1) the scheme requires a payment for the right to receive compensation for recruiting new salespersons into the plan; (2) there is inventory loading, that is, new salespersons must purchase an unreasonable quantity of a product or service; and (3) purchases of services are required as a condition of entry into the scheme.
- Personal data should be protected. Contracts with financial institutions signed by consumers should have a separate form that requires consumers' signed approval for personal data to be shared by the financial institution with other institutions, including any credit register (using an "opt in" approach).
- Consumers need an easy and inexpensive way to verify their own personal information in the credit register and correct any errors that may arise.
- Responsible finance should be encouraged. Codes of conduct help to improve business practices of financial institutions but the codes need to be adequately disclosed, known and enforced.

Complaints & Dispute Resolution

- Financial consumers should have access to a redress mechanism that is fast, inexpensive and effective.
- All financial institutions should be obliged to have a designated department (or at least an officer) responsible for handling customer complaints.
- When opening a new account and buying any new service, the consumer should be advised in writing as to where to submit complaints, inquiries and disputes.
- Financial supervisors should review the complaint files of the financial institutions they oversee.

- Ideally there should be one, clearly identified, central location where consumers of financial services and products can go when they have complaints or inquiries.
- The central complaints office should have a toll-free telephone line so that in case of a dispute, anyone from anywhere in the country can obtain information about financial services and consumers' legal rights.
- Consumers should be able to submit their complaints by email, by postal mail, or by visiting the premises of the complaints office.
- Statistics on consumer complaints should be analyzed and published—and used to identify future improvements in the financial consumer protection framework.
- Policy-makers should consider alternatives to courts, such as a financial ombudsman office, that can take and enforce decisions regarding consumer claims for small amounts of money.
- A financial ombudsman office may be set up under a professional association or as an independent statutory ombudsman.

Financial Literacy & Education

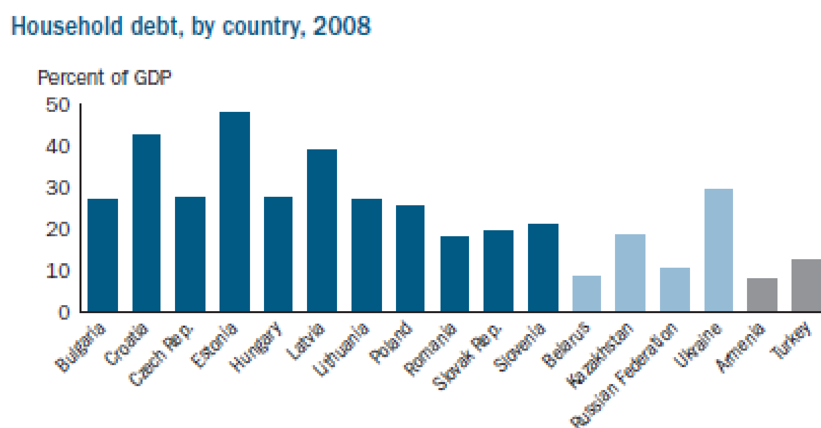
- The impact of different techniques of delivering financial education on financial literacy and on consumer behavior is evolving. Programs to improve financial education should be rigorously tested and evaluated.
- Financial education for consumers should be focused on "teachable moments."
- Middle and high-income countries should have national strategies on financial education and financial literacy. Low-income countries should develop financial education programs according to the country's level of institutional capacity.
- The first step is to conduct a national survey of financial literacy, to be used as baseline. Follow-up surveys of financial literacy should be conducted every three to five years.
- Qualitative monitoring of consumer protection should be conducted, e.g. using "mystery shoppers".
- Global surveys should be conducted of legal and regulatory frameworks for financial consumer protection, levels of financial literacy, and patterns of financial consumer behavior.

Introduction

In the decade running up to the global financial crisis of 2007-09, the global economy was adding an estimated 150 million new consumers of financial services each year. Rates of increase have since slowed but growth continues apace. Most new consumers are in developing countries, where consumer protection and financial literacy are still in their infancy. Particularly in countries that have moved from central planning to market economies, protecting consumers has become a prerequisite for sound, stable and competitive financial markets—and such protection is needed to give new consumers confidence in the formal financial system. It is also in the interest of financial institutions to have an informed and confident clientele.

Household use of financial services has been rapidly rising. Global consumer debt had stood at 12-14 percent of GDP in the first half of the 1990s, but increased to 18 percent in recent years. Mortgage debt rose still more rapidly—from 46 percent of GDP in 2000 to over 70 percent in 2007. In the countries of Europe and Central Asia, by 2008 household debt had risen to levels not previously seen—and as high as almost 50 percent of GDP for Estonia (see Figure 1). At the same time, households have increasingly become responsible for funding their own pensions while buying insurance policies and investing in securities and investment funds. In the Europe and Central Asia Region, households are also heavy users of payments services and remittances, reaching as high as 31 percent of GDP for Moldova (see Figure 2).

Figure 1: Household Debt in Europe and Central Asia

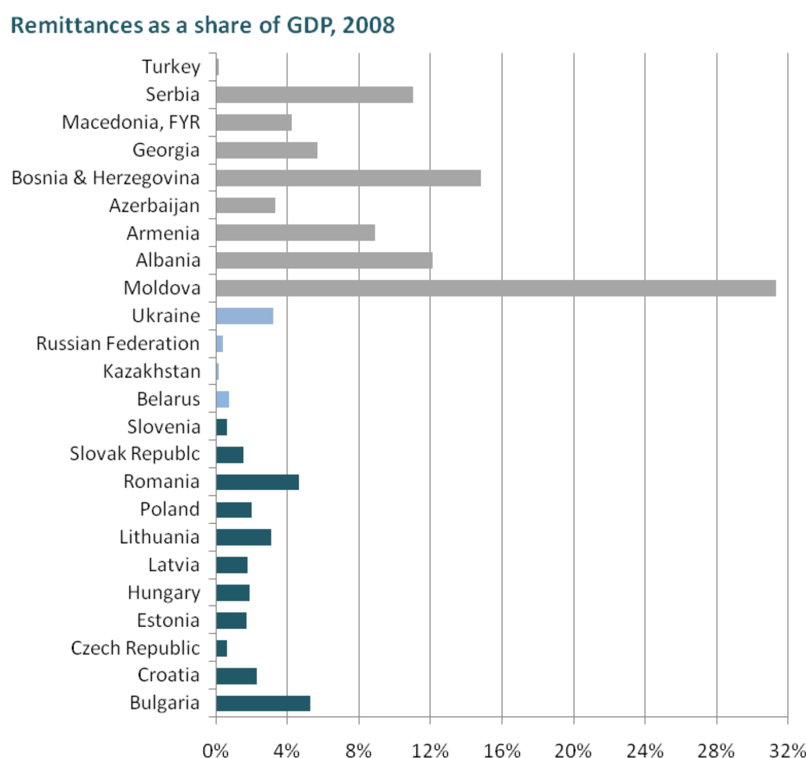


Source: World Bank, *The Crisis Hits Home: Stress Testing Households in Europe and Central Asia*, 2010

The 2007-09 global financial crisis has highlighted the importance of consumer protection and financial literacy for the long-term stability of the financial sector. Throughout Europe, the US and elsewhere, the rapid growth of household lending over the last decade has been accompanied by an increase in the number of households that had difficulty in understanding the risks and obligations that they assumed—or the full range of choices available.[1] Financial institutions have also transferred financial risks to households which have increasingly become exposed to new types of risks, such as

[1] See California Budget Report, *Locked Out 2008: The Housing Boom and Beyond,* 2008. As many as half of all subprime residential mortgage borrowers in the US had high enough credit scores to qualify for standard bank mortgages carrying, in the long run, lower risk and lower costs than subprime mortgages. See also Remarks by US Federal Reserve Board Governor Edward M. Gramlich at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois, May 21, 2004

Figure 2: Remittances in Europe and Central Asia



Source: World Bank, "Migration and Remittances Trends 2009", *Migration and Development Brief 11*, November 3, 2009

those related to changes in foreign exchange and variable interest rates. In developed mortgage markets, complex financial products (such as hybrid adjustable-rate mortgages) were sold to borrowers, some of whom had patchy credit histories. Securitization of such household credit—in today's deeply interconnected financial markets—spread the weaknesses in the household financial sector to the rest of the financial system.[2] Also of concern for long-term financial stability are unclear costs and hidden fees and charges related to products ranging from payments and remittances to insurance policies and investment funds[3]. Consumers International, which represents independent consumer organizations worldwide, argues that as a result of the financial crisis, consumers are paying three times over as: (1) borrowers and pensioners, (2) taxpayers and (3) potential consumers of other services now being starved of resources because of the scale of public debt.[4]

The US consumer protection framework has come under increasing criticism. US authorities have recognized the importance of consumer protection for the stability of the financial sector. As noted by US Treasury Assistant Secretary for Financial Institutions Michael Barr, "[The consumer protection regime] could not stem a plague of abusive and unaffordable mortgages and exploitative credit cards despite clear warning signals. It cost millions of responsible consumers their homes, their savings, and their dignity.

[2] Remarks by Vice Chairman Martin J. Gruenberg, United States Federal Deposit Insurance Corporation at World Bank Group Global Seminar on Consumer Protection and Financial Literacy, Washington, D.C., September 2008

[3] In September 2008 the World Bank launched the Remittance Prices Worldwide Database (http://remittanceprices.worldbank.org/). The website provides comparable data on the cost of sending and receiving money from 23 major remittance sending countries to 83 receiving countries. The World Bank also developed Standards for National Remittance Price Databases and is supporting the creation of national databases, which would use the Standards and tailor them to the needs of each country. In addition the World Bank is leading the initiative to set up a Global Remittances Working Group, announced at the G-8 Summit in Japan in July 2008.

[4] Consumers International Blogspot, *Why consumer protection must spur the financial recovery*, June 25, 2009

And it contributed to the near collapse of our financial system."[5] Chairman of the Federal Deposit Insurance Corporation Sheila Bair went further stating, "There can no longer be any doubt about the link between protecting consumers from abusive products and practices and the safety and soundness of the financial system. Products and practices that strip individual and family wealth undermine the foundation of the economy. As the current crisis demonstrates, increasingly complex financial products combined with frequently opaque marketing and disclosure practices result in problems not just for consumers, but for institutions and investors as well."[6] The US experience shows that where financial markets have developed a high level of innovation and growth in retail financial services, special attention should be paid to issues of consumer protection and financial literacy. 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 avoid some of the worst financial consumer abuses.

Weaknesses in consumer protection and financial literacy affect both developed and developing countries. Emerging countries worldwide have seen rapid development of their financial sectors over the last ten years and rapid growth of income has provided consumers with more resources to invest. Increased competition among financial firms, combined with improvements in financial techniques and information technology, resulted in highly complex financial products being sold to the public. The public in many emerging markets, however, lacks a history of using sophisticated financial products. For many first-time financial consumers, often no member of their extended families has entered into a long-term financial contract such as a home mortgage loan. The growth of financial literacy significantly lags the growth of available investment resources (or access to credit), widening the gulf between the complexity of financial products and consumers' ability to understand what they are buying. Especially in low-income countries, technology is also changing the types of protection needed by many first-time financial consumers. Where more than half the population has no bank account, financial services delivered via cellular telephones have filled a critical need for consumers, but such services raise important issues of consumer disclosure, safety and education. Even in well-developed markets, however, weak consumer protection and financial literacy can render households vulnerable to unfair and abusive practices by financial institutions (or just inadequate disclosure of the risks involved in taking on large debts, particularly in foreign currency), as well as financial fraud and scams.

The objective of this Working Paper is to take the lessons from nine country studies and lay out a broad framework for reviewing consumer protection and financial literacy in emerging markets. Starting in 2005, the Europe and Central Asia Region of the World Bank initiated a pilot program in Consumer Protection and Financial Literacy. For the pilot program, nine Diagnostic Reviews were conducted, six in new member states of the European Union (Bulgaria, Czech Republic, Latvia, Lithuania, Romania, and Slovakia) plus Azerbaijan, Croatia and Russia.[7] This Working Paper pulls together the lessons from the nine country studies and identifies common issues across all the studies. While this Working Paper summarizes key lessons from reviews only in middle-income countries, the findings may also be useful for low-income countries.[8] This Working Paper thus provides a framework against which detailed studies, such as consumer protection in mobile banking or consumer protection for low-income countries, can be developed.

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[5] Written Testimony by Assistant Secretary for Financial Institutions Michael Barr before the US Senate Committee on Banking, Housing and Urban Affairs, July 14, 2009

[6] Statement of Sheila C. Bair, Chairman of the Federal Deposit Insurance Corporation, on Modernizing Bank Supervision and Regulation before the US Senate Committee on Banking, Housing and Urban Affairs, March 19, 2009

[7] The Diagnostic Reviews, Good Practices and materials from dissemination seminars can be found at www.worldbank.org/eca/consumerprotection.

[8] The World Bank divides economies according to their Gross National Income (GNI) per capita, calculated using the World Bank Atlas method. Based on 2008 GNI, the groups are: low income $975 or less; lower middle income $976 - $3,855; upper middle income $3,856 - $11,905; and high income $11,906 or more.

The theme of this Working Paper is that a consumer protection regime should meet three objectives. First, consumers should receive accurate information in simple, plain and comparable language before they buy a financial service or product—as well as during the life of the product. Second, consumers should have access to a fast, inexpensive and efficient mechanism for resolving disputes with financial institutions. Third, consumers should be able to obtain financial education when they want it and in the form that they want it. The focus of this Working Paper is thus on ***results,*** that is, measurable improvements in the provision of financial services to households. As a consequence, this Working Paper looks at what institutional structures are needed to achieve improvement in provision of financial services for consumers, but does not focus on issues of institutional design or capacity building. To help policy-makers achieve the three objectives, this Working Paper points out areas where the interests of financial service providers and those of consumers overlap—and identifies areas of the greatest risk of mis-alignment between the interests of financial firms and those of their retail customers.

The country Diagnostic Reviews provide valuable insight into the kinds of problems faced by financial consumers in emerging markets. The Diagnostic Reviews for the EU new member states provide the opportunity to see how the European Commission's strategy on consumer protection in financial services has been applied in several former transition economies. Among those countries is Latvia, whose review was conducted in June 2009—in the midst of the worst financial crisis in the country's history. Croatia provides the perspective of a country managing a complex legal and institutional agenda for future accession to the European Union. Russia gives an insight into the largest country in the world in terms of area, spanning 11 time zones. Azerbaijan provides the view of an oil-rich country that was formerly a low-income economy. Taken together, the nine country Diagnostic Reviews provide a useful overview of the key issues emerging from systematic assessments of consumer protection and financial literacy in a number of middle-income countries. Examples of the types of financial consumer weaknesses found in the country studies are given in Box 1.[9]

Background

At its heart, the need for consumer protection arises from *an imbalance of power, information and resources* between consumers and their financial service providers, placing consumers at a disadvantage. Consumer protection aims to address this market failure, commonly referenced as "asymmetric information".[10] Financial institutions know their products well but individual retail consumers may find it difficult or costly to obtain sufficient information regarding their financial purchases. In addition, complex financial products can be difficult to assess, even when all relevant information is disclosed. Imbalances are also present in cases where:

- *Transactions are idiosyncratic or rare* (for example, when providing a mortgage on a personal residence);
- *Entry or exit costs are low* (such as for financial intermediaries), thus allowing disreputable firms to emerge; or

[9] Note that the data in this Working Paper reflects information that was accurate at the time the Diagnostic Reviews were conducted. Several countries have since improved their financial consumer protection frameworks.

[10] Technically speaking, asymmetric information raises two main problems: adverse selection and moral hazard. Adverse selection is also referred as the "lemon problem". The academic literature notes that, with imperfect information on the part of lenders or prospective car buyers, borrowers with weak repayment prospects or sellers of low-quality cars ("lemons") crowd out everyone else from the market. See George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", *Quarterly Journal of Economics*, Volume 84, No. 3, August 1970. This is a different issue from that of borrowers lacking sufficient information to make well-informed financial decisions. However in common parlance, asymmetric information refers to the imbalance between financial service providers and consumers.

- *The payoff to the consumer is postponed or very high* (for example, long-term investment products, where performance cannot be evaluated for many years and expenses may consume a large part of profits).

Box 1: Insights from the Country Studies

The Diagnostic Reviews provide a wide array of problems faced by consumers of financial services in emerging economies. Here are a few examples.

In **Slovakia**, the country study found consumers were borrowing from unregistered consumer credit companies at effective interest rates of 120 and 229 percent per annum when they could have borrowed from banks at 14 percent of less. Worse still, if they missed a single payment or two, they could find their wages garnished and eventually would lose their homes—court order or no court order. In the **Czech Republic**, trying to prepay a consumer loan could result in a prepayment fee of 100 percent of the original loan amount. In **Lithuania**, banks had made "exotic" housing loans with an initial grace period on repayments and low variable interest rates. As interest rates rose (but housing prices fell), new homeowners found themselves squeezed by mortgages that were increasing in size rather than declining—at the same time as home values were falling. In **Latvia**, banks notified borrowers of increased fees in their checking accounts—and advised them to open new accounts for loan payments. However after borrowers signed the new account contracts, they found that they had in fact agreed to new terms and conditions—and an acceleration of the repayment schedule from 25 years to just two years.

In **Croatia**, the common complaint to the central bank was that, "We did not understand what we signed". If they had co-signed a loan, consumers did not realize that they might be obliged to pay the debt of their friend or family member. Consumers were also not aware if their personal data was sold to a third party. In **Bulgaria**, personnel of financial institutions are unable to explain to customers their financial products and if consumers had disputes over entries in credit register, correction of errors was difficult at best. In **Romania,** borrowers received mortgage contracts printed in a 6-point font size that was too small to be read by anyone with less than perfect vision. Trying to obtain a copy of a contract before signing or finding out the amount of fees (or the foreign exchange rate) for a remittance before sending the money was a test in patience.

In **Russia,** over 400,000 investors had paid $1.4 billion to Ponzi schemes for investments that would never be repaid or apartments that would never be built. Over $60 billion a year is paid into stand-alone machines in subways and on the street to pay for utility bills, rent and other amounts under $1,000. It is estimated that at least 70 million consumers, or virtually all of the Russian working population, use such terminals at least occasionally. However the effective fees are not always disclosed. Furthermore the owners and operators of the machines are not registered with any financial supervisory agency. Also investors in private pensions received no information about their pension funds—or the financial performance of the funds. In **Azerbaijan**, elderly pensioners were obliged to learn how to use an ATM cash machine or give their personal identification number (PIN) to a third party to use the ATM card for them. In the weekly call-in hour to the central bank's executive management, the most common complaint was that the consumer did not understand why the bank would not provide a credit.

Source: Diagnostic Reviews

Consumer protection and financial literacy promote efficiency, transparency, competition and deepening of retail financial markets. The retail public operates in a marketplace where imbalances of information, resources and power are on the side of financial institutions. Consumer protection attempts to redress the imbalance, by giving individuals clear and complete information to make well informed decisions, by prohibiting financial institutions from engaging in unfair or deceptive practices, and by providing adequate mechanisms to resolve disputes between individuals and financial institutions. Consumers who are empowered with information and basic rights—and who are aware of their responsibilities—provide an important source of market discipline to the financial sector, encouraging financial institutions to compete by offering better products and services rather than by taking advantage of poorly informed consumers. Consumer protection also improves governance of financial institutions. By strengthening transparency in the delivery of financial services and accountability of financial firms, consumer protection helps build demand for good governance of the sector and the strengthening of business standards in the financial sector. Financial literacy helps consumers understand the information

and make risk/return choices that optimize their financial wealth. In addition, consumer protection and financial literacy help promote financial inclusion, attracting first-time consumers to access financial services and building consumers' trust in financial institutions to increase the use of retail financial services. .

Consumer protection also helps financial firms in facing the many risks that arise in dealing with retail customers. In its April 2008 report, the Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commission and the International Association of Insurance Supervisors identified three key risks related to possible "mis-selling" financial products to retail customers. They were: (1) *legal risk*, if successful lawsuits from collective action by customers or enforcement actions by supervisory agencies result in obligations to pay financial compensation or fines; (2) *short-term liquidity risk and long-term solvency risk*, if retail customers are treated unfairly and thus shun the financial institution and withdraw their business or if the financial institution is found liable and subject to costly compensation or redress; and (3) *contagion risk*, if the problems of one financial institution (or type of financial product) spread across the financial sector.[11] Effective consumer protection can help ensure that the actions of financial firms do not make them subject to criticisms of mis-selling or put the firms' reputation at risk.

Consumer protection also protects the financial sector from the risk of politically or ideologically driven reactions. The impact of too little consumer protection became evident during insurance and superannuation scandals in the United Kingdom and Australia. Since then, consumer disclosure requirements in both countries have been substantially enhanced and Australia has seen the transformation of a successful industry-led insurance complaints and inquiries body into an effective public entity with a broad mandate.[12] The political response to collapses of parts of the financial sector can be to over-compensate with heavy regulation. For example, some governments have resorted to interest rate caps for consumer loans (with questionable results especially on the development of credit markets) as a reaction to increasing public pressure.

Some regulation of financial markets is needed, at least for consumer protection. As noted by Dani Rodrik (2007), "Markets will not work on their own. You need all the institutions that regulate markets, stabilize markets, that compensate losers and provide the safety nets, without which markets can neither be legitimate or, for that matter, efficient, if you don't have the appropriate regulatory frameworks." [13] George Bentson (1999) also suggests that one of the (few) justifications for regulating financial markets is "protection of consumers from the loss of their investments, fraud and misrepresentation, unfair treatment and insufficient information, incompetent employees of financial-services providers, and invidious discrimination."[14] Furthermore consumer protection regulation (sometimes referred to as business conduct regulation) is closely related with prudential regulation. The two should be designed to be mutually enforcing.

Competition policy will not fully address consumer protection issues on its own. Mark Armstrong (2008) notes that in most competitive markets, competition policies are sufficient to ensure that firms succeed by providing consumers with the products and services they want. However Armstrong also argues that more is required to ensure efficient retail financial markets. He notes that policies are needed

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[11] Joint Forum of Basel Committee on Banking Supervision, International Organization of Securities Commission and International Association of Insurance Supervisors, *Customer suitability in the retail sale of financial products and services,* April 2008

[12] For additional discussion of scandals, see the Case Studies in the April 2008 report of the Joint Forum of Basel Committee on Banking Supervision et al. See also Australian Government Publishing Service, *The Financial System Inquiry Final Report* ("Wallis Report"), March 1997

[13] PBS NewsHour, Graduate Students Recount Experiences with Globalization, June 1, 2007

[14] George J. Benston, *Regulating Financial Markets: A Critique and Some Proposals*, American Enterprise Institute for Public Policy and Research, 1999

to provide consumers with comparable information, to increase consumer awareness of market conditions, to reduce consumer search costs, and to clarify hidden costs. They all help give consumers essential information to make decisions. He also points to the need for policies to prevent misleading and fraudulent marketing directed at consumers.[15]

However competition policies may be helpful in promoting consumer protection. In some markets where risks are short term and products are generic in nature (for example, motor vehicle collision insurance), it should in principle be possible to rely on market competition to deliver effective consumer protection rather than impose detailed rules and regulations. However regulators may still want to apply regulatory requirements where the purchase of a product is mandatory under the law, such as motor third party liability insurance.

The challenge is to strike the right balance between government regulation and market competition forces. Government intervention should only be considered when it is both feasible and cost-effective to do so. Rules need to be proactive to prevent abuses and not simply react to the problems of past. At the same time, care must be taken since excessive regulation can stifle financial innovation. As noted by US Federal Reserve Board Chairman Ben Bernanke in April 2009, regulators should "strive for the highest standards of consumer protection without eliminating the beneficial effects of responsible innovation on consumer choice and access to credit."[16] To ensure that regulation is both effective and efficient, cost-benefit analyses should be conducted.

One of the issues for most regulators is achieving the right balance between detailed rules and high-level principles. On the one hand, detailed rules—sometimes product by product—can ensure appropriate behavior by firms and provide for enforceability. As some have suggested, ex-ante review by regulators of all financial products sold to the public could be required, similar to the Federal Drug Administration's approvals for all medications sold in the US.[17] On the other hand, high-level principles can deal better than rules with innovation and development in markets, and are more likely to engage senior management's attention as opposed to that of compliance officers.

Codes of conduct for responsible lending are not a substitute for regulation but can be useful in improving business practices of financial institutions. Codes of conduct can encourage financial institutions to follow ethical standards in the treatment of retail customers. They are no substitute for adequate regulation intended to protect the interests of consumers of financial services. However they can fill in the details and may provide a useful first step, particularly if the regulator (or supervisor) oversees the codes and reports on their effectiveness. If the codes are not sufficient to improve business practices, the regulator may then wish to consider introducing new legislation. However in developing countries, self-regulation is frequently less than effective for numerous reasons—institutional capacities of industry associations are often limited, financial markets are highly concentrated and dominated by a small number of institutions, the legal and regulatory framework for financial services is underdeveloped, and even the laws and regulations are frequently not effectively applied or enforced.

The focus of consumer protection is on the relationship and interaction between a retail customer and a financial institution. Distinguishing between unsophisticated retail and highly sophisticated corporate customers is important when designing successful consumer protection. Transactions among

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[15] Mark Armstrong, "Interactions between Competition and Consumer Policy", *Competition Policy International*, Volume 4, Number 1, Spring 2008. See also OECD, Global Forum on Competition, *The Economics of Competition and Consumer Policies*, Contribution by Ms. Louise Sylvan, February 18, 2008.

[16] Chairman Ben S. Bernanke's Speech *Financial Innovation and Consumer Protection* at the Federal Reserve System's Sixth Biennial Community Affairs Research Conference, Washington, D.C. April 17, 2009

[17] Since 1938 in the US, every drug sponsor has to submit an application to the Federal Drug Administration, requesting the approval of the new medication before it is commercialized
(http://www.fda.gov/Drugs/DevelopmentApprovalProcess/HowDrugsareDevelopedandApproved/default.htm)

well-informed financial and corporate institutions are not subject to many of the problems that can potentially harm retail consumers. This Working Paper uses the definition of the retail market as those economic transactions made between economic operators and final consumers, sometimes called the business-to-consumer (or "B2C") market. This market does not include businesses—however small—in their role as purchasers of financial services.[18] Thus this Working Paper relates only to the direct relationship between retail customers and financial institutions (or their agents and intermediaries), although one of the Diagnostic Reviews (for Azerbaijan) also looked at consumer protection issues for the microfinance sector, in light of the importance of microfinance as part of the Azeri financial system. This Working Paper does not cover areas such as personal insolvency or collateral registries. Such areas are important parts of the financial sector infrastructure but they are not directly involved in relations between consumers and financial institutions.

Design of consumer protection and financial literacy measures should take into account recent research in behavioral economics. Psychological biases may influence consumers to make choices that are neither rational nor optimal. These biases include mistaken beliefs where consumers assume that interest rate charges or penalties will not apply to them: they are over-optimistic about their financial future and thus unable to forecast their future financial status accurately.[19] Individuals often over-estimate their financial capabilities, including their understanding of the concept of the time value of money and the impact of compound interest over time.[20] Other consumers fall victim to projection bias, that is, the prediction of personal preferences into the future.[21] Other related effects are hyperbolic discounting (where consumers apply a very high discount rate to future income and thus reduce the present value of savings to very low levels), impulse purchasing and weaknesses in self-control. The research points to the need for surveys of financial literacy and consumer spending habits as essential background for designing not only programs of financial education but also measures for improving policies of consumer information and awareness.

This Working Paper starts from the perspective that a financial sector should provide consumers with:

- ***Transparency*** by providing full, plain, adequate and comparable information about the prices, terms and conditions (and inherent risks) of financial products and services;
- ***Choice*** by ensuing fair, non-coercive and reasonable practices in the selling and advertising of financial products and services, and collection of payments;
- ***Redress*** by providing inexpensive and speedy mechanisms to address complaints and resolve disputes; and
- ***Privacy*** by ensuring control over collection and access to personal financial information.

In addition, consumers should have access to programs of financial education that enable them to develop the financial capability required to understand financial products and services and exercise their rights (and responsibilities) as financial consumers. Training in financial issues should also empower consumers to make well informed decisions about their finances—and to plan their financial needs over a lifetime. Financial education cannot, however, substitute for adequate financial regulation.

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[18] However recent evidence suggests that businesses in the form of sole proprietorships (as are many microcredit borrowers) suffer the same kind of consumer protection issues as do retail consumers.

[19] S. Brown, G. Garino, K. Taylor and S.W. Price, *Debt and financial expectations: An individual and household level analysis*, Working Paper, University of Leicester, 2003. See also N. Weinstein, "Unrealistic Optimism About Future Life Events", *Journal of Personality and Social Psychology* 39(5): 806-820, 1980

[20] Lewis Mandell, *Personal Finance Survey of High School Seniors*, The Jumpstart Coalition for Personal Financial Literacy, Washington, DC, 2004. Also see ANZ Banking Group, *ANZ Survey of Adult Financial Literacy in Australia*, Melbourne, 2003

[21] G. Loewenstein, T. O'Donoghue and M. Rabin, "Projection Bias in Predicting Future Utility," *Quarterly Journal of Economics* 118 (4): 1209-1248, 2003

Expanding access to financial services is also an important public policy goal, particularly in developing countries. Providing a low-cost bank account, for example, can provide an "entry-level" product that brings new consumers into the financial sector.[22] While expanding access to financial services helps spur the economy, both financial institutions and financial consumers need to be responsible in their use of financial services.

The primary areas of concern regarding consumer protection will likely depend on the level of development of the financial sector. Not all recommendations from the Working Paper are equally applicable to all countries and not all countries have the same areas of concern. For example in low-income countries, the major concern may be about remittances and non-bank payments systems. By contrast, in high-income countries, major areas of focus may be investment funds and "exotic" residential mortgages. Table 1 provides a simplified listing of key issues by level of financial sector development.

Table 1: Areas of Major Consumer Protection Concern by Level of Financial Sector Development

	Low-Income Countries	Middle-Income Countries	High-Income Countries
Exotic mortgages			x
Securities		x	x
Collective investment funds		x	x
Private pensions		x	x
Life insurance		x	x
Debit/credit cards	x	x	x
Data protection	x	x	x
Consumer credit	x	x	x
Ponzi schemes/pyramids	x	x	x
Microinsurance	x		
Microcredit	x		
Remittances/payments	x		

International Benchmarks for Consumer Protection and Financial Literacy

No international benchmarks for consumer protection and financial literacy are currently in place. The World Bank, working with the Bank for International Settlements have developed standards related to consumer protection for remittances[23] but there are no general benchmarks for consumer protection across the financial sector. In the absence of accepted international benchmarks or guidelines, policymakers often focus (sometimes in reactionary mode) on only a few of many consumer protection

[22] For a review of financial access in developing countries—and the pitfalls in providing access to financial services in low-income countries---see World Bank, *Finance for All? Policies and Pitfalls in Expanding Access,* 2008. See also CGAP, *Financial Access 2009: Measuring Access to Financial Services around the World*, 2009

[23] Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the World Bank, *General principles for international remittance services*, January 2007

issues while neglecting to close gaps in other areas. The recently created International Financial Consumer Protection Network (FinCoNet) is considering what role it could play in the development of international benchmarks for consumer protection in financial services.

A clear set of internationally accepted practices on consumer protection in financial services would help build a robust global financial architecture. Regulators have noted the pressing need for a set of guidelines of market conduct against which existing policies, laws and regulations, institutions and initiatives can be measured and assessed. Market conduct standards should complement—but not substitute for—rules regarding prudential supervision. Such a set of guidelines would be significant for any public debate on a national or international level since the discussion to date has suffered from the absence of a set of recognized guidelines against which existing rules or proposed changes could be measured. Well-developed and accepted guidelines are also very important tools when developing benchmarks for surveys of consumer protection and financial literacy levels.

At the G-20 summit in Pittsburgh in September 2009, leaders noted the need to further strengthen protection of users of financial services as part of the global financial architecture. The official statement from the summit noted that, "Far more needs to be done to protect consumers, depositors, and investors against abusive market practices, promote high quality standards, and help ensure the world does not face a crisis of the scope we have seen. We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."[24] Strong consumer protection should be part of a strengthened global financial regulatory system.

Several initiatives are underway worldwide to develop useful standards or benchmarks on consumer protection and financial education. The European Commission is developing a "scorecard" on financial consumer protection, and in October 2008 the European Parliament released its report on measures to increase consumer education and awareness on credit and finance.[25] In July 2005, the Council of the Organisation for Economic Co-operation and Development (OECD) distributed a set of principles and good practices for financial education and awareness, followed by the release of good practices on financial education and awareness for insurance and private pensions in 2008, and for consumer credit, including mortgages, in 2009.[26]In 2010, the OECD plans also to release good practices on financial education and awareness relating to insurance intermediation. Also in March 2008 the OECD launched the International Gateway for Financial Education as a clearing house for financial education programs, initiatives and research world-wide, and in mid-2008, the OECD created the International Network on Financial Education to analyze and assess the effectiveness of financial literacy programs.

The World Bank has contributed to the dialog on development of international benchmarks by preparing a set of Good Practices for Consumer Protection and Financial Literacy.[27] The *Good Practices of Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool* have been produced and refined over the course of the assessments as a practical assessment tool to evaluate financial consumer protection regimes in nine countries in Europe and Central Asia. The Good Practices provide a template for systematic analysis of the laws, regulations and institutions involved in

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[24] Leaders' Statement: the Pittsburgh Summit, September 24-25, 2009

[25] European Parliament, *Report on protecting the consumer: improving consumer education and awareness on credit and finance* (2007/2288 (INI)), October 14, 2008

[26] OECD, *Recommendation on Principles and Good Practices for Financial Education and Awareness*, *Recommendation of the OECD Council* (July 2005); *Improving Financial Education and Awareness on Insurance and Private Pensions* (2008); and *Financial Literacy and Consumer Protection: Overlooked Aspects of the Crisis, OECD Recommendation on Good Practices on Financial Education and Awareness relating to Credit* (2009)

[27] World Bank, Finance and Private Sector Department of the Europe and Central Asia Region, *Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool*, September 2009

consumer protection and financial literacy—and allow detailed comparisons across different countries. Separate Good Practices were developed for each part of the financial sector. They cover banking, insurance, securities and private pensions, as well as non-bank credit institutions, microfinance institutions and credit reporting systems. The Good Practices are not intended to establish a set of internationally accepted principles. However they provide useful insight that may be helpful in the eventual development of international benchmarks on consumer protection in financial services.

The Good Practices were developed using accepted good practices in the financial sector. The Good Practices are based on accepted international benchmarks for financial sector regulation and supervision such as the Basel Committee's Core Principles for Effective Banking Supervision, the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS), and the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO). Also used were the OECD recommendations for financial education and awareness on pensions, insurance, and credit products. Consumer protection principles are also part of the "General principles for international remittance services" issued by the Committee on Payment and Settlement Systems (CPSS) and the World Bank. In addition, the Good Practices have drawn on the approaches of developed countries and experiences in reforming emerging markets. Over the last 30 years, most work on financial consumer protection has been undertaken in industrialized countries, including Australia, Canada, the European Union (and member states) and the United States although work in other countries (such as Armenia, Brazil, Hungary, India, Malaysia, Mexico, Peru, Serbia and South Africa) has begun to emerge.

The Good Practices are applicable both in middle-income and low-income countries. While the Good Practices are based on successful experience primarily of middle- and high-income countries, the recommendations that emerge are simple and practical. Low-income countries may wish to phase-in the recommendations and take an incremental approach. The ideas, however, are of universal application and should be part of consumer protection strategies for countries worldwide.[28]

The country diagnostic reviews used *Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool* as a guide. Use of the Good Practices to assess each country's legal and regulatory framework for financial consumer protection generated a systematic form of review and assessment and ensured that the country diagnostic reviews were conducted using a common approach.[29] All of the Diagnostic Reviews provide separate analyses for each of banking, insurance, securities and private pensions sectors. As part of the pilot program, several countries also covered non-bank credit institutions, microfinance organizations and credit reporting systems. The result has been Diagnostic Reviews that provide both depth and breadth to a discussion of the best ways to improve consumer protection in financial services.

It is expected that all the Diagnostic Reviews will be published. The Reviews provide valuable information for other countries attempting to address the same sets of issues. (The published Reviews are available at www.worldbank.org/eca/consumerprotection.)

[28] Additional insights for consumer protection in low-income countries, particularly in the microfinance sector, are provided by reports on Malaysia and Cambodia prepared by the Consultative Group to Assist the Poor (of the World Bank Group).

[29] The review for the Czech Republic did not include an assessment of the Good Practices, since the Practices were prepared only following completion of the Czech review—and in response to Czech supervisors who asked on what basis their framework had been evaluated.

Key Issues & Lessons Learned

Institutional Structures

In the diagnostic reviews, one of the most difficult issues relates to the institutional structure for financial consumer protection. Regulation of financial consumer protection lies midway between financial sector regulation and consumer protection regulation for goods and services. Different countries have taken different approaches. While all banking supervisory agencies see their role as maintaining soundness and stability in the banking sector, some view consumer protection as an additional implied responsibility. Other banking supervisors take a different approach. They focus only on prudential supervision and view consumer protection in banking as the responsibility of the economy-wide consumer protection authorities. However in these cases, the consumer protection authority is generally responsible for a limited number of retail financial services, such as consumer credits and payments. Consumer protection in insurance, securities and private pensions falls to the financial supervisory agencies for each area. Table 2 summarizes the different approaches taken by the nine countries studied.

Table 2: Financial Consumer Protection: Who is Responsible?

Country	Financial Supervisory Agency	Depends on Financial Service
Azerbaijan	X	
Bulgaria		X
Croatia	X	
Czech Republic	X	
Latvia		X
Lithuania		X
Romania		X
Russia		X
Slovakia	X	

Source: Diagnostic Reviews

From a consumer's perspective, the government's structure can be difficult to comprehend. For five of the nine case studies, the applicable financial consumer protection authority depends on the type of financial service (as seen in Table 2). In all nine countries, if the problem relates to securities, the consumer should go to the securities supervisory agency and for private pension issues, to the pension supervisory agency. If a consumer has a problem related to an insurance product, the consumer should approach the insurance supervisory agency, although in Russia, the consumer protection service may have responsibility. (Experts on Russian insurance do not agree who is responsible for consumer protection in insurance.) If the problem relates to a consumer credit or a payment or remittance—and a consumer protection agency is in place—the consumer should contact the consumer protection authority. Otherwise the consumer should approach the banking supervisory agency.

The Diagnostic Reviews found that financial consumers generally had no clear idea of which agency to approach. For problems on consumer credits, consumers would write letters to any—or all—of nine different types of institutions: the financial supervisory agency, the consumer protection agency, the finance ministry, the ministry of economy (if it supervises the consumer protection agency), members of parliament, the president's office, the professional associations, the chambers of commerce and non-governmental consumer organizations. Moreover consumers do generally not realize that none of the nine

institutions may be responsible for responding to a specific complaint. The financial supervisors review the case to see if a law or regulation has been breached and if such abuse is a regular occurrence for a particular financial institution. The consumer protection agency reviews the case and attempts to mediate a solution. In the absence of a viable alternative dispute resolution mechanism, the consumer is usually left with only one option—to go to the time, trouble and expense required to file a lawsuit in the courts.

It would be best if consumers could go to a single agency to obtain help related to financial services. Rather than asking financial consumers to navigate a maze of government agencies, one agency should ideally be tasked with the responsibility of receiving financial consumer complaints and ensuring that a response is provided and action taken. In countries, such as the Czech Republic, where the financial supervisory agencies have been merged into one mega-regulator, this entity has established a consumer protection department to undertake business conduct supervision of all regulated financial institutions. Other countries are considering the same approach.

Consumer protection agencies are often overwhelmed when obliged to address financial sector complaints in addition to other economy-wide consumer protection issues. Following the 2008 EU Directive on Consumer Credit, many EU new member states (and Croatia) have adopted consumer credit legislation. In so doing, the law has assigned responsibility for enforcement to the state consumer protection agency—the same agency that is also tasked with enforcing consumer protection rules for food and clothing and other types of products. The agency is generally under strict civil service rules for compensation for staff and thus cannot attract staff—or cannot retain its staff after it trains its own—with sufficient expertise in financial services. Even setting up a separate department for financial services, as has been done by the Swedish Consumer Protection Agency (Konsumentverket), lies beyond the capacity of many overstretched (and often under-budgeted) consumer protection agencies.

Placing consumer protection in the same institution as prudential supervision creates potential conflicts but may also provide useful early warning signals for supervisors. Where the financial supervisory agency is responsible for consumer protection, as well as prudential supervision, supervisors may recommend a corrective measure against a financial institution that does not comply with consumer protection regulation—and this measure may weaken the soundness or stability of the financial institution. However the supervisory agencies that combine the two functions generally find that dealing with consumer complaints provides a useful "early warning signal" of problems to come with specific financial institutions, and prudential supervisors value the information about how a bank treats its retail customers. To solve the problem of conflicts of interest, some countries place the consumer protection department under a different reporting structure from that of prudential supervisors.

If a consumer protection agency is already responsible for basic consumer financial services, the agency should become responsible for *all* retail financial services. Such basic services include consumer credits, commodity insurance and deposit facilities. Consumers should not be obliged to identify what kind of financial service or product they have purchased and then determine which agency will help solve a problem. Particularly for consumers with low levels of financial literacy, tracking down the correct agency would be difficult. Concentrating all financial services in an overburdened consumer protection agency may be a difficult task and phasing in the expanded responsibilities may assist the consumer protection agency in taking on new responsibilities.

If a retail product consumer protection agency is also responsible for financial services, it should have a separate unit with adequate resources and expertise to deal with financial issues. A specialized financial services unit should be created of staff with experience in financial sector issues—and sufficient expertise not to be intimidated by financial sector products or institutions. This may also require setting different compensation levels for financial experts compared to other experts in the agency.

In the absence of pre-existing alternatives, the creation of a specialist financial consumer protection agency should be considered. While no government wishes to create additional institutions, some are considering the creation of a specialized agency. Many governments find that financial consumer protection is "neither fish nor fowl". When consumer protection is assigned to the financial regulators, looking out for consumers' interests always stands second behind issues of financial stability as has been seen in the US in recent years and the inability of the US Federal Reserve Board to put in place consumer protection regulations until the financial crisis hit its worst mark. On the other hand, when financial services are assigned to a consumer protection agency, the staff for financial services rarely receives sufficient support and training to fulfill its duties. In light of the difficulties of finding the right institution to handle financial consumer protection, in 2001 the Government of Canada created a special agency responsible for strengthening consumer protection and expanding consumer education. The current US administration has proposed a similar approach, whereby a Consumer Financial Protection Agency would deal with consumer issues related to plastic cards (credit and debit cards) and residential mortgages. In the UK and Ireland, the financial ombudsmen also take on the role of recommending strategies for consumer protection and financial education. The experience of the Financial Consumer Agency of Canada (FCAC) shows that creating a special financial consumer agency allows for consolidation of financial consumer laws and regulations in one place. It also helps to set clear priorities for the agency while increasing efficiencies from having all financial consumer issues handled by a single agency.

Whichever agency is responsible for financial consumer protection, its mandate on consumer protection issues should be clear. It is best if the mandate is part of the authorizing legislation for the agency (as it is now for some central banks, such as the Czech National Bank) rather than implied (as it is for most financial supervisory agencies).

Financial consumer protection authorities could also benefit from participating in the international networks, such as FinCoNet. The International Financial Consumer Protection Network (FinCoNet) was established in 2003 at the initiative of the FCAC. In total, 30 countries worldwide have participated in FinCoNet meetings but they include only two of the countries studied (Russia and Czech Republic). FinCoNet aims to become a standard-setting body on issues of financial consumer protection as well as regulations related to market conduct for retail financial institutions. Financial consumer protection authorities worldwide would benefit from participation in networks, such as FinCoNet, that promote the exchange of information on supervisory and regulatory issues as well as on market developments.

Consumer Disclosure

Simple and easy-to-understand consumer disclosure is at the heart of robust consumer protection. The Diagnostic Reviews found that where the EU Directive on Consumer Credit had been implemented, clear disclosure of effective rates for consumer credits was provided. However, many of the other terms and conditions required a careful reading of the financial contract, as well as the general terms and conditions imposed by the financial institutions. Outside the EU, disclosure was not entirely clear. For example, in Russia after the Central Bank required that banks provide consumers with both the nominal interest rate and the effective rate, consumers were verbally informed that the first rate was "the interest rate". The second rate was what the bank was obliged to file with the banking supervisors.[30] In none of the nine country studies were consumers informed of the risks involved in taking long-term loans in foreign currency and at variable interest rates.

[30] The US Federal Reserve Board has also found in its testing of consumers in shopping malls and other locations that consumers rarely understood disclosure of complex terms and conditions of credit cards, such as the application of double-cycle billing and universal default. As a result, the US Federal Reserve Board dramatically simplified consumer disclosure for credit cards bills (and prohibited other credit card practices that were difficult for consumers to understand even with full disclosure.)

Consumers should receive information in a standardized format, that is clear, concise and that employs plain language with limited use of jargons. For EU countries the content and format of the information to be provided to customers of consumer credit are set out in detail in the Consumer Credit Directive which prescribes the use of the Standard European Consumer Credit Information. However these provisions do not apply to mortgage credit, unless the EU member state expressly decides to do so. Such types of standardized format should be developed in all countries at least as self regulatory instruments at the level of professional associations. The format and content of such standardized document would need to be revised based on extensive testing with consumers, to ensure that it presents only the most useful and relevant information in a way that is easy for borrowers to understand.

A Key Facts Statement would give consumers a simple summary of the important terms and conditions of their financial contract. Use of a Key Facts Statement was developed in the United Kingdom to help consumers understand the terms of their financial contracts.[31] These Statements have proven to be effective mechanisms for consumer disclosure. The Key Facts Statements should be developed by the professional associations, which should recommend their use by member financial institutions. The Statements should be written in plain language and summarize in a page or two the key terms and conditions of the specific financial product or service provided. Such a standard format would allow consumers to compare across products provided by different financial institutions before they make a purchase—and provide a useful summary for later reference during the life of the financial product.

For consumer credit, for example, a Key Facts Statement should include: (1) the total amount of the credit; (2) the amounts of monthly payments; (3) the final maturity of the credit or investment; (4) the total amount of payments to be made; (5) all fees—particularly prepayment and overdue penalty fees—and any other charges that could be incurred; (6) any required deposits or advance payments; (7) if the interest rate is variable, the basis on which the calculation is made; and (8) if any additional insurance (such as personal mortgage insurance) is required to maintain the credit. If the credit is used to finance a consumer product, such as a television or washing machine, the consumer should be advised of the cash price of the product without financing charges. A Key Facts Statement for a consumer credit should also disclose any prepayment penalty which in some countries can be as high as the original cost of the loan. In most of the countries studied, existing regulations specify in some detail the information to be provided to retail borrowers, however there is no clear standard format used by credit institutions.

Simple and standard disclosure would help consumers compare offers by different financial institutions. Such comparison shopping would allow households to find the best financial product or service to meet their needs—and encourage financial institutions to compete for customers on a transparent basis. Financial supervisors should encourage such "comparison shopping" by asking the professional associations to develop a standard format and methodology for financial institutions to offer such standard products as motor third-party liability insurance.

Simple and standard consumer disclosure would also help consumers understand complex financial products. As more sophisticated financial products become available, the consumer well-being may become threatened by regulatory arbitrage in packaging the products. Before the recent financial crisis started, large financial conglomerates in many countries were able to pick and choose between regulators to sell consumers the financial products which were least regulated and frequently not suitable for the consumers' needs, especially in the securities market. One example where common rules would significantly benefit the consumer is unit-linked insurance, which often has limited disclosure requirements compared to strict disclosure for investment funds. Similarly the same information should be provided and the same rules applied for mortgages and mortgage alternatives, such as building savings loans or specific consumer credit related to home building or renovation.

[31] A similar approach is taken in the US with a focus on "plain language" and the use of the "Schumer Box" for credit card disclosure.

For long-term financial products, continuing disclosures are also important. For investment products, consumers need to receive information on investment performance (and compare actual performance to their expectations). Consumers should also receive an explanation of the choices available for deployment of the funds: without access to such information, consumers often fail to exercise valuable options. For investment-linked insurance products (which are similar in nature to collective investment funds), consumers also need information on current market values for their policies.

The use of standard provisions in retail financial contracts would also be helpful. When looking to buy a financial service or product, consumers have almost no ability to amend a financial institution's standard contract. Yet, as was seen in the Diagnostic Review for Romania, many consumers would like to obtain copies of the contractual terms and conditions and have a chance to study them (and discuss them with friends and family members) before they sign the contact. Some banks argue that the contracts represent intellectual property and they worry that such property would be stolen by competitors. A better solution would be for the professional associations to develop standard contracts (or at least standard provisions of basic contracts) for all high volume commodity-type retail financial services. In this way, the associations can develop a contract that meets the needs of the financial institutions while making the contracts easily accessible to future purchasers of financial products and services.

Professional associations have an important role to play in developing standard disclosures. As self-regulatory organizations (SROs), professional associations can recommend standard disclosures to their members, such as the use of a Key Facts Statement or application of standard contract provisions for basic retail financial products.

However countries may wish to adapt the consumer disclosure rules to their level of financial sector development. Countries of low levels of financial development may prefer to use standard contracts for consumer disclosure whereas those with deep development of retail financial services might wish to apply detailed disclosure rules. Table 3 provides some suggestions of different types of consumer disclosure.

Table 3: Levels of Consumer Disclosure

Level of Development	Measure
Low	Easy availability of standard contracts for retail financial products
Medium	Use of a Key Facts Statement
High	Disclosure of risks related to non-standard products, for example, residential mortgages denominated in foreign currencies

Business Practices

The Diagnostic Reviews found that most consumer complaints result from poorly regulated business practices of financial institutions. Common business practices are influenced not only by the laws and regulations and their application and enforcement, but also by the business culture of the country in question. In the nine countries studied—and in emerging markets generally—the legal and regulatory environment remains less than fully developed.

The current economic crises has shown that there is significant room for irresponsible lending and borrowing practices, especially when financial institutions providing consumer credit are not adequately licensed, registered and authorized. At a minimum, all financial institutions extending credit to households, including mortgage loans and mortgage-backed consumer loans, should be obliged to be registered with a financial supervisory agency. Financial institutions should be required to file

annual audited financial statements and the supervisory agency should verify that the significant owners (and those who control ownership), as well as the senior managers of the financial institutions, satisfy minimal fit and proper requirements, including no history of bankruptcy or criminal conviction.

The Diagnostic Reviews found that the worst abuses of financial consumer protection are often in the parts of the financial sector that are not subject to any form of licensing. In Slovakia, non-bank credit institutions (which, at the time, were not registered with the National Bank) charged consumers interest rates of 120 to 225 percent per annum while banks were lending at less than 14 percent. Another common problem relates to debt collectors. In Russia, when the financial crisis hit household lending and delinquencies started to rise, banks increased the use of third-party debt collection agencies to improve loan performance. However these debt collection agencies remain unlicensed and their methods of operation are not subject to any, let alone strict, controls. All agencies involved in debt collection from consumers should be subject to registration with a financial supervisory agency.

Unfair or deceptive practices should be explicitly prohibited. The six countries reviewed that are members of the EU plus Croatia have all implemented the EU Directive on Unfair Commercial Practices. In Russia and Azerbaijan, however, unfair practices were explicitly prohibited. In all jurisdictions, financial institutions should be obliged to ensure that they provide accurate and complete information and are held accountable for the information they provide to consumers. High-pressure sales tactics, such as doorstep (or "door-to-door") selling should be subject to a cooling-off period where the consumer can cancel any resulting signed contract without penalty during the period of 14 days following receipt of the contract. Cooling-off periods are needed for any products used for long-term savings (such as life insurance with a savings component and private pension products), since such products generally provide high bonus incentives for selling agents and are thus subject to high-pressure tactics. However, for financial products with market risk, consumers who cancel their contracts during the cooling-off period should be required to compensate the financial institution for any out-of-pocket losses.

Financial advice should be objective, based on the profile of the borrower and commensurate with the complexity of the financial products and the risks involved. Although not regulated in most of national legislations or financial regulations, providing financial advice to consumers needs to be subject to basic rules of conduct at least at the level of internal guidelines of financial institutions. EU member states such as the UK, Ireland and Denmark have included basic rules of conduct for advice provision. Examples of rules of conduct include to: (1) act honestly, fairly and professionally in the best interests of the borrower; (2) take reasonable steps to obtain all relevant information to assess the borrower's knowledge and experience relevant to the credit offered, the borrower's financial situation and his or her credit objectives; (3) assess the affordability of the product for the particular borrower; (4) determine whether the product is suitable for the borrower's needs and circumstances; (5) ensure that the product recommended is the most suitable among all the products available; (6) alert the borrower at an early stage of the costs for receiving advice; (7) provide written documentation as to the grounds on which advice for a specific product is being given; (8) provide a warning if the borrower wishes to purchase a product that the lender or intermediary deems not to be appropriate; and (9) disclose actual or potential conflicts of interest, including the level of remuneration paid to the intermediary or bank client-facing staff member for the specific product being advised.[32]

Those who sell financial services and products should be qualified and certified. In all nine countries of the Diagnostic Reviews, consumers complained that the officers in the financial institutions who sold them any financial product or service did not explain its key risks and rewards. Consumers were often of the view that those with whom they dealt within any financial institution did not, themselves, understand the product or service they were selling. Thus consumers often believed they had been misled. Loan officers in credit institutions should be trained to interview their customers to understand their financial situation and the risks they are facing and provide with instructions on how to maintain sound personal

[32] European Commission, *Public consultation on Responsible Lending and Borrowing in the EU*, June 15, 2009

finance and avoid risks overexposure. The practices should be described in detail in the internal procedures of the credit institutions or included in an industry code of conduct. Training and certification should be based on the nature of the services or products being sold. The retail sales agent, selling a simple product such as a bank account may only need training that is provided by the financial institution. Those who sell complex products, such as investment products, may be subject to advanced training and certification by the financial supervisory agency.

In none of the country studies did regulators approve specific financial products. Since the financial crisis, some international regulators have expressed interest in undertaking approval of complex products, such as hedge fund investments, when they are sold to retail investors. For highly complex products, it may be appropriate simply to prohibit all sales to retail consumers—or to prohibit sales without accompanying advice, subject to tight requirements to ensure that the product is suitable for the customer. However in the country studies, none of the regulators was developing programs to undertake product-by-product approvals.

Special attention should be paid to protection of personal data. In all three Diagnostic Reviews where issues of personal data protection were specifically reviewed, substantial weaknesses were found in the legal and regulatory framework. At a minimum, consumers who sign general contracts with financial institutions should have a separate form to record their signed approval for their personal data to be shared by the financial institution with other institutions, including any credit register (i.e. an "opt-in" approach). Consumers also need an easy way to verify their own personal information in the credit register and correct any errors that may arise. In addition, procedures should be in place to reduce the risk of identity theft and ensure that the technical security of the databases prevents unauthorized access.

Codes of conduct can help to improve business practices of financial institutions but they should be adequately disclosed, known and enforced. Codes of conduct cannot substitute for regulation but they can help fill in the details not covered by regulations. In the country studies, more than half of the professional associations had approved codes of conduct or ethics codes (See Table 4) but there was little evidence of any positive impact on the behavior of financial institutions. In none of the nine countries were the codes generally well known, even to the members of the associations. Some associations—but not all—had placed the codes on their websites and few financial institutions made the codes available on their premises. None of the associations monitored compliance and none had authority to take enforcement measures in the case of non-compliance by members. One strategy used in Canada is to have the regulators publicly report on the effectiveness of the codes of conduct. Where the codes were proven to be less than effective, the regulators would start the process of preparing new regulations. Financial institutions should also play an active role in promoting consumer protection. Behind every irresponsible borrower lies an irresponsible lender. Credit institutions should be encouraged to engage in "responsible finance."

Table 4: Codes of Conduct

Country	Banking	Insurance	Non-Bank Credit Institutions	Securities	Pensions
Azerbaijan	No	No	No	No	No
Bulgaria	Yes	In process	Leasing Credit cooperatives	Management companies	Yes
Croatia	Yes	Yes	No	Management companies	No
Latvia	Yes	Only brokers	Leasing	No	Yes
Lithuania	No	Yes	No	Yes	No
Romania	In process	Yes	No	Management companies	Yes
Russia	Consumer loans & mortgages	Only motor insurance	No	Management companies	No
Slovakia	In process	No	Installment sales companies	Yes	No

Source: Diagnostic Reviews
Note: Codes of conduct are under preparation for brokers in Bulgaria, Romania and Russia

Financial intermediaries were seen in all the country studies. As noted in Table 5, in all nine country studies financial intermediaries are used, either as agents tied to one financial institution, multi-agents working for several financial institutions, brokers representing consumers, or through multi-level sales distribution systems.[33] In the country studies, financial intermediaries were most often seen in the insurance sector. However intermediaries were also present for securities, pensions and consumer credits, including residential mortgages.

Improved regulation of financial intermediaries is often needed. At a minimum, clear liability and responsibilities should be set for agents and brokers. For agents, the financial institutions that they represent should be liable for the agents' advertising and statements made to customers. Brokers should have a clear legal fiduciary duty to the consumer. Non-bank payment systems should also be regulated. Non-bank payment providers (for example, those that in Russia operate ATM-like terminals that collect payments rather than disburse cash) should be registered with a financial supervisory agency, which should check that the owners and key managers are free of criminal records and bankruptcy.

[33] Terminology for financial intermediaries is confusing. Securities are sold primarily through intermediaries known as brokerage firms (brokers), which also directly sell investment funds. The individual officers working for brokers are known as agents. By contrast, insurance is sold either through agents (which may be companies or individuals) or through brokers (which also may be companies or individuals). This Working Paper's recommendations on intermediaries refer only to companies acting as agents or brokers.

Table 5: Modes of Distribution of Financial Products and Services

Country	Direct Sale	Tied Agents	Multi-Agents	Brokers	Multi-level Distribution
Azerbaijan	Credits Investment Funds Insurance		Insurance	Securities Insurance	
Bulgaria	Credits Investment Funds Insurance Pensions	Credits	Credits Insurance Pensions	Securities	
Croatia	Credits Investment Funds Insurance	Credits Insurance Pensions	Insurance Pensions	Securities Insurance Pensions	Insurance
Czech Republic	Credits Investment Funds Insurance Pensions	Credits	Credits Insurance	Credits Securities Insurance	Credits Insurance
Latvia	Credits Investment Funds Insurance	Credits Insurance	Insurance	Securities Insurance	
Lithuania	Credits Investment Funds Insurance Pensions	Credits Insurance	Insurance	Credits Securities Insurance	
Romania	Credits Investment Funds Insurance Pensions	Credits Insurance Pensions	Credits Insurance Pensions	Credits Securities Insurance Pensions	Insurance
Russia	Credits Investment Funds Insurance Pensions	Insurance	Insurance	Securities Insurance	
Slovakia	Credits Investment Funds Insurance Pensions	Credits	Credits Insurance	Credits Securities Insurance	Credits

Source: Diagnostic Reviews; European Commission, DG Internal Market and Services, *Study on Credit Intermediaries in the Internal Market* (MARKT/2007/14H), Final Report by Europe Economics, January 15, 2009

Special attention should be paid to multi-level schemes as a distribution mechanism. Multi-level distribution systems were seen in four of the country studies whereby the purchase of a product requires that the consumer also become part of the sales distribution force for the product. A multi-level scheme is often described as a program with three or more levels that promotes the supply of a product (or service) to participants of the scheme. Participants in the scheme earn compensation based on the supply of the product or service to other participants or non-participants of the scheme. While multi-level selling is often used for legitimate purposes, its structure is vulnerable to abuse. A legitimate multi-level scheme focuses on the supply of products or services—rather than the recruitment of prospective participants into the scheme. A legitimate scheme also offers products or services that consumers value and are willing to purchase. The law should identify a multi-level sales scheme as a pyramid scheme if: (1) the scheme requires a payment for the right to receive compensation for recruiting new salespersons into the plan; (2) there is inventory loading, that is, new salespersons must purchase an unreasonable quantity of a product or service; and (3) purchases of services are required as a condition of entry into the scheme.[34] Large

[34] Paying people a bonus for recruiting others is a common incentive in many legitimate schemes. The problem in the multi-level schemes (which is a form of a pyramid) is that participants have to pay to receive the bonus. If they cannot recruit anyone, they do not receive a bonus—and they are not reimbursed for the money paid to enable them to get the bonus. This—and being forced to buy inventory—are the essence of the fraud.

upfront bonuses provide strong incentives for high-pressure sales through multi-level distribution and distribution needs to be carefully regulated. In general, providing a substantial cooling-off period (of say 14 days) will help to protect consumers from high-pressure marketing tactics but specific legal prohibitions are also needed.

Pyramid schemes and other forms of financial fraud should be prosecuted by those with sufficient expertise in financial matters. The problem of financial fraud, where consumers pay for services not rendered or invest in residential construction projects that are in fact pyramid schemes, should be handled by ensuring that the criminal authorities have sufficient financial expertise to adequately handle financial fraud. The temptation to develop a Ponzi scheme—and repay later early-stage investors with the funds from late-stage investors rather than investment earnings—will be present in all financial markets. However, the securities supervisory agency should have broad powers to investigate such schemes—and then assist the criminal authorities in prosecution. Anyone who solicits funds from the public for the purpose of investment or speculation should be required to obtain a license from the securities supervisory agency. In this way, the securities supervisor can investigate any scheme that appears to be illegitimate. The Russia Diagnostic Review highlighted the ongoing problem of financial pyramids and their impact in undermining public confidence in financial markets. When households were asked if they would like financial education—and why—more than half who were interested in financial training wanted to know how to protect their rights and avoid investing in a financial pyramid.

Consumers should also be allowed to choose the provider of any product required to supplement or complement another financial product. Financial institutions should clearly provide customers with separate prices of each product in a bundle, as well as any discount available if purchased as a bundle from the same institution (or from a preferred vendor). Different practices of tied sales were found among the nine countries studied. In Bulgaria, auto dealers would often only allow the consumer to choose the provider of collision and comprehensive insurance—and the dealer would later intermediate the liability insurance via its insurance broker, without letting the consumer choose the liability insurance provider. In Latvia, banks set their own specific insurance requirements for borrowers in order to grant a credit, which include providing customers with a list of approved insurance companies.

Another issue relates to handling of client money—and compensation for retail customers if the financial institution (or its agent) goes bankrupt and cannot repay the funds held on behalf of customers. The Diagnostic Reviews found that compensation schemes for financial products vary across countries (see Table 6). The country studies found that all nine countries provided insurance for bank depositors in the case a bank collapsed, although most had increased their limits during the financial crisis.[35] The maximum amount covered ranged from about €14,000 in Croatia to as much as €100,000 in Lithuania. Also all nine countries provided 100 percent coverage for policyholders of compulsory motor third party liability (MTPL) insurance policies in case the insurance company becomes insolvent.

Apart from bank deposits and compulsory MTPL, deposit or guarantee insurance varies by the type of financial product. For cases where the broker-dealer or asset management company has collapsed, the EU member states generally provided for compensation of up to about €20,000 for loss of client funds. However no investor insurance was available in either Russia or Azerbaijan. For other types of insurance, such as life or health insurance, coverage in the country studies was either nonexistent or limited to a maximum of 70 percent of the insurance claims.

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[35] Prior to the financial crisis, international practice recommended that the compensation schemes be funded from a levy on financial institutions. However during the financial crisis, large commitments particularly for the banking sector have placed additional demands on government budgets, as seen in the US and elsewhere.

Table 6: Compensation Schemes for Depositors, Investors and Policyholders

Country	Depositors	Investors	Policyholders on MTPL	Other Policyholders
Azerbaijan	30,000 AZN (€25,100)	None	None	None
Bulgaria	100,000 BGN (€51,200)	40,000 BGN (€20,500 up to 90%)	100%	8,000 BGN (€5,000 up to 70%) for life insurance only
Croatia	100,000 HRK (€13,700)	150,000 HRK (€20,500)	100%	None
Czech Republic	€50,000	€20,000 (up to 90%)	100%	None
Latvia	€50,000	€20,000 (up to 90%)	100%	2,000 LVL (€2,800 up to 50 – 100%)
Lithuania	€100,000	€20,000	100%	None
Romania	€50,000	€9,000 (to increase to €20,000)	100%	25 - 70%
Russia	700,000 RUB (€16,300)	None	100%	None
Slovakia	€20,000	€20,000 (up to 90%)	100%	None

Source: Diagnostic Reviews, National Laws

Complaints & Dispute Resolution

Customer complaints provide a valuable source of information. Complaints from financial customers reveal what information consumers receive about their financial services and how and to what extent consumers understand the disclosure that is provided. This information is valuable to all stakeholders, including managers of financial institutions, supervisors, consumers and market participants.

If complaints are not satisfactorily addressed, they undermine public confidence in the financial sector. A financial literacy survey conducted in Russia in June 2008 found that more than half of respondents did not have confidence that in case of a dispute with a bank or insurance company, the case would be handled quickly, efficiently and fairly. Where consumers lack confidence that problems can be easily and quickly solved, they will be reluctant to invest their money or take a loan. To build a deep financial sector, consumers need to be assured that they are protected and that solutions will be found to problems if they arise.

At a minimum, all financial institutions should be obliged to have a designated department (or at least an officer) responsible for handling complaints. The Diagnostic Reviews found that in all nine countries, the large well-managed financial institutions generally had set up specialized complaint departments to receive complaint letters from consumers and investigate if an error had been made by the institution. All financial institutions—large and small—should have at least one officer designated to receive customer complaints. When opening a new account and buying any new service, the consumer should be advised in writing as to where complaints, inquiries and disputes should be submitted.

As part of the supervision process, financial supervisors should review the complaint files of the financial institutions they oversee. The Diagnostic Reviews found that in all nine countries, banking supervisors, while conducting on-site supervision visits at commercial banks, reviewed each bank's complaint files. This is a useful approach. Financial supervisors should review the ways in which

financial institutions treat their retail customers—and where necessary, they should enforce the legislation. In addition, financial supervisors should review complaint files to identify which institutions receive a high number of complaints from retail customers and why—and what remedial actions are taken. One approach is to go further and have the regulators publicly file an annual report on the number of consumer complaints by financial institution and the common sources of the complaints.

There should be one, clearly identified, central location where consumers of financial services and products can go to discuss their financial problems. This central office should have a toll-free telephone line so that anyone from anywhere in the country can obtain information about financial services and their legal rights in case of a dispute. Consumers should also be able to submit their complaints by email, by postal mail, or by visiting the office of the complaints office. Disputes over specific cases will likely be handled by a separate redress mechanism. However consumers should have one location where they can make inquiries, obtain reliable information and be directed as to how to request resolution of a dispute.

Different countries have different approaches to consumer complaints. More complaints in total, however, tend to be received where all financial complaints are centralized in one office. This suggests that centralized consumer complaints offices tend to achieve the highest level of public confidence. More and more consumers will go to the trouble of submitting a complaint if there is mounting evidence of at least a reasonable assurance that a solution is being found for the issues at hand.

Most complaints are inquiries rather than disputes. The Diagnostic Reviews found that at least half of complaints submitted to the supervisory authorities are requests for additional background information to help consumers understand the financial services and products they purchase. In Azerbaijan, the most common complaint consumers submitted to the central bank was that they did not understand why their commercial banks failed to grant loans to them. In Croatia, consumers complained to banking supervisors that "We don't understand what we signed". The Diagnostic Reviews found that consumers are often confused about the terms and conditions of their financial contracts and largely unaware of the full extent of the risks inherent in the financial product or service on offer or actually acquired. The EU Consumer Credit Directive (now implemented in most EU new member states) provides a clear algebraic expression for the calculation of the annual percentage rate of charge (APR). Yet consumers often do not understand how the final rate is calculated. For example, the Diagnostic Review for Latvia noted that one of the most common forms of complaint submitted to the consumer protection authority was over calculation of the interest rate on consumer loans. Numerous consumers complained that banks unilaterally increased the interest rate on their mortgage loans. Yet investigation of the terms for those contracts showed that the contract clearly stated that the interest rate was set at a specified margin over a widely quoted reference rate, such as LIBOR or the Riga inter-bank offered rate. In such cases, the consumer had clearly not understood the terms of the contract.

The complaints office should be able to access programs of financial education. Where a complaint is an inquiry rather than a dispute, the office should provide consumers with access to reliable financial education resources. Responding to consumer inquiries and providing reliable information to deal with consumers' immediate needs thus provides an excellent forum for consumer education on financial matters.

Statistics on consumer complaints should be analyzed and published—and used to identify future improvements in the consumer protection framework. In none of the countries of the Diagnostic Reviews were statistics on financial consumer complaints aggregated or analyzed to identify trends. Numerous agencies received consumer complaints and each tracked how many they received. However, the complaints were spread among different agencies. For example, in Romania only the insurance supervisor publishes data regarding the number of complaints received and how they are settled. In Russia, data on the number and types of complaints are published by the insurance and securities supervisors but no data is available about complaints about other types of financial services. In Bulgaria,

the financial supervision commission includes in its annual report a brief section on the number and main types of complaints regarding each sector under its supervision (insurance, securities and pensions). However no statistics are publicly available for other types of financial services. In general, statistical information and analysis of financial consumer complaints is scarce, disperse, not easily available and not aggregated. As a result, no government agency or non-government organization reviews complaints data to see what trends could be determined across the financial sector. Making the complaint statistics available to the public would allow such analysis—and potentially provide insights into what revision to legislation or institutions would be helpful in avoiding or at least limiting complaints in the future.

Consumers in the EU new member states tend not to pursue complaints. Looking at consumer complaints across all sectors (not just financial services), the October 2008 Eurobarometer survey of 27 member states found that consumers in the new member states tended not to pursue complaints. For example, in Bulgaria, 78 percent of consumers took no further action if a complaint was not satisfactorily resolved. However even across the EU, as many as half of all consumers give up even if there is no satisfactory resolution of the problem at hand.

As a financial complaints office gains public credibility, it is likely that the number of complaints will increase. The Financial Ombudsman Service in the UK handled above 31,000 complaints during its first full year of operation (2001) and the Financial Services Ombudsman in Ireland received around 2,600 complaints during its first year of activities (2005). Within three years, as the offices became well known and gained credibility as effective spokespersons for financial consumers, the number of complaints had risen more than two-fold—up to about 100,000 complaints in the UK and 6,000 in Ireland (although a large number of the complaints in the UK related to the ongoing resolution of cases of mis-selling of insurance policies sold to borrowers as repayment vehicles for residential mortgages). Financial institutions in the UK are required to alert consumers to the redress that is available through the complaints process. A similar increase in the number of complaints might be expected in developing countries.

Dispute resolution systems vary across countries. Among the nine countries in the Diagnostic Reviews, only three had some form of mediation or conciliation committees or arbitration court, which tried to help both parties amicably come to an agreement (see Table 7). Three countries had an arbiter, ombudsman or agency that covered only specific banking or insurance services—or even just payments services.

Table 7: Out-of-Court Dispute Resolution Systems

Country	Out-of-Court Dispute Resolution System
Azerbaijan	None
Bulgaria	Conciliation Committees
Croatia	Mediation Centers
Czech Republic	Financial Arbiter (payment services only)
Latvia	Banking Association Ombudsman (payment services only) Insurance Ombudsman (property and motor insurance only) Arbitration Courts
Lithuania	Consumer protection agency (payment services only)
Romania	None
Russia	Small Courts
Slovakia	Arbitration Court (banking sector)

Source: Diagnostic Reviews

Mediation processes should, but typically do not, address the issue of imbalance of power and information between a financial institution and a consumer. For example, even though mediation and conciliation committees exist in Bulgaria, there is no court-imposed obligation on potential litigants to exhaust efforts in good faith to seek a mediated settlement prior to a trial on the issues taking place. Thus, because the use of a mediation committee is voluntary, the financial institution can avoid responding to any consumer complaint simply by refusing to attend any session of the relevant conciliation committee. Furthermore, mediation processes assume roughly equal balances of power and information (as is true in business-to-business disputes). Even a well-informed consumer will have difficulty in maintaining a power balance with a large financial organization unless the mediator who is acceptable to both parties is especially well trained in this respect.

In none of the country studies were private forms of mediation used. However in high-income countries, private forms of mediation are often successful and might be useful approach for consideration in middle-income countries.

Going to court is not a viable alternative for most financial consumers. The vast majority of consumer disputes relate to claims from the equivalent of $100 to no more than the equivalent of $5,000. For most consumers, the amount of money involved is too small to make it worthwhile for them to spend the time and money to pursue a court case—or for over-burdened courts to give priority to cases involving financial consumers. Where no viable out-of-court mechanism is in place, consumers will generally abandon their efforts to gain a satisfactory resolution of their claims. As a reference, Table 8 provides a cross-country comparison of the costs of going to court to resolve commercial disputes in the nine country studies.

Consumer organizations are generally not sufficiently active in helping financial consumers. In eight of the nine countries studied, non-government organizations (NGOs) lacked sufficient expertise and sustained funding to follow financial sector issues. The one exception was Russia, where the consumers' union (KonfOP) has initiated lawsuits on behalf of financial consumers.

Table 8: Cross-Country Comparisons of the Costs of Going to Court

Country	Number of Procedures	Duration of Procedure (Days)	Cost in Fees (% Claim)
Azerbaijan	39	237	18.5
Bulgaria	39	564	23.8
Croatia	38	561	13.8
Czech Republic	27	611	33.0
Latvia	27	309	23.1
Lithuania	30	275	23.6
Romania	31	512	28.9
Russia	37	281	13.4
Slovakia	30	565	30.0

Source: World Bank Group, *Doing Business 2010*

Policy-makers should consider other alternatives, such as an office of financial ombudsman that can take and enforce decisions regarding claims for small amounts of money. For financial institutions, consumer disputes often cost more in administrative time than the amount of the dispute. It is therefore to the advantage of financial firms to support an independent third-party form of dispute

resolution, such as a financial ombudsman's office, which can inquire into specific cases and determine what should be done as a result.

A financial ombudsman office may be set up under a professional association or as a statutory ombudsman under the state, but in any case the scope of authority of the ombudsman should be clearly defined. For example, the German Banking Association established an office of banking ombudsman that can make binding decisions on amounts up to €5,000. The consumer may still appeal the decision to the courts, but the ombudsman's decisions must be followed by the financial institution. The decisions are binding on all banks that belong to the German Banking Association and the costs of the ombudsman's office are paid by the members of the Association. An ombudsman's office that is established under a professional association can, however, be perceived by consumers as being biased. Consumers may view an industry-sponsored ombudsman as one that will always favor the financial institution. To counter this argument, the UK and Ireland established statutory financial ombudsmen, with functions and powers set up by national laws and members appointed by government authority. Although their services are free to the consumer, their activities are funded by levies payable by financial service providers.

However resolution of disputes across borders remains a gray area. The country studies did not encounter examples of cross-border disputes regarding financial services, but the European Commission has noted that only one percent of all financial transactions within the European Union are conducted across national borders—hence the need for strong financial consumer protection across the European Union. However in other countries outside the European Union, cross-border disputes may arise as an important issue.

Countries may wish to take a graduated approach to recourse mechanisms. For example, an initial approach would be to require that all financial institutions set up a separate department—or at least designate one officer—to receive all customer complaints and provide responses on a timely basis. A second approach for countries with medium development of the financial sector would be to establish an alternative dispute resolution system based on mediators, arbitrators or conciliation committees. If there is an economy-wide consumer protection agency, then a separate unit or department for financial services should be put in place to review complaints related to financial services. Countries at high levels of financial development might wish to create a statutory ombudsman or encourage the professional associations to set up an ombudsman for the financial institutions that are members of their association.

Table 9: Levels of Recourse Mechanisms

Level of Development	Measure
Low	Requirement that each financial institution have a designated complaints department or officer.
Medium	Alternative dispute resolution system based on mediation services, arbitration courts or conciliation committees. A financial services unit in the consumer protection agency to deal with complaints related to financial services.
High	A financial ombudsman set up by statute or through the professional associations.

Financial Literacy & Education

Financial education can potentially be an effective form of consumer protection. A well-educated consumer will be able to understand consumer disclosures that are provided and make informed

decisions. Financial education cannot substitute for regulation but can complement an effective legal and regulatory framework for financial consumer protection.

However building financial literacy requires a sustained long-term effort. Addressing key weaknesses in financial consumer protection can be done quickly with immediate impact, but improving financial capability is a long-term investment. The experience of industrialized countries over the last thirty years—and more recently in developing countries—has identified lessons of "what works and what does not" in consumer protection. By contrast, little is clearly understood as to what works (and what does not) in improving financial behavior over the long term. [36]

None of the nine countries has a national financial education strategy in place. As shown in Table 10, some countries have conducted consumer awareness campaigns, especially in the initial stage of pension reform. In countries like Slovakia, Bulgaria and Croatia, the supervisory agency for the pensions sector organized campaigns to educate the public on the new private pension system, with mixed results. In its April 2009 meeting, the EU Expert Group on Financial Education suggested that the European Commission recommend that all new member states of the European Union develop national strategies on financial education[37]. None of the nine countries with Diagnostic Reviews has to date, however, adopted any such strategy, although several are considering their future development. Following the 2006 G-8 Meeting in St. Petersburg, the Government of the Russian Federation asked the World Bank to assist in developing a national program of financial education and financial literacy.

Table 10: National Financial Education Programs

Country	Financial Education Program
Azerbaijan	National financial education program under preparation
Bulgaria	Awareness campaign for pensions only
Croatia	Awareness campaign for pensions only National financial education program under preparation
Czech Republic	None
Latvia	None
Lithuania	Financial education program in schools only
Romania	Awareness campaign for pensions only
Russia	National financial education program under preparation
Slovakia	Awareness campaign for pensions only

Source: Diagnostic Reviews

[36] For a summary of academic research on the limited effectiveness of financial education in the US, see Shawn Cole and Gauri Kartini Shastry, *If You Are So Smart, Why Aren't You Rich? The Effects of Education, Financial Literacy, and Cognitive Ability on Financial Market Participation*, October 2007. Other analysts go further and argue that financial education fails to improve consumer decision-making and may even be harmful by developing consumer over-confidence. See Lauren E. Willis, "Against Financial-Literacy Education", *Iowa Law Review*, Issue 94(1): 197-285, November 2008

[37] European Commission, *Second meeting of the Expert Group on Financial Education: The financial crisis and financial education Report*, April 28, 2009

Any program to improve financial education should be rigorously tested. Techniques of delivering financial education have been well tested in the US, Europe and elsewhere over the last 30 years[38] but their impact on levels of financial literacy is still unclear. Yet even more unclear is the impact on consumer behavior. Taken together, financial literacy and consumer behavior determine the level of financial capability in households. The issues of consumer protection and financial literacy (and capability) are directly linked as "two sides of the same coin." It is not practical to consider measures of improving financial consumer protection without also looking for ways of strengthening financial literacy. Financial education should therefore be encouraged in developing countries, but it should be rigorously tested and evaluated and be viewed as a long-term investment.

Experience in developed countries suggests that financial education should be focused on "teachable moments." To be successful, financial education needs to provide information "at the time that the consumer wants it and in the form that the consumer wants it."[39] Studies in the US have found that consumers are very receptive to financial education at certain points in their lives, for example, when they first provide a mortgage for a house or apartment. Other teachable moments include times when consumers start to plan for eventual retirement. Financial education is also effective for children under the age of 12 years when they need to learn about financial well-being, as well as the fact that financial health is as important as physical health. In high school, interactive computer games (for example, simulating investments in the stock markets) are also effective in teaching students about how to invest for their futures—and the need to become financially literate.

Middle- and high-income countries should have national strategies on financial education and financial literacy. Few countries have such strategies in place. The US Financial Literacy and Education Commission has developed a national strategy on financial literacy, bringing together financial education programs provided by government agencies, non-government organizations and private sector institutions. Financial institutions—or their professional associations—should also assist in providing financial training for consumers through web-based financial planning programs and other easy-to-learn financial tools. Low-income countries should also adopt programs of financial education but may not want to use limited institutional resources in building a national strategy on financial education and financial literacy.

More resources should be channeled to consumer protection associations for increasing the financial literacy of the consumers. Financial literacy is a necessary condition of responsible borrowing as financially literate consumers are more able to understand and assess their financial situation and the credit products on offer by different providers, and make an informed choice on the most suitable product for them. However this is not a sufficient condition for consumers to borrow responsibly. Financial consumer protection programs should cover both facets for responsible borrowing.

The first step in developing a national program of financial education is to conduct a national survey of financial literacy. A rigorous survey is needed as a starting point for developing a national education program. The survey should be broken down by geographic area, socio-economic level, years of formal education, gender, age and other standard variables for sociological studies. A 2005 report by the OECD reviewing financial literacy surveys worldwide found that consumers are often intimidated by issues of personal finance. The report noted that in Australia, 67 per cent of respondents indicated that they understood the concept of compound interest. Yet when asked to solve a problem involving compound interest, only 28 per cent were successful. A survey by the Royal Bank of Canada found that respondents considered choosing the right investments for a retirement savings plan to be more stressful

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[38] For a summary of programs, see Shaun Mundy, *Financial Education in Schools: Analysis of Selected Current Programmes and Literature – Draft Recommendations for Good Practices*, published in proceedings of OECD-US Treasury International Conference on Financial Education, Washington DC, 7-8 May 2008, Volume II

[39] Quote from Lewis Mandell, leader of the US Jump$tart Financial Literacy Survey, which reviews the levels of financial literacy for high school students in America.

than going to the dentist.[40] In Russia, the findings of the Financial Literacy Survey (see Box 2) were used to develop recommendations for both the financial education and consumer protection programs in Russia.

Box 2: Financial Literacy Survey in Russia

In June 2008, the World Bank conducted a financial literacy survey as part of the Financial Literacy Program in Russia. The survey consisted of 40 questions, covering consumer understanding of financial calculations, spending habits and confidence in financial institutions. Over a two-week period, more than 1,600 households in forty regions were canvassed and the survey results were confirmed in discussions with four focus groups.

The survey found that about half the population views its levels of financial literacy as unsatisfactory. This low level of literacy was confirmed by a simple quiz of six questions on basic issues needed to manage household finances. Only 19 percent of respondents gave at least five correct answers to the six questions. About 25 percent could not provide more than one correct answer. Compounding the problem is weak trust in the Russian financial sector. Of the consumers who do not save, nine percent gave the reason as "lack of trust in financial institutions." Only 11 percent of households have insurance policies, whereas 21 percent of consumers consider that they need life insurance policies, but do not buy them because they "do not believe that the insurance companies will pay the claims in case of their death." Russian consumers also have little confidence that problems with financial transactions can be easily and fairly solved. Three quarters (77 percent) give a 50:50 chance (or worse) that disputes with financial institutions "will be resolved quickly and justly."

Over 80 percent receive financial information from newspapers, magazines and specialized TV shows. However, when making a financial decision, 51 percent turn first to the advice of family and friends and 36 percent look to "consultants". Households would generally like to receive financial education. Three-quarters of respondents said that they would like training on how to protect themselves financially from fraud and how to plan their financial future. One third (31 percent) wants to learn what laws protect financial consumers and what procedures should be followed when consumers feel that their rights have been violated. Over ten percent (13 percent) would like information about credits for household consumption and another 16 percent want to learn about credits to finance purchase a house or apartment. However about one-quarter of respondents expressed no interest in financial training on any topic.

Source: World Bank, *Russian Federation: Diagnostic Review of Consumer Protection in Financial Services*, 2009

Follow-up surveys of financial literacy should be conducted every three to five years. The follow-up surveys will help identify if programs of financial education and consumer protection are working—and if they are not effective, what needs to be done.

Regular financial literacy surveys may also provide food for thought in ways of improving financial consumer protection. For example, the US 2008 Jump$tart College Survey showed that most who graduate from a four-year college have a viable degree of financial literacy, regardless of the focus of their university studies or even specific classes in financial education. However this group encompasses just over 25 percent of the US population. The three-quarters of the population who do not complete a college education tend to not be financially literate—and tend to have little interest in becoming financially literate.[41] It is this group that most needs consumer protection in the form of mandates and/or "plain vanilla" products vetted by financial regulators before they are offered to the public. Products

[40] OECD, *Improving Financial Literacy - Analysis of Issues and Policies*, 2005
[41] President's Advisory Council on Financial Literacy, *2008 Annual Report to the President*

under development include possible government-sponsored financial products that guarantee the safety of (retirement) savings while still providing some possible capital gains from stock market appreciation.

Qualitative monitoring of financial literacy and consumer protection should also be conducted. The use of "mystery shoppers" can help regulators and other policy-makers understand what information is provided to consumers as they shop for financial services and products. It will also highlight areas where regulators should intervene (or encourage the professional associations) to take actions to improve the accuracy and ease of understanding of information provided to financial consumers.

The national financial education strategy should include a role for both the public sector and civil society. The country studies found that the professional associations for the financial sector, and particularly the banking associations, were very committed to providing financial education and training for consumers. This should be encouraged as part of a national strategy on financial education. However in the country studies—in every country except Russia— the consumer organizations lacked sufficient institutional strength to play an important role in improving consumer protection or financial literacy. Consideration should be given to ways of strengthening consumer organizations and ensuring that they have a long-term stable funding source that will allow them to play a vital role in strengthening protection and education of financial consumers.

For financial education, countries may wish to take a graduated approach, depending on the level of financial sector development. As noted in Table 11, at a minimum, the authorities could conduct a radio and television campaign to make consumers aware of the risks involved in financial products. At a medium level of development, more could be done. "Mystery shoppers" could be hired to test the experience of a typical consumer of financial services and products. Training from financial institutions would also be useful. Consideration should also be given to conducting a national financial literacy survey. For countries at high levels of financial sector development, formal training could be provided through the professional associations. Web-based financial tools are helpful as are internet-based stock market simulation games. A national financial literacy survey would provide critical information for the development of a national financial education strategy.

Table 11: Levels of Financial Education

Level of Development	Measure
Low	Mass media campaign to highlight risks for financial consumers
Medium	Use of mystery shoppers, financial training through financial institutions, national financial literacy survey
High	Financial training through professional associations, internet stock market games, national financial literacy survey, national financial education strategy

Future Work

Global surveys of consumer protection and financial literacy would be useful. While the Good Practices include useful policy approaches for consideration by regulators and self-regulatory organizations, it would also be helpful to conduct global surveys on consumer protection and financial literacy. In particular, regulators and others would benefit from global surveys of: (1) the legal and regulatory frameworks for financial consumer protection in different countries; and (2) the levels of financial literacy and common patterns of financial consumer behavior (financial capability) in different countries. Additional cross-country empirical data on levels of consumer protection and financial literacy would also be helpful.

Future country-based reviews might look at additional initiatives. Particularly in low-income countries, it would be useful to look at measures that increase the depth of services for under-served households. This might include, for example, the approach of giving all consumers the right to a minimum-service bank account. Analysis should, however, be made of the likely impact (and costs and benefits) of such provisions. It also might be helpful to establish some recommendations regarding self-regulatory organizations and their role in consumer protection and financial education. Consideration should also be given to ways of making non-government organizations effective participants in measures to strengthen consumer protection and financial literacy—and ensure that they develop stable sources of funding.

Future diagnostic reviews should include countries in other regions. In particular, the countries of Latin America and East Asia provide valuable experience that would assist in the evolution and refinement of the Good Practices. Also useful would be reviews in low-income countries.

Future work should also include developing tools to help regulators define priorities for choosing among the recommendations. National governments are often well-equipped to identify weak points and define what changes should, ideally, be made to reach a better consumer environment. Since all governments are faced with limited resources, however, it would be helpful to provide a tool to assist them in selecting the most important issues requiring attention, namely those with the best potential for positive impact. The positive effect of defining standards for consumer protection would be further strengthened by providing tools for risk analysis (in what order the government should deal with known issues to minimize key risks) and for impact assessment (what the expected changes in the financial sector are and when they can be expected to materialize).

Retrospective analysis should also be given to why the consumer protection regimes in the US and UK missed the mark. Before the financial crisis of 2007-09, the framework for consumer protection in the US and UK was considered to be among the best worldwide. Yet it failed to prevent millions of consumers from making financial decisions that have resulted in devastating losses. Consideration should be given as to whether the institutions or regulations should have taken a different form—and whether a new financial consumer protection agency, as is proposed in the US, will be able to deal with the complexities of the issues.

Future work should also include specialized papers in different areas of consumer protection and financial literacy. For example, additional analysis should be made of consumer protection and financial education programs needed for remittances and alternative delivery mechanisms for payments (such as mobile banking). Further reviews should also be made of consumer protection and financial education issues as they relate to consumers using microfinance and micro-insurance services.

Regulators might also benefit from the collection of experiences of agencies that have placed consumer protection in the same institution as that responsible for financial supervision. For example, England, Ireland, Hungary and Malaysia have all chosen to combine consumer protection (i.e. business conduct supervision) with the financial supervisory agency. It would be helpful to look at the benefits gained compared to the expense of handling conflicts of interest and see what lessons can be gained from this experience.

Financial literacy surveys should be further refined. The US Jump$tart surveys have found a near perfect correlation between years of formal education and levels of financial literacy. However recent evidence suggests that even middle and high-income earners are often financially illiterate. Further research is needed to test the extent of such financial illiteracy—and whether stronger consumer protection (such as prior regulatory approval of all new financial products) is needed.

Consideration should also be given to what support the international financial institutions could provide in emerging markets. To date, such support has primarily taken the form of country diagnostic

reviews and seminars and workshops. However consideration could also be given to providing financing for development—and then implementation—of national action plans for consumer protection and financial education.

Annex: Special Issues by Financial Sector Segment

Credit Institutions

Banks and credit institutions lie at the base of most financial systems. This is especially true in the case of many developing countries where banks constitute 70-80 percent of total assets of the financial system. There should be mutual trust and confidence in the relationship between a bank and a customer, but frequently it is lacking for many reasons. In the absence of transparency in pricing, adequate consumer awareness and protection and effective dispute resolution mechanisms, banking systems have less efficiency and consumers less access to finance.

The recent global financial crisis has proven that it is necessary to take steps to strengthen the protections provided to consumers and ensure that these protections effectively respond to market changes and emerging risks. While well-informed consumers can make decisions in their own best interests, effective disclosures are the first line of defense against improper lending. Many bank regulators now underscore the importance of clarity of disclosures, especially for mortgages and credit cards. Understanding that best disclosures may not always sufficiently protect consumers from unfair practices, they have ventured to issue written rules to provide strong substantive protections for mortgage borrowers and credit card users. The US Federal Reserve Board for example, has issued rules to strengthen underwriting, restrict prepayment penalties, and require escrow accounts for property taxes and insurance. Serious attention is also being paid to issuing rules to address deceptive mortgage advertisements and unfair practices related to real estate appraisals and mortgage servicing.

Approaches to the registration, licensing and authorization of credit intermediaries differ considerably among countries. Non-bank credit institutions may only need to be registered as a company under the general state register to operate in some countries. In other countries, non-bank credit institutions are required to have a license to undertake specific operations and need to fulfill minimum requirements. Requirements may not only include minimum capital, but also minimum professional competence and training requisites or professional indemnity insurance for staff, which would help to ensure a minimum level of professionalism in the sector.

Consumers should be protected from abusive debt collection practices by credit institutions or third-party debt collectors. This means that rules are required regarding the type of debt that can be collected, the person who can collect debts and the manner in which any debt can be collected. And these rules must then be indicated to the consumer at the time his or her transaction is entered into. There ought to be laws prohibiting debt collectors from using false statements when collecting a debt, using unfair practices, as well as giving false credit information to others, including a credit bureau.

Banks should be required to put in place a complaints procedure that provides effective resolution of complaints and disputes. Not many consumers have the ability to know when their rights have been infringed. Even if they know, they typically have few avenues to pursue their claims. Banks must inform their individual customers of the resolution mechanisms available to them and details of the procedures to enable customers to resolve their complaints and disputes. Since not all complaints and disputes get resolved at the bank level, providing an independent, affordable and accessible avenue for dispute resolution such as small claims court, mediation or financial services ombudsman's office is critical in order to provide credibility to the implementation and enforcement of legal rules.

Special issues arise for housing finance. In signing a mortgage contract, a consumer takes on a sizeable financial exposure over an extended period of time—and one in which the consumer risks losing his or her primary residence, which has been placed as collateral for the loan. In addition, residential housing

contracts include various financial options for the consumer (such as early repayment) and the lender (such as interest rate adjustments). The various options are highly sensitive to the changing financial markets and the outcomes may pose additional risk for the borrower. The mortgage market is also a textbook case for market failure cause by information imbalance. One party is in the market continuously while the other party engages infrequently—often only once or twice in the consumer's lifetime. The special issues emphasize the importance of consumer disclosure, standard mortgage contracts and financial education for borrowers. An out-of-court recourse mechanism, such as an ombudsman, should also be part of the consumer protection framework.

Insurance

Insurance is the most intangible of all financial services. It involves a promise to mitigate losses, either through cash or physical replacement. Losses may or may not occur at some undefined time in the future and may be difficult to quantify when they do occur. For this promise the policyholder pays a sum, or series of sums, called premiums. The situation is complicated by the fact that commission-based intermediaries usually stand between the insurer and the insured. These intermediaries often act as agents for both parties at different stages of the transaction.

The consumer protection challenge is thus to protect insurers against fraudulent claims, and to protect consumers against insurers avoiding legitimate claims and against intermediaries acting in their own rather than their clients' best interests. Some concrete examples can illustrate the challenges:

- A broker receives full risk information from a client but only passes partial information on to the insurer to make the risk more attractive. The insurer pays commission to the broker. Subsequently the insurer denies a claim on the basis that full information was not forthcoming.
- An individual is browbeaten into buying a long-term life insurance policy (which pays higher commission than a short-term policy) by a family member or acquaintance. The individual soon after realizes that this is not what he or she really wanted or needed.
- A purchaser of a consumer durable good using consumer credit is told by the vendor that he or she will have to purchase credit insurance from a defined insurer. Often most profit for vendors comes from ancillary financial services.

In addition to such direct issues there is a need to ensure that insurance is not mis-used from a societal point of view—for example as a means of gambling or to generate man-made claims arising from moral hazard. An extreme example would be being able to insure any property for fire then burning said property down. For this reason insurance law requires that a genuine "insurable interest" exists before a policy can be taken out, and that not more than the loss incurred may be indemnified.

Relevant law has developed over the last two hundred years, most notably under case law in the Common Law jurisdictions. However it has become increasingly clear that there is an asymmetry of power and information between insurers and certain classes of policyholder, namely individual households and certain classes of small business. Medium and large businesses with access to professional broking and risk management services are assumed to have the resources to deal with such asymmetries.

For this reason many jurisdictions have issued specific insurance contracts and intermediary laws and regulations. These typically require certain minimum levels of qualification of, and disclosure by, intermediaries, specify standard wordings and conditions for derogation there-from, allow for cooling off periods for long-term contracts, minimize the ability of insurers to avoid or reduce legitimate claims on the basis of technicalities, limit the scope for tied selling, and specify contract termination rights for both the insurer and policyholder.

In addition, in response to the substantial information and monetary costs of exercising rights under the law, there is a trend to introduce low-cost complaints resolution mechanisms. These mechanisms include ombudsmen, small claims courts and industry- or consumer-sponsored specialist self-regulatory organizations. Industry codes of conduct are also increasingly frequent and insurance supervisors are also often mandated to examine insurers' market conduct practices.

Securities

The lack of adequate consumer protection in the financial sector can impact on the health of individual financial institutions and the stability of the financial system. For a number of years, consumer finance was not considered to be of systemic importance and financial regulators did not focus their attention on the area. Indeed some regulators ignored warning signs and red flags of the cumulative effect of the improper sale of consumer financial products on the balance sheet of financial institutions.

Securitization of consumer debt "turbo-charged" the impact of bad consumer loans resulting from weak financial consumer protection. Weak loans and other retail financial instruments, which were traditionally the risk of one originating bank, were distributed across a wide number of institutions resulting in wide-spread losses when the underlying instruments defaulted or otherwise suffered from lowered credit ratings and loss of market value. These distressed securitized instruments then rebounded back on consumers when the mutual funds (as well as insurance companies and pension funds) where consumers had invested in purchased these securitized debts and suffered the resulting losses.

The risks for consumers of investing in high-risk securitized instruments and mutual funds which held the instruments were improperly disclosed and poorly understood. The risks of chasing higher yields in money market funds were not disclosed and the resulting loss of value of some funds below one dollar a share (called "breaking the buck") severely shook the confidence of the investing public in the securities markets.

The assumption that banks and other financial institutions would be able to accurately evaluate their market risks and provide full consumer protection to investors was incorrect. Incentive structures and inadequate risk modeling resulted in the sale of unsuitable products to retail consumers. Increased regulation and supervision are necessary to provide the rules and supervisory framework for retail financial consumer protection.

Large financial conglomerates were able to pick and choose between regulators to sell the financial products which were least regulated and which were frequently not suitable for the consumers' needs. Such "regulatory arbitrage" harms the interests of financial consumers. Conglomerates neither adequately disclosed the characteristics of the various products available, nor evaluated which were the most suitable for a consumer. The financial products which were sold to the consumers were generally the products that were most beneficial to the conglomerate.

The unregulated sectors of the financial system provide the least protection for financial consumers. Most of unregulated areas should be regulated, such as derivatives, credit rating agencies and hedge funds. Derivatives transactions were complex and subject to uncertain valuation. Credit rating agencies failed to properly rate the risk of securities and derivatives. Hedge funds had very high influence on the market, but very low transparency, which allowed many firms to engage in market manipulation and insider trading. These unregulated entities and instruments, among others, resulted in sever losses in financial investments by consumers, such as mutual funds. The unregulated activity of these entities resulted in considerable risk and losses to consumers without their understanding of the risks these entities posed.

Private Pensions

The long-term nature of pension benefits, consumer choices and asymmetries of information between contributors and professionals in the pension industry are compelling reasons for an adequate framework for consumer protection and financial literacy. In most countries, people contribute to a pension scheme from the time that they enter into the workforce or at the age of eighteen. In normal circumstances, a person is entitled to his or her benefit on retirement, generally at the age of sixty or beyond. On occasion, a person may be entitled to receive his or her benefit before the retirement age if a disability prevents him or her from employment.

Effectively, consumers are asked to forego current expenditure for the promise of some benefit which may be forty years or more into the future. On its own, this may be a difficult decision for consumers, but the difficulty is exacerbated by the fact that they are asked to make the decision at a time when current consumption needs are normally high, for example through their desire to buy and establish a home and start a family.

Behavioral economics posits the hyperbolic discounting phenomenon. Consumers tend to prefer smaller payoffs in terms of satisfaction now over larger payoffs in the future and will largely disregard the future when sacrifices are required in the present. The consequences of hyperbolic discounting in the pension context is that many consumers reach their late forties and fifties and the need for adequate income in retirement becomes sharply focused, just at the time when it is too late to do much about it.

The design of pension systems varies throughout the world. At one end of the spectrum, some countries offer only one mandatory fund with no investment choices. Some countries offer a number of lifecycle funds through which consumers move according to their age so that as they approach retirement, their entitlements are subject to minimal investment risk. At the other end of the spectrum, there are many countries where pension funds offer consumers a vast array of investment choices from which to choose, some with complex instruments that are difficult to understand. Often consumers are permitted to switch between investment choices and funds at will. In making choices, even more sophisticated contributors have to rely on pension fund management and other financial advisors to guide them.

Some countries that permit contributors to switch between funds have spawned an industry segment of pension fund agents. The income of pension fund agents is derived from commissions, so they are motivated to ensure that consumers do, in fact, regularly switch between funds, even if this is at a significant cost to the consumer through exit and entry fees.

Ongoing disclosure by pension funds can also be problematic. Most funds disclose information on current earnings and current crediting rates, at least annually. Pension benefits are long-term in nature and disclosing earnings measured over short periods such as one year are essentially meaningless. In fact, disclosing short–term indicators may be counterproductive if they induce contributors to reduce the level of their contributions or switch funds or investment options against their long-term interests.

These issues indicate the need for consumer protection at three levels – ongoing financial literacy initiatives, robust legislation and meaningful disclosure. Even in countries that do not have mandatory contributory pension schemes, the need to save should be one of the building blocks of financial education.

Even the most sophisticated countries tend to offer financial education at the start of the consumer's accumulation and the start of his or her payout. At the start of accumulation, education is directed at the need to provide for one's retirement and the designs of the pension plans that are available; at the start of the payout phase, the focus is more on living in retirement on the amount that the consumer has accumulated. Generally, there is little or no education in the intervening period to reinforce the need

to accumulate, especially when the effects of hyperbolic discounting and temporal myopia are the most acute. Education and reinforcement need to be ongoing throughout the consumer's working life.

Robust legislation should regulate all the parties who are in a position to affect consumers' choices– pension fund management, financial advisors and pension fund agents. The focus of the legislation needs to be on these parties acting in the best interest of consumers. They have to be able to understand the consumer's needs and objectives and his or her level of understanding of financial products. They have to know the pension products in the market and, based on that knowledge, match the products with the individual consumer's needs and objectives. These parties should be liable to the consumer for any advice which is given that does not match the disclosed needs and objectives, and where these parties have acted in their own interest at the expense of the consumer. The consumer should have access to a simple and cost-effective mechanism when seeking recourse against these parties.

Disclosure for private pensions needs to be considered at two levels. Those parties who benefit financially from the relationship with consumers, such as agents and financial advisors, need to disclose the financial benefits they will derive from the relationship. The management of pension funds must provide information that is meaningful and easily understandable by potential contributors. Disclosure must be tailored to the needs of consumers having regard to the level of financial literacy and not be so complex that consumers need professional advice in order to understand it. Disclosure of fees to be paid to pension fund management companies and administrators is a particularly important and troublesome issue and requires significant attention. Some countries allow fees to be charged to contributors and additional amounts to be deducted from the earnings of the fund. This method is considerably less transparent than charging fees directly to contributors. Any disclosure should provide real information about the basis on which fees are charged and the effective fees charged, to enable consumers to compare among different offers. On an ongoing basis, for existing consumers, pension fund management companies should be obliged to provide information about the risks and the current performance of funds that is meaningful and comprehensible and emphasizes the long term, not the short term, performance of the funds. Ongoing disclosure is subject to the same caveat—contributors should not need to seek professional advice to understand it.

Protection of Credit Data

Data protection legislation directly impacts data processing by private sector institutions such as banks, non-bank credit institutions and credit registers. The various national approaches to data processing reflect different historically used approaches and different legal origins. The basic rules of data protection refer to legitimacy of data processing, purpose of collection, limitations on data collection, and necessity and principle of proportional data processing. These are at the same time the main regulations of data processing by credit registers. Regulators have to ensure that: (1) the balance is maintained between the legitimate interest of the data controller and the rights of the data subject; (2) the relevant, adequate, and non-excessive nature of the data processed is proportionate to the determined, explicit and legitimate purpose for which it is collected and/or processed; and (3) the fact that data should be kept only as long as it is necessary. Even at the level of the EU where data protection is regulated by the European Data Protection Directive, implementation differs among member states. The difference relate not only to the different emphasis placed on the principles stated above but also the authorized purposes and authorized actors for exchanging credit data.

The main objective for creditors accessing credit data is to obtain reliable and up-to-date information that enables them to assess the credit risk of potential borrowers and facilitates the monitoring of existing credits. In some countries, additional authorized purposes may also include fraud prevention, other related credit risk and affordability uses, such as preventing over-indebtedness by consumers.

Since the most common purpose of processing credit data is credit risk management, the institutions authorized to access credit registers generally come from the credit sector. This includes banks, credit cooperatives, credit card issuers, factoring companies, debt collection agencies. In a minority of countries in the European Union, access to the credit registers is wider than just creditors. In these cases, the credit register is open to entities such as insurance companies, telecommunication providers, retailers and mail order companies.[42]

Since consumers' lives are affected by the data collected in the credit registers, transparency of the information stored and procedures to access data should be clearly regulated and enforced. Consumers need to be informed about data processing, such as the exact purpose for which their data is processed, so that they can estimate which economic decisions are affected by the data recorded in the database. It is also important for consumers to be aware of how the decisions they take affect the content of their personal data in the future.

Dispute settlement procedures should be known to consumers and data should be protected from theft. Consumers should have the right to contest erroneous data or provide explanations on causes of arrears. Credit bureaus should be legally obliged to provide consumers with their credit report upon request and free of charge within a certain deadline. Furthermore it is recommended that procedures be in place to reduce the risk of identity theft and ensure that the technical security of the databases prevents unauthorized access. In addition, consumers should be educated on the use of their data. Additionally verification mechanisms to enable credit bureaus to match their records against national ID data-bases would contribute to effective verification of borrowers.

[42] European Commission, DG Internal Market and Services, *Report of the Expert Group on Credit Histories*, June 2009

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