CLIENT PROTECTION: A THREE LEGGED STOOL?

April 2012

Abstract

Fair treatment and clear conditions make things work better for both financial institutions and clients, and it pays, not just in the long term. Fostering client protection is a win-win strategy for all agents involved, and requires that all three stakeholders play their role and stand out for what their responsibility is. As in a three-legged stool, if one of them is missing or is far too short or far too long, it gets hard to get balanced!. Transparency and Client Protection principles, standards and practices should be fully transversal to the whole organization. In the meantime, we will all be waiting for the authority to fully exercise its role as provider of regulation, institutional capacity, supervision and financial education.

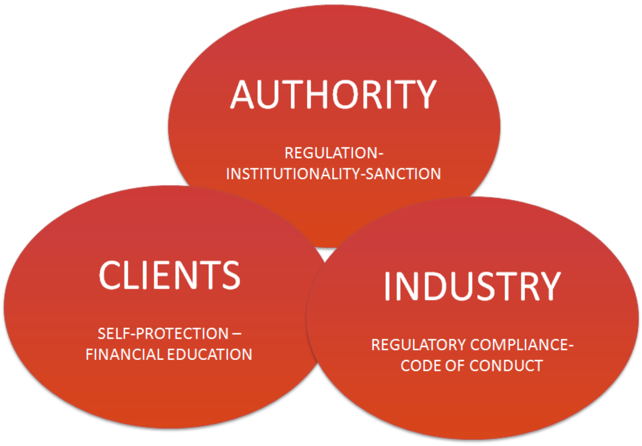
Introduction

Inequality, imbalances, incomplete regulatory frameworks, lack or excess of competition, illiteracy, dominant position, picaresque, political reluctance, misfortune… All these issues, and a few others, play a fundamental role in the construction of enabling environments for the development of safe and inclusive financial systems.

The well-functioning of client protection requires that all stakeholders comply with a set of basic responsibilities, especially with those that are under their exclusive scope of influence.

Who are these stakeholders anyway? Well, there are basically three of them: authority, industry and clients. And what are their responsibilities? A first answer is shown in Figure 1.

Client Protection: A Three-legged Stool?



The authority is (or ought to be) responsible for the establishment of an adequate range of well-defined and full-fledged institutions, as well as for the elaboration and application of proper regulation. The authority's role should guarantee a fair treatment (avoiding the existing regulatory arbitrage among different jurisdictions) as well as the design and execution of public, comprehensive and nation-wide financial education programs. The active participation of the financial sector is required in these programs in order to improve clients' capacities for self-protection.

The industry is (or, again, ought to be) responsible for strictly complying with the regulation on transparency and client protection. For those aspects that are either unregulated or under regulated, the industry is also responsible for designing, adopting and monitoring some kind of code of conduct (the so-called "self-regulation"). Banking associations and other financial intermediaries' guilds would be extraordinary players in encouraging their members to outstand in this particular non-prudential dimension of the financial business.

Finally, financial consumers (clients) must be responsible for their own protection by exercising their rights and complying with contractual obligations. Curiously enough, clients' obligations are not a regular topic found when reviewing many of the most advanced consumer protection pieces of regulation, neither in developed, nor emerging nor developing countries.

Therefore, our view is that the authority should not be alone in exercising the responsibility to ensure transparency and client protection. In fact, regulation is not the only option available to protect clients and to promote responsible financial markets.

The other stakeholders also play important and complementary roles:

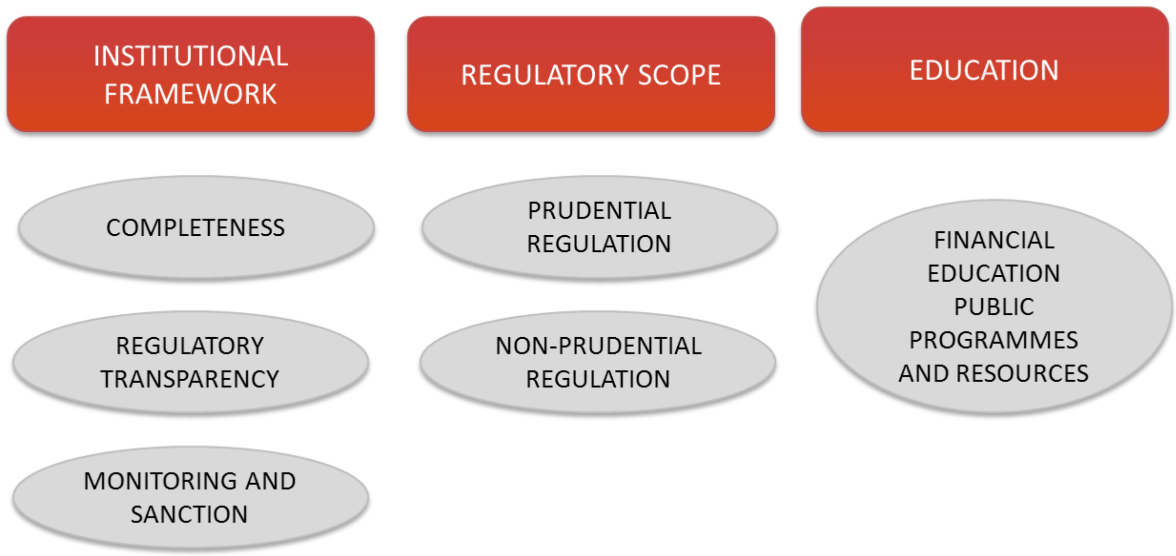
(i) The industry, by designing and implementing codes of conduct and standards of good practices for the sector, along with other self-regulation initiatives;
(ii) The clients, by raising their own awareness and improving their capacity and financial education.

The combination of the three pillars (regulation, codes of good practice, clients' awareness and training) contributes to improving the quality of financial inclusion and to promoting a suitable environment for the exercise of responsible finance.

Leg 1: The Authority's Role

There are three basic issues under the authority's responsibilities. These are, in our opinion: "Institutional Framework", "Regulatory Scope" (both prudential and non-prudential) and "Education".

Leg 1: The Authority



A Complete, Balanced and Unambiguous Institutional Framework

Transparency and Consumer Protection mechanisms and procedures must be consistent, comprehensive and have a unique and unambiguous focus on both the consumer and the industry. Additionally, they ought to be free of any conflict of jurisdiction. To achieve this, the following principles should be observed by the authorities in the design of an adequate and effective financial protection system:

Balanced goals and objectives on two apparently conflictive issues: Solvency/Stability and Financial inclusion/Transparency/Protection

The balance of objectives by the regulator / supervisor must be secured at all times, especially in the current crisis situation. For this reason, in those countries where no specialized financial consumer protection instance exists, it is appropriate to set up an instance / department / area exclusively dedicated to the protection of the financial consumer, so as to ensure the balance between the two objectives aimed by the financial authority.

First appeal at the (retail) financial institution

Since the vast majority of claims are effectively resolved at the financial institution's customer services, regulation should enforce the user's obligation to submit his/her claim to the financial institution as the first instance, to allow for resolution at that level.

Proper functioning of multiple appealing instances

When designing mechanisms for complaints resolution, the authority should analyze and assess the pertinence of including an intermediate instance (ombudsman) between the first instance (financial institution) and the second instance (financial consumer protection authority).

If the functioning of the basic two instances is appropriate, the inclusion of an intermediate instance must respond to specific identified needs.

In any case, the inclusion of additional instances in the complaint resolution mechanisms should meet the criteria of non-redundancy, clear definition of competences, adjudication (bindingness) and non-duplication of channels (no claim should be simultaneously in two separate instances, to guarantee fairness and efficiency).

Creating additional instances for conflict resolution just for the sake of offering the financial consumer more parallel alternatives can be counterproductive for each and every of the agents involved, especially for the clients.

One-stop-shop

Countries maintaining a dualism in the consumer protection authorities' competence (general consumer protection vs. financial consumer protection) should consider a one-stop scheme for the submission of financial claims. This unique instance will then refer the claims to the institution best suited to resolve them – the specialized financial protection authority/instance – avoiding coordination problems or differences of criterion that the former dualism could cause.

The introduction of a one-stop mechanism will result in better attention to financial users, reduction of times of response and resolution, and elimination of potential conflicts of competence, as well as strengthening legal certainty for both clients and financial institutions.

Clear definition of responsibilities

In countries with several authorities with competences in financial consumer protection, or with parallel instances for the filing and settlement of claims, there is an urgent need for a clear and unambiguous delineation of competences, either to make the proposed one-stop mechanisms effective, or to avoid multiple and contradictory binding interpretations on the same case.

In summary, mechanisms and procedures for financial consumer protection shall comply with the following characteristics:

- Coherence
- Completeness
- Uniqueness and unambiguity (no duplication),
- Certainty
- Freedom of conflicts of competence

Transparency in the Designing Process of the Regulation

The process of designing effective regulation for financial consumer protection demands a comprehensive and consultative approach among the various stakeholders, to ensure consistency with the full set of laws and regulations.

Consequently, the authorities ought to allow for a period of public consultation prior to approval of new or modifications to current regulations on transparency and financial consumer protection, to involve all stakeholders with technical capacity to suggest improvements to the regulatory framework. That would ensure that:

a. There is no conflict between norms of different rank that affect the same legal course, resulting in greater legal certainty, greater uniformity of regulation and better coordination of the authorities in the interpretation of the rules on the same subject;
b. The regulation protects debtors' and creditors' rights and interests, being both concepts extensible to either party regardless of their position or whether their transactions take place on the assets or on the liabilities side.

Enforcement and Sanctioning Power

It is essential that regulation is effectively implemented, and that its compliance is monitored and verified by the authority to avoid that the rules and principles are not empty promises that undermine trust between the client and the financial institution.

Thus, an integrated system of impact assessment to improve the quality of the regulation on transparency and financial consumer protection ought to be considered.

Furthermore, the authority must have the power to enforce the rules, to perform on-site inspections when necessary and to act accordingly in case of unlawful acts. Sanctions should certainly aim to punish the infringer but, above all, they should encourage the non-recurrence of the financial institution. Hence, it would be recommended that a specific mechanism be developed to monitor sanctions and to assess the degree to which compliance with regulation is being effectively achieved.

No Regulatory Arbitrage

Rules on transparency and customer protection should ensure the broadest coverage and the creation of equal conditions for the different types of providers (banks, non-banking financial institutions, non-financial institutions) offering the same or similar products (i.e. credit cards).

Despite the fact that not all of these providers may be subject to prudential supervision, all suppliers of financial products and services such as credit, savings, insurance and payments, should be subject to basic standards of transparency and financial consumer protection.

The change of focus from norms based on the type of provider to norms based on the products and services provided can be beneficial to clients, especially for those with less experience, who are more likely to trust their financial operations to unregulated financial providers. The ideal situation should be one in which the financial consumer protection regulation includes the greatest number / type of providers, reducing regulatory arbitrage. Thus, same products offered by different financial (and non-financial) providers should be subject to the same transparency and protection standards.

A good way to ensure that rules apply equally to all could be the establishment of a single supervisory body for non-prudential standards on transparency and customer protection to oversee all financial products and services, regardless of the supplier.

All financial intermediaries ought to be subject to regulation and supervision that is appropriately adapted to their size and/or type of operations.

Financial Education

Financial education benefits individuals in all stages of life: children should understand the value of money and savings; young people must be prepared for the exercise of responsible citizenship; adults need help planning their crucial economic decisions, such as buying a home or preparing for retirement. In addition, financial education helps families adjust their saving and investment decisions to their needs and risk profile, which promotes confidence and financial stability. In addition to that, financial education enhances the development of new quality products and services, competition and financial innovation.

An adequate basic financial education for the entire population[1] that will allow them to clearly understand and assess their financial transactions should be considered a priority and an essential tool to promote a thrift culture. It will also help establish conditions for greater financial inclusion, as well as to foster a greater and better use of financial services.

The financial education of a country's population should be understood as a public good, and therefore, the responsibility for its proper performance lies on the State's shoulders:

- As a starting point, the field authorities (Finance, Education) must offer a definition of the basic financial skills that the population should have. This requires a process of identifying needs and establishing minimum

[1] This could include (i) the financial products and services offered by different entities, (ii) the nature of the markets in which they operate, (iii) the authorized institutions on the supply side, as well as (iv) the different mechanisms available to protect and defense their rights, among other.

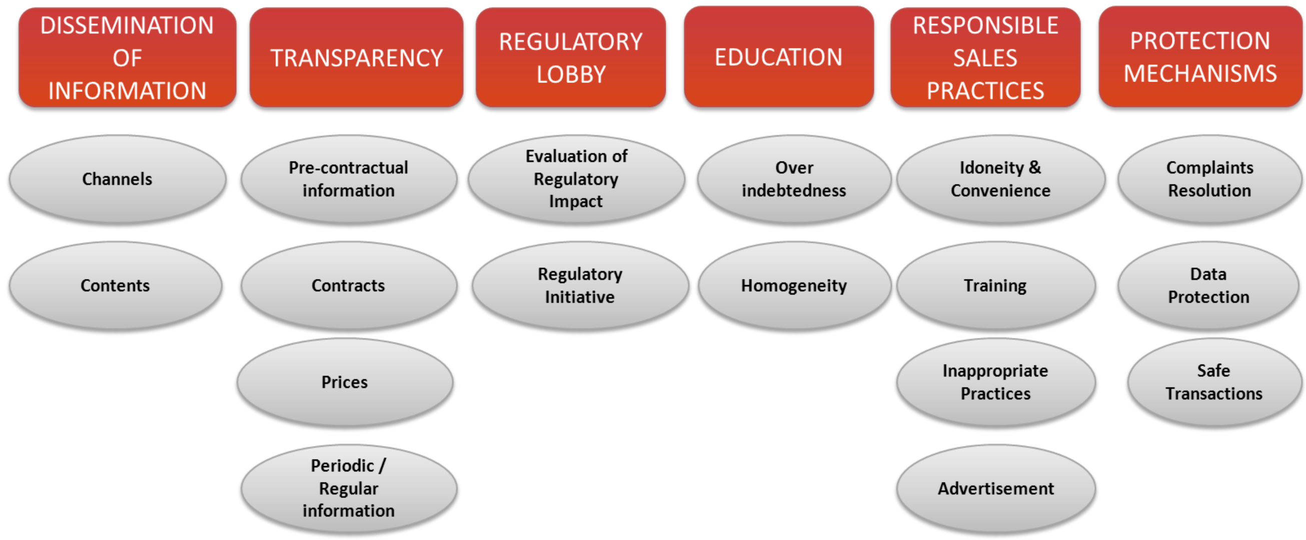
standards for adequate performance of the general public. In this sense, the results of the OECD's "Project for International Student Assessment" (PISA Report) are unequivocal.

- The strategic initiative on Financial Education lies on the authority without prejudice to the financial industry. Financial institutions – both at the aggregate level (i.e. associations) and at the individual level – should be actively involved in the sponsorship, design, implementation, monitoring and evaluation of Financial Education plans/ programs designed by the public authority.

Leg 2: The Industry's Role

As mentioned earlier, the authority should not be alone in exercising the responsibility to ensure transparency and financial consumer protection. There are multiple areas where the financial industry – either acting as an association or through individual institutions – holds specific responsibility. Figure 3 shows the full range of issues susceptible of being assumed by the financial industry.

Leg 2: The Financial Industry



Dissemination of Information

At the industry level, financial institutions' associations should consider the establishment of mechanisms to enforce its associates to show to the public the quality seal granted by subjection to formal regulation and supervision by the financial authority. They should reinforce their position as opposed to other financial institutions that may not be supervised, and even as opposed to other non-financial institutions that offer financial products (department stores). Moreover, the risks of not being subject to prudential and (specifically in our case of discussion) non-prudential regulation should be disclosed. Among other, the following are pieces of information that are relevant to the financial consumer and that could be disseminated by associations: (i) information as belonging or not to the official Deposit Insurance Scheme; (ii) information on the obligation of compliance with prudential regulation (solvency) and non-prudential regulation (transparency and consumer protection).

The above information is of paramount importance and relevance to the financial consumer, who very often cannot differentiate clearly between licensed and unlicensed institutions, or supervised/ unsupervised, and therefore, is not fully aware of the associated risks.

On the other hand, the industry could consider making efforts to develop a simple and standardized format for the dissemination of annual financial statements so that the general public can assess the financial viability of each of the member institutions.

At the individual level, financial institutions must guarantee the effective use of direct communication channels with their clients, and even consider the creation of a financial hotline that attends clients' requests for information. Furthermore, financial institutions could consider including recommendations on the use of specific financial products (as in the case of pharmaceuticals) and aspects related to the contractual terms and conditions (e.g. behavior of credit card debt if minimum monthly payment is chosen), and the risks associated with misuse.

Transparency

Precontractual information

The general operating principle on transparency is that information must be clear, adequate, objective and truthful (not misleading). Financial institutions must inform clients and potential clients of their rights and obligations, the existing protection mechanisms for the defense of their rights, and the costs to be assumed by the use of the products and services being acquired. Furthermore, they ought to deliver, free of charge and in advance, any pre-contractual information to allow comparison among similar offerings and to ensure that the client is able to make an informed decision about engaging in a particular financial product or service.

For each type of financial product or service, clients should be offered a one or two-page long Key Fact Statement, written in plain language, describing the key terms and conditions.

In the cases where regulation does not set the format and minimum contents of the Key Fact Statement, the industry should consider coordinating the partners' efforts to jointly agree on a standardized format that is suitable for all financial institutions.

Contracts

Contracts are free agreements between private parties acting under the principle of autonomy and, in this particular case (financial sector), designed unilaterally by the supplier of the products or services. However, they have specific attributes that allow any financial institution caring for the financial protection of its clients to differentiate from its competitors. This statement is especially important in contexts where price controls are in place (usury laws), limiting the institution's ability to design products and services.

Having said that, contracts must (i) be accessible to potential customers prior to subscription; (ii) avoid abusive clauses; (iii) avoid ambiguous clauses; (iv) state the obligation of early previous information on unilateral modifications of terms and conditions; (v) include information on APR, periodicity of the payment, settlement dates, formulas used, amount of accrued interest, fees and expenses (concept, amount, dates and accrual liquidation), duration, and applicable value dates if referred to loans or savings. In addition, conditions for modifying the agreed interest rate, fees, etc. must be reflected in the contract. And (vi) they must be delivered to the customer, once signed.

Prices

Financial institutions have (i) to publicize, through all service channels (branch, ATMs, internet, agents) the interest rates, fees and expenses applicable to each of the financial products and services offered; (ii) to allow the customer to compare prices by establishing a standard publication format; and (iii) in relation to the APR, to ensure:

a. The recognition of a standard definition that reflects the total cost of the loan as an annual percentage, allowing comparison between different offers from a single product with identical attributes.
b. The definition of the calculation for APR according to a mathematical formula established by law. If no APR formula is stated in the regulation, the industry ought to agree on one and to publicize the method of calculation so that users will be allowed to compare prices and easily choose between different providers.

When a variable interest rate is applied, financial institutions should use reference interest rates that are calculated at a market rate, free from the institution's influence and based on known data aggregated according to an objective and publicly accessible formula.

Regarding commissions charged for actually accepted and delivered services – freely established by the financial institution – financial institutions should clearly state their existence, exact value, calculation method and periodicity of application. Denomination should be standard to allow for comparison and better understanding.

Periodic/Regular Information

Within the period of the contract, financial institutions should make available periodic information to users on the accounts' balance and transactions performed including a detail of the charges and payments made in each settlement period, as well as the taxes withheld by the State. Industry should sponsor the definition of the minimum contents of such periodic information to customers if this specific issue remains unregulated.

Regular disclosure of information is particularly important in those products with a price that depends on the intensity and frequency of use, such as credit cards and overdrafts. Also, financial institutions must provide at least on an annual basis, all tax information associated with the products and services contracted with them. To this end, it is appropriate that financial institutions make available to its customers annually and free, at the beginning of each fiscal year, a breakdown of all commissions, accrued expenses and interest rates applied to each product / service provided to the client in the previous year. In this regard, industry coordination for the definition of a standard document may be of great value.

Responsible Sales Practices

Suitability

Before any recommendation is issued, financial institutions should obtain sufficient information on the client in order to verify that the product or service offered is appropriate for the client (risk profile, financial capacity, financial needs, and financial literacy). Thus, financial institutions will, within its sphere of influence and responsibility, ensure that lending operations are conducted in a responsible manner (i.e. appropriately assessed and monitored) to avoid over indebtedness practices by some customers.

Personnel

Financial institutions should ensure the highest level of competence and professionalism of their personnel, especially those in charge of sales and customer services.

Training, regardless of how it is implemented, must be continuous and updated to adapt personnel capacities to the changing conditions, new products, new client profiles, etc. Furthermore, training ought to be accompanied by institutional efforts to disseminate good practices and standards on transparency and client protection within the whole institution. Incentives should incorporate some measure of client satisfaction, beyond standard financial and commercial goals.

Inappropriate practices

Financial institutions, in addition to complying with the regulations on unfair terms (expressly prohibited), should avoid inappropriate practices in their business relationship with customers, especially for debt collection and when selling the product / service.

Advertisement

Advertisement must be truthful, accurate, complete, clear and timely, avoiding the explicit highlight of potential benefits while hiding risks inherent in such benefit.

Protection Mechanisms

Complaints

At the industry level, it is pertinent to suggest that associations make timely efforts to assess, with the highest degree of detail, the complaints appealed by clients against their associates.

Increased knowledge and understanding of the motivations of the most frequent complaints will facilitate the identification of the causes and the definition of solutions for their reduction/ elimination. For this task, it will be essential to establish mechanisms for information management within the banking associations, along with the necessary commitment of all partners. No extra effort would be required from financial institutions, since the same information is usually requested by the authority. Internal analysis of data will allow associations to (i) identify and (ii) quantify the most frequent claims and disputes, and (iii) formulate proposals for substantial reduction, such as the design of financial education programs adapted to the practical reality, leading to eliminate or substantially reduce the sources of the most recurrent claims and disputes, or improvements in the design of new products and financial services of recent commercialization.

At the individual level, financial institutions should have clear procedures for the reception, management, resolution and evaluation of complaints received by its customers. It is essential that procedures are disclosed to clients through free and direct channels. The information and data associated with claims should be fully updated, recorded and filed.

While there may be several instances to which claims can be submitted – although we support as a good practice that the first instance must reside at the financial institution – it must be ensured that none of them cuts clients' rights.

As mentioned at the industry level, it is also pertinent to suggest that financial institutions make timely efforts to assess, with the highest degree of detail, the complaints appealed by their clients. This is particularly important as financial institutions enable new service channels (online banking, telephone banking, agents), imposing a greater need to know the origin and cause of clients' complaints, depending on the channel used for transactions.

Data protection

The relationship between financial institution and client is grounded in trust. As such, and in compliance with existing data protection regulation, financial institutions are obliged to ensure confidentiality and technical security of customer data. Similarly, financial institutions should warn customers of the precautions they should take to ensure that such protection is effective, through the dissemination of safety and fraud alerts, information on the proper use of access devices/keys depending on the channel used, destruction of bank statements, etc.

Safe/ secure transactions

Financial institutions must guarantee that internet transactions are safe and therefore they must: (i) operate security measures (antivirus, firewalls, antispyware); (ii) provide mechanisms for identity confirmation; (iii) save the transactions' data generated by users; (iv) establish limits on operational electronic banking; (v) set automatic alerts based on "erratic" behavior of the financial user in relation to the universe of common transactions; and (vi) warn users of the risks security threats, and to recommend protective behaviors and practices. Also, financial institutions should make the efforts necessary to identify the source / origin of the attacks and to provide sophisticated means of identification for their clients.

Regulatory Lobby

Legislative initiative

Improvements in the regulatory framework are full responsibility of the regulatory authorities; however, it is an area where banking associations' regulatory lobbying efforts are key to raise new issues in the political agenda, such as: (i) the scope of application of the regulation and supervision on transparency and client protection; (ii) regulatory transparency (public consultation process); (iii) licensing, (iv) first instance for complaint resolution; (v) one-stop-mechanism, (vi) debt consolidation and access to credit bureaus; (vii) explicit denomination of clients' obligations, among others.

Impact evaluation

In the exercise of the regulatory lobbying function it is key to guarantee that a solid technical position is held by the financial industry. In this respect, elaboration of technical studies on the impact of regulatory changes that capture the benefits/burdens of the corresponding reforms will help articulate and present proposals to the authority.

Financial Education

The role of the financial industry at an aggregate level (along with the authorities) and the impact that it actions may have on financial literacy of the population are much larger than the isolated actions that may be developed by individual financial institutions.

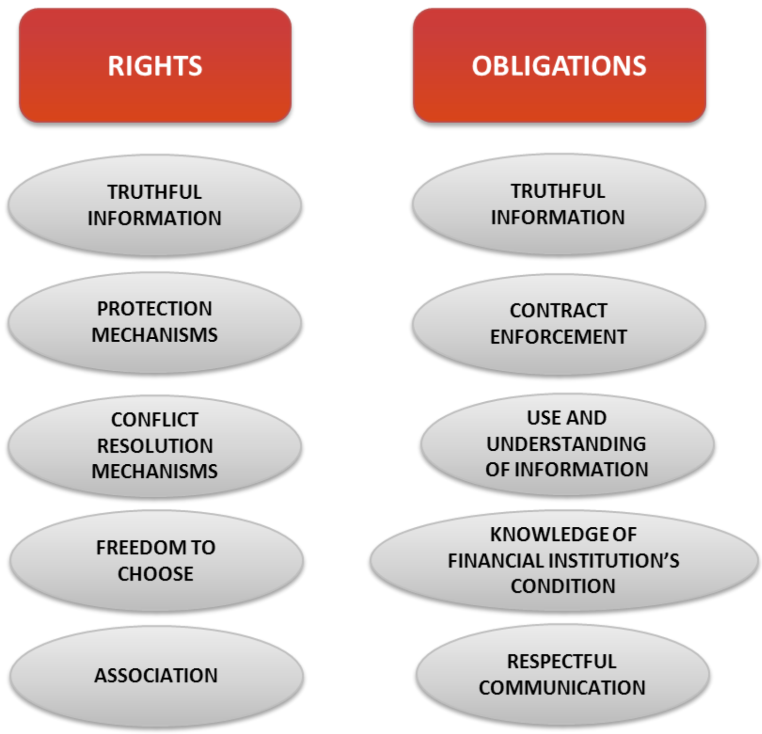
While active participation is necessary –financial institutions being entirely free to either develop or fund independent financial education programs – it will be more effective if these programs are framed in a national plan or long-term strategy that combines public and private efforts. Under this approach, the authority and the industry must agree on a proper financial education model consistent with the country's institutions and citizens' needs.

Leg 3: The Client's Role

Principles governing the behavior of clients must include both rights – referred to in most of the laws and regulations – and obligations for adequate protection (self-protection), which is uncommon in most regulations worldwide.

Self-protection, defined as clients' protection practices, is considered a necessary element (not sufficient, though) to guarantee that the financial transactions that they carry out are pursued under the highest conditions of safety and effectiveness.

Leg 3: The Clients



On the Clients' Rights Side

Among the basic clients' rights, the most common and recurrent are the following:

1. Accurate, true, sufficient, timely and verifiable information

Users are to receive all the information about the characteristics of goods or services offered to facilitate comparison and understanding for the different alternatives available in the market, as well as ensuring compliance with safety standards and quality, in accordance with the terms offered and the obligations assumed by the financial provider.

2. Reception of agile, efficient and adequate attention and quality information
   On issues such as the different ways of implementing the products and services, their rights and obligations and corresponding costs, as well as the various conflict resolution mechanisms in place to defend their rights.

3. Conflict resolution mechanism
   Users can respectfully submit inquiries, requests, complaints or claims against the financial institution; the financial institutions must efficiently and properly address them under the terms and conditions set in the regulations; financial institutions also ought to design and implement the necessary improvement/corrective actions that are timely and continuous.

4. Freedom of choice
   Clients and financial institutions can freely choose their respective counterparts to sign the contracts that instrument the provision of financial products or services.

5. Adequate representation
   Financial clients can rely on other groups or collective organizations to defend their rights.

On the Clients' Obligations Side

1. Accurate information
   Clients must provide certain, sufficient and timely information to financial institutions for the proper discharge of their duties, as well as update personal information and contact details whenever necessary.

2. Contracts' enforcement
   Clients must comply with the terms and conditions of the obligations set forth.

3. Use and understanding of information
   Clients should:
   i. Adequately get informed of the products/services to be purchased or hired, the general conditions of the transaction, including those that may materialize in the very long term in the case of breach of contract (including reporting to the credit bureau, foreclosure).
   ii. Follow all instructions and recommendations indicated by the financial institution on the management of financial products or services purchased.
   iii. Review contracts' terms and conditions and its annexes and retain copies of these documents.
   iv. Adequately get informed on the mechanisms and means available at the financial institution to submit requests, complaints or claims.

4. Confirmation of the status of the entity
   Clients must be adequately informed of the status of the financial provider, and be aware of the nature of their condition (regulated/unregulated, supervised/unsupervised) as well as the implications on the guarantees or risks from that condition/status.

5. Respectful communication
   Clients must respectfully submit inquiries, requests, complaints or claims against the financial institution. Also, they must litigate in good faith, diligence and procedural freedom.

Access to Finance is a priority within Afi's international activity, given its impact of on poverty alleviation, financial stability and socioeconomic welfare.

Financial inclusion

A financial system that lacks penetration is less efficient, riskier and more expensive for the majority of the population. It is not easy, however, to design an inclusive financial system. It is the result of several confluent factors such as proper regulation and supervision, the adequate development of the financial (banking and non-banking) industry, and the willingness and capacity of the financial operators to broaden their client base by offering services and products addressing their needs of the non-bankarised population.

Financial innovation

The application of innovative technologies to the financial sector is a proven cost-effective way of narrowing swiftly the existing gap between financial access and financial needs in most emerging and developing countries.

Financial education

One of the necessary conditions for expanding access to finance is the conformation of a well-informed and trained universe of clients of financial services. This contributes to the desired scenario of fair provider-customer relationships and the freedom to choose by consumers. Nevertheless, financial education must be accompanied by the most appropriate institutional and regulatory framework aimed at preventing potential predatory practices from providers and at guaranteeing the existence of accessible and well-functioning consumer protection mechanisms.

Afi Analistas Financieros Internacionales

For more information, please contact the authors

Virginia González Pérez
virginia@afi.es

Verónica López Sabater
vlopez@afi.es

Afi, Analistas Financieros Internacionales, S.A.

C/ Españoleto 19, 28010
Madrid, Spain
Tel. +34.915 200 100
www.afi.es/en