

Policy note

Consumer protection

Leveling the playing field in financial inclusion



About this note

AFI's series of policy notes are made specifically for policymakers and focus on the key policy solutions that have been proven to promote financial inclusion in developing countries. Drawing on existing research, they define the policy solution, identify the critical issues for decision-makers and give practical examples from developing countries. The notes also identify policy champions who are at the forefront of implementation, and give an overview of relevant reading material.

At a glance

Consumer protection

Consumer protection seeks to level the playing field between suppliers and consumers of financial services. Retail customers have less information about their financial transactions than do the financial institutions providing the services, which can result in excessively high interest rates paid, lack of understanding about financial options, and insufficient avenues for redress. Such an information imbalance is greatest when customers are less experienced and products are more sophisticated. Efforts to expand financial inclusion by reaching 'unbanked' customers encourage tens of thousands of these new customers to enter the market annually. Although many financial institutions adopt practices to ensure they are well served, some have used their information advantage (often abetted by regulatory loopholes intended to promote financial inclusion), to increase profits at the expense of consumers who may find themselves over-indebted, under-insured or without a return on their investment.

Policy questions

Regulation and supervision: Market conduct regulation falls across a spectrum between principles and rules. What is the correct balance? Effective supervision is necessary to ensure financial institutions' compliance with market conduct regulation. Do supervisors have adequate resources?

Role of the industry: To what extent can self-regulation be effective, when financial institutions have an inherent conflict in protecting consumers?

Consumer input: Given the prevalence of regulatory capture, who speaks for the consumer?

Financial education: Consumers need to have a basic level of understanding to use financial services effectively. How can education succeed at scale?

Demonstrated success

A number of countries have developed innovative policy solutions to improve consumer protection.



Leveling the playing field

Without adequate consumer protection, the benefits of financial inclusion can be lost.

Unchecked market forces and policies that relax regulation in an effort to open financial markets to serve the bottom of the pyramid can result in consumers that are harmed as a result of financial access. Harm can range from overindebtedness due to excessively high prices and predatory lending, to loss of savings or pledged assets when unscrupulous actors enter the market for short-term gain. High prices may be warranted in hard to serve markets, but left unchecked, some financial institutions over charge. Predatory lending resulting in overindebtedness is prevalent in un- and under regulated markets, which eventually suffer high default rates. Less frequently, unscrupulous actors steal customer's money or collateral and overzealous collections result in physical or emotional abuse of customers.

Consumers need information to make good decisions.

When buyers and sellers come together in a transaction, information is power. Consumers of financial services, especially new customers, lack information about the financial system and financial transactions. Increasingly, on the other hand, the financial providers serving these customers try to access a great deal of information about the customer and the market including credit histories, market assessments, and analysis to inform their decisions.¹ As financial products and services are offered by more sophisticated providers, the information gap between financial institutions and their customers grows ever wider. Competition can result in practices that go

some distance to reducing the information imbalance, if the market is disciplined and provides sufficient information to customers (see Peru example above). But where market forces do not result in this level of disclosure, providing information to customers in ways they can use it, will help build financial literacy and ease new customers into the market.²

Market discipline facilitates financial market expansion.

Consumers who demand information play an important role in ensuring transparency among financial institutions. Transparency in the market encourages institutions to compete on the basis of better products and services and lower costs. Ultimately the availability of quality retail financial services will draw in new customers and expand the market. (World Bank, 2008)

Improving financial literacy requires a multi-stakeholder framework.

If consumers are to fulfill their role of enhancing market discipline, other actors must also play their roles.

Consumers should be educated and able to voice their opinions about the financial services they are purchasing;

Financial institutions should actively participate in providing an environment where consumers are protected;

Governments should provide oversight and enforcement to ensure both sides are meeting on a level playing field.

The case of Peru

Peru has reduced the number of complaints across the financial system by 32% since 2004, due to the implementation of a holistic system of consumer protection. The Superintendency of Banking, Insurance and Private Pension Funds (SBS) supervises the policies and procedures that financial institutions put in place to protect consumers, but does not directly respond to complaints. In 2008, 99% of nearly 400,000 complaints were successfully handled by the financial institution itself. Of the remaining 4,000 complaints, two-thirds were referred to the Consumer Protection Commission, and one-third were referred to the Financial Ombudsman. In addition to oversight by the regulator, and multiple channels for redress, Peruvian consumers can access cost information about financial services published daily in newspapers. When this information was first published, interest rates dropped as much as 15% in six months.



¹ While many MFIs are small and unsophisticated, the trend is towards larger and more sophisticated institutions that would be capable of gathering and analyzing available information. See, for example, "Trends in Microfinance 2010-2015" by Triodos Facet for an analysis of the changing supply of financial services to previously unbanked customers.

² For a good discussion of the different definitions of financial literacy, see Angela Hung's useful memo on "Financial Literacy in Times of Turmoil and Retirement Insecurity", p. 2, available at <http://www.retirementsecurityproject.org>

How it works

Consumer protection is generally considered to be a regulatory response to a market failure. (Eisner, Allen, Worsham & Ringquist, 2006)

Without sufficient information it is difficult to make rational choices. Consumers have less information and sophistication than the retail financial institutions that provide them with services. Furthermore, as a result of the imbalance of information, consumers are vulnerable to abusive practices. Appropriate regulation should correct the balance and encourage market expansion by apportioning information disclosure at the right time. Relevant information has to be disclosed during the different stages of contractual engagement – pre-contract, during contract, and post-contract. The disclosure of information in manageable portions is necessary to avoid overloading the consumer, who can then better understand his rights and obligations.³

Market conduct regulations should be consistent across the financial sector.

Similar products offered by different financial service providers should be subject to the same regulations to minimize the opportunity for regulatory arbitrage. Consistency can best be assured through a single market conduct regulator for all financial products.

Regulators need to understand the consumer perspective to establish effective regulation and supervision regimes.

Without the active participation of consumer advocates, regulators tend to hear only from the industry and thus cannot ensure a level playing field between consumers of financial services and the institutions that provide those services.⁴ However, effective consumer advocates that speak for financial consumers exist in only a handful of emerging markets.⁵ To better understand consumer issues, some regulators analyze consumer complaints to identify areas of concern as well as trends in market practices and respond with appropriate regulations and enforcement actions. Supervisors may also identify practices that undermine public confidence in the market

for retail financial services. Supervisory tools include reviewing product-related information, conducting onsite reviews, telephone interviews, media surveillance as well as industry and consumer surveys. Without representation or a spokesperson, however, consumers cannot engage in the process of defining how financial markets should be regulated to protect them.

Consumers have rights.

When consumer rights are ensured, financial innovation can lead to more suitable products for customers at lower prices. The right to be heard, the right to information, the right to choice and the right to redress are among the most common. The right to privacy is generally added for financial consumers, and additional rights are often articulated to address local issues. The regulatory burden is to balance these rights with the need for financial institutions to innovate and grow.

General consumer protection laws often fail financial consumers.

Consumer protection laws that originate from concerns about product or food safety often fail to adequately protect consumers of financial services. Protections unique to financial services include:

Fair market practices – Financial service providers and their intermediaries must be fair in dealing with consumers and not exert undue pressure or influence on them. In this regard, financial service providers must ensure that sales promotion materials are not misleading, the terms of contract are fair to consumers, and market practices are sound. Even when activities are outsourced, financial service providers remain accountable and must ensure that outsourced agents perform their functions in a reliable and professional manner.

Equitable treatment – Financial service providers must not create barriers of access to financial services. All customers, including the poor and vulnerable who may not be perceived as 'income generating' customers, deserve to be treated with equal respect.

³ The Obama administration in 2009 highlighted the need for financial institutions to use 'plain language in plain sight', i.e. avoid technical financial jargon and making information available and accessible to consumers.

⁴ Regulatory capture, whereby regulatory agents come to be dominated by the industry they regulate, is a recognized feature of financial markets. For an insightful take on regulatory capture see "The Slow Drip of Faster Payments". John Kay, Financial Times. 16 June 2009

⁵ Independent advocates are rare in emerging markets, where most advocates for financial customers are affiliated with either the government or the industry.

How it works continued

Disclosure – Full disclosure of all relevant information to consumers, including interest rates and terms for loan products, and a schedule of other allowable fees and charges. The interest rate may be calculated as an Annual Percentage Rate (APR), according to a prescribed formula so that consumers can easily choose between providers without fear of hidden costs. Annual Percentage Yield (APY) can be calculated for deposit accounts.⁶ To improve transparency, the regulator may publish a list of all rates in newspapers or other freely accessible medium. A schedule of fees and charges may be posted in each financial institution's location, or provided to each customer.

Peru

As part of Peru's Regulation of Transparency, banks must disclose the "TCEA", or Annual Effective Cost Rate, which is expressed like an interest rate but includes all costs associated with a consumer credit, such as evaluation charges, credit insurance premiums, or monthly statements issuing cost. An amendment to the regulation will create the "TREA", or Annual Effective Yield Rate, which will include the interest rate paid on deposits, less any cost that affected the deposit during its term (for term deposits) or during a fixed period (for checking accounts, saving accounts and other non-term accounts).



resolve a large percentage of complaints, but may not cover all customers.⁷ Even where an industry mechanism does exist, there must be recourse to another body accessible by all consumers, such as the regulator, to ensure an adequate response.⁸ Due to the technical nature of financial services, separate mechanisms may be established for different types of services (banking, insurance, securities, etc.), or they may be mediated by different mediators in the same mediation centre.

Mexico

Mexico's consumer agency handles about 10% of consumer complaints against financial institutions. 90% are resolved by the financial institutions themselves.



Financial education – Consumer education is needed to balance information between consumers and providers of financial services. New entrants to the market, with less experience using financial services, are especially in need of education about their rights and responsibilities. Consumer education may be delivered by government agencies, consumer associations, or the industry, but most often consumer education programs are provided through public campaigns. Campaigns use the internet; print, radio and television media; advertising; publications and training.⁹ While campaigns are frequently used to inform consumers, there is little empirical evidence of their efficacy in changing behaviour. Nor is there reliable information on the best way to disseminate financial education messages.¹⁰

Redress – Mechanisms are needed for consumers to voice their complaints to their financial service provider and the industry regulator. In the first instance, a system must be in place to give the financial service provider responsibility to resolve the dispute. Failing which, customers should have access to alternative avenues of redress. Third party oversight through an independent Ombudsman or other agency improves impartiality and enhances trust in the system. Often there is not an independent body to provide redress and the regulator assumes this responsibility. Industry redress mechanisms are useful and cost efficient, and they can successfully

⁶ Some research suggests that annualized interest rates are not the best disclosure information for the poor, who borrow very small amounts for short terms. They may be better served by standardized payment information. See Portfolios of the Poor for a more thorough discussion.

⁷ Some industry mechanisms are provided as a service to financial institutions for a fee, covering only customers of those institutions.

⁸ The Financial Mediation Bureau of Malaysia is establishing branches in various parts of the country to facilitate consumer's access.

Philippines

Overseas workers sent \$16.4 billion to the Philippines last year, over 10% of that nation's GDP.

Recognizing that these nine million workers are important consumers of remittance services, the Bangko Sentral ng Pilipinas conducts its Financial Literacy Campaign through road shows in Singapore, Hong Kong and other countries, educating hundreds of Filipino working abroad about financial planning, saving and investing.



Malaysia

Since its establishment in April 2006, Malaysia's Credit Counseling and Debt Management Agency provides prompt and cost effective debt settlement for 20,409 accounts involving about RM 2.0 billion as of August 2009.



Consumer protection laws are not interchangeable from country to country.

Factors in structuring an appropriate consumer protection approach include the stage of market development, products and providers used by unsophisticated and vulnerable populations, and risk (e.g. loss of savings or guarantees, over-indebtedness, macroeconomic conditions such as inflation). Regulation should focus first on those risks that are most harmful and affect more vulnerable people. Alternatives should take existing local capacity into consideration, such as industry initiatives, the courts, ombudsman schemes and civil society organizations.

Credit counseling – In the event of over-indebtedness, credit counseling services are helpful in assisting consumers who are unable to meet their financial obligations. Credit counseling agencies help consumers with their household financial management through education, advice, and development of debt management plans negotiated with the consumers' creditors. Debt management plans can lower installment payments through reduced interest charges and longer repayment terms, enabling distressed consumers to better meet their financial commitments.

Privacy – Maintaining the secrecy of customer information is often not considered as part of general consumer protection frameworks based on product safety. However, security of personal financial information is important for financial consumers, as well as an element of Know Your Customer regulations. Financial customers in emerging markets may have little expectation of privacy and may not demand that their financial information be protected. However, proactively ensuring consumer information is kept secret, except in the case of legal requirements or reporting to a credit reference bureau, will protect the consumer against unethical use of financial information.

⁹ Examples of financial education delivery channels can be found at the OECD International Gateway for Financial Education (www.financial-education.org)

¹⁰ See, for example, 'Measuring the Effect of Financial Education', Alison O'Connell. The Retirement Commission of New Zealand. 2006. www.financialliteracy.org.nz

Policy questions

1. What type of market conduct regulation is most effective in ensuring consumer protection?

Regulatory models fall on a spectrum between general principles and detailed rules. In practice, it is rare to find a principles-based model without rules, or a rules-based model that is not grounded on principles.

A principles based approach is a more market sensitive, light touch approach building on the regulated industry's greater knowledge of the market, and encourages thoughtful solutions rather than box-ticking. However, it is more difficult for firms to know if they are in compliance and requires flexible supervision, which calls for greater capacity on the part of the supervisor and more maturity on the part of the industry. Customers may be confused with a principles based approach, as each institution creates a unique system to comply with the principles.

A rules based approach has the advantages of being clear and uniform in application by all institutions in the industry, making it easier for consumers and financial institutions to understand. Because of its straightforward nature, relatively less high level supervisory capacity is needed to ensure compliance with strict rules. However, supervisors must have sufficient staff to carry out on and off site supervision. Rules can never anticipate every situation and are often difficult to change, so gaps can emerge. Rules also tend to reduce innovation as institutions spend time documenting compliance and attempting to circumvent the rules, rather than improving products.¹¹

Supervisory capacity is limited. Superintendents' offices are generally structured to meet the needs of 'traditional' financial services – a small number of providers serving a relatively sophisticated customer base. As microfinance emerges from a model dominated by small NGOs to one more integrated with bank and non-bank financial services, supervisors find they do not have the human resource capacity or experience to oversee a large number of small institutions. (Ledgerwood & White, 2006) This has sometimes left large swathes of the financial sector, generally that portion serving poor customers, unregulated and potentially open to consumer abuse.

South Africa

In South Africa, proposed regulation for micro-insurance grapples with the need for capacity to supervise thousands of currently unregulated funeral insurance providers. Strategies include shared supervision with other regulatory bodies and improving recourse so that a statutory Ombud can target problem firms.



Regulators must balance the need to protect consumers while avoiding over-regulation. While adequate consumer protection requires some regulatory oversight, over-regulation occurs when the cost of ensuring equality of information for both provider and consumer reduces the availability of products and services in the market and/or drives prices higher than can be afforded by poor, unsophisticated consumers. Ultimately, over-regulation reduces the size of the market, pushing buyers and sellers to the informal sector. Peru, South Africa and the Philippines are oft cited examples of an appropriate balance, while over-regulation has been noted in China, the West African Monetary Union and Uzbekistan, among other emerging market countries.

¹¹ An example of the trade-off between innovation and regulation is now being played out in the United States, which already has one of the most compliance-oriented rules based systems in the world. To help ensure the financial services industry does not get ahead of regulators, the government has proposed creation of a Consumer Financial Protection Agency which would have the power to define standards for financial products, potentially limiting product offerings and consumer choice.

2. What is the role of the financial services industry?

The financial industry is responsible for setting high standards of professionalism. The industry must ensure that financial service providers act with due care and diligence in dealing with consumers. In this regard, responsible financial service providers will develop and offer quality products and ensure that marketing staff are well trained and have the requisite competency in selling products that are suitable to the consumers. For example, as countries such as India and South Africa explore and experiment with basic financial products (sometimes called 'no-frill' products) provided at no costs or minimum costs for new and 'unbanked' consumers, these should be subject to the same product development and market testing as other products on offer to ensure these meet the needs of this new market segment.

Self-regulation may work as an incremental step.

Setting and enforcing basic standards can be challenging until the sector's size, potential for significant market failure and government resources are sufficient to warrant statutory oversight, or as a complement to statutory regulation. Properly monitored and enforced, self-regulatory mechanisms take advantage of market knowledge possessed by the industry and help build industry acceptance of consumer protection.

Self-regulation is most effective when the financial industry understands its role in the market and ensures that the interests of customers are aligned with the commercial goals of the institutions in the long term. Such a perspective is reflected in self-regulatory mechanisms, such as consumer protection codes of conduct or industry ombudsmen schemes that are transparent, credible and enforceable. Self-regulation that does not seek such alignment may give the public a false sense of security and mask emerging problems. A statutory agency that listens to consumers is best placed to determine the correct balance between the industry and consumer needs, but must have leverage

over the industry to encourage meaningful self-regulation, generally through a credible threat of statutory regulation. Where self-regulation is credible and enforced, it can offer a less expensive alternative to statutory regulation, and is more acceptable to the industry.

Financial institutions that embrace transparency, redress and financial education promote financial inclusion and expand the market. Financial institutions that understand the potential of financial inclusion recognize that in the long term it is in their best interest to foster fair and equitable business practices as part of good governance and brand building which will promote good returns for the institutions and consumers. To avoid a first mover dilemma that puts individual institutions at risk in the market, industry associations should ensure all financial institutions act at the same time and in the same way. For example, interest rates should be disclosed using a common formula and all institutions should start using that formula at the same time. A credible threat of additional regulation may be required for the industry to act in concert.

Policy questions continued

3. How can consumers have a voice in policy dialogue?

Retail financial customers need to understand their rights and responsibilities.

In emerging markets, consumers are often unaware of their rights, inappropriate practices of financial service providers, or the extent of their responsibilities as financial consumers.¹² All actors have a role in educating consumers about their rights and responsibilities: consumers and their advocates, financial institutions and their representative bodies, and the government oversight and regulatory bodies.

Few emerging economies have consumer advocates that represent financial consumers. Consumer associations more commonly work on product or food safety issues. Representing financial consumers is more difficult because of the complexity of financial transactions, the information imbalance even for sophisticated consumer advocates, a regulatory system where banks and their supervisors have common backgrounds and perspectives (regulatory capture), and the emergent nature of 'popular' financial services. As these services become more widespread among vulnerable populations, consumer advocates have begun to emerge in Singapore, Senegal, El Salvador and other emerging markets to address consumer protection in financial services. Until these associations become more widespread and build their capacity to represent consumers of financial services, it falls to the public agencies such as central banks, superintendents and public policy makers to ensure the consumer voice is heard.

Baseline information about financial capabilities is limited.

Private sector market research often misses unbanked populations, although as financial inclusion gains legitimacy, more are looking seriously at these market segments, providing valuable information about how consumers use financial services.¹³ Private researchers are also increasingly trying to understand how the poor make financial decisions.¹⁴ Some countries, like Ghana, are including financial access issues in household surveys to try to understand how consumers approach financial services, what additional education they need to fully assert their economic power, and how they can best be reached.¹⁵ Additional research is needed to measure how financial education improves the ability of consumers to assert their rights and what types of education have the most impact.

¹² In "Consumer Protection: A Client Perspective" (www.microfinanceopportunities.org), researchers asked microfinance customers in Bolivia about their understanding of their rights.

¹³ See, for example, the FinScope surveys at www.finscope.co.za for examples of how low income markets can be segmented

¹⁴ "Portfolios of the Poor" analyzes information from financial diaries that track household financial transactions among poor households with interesting results

¹⁵ CGAP's Concept Note "Multi-Country Data Sources for Access to Finance" provides a good overview of the state of knowledge for the main thrusts in financial inclusion research.

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About AFI

The Alliance for Financial Inclusion (AFI) is a global network of central banks and other financial inclusion policymaking bodies in developing countries. AFI provides its members with the tools and resources to share, develop and implement their knowledge of financial inclusion policies. We connect policymakers through online and face-to-face channels, supported by grants and links to strategic partners, so that policymakers can share their insights and implement the most appropriate financial inclusion policies for their countries' individual circumstances.

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