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Country Studies Provide Powerful Lessons in Financial Consumer Protection

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Key Messages

- **In countries that have moved from central planning to market economies, protecting consumers is necessary to create stable and competitive financial markets and give new consumers confidence in the formal financial systems.**
- **By 2008, household debt in the Europe and Central Asia Region (ECA) had risen to levels between 20% and 50 % of GDP. However, many transactions still take place outside the formal financial sector, many people find financial service contracts difficult to understand, and consumer complaints are hard to redress.**
- **The World Bank has conducted nine country studies in ECA to review consumer protection and financial literacy frameworks in all financial segments - including banking, securities, insurance, private pensions, and non-bank credit institutions.**
- **The World Bank recommends that ECA countries develop strong and specific institutional frameworks for financial consumer protection, disclose financial information more clearly to consumers, improve business practices in the financial sector, set up efficient dispute resolution mechanisms, develop financial education programs, and conduct financial literacy surveys.**

Consumer Protection and Financial Literacy in ECA

Until the financial crisis of 2007, the global economy was adding an estimated 150 million new consumers of financial services each year. Rates of increase have since slowed but the growth continues. Most new consumers are in developing countries where consumer protection and financial literacy are still in their infancy. This is particularly true in countries that have moved from central planning to market economies where protecting consumers is necessary to ensure stable and competitive financial markets and give new consumers confidence in the formal financial systems.

Household use of financial services has been rising rapidly in emerging countries, yet consumer protection and financial literacy remain weak. By 2008, household debt in ECA had risen to levels between 20% and 50% of GDP. However, many transactions still take place outside the formal financial sector in emerging markets. At the same time, many people find financial service contracts difficult to understand and there are no agencies that are clearly identified as being responsible for addressing consumer complaints; consumers have to take their disputes directly to court systems, a process that is often slow and expensive.

The global financial crisis has highlighted the importance of consumer protection and financial literacy for the stability of the financial sector. In the US, the rapid growth of complex residential mortgage products, combined with securitized instruments 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 ECA too, damage to the financial sector was serious.

Why are Consumer Protection and Financial Literacy Important?

There are at least three reasons why consumer protection in financial services and financial literacy are essential for financial sector development in ECA countries.

First, they increase consumer confidence in the financial system and, in turn, contribute to reducing the risks to financial stability. Both consumer protection and financial literacy are needed to build trust in the financial system. In the banking sector, they typically broaden and diversify the

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deposit base of banks, thus reducing liquidity risk. Well-informed consumers also help foster financial stability by better protecting themselves from incurring large exposure to market and other risks. Across the financial sector, consumer protection and financial literacy promote access to, and prudent use of, financial services.

Second, consumer protection in financial services and financial literacy address the imbalance of power, information and resources between consumers and their financial services providers. This imbalance is often a typical market failure. Financial institutions know their services well but individual consumers often find it difficult or costly to obtain information on the financial products they purchase. In addition, complex financial products may be difficult to assess even when all the information is disclosed.

Third, consumer protection in financial services and financial literacy promote efficiency and transparency in retail financial markets. Consumers who are empowered with information and basic rights are an important source of market discipline. This encourages financial institutions to compete by offering better products and services rather than by taking advantage of poorly-informed consumers.

An effective financial consumer protection framework 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 ensuring fair, non-coercive and reasonable practices in the selling of financial products and collection of payments;
- **Redress -** by providing inexpensive and speedy mechanisms to resolve complaints and disputes; and
- **Privacy -** by ensuring control over access to personal 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 to exercise their rights (and responsibilities) as financial consumers.

Lessons from Nine Country Studies

Starting in 2005, the World Bank initiated a pilot program that has conducted country reviews in Azerbaijan, Bulgaria, Croatia, the Czech Republic, Latvia, Lithuania, Romania, Russia, and Slovakia. Each country review provided a detailed analysis of consumer protection and financial literacy frameworks in all financial segments, including banking, securities, insurance, private pensions, and non-bank credit institutions. Some reviews also looked at microfinance lending and credit reporting. The reviews were conducted using *Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool*.[2]

Five types of issues clearly stood out in the reviews of the nine countries:

Inadequate institutional structure for financial consumer protection. In some countries, the financial supervisors view consumer protection as part of their mandate for financial stability. In others, the general consumer protection agencies deal with financial services but are mostly 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 respective financial supervisors. The reviews showed that financial consumers generally have no clear idea about which agencies to approach in case of complaints.

Insufficient or unclear disclosure on financial products. Where the EU Directive on Consumer Credit has been implemented, clear disclosure of effective rates for consumer credits is provided. However, many of the other terms and conditions require a careful reading of the financial contracts. In Romania, some borrowers receive mortgage contracts printed in a 6-point font size that is too small to read. In none of the nine countries are consumers informed of the risks involved in taking long-term loans in foreign currency and at variable interest rates.

Unfair or abusive business practices. The worst abuses against financial consumers are often committed by unlicensed financial service providers. In Slovakia, some non-bank credit institutions (which, at the time of the review, were not registered with the National Bank) charged consumers interest rates of 120% to 225% per annum while banks were lending at less than 14%. Another common problem relates to debt collectors. In Russia, when the financial crisis hit household lending, some banks increased the use of third-party debt collection agencies to improve loan performance. However, these agencies remain unlicensed and their methods of operation are not subject to strict controls.

2 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*, December 2009 (available at http://www.worldbank.org/eca/consumerprotection)

Deficiencies in the customer complaint/dispute resolution framework. Complaints are not systematically analyzed and answered. Large financial institutions have generally set up specialized complaint departments and banking supervisors review banks' complaint files while conducting on-site supervision. Nonetheless, the process of collecting complaints is inefficient: there are neither central agencies for, nor aggregated statistics on, consumer complaints. The reviews found that at least 50% of the complaints are inquiries which can be addressed by financial education.[3] As for complaints leading to disputes, only three countries have some mediation mechanisms to help the parties resolve issues amicably. The other countries either have no out-of-court mediation services or have services that focus on specific financial services only. Yet, going to court is not a viable alternative for most financial consumers.

Low level of financial literacy and lack of awareness of customer rights in financial services. A 2008 financial literacy survey conducted in Russia showed that half the respondents considered their level of financial literacy as unsatisfactory. Over 80% were unable to correctly answer five out of six basic financial questions. None of the nine countries studied had a financial education strategy in place.

Recommendation for Consumer Protection and Financial Literary

Drawing lessons from the nine country studies, the World Bank recommends:

Strong and specific institutional frameworks. As one option, financial supervisory agencies may adopt consumer protection as part of their mandate. However, 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, they need to find a way to build the expertise and confidence to handle the complex technical issues related to financial services. A third approach would be to create special purpose consumer financial protection agencies, such as the one proposed in the US and currently in place in Canada. The bottom line is that there should be an institution identified to deal with consumer protection issues, with a clear mandate.

Clear information disclosure. One option is the use of "key facts statements" that provide 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.

Prohibition of abusive business practices. All financial institutions that deal with the public should be registered with a financial supervisory agency. All entities that solicit funds from the public for investment (or speculative) purposes should be licensed and those who attempt to engage in pyramid schemes[4] 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 reviews by regulators of all financial products sold to the public may be required. Unfair or deceptive practices should be explicitly prohibited and personal data carefully protected so that consumers are aware when their personal data has been shared.

Efficient customer complaint/dispute resolution mechanisms. 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 types of complaints. Complaints should be differentiated from 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 recommended.

Development of financial education programs. Financial education is an effective form of consumer protection but cannot substitute for regulation. Building financial education is a long-term investment and its effectiveness should be carefully evaluated. Focus should be placed on "teachable moments" —such as, when a consumer takes a mortgage for the first time or starts to plan for his or her retirement. Interactive stock market computer games are also effective in teaching high school students about financial investment. Middle - and high - income countries should develop national strategies for financial education.

3 For instance, 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, several consumers complained to banking supervisors that "We don't 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.

4 A "pyramid scheme" is a business model that involves the exchange of money for enrolling other people into the scheme, often without delivering any service. New money (brought by new investors into the scheme) is the source of the payoff for existing participants. Pyramid schemes require an exponential increase in the number of participants to sustain them.

Conducting financial literacy surveys. The surveys should review the ability of consumers to evaluate financial products, their spending/savings patterns, and their trust in dispute resolution mechanisms with financial institutions. 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 programs have been effective and if additional consumer protection measures are needed. Globally, surveys of consumer protection and financial literacy would be helpful, as would diagnostic reviews of countries in other regions like Latin America and Asia.

Consumer Protection in Financial Services: How to Get it Right?	
Institutional Structures	• Single agency is best. • If a consumer protection agency is responsible for financial services, create a specialized department for financial services with adequate expertise. • If a consumer protection agency is responsible for basic financial services, enlarge its mandate to include ALL financial services. • Alternative: create a specialized consumer financial protection agency (as in the US and Canada).
Consumer Disclosure	• Ensure simple and standard consumer disclosure. • Get professional associations to develop "key facts statements" that provide a simple summary of the terms and conditions of the financial contracts. • Have standard contract provisions for high-volume core retail financial products.
Business Practices	• Register all financial institutions dealing with the public with financial supervisory agencies. • Explicitly prohibit and sanction unfair or deceptive practices. • Require financial institutions to provide accurate information and hold them accountable for the information they provide to consumers. • Establish a cooling-off period for complex, long-term savings products and those sold aggressively. • Make provisions for annual audited financial statements, and fit and proper tests for credit institutions. • Require regulatory licenses for entities that solicit funds from the public for the purpose of investment or speculation. • Enhance the powers of securities supervisory agencies to investigate ponzi/pyramid schemes. • Require consumers' signed approval if personal data is to be shared by financial institutions. • Allow inexpensive ways for consumers to verify their personal information in the credit register. • Enforce responsible practices (via codes of conduct, for example).
Complaints and Dispute Resolution	• Provide fast and inexpensive redress mechanisms. • Have clearly identified departments to handle customer complaints in all financial institutions. • Advise customers in writing about where they should submit complaints when buying new financial services. • Have financial supervisors review the complaint files of the supervised entities. • Provide toll-free telephone lines at the central complaints offices. Complaints may be submitted by email, postal mail, or in person. • Analyze and publish consumer complaints statistics. • Provide alternatives to courts for disputes involving small amounts of money (for example, financial ombudsman).
Financial Education	• Focus financial education on "teachable moments." Systematically evaluate programs. • Elaborate national strategies/programs of financial education and financial literacy. • Monitor consumer protection (for example, by using "mystery shoppers").
Financial Literacy Surveys	• Conduct national surveys of financial literacy and follow-on reviews. • Promote global surveys of legal and regulatory frameworks for financial consumer protection, levels of financial literacy, and patterns of financial consumer behavior.

What can the World Bank Group Do?

The World Bank can assist by preparing Diagnostic Reviews of Consumer Protection and Financial Literacy, conducting financial literacy surveys, and developing strategies or action plans to implement recommendations for strengthening consumer protection and financial literacy.

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