

# PERSPECTIVES

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# Should Consumers Be Protected From Their Financial Institutions?

In countries traditionally as far apart on the regulatory spectrum as France and the United States, many are calling for much stronger consumer protection measures for financial services.

Just as a bill on consumer credit is being tabled by the French government, the House Financial Services Committee and the United States Congress have approved legislation aimed at tighter oversight of credit-card issuers, which is being described as a credit card holder “Bill of Rights.”

Both regulatory measures are moving in the same direction toward tighter controls in the interest of protecting consumers. On the one hand, the French government is proposing “guard rails” for new credit applications to ensure more responsible lending, tighter controls on advertising, more formal credit application procedures and extended sanctions. On the other, the U.S. bill approved by Congress will impose requirements such as 45 days notice for credit-card rate and fee increases, limits on who can receive a card and prohibit retroactive rate increases unless the cardholder is at least 60 days behind in paying the bill.

In this article we will review the existing frameworks that are in place to protect consumers in the United States, France, the United Kingdom and Canada. The financial crisis has exposed the strengths and weaknesses of these different systems and needed reforms. We will examine how the three pillars of a strong consumer protection system can be used as a framework to assess effectiveness and explore opportunities for improvement.

## The Economic and Financial Crisis – an Eye-Opener

Why did it take such a huge crisis to get a reaction from both sides of the Atlantic? In recent years, the United States has not shown a great appetite for strong regulatory or legislative environments of any kind. Moreover, any attempts to move in that direction are made all the more difficult by having to get both the House and the Senate to agree to such measures, not to mention the resistance that can be fuelled by extremely effective lobby groups in Washington.

Contrary to the UK, Canada or Australia, in the U.S. there is no centralized consumer protection body. The five main regulatory authorities and various others have had to establish commissions, carry out research, and deploy months of effort to sort out reliable information on the practices of their financial institutions. While some of these practices were merely aggressive or misleading advertising, others stagger the imagination. The U.S. Congressional Oversight Panel, in its January 2009 Special report on Regulatory Reform, listed a few of them: fees for payment by telephone, repeated changes in the dates bills are due, changes in the locations to which bills should be mailed, making it difficult to find the total amount due on the bill, moving bill-reception centers to lengthen the time it takes a bill to arrive by mail, misleading customers about grace periods, and double cycle billing. One could also add, credit-card offers to holders who already owned several cards at the same institution and who were already unable to pay them off, and mortgages granted for up to 125% of property value, with progressively rising interest rates on the mortgage as the years go by. The list just goes on and on.

In France, consumer credit slogans such as “quick money transfer, no questions asked”, “cash a check with a phone call” have added to the confusion. As well as expressions like “cash reserve”, “extra reserve”, and “available account”, which usually avoid any references to the fact that it is credit (which means it has to be paid back, with the extra cost of interest that it entails), have led many households into high debt situations. Financial services regulation in France is

also somewhat fragmented. Due to the separation of regulatory powers over financial institutions, markets and insurance, consumer protection comes under the responsibility of each regulator. It is primarily the French law called the *Code de la Consommation* and a strong network of consumer organizations, which protect consumers and address issues. Consumer organizations add some centralization to the consumer compliant and support functions. However, wider issues may not be identified by consumer complaints if they are not reported to the level where they can be dealt with for the entire institution, industry or financial system.

Conversely, regulation of the financial industry in the UK is centralized to the Financial Services Authority (FSA), which has consumer protection within its mandate. The FSA sets standards and regulations, monitors and enforces regulations and provides financial education to consumers. Although centralized structures were in place, the FSA has been strongly criticized thought the recent crisis for its weak prudential regulation and inability to identify systemic risks. The centralized system should, in theory, facilitate strong coordination between prudential regulation (that which ensures stability of the financial system) and consumer protection regulation (the rules specific to protecting individual consumers). However, this did not happen in the case of the collapse and nationalization of Northern Rock Bank. The FSA was criticized for ignoring the warning signals and continuing to allow the bank to operate without a risk mitigation program. The Northern Rock case demonstrated that the supervisory approach that the FSA takes to prudential regulation has not been effective.

Canada has recently received international praise for its strict financial services regulations. For example, many of the common U.S. credit practices are forbidden under Canadian regulation; mortgages exceeding the value of the property, increases to credit-card interest rates without sufficient notice or limits, mortgages requiring neither down payment nor insurance, and the list goes on. As a result, Canadian consumers do not appear to suffer from the same debt burden and crisis of confidence that are affecting UK and US households. The Office of the Superintendent of Financial Institutions (OSFI) and the Bank of Canada have set stringent capital requirements for federally regulated financial institutions and have monitored enforcement through risk assessment. However, the Financial Consumer Agency of Canada (FCAC), which is responsible for consumer protection at the federal level, has limited scope and power to prevent a financial crisis through its monitoring of consumer complaints. The FCAC has limited resources, with an annual budget of about \$9 million and 47 employees. A heavy reliance is placed on reporting and voluntary compliance by financial institutions, as they do not have the resources to conduct regular examinations or follow-up on all individual complaints.

The current crisis has exposed practices across the board that could be considered questionable when weighing the benefit to consumers.

## **Regulation: A Natural Solution but Not Enough by Itself to Resolve the Problem**

Setting up tighter and more precise regulations are a natural response at a time when governments are being called upon to intervene more closely in the economy. However, two other pillars also have to be present to ensure effective consumer protection. The second pillar is monitoring compliance through regulatory structures. This pillar consists of providing the framework and resources for enforcement and gathering and analysis of consumer complaints to their

financial institutions or consumer protection agency. Complaints can be early signals or indicators that action is needed, either through regulations, or through industry initiatives.

## EXHIBIT 1 THE PILLARS OF A SUCCESSFUL CONSUMER PROTECTION FRAMEWORK

THREE PILLARS	KEY ELEMENTS
1. Setting up the Right Regulations and Provisions	Setting up sufficiently detailed prudential regulation to protect the stability of the system as well as consumer protection regulation to protect consumer interest, but keeping it broad enough to allow for innovation and competition in the industry.
2. Monitoring Compliance through Regulatory Structures	<p>Overseeing the financial institutions to monitor their risk level and ensuring compliance to prudential regulation (i.e. capital adequacy, liquidity etc.).</p> <p>Monitoring compliance to consumer protection regulations, addressing and responding to individual consumer complaints, and identifying compliance issues and potential risks.</p>
3. Educating Consumers on their Rights and Responsibilities	<p>Providing relevant, simple, non-biased information that is easily accessible to all consumers.</p> <p>Providing value added services such as training and education as well as a customer contact centre.</p>

The third pillar is financial literacy. This is not to say that every consumer should understand the mysterious workings of sophisticated financial products. The simple understanding that nothing is free (we have all heard advertisements for “free credit” or “pay later, no interest”), and an understanding of budgets, interest payment calculations, and lending mechanisms as well as indebtedness ratios will help many consumers avoid risky situations. Even in Canada where prudential regulations are strong, a survey by the Canadian Securities Administration of 5,000 Canadians, found that although 88% of respondents believed it is important to have a financial plan, 56% did not have one.

We also need to recognize that the need for financial literacy depends on the consumer. Based on US Federal Deposit Insurance Corporation data, there are an estimated 28 million unbanked and 44.7 million under-banked people in the U.S. People are just beginning to grasp the extent of the disparities in financial practices and the numbers are shocking. Minority groups and the poor are not only the most vulnerable to but were also the most targeted by some lending institutions’ highly contentious financial practices. Broader financial literacy is an effective lever to limiting such situations.

### Integration: Creating a virtuous circle between prudential and consumer protection regulation

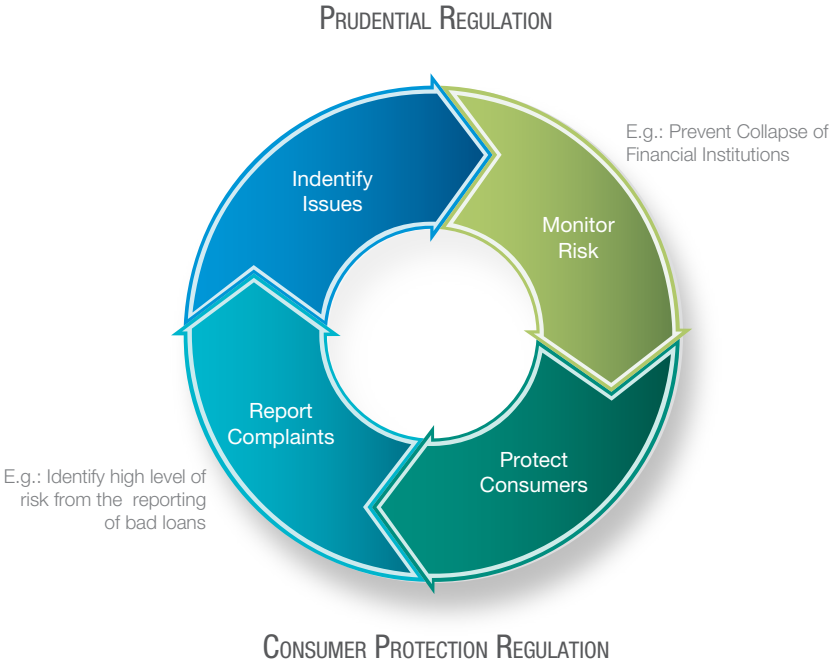
A comparison of four different countries on the consumer protection framework they have in place to cover these three pillars, shows that each system is unique.

## EXHIBIT 2 CASE STUDIES OVERVIEW

PILLARS	CANADA	UNITED STATES	UNITED KINGDOM	FRANCE
1. Setting up the Right Regulations and Provisions	<p>Formation of regulation for Federally Regulated Financial Institutions are centralized to the Ministry of Finance, with OSFI as a key contributor.</p> <p>At the provincial level there are Provincial Financial Institution Regulators and Securities Regulators.</p>	<p>Regulation is highly fragmented.</p> <p>There are 5 main regulatory authorities for banks, a separate national securities regulator and the insurance industry is regulated at the state level.</p>	<p>Regulation is highly centralized to the FSA.</p> <p>FSA is the main source of prudential and consumer protection regulation.</p>	<p>Formation of regulation is centralized to the Ministry of Finance and Bank of France.</p> <p>Regulation is somewhat fragmented, with regulation of banks, markets and insurance are under 3 separate authorities.</p>
2. Monitoring Compliance through Regulatory Structures	<p>OSFI, Provincial Regulators and Self Regulatory Organizations play a key role in enforcement.</p> <p>The FCAC takes individual consumer complaints and monitors enforcement of consumer provisions.</p>	<p>Each regulator has some role in enforcement and consumer protection.</p> <p>There is no centralized consumer protection body that takes consumer complaints.</p>	<p>The FSA and Office of Fair Trading (OFT) play a key role in enforcement.</p> <p>The Financial Services Ombudsman receives individual consumer complaints and provides mediation, but only refers cases to the FSA or OFT when there is a wider issue concern.</p>	<p>The three main regulators for the industry are responsible for enforcement.</p> <p>The consumer protection branch of government also has enforcement capability for certain parts of the financial services industry.</p> <p>Consumer organizations primarily take consumer complaints and help consumers address them.</p>
3. Educating Consumers on their Rights and Responsibilities	<p>FCAC provides information to financial consumers and is active in financial literacy.</p> <p>Non-profit organizations and Provincial consumer protection branches provide information and financial literacy services to consumers.</p>	<p>There is no single organization responsible for financial literacy, however several non-profit organizations have developed financial literacy programs.</p>	<p>The FSA is the main organization responsible for consumer education on financial products and market issues.</p> <p>FSA also leads the National Strategy for Financial Capability.</p>	<p>The consumer protection branch of government and consumer organizations provide consumer education on financial products and market issues.</p>

From these case studies, it is evident that none of the jurisdictions have a perfect system, however there are elements of each that are effective and opportunities to improve integration. Strong prudential regulation protects the consumer indirectly, by ensuring stability and consumer confidence in the financial system. In addition, consumer protection regulations should be visible and explicit, so that there is a central source of information and first response mechanism for consumer with complaints. However, the link between prudential and consumer protection regulation can make the system more proactive rather than reactive, as we have seen with all of our case studies. Coordination provides a feedback loop on system-wide issues that originate from consumer complaints and allows regulation to be informed by consumer feedback.

**EXHIBIT 3 THE BENEFITS OF INTEGRATION**



Even with an integrated regulatory framework for consumer protection, the ability of financial institutions and advertising agencies to innovate is limitless and regulatory and consumer organizations will not always be able to keep up with the pace of innovation. It is also likely that new products that provide something more or something better than those on the market today, will ultimately be more expensive and/or more risky for the consumer. This puts some onus on the financial institutions to take responsibility for their own actions.

## The Responsibilities of Financial Institutions

Should financial institutions be doing more to protect the consumer? Relevant and enforceable regulation as well as financial literacy can go a long way; but financial institutions also have a leading role to play.

Financial institutions all have the same purpose: they exist to meet consumers' financial needs. Can we be convinced that some of the advertising and commercial practices of the last few years were designed and delivered in a way that meets the needs of consumers? Inappropriate innovation, poor governance, defective compensation models, and a lack of internal controls created a bias toward short-term profits and higher incentive compensation from top managers right down to front-line employees. These problems are not just occurring in a few failing banks, but have become prevalent across the industry.

All financial institutions worldwide would be doing society a service by asking themselves how they could thrive instead by meeting consumers' financial needs and protecting their interests. By implication, this would mean adjusting the products and services, practices, compensation models, standards of governance and customer service. It would also mean reworking the corporate culture and values to become more responsible corporate citizens.

However, customer service and altruism need not be the only motivators. If doing the right thing for the consumer is not enough motivation, how about doing the right thing for the shareholders? The same practices that got the consumer into trouble are what ultimately got the financial institutions into trouble. If consumers can't afford the credit offered, then the bank cannot afford to lend it. Management and Boards of financial institutions should be overseeing consumer practices as part of institution risk management. Practices that fail the consumer test will usually fail the test of safety and soundness.

## Conclusion

The regulation reforms that are being prepared on both sides of the Atlantic will set some principles or rules that will reinforce consumer protection. Each country can learn from how others have leveraged the three pillars of consumer protection: regulations and provisions, monitoring of compliance and educating consumers. But financial institutions in all countries need to be at the forefront of this transformation.

Would that help us avoid another financial crisis? Not if the culture of some institutions remains indifferent. It is now up to the industry to use the opportunity of the crisis and regulatory response to set and practice a higher standard in order to regain the respect of the market as well as financial stability.

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