Financial Consumer Protection: Issues and Australian Experience*

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There are three main themes for my talk today (as well as providing some background to, and lessons from, Australian experience with Financial Consumer Protection Policies).

The first is that FCP policy should be structured to reflect what we know about behavioural biases of individuals – not based on a hypothetical assumption of informed, rational, economic, utility maximizing individuals. Even though some "homo-economicus" may exist (and as the "marginal" market participants drive market outcomes) they need little protection beyond adequate disclosure. But for the majority, reliance on disclosure, education and advice is inadequate – other interventions are also required.

The second theme is that product and service providers to financial consumers vary dramatically in terms of size, ethics, objectives etc. Approaches should be tailored where possible to reflect the resulting potential differences in consumer risk. Regulations based on problems arising from one group of providers will, unless appropriately tailored, have compliance and other adverse impacts on others for whom they may not be necessary. "Principles – based" regulation, giving flexibility to providers of financial products and services to meet desired standards in various ways most suitable to them has merit here. However, unlike "black letter law" it can create uncertainty for firms as to whether regulatory requirements are being met and whether the firm is thus inadvertently exposed to risk of prosecution and penalties.

Third, the location of FCP responsibility needs to take account of the institutional structure of regulatory agencies and legal powers. FCP crosses the boundaries of: prudential regulation (including deposit insurance); securities and market conduct regulation; Central Banking responsibilities for system stability; and general consumer protection. In Australia, for example, responsibility rests with ASIC, the securities and market conduct regulator, rather than the Australian Competition and Consumer Commission. whereas in some countries (such as the US and Canada) specialised FCP agencies have been established. There is unlikely to be any unique best model for allocating FCP responsibility, and its mandate and powers will need to reflect the nature of the legal system and thus the opportunities for individuals to seek redress and the deterrence effects from such actions.

Why Financial Consumer Protection?

What is special about financial consumer protection? Why is it different to consumer protection in general. I think there are two main reasons. First, confidence in the financial

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sector is important for economic development and growth, and this can be undermined if financial consumers are poorly treated. Second the potential for purely redistributive, unethical or immoral, activities is potentially greater in the world of finance than elsewhere.

The two reasons are interrelated. Economic development generates increasing household involvement with the financial sector. Financial development leads to increasing complexity of financial products and services. However, financial literacy is generally low, creating opportunities for miss-selling and overcharging to occur and to become significant problems, particularly given individuals' gullibility and greed. Some providers of financial products, services, and advice may have questionable ethics, poor governance, and misaligned incentives. Resulting financial failures, miss-selling, scams, and consumer losses reduce confidence and cause sub-optimal use of the financial sector which impedes economic growth and development.

On the second point, redistributive activities can range from pure theft to simple overpricing of financial products. At the pure theft end of the spectrum, one might place practices such as placement of underpriced company shares to outside investors or friends of the management, diluting the equity of existing shareholders. However, ambiguity arises because such placements may provide a faster and cheaper way of the company accessing finance, ultimately to the benefit of all shareholders. At the other end of the spectrum apparent overpricing of financial products could instead simply reflect different perspectives on the risk involved and compensation appropriate for bearing that risk.

It is these ambiguities which make the issues of financial consumer protection both interesting and challenging.

A Wide Range of Issues

Financial consumer protection issues range from large-scale systemic problems through to more specific problems affecting individuals, or small numbers of consumers, and involve: saving and investing; borrowing and credit; insurance; payments; advice. At the large scale end there have been a number of major mis-selling issues over recent decades, shown in Table 1.

In the UK for example there were in the 1980s - 1990s major mis-selling episodes involving personal pensions and also endowment mortgages. In the 1990s stretching into the 2000s the UK also had major problems associated with sales of payment protection insurance, which has led to banks making provisions for compensation currently in the order of £20 billion.

In the US the most obvious example is the sub-prime mortgage scandal starting in the 1990s and ultimately triggering the global financial crisis which emerged in 2007 and 2008. At that time the Madoff Ponzi scheme was also exposed.

In Asia during the 2000s, both Hong Kong and Singapore experienced the mis-selling of "mini-bonds" which involved very complex credit link note structures. In Europe there has recently been a spate of problems with widespread use of foreign currency loans in some countries. Homebuyers been offered and have taken out loans in foreign currencies of economies with significantly lower interest rates, without understanding the substantial risks from currency devaluation to the ultimate cost of their borrowing.

It is worth noting that Australia had a similar foreign currency loan scandal several decades ago. In fact, that case was arguably even worse because it involved dealers at the originating banks having the authority to switch the borrower between different currencies, thus incurring bid- ask spreads and transactions costs as well.

Table 1: Some recent major miss-selling scandals

When/where	Name	Features
1980s-90s (UK)	Personal Pensions Miss-selling	Introduction of personal pension schemes led to large commission based casual salesforce encouraging individuals (often family/friends) to shift from defined benefit company pension schemes to personal defined benefit schemes
1980s-90s (UK)	Endowment Mortgages	Property mortgages involving either interest only or final balloon payments of principal and interest attached to savings plans invested in stock market. Sold on "promise" that invested amount would grow sufficiently to at least meet required final mortgage payment.
1990s – 2000s (UK)	Payment Protection Insurance	Sold in conjunction with new mortgages, loans, credit cards, offering protection to meet loan obligations if loss of income due to unemployment, illness etc. Highly profitable for providers - claims payouts / premiums around 15 per cent. Inappropriate for many borrowers, marketed as "essential". FSA actions from 2006, GBP 20 billion estimated compensation bill at February 2014.
1990s-2000s (USA)	Subprime Mortgages	Mortgages sold to borrowers without adequate repayment prospects or initial equity position, with some originators misstating borrower financial position. "Teaser" initial interest rates with subsequent major upward adjustment, and premised on assumption that increased property prices would enable refinancing of mortgage on new terms.
1990s-2000s (USA)	Madoff Ponzi Scheme	Fraudulent managed investment scheme where high stable returns reported. New investor contributions were used to make distributions to or credit returns to accounts of existing investors.
2000s (HK & Singapore)	Minibonds	Complex credit- linked note structure issued by a special purpose vehicle related to Lehmans and sold by banks to over 40,000 investors. Projected returns were high, but would diminish if there were default events of a small number of high quality companies/sovereigns, through a credit default swap agreement. However, investor capital was invested in risky CDOs (rather than risk free securities) such that much value was lost when Lehmans collapsed – although subsequent recoveries of principal amount have been quite high.
2000s (Europe)	Foreign Currency Loans	Home-buyers offered loans in foreign currencies where interest rates are significantly lower and being exposed to the risk of home currency devaluation and substantial increases in the ultimate cost of the borrowing.

These are extreme cases. But there are many examples, brought to prominence by the financial crisis, of unsuitable products, miss-pricing, conflicted advice, financial firm failures and investor losses. In Australia, for example, the financial crisis exposed a variety of problems. They included:

- Failures of Agribusiness managed investment schemes where projections of returns were excessively optimistic and investor assets were not adequately protected. Indeed, investors often borrowed funds from an associated company of the management firm which remained owing when the scheme failed.
- Margin Lending arrangements which involved a securities lending structure whereby ownership of the equities involved was transferred to the lender (rather than retained by the borrower) and title the transferred to the lender's financiers. When the lender went into insolvency due to operational risk events, the borrowers faced substantial losses (although eventually, for reputational reasons, the large banks which financed the margin lender provided compensation).
- Sales of unsuitable CDOs and Credit Linked Note products to retail (and other) investors.
- Freezing of unlisted mortgage and property funds which offered withdrawal facilities but held mainly illiquid assets (a repeat of similar events in the mini-crisis at the start of the1990s)
- Failures of finance companies and other financial firms raising funds by issue of debentures and engaging in related party loans (often for property development).
- Managed fund frauds where investments were made offshore and funds unrecoverable.

Notably, the losses experienced by retail (and other) investors from such events did not lead to government compensation – since they involved investments and activities outside of the prudentially regulated sector. Having a clear demarcation of the boundary between prudentially regulated and non-regulated sectors has been one strength of the Australian system.

International Developments

The world-wide experiences have meant that Consumer Financial Protection has emerged as a prominent issue in the global regulatory agenda, with the G20 producing a set of high level principles (Table 2) and other international agencies (and national authorities) paying increased attention to the topic. The World Bank, for example, has produced guidance on good practices for financial consumer protection on an industry basis. But what guiding economic philosophy should underpin the process is a matter for debate.

Table 2: G20 High Level Principles

1. Legal, Regulatory & Supervisory Framework	FCP an integral part of the framework, reflect financial system and user features, good legal underpinnings, appropriate regulation of product /service providers and agents
2. Role of Oversight Bodies	FCP oversight bodies with mandates, authority, independence, accountability
3. Equitable, Fair Treatment of Consumers	Fairness should be an integral part of governance / culture of providers and agents
4. Disclosure and Transparency	Provision of key information expected on product benefits, risks, terms and conflicts of interest. Honest promotional material. Standardised disclosures allowing comparisons.
5. Financial Education and Awareness	Promote financial literacy and information on rights. Implement OECD INFE principles
6. Responsible Business Conduct of Providers and Agents	Customer best interests should be an objective and reflected in remuneration structures. Provider accountability for actions of agents.
7. Protection of Consumer assets against Fraud and Misuse	Information, control and protection mechanisms expected to protect consumer assets.
8. Protection of Consumer Data and Privacy	Control and protection mechanisms expected to protect consumer information and clarify permissible uses.
9. Complaints Handling and Redress	Jurisdictions should ensure accessible mechanisms. Providers and agents should have mechanisms for complaint handling and redress, and recourse available to independent process
10. Competition	Promote competitive markets to give consumer choice and ability to switch, and to promote product development and quality

Alternative Philosophies and Approaches

At the risk of caricature, Figure 1 indicates a spectrum of ideological / philosophical positions which can be adopted as the basis for financial consumer protection policies. At one extreme is the "free markets" / libertarian approach, consistent with the world of introductory economics textbooks. Markets should be allowed to operate freely, individuals should take responsibility for their actions, and have access to the legal system for the resolution of disputes.

In this view, decisions of informed individuals will promote efficiency, and "rule of law and reputational considerations will deter unethical behaviour by suppliers of financial products and services. Governments may need to ensure adequate information is provided, and if individuals are unable to assess the worth of financial products and services, it could be expected that skilled advisers would be available, for a fee, to assist.

This philosophical position influenced the development of Australia's FCP recent framework following the Financial System (Wallis) Inquiry in 1997. A need for a prudentially regulated sector providing a low risk home for savings was acknowledged, and legislation involved licensing of all providers of financial services and products. CFP was allocated to ASIC which had powers to oversee activities outside the prudential sector.

The main ingredients of that policy were disclosure, education and advice (which I'll refer to as DEA). Of course, for the policy to work what is really needed is "perfect" DEA, although "good" DEA, however that might be defined, would probably be seen as adequate by most. In practice, both in Australia and elsewhere, even achieving "good" DEA has proven problematic.

The problems are inherent in all parts of the DEA approach used in Australia. First disclosure documents are used more as a legal protection device by financial product producers than as information documents, making them large and, generally, unintelligible to the typical individual. There is considerable work also to be done in identifying the best way of presenting information about risks, costs, expected returns etc in ways that resonate with readers.

It is perhaps worth noting, as a digression, that in response to problems exposed in Australia ASIC introduced "if-not-why-not" disclosure requirements. Those financial product suppliers to retail customers affected are required to disclose and explain why, if it is the case, their business models and practices differ from an ASIC good-practice benchmarks. Components of those benchmarks include leverage and liquidity norms, lending practices, and governance arrangements. Like other disclosure approaches it does not appear to have been particularly successful.

Disclosure deficiencies are compounded by the fact that financial literacy standards, even though relatively high by world standards, are inadequate for even moderately complex financial products. Lusardi and Mitchell (2014) have recently surveyed the evidence on, and developments in, financial literacy and conclude that "researchers have demonstrated that low levels of financial knowledge are pervasive, suggesting that it will be quite challenging to provide the tools to help people function more effectively in complex financial and credit markets requiring sophisticated financial decision making." They note that we have little evidence on what types of financial decision making can be improved by enhanced financial literacy

Finally, the financial advice industry has been characterised by conflicts of interest, conflicted remuneration structures with reliance on commissions from product suppliers rather than up front fees, and with many advisers employed by large financial product producers such as banks and life insurance firms. The level of qualifications has often been inadequate, quality of advice has often been poor, and recent advice scandals have involved advisers placing individuals into products inconsistent with their desired objectives and risk tolerance.

The problems exposed have meant that regulatory approaches have moved somewhat along the spectrum shown in Figure 1.

Figure 1: Approaches to Financial Consumer Protection

Philosophies and Policies: a caricature

Approach	Free Markets/ Libertarian	Asymmetric Information	Behavioural Finance	Paternalism
Assumptions	Rationality Competition Rule of Law Full Information Caveat Emptor	Imperfect Information, "credence" goods	Behavioural biases	Inability to assess needs & products, exposure to unethical suppliers, and limits to legal system redress
Policies	Education, Advice Disclosure	Codes of conduct, dispute resolution, standardised products / contracts sophisticated – retail distinction, facilitate switching, standard products / contracts	Default options, product marketing rules	Product bans and approval processes, product design rules

Pre-crisis $\qquad$ Post-crisis

As well as the demonstrated failings of the DEA approach (although better DEA is always sought) two factors (as well as lots of bad experiences) are intertwined in influencing that shift away from the perfect markets paradigm. One is the increasing recognition of the pervasiveness of asymmetric information in financial markets, which is particularly relevant due to the inter-temporal nature of financial contracts. Assessing the reliability of a counterparty's promised future commitment to pay, or the risks associated with contracts with uncertain payoffs, or the true value of a financial product or service, are fundamental problems for financial decision-making. This is compounded by a second factor of widespread deficiencies in financial literacy which mean that individuals are generally unable to make such an assessment even if provided with large amounts of information relevant to such risks.

A third factor is that relying on *ex post* compensation for wrongdoing by suppliers of financial services and products is problematic due to the imbalances of economic power and knowledge between suppliers and consumers, and high costs of litigation relative to potential compensation. Consequently, if the expected costs of wrongdoing, miss-selling, or overcharging (relative to true worth) are low relative to potential benefits, deterrence effects may be inadequate to achieve good social outcomes. This problem is amplified by the fact that many financial products may be thought of as "credence goods" in which the purchaser relies on the credibility of the seller or adviser and is unable, perhaps even with the benefit of hindsight, to assess the true worth of the product or service purchased.

The second factor influencing a shift in focus is the increasing body of evidence that most individuals do not act like the "homo economicus" of the textbooks. Rather than rational beings making self interested decisions which maximize utility, most of us are subject to a range of behavioural biases and, given limits to our information processing ability, tend to act in accordance with various heuristics or rules of thumb. This means that decisions made may not be in one's best interest, and such decisions may be easily influenced by the way in which financial products are constructed and marketed. It is often said that consumers do not "buy", but are "sold" financial products.

The problem that recognition of these factors gives rise to, is how to design FCP policies without going to the other extreme of government paternalism (fixing prices, banning products etc) – which will typically involve significant economic inefficiencies.

The behavioural economics approach raises the question of to what extent appropriate policies might instead involve removing some financial products and services from the choice sets available to individuals, or appropriately designing the "choice architecture" to influence or "nudge" individuals towards making decisions policy-makers believe would be in their best interests. That "libertarian paternalism" approach (Thaler and Sunstein, 2008) assumes that individuals are not the rational economic man or woman of the economic textbooks, on which so much of financial regulation has been inappropriately based, but are behaviourally biased. And to the extent that is true, it raises the question of how best to also design financial literacy and education programs which recognise the pervasiveness of behavioural biases.

Several approaches consistent with the imperfect information and "liberal paternalism" perspectives have been adopted in Australia (although not explicitly referred to as such), and some examples follow.

Recognising the problems individuals face in assessing financial risk, most countries provide a "safe haven" for savings in the form of insured or guaranteed bank deposits. This provides FCP against counterparty risk of institutions inside the prudential perimeter. Australia, now does this, but prior to the financial crisis did not have such a scheme, relying instead on the assumption that depositor priority would be sufficient to both protect investors and remove uncertainty and consequent risk of "runs". While depositor preference may have provided sufficient protection, it certainly did not provide adequate comfort to depositors during the financial crisis – with few even aware of their priority position and some uncertainty existing about the extent of implied government guarantees.

The dilemma with providing a "safe haven" via deposit insurance is, of course, that it creates moral hazard – individuals no longer need to assess the riskiness of institutions covered. This puts increased onus on the regulators to ensure, via regulation and supervision, that excessive risk taking creating threats to the taxpayer or insurance fund does not occur. Particularly in the absence of risk-based deposit insurance premiums, an expected consequence can be tougher regulation and more intensive supervision.

Recognising the fact that behavioural biases lead individuals to discount the future too heavily, and thus make inadequate savings for retirement, many countries – Australia included – mandate compulsory long term pension savings (superannuation) out of employee incomes and provide tax incentives for such savings. This can, itself, generate other FCP concerns. In Australia, for example, when individuals reach retirement age and can access accumulated savings, they may lack sufficient expertise to manage those funds and, potentially be prey to unscrupulous counterparties. This was the case in Australia involving the "Storm Financial" advice scandal, where retirees were induced to use retirement savings (often augmented by funds from remortgaging their home) as the investor's equity in highly levered margin lending arrangements. When the stock market collapsed in 2007-8, substantial losses and hardship resulted. As another example, Self Managed Superannuation Funds (where individuals manage investment of their own retirement savings) have grown significantly in Australia, potentially exposing such individuals to sellers of unsuitable investment products, or fraud (as occurred in the Trio scandal).

Challenges in the Design of FCP Policies

Financial regulators face three main challenges in designing appropriate protection regimes for consumers of financial products and services such as savings and investment products, borrowings, payments services, insurance, and financial advice. One is the potential for "moral hazard", where government guarantees and support reduce consumer incentives for assessing and taking responsibility for risks. A second is identifying an appropriate prudential perimeter within which additional protection beyond that afforded elsewhere may be warranted. The third is understanding the determinants of consumer behaviour such that legislation and regulation can be fashioned appropriately to lead to desired outcomes.

More generally, policy involves both *ex ante* (prevention) and *ex post* (redress for loss or wrongdoing) aspects. They are inter-related via the role of deterrence. In general, the likelihood of undesirable practices occurring will depend on: the probability of exposure and punishment, which in turn depends upon individual access to courts, regulator mandate and resources, and “gatekeepers” (such as accountants, auditors, trustees, custodians, advisers) as well as the size of potential punishment (fines, licensing restrictions, reputation effects).

It can be argued that punishment levels and options have been inadequate in Australia, particularly given the limited resources which regulators have had available to pursue wrongdoers. As a more general point, in jurisdictions where potential exposure and punishment are less substantive, use of restrictions on behaviour is likely to be more necessary.

The legal/regulatory framework is crucial in this regard. For example, when can redress be sought? Will a court make decisions based on compliance with strict “terms and conditions” (even if unlikely to have been understood by the individual) or by applying a “reasonable expectations” doctrine? How are abusive practices defined and what duty of care is required of the product supplier?

Also important is the range of ways by which redress can be sought, ranging from individual legal action, through legislated dispute resolution schemes and government agency (enforcement) roles. The Australian approach has placed significant emphasis on requirements for both internal and external dispute resolution schemes which have worked well. But another significant development has been the emergence of class actions and litigation funders. While these provide a mechanism for poorly resourced individuals to jointly seek redress, they also create potential problems of opportunistic lawsuits.

Another challenge for FCP policy is that financial product/service suppliers range from unregulated individuals (eg payday lenders) to large global financial institutions. Moreover, suppliers can be “for profit”, cooperatives / mutuals, government owned, each with different incentives and therefore potential for creating FCP problems. One size of regulation is unlikely to fit all, and supplier culture, ethics, integrity, governance, incentive structures are all relevant.

This raises two related issues. The first is the merits of “principles – based” regulation versus a “black letter law” approach. The former gives flexibility to different types of providers of financial products and services to meet required standards in different ways most suitable to them. The “externality” of regulation targeted at one group of providers adversely affecting others for whom it is not necessary is removed. However, unlike “black letter law” it can create uncertainty for firms as to whether regulatory requirements are being met and whether the firm is thus inadvertently exposed to risk of prosecution and penalties. It also can make prosecution more problematic compared to cases where explicit regulations have been breached.

The second issue concerns the culture, governance, and incentive structures of financial service providers. In an ideal world, providers would act in a “fair” manner, not exploiting consumer lack of knowledge or behavioural biases for gains at the expense of the consumer. Of course, in the free markets paradigm, fairness does not emerge as an issue, since it is assumed that transactions are entered into voluntarily on the basis of full knowledge and because they are believed to be mutually beneficial. We do, however, know that not all individuals adhere to ethical standards which incorporate “fairness” as a consideration, even though psychological evidence suggests that fairness is a potentially important influence on decision-making of many individuals. Unfortunately, there is also substantial evidence that fairness considerations can be driven out of decision making considerations, and replaced by pure self-interest, by the institutional arrangements within which transactions are made.

Some would argue that “fairness” can get indirectly incorporated into corporate cultures by the need to preserve a reputation as a good counterparty. If repeat transactions with the same customer (or others who are aware of that customer’s experience) are desired, unfair treatment can threaten reputation and subsequent business. But that perspective relies on two assumptions – neither of which are necessarily appropriate for many financial transactions. First, many financial transactions are one-off or infrequent (such as taking out a mortgage to buy a house) so that the potential for information acquisition by the customer by learning by doing is limited. Second, many financial products and services are arguably “credence” goods, where quality and value added cannot be ascertained by the customer, even after the contract has expired.

And, digressing somewhat, even if the customer can assess that a product is not suitable after entering into the transaction, there may be impediments to switching to another supplier. Exit fees are one such impediment, and one response to this in Australia has been to ban exit fees on variable rate mortgages.

The need to ensure “fairness” makes corporate culture an important factor in FCP considerations. However, achieving a desired culture in a competitive world is a problematic issue for policy makers. One response, applied in Australia, is to impose requirements on financial firms to behave fairly. As well as general prohibitions on “unconscionable conduct”, lenders are now required to ensure that loans are suitable for the characteristics of the borrower – switching the onus for assessing product suitability from the borrower to the lender. Another response is government support of industry codes of conduct and professional standards, through which market participants seek to avoid reputational damage by excluding those whose actions could have harmful spillover effects on reputations of others in the industry.

Probably the most problematic area is that of remuneration structures, and particularly in the area of financial advice. In Mid 2012 the Australian government introduced Future of Financial Advice (FOFA) reforms involving introduction of explicit fiduciary duty for advisers and prohibition of conflicted remuneration structures such as commissions and volume based payments. In December 2013 the new government proposed amendments "weakening" some of the provisions, but these are currently on hold.

Conclusion

Designing effective or optimal CFP policies is challenging. The main lessons from Australia's experience I would argue are: (1) the inadequacy (albeit importance) of a DEA approach; (2) the importance of establishing a clear demarcation line between prudentially regulated institutions and products (where government support is expected) and the remainder of the financial sector where *caveat emptor* is the dominant principle. The challenges however are that (1) prudential regulation occurs also for financial stability reasons and may potentially lead to a wider range of products than desired being captured within that boundary, and (2) establishing a suitable set of CFP arrangements outside that boundary which reflect imperfect information, behavioural biases, realistic assumptions about financial literacy, and legal and cultural underpinnings of behaviour, is difficult.

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