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Financial Consumer Protection and the Global Financial Crisis*

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Abstract

This paper discusses the role and design of financial consumer protection (FCP), weaknesses of current FCP frameworks in light of the recent global financial crisis, policy responses to the crisis, and policy issues in FCP that remain to be addressed. The failures of financial consumer protection have been one of the detonators and amplifiers in the crisis. Policy responses during the crises have focused mainly on enhanced disclosure of pre-contractual and contractual terms and conditions of financial products, their professional and ethical distribution, and debt counseling and education programs for consumers. Most recently, more attention has been paid to the institutional design for financial consumer protection, including regulation, supervision and enforcement and access to financial education. This has been advanced by thinking about the need for a sound and safe design of future financial architecture, including benchmarks for FCP worldwide.

Keywords: Financial Consumer Protection, Global Financial Crisis, Business Conduct Regulation and Supervision, Financial Market Integrity.

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1. Introduction

The global financial crisis has highlighted the need for effective consumer protection in provision of financial products and services. This is especially important in the light of increased exposures of households to financial risks. Particularly over the past decade, households worldwide have increased their accumulation of assets (and debt). At the same time, governments have transferred to households key risks related to private pensions (particularly longevity risk) while financial institutions have passed to households some risks, such as foreign currency risk, traditionally held by financial institutions. Both governments and financial institutions have been motivated by the need to reduce their expenditures but such transfers have come at a cost to both consumers and the society. Consumers need adequate laws and regulations—and access to financial education—to protect themselves in the face of increasing financial risks. When financial consumers lack sufficient protection, they are unable to adequately manage the risks that they assume. This paper discusses the role and design of financial consumer protection (FCP), weaknesses of recent FCP frameworks (including financial literacy) in light of the recent global financial crisis, policy responses to the crisis, and policy issues in FCP that remain open and to be addressed.¹

2. Role and Design of Consumer Protection

FCP concerns the interactions (interface) between individuals and financial institutions. Consumers suffer from imbalances of power, information and resources vis-à-vis financial institutions. Such imbalances create market failures. The market failures enable financial institutions to transfer risk to consumers and conduct rent-seeking (cost-inefficient) transactions at the expense of consumers, including by encouraging supply-driven innovation that creates complex financial products.

¹ The World Bank conducted nine country-based detailed diagnostic reviews on consumer protection in financial services and compiled a set of good practices using internationally recognized approaches to FCP. Copies can be found at www.worldbank.org/eca/consumerprotection.

Consumer protection directly contributes to increased efficiency of financial intermediation, transparency of financial products and services, and product innovation driven by consumers' demand. Empowered consumers help foster competition, quality and innovation in provision of financial products and services, while educated and confident investors can provide additional liquidity to capital markets for their growth and development (Gauzes, 2008). Effective consumer protection facilitates increased penetration of the financial sector, through improved awareness of financial products and services, consumers' rights and obligations, and the advantages of life-long financial planning. Higher financial penetration then mobilizes economies of scale in financial intermediation, thus helping reduce the cost of finance and make financing more accessible. Increased financial penetration also helps in getting more people out of the gray economy by imposing higher transparency on their financial transactions. Moreover, well-functioning consumer protection empowers consumers to effectively exercise their demands and enforce demand-driven (as opposed to supply-driven) innovation in the financial sector. The enhanced suitability of a financial product increases its ability to fit both the intended financial purpose and existing risk profile of an individual or household.

In addition, consumer protection contributes indirectly to financial stability by forcing banks to retain risks which they are better equipped than consumers to handle. This concerns both the lending and deposit side of banks' business. On one hand, FCP ring fences accumulation of indirect credit risk in the household sector that materializes and further impairs banks in bad times, and against which banks typically do not hold any capital. This is done by requiring banks and other financial institutions to stick to responsible lending and loan origination practices. On the other hand, FCP improves confidence of depositors in the banking (financial) systems by making sure that they invested (deposited their funds) in products suitable for their risk profile and financial plans. This, in turn, enhances the stability of banks' deposit base and diminishes the risk of panic and runs on bank deposits.

Hence, financial consumer protection can complement prudential supervision, when implemented in proper balance (Gauzes, 2008). Consumers can enforce good business conduct and market discipline of

financial institutions as long as an inexpensive, fast and effective redress mechanism is in place. However, consumer protection does not substitute for prudential regulation as its scope is narrower. It overlaps with business conduct (market integrity) regulation and supervision in focusing on the relationships of financial institutions with retail customers. However, business conduct regulation and supervision includes other elements, such as fair competition among financial institutions and market integrity.

A well-designed consumer protection framework ensures five principles (World Bank, 2008). Namely provides the financial consumer with:

- 1) *Transparency* through clear, material and comparable information about the prices, terms and conditions, and risks associated with financial products and services;
- 2) *Free choice* via fair, non-coercive and professional practices in the selling of financial products and services, and collection of payments;
- 3) *Redress* through inexpensive, speedy and effective mechanisms to address complaints and resolve disputes;
- 4) *Privacy* through control over access to personal information; and
- 5) *Access to financial education* to enable consumers to empowers themselves by improving their financial literacy and capability.

Such a framework sets clear and transparent rules of engagement between households and financial institutions, and ensures their effective implementation and enforcement.

Financial consumer protection has two modes of delivery: (1) *regulation* and (2) *financial education*, where the regulation includes self-imposed, compulsory (enforced) and voluntary codes of conducts. In other words, FCP regulation imposes socially desirable constraints on the financial industry in its dealings

with consumers, while financial education intends to improve financial capability of consumers with the hope to promote well-informed and responsible financial behavior.

Some, but not complete, substitution may be possible between financial education and regulation. For example, in rapidly developing financial markets, such as those of developed and emerging market economies, financial education could teach consumers principles of sound and safe financial behavior including basic financial skills. However, it could be less successful in teaching consumers details of financial products, in which case the ongoing financial innovation could leave the consumer with false overconfidence and lead to undesirable financial behavior. The reasons for some regulation and paternalism could be three-fold: (i) financial education will always lag behind the development of financial markets (see also Cole and Shastry, 2007;² and Willis, 2008), (ii) the direct (immediate) costs of implementing financial education programs are relatively high compared to regulation, and (iii) the drive for profits (even at higher risks) and weak corporate governance create incentives for the financial industry to exploit even responsibly behaving and capable financial consumers, e.g. through supply-driven innovation and introduction of complex financial products (Barr, 2009; Bernanke, 2008). In its competition for profits and market share, the financial industry (or its segments) could collude on consumers with no incentive to reveal system-wide business misconduct from within the industry. Hence, for all financial markets, no matter how rapidly developing, a combination of financial education and regulation is needed, where the appropriate mix has to be developed with respect to the country specifics.

The development and design of the institutional framework for FCP has differed across countries and no broad convergence has been achieved in this respect so far. Some differing examples, in regards to the mandate for FCP, include an economy-wide consumer agency (e.g. in Sweden and Russia), a financial

² Cole, S., Shastry, G.K. (2007). If You Are So Smart, Why Aren't You Rich? The Effects of Education, Financial Literacy and Cognitive Ability on Financial Market Participation. Working Paper, Harvard University.

supervisory agency (e.g. in the United Kingdom and Malaysia) and a special-purpose financial consumer protection agency (e.g. in Canada). All three options can work well. The question is which agency has sufficient resources, technical expertise, enforcement tools, and no conflicts of interest to do a competent job.

Overall, there have been noticeable improvements in the FCP regulation. First, disclosure and clarity of pre-contractual and contractual information have improved, especially in the EU and US. The European Commission urged for increased information and pre-contractual information disclosure and making consumer rights more explicit while encouraging policy makers to raise awareness and application of consumer rights by consumers.³ Due to ineffective disclosure and methods of payment allocation used by creditors to produce the maximum cost to consumers, the Fed put rules in place which limit the discretion of creditors to allocate consumers' payments made above the minimum amount. The US Federal Reserve Bank also banned so-called double-cycle billing. Second, misleading advertising, professional misconduct and the role of financial advisors have been addressed. In the US, there have been continuing efforts to strengthen business conduct enforcement, especially on credit cards, other revolving credits and debt collections, and loan origination practices, particularly concerning mortgages. The European Commission and the Financial Services Authority have been addressing misleading advertising, aggressive sales practices, and treatment of consumers in financial distress.⁴ Third, improvements have occurred also in

³ The new EU Directive on Consumer Credit Loans aims to break open the €800 billion EU consumer loans market, which remains largely fragmented into national markets denying consumers choice and more competitive prices. Overly complex products simply cannot be adequately understood or evaluated by most consumers, no matter how clear the disclosure, and direct regulation, including the prohibition of certain practices, may be the only way to provide appropriate protections. The allocation of payments by credit card issuers could be an example. As creditors began offering different interest rates for purchases, cash advances, and balance transfers, they were also able to increase their revenues through their policies for allocating consumer payments.

⁴ In addition, the FSA has been conducting and publishing Responsible Lending Reviews which include recommendations to relevant financial firms for improvements in their product and service delivery.

personal data protection which has come to the forefront to preclude pressure sales, allow direct disputes of false consumer information furnished by financial institutions to consumer and credit reporting agencies.

Nevertheless, the crisis has shown that FCP frameworks and enforcement of FCP principles and rules have still major gaps and exposed limitations of existing policy measures concerning both FCP regulation and financial education, including: the issues of financial product complexity and related information disclosure, business misconduct and coercive practices of financial institutions, inefficiency and ineffectiveness of recourse mechanisms, and the limits to financial education as an effective measure of FCP.

3. The Crisis and Policy Issues

As the crisis unfolded, failures of financial consumer protection occurred on several fronts. One of the most important weaknesses, especially in the U.S., has been the weak and sometimes abusive loan origination particularly in the segment of residential mortgages. In addition, the evidence of abusing practices regarding credit card charges, high pressure and distant sales, misleading advertising, unprofessional judgment on product suitability, or mishandling of customer complaints have mushroomed once policymakers turned their attention to financial consumer protection, in light of the crisis. In emerging market economies, the main problem appeared to have been the accumulated large foreign exchange (FX) exposures, even in countries with flexible exchange rate regimes (e.g. Hungary or Romania).⁵ Apart from the adverse movements in exchange rates, the consumer have been hit by

⁵ This happened due to both banks bringing in whole sale funding in foreign exchange from abroad, as they could not finance ongoing battle for market shares through increases in deposits. In addition, the history of benign macroeconomic environment, booming emerging market economies, and their appreciating exchange rates led consumer to the misperception that such

increasing interest rates and refinancing rates as banks have been, sometimes unfairly, passing on the increase in their financing onto consumers, exploiting the vague and complex terms and conditions of the contracts. Due to non-transparent, inefficient, ineffective and sometimes non-existent redress mechanisms the consumers were left defenseless. Especially consumers who obtained credits at the peak of the credit boom at most lax credit standards and origination practice, appeared to be those first and most hit in terms of the inability to meet their debt obligations.

In response to the crisis-related weaknesses in consumer protection, countries have adopted a range of policy measures. These measures include, most notably, efforts to improve regulation and enforcement of information disclosure (especially regarding the annual effective interest rate), applied business conduct with respect to consumers, dispute resolution and personal data protection, and easier access to financial education, in particular for the most vulnerable parts of the population. The US, among others, has also proposed the creation of a special-purpose Consumer Financial Protection Agency. In addition, the crisis has brought to the fore other pending policy issues, such as the limits to financial education and the appropriate design of the institutional structure for FCP.

3.1. Complexity and Information Disclosure

A negative side effect of financial innovation from a consumers' point of view has been increasing complexity of financial products and services. While financial innovation has helped improve access to credit for many consumers, the growing complexity has increased the probability that even the most diligent consumer will not understand or notice key terms that affect a financial product's cost and riskiness in material ways. When complexity reaches levels when it significantly reduces transparency, it

favorable developments would continue and sellers of financial products and services did not warn them sufficiently, or at all, about the risks of such products.

hinders competition and leads consumers to making poor choices (Bernanke, 2009). Financial products have become more dangerous to consumers as disclosure has become a way to obfuscate rather than to inform (Warren, 2008). For instance, today's complex credit cards offer balance transfers and treat different classes of purchases and cash advances as different features, each with its own annual percentage rate. Further, interest rates are adjusted frequently and there is a multiplicity of fees charged for various services. The comprehensiveness of information disclosures clearly suffered in this case and the methods of payment allocation used by the creditors were clearly structured to produce the maximum cost to the consumer (Bernanke, 2009).⁶ Many of the poor underwriting practices in the subprime market were also potentially unfair and deceptive to consumers.⁷ The Fed established a comprehensive set of rules, released in July, 2008, banning or limiting certain underwriting practices. Emerging market economies, which felt the burn of large FX credit exposures, have implemented regulations introducing limits and tests that banks have to apply in regards to FX lending (e.g. Romania), and various measures to help unwind the FX credit exposures -- including announced gradual depreciation (e.g. in Russia). In addition, pre-contractual information is often not disclosed, especially in emerging markets, which increases substantially the costs of shopping-around or transferring for the consumer (e.g. WB, 2009).

The current good practice seems to be pointing to the future use of simple key-fact statements for transparent disclosure of product terms and conditions, such as the Schumer Box employed by the U.S. and UK as of 2000 and 2004, respectively, or the simple-fact card proposed in EC legislation (OECD, 2009a; and EC, 2008). A question remains though to what extent should the simple key-fact statements be customized for different types of financial products so that they include all material information. While

⁶ This includes also the so-called double-cycle billing where a bank calculates interest according to not only the current balance, but also the prior month's balance so that transparency to consumers is further impaired.

⁷ For instance, the failure to include an escrow account for homeowners' insurance and property taxes in many cases led borrowers to underestimate the costs of homeownership. Allowing for greater optionality, usually thought of as a benefit, could thus have adverse effects of increasing complexity and reducing transparency.

some customization and differentiation across financial products is needed, at the minimum across different financial sectors (banking, insurance, pension etc.), some generality needs to be preserved to ensure clarity and comparability of the key-fact statements. Clearly, one wants to avoid the situation when the key-fact statements are becoming as incomprehensible as general conditions of some current financial products.⁸ Further, the increased complexity of financial products has brought about suggestion for the creation of a Food and Drug Administration Agency-type agency to screen all new financial products and services, including those for retail customers (e.g. Warren, 2008 – who calls for a Financial Product Safety Commission). Moreover, the push for the prudential product supervision has been also raising questions of whether the safety and soundness supervision of financial systems should concentrate more on prudential product supervision rather than financial prudential supervision which has proved to be susceptible to considerable regulatory arbitrage through financial innovation (e.g. OECD, 2009a). In addition, disclosing and providing timely and adequate information to the consumer in the case of loan selling to a third party and the ensuing transfer of creditor rights, is an issue that remains to be adequately addressed in both emerging and industrialized economies.

3.2. Business Conduct

Weakened financial corporate governance and inadequate remuneration schemes led to financial product mis-selling and especially weakening of underwriting standards and loan origination practices. Some incentive schemes linked originator revenue to particular loan features and to volume rather than to the quality of the loans. The incentives for ensuring suitability of a financial product for a given consumer has been also weakened by the fact that originators of the loans could pass much of the risk, including that

⁸ Pacelle (2004) points out that, in the early 1980s, the typical credit card contract was a page long, while by early 2000 that contract expanded to more than thirty pages of text, which has proven incomprehensible for the average consumer. Pacelle, M. (2004). Fine Print: Growing Profit Source for Banks: Fees From Riskiest Card Holders. Wall Street Journal, July 12, 1.

from poor underwriting, on to investors. The latter, including individuals, have been facing the same degree of non-transparency and hence were also subject to business misconduct. Brokers and agents are often not subject to any licensing qualifications and had no continuing obligation to individual borrowers unlike prudentially supervised deposits-taking institutions operating in the same business line. For the U.S., Delgadillo et al. (2008) find that existing laws at the federal- and state-level curtail abusive lending and promote fairness in the market place. Although they are highly enforced among depository financial institutions, unregulated nonfinancial institutions, mortgage brokers, and originators are the primary source of predatory lending. The 2007-2008 subprime-mortgage crisis in the U.S. demonstrated how weakened corporate governance and business conduct and insufficient supervision can be detrimental to the functioning of financial systems (Foote et al., 2008). The largest portion of defaulting subprime loans was originated by mortgage brokers in which case business conduct supervision and professional requirements were often inadequate. For instance, in Florida one in 23 mortgage brokers has a criminal record, including for crimes of financial fraud—despite regulations limiting the ability of convicted felons to hold funds from the public (Dolan et al., 2008).⁹

The problems have been different in different types of markets. In the US, business practices saw loan-to-value ratios reach 100% for some segments such as “subprime” mortgage lending. By contrast, in Central and Eastern Europe loan-to-value ratios averaged around 80%. On the other hand Central and Eastern Europe witnessed a fight for market share in underbanked markets. The inability of banks to finance their business expansion through increased deposits resulted in sales of financial products, especially loans, with risk characteristics not suitable to the financial profile and investment horizon of the consumer. In conjunction with nontransparent disclosure, unprofessional selling practices resulted in banks and other financial institutions passing on variety of risk on the consumer, most notably the foreign exchange risk¹⁰,

⁹ Dolan, J., Barry, R., Haggman, M. (2008). Ex-convicts active in mortgage fraud. Miami Herald, December 14.

¹⁰ According to Morgan Stanley, Central and Eastern European countries held roughly \$1.6 trillion of foreign currency debt by October 2008 — most of which is tied to the consumer, not corporate, market (Business Week, October 17).

variable interest rate risk, and risk of changes in financing costs (see e.g. WB, 2009). In addition, policy makers in emerging markets are expressing a great concern over the coercive debt-payment collection practices in this crisis period, and inadequate licensing and supervision of this segment of the market.

Going forward, there is a clear need to level the playing field for financial institutions that provide similar financial products (see also Delgadillo et al., 2008). As stressed by Barr (2009), the lack of federal supervision of non-banks in the U.S. brings down standards across the board. During the credit boom independent mortgage companies and brokers grew apace with little oversight. In order to compete, over time banks and thrifts and their affiliates came to offer the same risky products and relaxed their standards for underwriting and sales. Another open issue that remains to be addressed is the role of financial advisers. In particular the arrangements relating to product sales and advice and potential conflicts of interest; appropriate disclosure and remuneration models for financial advisers; adequate licensing arrangements for products and services sellers; the appropriateness of information and advice provided to consumers; and contribution to consumers' understanding of financial products and services.¹¹ Furthermore, also emerging market economies express their keen interest in resolving the issues concerning appropriate licensing of financial advisors, counselors¹² and sales agent, their personal liability and remuneration policies applied by the principle financial institutions. In addition, some interesting developments regarding financial product risks have emerged in the pension sector with the introduction of *by-default* product selection in Australia and Peru¹³, among others.

¹¹ Australia appears to be one of the leaders on this issue as the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into and report by 23 November 2009 on the role of financial advisers.

¹² Despite its apparent effectiveness credit counseling has raised consumer protection concerns as less compassionate credit counseling agencies entered the market, which claim to operate on a non-profit basis, but are in fact designed to extract as much cash from over-indebted consumers as possible, and channel this cash to insiders or for-profit affiliates (OECD, 2009).

¹³ E.g. in Peru default-option based private pension scheme assigns a conservative allocation (mostly cash-based) to contributors above certain age, and allows for more risky allocation of individual pension funds of younger contributors; but, only on a opt-

3.3. Recourse Mechanisms

The inability of consumers to effectively dispute unfair terms and inappropriate advice from the financial institutions, their employees and agents, inhibited fair competition and the ability of financial supervisors to gather early-warning signals of market failures and engage in timely implementation of corrective measures in this area. The recourse mechanisms for financial consumers' protection are frequently inefficient and ineffective. Failures in the areas of disclosure, business conduct or private data protection, experienced by financial consumers during the crisis, have not been effectively and efficiently channeled, resolved and passed on to policy makers. This has been mainly due to distrust of consumers in the out-of-court settlement mechanisms, especially in developing countries, the mechanisms' ineffectiveness, and their failure to inform all relevant policy makers. In addition, centralized collection, analysis and publication of consumer complaints have been absent to facilitate information flow from affected financial consumers to regulators and supervisors and other financial consumers.

Going forward, low-cost, speedy and effective recourse mechanisms and dispute resolution are crucial to build consumers confidence, increase financial penetration and consumer capabilities. It is upon business conduct supervision to ensure that there is transparent timely and professional recourse available to consumer within each financial institution to foster professional service to customers. While this will be seen as cost to financial institution, over time the gathered information and experience of dealing with unsatisfied consumers could give the more successful financial institution in this regard an edge over their less successful competition. Further, it is important that consumers are not confused about where to turn next if they are not happy with resolution provided by the financial institution. Namely, it appears a good practice to disclose the available recourse mechanism with the sale of a financial product, and make the

out basis. In Australia, when consumers join their individual pension scheme they are by default put into the most conservative (money market-based) option, with the possibility to opt-out.

resolution decisions, e.g. by a financial ombudsman, binding on financial institutions for consumers' claims less than a certain amount¹⁴ (WB, 2008).

3.4. Limits to Financial Education

While the number of financial education programs has been increasing, their positive impact on responsible financial behavior and cost-effectiveness remain undetermined. Although training in basic financial subjects can be effectively provided through the school system, teaching students about financial products and services may have a little measurable impact on the levels of financial capability (Mandell, 2006¹⁵), and providing information at teachable moments¹⁶ (purchase of long-term sizable products, e.g. pension schemes) could prove more effective. Indeed, untimely education on financial products may embolden consumers with a false sense of confidence (Willis, 2008).

It appears as an easy, and perhaps populist, target to blame low financial capability of consumers and the lack of effective financial education programs for the strains that consumers have been experiencing in the context of the global financial crisis. However, there seems to be a no clear link from financial education to increased financial capability and then to responsible financial behavior (Mandell, 2006; Willis, 2008). This might be due to the fast development of financial markets and financial innovation

¹⁴ This amount should be determined based on the agreement between the consumers' representatives, financial associations and relevant government authorities. For instance, for payment disputes, an efficient solution could be to set this limit amount at the average amount of a consumer's payment transaction (see e.g. WB, 2009).

¹⁵ Mandell, L. (2006), Financial Literacy: If It's So Important, Why Isn't It Improving? Policy Brief No. 2006-PB-08, Networks Financial Institute, Indiana State University, April 2006. (SSRN-id923557)

¹⁶ The current crisis itself constitutes a teachable moment when people could be willing to learn about complex financial products.

that could quickly make the new knowledge of consumers acquired through financial education programs outdated and leave them with misleading overconfidence.

The likely shortfalls in expectations about the effects of financial education on consumers' capability and financial behavior have to be taken into account in the design of financial education programs and respective national strategies (see OECD, 2009b, for an overview). It appears that measures on better disclosure practices (e.g. the Truth-in-Lending initiative in the U.S.) could be quite effective in increasing financial capability of consumers with more education, income and debt experience (Brandt et al., 1975).¹⁷ Further, there is some evidence (e.g. Lusardi, 2009)¹⁸ that people learn through experience and even more so through adverse experience so that the aspect of learning-by-doing under a well-designed financial product safety supervision could be more effective. Nevertheless, the vulnerable groups, preferably identified by a nation-wide survey, should be a subject of targeted education programs. It is important that these programs are part of well-designed impact evaluation frameworks to assess their relative effectiveness within a country, and across countries with similar characteristics. This would not only contribute to continuing improvements in effectiveness of the education programs' design but also to much needed knowledge-sharing, especially across emerging market economies.

3.5. Links between Consumer Protection and Prudential Regulation

Financial consumer protection is not only a social issue but also a matter of financial sector safety and soundness. As previously mentioned, the role of households' financial behavior and stance could have important implication for financial sector vulnerability. A lack of adequate consumer protection exposes

¹⁷ Brandt, W.K., Day, G.S., Deutscher, T. (1975). Information Disclosure and Consumer Credit Knowledge: A Longitudinal Analysis. *Journal of Consumer Affairs* 9(1), 15-32.

¹⁸ Lusardi, A. (2009). *Overcoming the saving slump: how to increase the effectiveness of financial education and saving programmes*. University of Chicago Press, March.

consumers to accumulation of risks and obligations that they do not understand and did not considered when taking into account the uncertainty pertaining to their future income and implicit hedges they could possess – e.g. remittances could serve as a hedge of FX credit exposures. Current prudential supervision has not been able to enforce that banks create adequate provision and capital buffers to account for the indirect credit risk. Neither the applied risk-weights under Basel I nor the practical implementation of Pillar 1 and Pillar 2 of Basel II have proved to be effective in ensuring that banks possess a sufficient buffer to sustain economic downturn during which interest rate and exchange rate exposures (especially in Central and Eastern Europe) severely affected the repayment capacity of consumers with credits. Similarly, perverse incentives in financial product distribution and fragmented supply chains with unlevelled playing field made consumer commit to financial obligation that they did not understand and the financial sector has not accounted for in its risk rating. As these debt obligations were pooled, securitized and sold on, the consumer abuses created systemic risk in the banking and financial sector that has materialized when the securities obligation have been repeatedly downgraded as the crisis unfolded.

Functional complementarity needs to be built up between consumer protection regulation and supervision and prudential regulation and supervision. While some rules are necessary, regulatory and supervisory arbitrage will be always taking place. For this reason, ensuring that the consumer protection supervision can respond in a dynamic manner to the exploited loopholes by the financial industry it should be based on clear principles (see the Section on Role and Design of Consumer Protection; and Caprio et al., 2008¹⁹).

¹⁹ Caprio, G., Jr., Demisguc-Kunt, A., Kane, E.J. (2008). The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats. World Bank Policy Research Paper 4756. Washington, D.C.

3.6. Institutional Structure

In many countries, a plethora of institutions is involved in financial consumer protection. This could include financial consumer protection departments with sectoral financial supervisors, or varying division of labor concerning misleading advertising between consumer protection agencies and competition protection agencies.²⁰ Fragmented institutional structures that deal with financial consumer protection tend to confuse and discourage consumers from engaging in reporting of their mistreatment and violations of contractual terms and common rules by financial institutions. It is therefore important that compact institutional structures responsible for financial consumer protection are established, with clear mandate and policy tools to intervene on behalf of the consumer to restore safety and soundness in provision of retail financial services. These compact structures could take various forms but should be able to ensure that: (i) there is one institutional interface the consumer deals with when it comes to financial consumer protection issues, (ii) collection, analysis and publishing of complaints is done in a centralized manner while ensuring that their systemic and systematic elements receive due attention from financial supervision, and (iii) there are clearly defined policy tools for adequate interventions to strike balance in dealings between consumers and financial institutions.

As stressed by Barr (2009), the consumer protection regulation should be independent, accountable, effective and balanced. Consumer protection needs a clear mission that will create a basis for accountability, and promote buildup of expertise and effectiveness which are essential to maintain independence. Further, the regulator has to have comprehensive jurisdiction over all financial providers,

²⁰ For example, in the U.S. there are a number of authorities involved in financial consumer protection, including federal financial regulatory agencies, the Federal Reserve Board, the Federal Trade Commission, the U.S. Treasury, the Office of Thrift Supervision, NCUA, the Parliamentary Joint Committee on Corporations and Financial Services. Unless the consumer is well aware which institution s/he should turn to in a particular case, the effectiveness and efficiency of the dispute resolution mechanism may be impaired.

because carving up markets in artificial, non-economic ways is a recipe for weak and inconsistent consumer protection standards and captured regulators. Moreover, the authorities for regulation, supervision and enforcement must be consolidated, since a regulator without the full kit of tools is frequently forced to choose between acting without the right tool and not acting at all. According to Barr, splitting of authorities is a recipe for inertia, inefficiency, and unaccountability. Some practitioners and market observers, including Barr, argue for financial services competition solely based on strong rules. However other observers suggest that both rules and general principles are needed. Otherwise consumer protection supervision and enforcement cannot respond flexibly when loopholes in the rules are exploited by the financial industry.

5. Conclusion

The global financial crisis and its origins revealed some fundamental flaws in financial consumer protection frameworks. The failures of financial consumer protection have been one of the detonators and amplifiers in the recent crisis. One of the primary examples was the increasingly lax mortgage origination and underwriting practices during the peak of the credit boom in the U.S.. Ensuing pooling and securitization of such credit obligations created systemic risk in the financial sector that later on materialized when market confidence faltered. As the crisis spread around the world, more types of flaws in the origination of financial products and services have been revealed, including provision of foreign exchange denominated loans to unhedged borrowers in highly leveraged emerging market economies, most notably in Central and Eastern Europe. Policy responses during the crises have focused mainly on enhanced disclosure of pre-contractual and contractual terms and conditions of financial products, their professional and ethical distribution, debt counseling and education programs for consumers. Only very recently, more attention has been paid to the institutional design for consumer protection, including

regulation, supervision and enforcement. This has been advanced by thinking about the need for a sound and safe design of future financial architecture, including benchmarks for FCP worldwide.

Due to a recent push for better disclosure and business conduct in financial services from the industrialized countries, the emerging market economies have at hand some benchmarks in the respective areas that they could follow. However, going forward, there are some open issues for EMEs that are not sufficiently addressed or resolved in industrialized countries either, and for which good practices are yet to emerge. These issues include: licensing, professional requirements, remuneration and personal liability of financial advisors and sales agent; regulation, supervision and integrity of private debt-counseling agencies; the tradeoff between consumer protection regulation and financial education as cost-effective measures for increasing consumer protection in financial markets with different degrees of development and speed of innovation; an optimal institutional structure for consumer protection encompassing authorities for regulation, supervision and enforcement, dispute resolution and financial education.

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