
APPROACHES OF CONSUMER PROTECTION IN NON-BANKING FINANCIAL SERVICES

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Abstract

Consumer protection in the financial field through a bottom-up approach of the supervision has become a stringent condition as a wide range of regulations on non-banking financial products was implemented. The model applied assumes consumer protection through intervention in market circuits without affecting their function; decisions being take based on the impact on consumers. Tracking the consumer satisfaction in all phases will lead to an integrated approach using tools, methods and responsible persons in this process. It is important for any entity, that provides intangible services, to support human well-being. This paper aims to highlight the added value of consumer protection based to the new financial regulatory systems and risk-based supervision- The new international approach is starting primarily from the consumer, his needs, rights and interests and not only from financial reporting and prudential supervision.

Keywords: protection, consumer, MiFID, supervision

Introduction

Consumer protection is becoming nowadays more and more the key element that provides the opportunity to analyze regulatory elements and monitoring mechanisms. Basically, the function of consumer protection has reinstated the initial concept of markets real owners, the consumers, in the functioning of authorities. If until now financial reports were subject to supervisory scrutiny, by introducing consumer as key element of supervision we have to acknowledge that the consumer is part of the market, on the demand side and the final beneficiary of consumer protection activities. At European level, the initial purpose of supervision, the stability of markets is slowly but surely surpassed, by the purpose of protection of consumers' rights and interests. The main goal is the pursuit of the relationship between consumer and market, so that the value chain model leads to a satisfied consumer (he gets what he needs, is able to understand his rights and to ensure his welfare by knowingly accessing the appropriate financial service).

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At international level, it was ascertained that the level of consumer protection adequacy depends on market circumstances and includes even sophisticated, educated consumers. Thus, depending on such factors, regulators may implement more complex supervisory mechanisms, as consumers lacking financial literacy are the ones that require a higher level of protection to prevent the free expression of a market that may lead to instability.

At European level, the organizational structures specific to consumer protection inside the financial supervisory authorities are considered part of the core business and are allocated a significant organizational position. The European Banking Authority (EBA)¹ have established responsibilities in consumer protection as part of the directorate responsible for supervision, European Securities and Market Authority (ESMA)² has such functions within the directorate monitoring entities' management and corporate governance, European Insurance and Occupation Pensions Authority (EIOPA)³ has a special separate division, dedicated to supervision and consumer protection.

European national financial supervisory authorities have assigned an important role to consumer protection, by adopting supervisory actions and measures aiming to tackle the risks to which individual consumers are subject to, and also measures to mitigate such risks or reducing their effects.

In 2009, OECD noted that one of the specificities of the financial crisis was inadequate impact of regulated alternatives to traditional products that have exposed vulnerable consumers to unsuitable offers, unfair selling practices and purchasing of inadequate products. As a result, the G20 gave mandate to Taskforce Group G20 / OECD for consumer protection to develop a set of effective approaches for the 10 principles of consumer protection adopted by the G20 in October 2011.

US recognized the importance of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. World Bank recommends increased emphasis on actions aimed at strengthening consumer protection and supervisory and regulatory act based on consumer protection function⁴. World Bank, based on the studies that were conducted, concluded that consumer protection is a function of supervision⁵. Consumer protection is the one that counteracts possible conflicts of interest that may arise in relation to the level of regular supervision of regulated entities⁶. Similar findings about positioning at least as US

* <https://eba.europa.eu/consumer-corner>

² <https://www.esma.europa.eu/regulation/mifid-ii-and-investor-protection>

³ <https://eiopa.europa.eu/consumer-protection>

⁴ <http://www.cgap.org/sites/default/files/Technical-Guide-Implementing-Consumer-Protection-August-2013.pdf> ,

<http://responsiblefinance.worldbank.org/~media/GIAWB/FL/Documents/Publications/TechnicalNote-Belarus-FCP-Dept-FINAL.pdf>

⁵ <http://responsiblefinance.worldbank.org/~media/GIAWB/FL/Documents/Publications/TechnicalNote-Belarus-FCP-Dept-FINAL.pdf>

⁶ Behaviors slightly deviated have as purpose the improving of financial ratios affecting the customers and may affect significantly the future market; the financial reports register a delayed image of the reality concerning the financial health of a company and do not allow for evidence of fraudulent behaviors etc.

Treasury, recognizing the critical role of consumer protection in the financial system construction, stressed equal consumer protection against regular supervision also providing confidence, without which authorities cannot ensure financial stability.

Value Chain in the protection of financial consumer

The value chain model specific to intervention in supervision and regulation, from the consumers' point of view (*consumer protection involves intervention within the market circuits, without affecting their function but only to identify phenomena and straighten quantitative and qualitative level of market fair value*) replaces or significantly complements modeling different static assumptions based on scenarios (stress tests) which do not always give a true picture of reality.

Recognizing consumer protection as part of the core business, complementing regular supervision, has its origin in the international principles adopted in recent years, through which developed countries acknowledge the role of these functions / tasks in the context of orderly, fair and transparent financial markets. Thus, the primary purpose of consumer protection outperforms in importance the classical supervision (through reports), making as starting point in the addressing of risks, the impact of those risks on consumers and market practices to which they are subjected to (risk based); in fact, there is a change of typology from top to bottom supervision, to bottom-up supervision, which consistently amends the supervisory standards.

Since the last global financial crisis, financial authorities in developed countries and international organizations realized that financial market reform represents a priority and hence the approach to supervision must be changed. In this context, the G20 countries have included in their agenda the financial inclusion development to include a broader spectrum of population and sought to identify and implement innovative approaches to improve access to financial services, *financial literacy* and consumer protection. It is obvious that in this context, the G20 countries found out that consumer protection is at least as important as regular supervision as it ensures effective, practical and real investigation of the entities business conduct (that affects consumers directly) and does not seek theoretical models or financial reports that are, in terms of risk, static indicators. Structural improvements brought by this reform of financial supervision and regulation approach were adopted by a large number of countries, identifying and recognizing the contribution of qualitative value chain type of the consumer protection, whose concrete measures generates substantial changes on consumers and therefore on the market development.

In order to have a comprehensive understanding of the factors involved in the process of consumer protection, it is important to know their rights recognized internationally. Thus Romanian FSA (A.S.F.)⁷ mention certain rights each corresponding to the objectives, tasks and legal obligations of a supervisory authority, the list being not is not exhaustive:

- The right to be informed – ensuring that important and relevant information about financial products and services, rights and obligations is provided to customers, to

⁷ <https://www.slideshare.net/Asfromania/laboratorul-academic>

allow them to take informed decisions. Information has to be provided in clear and simple language, accessible to customers.

- Access to comparable information about prices of services and products to enable customers to negotiate and pay a fair price
- Preventive and corrective supervisory actions and measures to avoid fraud, misselling, misleading advertisements, unauthorized activities
- The right to complaint and free access to a dispute resolution mechanism for solving disputes easily and less costly.

The general principles underlying the consumer protection activity implemented in order to meet the basic objectives of a financial supervisory authority are:

- a) Consumer protection against moral hazard;
- b) Promotion and protection of legitimate interests of consumers;
- c) Ensuring consumer access to adequate information with impact on their choices (reducing asymmetry of information);
- d) Ensuring that financial education contributes to raising the level of customer satisfaction;
- e) Provision of alternative means of resolving disputes between consumers and market entities;
- f) Promoting sustainable consumer behaviors;
- g) Notification of unauthorized activities affecting consumers.

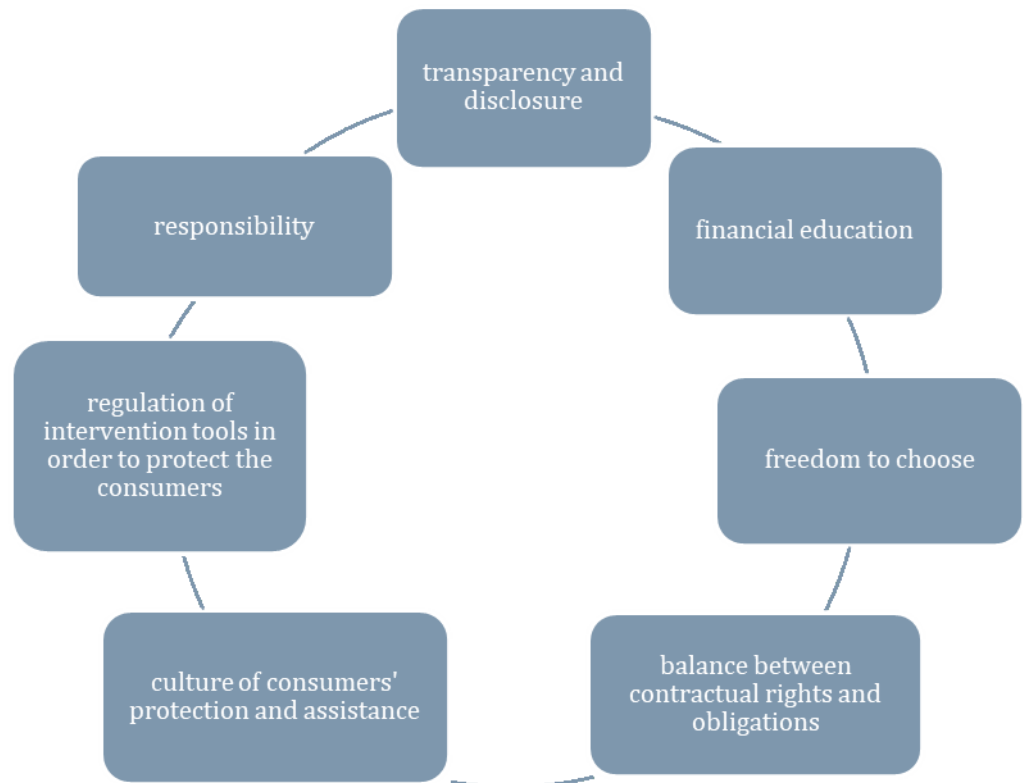


Figure 1. Value Chain for the financial consumer

Transparency and disclosure refer to the need of consumers to be informed in an appropriate and comprehensible way concerning key issues and conditions, tools / products / financial services, so as to understand their rights and obligations when establishing a contractual relationship with a financial services provider. Transparency is a fundamental principle in any structure of financial services consumer protection, which starts from the moment of proposing the sales (at that time, the consumer is only a potential customer).

Understanding (clarity, accuracy) eliminates the adverse effects (confusion, mistrust) and allows the adoption of rational investment decisions (buying), in other words, creates prerequisites of balancing supply and demand, generating trust between parties.

Financial education refers to the entire financial system and the entire life cycle of a product / instrument / financial service, including risks and benefits, consumer protection regulation and contractual terms. Financial education level not only allows the market development by increasing demand and diversifying its application, but also allows the elimination of disputes between the parties, thereby increasing the level of confidence and market stability.

Freedom of choice for the consumer with respect to products, instruments or financial services that meet or best meet their needs is a driver of competition on the supply side. A financial system characterized by a high degree of consumer protection gives them the opportunity to access information and tools for comparing products, instruments and financial services in terms of price levels, costs, characteristics, conditions of use, performance.

Balance between contractual rights and obligations – it is a condition aimed at eliminating the abusive and/or incorrect clauses. Domestic legislation contains clear provisions regarding contract clauses.

Culture of consumer protection and assistance represents the need to include both in the organizational culture of financial entities and supervisors, a dedicated and consumer-oriented behavior. While consumers are the destination of instruments, financial products and services, they should be treated with respect, care and protected in order to maintain a high level of confidence necessary for long term sustainable development. Otherwise, there is the risk to create a speculative system, difficult to manage in terms of financial stability.

Regulation of intervention tools to protect consumers of products, and financial services is necessary because this area is more complex than others in terms of contract issues.

Impact of European regulations on the financial consumer protections

On the European financial market, MiFID II⁸ and IDD⁹ provides for the need to increase consumer protection by different instruments. MiFID requirements have been taken by EU

⁸ <https://eur-lex.europa.eu/legal-content/RO/TXT/?uri=CELEX%3A32014L0065>

Member States' legislation and supervision by financial authorities incorporating the specific mechanisms for monitoring tasks.

Diversity of MiFID II/IDD requirements also includes supervisory recommendations with the scope of consumer protection that go beyond the usual measures of previously used supervision, and the authorities have to align to these new requirements. Thus, sales practices and in particular cross-sales (requirement introduced by paragraph 81 of MiFID), used in providing financial services to retail clients, can bring benefits to retail clients but can also become a practice whereby the clients' interests are not properly taken into account.

MiFID II retains, for example, that certain forms of cross-selling as tying practice whereby two or more financial services are sold together as a package, from which at least one service is not available separately, can distort competition and have a negative impact on customer mobility and on their ability to choose knowingly.

An example of bundling selling may be the necessity to open a current account when a retail client is provided an investment service. Although sales practices for bundling selling, by which two or more financial services are sold together as a package, each of these services can be purchased separately, may also distort competition and can have a negative impact on customer mobility and on their ability to knowingly choose. However, they allow customers a choice, permitting investment firm to comply more easily to legal requirements. The use of such practices should be carefully considered to promote competition and consumer's freedom of choice.

Another example (requirement introduced by paragraph 82) is to test suitability of the product for the consumer. MiFID introduces a minimal questionnaire (suitability test) which is required to be completed in order to recommend the proper products taking into consideration the consumer knowledge, risk profile and investment goal. IDD introduces the Demand and Need Test form. In practice, the development of this minimal set is necessary for adequate protection of consumers from countries with a low level of financial education, but observing the requirement creates significant additional costs and thus the interest in such activities disappears (conflict interest). EIOPA develops consumer protection and business conduct concept starting from the provision of the IDD Directive and the delegated Regulations¹⁰, by detailing the risks¹¹ and measures required at the insurers level throughout the life of the insurance product, by moving from the analysis at the company level to the risk-based approach at each product level, from the design to post-sales service and renewal services.

Consumer protection and financial literacy promotes efficiency and transparency of retail markets. Consumers that are provided with relevant information are aware of their rights and obligations and provide an important source of discipline within financial markets, encouraging financial institutions to compete in delivering better products and services and discouraging those attempts to profit, following uninformed or captive consumers.

⁹ <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32016L0097>

¹⁰ <https://eur-lex.europa.eu/legal-content/RO/TXT/?uri=CELEX%3A32017R2358>

¹¹ https://eiopa.europa.eu/Publications/Reports/2018.6644_EN_03_MOD-GP.pdf

In addition, consumer protection helps companies face specific risks arising from the relationship with retail consumers. In the April 2008 report¹², of the Joint Forum of the Basel Committee, IOSCO and IAIS have identified three key risks related to possible deceptive sales of financial products to retail consumers. These risks are:

- Legal risk, occurring as a result of law suits against companies, where consumers are to be financially compensated;
- Short-term liquidity risk and long-term solvency, which occurs due to incorrect treatment applied to retail consumers, causing them to withdraw from the contractual relationship with the financial companies;
- The risk of contagion, which arises from the transfer of risk from one company (or financial instrument) having problems to another or several others; effective consumer protection ensures the necessary measures so that these are not affected by criticism, extreme negative feelings (lack of trust causes panic).

The Insurance Distribution Directive (IDD) brings from the consumer perspective:

- Transparency and information: before being offered a product, the consumer must be given a two-page Product Information Document with the main details, especially the exclusions and risks to which the future client is exposed. In the past, the sellers presented only the positive aspects, the customers did not know about exclusions or risks, and then they were not compensated when certain situations materialized. Now the distributor are obliged to act honestly, correctly, to the benefit of the consumer.
- Avoidance of conflicts of interest generated by remuneration. It is no longer allowed to distribute only the products to which the seller receives the highest commission, but will be obliged to present to the customer the best product for the client, even if he will make less money from this sale. Investment product insurers will have to choose the investment funds that bring the best return for the client and not the insurer. In the past, especially for unit-link products, many consumers lost money even though the insurer or fund manager covered their expenses and even made a profit.
- Development of insurance products. Insurers when creating a product must put the benefits to the consumer before their profit. Anything to the detriment of the consumer should be avoided. The insurer must test the products, monitor them continuously, periodically review them, train distributors and receive feedback from them.
- Intermediaries must be well trained, have proven skills, competences. Distributors must have both knowledge and skills to act for the benefit of customers. They must have a training or professional development of at least 15 hours per year.
- Intermediaries must declare if they offer advice. If they offer this they must be for the benefit of the customers, and they are presented with several options from which they can choose.
- Intermediaries must declare their financial interests, how they make money, how they commission, who pays the commission.
- For the sale of insurance products with an investment component, five performance scenarios must be presented, including the minimum guarantee. Previously only optimistic scenarios that could mislead consumers were presented.
- The intermediary authorization system is modified, on two levels, main and secondary intermediaries. The ancillary intermediary, which does not require authorization, can be defined more clearly and can only sell products related to the main object of activity, for

¹² https://www.iosco.org/publications/?subsection=public_reports&keywords=&pcid=26

example, mobile phone, travel insurance, etc. They will be under the responsibility of the insurer or broker who created the product.

- A system of monitoring the products sold by insurers abroad and the way in which brokers can work with them is established. For the first time, the option to ban a product through the European insurance authority appears.
- It explains how the distribution from one EU country to another EU country, who and how they oversee those distributors with international activity.

Conclusions

The responsibility of financial institutions to consumers is continuous, whether it relates to information, safety of operations, or how efficient and effective complaints are handled. It is important to consider reputational consequences arising from cases of failure of entities towards consumers. Financial consumer protection in the financial sector has to be an integral part of the legal, regulatory and supervision and has to reflect national circumstances and international market developments in the financial sector.

The primary purpose of consumer protection became similar or outperforms in importance the classical supervision (through reports), making as starting point in addressing risks their impact on consumers and the market practices to which they are subjected to (risk based). In other words, we are talking about a change in the typology of supervision from top-to-bottom process to a bottom-up process, which amends supervisory standards consistently. Finally, a satisfied customer will increase the level of confidence in the system, thus ensuring stability, increased turnover for financial intermediaries but also loyalty. Moreover, a coordinated and supported financial education will have a multiplier effect throughout the economy, not just in the financial area, generating macroeconomic benefits.

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