Norman T L Chan: HKMA and the protection of bank customers

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the KPMG Luncheon Talk, Hong Kong, 11 July 2013.

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Ayesha (Macpherson Lau), distinguished guests, ladies and gentlemen,

First of all, let me thank Ayesha and KPMG for inviting me to this Luncheon Talk.

When I took up the post of the Chief Executive of the HKMA in 2009, we were faced with the aftermath of the Lehman Brothers saga. As most of you would remember, there was immense public pressure on enhancing the protection of consumers and investors. My colleagues in the HKMA and I have regarded this as one of our priority areas and we have put our hearts and souls into strengthening our regime on banking conduct supervision in the past few years. In 2010, I set up two new departments, namely the Banking Conduct Department and the Enforcement Department, within the HKMA. These are important milestones in the development of the HKMA, and we have indeed turned a new page in protecting bank customers, be they consumers or investors. I would like to take the opportunity of today's luncheon talk to share my thoughts on this.

Why should we provide protection to bank customers?

First, let me pose a question "Why should we provide protection to bank customers?" The answer is quite simple. In modern times, most societies would demand proper protection of consumers when they purchase a wide variety of goods and services, such as food, electrical appliances, drugs, health care and financial services. Consumers, as compared to suppliers and their intermediaries, are normally in a disadvantaged position in terms of product knowledge and bargaining power. Therefore, they need to be protected from unscrupulous sales practices or misrepresentations. Regardless of what kinds of goods or services are involved, the basic principle in consumer protection is that consumers should be treated fairly. In essence, what it means is that consumers should be able to know what they are buying, the costs involved and all other relevant terms and features of the transactions and should not be subject to high handed sales tactics.

In Hong Kong, when a customer walks into a typical retail bank, he or she can undertake a wide variety of financial transactions, ranging from conventional banking services, such as deposits, currency conversion, credit cards, remittances and loans, to the purchase of wealth management or insurance products. This is what we call "universal banking", a regime in which banks operate like financial supermarkets. Naturally, banks like the universal banking regime as it offers non-interest income such as fees and commission as well as diversification of businesses. At the same time, customers also like universal banking as it offers great convenience in the form of a one-stop service instead of having to go through different firms for different types of financial transactions or products.

There is a big difference though between a bank and a supermarket – you don't entrust a supermarket with your hard-earned money or life savings; and if you are enticed by a supermarket promotion to buy something you don't need, the loss is unlikely to be huge but this may not be case for investment or insurance products. You could lose your shirt. Therefore bank customers require protection not only on the safety of their deposits, but also in the way that they are treated as consumers and as investors. In terms of protecting the safety of customers' deposits, the HKMA seeks to maintain prudential soundness of individual banks. We do this through the regulation and supervision of banks and, in the unfortunate event of a bank failure, through the activation of the Deposit Protection Scheme to safeguard customers' deposits up to half a million Hong Kong dollars per depositor. In today's speech, I propose to focus not on prudential supervision but on the protection of bank customers as consumers and investors.

How do we protect bank customers?

So the next question is : How do we protect bank customers as consumers and investors? The answer is the very same principle: "treat your customers fairly". Now let me elaborate on how this can be achieved.

First of all, when selling a banking product, such as a loan or a credit card the bank must ensure that the key terms and conditions are fair and equitable. The bank should also ensure that the key terms and conditions are clearly spelt out and understood by the customer. For example, when a customer wants to take out a loan, the bank should highlight the key features about interest rates and any applicable fees, charges or penalty for late or early repayments.

When it comes to the selling of investment products, the situation becomes more complicated. The complication arises not only from the risk inherent in the investment products, some of which can be rather complex, but also from the special relationship between banks and their customers.

Banks serve a special function in modern times. They are different from other financial firms in that they are the institutions with which most of our citizens entrust their life savings. There is a special trust between banks and their customers. However, over the years and for a number of reasons including strong competition, narrowing interest margins and pressure for revenue growth, banks have sought to increase the share of fee- or commission-based income by expanding their businesses to the sale of financial products to customers. As a result, bank depositors have become the main sales targets for different kinds of investment or wealth management products. Very often the special customer trust that banks enjoy has made it easier for bank staff, as compared to their counterparts in other financial firms, such as securities firms, brokers, investment advisers and insurance agents, to market and sell investment products to their customers. Moreover, banks generally have more extensive branch network that makes it easier to reach out to their customers.

But there is no free lunch. While banks enjoy clear advantages in marketing and distributing financial products, they must also understand that they shoulder a higher level of responsibility to take care of their customers' interests. This is why the HKMA has required banks to put in place safeguards on top of what is generally required by the SFC, the lead regulator in the sales of securities and investment products. For example, banks are required to set up the so-called "red zone" for the purpose of selling investment products or investment-linked insurance products. Another example is that banks need to audio record the conversations between their sales staff and the customers in conducting the suitability assessment and in the sales process. There are many other examples and I do not propose to go down the full list here.

Some people have argued that banks are facing more onerous requirements when selling financial products, hence being put on an unlevel playing field when competing with securities brokers, investment advisers and insurance agents. I don't agree with this view. As I have just explained, banks enjoy a special relationship with their customers. That special relationship is one of the cornerstones of modern banking and should not be abused. Additional safeguards are necessary to provide bank customers with protection that is appropriate in the unique circumstances of a banking environment. This in turn will help boost customers' confidence and trust in their bankers, which in my view would be tremendously important to the sustainable development and credibility of our banking industry.

What do we expect a bank to do in consumer protection?

Just exactly what do we expect a bank to do in consumer protection? Under the guiding principle of "treating customers fairly", we expect banks to do three things when they market banking or investment products:

- banks should set out and explain clearly the key features and risks of the products concerned, including any applicable fees, commissions or charges;
- banks should conduct an assessment of the financial capability, investment experience and risk appetite of their customers. This is an important tool that enables the banks to have a more objective view of the risk tolerance level of the customers;
- banks should assess the needs of their customers, and the suitability of a financial product for their customers. If a bank considers that a product is not suitable for a customer, it should not solicit or recommend the customer to purchase the product.

I would like to point out that Hong Kong adopts a disclosure-based investor protection regime, which means that an intermediary is obliged to disclose and explain to the customers the key features and risks of an investment product. Under this regime, it is the investor who ultimately decides whether to purchase a product that entails risks higher than the risk profile generated through the suitability assessment. But in the process we expect a bank to take due care and diligence in protecting its customers' interests. In this connection, it may be useful for me to refer to a recent disciplinary case handled by the HKMA to demonstrate what a bank should not do to its customers.

This is what happened. A bank staff managed to sell an investment linked assurance scheme, or ILAS, product to a woman who had no prior investment experience. Her monthly income was less than HK$7,000 and her total life savings was HK$380,000. The product would require her to pay a premium of HK$300,000 per year for a total of five years. In other words, the total premium would be HK$1.5 million, which was four times her life savings or 18 times her annual income. When the customer found out, after the end of the first year, that her life savings had been wiped out through the payment of premium and that she needed to make the second annual premium payment of HK$300,000, she not unnaturally wanted to get out of the investment. At that point she found out that, according to the investment terms, she would have to suffer an early termination penalty amounting to 30% of the value of her investment, which is roughly equivalent to her income for one year.

Clearly in this case the bank staff had little, if any, regard for the financial circumstances and the lack of investment experience of the customer; nor did the bank staff adequately explain the risks and penalty of early termination. This is a blatant breach of the customer's trust. The HKMA cannot condone this kind of practice and will take necessary supervisory and disciplinary actions to protect the interests of bank customers. In this particular case, the bank agreed to cancel the policy and refunded the full amount of the first year premium to the customer and the bank staff concerned has been suspended by the HKMA from selling investment products for a period of three years.

What do we expect bank consumers to do to protect their own interests?

Justice upheld, sounds a happy ending. But there is always the other side of the equation. There is a commonly held view that the responsibility for consumer protection rests with banks, the regulators and the Government. I don't think this is a helpful view if we want to promote consumer protection. True that banks owe their customers the duty to look after their interests and to treat them fairly. True that the Government should provide the legal framework and set the policies for protecting consumers. Equally true that regulators will use their powers to enforce the consumer/investor protection requirements. But an important piece is missing from the jigsaw. Bank customers also bear a major responsibility in protecting their own interests and rights. Indeed I would argue that it is crucial for bank customers to become "smart and responsible" consumers of banking services. Incidentally, at the international level, the G20 in its High-level Principles on Financial Consumer Protection is also emphasising the need for financial consumer literacy. Let me use a couple of examples to illustrate this point.

Before a customer shops with a new credit card, he should take time and effort to understand the key terms of the credit card, such as the interest rates for cash advances and any applicable charges for late payments etc. He should learn how to take good care of his credit cards and ATM cards to avoid theft or other kind of scams. When he logs onto internet banking, he should exercise care to avoid bogus bank websites and reduce the risks of being hacked. This is also very true when it comes to investment decisions.

Investing one's savings with the hope of generating higher returns than bank deposits is a natural and legitimate aspiration of most bank customers, but they must also understand the inevitable correlation between returns and risks. So they must use their best endeavours to understand the likely risks and returns of any investment products that are sold to them. In order to become a smart consumer he must try to understand the nature of different kinds of banking products and to avoid those products that go beyond his risk appetite or personal financial capability.

This relates to the "smart" part. On the "responsible" part, it is important that when a person takes out a loan from his bank, whether to shop or buy a flat, he should fully assess his repayment capability in relation to his income and expenses. There is not much point in blaming the bank in granting you easy and cheap credit when you have overstretched yourself in exuberant spending or in taking excessive risks in properties or stocks.

In the context of buying investment products from a bank, the customer must realise that he is bound by his signature on the agreement, and that he cannot imply obligations which are contrary to the express terms of an agreement. Put it simply, a customer may not succeed in civil litigation for investment losses on the ground that he did not fully understand the terms of the investment contracts. Recent court cases in Hong Kong have clearly demonstrated that the existence of mis-selling by the bank would be a relevant factor in determining the culpability of the bank, but the customer must not harbour the expectation that mis-selling, regardless of its nature and severity, would necessarily lead to full compensation for investment losses. So the message is: consumers of financial services have to be responsible for the decisions they make and the consequences of such decisions. Think twice before you sign on the dotted line.

Conclusion

To conclude, the key takeaways are:

- banks must treat customers fairly by looking after their interests and not treating them just as target of sales; and
- bank customers must learn to become "smart" as well as "responsible" consumers of financial services.

Then how do we go about in achieving these two objectives? For banks, the HKMA will ensure that there is a set of robust but fair rules governing banking conduct. We will enforce these rules vigorously through on-site examinations and off-site surveillance. We will investigate and, if appropriate, take enforcement action against breaches when they are reported by customers or detected by the HKMA. But we appreciate no external forces can be as effective as internal controls and culture in guarding against breaches. We therefore consider it important for the boards and senior management of banks to share and cherish the same value as we do in terms of treating customers fairly. In this connection, we also believe that it is crucial that banks should review and revamp their incentive systems so as to avoid rewarding staff on the basis of sales volume and commission earned, which would nurture a tendency to push financial products to customers to meet business targets without giving sufficient regard to the interests of the customers. This change in the incentive system to reduce mis-selling is taking place in the more advanced markets, and Hong Kong must not lag behind if we wish to continue to pride ourselves as one of the leading international financial centres.

In terms of helping the customers to become smarter and more responsible, we need to enhance the financial literacy of our citizens. Surely there is plenty of scope to include financial literacy education in our school and university curriculum. In addition, the HKMA, in collaboration with key stakeholders such as the Consumer Council as well as the Investor Education Centre set up by the SFC, is going to launch a new public education programme that seeks to help bank customers become “Smart and Responsible”. The first of a series of programmes will be rolled out in the next few months.

Ladies and gentlemen, I am sure all of you are frequent users of banking services. Moreover, as many of you here are accounting, financial and business leaders of Hong Kong, I am sure you will also share my view that enhancing the financial literacy of our citizens is a difficult but worthy task, requiring the collaborations of all sectors of the community to work closely together. You are well positioned to help our public education programme, and we in the HKMA look forward to your continued support and advice. Thank you.