Philip R Lane: The role of financial regulation in protecting consumers

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the University College Cork, Cork, 23 February 2017.

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Introduction

It is pleasure to visit University College Cork and I thank the Financial Services Innovation Centre for hosting this talk. Today, I aim to outline the Central Bank's approach to fulfilling its consumer protection mandate. I will first discuss the underlying theoretical case for regulatory interventions to protect consumers. Next, I will describe the institutional framework for consumer protection at domestic and international levels. I will then explain our vision for how the Central Bank can contribute to consumer protection and the methods by which we implement this agenda. I will then turn to laying the current priorities in our consumer protection work. Finally, I will discuss some developments that will influence the nature of consumer protection regulation in the coming years.

The Case for Consumer Protection

A vast empirical literature shows that consumers tend to make poor financial choices, taking on too much debt, misunderstanding investment risk and choosing financial products that do not match their needs. Over recent decades, the formal economic theory to rationalise these patterns has been developed, with insights from economics and psychology blended in the vibrant fields of behavioural economics and behavioural finance.[1]

The fast pace of financial innovation has created a complex world for consumers, where the range of available financial products is broad, and the consequences of financial choices are significant. Coupled with this, the typical household tends to have a limited personal track record in making financial decisions, since the purchase of financial products happens only infrequently. This is problematic, since the demands for financial sophistication and knowledge are sizeable if a consumer is to navigate safely through the options put forward by providers of financial services. Financial decisions often require consumers to assess risk and uncertainty, for example, and to consider trade-offs between the near term and the long term. A growing body of academic literature shows that, among the general population, the level of financial knowledge, skills and ability to consider such complexities is low.[2]

There is also a growing body of evidence from the field of behavioural economics that consumers are subject to behavioural biases when making decisions. In other words, decisions are affected by emotions and psychological experiences, by rules of thumb and accepted norms. For example, consumers can exhibit present-biased behaviour, which leads them to over-value payoffs today relative to payoffs in the future, a bias which can be associated with self-control problems.[3] In addition, households can be overly attached to the status quo and suffer inertia bias, taking default options in financial contracts, failing to switch product or provider even when there are clear benefits to switching.[4] Retail investors also tend to follow naïve investment strategies rather than identifying superior options.[5] Consumers can also exhibit loss aversion bias, meaning that they care more about potential losses than making equivalent gains.[6]

The design of financial products and services can serve to ease or exacerbate these biases. In this context, behavioural economics shows that framing matters – put simply, firms can present the same information in different ways and this can lead to different choices by consumers. A key insight from the recent experience with financial crisis and from the growing literature on behavioural economics, is that consumers do not always act in their own best interest. In addition, market forces do not always act to reduce consumer mistakes. Firms face their own incentives when designing and framing products, and these incentives may not align with the best interests of the consumer. For example, analysis by the Office of Fair Trading in the UK shows that firms can frame prices in a way that plays on consumer biases.[7] Empirical research also suggests that firms can choose to market the salient features of products that appeal to consumer biases, while shrouding the less favourable aspects that could alter a consumer's choice to purchase that product.[8] The interactions between misaligned incentives and behavioural biases can adversely affect consumer welfare, and there are many examples of analytical work that highlight such costs.[9]

In summary, there is abundant empirical and theoretical research to show that consumers do not always act in their own best interest in making financial decisions and that biases can be exacerbated by the design of financial products. In this context, financial regulation to protect consumers can play a critical role and I would now like to talk to you about the institutional arrangements for the protection of consumers across the globe, and the vision for consumer protection at the Central Bank of Ireland.

Consumer Protection: Institutional Setup

Around the world, institutional arrangements in place to protect consumers vary from stand-alone consumer protection agencies to bodies with dual regulation and consumer protection mandates and bodies like the Central Bank of Ireland with financial stability, prudential regulation and consumer protection mandates.[10] Measures applied to protect consumers range from working to ensure financial stability, through prudential and macro prudential regulation, supervision and enforcement to personal financial information and education. Whatever the institutional architecture, achieving effective outcomes for the consumers of financial services requires collaboration between all the parts of the system.

Here in Ireland, a number of agencies are charged with the protection of consumers of financial products. Our prudential, supervision and consumer protection roles include the setting of statutory codes of conduct for financial services firms, such as codes on how products should be sold, the information that should be provided and how complaints should be dealt with. The role of the Competition and Consumer Protection Commission includes the provision of personal finance information and education, including a web helpline and comparisons of financial products.[11] The Financial Services Ombudsman assesses the complaints of individual consumers against their financial services providers and can direct redress where he finds against a firm.[12] We work co-operatively for the protection of consumers. A consumer can also take action through the courts against a financial services provider, although there is no legislative provision in Ireland for class actions by a group of consumers.

Following the global financial crisis, there is consensus on the need for greater international and European convergence and cooperation on how financial institutions are regulated and supervised. Within Europe, this has resulted in the setting up of the Single Supervisory Mechanism (SSM) for bank regulation (although it has no consumer protection mandate), as well as regulatory initiatives such as Solvency II which has the twin goals of enhancing consumer protection and maintaining financial stability in the insurance sector, the Capital Markets Union project and the growth and influence of the European Supervisory Authorities (ESAs). In addition, investor protection is being enhanced through the MIFID II Directive.

The three Supervisory Authorities, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) are working to shape the consumer protection framework across Europe.[13] EIOPA, for example, is focused on promoting transparency, simplicity and fairness in the market for retail insurance and pension products. Its guidelines on product oversight and governance for insurers aim to minimise the risk of consumer detriment and mis-selling of insurance products and underpin new regulatory requirements under the Insurance Distribution Directive which must be transposed into national law by member states by 23 February 2018. The introduction of EU directives into national legislation plays an important role in the ongoing strengthening of protection for consumers within the regulatory framework.

In the international arena, bodies such as the OECD, the G20 countries and FinCoNet are active in promoting the protection of consumers of financial services.[14] In October 2011, a set of ten high-level principles on Financial Consumer Protection was endorsed by the G20 Finance Ministers and Central Bank Governors.[15] These non-binding principles include that: financial consumer protection should be an integral part of the legal, regulatory and supervisory framework; there should be oversight bodies explicitly responsible for consumer protection; all financial consumers should be treated equitably; honestly and fairly at all stages of their relationship with financial services providers; and financial services providers and their authorised agents should aim to work in the best interests of their customers and be responsible for upholding financial consumer protection. Promotion of financial education and awareness by all relevant stakeholders as well as easily-accessible clear information on consumer protection, rights and responsibilities and the disclosure to consumers of key information informing them of the fundamental benefits, risks and terms are also among the high-level G20 principles.

Our Vision

At the Central Bank our mission statement is *"Safeguarding Stability, Protecting Consumers".* Our vision is of a well-functioning, well-managed and well-regulated financial services system that is underpinned by a strong culture of compliance, with firms and individuals within firms acting in the best interests of their customers, backed up by comprehensive and enforceable legislation, rigorous supervision, a credible threat of enforcement and powers of redress when consumers have suffered detriment.

A fundamental protection for consumers lies in ensuring that the financial system is stable and the firms that operate within it are financially safe and sound. This means, inter alia, that investor assets are safe and available and that an insurer's promise to pay out in the event of an unforeseen future loss will be honoured.

Our aims are articulated in our 5 C's framework. In order for regulated firms to act in the best interests of **C**onsumers, all regulated firms should embed and demonstrate a positive consumer-focused **C**ulture which will allow consumers to have **C**onfidence in the financial decisions they are making and the firms they are dealing with. We **C**hallenge firms where their focus is not on positive consumer outcomes and we take appropriate regulatory action to ensure that firms meet their statutory **C**ompliance standards.

As well as working to develop a positive consumer focused culture within firms, we continue to develop and review our consumer protection framework to enhance the protections in place. In this regard we participate actively in the European and International bodies, including the three European Supervisory Authorities and FinCoNet, to influence the future shape of consumer protection.

Our Methods

Let me explain our working methods. As an integrated organisation, we work to deliver consumer protection through a continuum of functions ranging from financial stability, through authorisation, prudential regulation, supervision and inspections to enforcement and redress.

As I said earlier, ensuring that the financial system is stable and the firms that operate within it are financially safe and sound is a basic level of protection for consumers. A recent example is the introduction of the macro-prudential mortgage lending rules aimed at reducing the risk of overheating in the housing market and reducing the risk of consumers over-borrowing.

In our role of authorising financial services firms to operate in the Irish market, we act as a gatekeeper to protect consumers. We are rigorous and challenging in our application of the requirements and standards so that the firms we authorise can be expected to meet the best interests of consumers. Our criteria include: the fitness and probity of individual directors and senior management; the adequacy of firm capital; the adequacy of internal controls and risk management systems; and the level of resources and expertise of staff. We can and do refuse applications from financial services providers and we can and do withdraw or revoke authorisations. We can investigate individuals performing specific functions where we suspect an individual's fitness and probity. We can issue a suspension notice and/or a prohibition notice potentially prohibiting the individual from performing all such functions indefinitely.

As prudential regulator, we have regular supervisory engagement with firms. During this engagement, we may identify an issue or process that is not necessarily consistent with the best interests of consumers. In such cases, we can seek additional information, request the firm to perform a task, cease a practice or modify a process. In the first instance, we may require the firm to mitigate the risk but we can also use our regulatory powers to issue a direction to the firm.

We use the Probability Risk and Impact SysteM (PRISM) as our framework for the supervision of regulated firms. We developed this risk-based framework so that we could prioritise our work and target our finite resources on the highest level risks. It allows supervisors to judge the risks a firm poses to the economy and the consumer and mitigate those risks we consider unacceptable. To identify high- level risk issues, we build business intelligence through the analysis of, for example, data on sales, complaints about products and services, advertising spends, new business and product development, issues arising from queries and social media, horizon scanning and feedback from supervisors, enforcement and authorisation officers. This helps us to detect and understand where potential consumer detriment can arise and helps supervisors compile conduct risk reports on which our actions to mitigate risk will be based.

We use themed inspections to focus on a specific issue, topic or product rather than on a specific institution. We identify the themes to pursue in a number of ways, including consumer queries, complaints, issues arising from previous inspections, market intelligence and annual sectoral risk assessments, as well as advice from the Consumer Advisory Group on our consumer protection strategy and policy initiatives.[16] Themed inspections are conducted by survey or by a combination of survey and on-site inspections. Following a themed inspection, we issue firm-specific letters, an industry-wide letter and a press release and publish our findings on the Central Bank website. Where we identify a specific compliance issue in an individual firm, we address this directly with the firm.

A credible threat of enforcement underscores our powers to protect consumers of financial services. We take robust enforcement action aimed at promoting principled and ethical behaviour by and within regulated entities. Transparent and strong action where entities or individuals fall short of required standards helps to deter poor practices, achieve compliance and encourage the behaviour we expect. We take action where firms or individuals have breached provisions in prescribed legislation, a code, or a condition, requirement or obligation imposed by the Central Bank. In 2013, legislation provided the Bank with formal redress powers to direct regulated financial services firms to make appropriate redress to customers where they have suffered or will suffer a loss as a result of widespread or regular relevant defaults by a regulated financial services provider. Where consumers suffered detriment prior to 2013, we have used our influence to obtain redress for consumers on a range of issues including payment protection insurance and credit card protection insurance, as well as part of the tracker mortgage examination.

Current Priorities

We set out what we see as the key risks now facing consumers in our Consumer Protection Outlook Report, which was published last week.[17] These range from the absence of a consumer-focused culture in financial services firms, through the ongoing problems of high levels of indebtedness and mortgage arrears, to the implications for consumers of the significant increases in the cost of health and motor insurance. There are risks to consumers from poor product design and marketing especially where products are complex and terms and conditions may be difficult to understand. There are risks, as well as advantages, for consumers from the greater use of technology to deliver financial products and services and from the pace and scale of technological innovation in the financial services sector. And there are potential risks for consumers from the changing international economic and political landscape from Brexit to the post-Trump reform of regulation in the United States.

In a recovering economy, there are also risks for consumers. We see an increase in the level of new lending in all areas which needs to be managed by lenders to ensure that new debt is both affordable and suitable for the borrower. Lenders are aware that they are required under our Consumer Protection Code to assess affordability and to lend responsibly on a case by case basis. In a low interest environment earning a return on savings or providing for retirement is more difficult and firms need to make their customers aware of the increased risks involved in products that offer higher rewards. Again, regulated firms know that they are required to ensure that the products they sell to their customers are properly explained and understood and appropriate to that customer's risk appetite.

Having identified these and other risks, what is the Central Bank doing to address these risks and to enhance its protection of consumers? First, we continuously assess our consumer protection regulatory framework to ensure it is fit for purpose and working for consumers. To do this we use market intelligence, our supervisory experience, consumer research and insights into consumer behaviour as well as feedback from key consumer protection bodies such as the Competition and Consumer Protection Commission and the Financial Services Ombudsman. European legislation, including new directives, as well as wider international developments continue to shape our framework. We are active participants in the three European Supervisory Authorities as well as in FinCoNet. Ongoing developments in the consumer protection framework include the implementation of EU Directives in Insurance, Payments Services and Markets in Financial Instruments and reviews of our Codes, including the Minimum Competency Code and the Consumer Protection Code for Licensed Moneylenders.

I referred earlier to the risk to consumers from the absence of a consumer-focused culture within financial services firms. What do I mean by such a culture? We see a positive consumer-focused culture as one in which financial services firms communicate clearly with their customers, help customers to understand the financial products and options available to them and to make the financial decisions that best meet their needs. It is a culture in which consumers can be confident that firms are acting in their best interests. It is a culture in which boards and senior management set the tone through their commitment to achieving good outcomes for their customers. It is a culture where a firm engages constructively with customers who have queries or complaints and which rectifies its errors or mistakes. It is a culture where staff are incentivised to build good customer relationships and to aim to sell appropriate products rather than large numbers of products.

Our work to promote the development of a consumer-focused culture includes directing all banking, insurance and investment firms to review and restructure their incentive payments for sales staff in light of guidelines we issued to ensure that employees, individually and collectively, act in the best interests of their customers and provide products suitable to their needs. We are currently examining additional measures to ensure that firms remuneration structures for intermediaries encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest.

There has been progress by some firms towards this type of culture but there is a long way to go. Firms need to put internal consumer risk management frameworks in place to help make the shift to a consumer focused culture. Recognising the fundamental importance of risk management in achieving this cultural shift, we have enhanced our on-site Consumer Protection Risk Assessment model (CPRA), which provides us with a robust framework to assess how consumer risks are being identified and managed by firms. The new model equips us to assess how firms' risk management frameworks are designed and governed, but also how effective they are in practice at delivering fair consumer outcomes.

Following the successful pilot-testing of the model in 2016, we will conduct a series of targeted CPRAs across the different retail sectors throughout 2017, with a particular focus on culture, performance management, sales incentives and product governance. The CPRAs will be in addition to and support our regular programme of consumer-focused thematic inspections, which examine how firms are selling their products and services in practice. And we continue to engage with the boards and senior management of regulated firms to ensure there is a very clear focus from the top on embedding and measuring the firms cultural change programme.

Looking to the Future

In determining the appropriate scope of the Central Bank's work to protect consumers, I would like to sound a note of caution. The Central Bank is committed to working effectively to protect consumers of financial services but it is important we do not over-promise on the outcomes we can achieve. The goal is to secure an appropriate degree of protection of consumers while recognising that expectations of what can be achieved through regulatory mechanisms need to be reasonable.

It is inevitable that consumer protection issues will arise that could not have reasonably been foreseen or may be the result of fraud, criminal conduct or human error. What is important is that where these issues arise, we take corrective action swiftly and work to redress the detriment to consumers. The Central Bank played a leadership role in this area with the development of the Consumer Protection Code and we continue to pursue a strong consumer protection agenda through our involvement in European and international bodies.

It is important to appreciate that much of the consumer protection work undertaken by the Central Bank is not publicly visible, such as when we take action to address potential problems at the outset and thus avoid consumer detriment. Examples would include where we refuse to authorise firms to offer financial services here, where we identify issues through supervision or themed inspections and take action to mitigate before consumer detriment arises. Restitution of over €19 million was paid to consumers in 2015 on foot of issues identified through our supervisory activity. We have also taken strong enforcement action – since 2010 we have concluded some 80 enforcement cases, half of which dealt with consumer issues. We have imposed fines totalling over €46 million and have removed individuals for the management of firms.

But this is a challenging area and sometimes our best efforts will not achieve our desired targets or may not progress as quickly as we would wish. In tackling the issue of the fair treatment of tracker mortgage customers, for example, we have initiated the largest and most complex consumer protection investigation we have even undertaken. To ensure that a fair outcome is achieved for consumers this review will some take time. We have required each lender to carry out a thorough, comprehensive and robust review which is independently overseen. Some two million mortgage accounts are being reviewed and lenders will have to pay redress and compensation to affected customers and are facing enforcement action by the Central Bank. We have fined one lender €4.5 million and directed that its customers receive appropriate redress and compensation – by November 2016, this had amounted to €5.8 million. Two other enforcement cases are currently ongoing.

As we strive to protect the consumers of financial services, I believe that more needs to be done to empower consumers in their dealings with financial services firms. Improving financial literacy is an integral part of the consumer protection agenda. International financial literacy studies indicate that a majority of the world population do not have sufficient knowledge to understand even basic financial products and fail to make effective decisions to manage their finances and the risk associated with them. The OECD and G20 have advised that this needs to be undertaken through nationally coordinated and tailored approaches.[18]

At the Central Bank, we know we need to deliver effective protection for consumers of financial products and services in a rapidly evolving financial services landscape. It is our responsibility to respond to emerging threats, to be vigilant to evolving potential threats and to be proactive in tackling risks to consumers. Looking ahead, consumers would benefit from simpler products for example in the areas of pensions and health insurance. In the insurance sector, work needs to be done to attain the goal of consistent supervisory standards across Europe and to coordinate the various national protection schemes for policyholders.

Finally, the technological innovations that bring the potential benefits of lower costs, speed, automation and convenience for consumers also pose some challenges for regulators in relation to consumer protection. Our focus is on ensuring that the appropriate frameworks are in place so that firms must take the best interests of consumers into account in their design, operation and monitoring of online distribution and automated advice channels. Furthermore, given the scope for online distribution channels to foster cross-border trade in financial services, it is essential that the legislative framework fosters internationalisation without compromising consumer protection.

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1 See Campbell et al. (2011), Campbell (2015), Badarinza et al. (2016) for surveys of the literature.

2 See Lusardi and Mitchell (2007, 2011), Lusardi et al. (2010) and Lusardi and Tufano (2009).

3 See Loewenstein et al. (2003), Della Vigna and Malmedier (2006) and Gabaix and Laibson (2006).

4 Madrian and Shea (2001) and Carroll et al. (2009).

5 Benartzi and Thaler (2001).

6 Heidhues and Kőszegi (2010).

7 Office of Fair Trading (2010).

8 Henderson and Pearson (2011).

9 May et al. (2014) and Lusardi and Tufano (2009).

10 Consumer Protection agencies such as the Financial Conduct Authority in the UK, the Netherlands Authority for the Financial Markets, and the Financial Consumer Agency of Canada do not have a prudential regulation role. Agencies with dual regulation and consumer protection mandates include the German Federal Financial Supervisory Authority (BaFin), the Financial Supervisory Authority in Denmark and the Financial Supervisory Authority of Norway. The Central Bank of Ireland and the Central Bank of Portugal have financial stability, prudential regulation and consumer protection mandates.

11 ccpc.ie/.

12 www.financialombudsman.ie/ .

13 www.eba.europa.eu/ , www.esma.europa.eu/ , eiopa.europa.eu/ .

14 FinCoNet is the international organisation of financial consumer protection supervisory authorities. www.finconet.org/

[15] G20 High-Level Principles on Financial Consumer Protection. Published by OECD October 2011. Followed by "Effective Approaches to Support the Implementation of the remaining G20/OECD High-Level Principles on Financial Consumer Protection". Published by OECD September 2014.

[16] The Consumer Advisory Group was set up under the Central Bank Reform Act 2010 to advise the Central Bank on the performance of our functions and the exercise of our powers in relation to consumers of financial services.

[17] www.centralbank.ie/press-area/press-releases/Pages/CPOR2017.aspx

[18] Advancing National Strategies for Financial Education: OECD 2013 message from Anton Siluanov Minister of Finance Russian Federation. P 6