

**8th SEACEN Conference of Directors of Supervision of Asia-Pacific Economies,
Kuala Lumpur**

SESSION 6: Developments in Consumer Financial Protection

8th August 2006

**Presentation By
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It is my pleasure to be with all of you here this afternoon. I am very impressed with the good work that the SEACEN has been doing to provide a forum for discourse for supervisors to speak frankly on the many issues that affect their stakeholders. I have noticed that SEACEN has been very proactive and taken initiatives to highlight relevant issues to the attention of supervisors. This topic on *Developments in Consumer Financial Protection* is a fine example. Consumerism and the role of supervisors in consumer financial protection is definitely an issue that we can relate to, as supervisors and as consumers.

2. Consumer protection is an exceptionally wide topic. The issues are as many as they are diverse. Today, I want to offer my perspective on the major consumer protection concerns the financial industry is grappling with, the scope of these concerns as well as their impact on consumers and the industry. I will then discuss the issue of whether banks should take more responsibility for consumer financial protection. I will also address how deposit insurance can contribute to consumer financial protection and finally, I shall suggest an international perspective for addressing consumer protection.

Consumer protection concerns

3. Let me first begin with a truism - financial markets are not perfect. These imperfections have spawned various difficulties for protection issues. My friends at the *Financial Consumer Agency of Canada* have informed me that the major concerns are rather similar globally. The difficulties are well known - information asymmetry, complexity of financial products and consumers who are unable or unwilling to understand both the risks and rewards involved. Or once they see the rewards, consumers are obtusely blind to the risks, whether recklessly or unconsciously. Additionally, there is the gross imbalance of knowledge between sellers and buyers. While the seller has in-depth knowledge of the financial product that he is offering as well as similar products in the market, the buyer is more likely to have minimal information. More often, to cloud comparison, sellers market their products on perceived value, which is not easily quantifiable, rather than on the hard facts of the product. It has also been said that the oligopolistic nature of the financial industry has exacerbated abuse in the power relationship between borrowers and lenders.

4. Other major consumer protection issues involve unfair dealings and predatory practices, largely associated with aggressive marketing means. Unfair dealings include instances of lenders imposing contract terms that cause a significant imbalance in the rights and obligations of the parties to the detriment of the consumer. I would like to cite a couple of examples¹. Firstly, terms binding consumers to a contract but the bank is allowed to decide whether or not to provide the services. Secondly, allowing banks to change important parts of the service without consulting the consumer or receiving their approval. As for common predatory practices, these include the lack of cooling-off period, tied selling, bait and switch, high-pressure and questionable marketing and sales practices, prepayment penalties, balloon payments, as well as abusive and aggressive collection practices².

¹ Financial Services Authority, U.K. Factsheet on "Challenging unfair contract terms", January 2005.

² Source: *Report of the Staff to Chairman Gramm Committee on Banking, Housing and Urban Affairs*, 23 August 2000, US.

5. Increasingly, consumers are the victims of fraud as seen globally in the numerous cases of and losses arising from identity thefts, credit card fraud and ATM card cloning. Despite this, banks, driven by the lucrative consumer business, have continued to come up with various innovative means to capture additional market share. For instance, in the U.S., at least six of the 12 biggest banks have recently rolled out or are developing live-chat capabilities while most major banks will offer at least a basic chat option by year's end³. Bank employees, through online live-chat, offer real-time help with loans, advice customers on buying a house and pitch new products and services.

6. Another common concern is the issue of privacy safeguards and their adequacy. Advances in information technology have enabled financial institutions to gather extensive personal data of customers. As a result, financial institutions have at their disposal a vast database of customer information. The main issue surrounding privacy is whether the bank has a legal right over customer data to do as it pleases. If it has such rights, then it follows that the information may be mined by the institution for its own use or it could be sold for a profit. There is no correct answer to these questions. As a compromise, most regulators have taken the middle path by adopting the "Own use, no sale" approach. Still the issue of adequacy of privacy safeguard remains unresolved. In the case of Canada, government statistics show that complaints regarding misuse of personal information in the banking sector constitute the largest proportion, that is, 42% of the total complaints from all sectors⁴.

³ Source: *The Asia Wall Street Journal*, 13 July 2006.

⁴ Complaints received by the *Office of the Privacy Commissioner under the Personal Information Protection and Electronic Documents Act*, by sector, 2004. The breakdown is - Banking sector (42%), telecommunications & broadcasting sector (26%), transportation companies (19%), credit reporting agencies (4%) and others (9%). Others include rewards programs, internet service providers and Aboriginal bank councils. Source: *Annual Report to Parliament 2003–2004, Office of the Privacy Commissioner, Canada, November 2004*, pp. 57-58.

Scope of consumer issues

7. Let me touch now on the scope and implications of some of the above concerns. IT has brought banking access to a larger number of consumers than ever before. And many of the consumer issues that we face today are directly attributable to advances in IT and telecommunication. Take for example, automated teller machines. ATMs are ubiquitous and have become a standard feature of banking. As at end-2005, Malaysia has 5,900 ATMs and approximately 15 million chip based ATM cards⁵. Another major household financing channel is the credit card. Evidence from Bank Negara Malaysia shows that, over the past 10 years, the total number of credit cards issued has increased by more than four-fold⁶ whilst the outstanding credit card debt increased almost six-fold⁷. The misuse of stolen identities arising from identity thefts and credit and ATM card cloning is recognized as one of the fastest growing crime globally. In the U.S., in 2003 alone, there were 10 million victims reported with losses amounting to USD1 billion. During the same year, U.K. reported over 100,000 cases and £1 billion in losses. Losses of about AUD 1 billion were reported in Australia in 2002.⁸

8. Electronic banking is another product that is fast gaining ground. Of significance here, is the usage of Short Messaging Services (SMS) via mobile phones to effect own account funds transfer, bill and loan payments, mobile prepaid airtime reload and balance inquiries via mobile banking and internet banking. In 2005, a total of almost 400,000 mobile banking instructions were transacted, mainly for bill payments and own account funds transfer transactions while online banking transactions grew by 70 % to RM19 billion.⁹

⁵ Source: Bank Negara Malaysia 2005 Annual Report, pp. 226-227.

⁶ Total credit cards in circulation include principal and supplementary cards. 1995: 1.77 million; 2005: 7.82 million. Source: BNM Monthly Statistical Bulletin, May 2006.

⁷ Total outstanding balances due from cardholders for 1995: RM2.8 billion; 2005: RM16.7 billion. Source: BNM Monthly Statistical Bulletin, May 2006.

⁸ Source: Citigroup, 3rd International Forum on Financial Consumer Protection & Education, December 2005.

⁹ Source: Bank Negara Malaysia 2005 Annual Report, pp. 226

9. The combination of advancements in information technology, product innovation, deregulation and enhanced competition over the last two decades has helped lower lending costs and increase accessibility to credit. In turn, this expansion in lending created new borrowing opportunities for households. Financial institutions have developed products that match the income stream of borrowers, by enabling borrowers to repay larger portions of their loans as their income stream increases. This has further improved consumer accessibility to a wider range of products, particularly those consumers who traditionally had difficulty gaining access to credit from mainstream institutions. Examples are mortgage lending, personal loans and credit cards to young couples with initial low income streams. The relative ease of accessibility to credit is seen in the total household debt accounting for 55% of total loans in the Malaysian banking system¹⁰.

10. These findings indicate that credit is no longer confined to a privileged group but has spread over a larger population. A very simple review of the use of credit across income groups shows the level of debt has increased sharply on a per borrower basis. This has positive and negative implications. Such increases mean that borrowers have opportunities to use credit to create wealth by acquiring assets. Home ownership, investments in stocks and other asset acquisitions are good illustrations of wealth creation. The rise in the use of credit is good for the economy as it enables households to purchase assets over a period of time based on their existing capacity.

11. But there are inherent risks. Concerns have been raised that the increase in the use of credit among the lower-income groups and the less financially sophisticated households could lead to financial distress for the more vulnerable households. A useful indicator of financial distress is the proportion of households with very high debt burdens against the GDP. Based on Bank Negara Malaysia's statistics, household debts to GDP increased from 45 % in 2000 to 62% in 2005.

¹⁰ Source: Bank Negara Malaysia 2005 Annual Report, pp. P52-P53 (Tables A.38 and A.39).

12. How exposed are consumers to risks? Surveys of financial literacy indicate that many countries do not have an adequate financial background or understanding. In the U.S., 55% of adults and 66% of high school students do not understand such basic economic concepts as inflation and interest rates. In Japan, only 1% of consumer education professionals said that consumers have an adequate level of financial knowledge. In Australia, 37% of those with investments do not understand that their investments can fluctuate in value¹¹. In Canada, 42% do not have the basic literacy and life skills to cope with the demands of knowledge society and economy¹².

Balancing the scales

13. In addressing consumer protection issues, supervisors recognised the asymmetrical power distribution between lender and borrower. To balance the scale for consumers, supervisors globally have adopted three main approaches:

- Enhancing information disclosure to address asymmetries in information;
- Increasing consumer financial literacy; and
- Enhancing market efficiency and competition to improve customer choice.

14. Rather than discuss the details of each approach, allow me to highlight some key points on issues affecting these approaches and hence supervisors' attempts to balance the scales:

- An important aspect of empowerment is financial education where the primary focus is on improving financial understanding. Ultimately, the objective is to upgrade financial literacy so that consumers have the tools and knowledge to make proper assessment of risks, quality and relative prices of diverse and often complex financial products. Financial literacy also aims at educating consumers on the means to access information and the ability to compare information.

¹¹ Source: *The Organisation for Economic Co-operation and Development (OECD) Financial Education Project, Financial Market Trends, No. 87, October 2004*

¹² Source: *The Financial Consumer Agency of Canada, May, 2006.*

- But financial literacy takes time to build up. It is also dependent on the level of development of the financial sector and how banks position themselves. The structure of the industry and the level of prudential supervision are also important factors that have a bearing on the efficiency of this approach.
- Information disclosures are, more often than not, imposed by regulation on lenders. This presumes the fact that financial institutions would not, on their own, disclose information willingly to consumers. This pre-supposition weakens the power relationship that the oligopolistic structure has endowed upon the financial institutions¹³. Interestingly in Canada, banks do not want to provide more consumer information – always arguing about regulatory burden and their costs but the increasing profits of banks show a different picture.
- In recent years, increasingly supervisory attention has focussed on the effectiveness of disclosure notices. In addressing the many concerns related to this issue, supervisors have begun to recognise that disclosure notices should be addressed from the consumers' perspective – that is, similar to the treatment given to disclosures for food items¹⁴.
- The Office of the Comptroller of Currency's experience provides invaluable lessons. These include keeping the notices simple. Studies have shown that consumers would rather not read them if the notices are complex. Simple language is not sufficient. You also need good designs to attract consumer attention. Further, consumers require a context or background information to build understanding on the need for the disclosure information. In addition, to achieve understandable and effective consumer disclosures, one critical element is for the disclosure to

¹³ The OECD attests to the importance of empowering consumers and regulating the financial institutions. Following the completion of its Financial Education Project, the OECD recommended as one of its seven *Principles for Financial Education and Awareness*, that:

“Financial education should be taken into account in the regulatory and administrative framework and considered as a tool to promote economic growth, confidence and stability together with regulation of financial institutions and consumer protection (including the regulation of financial information and advice). The promotion of financial education should not be substituted for financial regulation, which is essential to protect consumers (for instance against fraud) and which financial education is expected to complement.”

¹⁴ Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller of the Office of the Comptroller of Currency, before the University of North Carolina School of Law, March 30, 2006

undergo consumer testing. Consumer input improves significantly the effectiveness of disclosure notices.

- Certain regulators prefer to give greater importance to market efficiency to balance the scales for consumers. This approach is favoured by the Financial Services Authority (FSA). It focuses on consumer responsibility or qualified "*caveat emptor*".
- Technology can be an effective enabler. In Canada, various government agencies, supervisors and the financial institutions, collectively work towards providing consumers easy access to redress complaints. One common web portal links all these parties. All a consumer needs to do is to get onto this portal, indicate the name of the financial institution that he wishes to lodge a complaint and he will be directed on the specific complaint-handling steps.

Should banks take on a larger role in consumer protection?

Ladies and Gentlemen,

15. Much has been done to protect consumers. The results speak for themselves. Legislative frameworks and informal arrangements, such as the ombudsman, have been established in many countries. We have also seen numerous specific agencies and Ministries created to protect consumer rights. But more can still be done. New technologies bring new issues. New financial products bring new practices and new challenges. But regulation cannot keep pace with market developments. It would be time consuming and totally wasteful to come up with regulations to address every new issue that may crop up. In this we are all of like-mind. The impact of over-regulation has implications for consumers. It drives up the cost of doing business and, in some cases, fewer product choices.

16. Turning to the issue of who should take responsibility for consumer financial protection, a view had been expressed that banks be made to take on a larger role in customer protection. My view is that an effective consumer protection framework would require the concerted effort of regulators, consumers and market players in the financial system. No doubt, the party with the larger financial muscle would have a heavier burden. This effectively places the burden on regulators and the government.

17. Banks have a role to play. In recent years, a new trend has been observed. Banks have begun to move towards a pro-consumer stance by adopting higher standards of consumer disclosure.

18. What brought about this change? Competition and the quest for profits are the primary motivators. With growing consumer affluence, near instantaneous communications and heightened competition, banks have begun to appreciate that a pro-consumer stance on higher ethical practices can and does attract more customers. And that, in turn, boosts their earnings, strengthens their asset base and certainly, their reputation. Enlightened banks have therefore, voluntarily aligned the scales in favour of consumers. The result is a convergence of safety and soundness standards in the banks with consumer protection concerns. In this regard, I am optimistic that banks will continue to see benefits in treating customers fairly and responsibly.

Deposit Insurer's Role

Ladies and Gentlemen,

19. As deposit insurers, we have often been asked on how deposit insurance contributes to consumer financial protection.

20. MDIC's statutory objects require us to protect depositors against the loss of part or all of their deposits in a financial institution. Our mandate also requires us to promote or contribute to the stability of the financial system. To us, public awareness of the soundness of the financial system is a critical element of financial stability as it is synonymous to depositor confidence. Depositors who are aware and confident of the safety of their deposits are the main stabilising blocks to a stable banking system. Our aim, therefore, is to promote a clear understanding of what deposit insurance does and

its benefits. Our efforts in building awareness include that of a toll-free line and a Call Centre to handle public enquiries in the various languages of choice. Our website has comprehensive information on deposit insurance. We have also formed partnerships with our member institutions for the dissemination of information and to train employees of member institutions. Our focus has been on operation and front line employees, who are most likely to be involved in advising their customers about deposit insurance.

21. MDIC's statutory mandate also requires us to provide incentives for sound risk management. In this regard, we are considering the use of our legislation to drive higher standards of governance in our member institutions. We plan to reduce information asymmetries by regulating the disclosure requirements, particularly, for deposit products.

Consumer protection – a continuing agenda

Ladies and Gentlemen,

22. In Malaysia, the importance of consumer financial education has been long recognised. Bank Negara Malaysia has been taking the lead in this area as far back as the 1980s. Bank Negara has recognised that a crucial aspect of financial stability rests on consumer confidence of banking institutions' capacity to deliver products with integrity. "The need to protect consumers from potential unfair practices by banking institutions will continue to be one of the main areas of responsibilities of BNM."¹⁵ As part of its continuing measures to reinforce the consumer protection infrastructure, Bank Negara has recently established the Consumer Protection and Market Conduct Department within the Bank. This Department has been tasked with the responsibility for developing a comprehensive consumer policy for the financial sector, financial education and awareness, and developing an integrated consumer communications strategy. The efforts of Bank Negara Malaysia and other agencies that have established formal consumer protection departments are to be applauded.

¹⁵ Page 104, Bank Negara Malaysia's Financial Sector Masterplan, issued March 2001

23. However, while many developed countries have developed structured financial consumer education programs, far and few have been developed in Asia. Definitely more needs to be done in many national jurisdictions. Moreover, cross-border and international issues have to be addressed. On the international front, presently, consumer regulators meet once every two years under The International Forum on Financial Consumer Protection and Education. This forum provides an excellent platform to explore emerging issues on consumer protection and education, to share knowledge and insights as well as exchange views in these areas. There had been three of such forums which are held once every 2 years. At the last round which was hosted by Bank Negara Malaysia in December 2005, it brought together regulators from over 30 countries. I understand they shared survey results on consumer trends, experiences, developments in combating fraud and a host of extremely useful information.

24. Given the importance and usefulness of this forum, a two-year frequency leaves a lot to be desired! I believe that there needs to be a more concerted effort at the international level with regard to management of financial consumer issues. In this regard, I would suggest that the time has come for the establishment of an international association for financial consumer protection. A global association will be able to put together best industry standards and practices, act as a depository of members' experiences, laws and developments as well as provide knowledge transfer and training. In our efforts to educate consumers, as regulators, we must first of all be educated. A global association can greatly assist in many areas, including the design of appropriate consumer education programs. Until and unless the scales are equitably balanced, consumer protection will remain a continuing agenda for all of us. A global association can help to tip the scales in favour of consumers and to accelerate our common agenda.

On that note, I thank you for your attention.