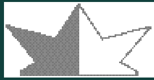


Task Force on the
Future of the
Canadian Financial
Services Sector

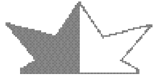
Consumers in the Financial Services Sector

Volume 2:
International Experience

Edited by Robert R. Kerton

September 1998

Research Papers Prepared for the Task Force on the Future of the Canadian Financial Services Sector



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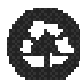

Preface

Rapid change in the financial services sector has brought important new opportunities. However, the proliferation of novel financial offerings has also been accompanied by deregulation, new selling tactics, new sellers in new clothes, old sellers in new clothes, inadequate education for customers with new responsibilities, mystifying contract terms for inexperienced consumers, and redress provisions designed for the most ethical sellers rather than for the full range of market participants. What can be done?

Most of the challenges confronting Canadian consumers of financial services are tests that have been faced by consumers in other countries too. An important opportunity rests in the fact that the new challenges have been addressed in so many different ways in those nations. Germany and the United States place a heavy reliance on courts and liability – extending, in certain circumstances, to the regular supply of public funds for class action suits by consumer groups. Sweden and Denmark make substantial use of market courts and negotiated guidelines on sales tactics and also on contract provisions. The approach in the Netherlands is based on a tripartite system with the national consumers' organisation participating fully in policy formulation and playing a very formal role in redress. The European Union has directly addressed transparency in EC Directive Article 5, which requires contract terms to be drafted in plain, intelligible language. The US makes use of publicly funded bodies to provide model contracts to be used in the financial sector.

Most countries have had poor experience with voluntary approaches and have now moved to more effective methods. Canada is a relative novice in its experiment with the office of an ombudsman: Nordic countries have been using the approach for three decades or more. In the last decade, most independent studies have singled out the ombuds in place in the United Kingdom as examples of best practice. However, even there, important modifications are now being implemented. Finally, Australia has a financial sector with many of the same characteristics in place in Canada. Very recently, Australia completed a thorough review of its financial system and issued a long list of recommendations, many with direct application to consumers. This was published in 1997 as the Wallis Report. All appropriate experiences in similar countries deserve our attention.

It is important that Canadian recommendations for transparency and redress be informed by what has been learned from experience in other countries. Accordingly, the Task Force commissioned a number of studies on best practices in countries similar to Canada.

This volume presents the studies of policies and practices affecting transparency and redress in Australia, Denmark, the European Union, Germany, the Netherlands, Sweden, the United Kingdom and the United States. The companion volume entitled *Principles, Practice and Policy – the Canadian Experience* has three components. First, it presents a framework for analysis based on consumer economics. Second, it conducts a detailed analysis of the readability of actual contracts in force in Canada's financial services sector. Finally, it concludes with an assessment of what all this means for consumers of financial services in Canada. The country studies included here are an important component of that assessment.

Robert R. Kerton

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Part I

European Union – Policy and Practice

by
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1. The Overall Strategy

The First Phase: Attempts to Build a Harmonised Legal System

The objective of establishing a single European market has its origins in the formation of the European Community, one of the constituent elements of the European Union (EU)[1], as set out in the 1957 Treaty of Rome. The Treaty envisaged the setting up of a single, transnational, integrated common market within which the free movement of people, goods, services and capital would be assured.

For a long period after the signing of the Treaty, progress towards achieving this single market was very slow, especially in the financial sector. This was because proposals were based on a programme of harmonisation, aimed at creating sets of common laws, regulations and administrative actions on an EU-wide basis. Given the diversity of national legal and administrative systems, the establishment of a single market by this route proved to be a virtually insuperable task, not least because each proposal for harmonisation required the unanimous consent of all the member states.

In 1985, a European Commission[2] White Paper [3] (surprisingly coloured pink in its English language version) laid down a fresh strategy founded on home country control and 'mutual recognition' between member states, based on the implementation of common standards of prudential supervision.

The underlying principle of this strategy is that goods and services from one member country should be allowed free entry into the others. Each member country is required to recognise the relevant laws and regulations of all the others, subject only to the minimum necessary harmonisation. If a product or service meets the requirements of any one member state, there should be no restrictions on its sale or supply throughout the EU. The White Paper also included a comprehensive programme for achieving a single European market within which there would be free movement of people, goods, services and capital. The programme was based on the removal of barriers to cross-border trade. The target date for implementation was 31 December 1992.

In the same year, a Resolution by the Council of Ministers – the political decision-making body – set out revised procedures to speed up decision-making, including extending majority voting to

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[1] The EU is a formal association based on inter-governmental treaties which grant specified functions and powers to certain institutions – notably the Council of Ministers, the European Commission, the European Parliament and the European Court of Justice. There are currently 15 Member States: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. Twelve further countries have formally applied for membership and seven accession negotiations are currently in progress.

[2] The EU's central administrative and policy-making body, responsible for putting forward proposals for most EU legislation and for supervising its implementation.

[3] Completing the Internal Market – White Paper from the Commission to the Council, COM(85)310 of 14 June 1985, Brussels.

most aspects of the single market programme. It was given effect in the reforms to the Treaty of Rome embodied in the 1986 Single European Act. This Act also raised the status of consumer protection in its Article 100(a)(3), by requiring the Commission, in its proposals on, *inter alia*, consumer protection, to "...take as a base a high level of protection".

The Second Phase: the Drive Towards a Single Market in Financial Services

The first (that is, pre-1986) phase of the single market programme had focused much more on measures to facilitate the movement of goods across the EU's internal frontiers than on the freedom to provide services. However, the White Paper put much more emphasis on the whole range of services, because "...it is no exaggeration to see the establishment of a common market in services as one of the main conditions for a return to economic prosperity".

Objectives

Within the service sector, financial services were highlighted as being of primary importance, because they provided the infrastructure for so many other areas of the economy. Three main strategic objectives were specified:

- Free flow of capital and money across the EU's internal frontiers, requiring member countries to abolish all remaining controls on capital movements to other EU countries, qualified only by short-term concessions to enable national governments to deal with economic crises;
- Freedom of financial services organisations authorised in any one EU country to establish themselves in any other EU country without having to seek separate authorisation, this 'passport' approach to apply to banking, insurance and investment services;
- Freedom of any EU-based financial institution to sell its services across the EU's internal frontiers.

To a significant degree, though not completely, these objectives have been achieved, by the adoption of a range of EU Directives[4] covering liberalisation of capital movements across the EU's internal frontiers, banking, life and non-life insurance and investment services. The implementation of these Directives into national laws has therefore established the framework for the development of a single EU-wide market for financial services. Their provisions are summarised later in this report with the consumer protection aspects spelled out in rather more detail.

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[4] Directives are the most frequently used form of EU legislation. The contents of a Directive have to be implemented into the national laws of member states by a specified deadline. A Directive is binding as to the result to be achieved but there is normally flexibility as to the actual wording that may be used in national laws.

The Reality of the Single Market for Financial Services

To what extent is this single market a reality? There is no doubt that the liberalisation of capital movements has led to the free flow of money across the EU's internal frontiers, though this is a change which has also occurred in all OECD countries, and even beyond.

However, so far as financial services themselves are concerned, progress has perhaps been less rapid than expected. Financial services organisations have so far been slow to establish themselves directly in other EU member countries. Expansion in foreign markets has tended to be via the mergers and acquisitions route. Cross-border selling of financial services has been even slower to develop. It is becoming clear that, as well as the caution about foreign expansion which is displayed by the management of financial services organisations, there are considerable cultural distinctions between retail financial services markets in EU countries.

Choice of methods of payment is an obvious example. Consumers in the UK, France and Italy tend to use cheques rather than bank transfers for non-cash payments. On the other hand, German and Dutch consumers are heavy users of bank transfers, but don't write many cheques. Patterns of savings also vary greatly. Less than a quarter of the money invested in German collective investment funds is equity-based, compared with over three-quarters in the UK. Housing credit markets are markedly divergent. Long-term variable interest rate mortgages dominate the UK market, while medium-term, renewable fixed interest rate loans are the norm in Belgium, France, Germany, Italy and the Netherlands.

Consumers are slow to change their pattern of usage of financial services. They also find security in familiar names of financial services organisations. An unfamiliar name suggests to many an unnecessary degree of risk. There tend therefore to be formidable cultural barriers of entry to national retail financial services markets in Europe which are not found to the same extent in markets for corporate financial services, where internationalisation has proceeded rapidly.

Changes in National Regulation

There is a strong case for saying that, so far, the main impact of the drive to create a single EU market for financial services has been to cut a swathe through the bewildering and complex mass of domestic national regulations and restrictions on financial services organisations, products and markets in different member countries.

For example, in the mid 1980s banks in virtually every EU member state carried on their business in a highly regulated environment in which competition among them was very restrained. The pattern of banking regulation varied from country to country, but involved some mix of the following:

- State ownership of commercial banks;
- Controls over the kinds of activities in which banks could engage;
- The types of bank account that could be offered to customers;

- Controlled deposit interest rates, fixed either directly by the government or central bank or indirectly through approved interbank agreements;
- Controlled credit interest rates;
- Ceilings to the volume of credit;
- Limitations on the number (and sometimes the location) of bank branches;
- Specified branch opening hours;
- Compulsory reserve requirements;
- Fixed exchange rates;
- Controls over cross-border capital movements;
- Controls over the entry and activities of foreign banks.

There were a number of different justifications provided for the high degree of intervention by governments in the banking sector, including ensuring the safety of the banking system, safeguarding the soundness of the national currency, limiting foreign competition and protecting consumers. However, the links between specific objectives and detailed regulatory instruments were often not transparent.

This pattern of heavy and complex government regulation was also found in the insurance sector in many EU countries. The modes of insurance regulation included:

- State ownership of insurance companies;
- Authorisation of entry into the market, either general (for example, all life insurance) or specific (for example, separate authorisation for each different type of life insurance business);
- Prohibitions or severe limitations on the activities of foreign insurers;
- Prudential controls over size of reserves and financial ratios;
- Standardisation of insurance contract conditions;
- Limitations on the investment policies of insurance companies (for example, minimum proportion in domestic investments or in government securities);
- Use of standardised mortality tables for life insurance;
- Controls over advertising and marketing methods and conduct of business;

- Standardisation or approval of premium rates;
- Compulsory insurance requirements (for example, motor liability insurance);
- Actual state provision of insurance, either as a monopoly or in competition with private insurers;
- Requirement on life insurers to give part of their business to a state-owned reinsurer;
- Requirement on government and quasi-government bodies to buy insurance from state-owned insurers or insurers which are subsidiaries of state-owned banks.

These forms of government involvement had the effect of severely limiting domestic as well as international competition. There were, however, significant variations between different EU countries in the overall impact of insurance regulation. Greece, Italy, Portugal and Germany all had heavily regulated insurance markets, while the Netherlands and the UK were at the other end of the spectrum. The justification for heavy regulation tended to be that the development of ‘orderly markets’ and the ‘avoidance of destructive competition’ were necessary to protect consumers. However, this approach carried a substantial price tag for consumers. A study carried out in 1988 by BEUC, the confederation of consumer organisations in the EU, showed very wide variations in premiums between countries – for example, premiums for comparable term insurance policies were between seven and ten times higher in Portugal than in the UK[5] . There was a marked correlation between the level of premium and the degree of regulation. A later study by BEUC in 1996 revealed that house insurance could be as much as five times more expensive in one EU country than another[6] .

It was clear that the EU’s strategic objective of achieving a single market for all financial services could not be achieved without extensive dismantling – and to some extent rebuilding – of national regulatory systems. This policy aim coincided with strong market and technological changes which pointed in the same direction. It would, however, be a mistake to assume that <u>de</u>regulated markets are the same as <u>un</u>regulated markets. What has happened is that the boundaries of regulation in financial services markets in EU countries have been changed, not abolished. Indeed, in some crucial aspects – for example, in capital adequacy and prudential supervision, and in some aspects of marketing methods – controls have been strengthened rather than weakened. Nevertheless, it is something of a paradoxical result that the primary outcome of an EU strategy aimed at creating a single market for financial services, with freedom for financial services organisations to compete on an EU-wide basis, has been national deregulation and intensified domestic competition, with effective international competition at retail level still to emerge.

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[5] Term Insurance in Europe. Bureau Européen des Unions de Consommateurs, 1988, Brussels.
[6] BEUC in Brief, no 17, April 1996.

The Impact on the Consumer

What has been the impact of the drive towards an EU-wide single market on the individual consumer of financial services? With a few exceptions, the panoply of Directives that have been adopted has been aimed primarily at creating freedom for financial services organisations to compete throughout the EU and has not had the consumer's interests as an explicit and central preoccupation. It has been assumed that the new framework for financial services markets will bring benefits to consumers in the form of lower prices and a wider choice of financial services organisations and products. These are intended to be the result of intensified international competition and the removal of distortions to markets – especially those brought about by differing degrees and forms of government intervention and widely varying regulatory regimes.

To date, the economic consequences of the single market for the individual consumer have been limited, though it is still early days as the most significant EU Directives were only translated into national laws in the period 1993-96. In banking, most of the impact has been on the wholesale side, with reduced prices for corporate loans. On the retail side, large price differences between EU member states remain for current accounts and personal equity transactions. However, the price range for credit cards narrowed by about 30 percent and there have been slight reductions in the prices of loans, mortgages, retail deposit charges and fee levels. In insurance, the effects are even less discernible.

There are, however, some more specific consumer benefits which have come about as a result of the translation of EU Directives into national laws. As the outlines of EU legislation in part 2 of this report will show, these arise in the areas of consumer information, legal protection and redress, and consumer credit.

The Embryonic Third Phase: a Stronger Emphasis on Consumers' Interests?

From the consumer side, the balance of benefits from the drive towards a single market for financial services has seemed very much to favour the financial services industry. The industry has been given the freedom to compete on level playing field terms throughout the EU. It has been relieved of a mass of national regulatory restrictions. Minor economic and legal benefits apart, the gains for consumers are so far less easily discernible. Certainly there is a wider choice of financial services products, but this might have taken place anyway as a result of market and technological changes. The largely notional benefits of increased international competitiveness have been counter-balanced by the reduced choice of financial services providers brought about by industrial concentration through mergers and acquisitions. Price benefits are not yet easy to quantify – and in any event difficult to isolate from those arising from innovation.

This feeling of distinct unease came to a head in 1995 in a heated debate around a proposed Directive on the protection of consumers in relation to distance selling. This was a consumer protection measure designed to cover distance selling (by any mode) of a wide range of goods and services, including financial services. After vigorous lobbying by the financial services industry of the European Commission, the European Parliament and national governments by the

industries concerned, banking and financial services were excluded from the scope of the Directive[7]. As BEUC pointed out, the effect of this was that the consumer was better protected buying a book by post than an insurance contract.

However, the European Commission accepted that the consumer protection aspects of the marketing of financial services in general, and the question of distance selling in particular, needed special consideration. The outcome of this consideration was a European Commission consultative Green Paper, issued in 1996 under the title *Financial services: meeting consumers' expectations* [8]. As well as difficulties in distance selling of financial services, this document singled out a range of problems met by consumers, including:

- Refusal to sell financial services to non-residents – for example, an insurance company in one EU member state may refuse to insure certain consumers on the grounds that they were nationals of or resident in another EU member state;
- Poor quality of service and lack of information for consumers about financial services being sold on a cross-border basis – for example, contract and other documentation not being made available in the consumer's own language;
- Activities of unregulated intermediaries, especially in banking and investment transactions;
- The absence a cooling-off period in non-life insurance and banking services (EU legislation already provides for a cooling-off period in life insurance contracts, as has previously been noted);
- Possible future difficulties arising from the use of new information and communications technologies for the selling of banking and other financial services.

Although not mentioned explicitly in the consultative Green Paper, the mid 1990s had seen something of a change in the climate within the EU in favour of greater emphasis on consumers' interests. In 1993, the concept was introduced for the first time into the legal foundation instrument of the EU. Article 3(s) of the Maastricht Treaty (Treaty on European Union) defines "a contribution to the strengthening of consumer protection" as one of the designated activities in achieving its task. Further, Article 129 states that "The Community shall contribute to the attainment of a high level of consumer protection through.measures adopted.in the context of the completion of the internal market." This gave a much stronger legal basis for the consumer protection strand in single market initiatives.

Reaction from the consumer side to the Green Paper was generally positive, though urging the European Commission to develop a comprehensive consumer protection strategy and to range

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[7] Eventually adopted as Directive of the European Parliament and of the Council on the protection of consumers in respect of distance contracts (97/7/EC), OJ L 144 of 4 June 1997, p19.

[8] COM (96) 209 final of 22 May 1996, Brussels.

wider and deeper in its analysis of specific consumer problems. Examples given were the need for a systematic strategy covering consumers' information needs, control of self-interested financial advice and mis-selling, continuing problems with payment cards and the absence of effective dispute resolution schemes which would have powers to deal with cross-border complaints and to secure redress for consumers when complaints were justified.

As might be expected, reactions from the financial services industry emphasised the need for prudence before considering new legally based consumer protection measures in the financial services sector, and the possibility of dealing with any problems by voluntary industry initiatives.

The European Commission's conclusion to the debate on the Green Paper consultation was published in June 1996, as *Financial services: enhancing consumer confidence* [9]. In general, the Commission concluded that a response to the issues required "...as much a change of attitude...as a targeted programme of legislation". It set out a number of proposals for new or amended Directives, but stressed that legislation was not appropriate for all the problems identified, It considered that other means, "notably a dialogue between industry and consumers", were more suitable for improving information, market transparency and resolving consumer problems and complaints.

2. Current European Union Legislation

Liberalisation of Capital Movements

The abolition of all national restrictions on the free flow of money across the EU's internal frontiers has been a necessary condition for the development of a single market in banking and financial services. A progressive reduction in controls over cross-border capital movements culminated in 1988 in the Fourth Capital Liberalisation Directive[10] , which committed member countries to the abolition of all remaining controls on capital movements within the EU and to policies aimed at the same objective in relation to non-EU countries.

The Directive is qualified to a certain extent by concessions aimed at helping member countries in times of severe economic crisis. There is a safeguard clause which allows temporary (up to six months) exchange controls on short-term capital movements, subject to authorisation by the European Commission and the Council of Ministers. This is intended only for use at times when capital flows are of "exceptional magnitude" and likely to lead to "serious disturbances" in the conduct of monetary and exchange rate policies. In addition, member states may introduce measures to regulate bank liquidity, even if these constitute a restriction on capital movements, so long as such measures are accepted as being necessary.

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[9] Communication from the Commission – Financial services: enhancing consumer confidence. COM (97) 309 final of 26 June 1997, Brussels.
[10] Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty (88/361/EEC), OJ L 178 of 8 July 1988, p5.

The liberalisation of capital movements was accomplished against a background at the time of extensive controls, especially but not only in southern European countries. Indeed, Greece, Spain, Portugal and Ireland were granted extended periods to dismantle their national exchange control regulations and implement the Directive. The fears in some countries that the removal of cross-border capital controls might lead to massive flight of capital motivated largely by tax evasion have not been borne out in practice. There is now to all intents and purposes a fully liberalised capital market within the EU which will persist even in the face of the introduction of a single currency, the Euro, for some EU member states but not others.

Banking

The cornerstone of the EU's legislative framework is the banking sector is the Second Banking Directive, adopted in 1989[11], which member states were required to implement by 1 January 1993. Its most significant provision is that of a single banking licence issued by the home country's banking supervisory authority. This licence functions essentially as a banking 'passport' allowing a bank to operate throughout the EU and making it unnecessary for the bank to seek separate authorisation in each of the other EU member states.

The single licence authorises a bank to carry out in all member countries any of the banking activities on an agreed list, providing the activity is not forbidden in the bank's home country. The agreed list includes the following:

- Acceptance of deposits and other repayable funds from the public;
- Lending, including consumer and mortgage credit, factoring and financing of commercial transactions;
- Money transmission services;
- Issuing and administering means of payment – credit cards, travellers' cheques and bankers' drafts;
- Guarantees and commitments;
- Trading for own or customers' account in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments and transferable securities;
- Participation in share issues;
- Advice to undertakings on capital structure, industrial strategy and mergers and acquisitions;

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[11] Second Council Directive of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (89/646/EEC). OJ L 386 of 30 December 1989, p1.

- Money broking;
- Portfolio management and advice;
- Safekeeping and administration of securities;
- Credit reference services;
- Safe custody services.

This list may not look particularly radical, but in fact at the time the Directive was adopted it was appreciably more extensive than existing permitted banking functions in some EU member states. For example, in France banks were not allowed to engage in securities trading on the stock exchange, while in Greece banks were forbidden to manage investment portfolios.

The Directive provides for any national banking supervisory authority to authorise a bank to engage in other activities outwith the scope of the list, but ‘unlisted’ activities such as insurance broking may be subject to host country control. The host country remains responsible for supervising liquidity ratios, in collaboration with the home country, but is not allowed to discriminate in favour of its own domestic banks.

Subject to these exceptions, the principle of home country supervisory control is intended to be dominant. If a bank wants to set up branches in another EU member country or provide listed services on a cross-border basis, it does not have to be separately authorised by the host country, nor may such branches be required to have separately endowed capital and to keep separate branch accounts – formerly widely used methods of limiting foreign competition.

A corollary to this principle of home country control is the harmonisation of essential standards for prudential supervision of banks by national supervisory authorities and mutual recognition. The prudential standards harmonised in this Second Banking Directive relate to minimum authorised capital, information on major shareholders and limitations on a bank’s holdings in non-financial institutions.

Throughout the debate on successive drafts of the Second Banking Directive, consumer organisations were concerned that the principle of home country control could undermine national consumer protection systems unless there was some degree of harmonisations of the standards of consumer protection in banking throughout the EU. The fear was that levels of national consumer protection would be forced downwards to the lowest level to be found in any member country.

However, Art.21 in the final text of the Directive has provided some comfort. It safeguards the power of host countries:

> *“...to take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the general good. This shall include the possibility of preventing offending*

> *institutions [i.e. banks] from initiating any further transactions within their territories."*

The text of the Directive does not give any more precision on what is meant by "the general good". The matter is left to the courts to decide. The Commission is currently engaged in developing guidance on what is intended – in particular, differentiating consumer protection and other 'genuine' aspects of the general good from measures which implicitly discriminate against banks from other EU member countries.

However, this Directive is closely tied in with other key banking measures, which include the Own Funds Directive[12], the Solvency Ratio Directive[13] and the post-BCCI Directive[14,15].

The 1989 Own Funds Directive is a largely technical measure establishing common definitions and a classification system for bank capital as a basis for setting minimum levels of capital adequacy. The 1989 Solvency Ratio Directive (subsequently modified by the 1996 Netting Directive) uses the definitions of the Own Funds Directive to set minimum standards of capital adequacy to be met by EU banks, by establishing a common method of assessing the ability of banks to meet credit losses arising from customer default. Its provisions are aligned with the requirements on capital standards drawn up by the Basle Committee, formed by the Central Bank Governors of the G-10 countries[16].

The 1995 post-BCCI Directive requires EU member states to adopt certain measures tightening up the supervision of conglomerate financial institutions. These include requirements that:

- Where a financial organisation (bank, insurer or investment company) is part of a group, the structure of the group must be sufficiently transparent to enable it to be effectively supervised;
- The head offices and registered offices of banks and insurers must be located in the same member state (which was not the case with BCCI);
- Auditors must report any irregularities which they discover when carrying out their duties, with indemnity from liability for any breach of confidentiality.

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[12] Council Directive of 17 April 1989 on the own funds of credit institutions (89/299/EEC). OJ L 124 of 5 May 1989, p16.
[13] Council Directive of 18 December 1989 on solvency ratios (89/647/EEC). OJ L 386 of 30 December 1989, p14.
[14] One of the most notorious recent bank failures was that of the Bank of Credit and Commerce International (BCCI), which collapsed in 1991 with serious consequences for hundreds of thousands of depositors worldwide and losses estimated at over US $5 bn.. This failure disclosed serious weaknesses in banking regulation, particularly of banks operating internationally.
[15] Council Directive on prudential supervision (95/26/EC).
[16] Currently Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the UK and the USA.

Protection of Consumers' Deposits

One important aspect of consumer protection not covered in the Second Banking Directive was the need for consumers' deposits to be protected in the event of bank failure. In the past, many EU member countries have operated their banking regulatory systems on the basis that no major bank should be allowed to fail. However, changes in regulatory structures and the increasing exposure to market forces have meant that the 'too-big-to-fail' syndrome is becoming increasingly outdated. While governments and central banks still come to the rescue of some big banks when they are in trouble – usually as a consequence of unsound lending – the failure of the Luxembourg-registered BCCI and a number of other banks has caused actual loss and widespread unease.

Quite apart from the absence of any kind of bank deposit protection scheme in a number of EU countries, those which did exist varied widely in their provisions – for example, in the maximum amount covered and in whether all of the deposit is covered or only a percentage. The European Commission's first attempt to deal with this was a non-binding Recommendation[17] which asked member states with actual or proposed bank deposit protection schemes to meet certain criteria, by the beginning of 1990[18].

However, this Recommendation proved to be very much an interim measure and binding legislation was enacted in the 1994 Bank Deposit Guarantee Scheme Directive, to be implemented in national laws or regulations by 1 July 1995[19]. This standardises bank deposit protection arrangements throughout the EU and requires all banks to be covered by a deposit protection scheme in the country in which they are authorised.

In the event of the failure of a bank, a national deposit guarantee scheme must provide each depositor with at least 90% of the protected deposit up to a minimum deposit level of ECU 20,000 (c.C$30,800), though this figure may be fixed at the reduced level of ECU 15,000 (c.C$23,100) for a transitional period of five years. All a depositor's deposits in a bank are aggregated for the purposes of these figures, irrespective of the number or location of accounts held. Other provisions in the Directive cover the speeding up of payments and depositors' rights of action against a protection scheme. There is nothing to prevent individual member states from having deposit protection schemes which are more generous than the minimum standards laid down in the Directive.

The preparation and passage of this Directive was accompanied by a surprising degree of controversy and by strong opposition from the German government, which considered that the proposals were anti-competitive and unfair and threatened to challenge the decision in the European Court of Justice. It eventually backed down, though it has yet to implement the

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[17] A recommendation issued by the European Commission to governments or to other parties has some moral force but no legislative basis. Governments of member states are not required to translate its terms into national legislation, though the Commission may sometimes threaten that if a recommendation is not acted upon, it will form the substance of a later binding Directive.

[18] European Commission Recommendation concerning the introduction of deposit-guarantee schemes in the Community (87/63/EEC) of 22 December 1986. OJ L 33 of 4 February 1987, Brussels.

[19] Council Directive of 30 May 1994 on bank deposit guarantee schemes (94/19/EC).

Directive's provisions in national law. Denmark, France and Italy also thought that the minimum level of protection was too low.

Payment Cards and Electronic Money

The consumer problems that have arisen in the EU (and, indeed, in other countries) in relation to the terms and conditions on which payment cards are issued by banks, other financial services organisations and retailers include the following:

- The failure to provide consumers with a written set of terms and conditions, or with written terms and conditions that are easy to read and expressed in plain language;
- Issuing payment cards to consumers without being asked to do so;
- Slack procedures in delivering the payment card and/or associated Personal Identification Number (PIN) to the consumer, so that one or both get stolen or intercepted on the way;
- The financial liability placed on the consumer if the payment card and/or PIN are lost or stolen and used by an unauthorised person to obtain money or goods and services;
- The difficulties facing the consumer in proving that a particular use of the payment card was not authorised by her or him;
- The failure to provide a 24 hour, 365 day, year round system for consumers to notify the loss or theft of a payment card and/or PIN;
- The failure of payment card issuers to take full responsibility if their equipment develops mechanical or electronic faults (for example, if the consumer receives less money from a cash dispenser than the amount debited against her or his bank account);
- Inadequate procedures for resolving disputes between consumers and card issuing financial organisations.

A few countries have taken legislative action to deal with these problems. The USA was first in the field with the Electronic Funds Transfer Act 1978 (and the associated Federal Reserve Board Regulation E). This was passed in the very early years of electronic banking, when there was little experience to go on. The Danish Payment Cards Act, first passed in 1984 and revised in 1994, is much more wide ranging and is described in the report on Denmark and Sweden.

In some other countries outwith the EU, the approach has been through non-statutory codes of practice. In New Zealand, a Code of Practice to Cover the Issue and Use of Electronic Funds Transfer Cards was first issued by the Bankers' Association in 1987. Though non-statutory, the Code provides for its review by the government Ministry of Consumer Affairs. In Australia, there is an Electronic Funds Transfer Code of Conduct issued by the Australian Bankers' Association. Again, this is non-statutory but is subject to review by the government.

At EU level, there has been considerable debate about the strategy which should be adopted to deal with payment card problems. Consumer organisations pressed for a legally binding Directive but the European Commission decided in 1988 to issue a non-binding Recommendation on Payment Systems[20] . All the preparatory work was carried out by the Commission with the intention that there would be a legally binding Directive, but at a late stage and after intensive lobbying by the banking industry this was abandoned in favour of a 'soft law' Recommendation.

The Recommendation covers the use of payment cards to withdraw cash or make deposits in ATMs (Automated Teller Machines) and to pay for goods and services in EFTPOS (Electronic funds Transfer at Point of Sale) systems. It also included electronic home banking and paper-based card systems, but excludes the cheque guarantee function of plastic cards.

The main thrust of the Recommendation was to urge that by 17 November 1989 card issuers and payment systems providers should comply with the provisions set out in the Annex to the Recommendation, the most important of which concerned the need for a clear written contract, the allocation of liability for loss between the consumer and the card issuer when use of the card was unauthorised and notification of fees and charges. The Commission warned that if, after twelve months, it found that implementation was unsatisfactory it would take unspecified "appropriate measures".

A review in 1990 of the implementation of this Recommendation showed that there was at the time extensive failure to comply by a number of card issuers, with great variability between member countries[21] . A second review published in 1995 showed that there was still widespread non-compliance by banks, retailers and other payment card issuers with many of the provisions, as well as continuing wide variation in implementation between different member countries[22] .

In spite of this considerable degree of non-compliance with the Recommendation, the Commission did not move in the direction of a binding Directive. Instead, in July 1997 it issued a revised Recommendation extended to include all electronic payment instruments as well as payment cards[23]. The scope of the provisions now brings in reloadable electronic money instruments, including stored-value cards and and electronic tokens stored on network computer memory – that is, electronic purses and cyber-money.

The Recommendation states that the issuer of an electronic payment instrument should draw up a written contract written in plain language and in a readily comprehensible form, including a description of the payment instrument, the financial limit if any, a description of the holder's and issuer's respective obligations and liabilities, debit and credit periods (including the value date), charges (including initial and annual fees, commission and interest rate), the period of time

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[20] Commission Recommendation of 17 November 1988 concerning payment systems, and in particular the relationship between cardholder and card issuer (88/590/EEC). OJ L 317 of 24 November 1988, p55.
[21] Charlotte Knobbout-Bethlem. A survey of the EC-Recommendation concerning payment systems. 1990, Mollengraaff Institute for Private Law, University of Utrecht, Netherlands.
[22] Jeremy Mitchell and W H Thomas. Payment card terms and conditions in the European Union. 1995, Consumer Policy Research Report No.3, International Consumer Policy Bureau, Edinburgh.
[23] Commission Recommendation of 30 July 1997 concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder (97/489/EC). OJ L 208 of 2 August 1997, p52.

allowed for disputing a transaction and redress and complaints procedures. If the instrument can be used abroad, the holder must also be told what charges are made for foreign currency transactions and the reference exchange rate used.

The Recommendation also sets out the information which the issuer should give to the holder after a transaction, including a way of identifying the transaction and the acceptor, the amount, any specific charges levied and, for foreign currency transactions, the exchange rate used.

The holder's obligations focus on the care to be taken when using the instrument, including not recording a PIN (Personal Identification Number) or other code in any easily recognisable form and notifying of loss or theft without delay. Before such notification, the holder may be liable for up to a limit of ECU 150 (c.C$231), though this limit does not apply if the holder acted with extreme negligence or fraudulently. After notification, or if the instrument has been used without physical presentation or electronic identification, the holder has no liability.

The issuer may alter the terms of the contract after giving sufficient notice and the holder may be deemed to have accepted after a period of not less than one month. However, interest rate changes are not subject to this delay. The issuer should not disclose the holder's PIN or other code or send out an unsolicited payment instrument. Also, the issuer should keep proper audit trail records and ensure that the holder can notify loss or theft at any time of day or night, when all reasonable action must be taken to stop further use of the instrument. The issuer should be liable for the non-execution or defective execution of a transaction and for unauthorised transactions and errors for which he is responsible.

In some respects, the obligations on issuers of electronic money instruments are lighter than on issuers of conventional payment cards, on the basis that electronic money is the equivalent of cash. There are no limits on the holder's loss if the instrument is lost or stolen and the issuer is not obliged to stop further use of the instrument when this happens. Also, only the last five transactions have to be verifiable by the holder. However, these relaxations do not apply if value can be loaded on to the instrument through direct access to the holder's account.

Finally, there is a provision inviting member countries to make sure that there are adequate and effective means for the settlement of disputes between a holder and an issuer. From the consumer viewpoint, this is very inadequate, as a number of EU member countries do not have such alternative dispute resolution procedures in place.

The date for implementation of the Recommendation is 31 December 1998. Once again, the Commission says that it will monitor implementation and that if this is unsatisfactory it will put forward proposals for binding legislation. However, in view of the Commission's previous reluctance to take this step in the face of opposition from the banks, consumer representatives may be forgiven for viewing this statement with considerable scepticism.

Cross-border Payments

The European Commission's objective is to break down the existing obstacles which make it difficult, uncertain and expensive, not only for consumers, but also for small and medium sized

enterprises, to make payments across national frontiers within the EU. The achievement of an efficient single European market for cross-border payments is considered important both in its own right and as a necessary condition for the unhindered movement of goods, services and people throughout the EU.

Five main problem areas have emerged:

- Cross-border payments are sometimes slow and uncertain – and occasionally never reach their destination;
- The proportion of lower value payments absorbed by charges is often high;
- Cross-border payments are sometimes subject to double charging, which occurs when charges are levied on the beneficiary customer even when the originating customer has instructed that all charges should be debited against her or his own account and the originator's bank has accepted these instructions;
- The quantity and quality of information available to originator and beneficiary is often inadequate;
- Customers do not have any effective redress if payments are unduly delayed or lost as independent, comprehensive, well-publicised and effective redress systems for dealing with complaints do not exist in all EU member states.

Evidence on the nature and extent of these problems is provided by research studies carried out by BEUC in 1992 and by Retail Banking Research Ltd in 1993[24] and 1994[25]. Results from the three studies are consistent in showing the problems that consumers face, as outlined above.

The first attempt to deal with these problems took the form of a Commission Recommendation[26], which was followed by the publication of industry guidelines prepared by the European banking trade associations. These were annexed to a Commission working document on *Easier cross-border payments: breaking down the barriers*[27] and were intended to be implemented by 31 December 1992. A Communication from Commissioners Vanni d'Archirafi and Christiane Scrivener was adopted by the Commission on 14 December 1993. This allowed the banks an extended timetable to achieve improved performance and transparency and warned that if this did not take place on a self-regulatory basis the Commission would be ready to put forward a Directive.

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[24] Remote cross border payment services: transparency in conditions offered and performance of transfers executed. retail Banking Research Ltd, 1993, London.

[25] Study in the area of payment systems into the transparency of conditions for remote cross-border payment services and the performance of cross-border transfers. Retail Banking Research Ltd, 1994, London.

[26] Commission Recommendation of 14 February 1990 on the transparency of banking conditions relating to cross-border financial transactions ((90/109/EEC). OJ l 67 of 15 March 1990, p39.

[27] SEC(92)621 final. European Commission, Brussels.

The banks did not get their act together in time and, against their strong opposition, a binding Cross-border Credit Transfers Directive was adopted at the beginning of 1997 for implementation in national laws by 14 August 1999[28] (an unusually long implementation period, to allow banks and other financial services organisations to modify their systems). This lays down standards of information, performance and compensation for cross-border credit transfers, which are a growing way of transferring money abroad and are tending to replace banker's drafts and cheques for this purpose.

The scope of the Directive covers all cross-border credit transfers up to ECU 50,000 (c.C$77,000) in value carried out at the request of originating customers, either individual consumers or firms. It deals with information that must be provided both before and after a transaction. Beforehand, the bank (or other financial services organisation) must make available to an actual or prospective customer in writing and in a readily comprehensible form:

- The time needed for funds to be credited to the beneficiary customer's bank, and when that period starts;
- The time needed on receipt of a cross-border credit transfer for the funds credited to a bank to be credited to the beneficiary's account;
- How any commission, fees or charges are calculated, including the rate where appropriate;
- The value date, if any, applied by the bank;
- Details of complaints and redress procedures and access arrangements;
- The reference exchange rates used.

Unless the customer expressly forgoes it, the bank must supply the following information after:

- A reference enabling the customer to identify the transaction;
- The amount transferred;
- The amount of all charges and fees payable by the customer;
- The value date, if any, applied.

The performance standard laid down is that the originating customer's bank must deliver the credit transfer to the beneficiary customer's bank within six working days, unless the originating customer specifically agrees to another timetable. If the transfer takes longer, there are provisions for the payment of interest.

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[28] Directive of the European Parliament and of the Council of 27 January 1997 on cross-border credit transfers (97/5/EC). OJ L 43 of 14 February 1997, p25.

Charges and fees are normally payable by the originating customer and money must not be deducted from the amount transferred unless the originating customer has specifically indicated that some or all of the charges are to be paid by the beneficiary (this is to overcome the double charging problem). Sums wrongly deducted in breach of this prohibition must be reimbursed. If the transfer never arrives at the beneficiary's bank, the originator's bank must reimburse the originator within 14 days of his or her request, up to a ceiling of ECU 12,500 (c.C$19,250) plus interest and any charges levied.

Banks are released from their obligations under the Directive in cases of *force majeure* (though it will be interesting to see whether millennium bug problems qualify under this heading). EU member states are required to ensure that there adequate and effective complaints and redress procedures for settling disputes.

Consumer Credit

Consumer credit was the first financial service to be the subject of specific EU consumer protection legislation. The Commission's work started back in 1979, along the lines of the old approach, involving detailed harmonisation. The First Consumer Credit Directive was eventually adopted at the end of 1986, with an implementation date of 1 January 1990[29]. It does not cover mortgage credit and its main provisions are diluted for bank overdrafts. Credit agreements for less than ECU 200 (c.C$308) and more than ECU 20,000 (c.C$30,800) are outwith its scope.

The content of this First Directive was weakened at a late stage in its passage, following national and international lobbying by the banking and financial services industries and opposition by some EU governments to many of the detailed harmonisation provisions. Provisions that were cut out of the text of the Directive before it was adopted included connected lender liability, compulsory licensing of lenders and general protection of consumers from unfair credit contract terms.

Information on the Cost of Credit

The Directive's key provisions are about information on the cost of credit and are designed to deal with the situation in which different lenders quote the cost of credit in widely differing ways – or not at all in some cases. If an advertisement for credit includes a rate of interest or any figures about the cost of credit, then it must also include the Annual Percentage Rate of charge (APR). All credit agreements must be in writing and include both the APR and (for agreements where the APR may change during the course of the loan) a statement of the conditions under which the APR may be changed. However, "where it is not possible" to state the APR, the consumer should be told the annual rate of interest – that is, the 'flat' rate of interest which does not take any account of repayments made during the course of the loan. This first diluted provision involving the use of a flat rate of interest also applies to bank overdrafts.

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[29] Council Directive of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit (87/102/EEC). OJ L 42 of 12 February 1987, p48.

There was a second diluted provision in the First Consumer Credit Directive which allowed member states which did not have an established method of calculating APR to require only the total cost of credit to be indicated. The decision on a common, EU-wide method of calculating the APR was deferred and it was left to member countries to continue to use their existing rules either for calculating the APR or for otherwise indicating the cost of credit.

The question of establishing a common method of calculating APR was tackled in the Second Consumer Credit Directive, adopted in February 1990 for implementation by the end of 1992[30]. This amends the definition of the total cost of credit to the consumer to include interest and other charges (with some specified exceptions) which the consumer has to pay for credit and requires that the APR shall be calculated according to the mathematical formula that is set out in Annex II to the Directive.

There are, however, continuing difficulties with some member countries which use different formulae for calculating APR – notably France, which uses the 'nominal' actuarial method, and Germany, which uses the '360-day' calculation. These technical problems continue to drag on, but may be within sight of resolution. The 1997 Commission Communication on *Financial services: enhancing consumer confidence* set out a commitment to review the 1987 Consumer Credit Directive. This has been followed up by an agreement between the European Parliament and the Council at the end of 1997 on the Proposal for an amending Directive put forward by the European Commission[31]. This agreement (or Common Position) has as it main points the adoption of a single, EU-wide mathematical formula for calculating APR to at least one decimal and a common method of calculating the duration of a year. Also, there will be further work on which cost elements should be included within the APR.

Fair Credit Contract Terms

The approach to dealing with contract terms in credit agreements must of course be consistent with the approach that is adopted in general law dealing with fairness in contracts. In EU law, this is the 1993 Unfair Contract Terms Directive[32]. One important provision of this requires that all standard contracts should be written in plain, easily understood language. Art.5 provides that "...in the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language. Where there is doubt about the meaning of a term, the interpretation most favourable to the consumer shall prevail."

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[30] Council Directive of 22 February 1990 amending Directive 87/102/EEC for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit (90/88/EEC). OJ L 61 of 10 March 1990, p14.

[31] COM(96) 79 final of 12 April 1996, Brussels.

[32] Council Directive of 5 April 1993 on unfair terms in consumer contracts (93/13/EEC). OJ L 95 of 21 April 1993, p29.

While the Consumer Credit Directives do not contain any general prohibition on the use of unfair contract term, they do cover some specific points:

- The consumer must receive a written copy of the credit agreement (Art. 4 (1)).
- The written credit agreement must include details of the amount, number and frequency or dates of the repayments which the consumer must make, as well as of the payments for interest and other charges, together with (where possible) the total amount of these payments (Art. 4(2)(c)).
- Art. 4(3) requires that the written credit agreement shall include "...other essential terms of the contract." In Annex 1 there is an illustrative list of terms which EU member states may require to be included in written credit agreements – for example, a description of the security required, if any.

There is thus no EU-wide standardisation of the form of the terms in consumer credit contracts, though there is an element of standardisation within some countries – for example, Austria, France, Greece and the Netherlands.

The contract terms and conditions for credit and other payment cards present special problems, which have been dealt with above under payment cards.

Early Repayment

Many consumers – especially in Germany – wanting to repay their loans early have encountered problems. Either this has been forbidden by the credit contract, or the consumer has found that she or he has had to pay the total cost of the credit, in spite of the fact that the loan has not run its full course. These issues are dealt with to some extent in the First Consumer Credit Directive. Art.8 gives the consumer the right "...to discharge his obligations under a credit agreement before the time fixed by the agreement." It also says that the consumer "...shall be entitled to an equitable reduction in the total cost of the credit. " However, it does not lay down how that reduction should be determined. Different EU countries have therefore gone about this in different ways. Some countries have introduced a formula for the way in which the rebate shall be calculated. In general, there are no penalties for early repayment, but in some countries limited charges are allowed, if they are stated in the credit agreement.

Repossession

Another set of problems can arise when the consumer is unable to maintain the repayments on a loan and the bank or other financial organisation repossesses the goods which have been bought with the credit. This is dealt with by Art.7 of the First Consumer Credit Directive, as follows:

> *"In the case of credit granted for the acquisition of goods, Member States shall lay down the conditions under which the goods may be repossessed, in particular if the consumer has not given his consent. They shall further ensure that where the creditor*

recovers possession of the goods the account between the parties shall be made up so as to ensure that repossession does not entail any unjustified enrichment."

Again, different EU countries have implemented this in different ways, including the following:

- Repossession is forbidden without a court order;
- Repossession is forbidden after a certain time, or after a certain percentage of the price has been paid;
- Repossession can only be carried out if the consumer is endangering the goods or preparing to leave the country;
- Notices of repossession must be in writing and sent in advance.

It should be emphasised that repossession only applies to hire purchase and other forms of credit granted against the purchase of specific goods. It does not apply to free-standing credit or credit cards.

Licensing

Earlier drafts of the First Consumer Credit Directive provided that all financial services organisations either offering credit or offering to arrange credit should be officially authorised – that is, that there should in effect be a licensing system. However, this was watered down at the last minute following lobbying from the industry. In the final text, Governments are required *either* to ensure that there is official licensing of lenders, *or* to ensure that lenders are officially inspected, *or* to promote the setting up of bodies to handle consumer complaints and provide consumer information.

The outcome is a wide variety of arrangements in EU countries, too complex to be summarised here. The issue of licensing has not in fact been dealt with at an EU level, though it is in place in some countries, including Belgium, Ireland and the UK. The arguments in favour of a licensing system are that it deters unscrupulous and crooked operators from coming into the field of consumer credit and that it enables sanctions to be taken against those who are in breach of regulations. The arguments against are that it is expensive and bureaucratic to administer.

Insurance

The European Commission's goal in the insurance sector is in principle the same as in the banking sector – that is, that an insurer based in any member country has a right, under Art.59 of the Treaty, to sell in any other member state the kinds of insurance which it is authorised to sell in its own country. However, the obstacles to achieving this end have been greater for insurance than for banking, because of the deeper involvement of the governments of many member states in complex national regulatory systems for insurance.

These countries, notably Germany, have argued that any insurer selling insurance in another EU country should be subject to the host country's national laws and regulations, should be properly established in the host country and should be authorised by the host country's national regulatory authority. However, the Commission's approach has been strongly supported by a minority of member states, notably the Netherlands and the UK. It is no coincidence that Dutch and British insurance companies, which have long operated in more competitive national environments, stand to gain from the opening up of insurance markets in other EU countries.

The consumer interest in the overall strategy is to assess the trade-off between the possible benefits of greater competition and the possible weakening of consumer protection. It is not an easy assessment to make, especially as the price benefits from greater competition are difficult to quantify. There has therefore been an understandable emphasis by consumer organisations on not losing the consumer protection elements in existing regulatory systems.

The First Insurance Directives

The European Commission's initial strategy was to build a framework within which insurers authorised in one EU member country could establish branches in other member states by way of multiple authorisation. The first step was the adoption of the 1973 First Non-Life Insurance Directive[33]. This laid down a division of responsibility between the regulatory authorities in the home country where the authorised insurer's head office is situated and in the host country in which it planned to open branches, as well as minimum solvency margins.

A roughly similar First Life Insurance Directive was adopted in 1979[34]. The interval of six years between these two Directives arose mainly because of the very different approach adopted by EU member states to composite insurers – that is, insurers who carry on both non-life and life business. Some countries prohibit or exercise extremely tight controls over composites, on the grounds that life insurance funds might be put at risk if they are used within a composite to meet the insurer's bad experience of non-life risks, which tend to follow a cyclical pattern but with large elements of unpredictability. The eventual compromise adopted was to forbid new composites, but to allow existing ones to continue in business if that was provided for in a country's national regulations.

Neither of these First Directives explicitly provided for an insurer's right to supply insurance across the EU's internal frontiers. Also, they did not deal with important issues such as marketing and selling practices ('conduct of business') or control of policy conditions and premiums. They had little impact in insurance markets apart from codifying a qualified freedom of establishment.

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[33] First Council Directive of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life assurance (73/239/EEC). OJ L 228 of 16 August 1973, p3.

[34] First Council Directive of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance (79/2657/EEC). OJ L 63 of 13 March 1979, p1.

The Schleicher Case

There then followed an important test case in the European Court of Justice, the 1986 Schleicher Case, in which the European Commission challenged provisions in German law which required an insurer covering a risk in Germany to be authorised and established in Germany[35] . Similar cases were taken against three other EU member states, Denmark, France and Ireland.

In its judgment, the Court emphasised that insurance is a specially sensitive area so far as policyholder protection is concerned. There might therefore be imperative reasons which could justify member countries' restrictions on freedom to provide insurance services. Host countries, though not entitled to require insurers to be established on their territory, might nevertheless be justified in imposing their own authorisation procedures. However, any conditions attached to authorisation of an insurer from another member state had to be objectively justifiable and should not replicate the home country's regulatory requirements. As one of the exceptions, the Court said that controls might be exercised by the host state for policyholder protection reasons, though this need for protection might not be the same in every instance. However, a high level of host state control might be justified for 'mass risks' because of the difficulty that the individual consumer or small business faced in ensuring that she or he was properly protected and in judging whether the insurer would be able to meet its long-term obligations.

This extremely complex judgment, which is only summarised here, settled the point in the Commission's favour that the freedom to supply insurance services stemmed directly from the Treaty and did not depend either on prior harmonisation of laws or on the insurer being established in the host country. However, it left the European Commission with the problem of finding a legal framework which would distinguish situations in which buyers of insurance might need 'special protection' from situations in which such protection is not necessary. The subtext of the policy debate has been how to prevent 'special protection' being invoked by some member states as a way of preserving insulated national insurance markets and keeping out competition from other EU member countries.

The Second Insurance Directive

The European Commission set out to tackle this set of difficulties by attempting to define situations in which, in the context of the Schleicher Case judgment, special protection of the policyholder is *not* needed. The 1988 Second Non-Life Insurance Directive[36] distinguishes between 'large risks'. where insurance is taken out by medium and large businesses, and 'mass risks', covering the insurance needs of small businesses and individual consumers, with the aim of making it possible for large risks to be insured across the EU's internal frontiers. The definition of a large risk depends partly on the nature of the risk, including all transport risks

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[35] Case 205/84, *ECR* 3755 at 3803 No.30 – European Commission v Germany.

[36] Second Council Directive of 22 June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life insurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 72/239/EEC (88/357/EEC). OJ l 172 of 4 July 1988, p1.

other than road vehicles and all credit and suretyship risks, and partly on the size of the business, with detailed criteria relating to balance sheet assets, turnover and number of employees.

This Directive still left it open to any host member country to require a non-established insurer to seek authorisation and to comply with host country rules It therefore left existing national regulatory systems largely intact and did not differentiate genuine consumer safeguards from measures which inhibit foreign competition.

In the life insurance sector, the 1990 Second Life Insurance Directive did not follow the route of distinguishing between ‘large risks’ and ‘mass risks’, but set out a distinction between the ‘active’ and ‘passive’ purchaser of insurance[37]. It defined the active consumer as someone who either makes a direct approach to an insurer established in another member country, or makes such an approach through an insurance intermediary established in his or her own country. Such a consumer is not held to be in need of the ‘special protection’ cited in the Schleicher Case judgment, and must sign a pre-contractual statement confirming her or his awareness that the insurer is subject to the regulatory controls of the country in which it is established rather than the consumer’s own country.

Insurance sold on a cross-border to ‘passive’ consumers (the overwhelming majority) may still be subject to national host country regulations which are justified on policyholder protection grounds, to the extent that the insurer’s *home country* rules are insufficient to achieve the “necessary level of protection”, left undefined.

It hardly needs to be said that the complex provisions of the Second Non-life and Life Directives did not provide a workable basis for the establishment of a true single insurance market and the European Commission soon moved forward with fresh proposals.

The Third Insurance Directives

The 1992 Third Non-Life and Life Insurance Directives emulate the approach that the European Commission has taken on banking, in that they provide for a single authorisation ‘passport’, so that an insurer authorised in one member state is free to open branches and provide insurance services on a cross-border basis without further authorisation[38] [39] . Initial authorisation and continuing prudential control are the responsibility of the insurer’s home state. Host countries no longer have the right to require prior approval of premiums or policy conditions. However, in

[37] Second Council Directive of 8 November 1990 on the coordination of laws, regulations and administrative provisions relating to direct life assurance. laying down provisions to facilitate the effective exercise of freedom to provide services and amending Directive 79/267/EEC (90/619/EEC). OJ L 330 of 29 November 1990, p50.
[38] Council Directive of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC (92/49/EEC). OJ L 228 of 11 August 1992, p1.
[39] Council Directive of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC. OJ L 360 of 9 December 1992, p1.

deference to the Schleicher Case judgment, they are still able to forbid the sale of insurance contracts which conflict with their "legal provisions protecting the general good".

These vague general good provisions continue to give trouble in the insurance sector, as they do in banking. The European Commission thinks that some member states abuse the concept to enforce rules that effectively restrict the freedom of insurers established in other EU member countries to provide services. One example is that some member states only allow tax deductions on premiums when the policy is concluded with an insurer established in that member state. The Commission is therefore currently engaged in drawing up an "Interpretative Communication" setting out its intentions in relation to the general good provisions. It remains to be seen what weight will be given to such a statement by the European Court of Justice in any test case that comes before it.

Both Directives had an implementation date of 1 July 1994 and were complemented by a Directive which laid down a common system for the publication of adequate and comparable information on insurers' activities and financial positions as a basis for coordinating national rules on prudential supervision[40].

The main explicit consumer information provisions in the Third Non-Life Insurance Directive are that the insurer must tell the consumer which national law will apply to the contract and what arrangements there are for handling complaints. The information requirements set out in Annex II of the parallel Life Directive are much more extensive. They include:

- The name, legal status and address of the insurer, the member state in which the head office and (where appropriate) the relevant branch or agency is located;
- Definition of each benefit and option;
- Contract duration and ways in which the contract may be terminated;
- Ways in which premiums may be paid and duration of payments;
- Ways in which bonuses are calculated and paid;
- Indication of surrender and paid-up values and the extent to which these are guaranteed;
- Information on the premiums for each benefit, both main benefits and any supplementary benefits;
- For unit-linked policies (i.e. policies linked to mutual funds), definition of the units to which the benefits are linked;
- Indication of the nature of the underlying assets for unit-linked policies;

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[40] Council Directive of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (91/674/EEC). OJ L 374 of 31 December 1991, p7.

- Arrangements for the application of the cooling-off period (specified as 14 to 30 days);
- Information on any relevant tax arrangements;
- Arrangements for handling complaints by policyholders, lives assured or beneficiaries including (where appropriate) the existence of a complaints body, without prejudice to the right to take legal action;
- The law applicable to the contract where the parties do not have a free choice or, if there is a choice, the law the assurer proposes to choose;
- Any change during the contract term in the name of the insurer, its legal status or address;
- Any change during the contract term in policy conditions or relevant law;
- Annual information on the state of bonuses.

Any further compulsory information may only be required by a member state "...if it is necessary for a proper understanding by the policyholder of the essential elements of the commitment".

While the main thrust of the European Commission's efforts in the insurance sector has been to secure the freedom of the insurer to operate without hindrance throughout the EU, the pair of Third Directives do something to take account of consumer protection needs, especially in relation to transparency and consumer information. Many national regulations which have stifled competition and innovation, and have thus contributed to unnecessarily high premiums in some member countries, are being swept away as the Directives are implemented in national law. It is still not clear whether any essential elements of consumer protection have also gone by the board and whether more genuinely competitive insurance market will ensue, with enhanced value for money for consumers.

Motor Insurance

Motor insurance is outwith the scope of the Non-Life Insurance Directives, primarily because each member state has a different system of civil liability. Through the First[41], Second[42] and Third[43] Motor Insurance Directives, the EU has developed a system of law on compulsory motor insurance which is harmonised to a considerable extent. The main consumer characteristics of this are:

- Motor liability insurance is compulsory in each EU member state;

[41] First Council Directive of 24 April 1972 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles(72/116/EEC). OJ L 103 of 2 May 1972, p1.
[42] Second Council Directive of 30 December 1983 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles(84/5/EEC). OJ L 8 of 11 January 1984, p17.
[43] Third Council Directive of 14 May 1990 on the approximation of the laws of the Member States relating to insurance against civil liability in respect of the use of motor vehicles (90/232/EEC). OJ L 129 of 19 May 1990, p33.

- A policy valid in any one member state must be valid in any other member state;
- A policy must cover liability for personal injuries and property damage, above certain minimum levels of cover;
- National guarantee funds must provide compensation for at least these minimum levels for injury or damage caused by uninsured drivers;
- National guarantee funds are forbidden from requiring victims of uninsured drivers to establish that the person liable is unable or refuses to pay;
- Compensation to victims should not be delayed by disputes between the guarantee fund and a civil liability insurer as to who is liable to pay;
- Those involved in a road accident must be able to identify the insurers of the vehicles involved.

A draft of a Fourth Directive is currently under consideration. It is aimed at overcoming problems encountered by the consumer in seeking to make a claim for compensation for loss or injury suffered as a result or a road accident in another member state, where the victim may be unfamiliar with the law, procedure or language.

There is also a 1990 Motor Insurance Services Directive[44]. This is broadly equivalent to the Second Non-Life Directive and is of little direct consequence to the individual consumer, in that it provides qualified freedom for motor insurers to sell insurance on a crossborder basis.

Intermediaries

There are wide variations among EU member countries in the way in which insurance is sold. In general, there are three different channels of distribution:

- Direct sales by the insurer’s own sales force;
- Sales by agents appointed by the insurer;
- Sales through independent intermediaries.

The relative importance of these three channels differs greatly, as does the pattern and intensity of national regulation and the legal status of the intermediary (for example, whether the intermediary is acting as the agent of the insurer or the insured).

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[44] Council Directive of 8 November 1990 amending, particularly as regards motor vehicle liability insurance, Directive 73/239/EEC and Directive 88/357/EEC which concern the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance (90/619/EEC). OJ L 330 of 29 November 1990, p44.

From the consumer viewpoint, intermediaries often play a critical role in providing information and advice about the kind and level of insurance, as well as the choice of insurer. Indeed, the complexity of insurance products may mean that consumers are unwise to enter into a substantial insurance contract without guidance from an intermediary. However, relationships and responsibilities are frequently lacking in transparency, not least because intermediaries are often remunerated by the insurer on a commission basis, even though such charges are eventually paid explicitly or implicitly by the consumer.

An early start was made on the intermediaries sector with the adoption of the 1976 Intermediaries Directive[45], intended to provide for the freedom of establishment of intermediaries and their freedom to offer insurance services on a crossborder basis. The Directive divides insurance intermediaries into three types, brokers, agents and sub-agents. It provides for mutual recognition by the host member state of an intermediary's knowledge and ability, good repute and non-bankrupt status acquired in the home member state. All member states are required to designate "competent authorities" for the issue of certificates to intermediaries who meet these criteria. From the consumer viewpoint, this certification process can be said to meet a necessary but minimum level of consumer protection.

This Directive was followed up by a non-binding 1991 Council of Ministers Recommendation on Insurance Intermediaries[46]. This asks member states to make sure that insurance intermediaries established on their territory are subject to professional requirements and registration, and in particular that they should:

- Possess general, commercial and professional knowledge and ability;
- Enjoy professional indemnity insurance (that is, where the consumer has been the victim of negligence by an intermediary, she or he can seek compensation);
- Be of good repute;
- Not have been previously declared bankrupt (unless rehabilitated);
- Be registered.

Only registered persons should be allowed to act as intermediaries and, to ensure compliance, adequate sanctions and enforcement measures should be put in place. Also, intermediaries who are brokers may be required to have adequate financial capacity.

The Recommendation clearly strengthens the consumer protection aspects of the preceding Directive. However, its effectiveness in practice depends on the extent to which its provisions are implemented by member states. Furthermore, the 1996 Commission Green Paper on *Financial*

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[45] Council Directive of 13 December 1976 on insurance intermediaries (77/92/EEC). OJ L 26 of 31 January 1977, p14.
[46] Council Recommendation on insurance intermediaries (92/48/EEC). OJ L 19 of 28 January 1992, p32.

services: meeting consumers' expectations identified the activities of unregulated intermediaries as a consumer hazard.

The subsequent 1997 Commission Communication on *Financial services; enhancing consumer confidence* lists a number of specific problems:

- It may not be clear for which company an intermediary acts;
- Information provided by an intermediary may not be clear or adequate;
- The cost of credit provided through an intermediary may be way above the market average;
- An intermediary may lack the competence and integrity needed to provide sensible advice;
- An intermediary may take advantage of consumers who are in a precarious financial position, and to whom alternative sources of credit are not available.

It is clear from this that the debate about the EU's policy is extending from insurance intermediaries to include intermediaries handling other types of financial service. Indeed, the Commission Communication makes a distinction between financial and insurance intermediaries and points out that, with the exception of activities falling within the scope of the Consumer Credit Directives, the activities of financial intermediaries are not at present covered by EU-level legislation, though they may be subject to national laws.

Future Steps on Insurance Intermediaries

The Commission has therefore undertaken to carry out a review of the Insurance Intermediaries Directive and Recommendation and to consider what further steps are needed, including the possibility of widening the scope of the Directive in relation to access to and exercise of the profession. The state of play of this review at the time of writing is that the Commission has produced a Working Paper[47]. This concludes by setting out three options for the future:

- Optimising the existing EU framework, with some sharpening up of the criteria;
- EU-wide harmonisation of rules governing access to the profession, for example in relation to training and competence requirements;
- Limited harmonisation and mutual recognition of registration requirements.

Each of these options falls short of the full 'passporting' approach adopted in banking and insurance provision, but would mean some strengthening of consumer protection, though much

[47] Draft working paper on insurance intermediaries (XV/2072/97 rev.1). European Commission, Brussels,18 September 1997.

would depend on what minimum standards might be set for EU-wide registration. Clearly, there might be some reduction in levels of consumer protection if member states were forbidden to impose registration or authorisation requirements above the minimum.

Future Steps on Financial Intermediaries

For what it calls financial intermediaries, the Commission is committed to considering regulation dealing with access to the profession (for example, qualification requirements and compulsory licensing or registration), exercise of the activity (for example, information disclosure) and the relationship between the financial services organisation and the intermediary. Given the complexity and variety of existing national situations in different EU member states, it may be some time before the debate in this area reaches any effective conclusion, though adequate protection is very much a consumer priority.

Investment

Wide variations in industrial structure and in national legal and regulatory systems contributed to the relatively slow development of an EU-wide framework for investment services. However, the financial sector 'troika' of law covering banking, insurance and investment was substantially completed with the adoption in 1993 of the Investment Services Directive[48]. The Directive came into force on 31 December 1995, though the date fixed for its implementation into national laws and regulations was six months earlier.

The Directive's aim is to allow an investment firm authorised in its own (home) state to open branches and conduct crossborder business in any other (host) member state on the basis of a single 'passport' licence issued by the home state, which is responsible for prudential regulation, including financial requirements and the fitness and properness of controllers. The host state is responsible for conduct of business rules (which must not of course discriminate against firms licensed in an other member state) and any additional requirements if these can be demonstrated as being in the "general good".

The core investment activities covered are:

- Transmitting orders (arranging deals);
- Executing orders (dealing on behalf of a client);
- Dealing for own account as principal;
- Discretionary portfolio management;
- Underwriting.

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[48] Council Directive of 10 May 1993 on investment services in the securities field (93/22/EC).

Other activities such as investment advice, safe keeping and safe custody may be added to a licence, in conjunction with core activities.

The financial instruments covered are:

- Transferable securities;
- Units in collective investment undertakings (roughly equivalent to mutual funds);
- Money market instruments (for example certificates of deposit, Treasury bills);
- Financial futures and options;
- Forward interest-rate agreements (FRAs);
- Interest-rate, currency and equity swaps.

The minimum prudential rules that should be applied by home state regulatory authorities are laid down in Art.10. Of particular importance from a consumer protection viewpoint are requirements that the investment firm should make adequate arrangements for safeguarding the ownership rights of funds and financial instruments belonging to investors and that the firm should "...structured and organised in such a way as to minimise the risk of clients' interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another." However, the prudential rules are set out in very general terms and leave plenty of room for differences in interpretation.

EU member states are required by Art.11 to draw up conduct of business rules which ensure that an investment firm:

- Acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market;
- Acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market;
- Has and employs effectively the resources and procedures that are necessary for the proper performance of its business activities;
- Seeks from its clients information regarding their financial situation, investment experience and objectives;
- Make adequate disclosure of relevant material information;
- Try to avoid conflicts of interest and, when they cannot be avoided, ensure that its clients are fairly treated.

Like the prudential rules, these conduct of business rules are expressed in very general terms and are open to differences in their detailed expression in national laws and regulations. For example, Art.11.1 requires member states to take into account the professional nature of the client for whom a firm is providing investment services. This has been interpreted by most countries to allow an exemption when investment firms are dealing with professional clients, but there is no common definition of the meaning of 'professional'.

However, there is no doubt that the requirement on EU member states to have conduct of business rules which follow the principles laid down in the Directive represents a major step forward in consumer protection, not least because many countries previously had nothing comparable. It is an example of an area in which the single market initiative has gone against the general deregulatory trend in leading to a tightening up of regulation.

It should be emphasised that the Investment Services Directive licensing requirements are not automatic and do not apply to all investment firms. A 'passport' has to be applied for by any firm which intends to operate outside its domestic national boundaries in another EU member state and the home state regulator must forward relevant information to its host state equivalent. The division of responsibility between home and host state regulators demands a high degree of cooperation among regulatory bodies and the framework for this is set out in the Directive.

Capital Adequacy

The Investment Services Directive is closely articulated with the 1993 Capital Adequacy Directive[49], which sets minimum capital requirements for investment firms operating within the scope of the Investment Services Directive and for banks. It breaks new ground by requiring such organisations to separate their assets into a banking book – roughly the equivalent of traditional lending, deposit-taking and long-term investment activities – and a trading book, with separate and differently calculated capital adequacy standards. This division enables a level competitive playing field to operate as between banks and investment firms.

Requirements for the 'passporting' of investment firms involve harmonised capital rules which take market risk into account. For example, there are lower minimum capital requirements for investment firms which are not authorised to hold clients' money or securities than for those that are. There are 'grandfathering' provisions for investment firms already in being before the implementation of the Directive. The Directive is currently being amended to take account of key elements in 1997 proposals on market risk put forward by the Basle Committee.

From the consumer viewpoint, the main benefit of the Capital Adequacy Directive is to enhance the financial soundness of investment firms, especially (but not only) through the requirement on investment firms to maintain financial resources, or 'own funds' at all times in excess of their capital requirements.

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[49] Council Directive of 15 March 1993 on capital adequacy (93/6/EC).

Investor Compensation

It has been something of an anomaly that the EU legislative framework has provided for protection of consumers' deposits in banks, there has been no equivalent in the investment sector. This has now been put right by the adoption in 1997 of the Investor Compensation Directive. Its purpose is to provide an EU-wide minimum level of compensation when an investment firm fails and is unable to meet its obligations. The detailed provisions are closely aligned with those for laid down for bank deposits in the Bank Deposit Guarantee Scheme Directive.

If an investment firm fails, the national investor compensation scheme must meet at least 90% of an investor's claim up to a ceiling fixed at not less than ECU 20,000 (c.C$30,800). National schemes which currently have a lower ceiling can use a ceiling of ECU 15,000 (c.C$23,100) for a transitional period until 31 December 1999. Individual member states may have deposit protection schemes which are more generous than the minimum standards laid down in the Directive. Some EU member states, notably Germany, have been critical of the low level at which the minimum ceiling has been set.

Branches of investment firms which are established in a host member state may join the host country's national scheme if it offers a higher level of compensation than the parent investment firm's home state scheme. However, for the present such branches will not be able to offer a higher level of compensation than that available under the host country's national scheme. banks which are also investment firms may join a single scheme, rather than both the banking and investment firm schemes.

This Directive offers improved consumer protection for investors in those EU member countries which did not previously have investor compensation schemes.

Collective Investments

There is one EU instrument which stands out rather oddly in that it deals with a particular type of investment product – UCITS, an acronym for Undertakings for Collective Investments in Transferable Securities. This is a term of art for collective investments very roughly equivalent to mutual funds in North America and unit trusts in the UK. Discussion of the preparation of a Directive went on from 1968 until the UCITS Directive was eventually adopted in 1985[50]. It is something of a hybrid between the old approach of detailed harmonisation and the newer one based on mutual recognition. It includes a number of detailed harmonisation provisions which are absent from the later framework Directives on banking, insurance and investment services, but nevertheless incorporates an early version of the passport principle in that a UCITS investment product which is properly authorised in one EU member state may be sold in others without separate authorisation.

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[50] Council Directive of 20 December 1985 on undertakings for collective investments in transferable securities (85.611.EEC). OJ L 375 of 31 December 1985.

To meet the definition of a UCITS, a collective investment must have at least 90 percent of the fund in quoted securities, with normally not more than 5 percent invested in any one company. the capital must be raised by way of offers open to the public who must be able to redeem or have their investment repurchased on request. A wide variety of funds lie outwith the UCITS criteria, including money market, currency and property-based funds, investment trusts which have quoted shares, investment clubs with restricted membership, closed-ended funds and funds based on derivatives such as futures and options.

A collective investment which does not meet the UCITS criteria is not prohibited and may be bought and sold domestically subject to the national rules which apply in the member state in which it is based. The difference is that it does not have the 'passport' attached to UCITS status and therefore requires separate authorisation in whichever country it is marketed.

There are some consumer information requirements. A UCITS has to publish a prospectus as well as half-yearly and annual reports. The minimum information which these must contain is laid down in two annexes to the Directive. Also, control over the marketing of a UCITS is in the hands of the host country, though the host country must not discriminate against a UCITS based in another EU member country. There remain wide national differences in the way that UCITS are priced (for example, single or dual pricing), tax treatment and distribution channels.

Plans for broadening the scope of the UCITS Directive have been on the stocks for some time but seem to have made little real progress, perhaps because there is no sense of political urgency about a measure whose contribution to the realisation of the single market is relatively modest.

3. The Future Consumer Protection Agenda

Work in progress on a number of the topics identified in the 1996 Commission Gren Paper on *Financial services: meeting consumers' expectations* and the 1997 Commission Communication on *Financial services: enhancing consumer confidence* has already been outlined, including electronic money and payment cards, consumer credit, unregulated intermediaries and victims of car accidents abroad. There are, however, a number of other issues which the Commission has identified.

Mortgage Credit

There are wide differences between EU countries in the sources of and regulatory controls over mortgage credit. Some countries have specialised mortgage lending institutions, such as building societies in the UK and Ireland and mortgage banks in Germany, though these may compete with other types of financial services organisation. There are varying patterns of funding, for example by consumer deposits or by bond issues. State-owned financial institutions are sometimes involved in wholesale or retail funding arrangements.

The public policy interest in ensuring that there is an adequate supply of housing available at reasonable cost is reflected by a complex pattern of regulation in some countries. There may be ceilings set to the maximum amount of a mortgage in relation to the value of the property being

bought, while in some countries the consumer’s income or personal financial standing may not be taken into account in deciding the maximum amount of the mortgage, only the value of the property. Interest rates on the mortgage loan may be fixed or variable. If variable, there may be controls on the timing and limits of variation.

Initial proposals for a mortgage credit Directive were first put forward in 1984 but despite being repeatedly reformulated have never made significant progress. The complexities of land law as well as the structural and regulatory differences outlined above seem to contrive to prevent any headway being made. However, quite apart from the absence of anything approaching a single market for mortgage credit, there are significant problems on the consumer side, including inadequate information, difficulties in comparing the true cost of credit and oppressive contract conditions. The Commission is therefore taking a breather before deciding how to move forward.

Over-indebtedness

Widespread excessive consumer debt has become a major problem in many EU member countries. The problem has been scrutinised by a number of governments and at EU level by the Commission, although it is not covered by the Consumer Credit Directive.

It is of course easier to identify the problem of overindebtedness than it is to find ways of dealing with it. One possible approach, adopted in the Netherlands, is to put financial services organisations which supply credit under an obligation to engage in ‘responsible lending’, by taking account of the consumer’s ability to repay the loan. Another is to fix a maximum to the cost of credit. The law on this varies considerably from country to country within the EU. Belgium, France and the Netherlands all have interest rate ceilings, fixed by different methods, but all with a provision for changing the level of the ceiling according to changes in the markets. Germany, Italy, Spain and the UK all have laws against extortionate rates of interest, or usury, but the criteria for deciding what is or is not extortionate vary and it is usually left to the courts to decide. This approach is relatively effective in Germany (see the separate report) and not at all in the UK.

There are arguments for and against fixing a maximum rate of interest by law. The main argument in favour is that many consumers seeking credit are in a vulnerable situation and open to exploitation by unscrupulous financial organisations, which take advantage of them by charging extortionate rates of interest. The principle argument against is that fixing a ceiling means that poorer consumers will find it difficult to get any credit, as the system will work in practice by channelling credit to better-off consumers who are better credit risks. In fact, in all three EU countries which have interest rate maxima, there is an attempt to compensate for this by having various forms of 'social credit' available to the less well-off (see the separate report on the Netherlands).

In any event, despite pressure from consumer organisations the problem has not yet been tackled at EU level, the the 1997 Commission Communication states that “...certain pilot projects will be implemented as from 1998, some of which will aim at improving consumer education and information”. This does not sound like a preliminary to legislative action.

Refusal to Sell Financial Services

Consumer organisations have long been concerned that some financial institutions undermine the principle of a single market by discriminating against nationals or residents of other EU member states. Financial services organisations are free to sell where they wish throughout the EU, but there is no reciprocal freedom of consumers to buy. Regrettably, the Commission in its Communication has taken the stand that "...private companies are free to decide with whom to do business" even if this involves national or residential discrimination within the EU.

The Commission also refuses to take action to deal with situations where there is discrimination against low-income consumers, such as refusal to open a bank account. Consumer organisations are likely to continue to press on these points, but the Commission's attitude may well be interpreted as reflecting the overall orientation of the single market initiative towards the interests of financial services organisations.

Distance Contracts

As has already been mentioned, the scope of the Unfair Contract Terms Directive was altered at the last minute to exclude financial services[51] . However, the Commission is now in the course of putting forward a fresh proposal, which looks as if it will be subject to lengthy debate, especially in the light of opposition from much of the industry and some governments.

Consumer Information

While a number of the Directives include consumer information provisions, these appear to have been included in a rather haphazard way. Consumer organisations have therefore pressed for a consistent consumer information strategy to be adopted. The Commission's response has been less than enthusiastic. Its 1997 Communication states that "Those most closely involved [that is, the industry] know best what information is useful to consumers whilst avoiding unnecessarily onerous requirements on financial institutions in terms of information provision (the costs of which will ultimately be passed on to the consumer)". The Commission goes on to ask for a "...clear commitment from the industry and consumers to agree voluntarily improvements in the provision of information" and says it will monitor progress in implementing such agreements. If enough progress is not made, it will "... propose further initiatives". Consumer organisations retain considerable scepticism about the likelihood of any EU-wide agreements being implemented effectively on a voluntary basis.

Redress

In a number of EU member states, especially in Northern Europe, there are now effective alternative dispute resolution schemes in place for handling consumer complaints about banking,

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[51] European Parliament and Council Directive on the protection of consumers in respect of distance contracts (97/7/EC). OJ L 144 of 4 June 1997, p19.

insurance and investment services. These are frequently non-statutory and funded by industry at arm's length. Many of them have a good record of securing redress for consumers, although they almost all suffer from lack of publicity and shortage of resources. They are a positive example of industry-based consumer protection, but receive only sketchy recognition in EU legislation.

The Commission's 1997 Communication "...seeks a clear commitment from the industry to set up or complete schemes, in co-operation with consumers, that deal with consumer complaints". It goes on to say that it will monitor progress before assessing whether problems can be adequately solved on a self-regulatory basis or whether further initiatives, including legislation, are necessary. From the consumer viewpoint, this is a relatively heartening development for the medium term future.

4. Conclusion

In spite of a stuttering start, the push towards a single EU-wide market for financial services has made considerable progress, notably by the adoption of the main framework Directives for the banking, insurance and investment services sectors. When these and their associated legislation are fully implemented, there will be considerable freedom, only lightly qualified, for financial services organisations to sell their services in other EU countries by setting up branches or selling across frontiers. There has been a consequent major shift in regulation at national level in order to comply with EU Directives, with many controls swept away, but some strengthened.

The indirect benefits of the single market in financial services for consumers, in terms of wider choice and lower prices, have yet to materialise in any substantive way, whatever the future may hold. Relatively few EU level initiatives have been aimed directly at consumer protection. The Consumer Credit Directive and the Bank Deposit Guarantee and Investor Compensation Directives are the exception rather than the rule, though there have been some improved transparency provisions in other Directives.

The recent Commission Green Paper and Communication documents focusing on consumer needs in financial services are a welcome change of emphasis. Against this, with the exception of the proposal on distance contracts for financial services, the Commission is displaying increasing reluctance to push forward with binding Directives to improve consumer protection, especially in the face of opposition from the financial services industry, and is showing a leaning towards ‘soft law’ and ‘dialogue’. It remains to be seen how effective this route will prove to be.

Part II

The Netherlands – Financial Services and Consumer Protection: Policy and Practice

by
Joop Koopman

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1. The General Setting

Government Responsibilities

Each Government Minister is responsible for the consumer problems in her or his own portfolio. A State Secretary (junior Minister) within the Ministry of Economic Affairs has been assigned a general and coordinating responsibility for government consumer policy at large, in addition to a number of other consumer policy concerns which have been attributed to this ministry in the past. The Consumer Credit Act, which features prominently in consumer protection in financial services, is one of these issues for which the State Secretary for Consumer Affairs is responsible. 'Other' ministers may however exert influence on the policy-making of the 'responsible' minister, depending on the degree of shared or conflicting interests.

Consultation Structure

Consumer Organisations[1]

In 1953, the Consumentenbond (CB) was established. This currently has some 650,000 members and covers one out of every nine households. Relative to national population, CB is the largest consumer organisation in the world. Konsumenten Kontakt (KK), a body in which the trade unions and some other organisations participated, was founded later. These two consumer organisations dominated the consumer scene in the 1970s and 1980s. KK was discontinued in the early nineties when the trade unions, by far the largest donors, withdrew their support.

In 1974, the Union of Home Owners was established. It confines itself to property-related consumer issues (including financial aspects such as mortgage credit). Membership is over 400,000.

The Social and Economic Council and its Committee for Consumer Affairs

The Social and Economic Council (SER) was founded in 1950[2] . It is structured on a tripartite basis: 11 representatives of trade and industry, 11 representatives of trade-unions and 11 independent members appointed by the Crown, usually professors or other experts with wide experience. One of its major tasks is to advise the Government on social and economic questions, either following a request from Government, or on its own initiative. In 1965, a Committee for Consumer Affairs (CCA) was established under the aegis of the SER, giving advice to the

[1] Joop Koopman, *Consumentenmacht en mark*t, Ministerie van Economische Zaken, 1993.
[2] Sociaal – Economische Raad, Wet op de bedrijfsorganisatie: Wet van 27 januari 1950, staatsblad K 22 (Law of 27 January 1950, Public Journal K 22).

Government on consumer policy issues in a rather independent manner[3] . The CCA is currently composed of six representatives from CB, four from the largest confederation of trade and industry, two from the organisation of small and medium enterprises and six independent members[4] . The task of the CCA has been, since its inception, twofold – to advise government and to act as a platform for dialogue between business and the consumer.

This latter function has recently been transferred to the newly established Co-ordination Group Self-regulation Dialogue. This institution offers a framework for dialogue and negotiations between consumer organisations and trade associations on standard clauses in consumer contracts. These negotiations are conducted in *ad hoc* consultation groups chaired by an independent member and supported by the CCA secretariat. They take place under the guidance of a *Protocol for consultation on general clauses* drawn up by this Co-ordination Group, which functions under an independent chairperson and is further composed of two representatives from business and two from CB. Standard clauses have been drawn up for widely diverging activities such as travel agents, public utilities, mail order companies and banks. Neither the SER nor the CCA carry any responsibility for these negotiated clauses[5] – their role is to provide the framework for negotiation.

In conclusion, it may be said that the CCA has played a crucial role in the shaping of consumer policy since its early days.

The Concept of Self-regulation in Consumer Policy

The functioning of the CCA illustrates the Dutch approach to decision-making on socio-economic issues. This approach not only involves all the players in the process, but also aims at making them, as far as possible, responsible for the policies in which they participate. It has also resulted in a gradual acceptance of consumer organisations by trade and industry bodies. This positive attitude on the part of business has also been fostered by the responsible behaviour of the consumer organisations when pleading their case and by their quantitative and qualitative strength.

Self-regulation can aim at protecting consumers' interests as a supplement to government regulation, or function as a 'substitute' for legislation, for instance by filling up framework legislation. It can also satisfy certain needs of the stake holders concerned, irrespective of possible government concerns. The government and the parties involved see to it that these agreements do not interfere with the demands of markets that are working properly.

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3 Its intricate relationship with the SER may be ignored in this report. It is enough to say that the government may be more inclined to solicit advice from the SER when (also) other aspects of government policy play a (significant) role in the problem for which it seeks advice. If that is so, the CCA may act as a preparatory committee for the SER. See for further reference *Van consument en consumptie,25 jaar advies en overleg door bedrijfsleven en consument*, SER, 1991.

[4] The trade unions participated in the CCA until 1996, when they decided that consumer policy was no longer part of their core business.

[5] The results of which will however be sent to the CCA, the State Secretary of Economic Affairs and the Foundation for Dispute Settlement.

This approach is also visible in the setting up of other *ad hoc* consultation machinery when the need arises, such as the establishment of a platform for efficient payment systems in the early nineties, composed of retail and consumer organisations which joined forces in order to ward off the indiscriminate introduction by the banks of tariffs for different payment methods. As a result, banks agreed to only introduce tariffs for inefficient methods of payment (such as the use of checks for small amounts).

This philosophy has also provided a strong impetus to the implementation of the concept of deregulation and self-regulation in consumer policy in the 1980s, when it was not so much the objectives of consumer policy that were at stake, but rather the prudent use of statutory legislation. In the course of time, several structures were established in which consumer and business organisations participated and which were aimed at the protection of the economic interests of the consumer.

The Foundation for Dispute Settlement (SGR)

The Foundation for Dispute Settlement (SGR) was established by CB and some business sectors in 1970. Dispute resolution takes place in committees, which have been set up for each of the sectors involved. In a general regulation the government has stipulated a number of conditions which have to be fulfilled by these committees in order to be recognised[6] . The major conditions mentioned in this 'recognition regulation' are:

- The participating suppliers in the particular market sector concerned should constitute a significant share of the totality of suppliers;
- All suppliers in the sector should be allowed to participate in the dispute settlement mechanism;
- There should be explicit rules about the procedures to be used in the dispute resolution process;
- The Minister of Justice should take the view that the committee will make a substantial contribution to the solution of consumer disputes.

Specific regulations determine the procedure for dispute resolution for each of these committees, and these take into account the provisions of the 'recognition regulation' and the prevailing standard contract clauses. Generally speaking, the committees consist of an independent chairman (lawyer), a representative from the industry concerned and a member designated by CB.

The Government provides a subsidy to meet the the Foundation's expenses and the consumer who lodges a complaint pays a moderate fee, which is usually refunded if she or he wins the dispute. The balance of funding is paid by the industry sectors involved in the Foundation's

[6] Staatscourant (Official Journal) 248, 23 December 1996.

work. Support by CB is given 'in kind'. Since the 1980s, there has been a steady reduction of the residual burden on public funds. At present, about two-thirds of the total costs are borne by business.

Those business sectors which have successfully negotiated their general contract clauses under the auspices of the Co-ordination Group Self-regulation Dialogue are eligible to participate in the SGR. At present, 23 dispute settlement committees function within the Foundation.

Other self-regulatory agreements and bodies relevant to protecting consumers' economic interests in the field of financial services, and which will be dealt with elsewhere in this report, are:

- The code of conduct of the Union of Finance Companies (VFN) on "good" lending behaviour;
- The credit registration system of the Central Credit Registration Office (BKR);
- The Insurance Ombudsman;
- The code of conduct of the Dutch Association for Public Credit (NVVK), the union of municipal credit banks, on personal bankruptcy.

2. The Consumer Credit Act

Introduction

The Annex to this report gives some background information on the extent of consumer credit and indebtedness in the Netherlands.

The Consumer Credit Act[7] implements the EU Consumer Credit Directives (87/102/EEC and 90/88/EEC). This law also contains a number of other provisions which are typical of the Dutch approach towards consumer protection in the financial services and its treatment of indebtedness. The inclusion of these additional provisions was made possible because the Directive (Article 15) allows Member States to adopt more stringent consumer protection measures.

The Act applies to lenders established in the Netherlands and to lenders based abroad and offering credit in the Netherlands. In order to restrict credit granting to professional and *bona fide* lenders only, a license is needed to enter the market. A licence may be refused if the Ministry of Economic Affairs has good reasons to assume that the lender may contravene the law or may act contrary to what may be expected of a 'good creditor' (Article 13.b). Another condition for obtaining a licence, is the obligation to participate in a 'system of credit registration', unless this provision may not, in the judgment of the Minister, in all fairness be demanded from the

[7] Law of 4 July 1990, Official Journal 1990 No. 395.

applicant (Article 14.2). No special provisions exist for intermediaries. The creditor is held accountable for the operations of any intermediary.

Debt consolidation and rescheduling is prohibited as a commercial activity (Article 43). These services are reserved to municipal credit banks, specialised lawyers and executors appointed by the courts in conformity with the Bankruptcy Act. Others may be appointed on the basis of secondary legislation.

The Union of Finance Companies Code of Conduct

The explanatory memorandum of the Consumer Credit Act refers specifically to the Union of Finance Companies Code of Conduct[8] . It also mentions the term 'good lending behaviour' in reference to the supervision of the enforcement of the Act (Chapter 7).

The preamble to the Code states that the members of the Union have not only agreed to adhere to the law, but also to the Union's own rules and regulations, as well as to delegation of the supervision of their compliance with the Code to a supervisory committee. The Code itself consists of three sections:

- General rules of conduct and directives;
- Specific rules of conduct and directives (consisting of eight annexes and 27 pages);
- The supervisory committee (41/2 pages).

The main features of this important standard-setting code for consumer lending are summarised below under 2.2.1 and 2.2.2.

General Rules of Conduct and Directives

There are ten general rules, whose most important elements may be summarised as follows:

- Behaviour which is detrimental to the reputation of the credit lending industry should be avoided;
- General information on lending and information provided to individuals will as far as possible be guided by openness and transparency;
- Requests for loans will be judged on the basis of common and professional standards, irrespective of religion, politics, sex, sexual inclination, race or national background;
- Loans will only be offered after an investigation of the applicant's financial circumstances. Overindebtedness should be avoided;

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[8] Honorary Code VFN 1996 of the Vereniging of Financieringsondernemingen in Nederland.

- Genuine efforts will be made to find solutions for debtors who may experience serious financial problems. Loyal support will be given to *bona fide* organisations endeavouring to arrive at debt settlements.

Specific Rules of Conduct and Directives

The first annex to the Code deals with the situation in which two or more creditors have conflicting claims to a good which has been bought on hire purchase. It sets out a model for a contractual relationship between these parties and refers to the supervisory committee for arbitration, if necessary. A second annex lays down guidelines on the terms and conditions of an offer of credit. These aim at procedures and other methods (for example, credit scoring) on the basis of which the lender may, in fairness, assume the debtor will be able to meet her or his obligations within a reasonable period. The lender is not allowed to provide loans which may endanger the fulfilment of the debtor’s basic needs, for which the Social Assistance Act provides the criteria. A further obligation requires the Central Credit Registration Office to be consulted (see also 2.3 below). The third annex is concerned with the protection of the 'tally' of the intermediary’s clients. The fourth annex obliges the new lender to inform the original lender he replaces. The fifth annex regulates the relationship with intermediaries. The sixth annex is concerned with provisions aimed at preventing fraud by the loan applicant. The seventh annex deals with tailor-made credit offers. The last annex presents an elaboration of the anti-discrimination Article of the general code, in order to prevent a conflict with legal provisions.

The Supervisory Committee

The committee is composed of three members, for whom substitutes may be appointed. The chairman is a lawyer, appointed by the General Assembly of the VFN. The chairman and at least one member will be selected from outside the General Assembly’s voting members. A member associated with the company a complaint is lodged against must abstain from handling that case. The committee deals with complaints about infringements of the Code by members of the VFN. The charter sets rules for the admission of complaints, the manner in which the committee will treat these and the sanctions it may impose. These sanctions comprise a warning letter, a reprimand, publication of the ruling in the VFN magazine and, lastly, if the earlier sanctions have not resulted in the desired outcome, a discussion on the ruling at the General Assembly with a view to further measures. These could be a suspension of membership for a year and, ultimately, expulsion. Given the linkages with the Consumer Credit Act, any possible 'offender' will think twice before ignoring the rulings of the committee, on penalty of losing his credit licence.

The Central Credit Registration Office (BKR)

Article 28 (2) of the Consumer Credit Act stipulates that a creditor who participates in a system of credit registration is obliged to solicit such information if the request for a loan exceeds 2,000 Guilders (c.C$1,420) . This information is kept by the BKR[9] .

BKR is a foundation which aims at helping to limit the risks of lenders and to prevent overindebtedness, by collecting, recording and arranging relevant data. In doing so it protects the privacy of those concerned as much as possible. The board of directors may confine its task to supervisory activities and delegate its responsibilities for managing the foundation to the managing board. The board of directors is composed of an independent chairman and a representative of each of the (ten) recognised groups of participating lending institutions. A lender who wants to take part will be recognised, unless he cannot be so considered, is bankrupt or violates the integrity of the profession[10] .

The general regulations lay down the procedure and conditions for the registration of data in connection with granting credit and checking data on the financial position of consumers who have either been granted credit or are making an application. Each participant is issued a (secret) number which he is not allowed to divulge to other lenders. The foundation is obliged to keep a system of registration which allows the participants, through the use of their allocated numbers, to check their information promptly and efficiently against the data held by the BKR. For each debtor, the Foundation registers any loans granted by participating member firms, payment irregularities and loan terminations.

The following types of credit are differentiated:

- Loans with an agreed repayment schedule;
- Revolving credit;
- Hire purchase transactions (including financial leasing agreements);
- Durable consumer goods hire agreements;
- Debt consolidation and repayment;
- Mail order credit above 1,000 Guilders (c.C$710) for two months;
- Credit stemming from a payment account (more than 10 percent of the credit ceiling, or more than 1,000 Guilders);

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[9] Stichting (Foundation) Bureau Krediet Registratie. See also its regulations, such as its general regulation, its privacy code of conduct, and its regulation on dispute settlement. These regulations are available from BKR's head office in the municipality of Tiel. See also its Annual Report 1996.

[10] These conditions are in harmony with the provisions (conditions for entering the market) of the Consumer Credit Act.

- Mortgage credit (if the debtor has not paid his instalment by 120 days after the due date).

Participating firms have to notify the BKR if a debtor defaults on his repayment obligations after specified periods. Other irregularities have to be notified as well, such as the institution of a formal debt recovery procedure, not knowing where the debtor lives, repossession of the good obtained by credit, the official sale of property in case of mortgage credit and the conclusion of a debt settlement. Data is removed from the register five years after the credit facility actually finishes.

In its code of conduct on privacy, the BKR sets rules for protecting the privacy of people whose data is entered in its credit registration system. The Foundation appoints a registration manager who is responsible for the management of the credit registration system. The code specifies what information about credit and debtors should be entered. Its contents follow closely the data requirements set out in the general regulation. Every individual has a right to learn to whom information has been given about her or his credit data in the previous year, subject to payment of a fee of 10 Guilders (c.C$0.71). There is a similar procedure for finding out what information has actually been conveyed.

Anyone who thinks that their credit information is incorrect has a right to ask for it to be put right. A consumer who is dissatisfied with the manner in which a request for data correction has been treated may complain to the Dispute Settlement Committee. The dispute settlement regulation deals with the solution of such privacy disputes. The Committee is composed of at least three members, who must be independent of the parties to the dispute. The members are appointed by the president of the district court of Amsterdam on the basis of a nomination put forward by the board of directors. The Committee’s rulings are binding.

In 1997 this Committee received 48 complaints, the same number as in 1996. It dealt with 13 disputes. In four cases a settlement was reached and in the remaining nine a binding ruling was issued. Of the other 35 complaints, six were withdrawn because the parties reached a solution before the hearing could take place, two were carried forward to 1998 and the remaining 27 were either dismissed on the basis of non-admissibility or temporarily set aside because the complainant had not yet complied with the rule to complain first to the lender.

The board of directors has recently set up a supervisory committee which, on behalf of the board, will oversee whether its regulations on the collection, registration and arrangement of data for its central credit registration system, as well as the handing over of personal data to participants, are correctly observed by the BKR itself and its participating members.

In 1996, 9.8 million credit checks were made by participating members, an increase of 10 percent over the previous year (there was a further increase to 10.7 million in 1997, reflecting the increasing use of credit). The number of people whose credit data was registered in the system was 4.95 million. The number of credit transactions in 1996 was 4.6 million, of which 40 percent were revolving credit, 15 percent personal loan, 15 percent shop cards and 13 percent credit cards.

The Regulation of Maximum Interest Rates

Article 35(1) of the Consumer Credit Act stipulates that a maximum rate of interest may be determined on the basis of secondary legislation, to prevent creditors from reckless lending. This is aimed at helping to prevent overindebtedness.

In the secondary legislation[11] , APRs (Annual Percentage Rate of charge) have been developed which include all the costs of providing credit for each of the seven credit amount tranches which have been distinguished. Different maximum APRs are specified for initial credit transactions, for credit transactions in default and for transactions which are the subject of early repayment and which are adjusted to prevailing market rates in a specified manner. These maximum rates for the various tranches of credit imply a limitation of the compensation for costs incurred by bad risks. In this way, restrictions are indirectly imposed on the credit risks which lenders can accept – a lender is unlikely to grant a loan if the APR warranted by a particular risk came out higher than the maximum he could charge by law.

While a system of periodically adjusted maximum interest rates would appear to be a severe intervention in the market, it is held to be justified because of the causal relationship which has been found between the risk of non-payment and the price of borrowing. Evidence shows that relatively creditworthy debtors who representing a good risk for the lender are able to borrow at substantially lower rates than the maximum, while high credit risk consumers can only borrow at the maximum, if at all. This is in line with the well-known maxim ‘The poor pay more’[12] .

However, the explanatory memorandum mentions conditions which limit these risks. First, the level at which the maximum interest rate is fixed must allow for a fair rate of return, and second, the rate must meet the needs of lenders specialising in market segments characterised by small amounts of short-term credit and by a relatively short duration – for example, mail order credit.

3. Dispute Settlement

Banking

Two dispute settlement committees operate under the aegis of the Foundation for Dispute Settlement (SGR), the Committee for Banking Affairs and the Committee for the Mortgage Lending Code of Practice. The regulations on both these are outlined below, as well as the general clauses used by the Dutch Union of Banks (NVB), its clauses applicable to ATMs (Automated Teller Machines) and the Mortgage Lending Code of Practice .

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[11] See Besluit Kredietvergoeding.

[12] Derived from David Caplowitz *The Poor Pay More*, Free Press of Glencoe, New York, 1963 – a seminal study of the use of credit by low-income families in New York City.

General Banking Services

The Banking Dispute Settlement Committee

The composition and tasks of this committee are set out in articles 2 and 3 of the regulation. The SGR appoints a chairperson and a number of vice-chairs, as well as a number of members nominated by CB and NVB but acting in an individual capacity rather than as representatives of their organisations. Each individual committee is chaired either by the chairperson, or one of the vice-chairs. If the chairperson thinks it would be useful, four members (two each from CB and NVB) are appointed instead of two .The committee deals with disputes between a consumer and a bank arising from the conclusion or implementation of agreements for services supplied by the bank, as well as privacy matters, by issuing a binding advice or by promoting a settlement.

The committee has no power to deal with a case if the dispute is, or has been, heard by a court or if it could be submitted to another informal settlement committee such as the supervisory committee of the VFN Supervisory Committee (see 2.2 above) or the BKR Dispute Settlement Committee (see 2.3 above). The committee has no power either to deal with disputes which may follow from dealings with bank subsidiaries abroad.

A number of articles in the regulation deal with the admissibility of the dispute. Consumers are, for instance, required to submit their dispute by completing a form. Also, consumers have to complain first to the bank and there are time limits within which they must lodge their complaints before they may turn to the committee.

The treatment of disputes is set out in articles 12-14. The committee informs the bank of the dispute by forwarding a copy of the form submitted by the consumer. The bank is asked to reply within a month and may obtain permission to extend this by another month. The complainant is given the opportunity to present her or his views on the bank's reply within one, or if necessary, two months. The committee then invites the parties to a hearing, if it thinks this would be useful, or if one of the parties wants a hearing. The parties may be accompanied or represented by others and may also be allowed by the committee to invite witnesses or experts. The committee may, also on its own initiative, make inquiries, or institute an investigation, the results of which are sent to the parties, who are given 14 days to comment in writing.

The major elements of the procedure for passing judgment are set out in articles 15-19. The committee should reach its decision on the basis of reasonableness and fairness and in accordance with Dutch law, based on a majority vote. Obvious mistakes in the committee's judgment may be put right by the chairperson in accordance with certain provisions in the regulation. The parties are informed of the judgment in writing. The judgment contains the following elements: the decision, the names of the chairman, secretary and members of the committee, the names of the parties, the day the judgment was passed and the reasons for the decision. The committee has the authority, *inter alia*, to take the following decisions: to compel the bank to honour an agreement, to pronounce an agreement dissolved, to determine the amount of compensation, to deny the bank authority to execute certain rights set down in the agreement and to take any other decision which it considers reasonable and fair to solve the dispute. If the committee decides that the consumer's complaint is fully, or partially justified, it also requires

the bank to refund the fee the consumer has paid to the Foundation when submitting the complaint. The final provision stipulates that the parties are allowed to submit the binding decision to a court within two months for a marginal check. This is necessary as Dutch law nullifies any agreement which does not allow recourse to the courts. The bank may however submit the case to the court for full consideration if the bank convinces the judge that the nature of the committee's judgment is so fundamental that its implications for either the bank or the banking community will exceed 1 million Guilders (c.C$710,000).

General Clauses of the Dutch Union of Banks

These clauses have resulted from negotiations conducted by an *ad hoc* consultation groups set up under the auspices of the Co-ordination Group Self-regulation Dialogue in December 1995 (see also 1.2.2 above). No agreement could be reached on three matters:

- Article 3, which deals with limitation of the liability of banks involving third parties in the execution of an agreement;
- Article 10, which limits the bank's responsibility to compensate consumers fully for damages caused by shortcomings in the execution of payment transactions involving banks connected to the Bank Giro network;
- Article 31, which excludes liability for shortcomings resulting from specific '*force majeure*' events.

In an accompanying statement, the consumer organisation CB recognises the consequences for banks arising from such a far reaching liability, but does not accept the limitation of the bank's liability in these clauses, given that the bank itself is held to be responsible. The banks understand this position, but refer to the incalculable and unaffordable risks they may incur. They also stipulate that their obligation to provide their services in a prudent manner, as laid down in article 2, always prevails. According to the banks, these limitations of liability in no way diminish this obligation.

The reservation CB expresses towards these three disputed articles enables it to submit complaints covered by these clauses to a court for nullification as is provided for in the law on general clauses[13] . These general clauses apply to banks' professional customers as well as to individual consumers.

General Clauses on the Use of ATMs

The clauses apply to banking transactions in which plastic cards and a PIN code are used through the Dutch payments network and to transactions abroad which do not involve use of PIN code. The bank should ensure the uninterrupted functioning of its equipment and infrastructure. It

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[13] See Mölenberg and Verstappen "The new banking general clauses" in *Tijdschrift voor Consumentenrecht (TvC)*, 1996, No. 5, page 346 (in Dutch).

should also ensure that loss, theft, abuse or falsification of cards can be reported 24 hours per day and seven days per week. Customers are obliged to take care of their card and PIN code and banks will inform customers about taking precautionary measures. The PIN code is strictly personal and should not be divulged to anyone, including other members of the household. The customer is liable to the bank for the use of the card and any consequences, subject to the following. He should, when discovering loss, theft, abuse or falsification, report this immediately. The customer is liable for the consequences of unauthorised use of a card, until such time as loss etc. is reported, up to a maximum of 350 Guilders (c.C$250) per card and for any unauthorised use which takes place more than three days after the account statement date. The customer is also liable for any unauthorised use if the condition of secrecy has been breached but is not liable for any unauthorised use after the card's loss etc. has been reported. In any event, the consumer's liability can never exceed the card's maximum credit or withdrawal limit.

The Dispute Settlement Committee's Decisions

Professor Molenaar, an authority on banking law, has commented on the publication of the judgments of the committee's decisions. Sixty two decisions were made between mid-July 1992 and March 1993, 44 against the consumer and 12 in favour[14] . These figures differ from previous periods when almost half of the judgments were in favour of the consumer – especially true for consumer disputes with the Postbank. Professor Molenaar's view is that the following factors have contributed to this change:

- The committee dealing with Postbank complaints used to treat the consumer strictly in earlier days, became more lenient later on and is now striking a fair balance;
- Banks have learned from the judgments – "they hardly dish up obvious stupidities any longer";
- On the other hand, consumers collectively have learned little[15] .

The Committee dealt with 124 disputes in 1996. 17 judgments were fully in favour of the consumer and eight partially. In 75 cases the claim was rejected, while in 24 cases the complaint fell outwith the committee's terms of reference. Examples of rejected claims included unauthorised withdrawal of money from an ATM because the consumer did not keep the PIN code secret, misuse of a stolen bank card as a result of the consumer's negligent behaviour and termination of a payments account by a bank because there was not enough money in the account.

[14] At that time, there were two committees were functioning which later merged, one for the Postbank (giro) and another for other banks. The figures for the Postbank committee are not only significantly higher, but also differ in that a higher proportion of its judgments favoured the consumer.

[15] Tijdschrift voor consumentenrecht, no. 5, 1993, p. 326.

Mortgage Lending

The Mortgage Lending Code of Conduct[16]

The origin of this code lies in the Government's wish to exclude mortgage lending from the scope of the Consumer Credit Act and to find a solution based on self-regulation. This Government stance was fostered by the mortgage credit sector's resistance to legislation. The Government was compelled to take appropriate measures for regulating mortgages with a ceiling of ECU 20,000 (c.C$30,800) in the process of transposing the EU Consumer Credit Directive into Dutch national law. After the Government had reached a basic agreement with the mortgage credit banks on a code of conduct for all mortgage lending, including all mortgages above ECU 20,000, the consumer organisations entered the negotiations. They agreed to the content of the code of conduct, after having achieved a number of improvements from the consumer perspective. A revision of the code is currently being contemplated.

The code is applicable to all new mortgages offered, or which have been concluded since October 1990, that are of a standard nature. The code covers the following:

- An indication of the development of the financial burden on the consumer;
- The content of a mortgage offer;
- Calculation of the APR;
- Secondary agreements;
- Early redemption and accompanying compensation to the lender;
- Notice of prolongation;
- Change of conditions during the contract term;
- Consultation if the consumer cannot meet her or his obligations;
- Mortgages for subsidised dwellings;
- Interest to be received for parts of the loan not yet transferred;
- Permission to deviate from the provisions of the code,
- Intermediaries;
- Complaints.

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[16] The code together with an explanatory memorandum is published (in Dutch) by the organisation of mortgage lenders.

The Mortgage Lending Code Dispute Settlement Committee

Before 1997, compliance with the mortgage lending code of conduct was entrusted to an independent supervisory committee. In accordance with a general tendency to strengthen and streamline dispute settlement under the aegis of the SGR, the Foundation took over supervision of the code on 1 January 1997.

As the regulation under which the dispute settlement systems operates largely follows the structure and content of the regulation described in 3.1.1.1 above, it will only be summarised here. The Committee's task is to supervise compliance with the code. It may pursue this task by passing judgment, either at the request of a complainant having a dispute with a mortgage lender about the application of the code, or at its own initiative. The Committee may only pass judgment in the form of binding decision if the complainant is a consumer. Also, the Committee is entitled to pass judgment according to disciplinary rules, or to promote a settlement between the parties. The committee has no power to pass judgment if the origin of the dispute with the lender is not covered explicitly in the code of conduct. In such cases, the consumer should take the complaint to the Dispute Settlement Committee for Banking Affairs. The terms of reference of both committees overlap to some extent, often leaving the consumer a choice between them. A consumer with a complaint is asked to opt for a binding decision, or for a judgment according to disciplinary rules. The committee may, in implementing its binding decision, compel the lender to observe the code, determine the amount of compensation, or take any other decision which it considers reasonable and fair to solve the dispute. When the committee passes judgment according to disciplinary rules, it may take only one of the following decisions – a recommendation to the lender, a warning, or exclusion of the lender from participation in the code of conduct.

The Mortgage Lending Dispute Settlement Committee's Decisions

In 1996, 13 complaints were filed. The committee passed judgment in ten cases, of which seven were carried forward from 1995. Six complaints were rejected, three cases were outwith the committee's terms of reference and in one case the consumer's complaint was not admitted. Three cases were resolved by a settlement between the parties and two were terminated at the request of the complainant. In one of these the complainant opted to go to court. Another case was terminated because the complainant failed to respond and five were carried forward to 1997.

Insurance

This has developed differently from the banking sector because the life assurance companies' trade association set up an 'Ombudsman' in 1971, long before other complaints and dispute settlement committees in the financial services sector were established. The life assurance Ombudsman soon gained wide acceptance and respect. This happened not so much because of the fairness of the judgments, but more because of the authority that, in the absence of formal powers, the first Ombudsman wielded over insurers, to make them comply with his recommendations. Because of this success, there has never been a strong demand for a different set-up, either via the Foundation for Dispute Settlement, or via other independent organisations.

This is presumably also the reason why other dispute settlement systems in the insurance sector develop along the same model for example, such as the Ombudsman for damage (non-life) insurance (1991), the Ombudsman for health insurance (1996) and the Ombudsman for pensions (1995).

The Life Assurance Ombudsman[17]

The Ombudsman is appointed by the Union of Insurance Companies on the basis of a nomination by the life assurance division. The Ombudsman and his staff must not have any connection with the industry. His task is to deal with complaints or disputes arising from life assurance agreements in the Netherlands.

Initially, the Ombudsman mediates between complainant and company. He fulfils this task independently and on the basis of his own views without taking instructions from anyone. His task is also to answer queries about the conclusion of agreements and their implementation. He settles a case by issuing a written opinion, which is sent to those involved. If a company ignores this opinion, the Ombudsman informs the chairman of the board of the trade association's life assurance division about the non compliance, together with his views.

If the Ombudsman considers he is unable to deal with a complaint himself, he will forward it to the trade association or the company in question and inform the complainant. In such cases, these bodies deal with the complaint and are required to consult the Ombudsman in this process. These bodies also have authority to take a decision in case of disagreement with the Ombudsman of which the latter will inform the complainant.

In 1996, the Ombudsman received 740 complaints, of which 15 were not admitted, 16 were withdrawn by the complainant and 13 were set aside by the Ombudsman.

156 complaints were awarded, 389 dismissed and 151 carried forward to 1997. The Ombudsman reported that the number of complaints had decreased slightly, in contrast to the steep rise between 1991 and 1995. He also observed that the percentage of cases awarded to the complainant in the last two years, 38 percent, was much lower than that in the four preceding years, though well in tune with the "historic average of over 29 percent".

About a quarter of the complaints handled in 1996 referred to redemption and the value of the final entitlement and slightly less than 20 percent to claims arising from the contract.

The Ombudsman for Damage (non-life) Insurance[18]

Before the office of the Ombudsman was set up in 1990, the Council supervising the functioning of the damage insurance companies dealt with consumer complaints, not always to the

[17] 26th annual report (in Dutch).
[18] 6th report (1996) (in Dutch).

satisfaction of the consumer organisation (CB). An important contributing factor to the discontent was the fact that this Council functions primarily as the sector's disciplinary tribunal.

To address CB's justified demand to improve its consumer complaint handling, the sector decided to establish an Ombudsman modelled on the Ombudsman life assurance.

There are some differences. The Ombudsman may forward a complaint to the Council of supervision when:

- He is of the opinion that the complaint only involves aspects of disciplinary regulation;
- He will not be able to settle the case within a reasonable period;
- The complainant or insurance company asks for this to be done after he has given his opinion;
- If he thinks it is desirable for the Council of supervision to pass judgment.

There are no other provisions covering the possibility that the Ombudsman and the insurance company disagree about the Ombudsman's opinion.

In 1996 the office of the Ombudsman received 2,517 written complaints, a fall of 342 on the preceding year. To a large extent, this decline was caused by the recent appointment of the Ombudsman health insurance, who took over 265 complaints from the Ombudsman damage insurance. The damage insurance complaints were divided into liability (16 percent), fire (18 percent), automobiles and motor bikes (39 percent) and other(27 percent).

Two-thirds of the complaints submitted and concluded in 1996 were made by consumers, 20 percent by intermediaries and four percent by companies. On average, it took almost ten weeks to deal with each of the 2,008 complaints. The report distinguishes between complaints about which the insurance company was consulted (962 cases) and those which were concluded without involvement of the company (1046).

The Ombudsman reached the following results for complainants in the first category:

- The insurance company was not prepared to accept the complaint and the Ombudsman refrained from further action (419 cases);
- The Ombudsman took further action, leading to a compromise acceptable to both parties (123 cases);
- The insurance company decided after the the Ombudsman's intervention to honour the complaint fully (364 cases);
- The complaint could not be resolved and was referred to the Council of supervision (5 cases);

- Other solutions (51 cases).

For the second group the results were:

- The Ombudsman informed the complainant, or advised him how to proceed (336 cases);
- The Ombudsman informed the complainant about his inability to mediate, for instance because the complaint was inadmissible (568 cases);
- The case was dealt with in another way (142 cases).

4. Overindebtedness[19]

Introduction[20]

Attitudes towards overindebtedness have changed over the years. At one time, it was hardly felt proper to to build up debts to buy goods and services. Nowadays, consumer credit is increasingly seen as an alternative to the use of savings for acquiring consumer goods. This necessarily involves the risks of problematic debt situations. This change in attitudes has been reflected in the Government's approach to the prevention and solution of overindebtedness. Fortunately – and perhaps also due to these policies – the incidence of credit and overindebtedness in the Netherlands is low by comparison with other countries, though on the increase (see Annex). It is estimated that some 200,000 households are faced with problematic debts, defined as a situation in which a consumer is no longer able to solve her or his financial problems without professional help.

Overindebtedness is being combated by an integrated, three-track strategy:

- Regulation, including self-regulation. A number of the provisions of the Consumer Credit Act, linked to self-regulation, contribute directly to the prevention of indebtedness, including maximum interest rates, the registration system of the BKR credit reference agency and the code of conduct of the VFN (Union of Finance Companies) Other important instruments are the debt settlement code of the Dutch Association for Public Credit (NVVK), and the draft law on debt resolution, outlined below under 4.3 and 4.4 respectively[21] .

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[19] Nic Huls at al. Overindebtedness of consumers in the EC member states: facts and search for solutions. Droit et Consommation XXIX, Louvain-la-Neuve, 1994.

[20] P.B.Boorsma (ed.) Problematische schuldsituaties, Bundel van congresinleidingen, Universiteit Twente, CBOO, no. 61, Enschede, 1991 (papers on problematic indebtedness).

[21] Tweede Kamer, 1992-1993, 22 969.

- Direct support for ‘debt casualties’ (advice, debt counselling, debt mediation and debt resolution) through local organisations such as social welfare bodies, the social welfare services of local authorities, municipal credit banks and a professional organisation (with many local branches) specialising in the management of household financing with many local branches, whose services are hired by local authorities;

- Indirect assistance. The National Institute for Information on Household Budgeting (NIBUD) is an independent organisation which provides information, advice, lectures and policy support on household economics to social welfare organisations, government, the financial services sector and legal experts. It also provides information to consumers through brochures, diskettes and budget counselling by telephone (two mornings per week). This enables NIBUD to compile a list the five questions asked most frequently – costs of children and alimony, food, budgeting, debts and college expenses. It issues a computerised MoneyManager programme which enables the consumer to draw up a detailed household budget, including norms for the various outlays. Also, the NVVK gives advice to its members and has developed a Debt Regulation Scheme which describes in detail the process for settling problematic debts according to the contents of the code it has drawn up (see 4.3 below).

Dutch Association for Public Credit – NVVK[22]

The NVVK is the representative organisation of the 49 municipal credit banks in the Netherlands. These banks are founded by and also accountable to their respective local councils. In that sense they may be unique and this is the reason why the Consumer Credit Act exempts them from an obligation to be licensed in order to provide credit. Their banking rules are approved by their Province’s administrative authority (Provinciale Staten). They were originally established in order to wipe out usury, which was rampant at the beginning of this century. The municipal banks were the first institutions operating in the consumer credit market to benefit the working class. They have grown into fully fledged banks, providing ’normal’ credit at commercial rates in addition to their prime task of providing ’social’ banking services. Normal credit, on conditions comparable to other banks, is granted to consumers who are situated at the lower end of the consumer credit market and to some extent, by the bigger banks, also to consumers generally. The social banking activities consist of social credit and debt settlement.

Most of these banks have concluded agreements with neighbouring cities on social credit services and debt settlement. They therefore constitute a nation wide network.

At present, some of the municipal credit banks are operating a pilot scheme involving the introduction of a bank card in the context of their ‘budget-management payment accounts’. Using a bank card, money may be withdrawn from an account through ATMs, if the account has a positive balance. The scheme will be extended after official clearance has been obtained.

[22] Annual Report 1996. Address: Brouwerstraat 4, 1315 BP Almere-Stad, Tel. (0)36 5345515.

The NVVK's objectives are:

- To promote the balanced and healthy provision of credit in a responsible non-commercial manner;
- To regulate the provision of credit in a proper manner;
- To promote the introduction of measures aimed at the prevention of overindebtedness.

The NVVK is member of a European network for debt settlement established in 1994, 'Debt Net', with its quarterly magazine *Money Matters*.. This includes articles on the way in which debt settlement is conducted in various European countries. The NVVK plays an active role in Debt Net[23] .

Debt settlement covers a wide range range of activities, including:

- Debt resolution – full redemption of a debt package by the provision of a debt resolution loan;
- Debt mediation – full redemption of debts by mediation with creditors and other parties by arranging a settlement but not by granting a debt resolution loan.

The most important reason for failure to reach a settlement is insufficient repayment capacity. In such cases, the client is not just sent away, but advised what other options are open.

The debt settlement activities of the municipal banks are as follows

	1992	1994	1996
Number of requests for debt settlement	19,371	27,936	28,625
Number of debt settlements achieved of which:	8,792	10,029	11,340
- debt resolutions	5,905	7,120	8,379
- debt mediation	2,887	2,909	2,961

The NVVK Debt Settlement Code

The NVVK's debt settlement code was introduced in 1979. It met a long-felt need for practical and authoritative solutions to problematic debt situations. The code has been revised a number of times as a result of experience and changed conditions.

Code provisions include the following:

- A request for debt settlement must always be taken into consideration by a municipal credit bank (Art.2);

[23] Coordinator: Joan Conlin, e-mail: joanconlin@mail.easynet.co.uk

- Following an analysis of a debt package and the options for debt settlement, the bank will decide whether or not to continue its attempt to settle the debt (Art.3);
- If this attempt is discontinued, the debtor involved will be notified and will be advised how to proceed, if this is possible (Art.4);
- If it is decided to continue, the debtor and creditors will be notified (Art.5);
- Creditors will be asked to state the total net amount of their claims and requested not to increase the debt burden by interest for delayed payment and /or collection costs during the mediation period (Art.6);
- A municipal bank should not co-operate in a debt-settlement scheme, if this will only result in a partial solution (Art.7);
- The debtor should, in principle, pay an amount which equals her or his maximum redemption capacity (Art.8);
- In principle, the maximum redemption period should be 36 months (Art.9);
- The maximum amounts available for the amortisation of debts is equal to a multiple of 36 times the debtor's monthly redemption capacity, after deduction of costs (Art.10 and 11);
- If a resolution loan does not cover all debt, the creditors should be offered a so-called percentage proposal (Art.12);
- If, in spite of debt mediation, the debts cannot be paid in full, the creditors will be offered a compromise, allowing final discharge under conditions that the debtor has strictly complied with his obligations during the agreed period and his financial position has not significantly changed (Art.13);
- If a debtor temporarily has insufficient redemption capacity, the creditors may be asked to freeze their claims and suspend coercive collection activities for an agreed period, after which the bank may again explore the possibilities of a debt settlement (Art.14);
- The municipal credit banks should operate the principle of non-preferential creditors (Art.15).

Although this code is not binding on the financial services industry and other organisations – for instance public utilities – it is highly respected by the financial services sector, as it makes an important contribution to efficient and sensible co-operation between creditors, debtors and mediators. The code of the Union of Finance Companies (VFN) mentions explicitly the loyal support that will be given to *bona fide* organisations endeavouring to arrive at debt settlements (see 2.2.1 above).

The Draft Law on Debt Resolution

A draft law on debt resolution was tabled in Parliament in December 1992. It proposed a system of debt resolution which would allow the debtor, after positive intervention by a judge, to opt for a repayment plan much along the lines of the debt settlement code of the NVVK. The law aims at complementing the code and at reducing the number of problematic debts for which the code does not provide a solution. According to the draft, the debtor must put his property and a percentage of his income at the disposal of his creditors for a maximum of five years. After this period, the remaining debts are transformed into 'natural obligations', which means that they are not enforceable by the creditors, but could be paid back voluntarily if the debtor wishes. Before deciding whether a debtor has to be declared bankrupt, or needs to be granted a suspension of payment, he is given the opportunity by the Court to opt for a repayment plan.

Nic Huls characterises the draft law as an example of the 'social liberal' model, as distinct from the 'fresh start' model which prevails in the USA, the 'social conservative' model of supervised re-education in Germany and the state-regulated model of moral pressure on creditors and debtors in France. In the social liberal model, the debtors, debt counselling agencies and banks all bear responsibility for the financial rehabilitation of the debtor after the rescheduling of debts[24].

The Second Chamber of Parliament amended and subsequently adopted the proposal. In one of the amendments, the five year redemption period was reduced to a period of three years, in accordance with the NVVK code – unless the debtor, after discontinuing his business, has incurred new debts, which are either fraudulent or excessive, when the redemption period would stay at five years. Under certain conditions, this period could even be reduced to one year, if the debtor's income was at the official minimum level and if he had no other means. The Senate, however, rejected the proposal in 1996, because it was sensitive to criticisms voiced by legal experts and the judiciary. These concerns were about the complexity of the proposed settlement procedures, fears of a much bigger case load than the judiciary could cope with (involving some 36,000 additional court sessions, three for each of the expected 12,000 applicants) and the meagre reward offered to the executor of the settlement. A commission was appointed to look into these problems, on the basis of which amendments to the draft law were proposed. Because of all these interventions, the new legislation is not yet in place.

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[24] See footnote 20, pp.116-118

Annex: Some Data on Consumer Credit and Indebtedness

Growth of Consumer Credit
(million Guilders at 1 Guilder= c.C$0.71)

	1990	1993	1996
New consumer credit	8,498	12,975	16,128
Outstanding consumer credit	15,800	20,500	23,461
Outstanding consumer credit as % of GDP	3.1%	3.9%	2.8%

The market shares of lenders in 1996 were as follows:

- General and saving banks 41.3%;
- Finance companies (usually subsidiaries of general banks) 49.4 %;
- Municipal credit banks 3.7%;
- Mail order firms 3.2%;
- Credit card companies 2.4%.

Over time, the share of the general banks has increased at the expense of finance companies and municipal banks.

(Sources: Annual Report 1996 of NVVK and Central Planning Bureau)

Comparative International Data on
Outstanding Consumer Credit Per Household
(Guilders at 1 Guilder= c.C$0.71: 1990 figures converted from ECU to Guilders at 2 Guilders = ECU 1)

	1990	1996
The Netherlands	2,288	3,800
Belgium	3,030	5,100
United Kingdom	6,270	
Germany	9,364	11,400
EU-wide average	5,452	

Among EU countries, only in Greece is the consumer credit per household significantly lower than in the Netherlands, while figures for Spain and Italy are roughly the same.

(Sources: for 1990: Com(95)117 final of 11 May 1995, Report on the Operation of Directive 87/102/EEC) and for 1996 the Netherlands Central Bureau of Statistics).

Part III

Germany: Financial Services and Consumer Protection – Policy and Practice

by
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1. Introduction

In Germany, consumer problems with financial services have grown substantially over the last ten years. Consumer organisations have sometimes received more than ten thousand complaints or requests for help about a single issue. Solutions to these problems have tended to come from court decisions rather than the operation of competitive market forces.

This report describes the policy framework in general terms rather than in detail. Some examples of court decisions are given to illustrate how legal principles and public policies work out in practice.

2. The Legal Framework

Specific consumer protection legislation in relation to financial services is only in place for some sectors of the market. Most recent laws derive from European Union Directives which are binding on member states, for example legislation on consumer credit and investment services. In most cases, only the mandatory minimum standards laid down in a Directive have been translated into national legislation. Sometimes, national legislation required by a Directive has not been adopted before the implementation date specified in the Directive. This recently created a problem for consumers when a Düsseldorf bank failed and consumers did not benefit from the compensation required by the EU 1994 Bank Deposit Guarantee Scheme Directive[1] , as the bank concerned was not a member of a compensation scheme.

In other cases, the minimum standard of consumer protection is further weakened by regulatory bodies. The EU Investment Services Directive [2] and its associated German implementing legislation both contain significant information disclosure requirements. However, the Bundesaufsichtsamt für den Wertpapierhandel (Regulatory Board for Investment Services) grants an exemption for so-called 'direct banks', whereby they are not obliged to give advice in the case of 'execution only' services. Consumer organisations have attacked the general condition in these banks' contracts which says that they have no obligation to give advice. The first decision of a court has declared that this condition is unfair and not in compliance with German law.

The only important purely national legislation (that is, not derived from EU legislation) in recent years has been a consumer bankruptcy law. From 1 January 1999, an individual consumer will be able to apply for bankruptcy and be given a 'fresh start'. A number of obligations may be attached to this – for example, to make payments to creditors and, if unemployed,a requirement to search for employment and to accept an offer of employment.

Legal problems that arise in relation to financial services that are not subject to specific legislation, such as bank current accounts, have to be solved on the basis of the very general German Civil Code or the law on unfair contract conditions. Because the general law on services

[1] Council Directive of 30 May 1994 on bank deposit guarantee schemes (94/19/EC).
[2] Council Directive of 10 May 1993 on investment services in the securities field (93/22/EC).

is written in very broad terms, finding solutions that can be applied even to simple banking services – for example, precise definitions of the respective rights and obligations of the parties concerned – may involve long and complex processes. It is particularly difficult to find solutions applicable to new technology-based services, such as home or internet banking, when the legal principles concerned were laid down in the last century. It is not therefore surprising that some lawyers have recently suggested that there should be specific legislation governing banking contracts. So far, problems that have arisen from new technologies in banking, such as the imposition of unfair responsibilities on the consumer in the event of fraudulent use by a third party, have been tackled by consumer organisations on the basis of the general law on unfair contract terms and conditions – often successfully.

Federal and Provincial Powers

The hesitancy shown by the Federal legislature, which stems from the concept that the market itself will take care of consumers' problems, does not take account of the fact that there are many problems which are not solved by competition. Examples are the lack of transparency of bank charges and the interest rates levied on credit granted to consumers who are in financial difficulty. Indeed, this latter group is especially vulnerable, as consumers in this situation may be unable to change their bank or enter into a new credit contract.

Inaction at the federal level cannot be compensated for by legislation at the Länder (Provincial) level. Under Art.70 of the German Constitution, the power of legislative initiative generally lies with the Länder. Federal law may only be enacted in specified sectors of the economy or society when the Constitution provides explicitly either for sole Federal competence, or for dual competence shared by the Federal and Länder Governments (Art.74). Art.72 states that where there is dual competence, the Länder cannot act in an area which is already subject to Federal law. There is also a legal principle that the Länder are not free to search for small, unregulated issues in an area covered by wider Federal law, but that they should respect the Federal Republic's intentions of either not regulating the matter at all, or only to a limited extent.

There is therefore hardly any Länder legislation in the field of financial services and consumer protection. The only important exception is Länder legislation on savings institutions. By historic tradition, these bodies were originally founded by municipal authorities and still have strong local ties. For example, the Nordrhein-Westfalen Savings Institutions Act states that savings institutions are responsible for supplying local consumers and businesses with financial services. There is similar savings institution legislation in all the Länder. One way in which these acts differ is whether they include an explicit obligation on savings institution to open a current account for any local citizen if a positive balance is maintained. Some Acts remain silent on this, while others provide for it explicitly, even going so far as to specify the criteria which a savings institution may use to refuse to open an account – for example, if the consumer concerned has a past history of not complying with the terms and conditions on which financial services have been supplied.

Having a bank account is of major importance to consumers. It is almost impossible to get a new job or enter into a rental contract without one. Salaries are universally paid directly into bank

accounts and no employer is likely to set up a cash payment system just for the sake of a handful of employees. The number of consumers without a bank account has been in the tens of thousands and this has involved social security authorities in considerable extra expense arising from the operation of systems to make cash payments of social security benefits. This is one reason why there has been such strong popular support for the movement to give everyone the right to have a bank account (see below).

In some Länder, savings institutions are required by law to provide funds for debt counselling. By contrast, commercial banks, which are not subject to this legislation, do not have to contribute, even though many of their customers may well have financial problems.

Municipalities or districts – that is, the third tier of government, at the level below the Länder – have no right to legislate on financial services issues.

In essence, legislative authority over financial services and consumer protection lies with the Federal Republic. If a decision is taken not to intervene in a particular sector or in relation to a specific issue, the Länder cannot take action and the matter remains unregulated. Even when the legislative approach adopted by the Federal Republic is one of information disclosure, as it is with the Consumer Credit Act, it is not open to the Länder to supplement Federal requirements by introducing additional measures.

This means that the only route available for consumer organisations and individual consumers to improve consumer protection is through legal action on the basis of the general civil code or the law on unfair contract conditions. The reluctance of the Federal legislature to take action may be one important contributory factor to the significant role played by the courts.

3. Regulatory Boards

After the severe crisis in the German financial system in the 1930s, when there were a number of major bank failures, legislation on the establishment of banks and the setting up of a banking regulatory board was introduced. The main goals were to restore the credibility of the banking sector and to ensure proper functioning of the financial system. However, consumer protection as such was not one of the objectives.

The Kreditwesengesetz (Credit/Banking Institutions Law) lays down a definition of a banking business and requires all institutions that carry on such business to be authorised by the Bundesaufsichtsamt für Kreditwesen (Banking Regulatory Board). As well as initial authorisation, there is continuing supervision. After a Bundesgerichtshof (Federal Court) decision that inadequate supervision gave individual bank customers the right to sue the Federal Republic for damages, the legislation was changed. Art.6, sec.(3), now explicitly states that supervision only serves the general public interest and is not intended to protect individual depositors.

In general, regulatory boards in Germany do not claim that they are responsible for consumer protection matters, though there is some difference of emphasis between them. The Bundesauchsichsamt für das Versicherungswesen (Insurance Regulatory Board) has recently

shown increased activity with respect to consumer complaints. On the other hand, the Bundesaufsichtsamt für Kreditwesen (Banking Regulatory Board) generally denies jurisdiction over all contractual matters, even though these are invariably at the heart of consumer complaints. The Federal Government has stated that it sees responsibility for consumer protection only when there is an "obviously illegal" banking practice.

However, even in respect of extortionate interest rates or other malpractices, the Banking Regulatory Board has never identified such an obvious violation until and unless the courts have taken a decision. The only general initiative taken recently by the Banking Regulatory Board has been in respect of banking services for minors. Consumer organisations had revealed new and legally doubtful practices – for example, that banks had opened accounts for minors without asking the parents and in a number of cases had even granted loans to minors without the necessary permission of the Guardianship Court, as required by law. To deal with these problems, the Banking Regulatory Board published 'guidelines' of what it considered to be good practice for banking services provided to minors.

Many consumers find it a very frustrating experience to approach a regulatory board, under the impression that it is generally responsible for supervision, only to receive a standard letter that the board has no jurisdiction over consumer complaints and that the consumer should get in touch with a consumer organisation.

Insider Trading

The newly established Investment Services Regulatory Board has an explicit power to investigate insider trading and other unfair practice in the investment sector. However, it is too early in this body's life to evaluate what impact this will have on consumer protection.

The 'Grey Market'

Another new development concerns the so-called 'grey market' for investment services. For many years, there was an unregulated investment sector. As long as the firms or individuals operating in this market did not carry on business reserved for banks, they were free to 'advise' consumers and even to handle investments in sometimes dubious companies. Many consumers lost large sums of money, often to more or less criminal operators. Only from 1998 has there been an obligation to register with the Banking Regulatory Board and accept some continuing supervision.

There is still some doubt whether this new requirement will bring effective consumer protection. This 'grey market' did not even make a substantial contribution to the supply of new venture capital, but only resulted in heavy losses to consumers, and consumer organisations believe that regulation in this sector should be much stronger. Consumer organisations have regularly published warning lists of firms about which consumers should be wary. Quite often the warnings came too late, or the organisers had started a new company under a different name. Consumer protection based on information or warnings seems to be inadequate in this area if there is some criminal intent.

4. The Role of the Courts

Extortionate Interest Rates

Over the past 20 years, the courts have played the most important role with regard to consumer protection and financial services. For example, the courts decided that consumer loans with extortionate interest rates do not comply with the general standard of fair practice (section 138 of the Civil Code). The test criterion developed by the courts for a maximum rate of interest for consumer loans is a formula based roughly on twice the market rate of interest, as shown in the monthly statistics of the Bundesbank (Central Bank). This was a widespread consumer problem, involving thousands of households.

When new forms of consumer credit were developed, which were more flexible and made the interest rate more difficult to calculate, the courts developed a principle that banks offering such complex kinds of credit were obliged to disclose the disadvantages of using these types of credit. The courts also decided that many terms and conditions in consumer loans did not comply with the Law on General Conditions.

Value Dating

With regard to bank current accounts, one of the most important decisions was to prohibit formulaic 'value dating'. The Bundesgerichtshof (Federal Court) decided that this is an unfair practice because the consumer has to pay interest on a debit that in reality no longer exists, either because the consumer has made a cash payment into his account or because a credit transfer has already reached her or his account. The banks' argument that they need the benefits from value dating to cover the costs of current accounts was not accepted. It was considered that this did not justify the disadvantages for individual consumers and that for the purposes of fair competition the costs of operating an account should be shown openly and fully, not hidden via value dating. In a later decision, value dating was also ruled to be an unfair practice when applied to accounts held by businesses. Value dating was only ruled acceptable when applied to the collection of cheques, as the bank does not have cleared funds available at the time when a third party cheque is paid in for collection.

Bank Charges

A number of important cases have been decided on bank charges. The courts have not acted as a 'price control mechanism' by deciding whether a particular charge was too high or not, but rather whether there is any legal justification for levying a charge on consumers. Before these decisions, an almost opaque jungle of charges and fees had developed. The rationale of these decisions is that banks can make a charge only when they have rendered a real service to consumers, but not when they have fulfilled a contractual obligation on themselves – for example, to give receipts for in-payments. One very important decision was to allow customers to use cashier services without any extra charge. It was considered that a current account carries the implicit right for a customer to withdraw any positive balance, which is in effect the customer's own money,

without being charged extra. If the customer is overdrawn, any in-payment is in effect repayment of credit granted and this, too, is not a chargeable service. Also, because of the risks associated with fraud when payment and cash withdrawal cards are used at ATMs (automated teller machines), consumers should not be forced to use this method of obtaining cash by the imposition of a charge for using cashier services.

Another significant decision was that banks cannot charge when they are acting for their own benefit – for example, when carrying out a check to see whether there is a sufficient positive balance in an account to clear a cheque or to carry out an outgoing money transfer or debit. This very recent decision has led to thousands of requests to consumer organisations for information or support.

A further category of unacceptable charges was defined by the courts in relation to actions by the banks to fulfil a legal obligation imposed on them. A legal obligation imposed on banks cannot be changed into a 'service' to consumers and become the subject of charges. For example, when tax law requires banks to pay amounts tax free, banks cannot charge customers who ask for this to be done. This German principle of 'obligatory services' has recently strongly influenced the EU's approach to banking charges for conversion from national currencies into the Euro.

These decisions in favour of consumers should not be taken to mean that all disputed charges have been considered unfair by the courts. The Bundesgerichtshof (Federal Court) allowed additional charges for the cross-border use of credit cards, even though such cards were offered to consumers as international payment instruments. The court accepted that that cross-border use was an additional service and that extra charges were acceptable.

Early Termination of Mortgage Contracts

A major dispute about mortgage loans went unresolved for years. Consumers with mortgages at a fixed interest rate for a specified period – say, ten years – were not released by banks from mortgage contracts even when the property was to be sold, unless they paid additional very high charges which were often levied without any explanation as to how they had been calculated. The Federal Court finally decided that consumers who sell their property had a right to terminate their contract early and that the banks were only entitled not to be disadvantaged by this. Also, banks were required to explain how their charges for early termination were calculated.

Insurance Contracts

So far as insurance is concerned, the Federal Court decided that consumers should not be locked into long-term contracts of five or ten years when the duration of the agreement was a general contract condition rather than one specific to a particular contract. The rationale of this decision was that consumers who were locked into such long-term contracts could not take advantage of favourable market developments.

In other cases, the court had to decide on issues where consumers claimed that they had given oral information to the insurers' representatives but had not put this information down in writing

on the application form. Insurers often rejected liability on the grounds that under the general contract conditions only written statements should be taken into account. The court decided that representatives are the 'eyes and ears' of the insurers and that liability must be allowed when information was given orally.

Development of Case Law

These outlines of significant cases should not be interpreted as meaning that the problems were all solved with sudden or surprising decisions by the Federal Court. Rather, they are the outcome of complex development of case law that has often lasted for years. The lower courts often took a substantially different view. Intensive legal debate has contributed effectively to finding solutions that have in general solved many major problems for consumers and have given clear guidelines for the future to banks and other financial services organisations. Since the decisions of the Federal Court are based on general legal principles, there is also the advantage that they can be adapted flexibly to market developments. The court has refrained from excessively narrow definitions so as not to set up too many obstacles to the working of market forces, but it has also forced the financial services industry to pay attention to legal precedents and guidelines when developing new services. This 'preventive' effect is also supported by the active part that the judges concerned take in writing books on banking law and taking part in legal conferences.

Neither statutory legislation nor the Regulatory Boards for Banking and Insurance have been able or willing to deal with consumer issues in a satisfactory way. Both the legislative process and the Regulatory Boards seem more open than the courts to lobbying pressure by the financial services industry. Yet many of the general terms and conditions widely used by the industry have been ruled unfair by the courts.

An important factor seems to be that bank and insurance cases are dealt with by specialised divisions of the courts. This has enabled the courts to develop specific legal experience in the financial services sector and also to build up their economic expertise. The number of similar cases has also helped to develop the courts' awareness of consumer issues.

A system in which both the legislature and the regulatory authorities refrain from positive consumer protection initiatives seems to demand that both consumer organisations and the courts play an active part to achieve a satisfactory balance of power between the interests of consumers and those of the financial services industry.

5. Consumer Organisations

Class Actions

An important element in consumer protection in recent years has been that consumer organisations have been able to bring class action cases in the courts. This has been especially significant in relation to unfair contract terms and conditions and has been most important when an individual consumer may suffer only a small loss, though the combined loss to all consumers

may amount to a very large sum. For example, the financial loss suffered by an individual consumer as a result of value dating of a particular transaction may only have amounted to a fraction of a DM, but the total loss to all consumers over a period ran into millions of DM.

The disadvantage of the German approach to class actions taken by consumer organisations is that the court's decision is limited as to whether a contract condition is fair or unfair. Consumers who are affected by the decision do not automatically get redress as consumer organisations cannot seek collective damages.

The Organisations

Germany has a complex system of consumer organisations. Their legal status is either a private body or a foundation. In most cases, the membership of private bodies does not consist of individual consumers but of other organisations, such as family organisations and trade unions. They receive substantial public financial support, in exchange for which they provide services in the fields of consumer policy, information, advice and education.

The most important organisations are:

- Arbeitsgemeinschaft der Verbraücherverbande (AgV), which is the national umbrella federation of the Verbraucher-Zentralen (Consumer Centres) of the Länder. Its main function is consumer policy, for example responding to new legislative initiatives at federal level and representing consumers at EU level. It is funded almost entirely by the Federal Government;

- Verbraucher-Zentralen at Länder level, primarily providing information and complaint-handling services for individual consumers as well as sometimes initiating class actions in the courts;

- Stiftung Warentest (Foundation for Comparative Testing), primarily a product testing organisation which currently publishes two magazines, *Test* and *Finanztest*, and a large number of books. The publications are quite successful and as Stiftung Warentest does not provide advice services for individual consumers its costs are quite low. It does not depend on financial support from public funds but does receive some compensation as its publications do not carry advertising. *Finanztest* has more than 300,000 subscribers and provides information on a wide range of financial services. It also publishes test reports, for example on the quality of investment advice given by banks and building societies;

- The Verbraucherschutzverein (Association for Consumer Protection) is an organisation which specialises in class actions in the areas of unfair contract terms and unfair competition (for example, misleading advertising). It is funded by the Federal Government and focuses on problems which are national in character, by contrast with the Verbraucher-Zentralen which work on Länder level issues – though quite often these are similar in character.

As well as these consumer bodies there are many organisations which deal with specific consumer problems – debt counselling centres, for example, and the automobile owners' association (ADAC).

A recent issue in Germany has been whether it is really desirable to have such a varied range of consumer bodies. The structure of the Verbraucher-Zentralen mirrors that of the Länder Governments. While they are private bodies in terms of their formal legal structure, between 84 and 95 percent of their funding comes Länder or municipal Governments. The rest comes mainly from fees charged for services provided to individual consumers. There is a wide range of fees – for example DM5 (c.C$4) for standardised printed information on a specific problem, DM20 (c.C$16) for a book on savings and investment, and DM250 (c.C$200) for individual advice on mortgages. The amount of financial support received from public funds strongly affects the ability of a Verbraucher-Zentrale to developed a capacity to specialise in financial services and in practice only a small number have been able to play an active part in initiating court actions.

6. Agreements and Codes of Practice

In Germany, there is virtually no tradition of securing consumer protection by means of agreements or codes of practice. Formal agreements between banking trade associations and consumer organisations are unknown. Banks have developed their general contract conditions within their three trade associations (that is, for commercial banks, co-operative banks and savings banks). Discussions with consumer representatives occur, if at all, only at the end of the process. There is some scepticism as to whether this 'consultation' has been motivated by a genuine desire to take consumers' views into account in drafting the conditions rather than to signal to the Bundeskartellamt (Competition Authority) that consumers had been listened to. Certainly, none of the consumer representatives involved recalled any major changes being made as a result of these discussions. The only changes that have occurred have been as a result of dialogue between banks and consumer bodies at Länder or local level, usually about relatively minor problems.

The situation may change as a result of the European Commission's strategy to encourage dialogue between banks and consumer organisations[3]. However, some political pressure seems to be necessary – for example, a threat to introduce legislation. The only instance of a positive commitment made by the banks occurred as a result of just such political pressure. An undertaking to open a new account, with a positive balance, for any consumer without an account was made by all three banking trade associations after intensive political pressure. All the major political parties had signalled that if this did not happen, legislation would follow. In spite of this, consumer and debt counselling organisations report that in practice this undertaking is often not complied with and that a legal obligation on the banks would be a better way forward.

Because there is no real institutional dialogue and no experience of agreements and codes of practice, these 'soft law' instruments are of little or no importance in Germany.

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[3] Communication from the Commission – Financial services: enhancing consumer confidence. COM (97) 309 final of 26 June 1997, Brussels.

7. Ombudsman Schemes

Whether an individual German consumer can get redress through an ombudsman scheme depends on which bank she or he has an account with. Most of the banks that are members of the trade association for commercial banks and mortgage banks are part of the ombudsman scheme for these organisations, which was set up in 1992. The Federal association for the savings banks does not have an ombudsman scheme, but some of the Länder savings bank associations do. Also, some local savings banks have a scheme, sometimes internal to the bank. There is not yet any ombudsman scheme for the co-operative banks.

This situation is confusing for consumers. The latest annual report[4] of the ombudsman for the commercial banks states that, out of 8,000 complaints made, only 5,000 were against the commercial banks. The rest were against savings or co-operative banks over which he has no jurisdiction. It would seem to be highly desirable for consumers to have clear information about which ombudsman scheme they should go to if they have a complaint.

Consumer organisations were not involved at all when the schemes were set up. Their critique focuses on the following issues:

- The choice of ombudsmen is made by the banks. There are doubts as to whether all ombudsmen are really independent of the banks and consumer organisations have received complaints about the decisions.

- The decisions made by ombudsmen are not always binding on the banks – sometimes not at all, sometimes only up to a ceiling, for example DM 10,000 (c.C$8,000). This can cause problems, especially in cases which involve investments;

- When first set up, one of the schemes involved a filtering system by the banking trade association concerned, Complaints could not be addressed directly to the ombudsman, but only to the trade association, which took a decision as to whether the complaint would go through to the ombudsman. This has been changed recently;

- Some schemes will not deal with new problems, for which there is no precedent;

- The ombudsmen do not publish detailed case reports. Consumers cannot find out whether a similar case, notably in relation to the same bank, has already been decided, and with what result. Only general statistical information is published – for example, that 47 percent of cases were decided in the banks' favour, 48 percent entirely or partially in favour of consumers, with an agreement being suggested in the remaining five percent. Unfortunately, these statistics do not show the exact extent to which consumers were successful – the phrase "entirely or partially" leaves the exact degree of success open.

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[4] Fünf Jahre Ombudsmann – Aktive Verbraucherpolitik der privvaten Banken. Bundesverband deutscher Banken, July 1997, Köln.

The European Parliament Resolution of 20 February 1997 on the European Commission Green Paper *Financial services: meeting consumers' expectations*, which stated that ombudsman schemes should be independent and that consumers' interest should be properly represented in their operation, is not met by the German schemes – nor is the requirement that reports should be published on the complaints and their outcome. Also, it would seem to be desirable to set clear standards for an ombudsman's independence, otherwise one-sided or biassed schemes may lay claims to be impartial.

The establishment of banking ombudsman schemes has reduced neither the number of complaints to consumer organisations nor the number of financial services cases being brought before the courts. The main consumer problems remain unchanged. Without making any judgment on ombudsman schemes in general, it can be said that, because of their national characteristics the German schemes are only a limited success – at least, they do not involve the consumer in any costs.

8. Conclusion

Consumer protection in financial services in Germany is not the outcome of a carefully constructed system based on a single theoretical concept, but has developed as a result of particular historical events, the influence of European Union developments and the important role played by independent courts. The system is characterised by divided competences and responsibilities. A more stringent system would be more effective.

Part IV

Denmark and Sweden: Financial Services and Consumer Protection – Policy and Practice

by
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1. Introduction

The aim of this report is to provide a description of the Danish and Swedish approaches to consumer protection and the financial services industry. This report is part of a comprehensive description of financial services and consumer protection in the European Union intended to enable the Canadian Government Task Force on the Future of the Financial Services Sector to take a look at how the European Community and some of its member states approach law, regulation and best practice governing relations between consumers and the financial services industry. The report takes as its starting point examples from statute law, regulatory frameworks and (where relevant) the role of the courts.

The financial services industry is defined as including:

- Banks;
- Building societies or mortgage companies;
- Credit brokers;
- Insurance companies;
- Credit card companies.

The concept of financial services covers a great variety of services including:

- Savings – deposit accounts, savings in stocks and shares and pension savings;
- The purchase of stock, shares and other securities;
- Payment services – giro payment transfer, payment cards, prepaid cards and cheques;
- Consumer credit – buying on credit and hire purchase, credit secured by mortgage on real property, bank loans and loans secured on another person's guarantee;
- Insurance, both of goods and real estate (non-life insurance) and of persons (life assurance).

The concept of the consumer in Danish and Swedish marketing law is normally understood to be the private individual who buys goods and services for her or his own use at home or for leisure purposes. However, the concept is sometimes extended to cover 'legal persons' who, even though they are not buying goods or services for this specific purpose, are acting in very similar roles. In this report, the concept of the consumer is extended to cover small businesses. A small business is often treated by banks and other financial services organisations more or less in the same way as the individual consumer, as neither is able to determine its own terms and conditions when negotiating with a bank. Both categories are distinguished from the larger business, well able to negotiate on an equal footing with its bank.

This report is based on a examples, selected because they illustrate the most recent and significant developments in Denmark and Sweden. At the end of the description of these examples, an evaluation will be made for Denmark and Sweden respectively. As it is impossible to give a comprehensive description of consumer protection and the financial services, the examples have been selected as representing the most recent and most important issues in consumer protection in the following areas:

- Information and advertising: information must not be misleading;
- Contract terms and conditions: the need for transparency so that the consumer is able to take appropriate decisions: fairness: the balance between consumers and financial services organisations: unfair and oppressive contract terms: discrimination against certain categories of consumers – for example, low income consumers or the elderly;
- Redress: an effective redress procedure: alternative dispute resolution systems;
- Security: protection against risks which consumers cannot foresee: compensation if a financial services organisation fails:
- Consumer representation.

Financial services and consumer protection in Denmark and will be described below in part 2. The description will contain a brief reference to the relevant legislation in 2.1, followed by selected examples in 2.2 and an evaluation of these in 2.3. Part 3 of the report will follow the same pattern for Sweden.

2. Denmark

The Legal Framework

Issues relating to financial services and consumer protection have both a public law and a private law aspect. There is also a procedural law aspect.

Public Law

In Denmark, it is a rule that all businesses which lend money or receive money or other assets from the public on loan to be paid back are subject to regulation by law and to supervision by a public authority. Legal regulation can be divided into two categories, specific legislation dealing with financial organisations but with no consumer protection provisions for consumer protection (described below under 2.1.1.1), and consumer protection legislation which applies to all businesses, not just financial organisations (described below under 2.1.1.2).

Financial Services Legislation

There are four types of financial services organisation – banks, mortgage companies, insurance companies and savings and loan businesses. Banks and mortgage companies are regulated by two main Acts of Parliament, the Banks and Financial Institutions Act[1] (abbreviated as the Banks Act) and the Mortgage Act[2]. All insurers are governed by the Insurance Business Act[3]. Supervision under the Banks Act is carried out by the Financial Supervision Authority (sections 49-52). This Authority also supervises insurance companies under the Insurance Business Act (sections 237-247a) and mortgage companies under the Mortgage Act (sections 94-100a). There is therefore a unitary regulatory body, the Finance Supervision Authority.

These three Acts of Parliament form the backbone of regulation for financial services organisations. However, there are other savings and loan businesses which exist side by side with the banks and mortgage companies. These used to be regulated under the 1934 Savings and Loan Businesses Act. This Act was changed in 1996 to regulate – among other things – the new prepaid payment cards (such as the DANMØNT card), which were introduced at that time[4]. The Finance Supervision Authority also supervises these businesses (s.11).

To protect the consumer against the risk of a financial organisation becoming bankrupt, a Depositor Guarantee Fund Act was first introduced in 1987 and came into operation in 1988. It has been used several times. It was amended in 1995 to implement the EU Bank Deposit Guarantee Scheme Directive[5]. The Act established a guarantee fund for depositors who lose their deposit due to bankruptcy of the bank[6]. The Ministry for Commerce has laid down rules for cooperation between the Fund and the Finance Supervision Authority[7].

Consumer Protection Legislation

The Payment Cards Act is specific in that it regulates a particular kind of financial instrument, namely payment cards and electronic payment systems without a card, but with a PIN code, issued not only by banks but also by credit card companies, supermarket chains and others

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[1] Act No 730 of 6 August 1966 (Lov om Banbker og Sparekasser mv).
[2] Act No 924 of 23 October 1996 as amended by Act No 1048 of 11 December 1996 (Realkreditlov).
[3] Act No 746 of 6 August 1996 (Lov om Forsikringsvirksomhed).
[4] Act No 375 of 22 May 1996 (Lov om Sparevirksomheder og Udstedere af Forudbetalte Betalingskort). Prepaid payment cards also fall within the scope of the Payment Cards Act described below. The DANMØNT card is a Prepaid ('electronic purse') plastic card which can be used instead of cash for small purchases like newspapers, coffee and sweets , or cigarettes in slot machines. It can also be used as a phone card or for buying rail tickets. There are other prepaid cards which are dedicated phone cards.
[5] Council Directive of 30 May 1994 on bank deposit guarantee schemes (94/19/EC).
[6] Act No 367 of 14 June 1995 with later amendments Nos 376 and 386 of 22 May 1996 (Lov om en Indskydergarantifond). Regulation No 754 of 15 September 1995. The Fund is a private foundation, but day to day administration is carried out by the National Bank of Denmark (central bank). The Fund covers bank deposits paid by customers into a bank if the bank is declared bankrupt, after deducting any debts or loans, and covers the remaining sum up to 300,000 Danish Kroner (c.C$00,000) per customer. In some cases, the Fund covers the deposit fully without any maximum and without deducting any debts or loans first, for example if the deposit was paid into the customer's pension savings account.
[7] Section 2(4) of the Depositor Guarantee Fund Act and regulation No 755/1995.

similar businesses[8]. The specific purpose of this legislation is consumer protection and the Consumer Ombudsman is the supervising authority under the Act (s.10). The Act prescribes a duty on all card issuers – whether of a payment card, a credit card or an account card – to notify their payment card system to the Consumer Ombudsman (s.6). No similar duty is imposed in relation to electronic payment systems which work without a card. The Act lays down a legal standard against which payment card systems must be developed and operate – they must be transparent and afford the consumer protection against misuse (s.12a).

The general consumer protection law which also covers financial services organisations is the Marketing Practices Act[9]. This functions as a safety net and supplements the financial institutions legislation. In particular,the 'good practice' requirement which is included in the Banks Act (s.1(6)), by which banks must observe honest business practice and good practice for financial services organisations, is supplemented by the legal standards of the Marketing Practices Act. According to s.1, all businesses, whether public or private, must observe good marketing practices. According to s.2, businesses may not use false, misleading or unreasonably insufficient information in advertising. Thus sections 1 and 2 lay down the legal standards of 'good marketing practice' and 'truth in advertising'. The Consumer Ombudsman is the supervisory authority under the Act.

The Price Marking and Price Display Act contains rules for price marking of goods[10]. In the case of services, including financial services, there is no general obligation to price mark under the Act. But the Consumer Agency, which functions as the administrative office of the Consumer Ombudsman, is given powers by the Price Marking and Price Display Act to lay down special rules for the price marking and price advertising of services. The Consumer Agency has laid down two such regulations for banks:

- A regulation which lays a duty on banks to publish their interest rates on deposit and loan accounts as well as other credit costs in advertisements and on posters in their premises, where consumers can see them easily[11];

- A regulation which lays a duty on banks to advertise their fees and foreign exchange rates in advertisements and on posters in their premises[12].

Private Law

The private law dimension is more difficult to deal with. The regulation of the contract between borrower and lender, depositor and bank, insured and insurer, houseowner and mortgage company, card holder and card issuer is regulated, not in one comprehensive body of legislation, but in different places in various Acts. Some of these deal exclusively with consumer protection, others not. There is, however, one piece of comprehensive legislation, namely the Insurance

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[8] Act No 811 of 12 September 1994 (Betalingskortloven).
[9] Act No 428 of 1 June 1994 (Markedsføringsløven).
[10] Act No 456 of 17 June 1991 as amended by Act No 429 of 1 June 1994 (Prismaerkningsloven).
[11] Regulation No 902 of 12 November 1992.
[12] Regulation No 237 of 30 March 1994.

Contracts Act[13] , which regulates many different aspects of the insurance contract, even though, strictly speaking, it is not specifically aimed at consumer protection. It has a special chapter on life assurance (s.97-118). Apart from this, contracts between financial services organisations and consumers are regulated by, for example, the Contracts Act (s.38a-d)[14] which deals with unfair or unreasonable contract terms, as well as the Consumer Contracts Act[15] , which deals with doorstep selling, distance selling and the provision of ongoing services. The Credit Contracts Act[16] replaced the former Credit Sale of Goods Act in 1991 and regulates the relationship between borrower and lender. By contrast with its predecessor, which only applied to hire purchase credit, the new Act governs all types of credit contract where the consumer borrows money to buy something, including hire purchase, agreements on money loans and account contracts. Some of the provisions apply outside the consumer context.

Procedural Law

The basic principle is that administrative supervision is general in character. In other words, the supervisory body cannot interfere in individual cases and give the consumer redress. Consumers are thus normally referred to the general courts if they are seeking redress under a contract. Consumers need not go the long, difficult and costly way through the courts, however, but can submit their complaints to the Consumer Appeal Tribunal. The Appeal Tribunal has three members: a chairman and two members who represent the interests of consumers and of business respectively. The Consumer Agency functions as the secretariat. There is no fee or charge for taking a case to the Tribunal and the Tribunal route is available if the case falls within certain minimum and maximum financial limits[17]. However, it is always open to the consumer to initiate action in the courts, though once proceedings have been started at the Appeal Tribunal, court action must be suspended and the court must await the decision of the Tribunal. Also, consumers cannot complain to the Consumer Appeal Tribunal if there is a special Appeal Tribunal dealing with a particular category of complaint. Such a special Appeal Tribunal, the Banks Appeal Tribunal, has been set up to deal with individual consumer complaints against banks.

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[13] Act No 726 of 24 October 1986 with later amendments, most recently Act No 262 of 6 May 1993 (Forsikringsaftaleloven) and dating back originally to 1930. In 1975, the Act was reconsidered for the specific purpose of introducing consumer protection provisions, but without any result. However, the Act protects all private individuals who want to take out an insurance policy and can thus be categorised as consumer protection law in the insurance sector. On this particular point, Denmark lags behind both Sweden and Norway.

[14] Act No 781 of 26 August 1996 (Aftaleloven). The Act was originally introduced in 1917 and is a result of cooperation between the Nordic countries in this area.

[15] Act No 886 of 23 December 1987 with later amendments, most recently Act No 1098 of 21 December 1994 (Lov om Visse Forbrugeraftaler).

[16] Act No 398 of 13 June 1990 with later amendments, most recently Act No 1098 of 21 December 1994 (Kreditaftaleloven).

[17] The price of goods and services which are the subject of the complaint must not exceed 24,000 Danish Kroner (c.C$4,800) or be less than 500 Danish Kroner (c.C$100). The Tribunal Chairman may allow complaints about goods or services which cost less than the minimum. For automobiles, the upper limit is 82,000 Danish Kroner (c.C$16,400) but the lower limit stays the same (Regulation No 871 of 14 October 1994, s.2).

Consumer Complaints about Banks and other Financial Organisations

Individual complaints from consumers about banks can be put to the Financial Supervision Authority, but the Authority can only decide on general aspects of the bank's practices. Individual complaints can also be brought before the Consumer Ombudsman who then considers if the bank has acted in accordance with standards of good marketing practice or truth in advertising. The Ombudsman may then start negotiations with the bank, if he considers that the bank has infringed either of these legal standards, with the aim of making the bank change its behaviour and conform to the rules. If he finds the infringement sufficiently grave, he may decide to sue the bank, but in no case can he grant the consumer private law remedies, such as, for example, the right to cancel a contract or the right to redress – or, where there is an invalid contract, declare the contract null and void.

In cases where there is a dispute between the individual consumer and a bank, where the consumer is seeking a private law remedy, the Financial Supervision Authority or the Consumer Ombudsman must direct the consumer to the Banks Appeal Tribunal. The consumer may always take her or his case to the courts but, as already mentioned, this is a long and costly process. The Banks Appeal Tribunal has specialised knowledge and experience in banking and financial services. Its Chairman is a judge and there are two members, one of whom represents the interests of consumers, the other the interests of the banks. The Tribunal is privately organised, financed by the banks themselves and set up under the Consumer Appeal Tribunal Act[18]. The Consumer Appeal Tribunal has the power to authorise such privately organised appeal tribunals under s.12 of the Act and once such a specialised private appeal tribunal has been set up, the Consumer Appeal Tribunal itself can no longer deal with complaints in that sector. Two other similar specialised private appeal tribunals have been set up in the financial services area, the Mortgage Appeal Tribunal and the Insurance Appeal Tribunal.

Procedure at these specialised Appeal Tribunals is quick and cheap. The consumer has to pay a fee of 100 Danish Kroner (c.C$20), which is refunded if she or he wins the case. Otherwise, there are no fees or charges. Once the Appeal Tribunal has made a decision in favour of the consumer, the bank or other financial organisation is given 30 days to comply. In most cases, the financial organisation complies. However, the decision cannot be enforced by the bailiff, so either of the parties involved must bring the decision back to the court to make it enforceable. In most cases, the court confirms the Appeal Tribunal's decision. If the bank has refused to comply with the Appeal Tribunal's decision, the Appeal Tribunal will, at the consumer's request, present the consumer's case to the court. Free legal aid is granted to the consumer to take the matter to the court if the Appeal Tribunal has decided wholly or partly in her or his favour. The consumer also has the right to legal representation during the court procedure, subject to income limits. The consumer's annual income must be below 186,000 Danish Kroner (c.C$37,200) if single or 236,000 Danish Kroner (c.C$47,200) if married, with the limit raised by 32,000 Danish Kroner (c.C$6,400) for each child[19].

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[18] Act No 282 of 10 May 1988 (Lov om Forbrugerklagenaevnet).

[19] The Court Procedures Act No 752 of 15 August 1996 as amended by Act No 1201 of 27 December 1996, s.330-336c (Retsplejeloven). The Legal Aid Regulation No 1069 of 9 December 1996 (Bekendtgørelse om Fri Proces).

Examples

The legal framework, as described above, indicates that Denmark has fairly well developed legislation for consumer protection in financial services, both as regards content and procedure, and that the consumer has easy access to redress and to be represented in court. There have been some innovations in this field in Denmark recently, the most striking feature of which is that these new developments take the form of 'soft law' rather than 'hard law' – that is, they deal with ethical guidelines rather than mandatory rules. These new initiatives have not been taken by Parliament and do not take the form of binding legislation, but have been introduced by the supervisory body, the Consumer Ombudsman. They take the form of guidelines which the Consumer Ombudsman has issued, chiefly under the legal standards of the Marketing Practices Act (s.1 and 2), aimed at regulating the conduct of business of financial organisations when dealing with their customers.

The proposed content of the guidelines is discussed by the Consumer Ombudsman with those parties who have a vested interest in the area concerned. Once the guidelines are issued, they are an expression of what is considered good marketing practice. The way in which the firms affected obey the guidelines is subject to supervision by the Consumer Ombudsman under the Marketing Practices Act. The guidelines are not mandatory and represent a trend towards the increasing use of 'soft law' in Scandinavian consumer protection The following three examples are drawn from banking (1994 and 1997), payment cards (1996) and mortgage credit (1995).

Guidelines on Conduct of Business in Bank Advice

These guidelines are intended to ensure that information and advice provided by a bank employee to the customer are transparent and do not mislead. Under the title *Ethics in Bank Advice* (Etik i bankradgivning), they were first introduced in 1994 and came into operation on 1 October of that year. They were amended in 1997 to clarify certain problems of interpretation. In 1996 they were supplemented by a pamphlet issued to consumers explaining what the duties of bank advisers are when they advise their customers. The guidelines were issued after the Consumer Ombudsman had negotiated their content with the Banks' Association, the National Consumer Council, the Council of Handicrafts (small business) and the Competition Authority.

The guidelines give expression to the content of the legal standard of 'good marketing practice' when banks give advice to their customers. They do not deal with the questions of how banks should deal with their customers outside the advice situation, or with customers who seek advice unsuccessfully but who nevertheless need help. Also, they do not deal with questions as to how banks should devise their standard contract terms and conditions, nor with their pricing policy. In short, the guidelines deal exclusively with conduct of business matters when advising customers and prospective customers. However, within this context they are intended to be carefully implemented by the banks and form the basis on which the Banks Appeal Tribunal can decide in cases where these questions arise. The guidelines apply to banks' relations with both individual consumers and small businesses.

The salient points in the guide lines are:

- The advice which a bank employee gives to a customer must take account of the interests of the customer and only those interests. The employee must meet a high professional standard when advising customers. In case of a possible conflict between the interests of the bank and those of the customer, the bank adviser must only have regard to the interests of the customer;

- Bank advisers should be careful when advising private consumers about high risk investment, for example in shares, or about foreign currency speculation, unless the customer already has experience, background knowledge or is otherwise very familiar with the risks involved. The bank adviser should never encourage a customer to invest money in a way which contravenes the intention of the legislation in force or to make use of possible loop holes in taxation laws. The bank adviser should always evaluate with the customer whether she or he is able to afford the risk of a proposed investment in case it turns out badly;

- Some banks negotiate individualised terms and conditions with some of their customers. For example, a bank may fix a more favourable interest rate and a less costly fee for one customer, who is a good customer, but may apply standard terms and conditions to other customers who are less so. If a bank makes use of this strategy, it must inform each individual customer about this procedure, perhaps in the annual or monthly statement, by including a statement of the highest and lowest interest rates and fees, and the possibility of variation in the costs charged for each particular account category;

- Banks should advise their customers about tax questions whenever relevant, but should be careful to refer them to seek advice elsewhere. This is particularly so when the bank adviser has insufficient knowledge of the individual circumstances of the customer, or in highly specialised areas where the bank adviser cannot be expected to have the required expert knowledge. The bank adviser has a duty to advise once he becomes aware of any circumstance which may affect the customer or refer the customer to seek advice elsewhere;

- The advice given by banks must cover all the services offered by the bank itself in detail, so that the customer can arrange her or his financial situation in the most advantageous way. The bank adviser must also provide the customer with a general description of the services provided by competing institutions, but this need not go into detail – for example, the bank adviser cannot be expected to provide the customer with detailed information about the terms and conditions of accounts with other banks;

- The bank must ensure that all the contracts it enters into with individual customers are put in writing and signed by both parties. If a customer has specific and important conditions which she or he wants fulfilled in connection with obtaining advice, great care must be taken in putting them in writing. The more specific and atypical these conditions are, and the greater their significance for the customer's financial situation, the greater should be the care taken in putting them in writing;

- If a customer applies for a loan for which someone else is a guarantor, the bank must make sure that the guarantor understands the nature and content of her or his obligation and the risks involved. A bank should never agree to give a loan to a customer if the prospective guarantor cannot afford to carry the risk involved because there is a significant discrepancy between the amount of the guarantee and the prospective guarantor's personal financial circumstances. Banks should exercise particular caution in cases where the prospective guarantor's financial circumstances are modest;

- The pamphlet issued by the Consumer Ombudsman summarises these points and provides consumers with advice about how to do business with banks – for example, they are advised to compare the terms and conditions offered by different banks. Similarly, consumers are advised that it may be a good idea for them to do business with more than one bank or with different kinds of financial services organisation, as suits their needs. Consumers are informed about how to bring complaints before the Banks Appeal Tribunal, but only after they have tried to settle their complaint directly with the bank.. Finally, consumers are advised about the compensation role of the Depositors Guarantee Fund in case the bank with which they deal is declared bankrupt.

These guidelines are part of a new initiative to make ethical and conduct of business questions and answers the order of the day in economic life in Denmark. Their introduction was prompted by a number of scandals in the business sector. In particular, scandals had erupted in the banking sector when some banks started selling their liable invested capital, resulting in their financial collapse. These events provoked discussion about the role of banks as financial advisers in their relationship with customers. The scandals were followed up in the press and debated in Parliament, with the focus on how similar situations could be prevented from recurring. It was considered that the optimum balance between the interests of banks, consumers and the public interest in general could best be struck by introducing guidelines to encourage the banks themselves to consider the ethical aspects of their conduct of business with customers and to develop solutions in a dialogue between management and employees. The guidelines lay down in some detail what is considered to be good marketing practice in accordance with the principles set out in the Marketing Practices Act. The management of a bank is responsible for the compliance of its staff with the guidelines and must ensure that their staff are appropriately trained.

Guidelines on Distance Selling in Payment Systems with Payment Cards

These guidelines were issued in December 1996, to be implemented from 1 May 1997[20]. They were issued under s.12a(2) of the Payment Cards Act[21] and s.17 of the Marketing Practices

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[20] Retningslinier vedrcrende Fjernsalg m.v. i Betalingssystemer med Betalingskort.

[21] S.12a(2) provides that if the Consumer Ombudsman finds that a payment system is inadequate in respect of transparency or protection against misuse, he must start negotiations to change that situation. This provision gives the following examples: (i) the necessary control, security and correction procedures have not been established; (ii) the standard terms and conditions of the payment card contract are biassed to the detriment of the cardholder or are otherwise unreasonable; (iii) the provisions of the Act are breached in other ways.

Act[22]. A draft of the proposed guidelines was first discussed between the Consumer Ombudsman and the Danish Mail Order Association, the Banks Payment Systems Association, The Banks' Association, the Danish Commerce and Service Association, the Danish Retail Credit Council, Diners' Club Denmark Ltd and the National Consumer Council.

The purpose of the guidelines is to protect card holders against misuse in situations where the payment card is used without being scanned in a payment transaction, for example in a distance selling transaction. The guidelines are also intended as a protection for cardholders who make use of distance selling with the card but find themselves in a weaker position than that of consumers who pay cash on delivery. The guidelines cover those situations where the cardholder does not authorise payment by signing an invoice or by using her or his PIN, but the merchant later requires a further payment transfer which has not been formally authorised. The guidelines apply irrespective of the ways in which the consumer orders the goods – that is, they cover traditional orders by post, telephone orders and orders over the internet or via other media. However, the guidelines apply only to card-based payment systems and not to electronic payment systems which function without a card, which are regulated under Chapter 6a of the Payment Cards Act.

The main points of the guidelines are:

- They establish a general legal standard by which payment card issuers are encouraged to establish procedures to safeguard against the risks of misuse and mistakes when charging the customer for her or his purchase in connection with distance buying and selling. The terms and conditions of the payment card contract must tell cardholders of their access to distance selling and the procedures they must follow when using this way of buying goods and services. Card issuers are encouraged to terminate agreements with those merchants who repeatedly infringe the guidelines or the card issuer's relevant rules. If foreign merchants breach the rules, issuers of international payment cards must seek to negotiate their compliance with the rules of the international payment system. Payment cards developed in future should be structured so that the cardholder can decline access to distance selling with the card. Account statements should single out distance selling from conventional transactions;

- The merchant should not initiate a payment transfer without the express authorisation of the cardholder. The transfer must only cover those amounts and items which are covered by the cardholder's express authorisation. Thus it is not sufficient authorisation if the cardholder has given his card number to the merchant without specifying his order exactly. The cardholder can authorise the merchant to debit her or his account on a regular basis, but the cardholder's express acceptance of this must be given – for example, when the cardholder subscribes to a monthly magazine. The cardholder may also give express authorisation for the merchant to charge the account with an amount not fixed in

[22] According to s.17, the Consumer Ombudsman must – in connection with or after having had negotiations with the relevant business and consumer interests – seek to influence the way in which businesses conduct their business by issuing guidelines about a particular marketing practice within a specific area which is considered to be of particular importance, especially so far as the consumer interest is concerned.

advance – for example when ordering a book that hasn't been published yet. The merchant is under a burden of proof that the cardholder authorised a transaction of this kind;

- Card issuers are not allowed to require card holders to keep their card number secret. Card issuers are allowed to restrict the use of the card number, for example to internet transactions, but if the cardholder infringes these provisions, the transaction itself will still be covered by the guidelines, unless the cardholder has acted fraudulently;

- If the cardholder maintains that a distance selling transaction was unauthorised; or that the amount charged exceeds the one agreed on; or that the cardholder did not receive the goods ordered; or that the cardholder has made use of a right of withdrawal from the transaction; then the merchant must suspend the payment transfer until the objection has been looked into. If it appears to have some foundation in fact but it cannot be fully proven, the merchant may only charge the account of cardholder with the amount acknowledged by the cardholder. If the merchant has already charged the full amount to the cardholder's account, the disputed amount must be credited to the account immediately, that is a within a few days of the merchant being told of the cardholder's objection;

- Card issuers may not seek to limit cardholders' right to complain as mentioned above by introducing time limits for complaints in the contract terms and conditions. Nor are card issuers or merchants allowed to enter into special, individual agreements with cardholders under which they seek to introduce such time limits. In Denmark, the ordinary time limits for notification of defects under the Sale of Goods Act apply. Cardholders may lose their entitlement to notify defects if they do not do so within a reasonable period;

- A card issuer is not allowed to withdraw a cardholder's card or to terminate a contract only because the cardholder has made a complaint about a particular transaction. However, the card issuer can issue a replacement card with a different number, if this intended to prevent future problems. The card issuer may cancel an agreement with a cardholder if the cardholder has made repeated unjustified complaints about distance selling transactions or has breached the contract terms and conditions in other ways;

- Order forms do not have to be used for distance selling transactions. However, if they are used, they must contain clear information identifying the goods or services sold and the cost of the transaction, including postage and packing. If the consumer has to pay any costs on withdrawing from the transaction, this must also be stated clearly on the form. The consumer must sign and date the form. The same conditions apply if the order is placed electronically, except that there is no need for a signature. All the merchant's marketing material must contain adequate information about the terms and conditions, postage and packing charges and any other charges, so that the cardholder can estimate the total cost of the distance transaction. Merchants must be especially careful when they give information about prices and charges by telephone and in other situations where it may be difficult to prove what was actually said;

- Invoices must be sent to the cardholder at the same time as the merchant applies for transfer of the money from the cardholder's account. Invoices must always contain information which specifies the date when the goods were sent, the total amount due and the payment card to be used. If the consumer has a right of withdrawal under the Consumer Contracts Act, the merchant must, when delivering goods, inform the cardholder clearly and in writing about the right of withdrawal. The contract is not binding if the merchant neglects this duty.

The use of electronic payment systems poses many legal problems which must be answered as they tend to arise, in connection with the quality, safety and reliability of the information provided, the start, finish and performance of the contract, the effects of a breach of contract, liability of the parties to the contract, data protection, settlement of disputes and the sanctions for criminal offences. The Payment Cards Act, which was first introduced in 1984 and later revised in 1992 and 1994, when it was extended to cover electronic payment systems without cards but using PIN codes, answers some of these questions from a consumer protection viewpoint. The guidelines summarised above represent the most recent and most interesting development in this area.

They have a weakness that as guidelines they can only be expected to have an effect on distance selling contracts within Denmark. As distance selling using a credit card is often useful when the cardholder buys goods or services from abroad, the influence and effect of the guidelines will probably be limited, at least for the present. However, it is a beginning that these guidelines have been written down and are being implemented in Denmark. Their effect may well come to be widespread in the longer run as these problems have to be tackled everywhere where payment cards are used in distance selling contracts. A further revision of the Payment Cards Act is now in its first stages. Technological and international developments are rapid, particularly in relation to internet transactions and payments. New provisions and a revision of the existing rules will probably be included in the amended Act.

Guidelines on Conduct of Business by Mortgage Companies

These guide lines, with the Danish title *Etik i realkreditinstitutter* were issued in September 1995 by the Consumer Ombudsman after they had been negotiated with the Mortgage Council, the National Consumer Council, the Danish Commerce and Service Association, the Council for Agriculture, the Council of Handicrafts, the Finance Association, the Finance Supervision Authority, the Competition Authority and the Ministry of Economics. They were implemented as from 1 June 1996. The guidelines lay down what is to be understood as good marketing practice in connection with the business of offering mortgage credit. They are intended to offer protection to two groups of buyers, both of whom – individual consumers and small businesses – are often in a weak position in the market with no realistic possibility of influencing market mechanisms.

The guidelines therefore aim to make mortgage companies and building societies do business so that they look after not only their own (perfectly legitimate) business interests, but also those of borrowers. The guidelines represent an attempt to strike a balance between the interests of consumers, mortgage companies and society as a whole. As a rule, those actions of mortgage companies which are unethical also infringe the legal standard of good marketing practice. The

guidelines lay down the minimum conduct of business requirements which the mortgage companies must meet. In particular, they discourage the use of certain terms and conditions. They represent a minimum standard and mortgage companies are allowed to set a higher standard if they wish.

The most important points in the guidelines are as follows:

- Mortgage companies must – when they advertise their products, advise their customers, enter into contracts with borrowers, and during the subsequent performance of contracts – act in a manner which considers the interests of the borrower. The company must provide information about its own products, including the terms and conditions and price for each of its appropriate alternative products. The company must enable borrowers to compare and choose freely between competing products from other mortgage companies. Management has a duty to see that these guidelines are put into practice by their staff and to develop their own conduct of business standards. Staff must be trained and given guidance when putting these guidelines into practice;

- The general marketing material published by the mortgage company must contain reasonably reliable information. All the written information about the products offered must be easily understandable. If a customer asks for a loan, the company must, in case of need, inform the applicant of the length of time which will elapse before an offer can be made (two weeks is the maximum). Offers must be made in writing and accompanied by information about the particular type of loan chosen and the reasons for choosing it. The company must tell the applicant about the effects which changes in interest rates may have on the size and conditions of the loan, as well as the effects of making a contract to safeguard against interest rate fluctuations. If the company offers a smaller loan than the one applied for, it must say why;

- If a borrower applies for a discharge of an existing loan, the offer made by the company must include information about the total amount covered by the discharge, including all fees and charges. The offer must indicate the various ways in which the loan may be discharged and their consequences. Discharge offers must always be given in writing. If the borrower applies for a loan to be restructured, so that a new loan replaces the existing loan, similar rules apply. The company must ensure that the borrower does not end up in a situation where the new loan proves insufficient to discharge the old one. If there is a risk that this may happen, the borrower must be told before the contract is made. The borrower must be expressly told if the company is unable to include all the charges arising from the restructuring of the loan;

- When a contract for a loan is made, the company must tell the borrower in the contract what will happen if the borrower wants to sell the house. Is it possible for the new owner of the house to take over the loan or must the borrower discharge it when the sale takes place? If the terms and conditions of the loan allow the new owner to take it over, this must be stated expressly and clearly. Once the company has 'approved' the new owner, it cannot subsequently withdraw its consent to the loan being transferred. Once the transfer is complete, the original owner must be told in writing that she or he is released from all

obligations under the original loan. If transfer is refused, reasons must be given in writing to both parties involved, The time limit for the company to consider acceptance of a transfer is one week, otherwise the parties must be told how long it will be before a decision is made;

- There are similar provisions for guarantees, described earlier, though these are used far more rarely for mortgage loans. In practice, they are only used for married or cohabiting couples. Even in these cases, great care must be taken because of the risk that at some later stage the couple concerned may want to stop living together. The joint financial situation of the couple must be taken into account when evaluating whether there is a discrepancy between the financial situation of the applicant for a loan and that of the partner who is guaranteeing the loan. Mortgage companies are encouraged to prepare brochures which explain the rules for guarantors in such situations;

- If the price policy of the mortgage company entails differentiation between different applicants for loans when it calculates its fees and charges, each applicant for a loan must be told of this practice. When asked, the company must also tell the applicant about the grounds on which differentiation is made and what circumstances determine where an applicant is placed on the scale;

- If the mortgage company offers only standardised types of advice, applicants must be told. All advice which the mortgage company gives to an applicant must live up to a high professional standard and take the interests of the customer into account. Similar provisions are found in the guide lines for conduct of business in bank advice described above under 2.2.1. Similarly, all contracts must be made in writing and all the terms and conditions for the loan must reflect a reasonable balance between the duties laid on the borrower and on the company. The terms and conditions of the loan must ensure a high level of protection for the borrower and may not impose excessively heavy burdens. The company may not reserve its right to alter contract terms unilaterally. This will be considered an infringement of the standard of good marketing practice covered by s.1 of the Marketing Practices Act. Furthermore, such terms are regarded as unfair under s.36 and s.38 of the Contracts Act and may result in the contract being declared null and void;

- If a borrower does not fulfil his duties under the contract, and the company must collect the debt, this must be done with a reasonable consideration for the interests of the borrower. If the borrower does not pay one of the instalments, she or he must be given information in writing of the consequences of this, including any fees and interest on overdue payments and the risk that the debt will be handed over to be collected – and eventually that the home of the borrower may be sold at auction;

- If the mortgage company cooperates with other professionals, such as estate agents, lawyers, auditors, banks or insurance companies, a clear-cut division of the work done by the different parties must be worked out and the applicant must be told. It is the responsibility of the mortgage company to see that their partners obey these rules;

- In case of disagreement between a borrower and the mortgage company, the company must try to negotiate a settlement. If this is not possible, the company must tell the borrower of the right to complaint to the Consumer Ombudsman and to the Mortgage Appeal Tribunal.

The guidelines for mortgage companies have a much wider scope and coverage than the guidelines described above under 2.2.1, as they cover all the business activities carried out by mortgage companies, not just giving advice. The guidelines proved controversial in that they imposed certain duties on mortgage companies, particularly in restraining their freedom to alter fees and repayments unilaterally. They protested against these provisions and did not implement them. In reply, the Consumer Ombudsman cited s.9(3) of the Credit Contracts Act, by which a contract term which allows the lender to amend the costs charged under the contract must be given to the consumer with express explanation of the conditions under which such changes may be made[23].

Denmark – an Evaluation

The three examples of guidelines summarised above could be supplemented by others. In the insurance sector, the Consumer Ombudsman issued guidelines in February 1990 to insurers and banks when issuing bonus projections or forecasts and projections for pensions savings. In November 1990, the Consumer Ombudsman issued a recommendation about loans offered to consumers when buying goods on credit[24]. Two sets of guidelines to banks were issued in 1990 and 1991 respectively, concerning the sale of securities quoted on the stock exchange and the settlement of such sales, as well as the settlement of foreign exchange transactions.

Hopefully, the main point has already been made clear. The Consumer Ombudsman's role is general in character. He exercises general surveillance over what is going on and tends not to intervene in individual cases. Also, even though there is some mandatory legislation, consumer protection in financial services is better suited to regulation according to standards of good practice which allow the banks and other financial services organisations to develop over time a high standard of conduct of business covering, for example, price display, payment practices and minimum standards of information disclosure.

The examples given should, however, be seen in the context of fairly well developed consumer protection legislation and good consumer access to complaints and redress systems, as well as effective consumer representation. It is also important that consumers are safeguarded against the risk of banks going bankrupt.

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[23] Annual Report of the Consumer Ombudsman 1996 (Juridisk Årbog 1996), p.72.

[24] Some loans of this kind were no longer being offered by the seller directly, but by a third party with whom the seller had made an arrangement to finance the purchase. In the Consumer Ombudsman's opinion, an agreement of this kind would fall within the scope of the Credit Contracts Act which offers protection to the consumer. It would thus be an infringement of s.1 and s.2 of the Marketing Practices Act if such loans were marketed or advertised as loans outside the scope of the Credit Contracts Act.

In the area of marketing law, it is a great art to strike the right balance between rule-making and market forces. The Marketing Practices Act is quite open-ended and the supervising authority, the Consumer Ombudsman, has his strongest power in the way he seeks to influence the businesses it is his duty to supervise. He achieves far more by convincing these businesses of the right way to behave than by suing in court. Another factor is that he does not have the human resources to police every aspect of the financial services industry.

The characteristics of the Danish system are therefore are therefore legal standards of behaviour laid down in general terms in legislation and open to a great variety of interpretations and ongoing revision as Danish society develops, combined with a supervisory authority with little power of coercion but playing a very significant role in influencing businesses to adopt high standards of consumer protection. The central position of guidelines for pinpointing what constitutes good marketing practice in an area such as financial services was strengthened in 1994 when the Ombudsman was given express powers by s.17 of the Marketing Practices Act to issue guidelines. Until then, he had issued guidelines, but as a practical measure and without any formal power to do so. The power to issue guidelines opens a quick, efficient and flexible approach which is a great advantage for a public authority in its dealings with business. It also has the advantage of offering an easy way of adjusting the market to changing standard of good marketing practice in accordance with developing needs in an area like financial services, where rapid changes are taking place. Also, the power to issue guidelines enables the Consumer Ombudsman to negotiate their content with the parties concerned and to listen to their views before the guidelines are published. This happened with financial services, as both consumer representatives and business interests were consulted before the guidelines were issued. The guidelines, even though they are not formally binding, then function as a basis for the courts when considering what is good marketing practice – and the courts can test them to see whether or not they are adequate. Perhaps this approach to administering an area of powerful, opposing market forces may be a model for future developments in Canada.

3. Sweden

The Legal Framework

This corresponds quite closely to the legal framework in Denmark and is only described here in broad outline except where there are differences.

Public Law

Financial Services Legislation

Sweden's banking legislation is similar to Denmark's. Supervision under it is carried out by the Swedish Finance Inspection Board, corresponding to the Danish Finance Supervision Authority. Also, Sweden has an Insurance Business Law which includes a principle of reasonable business

practice[25]. There is a proposal in the Swedish Parliament, called "Insurance Business and Change", according to which this principle of reasonableness should be taken out of the Insurance Business Law and transferred to the Contract Terms Act (see below) where it would be more appropriate[26]. As in Denmark, the Swedish Finance Inspection Board supervises Swedish banks, other financial institutions and insurance companies. Similarly, the Swedish banking and financial institutions legislation is not specifically concerned with consumer protection in financial services, but the Finance Inspection Board does cooperate with the Consumer Agency and Consumer Ombudsman, particularly concerning the application of consumer protection law to financial services.

Consumer Protection Legislation

There is a Marketing Practices Act, which was revised in 1995[27]. Before its revision, it corresponded closely to the Danish Marketing Practices Act, but it now differs on two main points. It has nine specific prohibitions which in most instances have no parallel in the Danish Act[28]. Also, it has introduced a specific fine for "market disturbance" which can be imposed on a business which infringes one of the nine prohibitions[29]. The amount of the fine may vary from 5,000 Swedish Kroner (c.C$926) to a maximum of 5 mn. Swedish Kroner (c.C$926,000). The amount of the fine depends on the seriousness of the infringement. The Danish Act forbids “free gifts”, “side benefits” or “throw ins”. The corresponding prohibition in the Swedish Act was abolished and replaced by a duty on the merchant to provide detailed information about the “throw in”. It should be noted that the Act retains the legal standard of good marketing practice in s.4 and adds a clause by which marketing practices must be “proper” not only to individual consumers but also to other businesses.

Sweden has a Price Information Act as in Denmark[30]. Price information must be clear. The Act applies to financial services and is supplemented by information duties laid down in the Consumer Insurance Act and the Consumer Credits Act. It is recognised in Sweden that information to the consumer is very important and a report presented to the Swedish Parliament in 1995 with the title *Increased Competition between Banks* contains a variety of different proposals for facilitating competition in banking. One of them involves better consumer information. If the proposals are adopted, the Consumer Ombudsman will be responsible for supervising how they are complied with in practice.

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[25] The principle of reasonableness in insurance business involves an insurance business acting reasonably and in a well balanced way, for example when fixing insurance premiums account should be taken of the necessary costs and the risk covered by different types of contract.
[26] Final Remarks of the Insurance Review Committee, SOU 1995:86 (Försäkringsrörelse i Förändring).
[27] Act (SFS 1995:450) (Marknadsföringslagen).
[28] The nine prohibitions concern: (i) identification of advertisements; (ii) misleading advertising; (iii) misleading packaging; (iv) misleading product imitations; (v) bankruptcy sales; (vi) general sales; (vii) realisation sales; (viii) delivery of goods to consumers who have not ordered them; (ix) precise information about special offers (s.5-s.13 of the Act).
[29] S.22-28 of the Swedish Marketing Practices Act.
[30] Act (SFS 1991:1601) (Prisinformationslagen).

There is no Payment Cards Act in Sweden. However, Sweden has one Act which has no parallel in Denmark, the Act on Contract Terms in Consumer Relationships (usually called the Contract Terms Act)[31]. The Act contains both civil and marketing law provisions. It deals with contract terms used by businesses when offering goods and services for sale to the consumer. The marketing provisions of the Act forbids the use of contract terms which are considered unreasonable for the consumer in relation to the price of the goods and other conditions of sale. This prohibition is parallel to a provision for annulment under the Act's civil law provisions. The Market Court can issue prohibitions against the use of such terms and conditions if necessary for the common good or to safeguard the interests of consumers or to promote competition. The Consumer Ombudsman can issue prohibitions in lesser cases.

The Market Court's practice distinguishes three categories of unreasonable contract terms:

- Those on which the parties have agreed and which do not stem from compulsory law. In these cases, the Court will consider contract terms to be unreasonable if they load the duties on one party to the benefit of the other, and if the burden is considerable. The Court tests each contract term in context, so that a contract term may well be found to be reasonable in one context but not in another, especially if the drawbacks to the consumer are set off by a corresponding advantage. Any advantages must be brought to the attention of the consumer and must at least compensate for the disadvantages;

- Those which infringe compulsory legislation. In these cases the contract term is prohibited irrespective of the context in which it occurs. Contract terms in this category may infringe compulsory requirements in consumer protection or other legislation, or compulsory legal principles;

- Those that are misleading or unclear, so that the consumer is misled as to the consequences of the contract and her or his own rights. Such contract terms do not meet the requirements of transparency and predictability in consumer contracts and can also be prohibited[32]. There are only very few Market Court cases affecting financial services because until 1995 the Contract Terms Act did not apply to businesses subject to supervision by the Finance Inspection Board[33].

Private Law

In this area, consumer protection law is more developed in Sweden than in Denmark. Thus there is a specific Consumer Insurance Act which contains rules for consumer protection in insurance contracts[34]. There is a proposal in the Swedish Parliament dating back to 1993 to improve

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[31] Act (SFS 1994:1512)(Lagen om avtalsvillkopr i konsumentförhållanden (avtalsvillkorslagen).
[32] A summary of Market Court practice is included in a 1993 Consumer Agency publication *Contract terms inadmissible in consumer contracts* (Konsumentverkets shrift Avtalsvillkor – Otillåtet i avtal till konsument).
[33] Report of the Consumer Agency and the Consumer Ombudsman (Konsumentverket & KO Rapport) *Financial services and contract terms (Finansiella tjänster och avtalsvillkor)*, 1995-96:36, p.11.
[34] Act (SFS 1980:38) (Konsumentförsäkringslagen).

consumer protection in insurance[35]. Sweden has introduced a Doorstep Selling Act, which corresponds to the Danish Consumer Contracts Act[36] and a Consumer Credit Act which is similar to the corresponding Danish Act[37]. Side by side with the Contract Terms Act, which was mentioned above and which contains both private and market law provisions, the Contracts Act lays down provisions for unfair and unreasonable contract terms[38]. There is a proposal, *Payment Services*, for introducing legislation on consumer protection and payment services, but it has not yet resulted in legislation[39]. According to this proposal, the authority of the Consumer Agency must be strengthened, so that it can supervise all firms in which consumers invest. This proposal only applies to those firms which are not already supervised by the Finance Inspection Board.

Procedural Law

It has been mentioned above that there is a special court, the Market Court, which deals with cases under the Marketing Practices Act. This court has the same role as the Danish courts in this area: The Consumer Ombudsman can sue businesses in the Court and the Court can issue injunctions, for example under s.14 of the Act. According to this provision, the Court can issue a prohibition to a business which has initiated a marketing procedure considered to be against good marketing practice, as laid down in s.4 of the Act. Consumers who are seeking redress may submit their case to a General Appeal Board. This Board has special departments, one for banking cases and another for insurance cases. The Consumer Agency represents consumer interests in these departments of the Board and works for the integration of consumer protection aspects when the Board adjudicates on financial services cases. If many consumers have similar claims, the Consumer Ombudsman may sue the business on their behalf, so that all may receive redress in the same case[40].

A very significant innovation in procedural law for financial services concerns representation and was introduced as an experiment in 1996. It was proposed in *The Consumer Ombudsman's intervention on behalf of private persons*[41] , presented to the Swedish Parliament in 1996, suggesting that an experiment should be introduced to allow the Consumer Ombudsman, in a dispute between the individual consumer and a business, to intervene as the consumer's representative. An Act embodying this proposal was passed on 5 June 1997[42]. It concerns disputes between consumers and firms about financial services and, according to s.2, the Consumer Ombudsman may intervene on consumers' behalf in such cases either before the

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[35] Ds 1993:39, (Ny Försäkringsavttalslag).
[36] Act (SFS 1981:1361) (Hemförsäljningslagen).
[37] Act (SFS 1992:830) (Konsumentkreditlagen). Denmark has no specific Consumer Sale of Goods Act, as consumer protection provisions are included in the Sale of Goods Act, but Sweden has Act SFS 1990:932 (Konsumentköplagen). Sweden also has a special Consumer Services Act (SFS 1985:716) which has no parallel in Denmark.
[38] Act (SFS 1915:218) (Avtalslagen). The Act was an outcome of cooperation among the Nordic countries at that time, which explains the similarities between the Danish and Swedish Contracts Acts.
[39] SOU 1995:69 ("Betalstjänster", Slutbemerkande av betaljänstutredningen).
[40] A similar access for the Danish Consumer Ombudsman was introduced in the 1994 Danish Marketing Practices Act, s.20.
[41] Report (SOU 1996:140) *KOs biträde åt enskilda*.
[42] Act (SFS 1997:379) Lag om försöksverksamhet avseende medverkan av Konsumentombudsmannen i vissa tvister.

ordinary court or the bailiff, if the dispute involves an important legal question or there are other special reasons. If the Consumer Ombudsman intervenes in this way, there is no cost to the consumer. The Act came into force on 1 December 1997 and applies until 30 November 2002. There is no parallel in Denmark.

Examples

The two examples of the Consumer Agency's work outlined below differ from the Danish examples because the Agency has not issued guidelines in the formal sense of the word, but has pinpointed areas where the it is going to make a special effort. The areas identified are those which are often neglected by the financial services industry – perhaps even distorted – to the detriment of the consumer. They concern information disclosure in marketing and the use of standard terms and conditions.

Information Disclosure in Marketing

During 1997, the Consumer Agency dealt with consumer problems in the marketing of insurance and credit against the background of provisions in the Consumer Credit Act, the Consumer Insurance Act and the Marketing Practices Act[43]. The Agency also made an effort to improve the provision of information to consumers by banks and credit institutions about the content of financial services and about the credit assessment systems used by banks. Many consumers have complained to the Consumer Agency about the content of banking services, including lack of price information, the margin between deposit and loan interest rates and about the difficulty of getting a real understanding of the implications of the contract terms used. Consumers have also questioned whether competition between financial services organisations is working well enough.

The Consumer Agency tries to solve these problems by putting pressure on financial services organisations to make them provide better information about their services and to make them develop systems for dealing with complaints. Certain insurance companies have established their own 'customer ombudsmen'. The Consumer Agency considers that the banks should imitate them and also establish such customer ombudsmen. The banks have officials in charge of complaints, but the content and quality of this service varies from bank to bank. The Finance Inspection Board has examined the way in which banks deal with complaints and has issued guidelines to improve matters.

The Consumer Agency has required banks to issue better and more comparable information when they market new savings accounts or alternative and different kinds of pension savings accounts. The banks tend to give insufficient information about these new services. The information provided may even be misleading, particularly about the return which these new forms of savings accounts are expected to give in the future.

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[43] Report of the Consumer Agency & Consumer Ombudsman (Konsumentverket & KO Rapport) The Consumer Agency's work with financial services (Konsumentverkets arbete med finansiella tjänster), 1997-98, pp.5-14.

The Agency is at present examining monthly account statements to see whether the information provided to customers is sufficient. Also, the Agency is examining how banks deal with information about the calculation of interest rates. It also wants them to improve the information given to certain customer groups – for example, the elderly, who traditionally know little about the services provided by banks and are reluctant to make active use of them.

In the insurance sector, the Consumer Insurance Act prescribes compulsory information requirements on insurance companies. The Agency has issued guidelines on the information required when consumers buy insurance and about the content of the terms and conditions in the most common categories of consumer insurance.

Information in connection with payment services is another area where the Agency predicts that its supervisory powers will be strengthened to see that the information requirements which are going to be introduced in this area will be fulfilled.

It is not the task of the Consumer Agency to provide consumers with advice and guidance directly. However, the Agency supports the independent consumer advisers established by local authorities in Sweden, for example, by providing courses in consumer law and budgeting advice, and also by giving advice in the daily contacts between the Agency and consumer advisers. Such contacts may be about the interpretation of contracts and disputes between consumers and financial services institutions. More and more households need information on financial matters and the Agency supports local authority advisers in this work.

Contract Terms

The main problem with financial services contracts is that they lack clarity. Consumers find it difficult to understand them. The way in which contracts are written, especially the lack of information about the contract and its consequences, make it very difficult for consumers to understand their rights and fulfil their duties. This is true in two areas in particular, namely contracts which involve someone acting as guarantor for the borrower and the calculation of interest rates in credit contracts. The legislation which applies is found primarily in the Contract Terms Act and is supplemented by other consumer protection legislation, for example the rules on information disclosure in the Marketing Practices and Credit Contracts Acts. However, the Contract Terms Act has only applied to financial services for the last two years and there is as yet hardly any relevant case law.

The Consumer Agency has made it a high priority to strengthen the rights of consumers in respect of financial services. The conditions under which financial services organisations work have changed radically in the last few years in Sweden. Deregulation, the establishment of a level playing field between banks, insurers and retailers, as well as the access by consumers to cross-border services, are all changes of great significance to consumers. Recent cut backs in social services have also increased consumer demand for financial services. Similarly, the number and variety of financial services have increased enormously within a relatively short period and the services themselves are now often very complex, all of which makes it very difficult for consumers to get a grip on the whole market. This means that the need for advice and consumer protection before buying has increased. This need is now much stronger when consumers are in

the process of entering into a contract as they are in a weak bargaining position in their relationship with a bank, insurer or mortgage company.

Problems

The Consumer Agency cooperates with the Finance Inspection Board and has ongoing consultations with it about the consumer aspects of financial services. In particular, they have scrutinised contract terms and conditions and identified the following problems:

- Banks and credit organisations make use of vague and unclear contract terms about interest payments and about interest on overdue payments. On savings accounts, banks tend to reserve their right to amend the contract conditions without prior notice. Also, banks reserve their right in the contract to lower interest rates on deposit accounts even though the level of the interest rates in the Swedish economy has not changed. This means that inattentive consumers may find that the yield on their deposit accounts turns out to be much lower than expected. Banks also use contract terms under which deposit account interest rates are fixed at a much lower level than those on credit accounts. This means that the consumer pays a lot for a loan but gets very little return from a deposit. Another contract term used by banks concerns value dating and specifies that account deposits and withdrawals may not be entered on the account on the same day on which the transaction occurs, so that the consumer loses between two and six days interest;

- On payment services, the Consumer Agency has discovered that the banks introduce exemption clauses to free themselves from liability if something goes wrong. An example is the bank strike which hit Sweden at the beginning of the 1990s. One consequence of the strike was that the banks did not carry out any payment services while it lasted. This meant that the banks were in breach of contract with their customers and the customers for their part had to pay interest on overdue payments to creditors. When the customers turned to their banks to claim redress, the banks refused to pay on the basis of the liability exclusion clause. Another associated problem is the use of exemption clauses which free the bank from liability if payment is delayed because of technical breakdown. If the contract involves use of a payment card, the contracts omit to lay down rules for consumer liability in case of card loss or theft. If rules are included, they normally only refer to the information disclosure requirements specified in s.34 of the Credit Contracts Act. Also, if the consumer tries to withdraw money from a cash dispenser, but receives no cash despite the transaction being registered on the her or his account, it is practically impossible for the consumer to prove that no money was issued;

- The Consumer Agency has identified several problems with mortgage credit. One of them concerns so-called ‘false annuity loans’. These often involve a floating interest rate with a fixed repayment instalment and a fixed duration. There is no statement in the contract about the consequences of a change in interest rates. The main problem is whether or not an interest rate increase allows the lender to extend the duration of credit or to require the consumer to pay a once-and-for-all amount to make up the deficiency. This particular question is now the subject of a test case in the High Court. Another problem concerns mortgage credit contracts where a third party is acting as guarantor. Often, the guarantor

does not get enough information about the duties and responsibilities involved. The guarantor may get into trouble if she or he relies on the bank having made an intensive evaluation of the borrower's credit worthiness and the bank has not really carried this out. Also, it is a problem if the guarantor is not advised at once when it becomes clear to the bank that the guarantor is in default;

- In the insurance sector, consumers tend to expect that the insurance policy they have taken out covers more risks than it really does. The problem here is that the terms and conditions of the insurance contract are often far too vague and the liability of the insurance company not sufficiently well-defined. For example, insurance companies tend to exempt damage caused by sudden or unexpected accidents, without defining exactly what is meant by these terms. Under the Consumer Insurance Act, insurance companies must provide consumers with written information about the terms and conditions of the insurance contract so that they can judge the exact scope and coverage of the insurance. It is sometimes a problem that the information given to the consumer does not correspond exactly with the policy terms and conditions. This may mean that, when an accident happens, it turns out not to be covered by the insurance – much to the consumer's surprise.

Possible Solutions

The Consumer Agency has put forward the following possible solutions to these problems:

- The marketing provisions of the Contract Terms Act enable the courts to annul unreasonable contract terms included in standard contracts, but the Act does not enable the courts to lay down what the content of these contract terms should be in order to be reasonable and to serve the interests of consumers. It is the Market Court which, in the last resort, tries unreasonable contract terms. However, the Consumer Ombudsman only brings a few such cases to court. This is because the Contract Terms Act offers a basis for negotiation with businesses about improving their contract terms and finding broad and flexible solutions to these problems. Much of the work carried out by the Consumer Agency on standard contract terms consists of this kind of negotiation with trade associations. Many problems are solved by these negotiations and it is a fundamental experience that clarity of expression serves the consumer interest best. Because the Contract Terms Act has only applied to financial services for a relatively short time, the Agency has so far not had a lot of experience in this sector. It hopes that financial services trade associations will be cooperative, but if this does not happen the only way forward would be way of a thorough revision of he Contract Terms Act. This Act is an important basis for strengthening the position of consumer in the market place, but it is not the only one. In this context, the Consumer Agency stresses the importance of high standards in conduct of business and good consumer information in the marketing process, all of which are the responsibility of businesses themselves, backed up by the provisions of the Marketing Practices Act. Also, the Agency stresses the importance of an effective complaints and redress procedure. Finally, the Consumer Agency works to improve

consumer knowledge of rights and duties, through the school curriculum and consumer advisers;

- In relation to bank and credit contract terms, the Consumer Ombudsman has in many instances sued banks in the Marketing Court under the Contract Terms Act to obtain prohibitions from the Court. Thus the Court has prohibited contract terms according to which banks have reserved their right to increase the rate of interest completely at their own discretion. The same applies to contract terms for interest rates on overdue payment, which deviate considerably from non-compulsory law. Furthermore, the court has prohibited contract terms by which a bank reserves its right to unilateral terminate a loan to the consumer.

- The problems posed in the insurance sector are slightly different, in that the contract terms in the policy are really part of the insurance product – that is, they determine the obligations of an insurer once damage is caused to the consumer or to her or his property. The possibility of using the Contract Terms Act to adjust policy terms and conditions is therefore limited. However, there some terms and conditions which may be unreasonable. For example, the requirement that the original receipt of purchase must be handed in to the insurer for compensation to be paid out may be looked on as an unreasonable contract term. Contract terms which breach the compulsory provisions of the Insurance Contracts Act, or contract terms which are too vague, may fall within the scope of the Contract Terms Act and may be adjusted accordingly;

- Within the scope of the Consumer Credit Act, there is a duty on the lender to give information about the effective rate of interest, about credit costs and about the cash price of goods. This information must be given to the consumer before the credit agreement is made. The purpose of these provisions is to enable the consumer to compare various offers of credit and to evaluate the financial consequences of a credit purchase. Furthermore, the Act prescribes that credit contracts must always be made in writing, that the consumer must be given a copy of the agreement and that the lender must tell the consumer about changes in interest rates and obligations. The Consumer Agency has issued guidelines for the implementation of the Consumer Credit Act[44] ;

- The disclosure aspects of the Consumer Insurance Act provide that the insurance company must give the consumer written information about terms and conditions which limit the scope and coverage of the insurance compared with what consumers would expect in normal cases. The provisions of the Consumer Insurance Act are more comprehensive than those of the Marketing Practices Act as they also regulate the provision of information after the contract is made. The Consumer Agency has issued guidelines for the implementation of these Consumer Insurance Act provisions[45];

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[44] KOVFS 1992:4.
[45] KOVFS 1981:3.

- It was referred to above that the Consumer Ombudsman may sue a business on behalf of many consumers who have identical claims for damage before the General Appeal Board. The Consumer Ombudsman has conducted nine such class actions in financial services. One case was concerned with increases in interest rates not in accordance with the terms and conditions of the credit contract or the provisions of the Consumer Credits Act. Another concerned contract terms laying down unreasonably high rates of interest on overdue payments. A third was about the ‘false annuity loans’ referred to above. The Consumer Agency expects that class actions will be useful in the Contract Terms Act area, but so far none of the financial services cases has reached adjudication. the mere possibility of such class actions may well serve as a warning to banks and other financial services organisations not to introduce contract terms which may be considered unreasonable.

Sweden – an Evaluation

The number and variety of financial services in Sweden have increased enormously in recent years. The importance of financial services to consumers has also increased with the deregulation of the financial market and the cutbacks in social security. As in Denmark, legislation which covers the relationship between the banks and other financial services organisations on one side and the consumer on the other is far from adequate and has many loop holes. Again as in Denmark, the legislation is fairly recent, apart from the Insurance Contracts Act. There is still little case law in the courts. By comparison with Denmark, Sweden does not seem so far advanced in the use of conduct of business guidelines.

The Consumer Ombudsmens’ work in financial services in Denmark and Sweden is marked by a very flexible approach, with more and better results being obtained by negotiations between the Consumer Ombudsmen and the financial services organisations than by taking cases to court. In both countries, great emphasis is put on the provision of detailed information both before and after contracts are made. Unreasonable contract terms are also the focus of attention. Denmark is remarkable for having focused in particular on standards of the conduct of business by financial services organisations. Sweden is unique in having introduced the experimental Act to enable the Consumer Ombudsman to intervene in certain disputes, though there is not yet any experience of how this works in practice. The framework of financial services legislation is far from complete, but both countries afford consumers easy access to redress systems and to representation in court.

Part V

United Kingdom: Financial Services and Consumer Protection – Policy and Practice

by
Jeremy Mitchell

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1. Context

The United Kingdom market for retail financial services is mature, complex, growing and competitive. There is a wide range of different types of financial service and of financial services organisations. Some of these are niche players – for example, specialising in mortgage lending or collective investments – while others are financial conglomerates, providing a full portfolio of banking, life and non-life insurance and investment services.

Financial services are currently undergoing rapid market change. The market structure is being transformed by a wave of mergers and acquisitions, particularly affecting medium sized firms. Increasingly, market conditions appear to favour both very large financial services organisations and some specialised firms, leaving intermediate players in the cold. Also, the growth rates and profit margins in retail financial services, as well as the increasing emphasis on well organised service delivery systems, are attracting firms from other industries – especially retailing. The food and clothing retailer Marks and Spencers has moved into financial services in the last few years, as have Virgin and three major national supermarket chains.

The use of new technologies has moved rapidly from back office operations to delivery systems. Automated teller machines (ATMs) are now the predominant way in which most consumers obtain cash – there are 23,000 in the UK, compared with 19,000 in Canada[1]. Increasingly, the telephone is used for buying motor and other non-life insurance and, to a lesser extent, operating bank accounts. Use of the Internet for buying financial services and for transactions is increasing rapidly, albeit from a small base.

These rapid market and technological changes have been – and still are – accompanied by an increasingly sharp focus on developing an optimal legal and regulatory structure able to deal effectively with market imperfections without putting undue burdens on the financial services industry.

Until just over a decade ago, consumer protection issues in financial services tended to be dealt with on an *ad hoc* basis as they were identified. There were therefore a number of separate and largely unconnected pieces of legislation. A succession of Companies Acts from 1948 included provisions dealing with public share issues. The approach adopted in the 1958 Prevention of Fraud (Investments) Act was not greatly different from its 1939 predecessor. The 1974 Consumer Credit Act provided for licensing of consumer credit firms as well as extensive disclosure requirements. Various Insurance Companies Acts from 1974 onwards dealt with the authorisation of insurers and their continuing prudential supervision. The Policy Holders' Protection Act 1975 covered compensation if an insurer became insolvent. The 1979 Banking Act provided for detailed prudential supervision by the central bank (Bank of England).

While there were consumer protection strands in much of this primary legislation – and even more in the detailed regulations made subsequently – much of it was unfocussed. The first coherent attempt to review the consumer protection aspects of investor protection led to the 1986

[1] Banking Automation Bulletin for Europe. 160, March 1998.

Financial Services Act and a new range of regulatory responsibilities and institutions. The ensuing scenario is currently undergoing radical statutory and institutional change designed to build an integrated regulatory structure covering most, if not all, financial services.

This report will start with a brief review of the 1986 changes and current plans for new legislation. The embryonic new regime will then be described thematically from the consumer viewpoint, rather than sectorally, the themes being conduct of business, complaints and redress, compensation and consumer representation. Consumer credit will be dealt with separately, as it is still relatively self-contained in statutory and regulatory terms and largely unaffected by the current changes.

2. Regulatory Structure and Consumer Protection

The 1986 Financial Services Act

The 1970s witnessed a number of financial scandals, including the collapse of a major insurer. They also saw deep-rooted changes to the retail market, including the spread of individual holdings of investment-linked life assurance and unit trusts (roughly equivalent to mutual funds). At the same time, European Union policy aimed at developing a single European market in financial services was beginning to pick up speed, with a number of legislative initiatives in course of preparation (see separate report on EU policy). The UK government therefore decided in July 1981 to commission Professor L.C.B.Gower to review the structure of investor protection and to make recommendations as to how it could be improved.

The Gower Report

The 1984 Gower report identified extensive failings in the regulatory structure that existed at the time[2]. There was no single system for regulating the investment and securities industries, no single prosecuting authority and no compensation for investors in the event of loss. Also, there was no effective regulation of the way in which banks, building societies, insurers and collective investment schemes marketed their investment services, even though they might be subject to prudential regulation. The report was critical of a number of current sales and marketing practices, including the opaque status of many distribution channels, which included direct sales forces and intermediaries, all paid predominantly on a commission basis. The high charges and low surrender values of many investment-linked life assurance policies were also subjected to critical comment (criticism still widely current to this day).

The core of the report's recommendations was that the law should provide a regulatory framework for investment markets designed to prevent investors suffering loss arising from the default or negligence of firms or individuals. This could best be done by initial vetting and continuing supervision, which should be the responsibility of an independent body with statutory powers and responsibilities, rather than a government department. However, the report expressed

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[2] L.C.B.Gower. *Review of Investor Protection*. Cmnd.9125, January 1984.

the view that investors should never expect a regulatory system to protect them from their own folly. Regulation "...should be no greater than is necessary to protect reasonable people from being made fools of" – a splendid axiom, though leaving considerable discretion as to its practical application.

The Gower Report was followed by a White Paper setting out the government's proposals for legislation[3]. There would be self-regulation within a statutory framework, in which the statutory responsibilities would be carried out primarily by an independent agency, appointed by the government.

The Scope and Content of Legislation

After considerable debate within and without Parliament, and some dilution of the government's original proposals as a result of lobbying by different sectors of the financial services industry, the Financial Services Act was passed in 1986, though its implementation was phased over a two year period. Essentially, the Act regulates the carrying on of investment business, which is defined as covering the activities of:

- Dealing in investments as principal or agent;
- Arranging investment deals;
- Managing someone else's investments;
- Giving specific investment advice;
- Operating a collective investment scheme.

The regulated investments that fall within the scope of the Act are:

- Shares and stock;
- Debentures (roughly, financial instruments creating or acknowledging indebtedness);
- Government and public securities;
- Warrants or other instruments entitling the holder to shares or securities;
- Certificates representing securities;
- Units in collective investment schemes;
- Options;

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[3] *Financial services in the United Kingdom*. Cmnd.9432, January 1985.

- Futures;
- Contracts for differences;
- Long-term life assurance contracts (excluding protection-only assurance);
- Rights and interests in investments.

The limited scope of this definition of regulated investments should be noted, not least because it has given rise to many subsequent difficulties. It does not include deposit-based savings and investment products (such as bank and building society accounts), mortgages, protection-only life assurance and non-life insurance. Also, it does not cover 'tangibles', such as art treasures, land, houses, apartments and timeshares, unless they form part of a collective investment scheme.

The central provision of the Act is to make it a criminal offence to carry on of regulated investment business without authorisation, which would include a 'fit and proper' test. This is parallelled by a civil law provision which renders an investment contract of an unauthorised person unenforceable against the consumer concerned, who may recover compensation.

The Act provides for the bulk of the government's regulatory functions and powers, with some exceptions, to be delegated to a 'designated agency', the Securities and Investments Board (SIB) – which, as described below, was subsequently transformed into the Financial Services Authority (FSA) in October 1997. This approach was very much a hybrid one, in that the SIB was a private body, but with its members appointed by the government and with legislative functions. It had powers to draw up and enforce rules. Although funded by the industry, it was fully accountable to the government, Parliament and the courts.

One of the most important functions of the SIB was to recognise 'self-regulating organisations' (SROs) and 'recognised professional bodies' (RPBs). SROs are private bodies financed and controlled by their members. Initially there were five of them, covering different sectors of the industry, but as a result of mergers there are now three. From the viewpoint of the individual consumer as investor, the most relevant SRO is the Personal Investment Authority.

The Act provides, in effect, for the Director General of Fair Trading to advise the government on whether or not the rules of the SIB and the SROs have any anti-competitive implications.

Financial services firms wishing to carry on regulated investment business normally apply for authorisation to an SRO, which must satisfy itself that the applicant is fit and proper. The firm then becomes subject to the rules and to the supervisory and enforcement systems of that SRO. Given that SROs are private bodies, it was not felt to be legally sound to compel a firm to join an SRO. There is therefore provision for firms to be directly authorised and regulated by the SIB. Only a small number of firms have taken this route, although they included until recently the largest insurer in the UK. By an unforeseen quirk in the legislation, the enforcement powers of the SIB have been more limited than those of the SROs, in that it does not have the power to levy fines on transgressing firms.

The Recognised Professional Bodies (RPBs) are existing professional bodies of lawyers, accountants, actuaries and (mainly non-life) insurance brokers. Their members carry on regulated investment business incidentally to the practice of their profession. The regulatory functions of the RPBs have been overseen by the SIB in much the same way as it supervises the SROs.

The general picture of the currently expiring system established by the 1986 Financial Services Act is that of two tier regulation of the investment sector. At the first level is the SIB, a private body but with members appointed by the government and possessing statutory powers delegated by the government. At the second level are the SROs and RPBs, again private bodies governed by boards drawn largely from the sectors they regulate, but often with some independent public interest members, drawing up detailed rules and exercising regulatory control over their members.

This complex new structure put in place by the 1986 Financial Services Act has undoubtedly led to many improvements in protection for the individual investor, notably in reduced risk of investment scams, better transparency, and improved arrangements for redress and compensation.

However, the chorus of criticism has grown over the last decade. For example, the new system failed to prevent the collapse of Barings. More generally, individual consumers are still less than fully protected. The most notable, industry-wide problem is that, between 1988 and 1994, an estimated 2.24 million consumers were sold a personal pension plan by the industry when they could, to their financial advantage, have remained in or joined an occupational pension scheme. The estimated total losses to consumers amount to over £10 be.(c.C$23.5 be.)[4]. Incidentally, this problem, and the immense difficulties encountered in putting it right, demonstrate the serious danger of a government getting too closely involved in deciding which kinds of financial service are good for consumers – the original campaign to persuade consumers to depend on personal rather than occupational pensions had the explicit encouragement of the then government.

Persisting Problems

Despite increased emphasis on fitness and properness and on conduct of business rules, inappropriate advice and sales seem to persist. Even now, over a third of regular premium personal pensions sold by company representatives have lapsed within three years, with loss of premiums and no detectable benefit to the consumers concerned[5]. There is considerable consumer confusion over which regulatory body is responsible for what and where to go with a complaint. From the industry side, there are continuing grumbles about the excessively detailed content of SRO rule books and the oppressive nature and high cost of regulation, which is paid for by the industry.

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[4] *Pension transfers and opt outs review – phase 2*. Consultation paper no.7, Financial Services Authority and Personal Investment Authority, London, March 1998.

[5] *Third survey of the persistency of life and pensions policies*. Personal Investment Authority, London, November 1997.

However, paradoxically, the greater integration of regulation and consumer protection in relation to investment services brought about by the 1986 Financial Services Act has highlighted the disparity between this sector and other kinds of financial service. There has been a patchwork quilt of responsibilities across the industry as a whole with little apparent consistency or harmonisation.

For example, the authorisation and prudential regulation of banks has been carried out by the Bank of England (the central bank) and of building societies by the Building Societies Commission, a statutory body. Life assurers and non-life insurers have been authorised and prudentially regulated by the Department of Trade and Industry, a government department, and independent financial advisers by the Personal Investment Authority, an SRO.

The conduct of business of banks and building societies in relation to deposit-based products is not subject to specific statutory regulation, though it does come within industry-based voluntary codes of practice. On the other hand, the conduct of business of these bodies in relation to packaged investment products is regulated by the Personal Investment Authority, which also regulates the linked life and investment business of insurers. However, protection and non-life insurance are subject only to trade association codes of practice, as is most mortgage lending. Consumer credit licensing and conduct of business are regulated entirely separately by a non-ministerial government department, the Office of Fair Trading, under powers derived from the 1974 Consumer Credit Act. There are no less than seven sectoral consumer complaint and redress schemes across the financial services industry, with varying terms of reference, procedures and financial limits. No wonder that confusion has reigned both among consumers and in the industry.

The Emerging New Structure

The Labour Government that came to power in the UK in May 1997 had reform of financial regulation as one of its first priorities. Within a few weeks of taking office, it was announced that the current responsibilities of existing regulatory bodies, including government departments, would be transferred to a new, single tier regulatory body which would function across the financial services industry on the basis of statutory powers. Responsibility for banking supervision would be transferred to this new body from the Bank of England. The self-regulatory component of the existing system would in effect be brought to an end and the SROs would disappear.

The then Chairman of the SIB was asked, in conjunction with other existing regulators, to bring forward a plan to implement this policy and this was published some two months later[6]. It set out the primary aims of the new unitary regulator as being:

- To protect consumers of financial services;

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[6] *Report to the Chancellor on the reform of the financial regulatory system*. The Securities and Investments Board, London, July 1997.

- To promote clean and orderly markets;
- To maintain confidence in the financial system.

These aims are not in themselves revolutionary. Regulation has always involved both the protection of consumers and the safeguarding of financial markets through the containment of systemic risk (that is, limiting the effects of a major financial institution's insolvency on counterparties). What is new is the rebuilding of the institutional structure in the shape of a unitary regulator in order to achieve these objectives.

A New Unitary Regulator

This report was accepted by the government and on 28 October 1997 the Chancellor of the Exchequer launched the new regulatory body, the Financial Services Authority (FSA), confirming its expected scope in terms of bringing together under one roof the functions of all the current major regulators of the financial services industry. At the same time, the FSA published an outline 'prospectus' setting out its aims, regulatory approach, governance, management and funding[7].

One of the main areas of uncertainty had been how the various elements of responsibility for the health of the UK's financial system would be reallocated. This was now made clear. The Bank of England would remain responsible for the stability of the monetary system, including monitoring and support operations in markets (though the latter only when absolutely necessary "...to avoid a serious disturbance to the UK economy"). Among government departments, the Treasury would remain responsible for the institutional and legislative structure, though without any operational involvement in the work of either the Bank of England or the FSA, and the Department of Trade and Industry, previously responsible for the authorisation and prudential supervision of insurers, would bow out of the picture. A Memorandum of Understanding sets out a framework for co-operation between the Treasury, the Bank of England and FSA and how the three bodies would work together to achieve financial stability[8]. This is based on the four principles of clear accountability, transparency, no duplication and regular information exchange, to be implemented by a monthly meeting of a Standing Committee of representatives of the three bodies.

The transitional arrangements to move from the existing regulatory situation to the new regime are being phased. For the moment, the FSA is in legal terms a rebadged version of the SIB. It does not at the time of writing have any new powers or responsibilities. It will acquire these in two stages. First, a Bank of England Bill currently before Parliament proposes the transfer of responsibility for supervising banks, listed money market institutions and related clearing houses from the Bank of England to the FSA. This is expected to become law before mid-1998.

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[7] *Financial Services Authority: an outline*. Financial Services Authority, London, October 1997.
[8] *Financial Services Authority: an outline* (previously cited). Appendix 2.

Second, in mid-1998 the government will publish a draft financial regulatory reform Bill setting out the new regulatory regime as outlined above, with the FSA to be established on a statutory basis. The timetable is that this Bill will be enacted in 1999, with implementation following as soon as possible.

3. Conduct of Business Regulation

The most developed regulatory form of conduct of business – defined as what happens at the interface between the financial services firm and the consumer- is found in the rules laid down by the Personal Investment Authority (PIA), the SRO which regulates the retail investment sector. These are outlined below and are followed by summaries of the industry-based voluntary codes of practice covering banking and mortgages.

Retail Investment

There are a number of strands in the PIA's approach to regulating conduct of business, including disclosure, standards of advice and standards of training and competence.

Disclosure

Three of the most important aspects of the PIA's disclosure regime relate to status, product characteristics (including the effect of charges and expenses) and commission.

Status disclosure

PIA regulates two types of firm, product providers such as life assurers and unit trust firms, and independent financial advisers. Following the principle of 'polarisation', each product provider, with its direct sales staff and appointed representatives, is 'tied' to advising on its own products. It is not permitted to advice on the products of another product provider. On the other hand, independent financial advisers and their appointed representatives can advise on and arrange deals across the whole market as the agent of the consumer, even though they are usually paid on a commission basis by product providers rather than getting a fee from the consumer. This polarisation principle effectively outlaws the pre-1986 situation, when there were some firms of advisers who were 'multi-tied' to, say, three or four different product providers, selling only their products and not advising across the whole range of the market.

The polarisation status of the firm must be disclosed to the consumer at an early stage, in the 'Terms of Business' letter which the firm is required to send. This status must also be disclosed in advertising and marketing material which is product-specific (as distinct from general 'image' advertising), as well as in premises where any marketing material is displayed (for example, in branches of banks or building societies carrying on investment business). Also, the firm's stationery must state that the firm is regulated by the PIA.

Product characteristics

The ‘key features’ of a product must normally be given in writing when a recommendation is made and before the consumer is committed to a purchase. They must be at least as prominent as any accompanying marketing literature. In certain circumstances (for example, when buying unit trusts over the telephone) investors may be told orally about key features and be sent the document subsequently. Key features are defined to include the nature of the product and its objectives, risk factors, the consumer’s commitment (for example, the payment of regular premiums on a life assurance policy) and information about any charges or deductions (including the cost of any life assurance cover, commission and expenses) and the effect of these on any benefits or returns.

Disclosure of commission or remuneration

The consumer must be told how much commission is being paid to the independent financial adviser in respect of the transaction or how much remuneration (including benefits and services in kind) is being received by the product provider’s representative. This requirement is intended to increase price competition in commission rates and to bring into focus any bias as between firms or products.

PIA’s disclosure requirements are monitored closely and their impact is the subject of annual reports[9].

Standards of Advice

PIA requires all firms, both product providers and independent financial advisers, to comply with the twin requirements of ‘know your customer’ and ‘suitability’.

The know your customer obligation involves building up a picture of the consumer’s financial position, objectives, attitude to financial risk and investment needs (if any). It normally entails completion of a ‘factfind’ by the independent financial adviser or company representative, prepared on the basis of the consumer’s replies to questions.

The suitability requirement means that a consumer should be recommended to buy an investment product only when there are reasonable grounds for believing that it is suited to his or her needs.

Standards of Training and Competence

In 1995 PIA introduced an extensive set of training and competence requirements, aimed at raising the quality of advice given to consumers by professionalising the industry’s sales and advisory force. All member firms, both product providers and independent financial advisers, were obliged by 30 June 1997 to ensure that their existing advisory staff proved their competence

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[9] *Life assurance disclosure: three years on* and *1997 Disclosure report: unit trusts, investment trust savings schemes and personal equity plans*. Personal Investment Authority, London, January 1988.

to undertake their advisory responsibilities. This involved attainment of an appropriate formal qualification, successful undertaking of an in-house assessment of their performance on the job and a minimum of one year's appropriate experience. There are training requirements for new entrants to the industry and rules governing the training and appointment of supervisors. All advisers are required to undertake an appropriate programme of continuing professional development.

All firms are required to appoint a training and competence officer. In addition, all firms with less than ten advisers are required to have a plan of their training and competence arrangements. Firms with ten or more advisers are obliged to have detailed written training and competence procedures.[10]

It is too early to say what impact these elaborate training and competence requirements, which are only outlined here, will have on raising the standards of advice in the industry. The first immediate effects are a substantial increase in the number of advisers sitting for professional qualifications – and in the number who have decided to leave the industry for less demanding occupations.

PIA's conduct of business rules, as well as its other regulatory requirements, are enforced through extensive monitoring. This includes visits to firms at intervals, based on a risk assessment system. There is an elaborate disciplinary procedure, with rights of appeal. When a rule breach is found, the sanction imposed may range from a public reprimand, through fines (which may run up to and over £500,000, roughly equivalent to C$ 1,165,000) to, in extreme cases, effectively putting the firm out of business so far as regulated financial services are concerned[11].

While the work of the PIA is due to be absorbed into the new Financial Services Authority when new legislation is passed, the essential elements of the regulatory strategy are likely to persist. There may be changes in detail and in style, and regulation will have a firmer statutory base, but the objectives of regulation in the retail investment sector will stay much the same.

The Banking Code

In 1989, a government-appointed Review Committee, chaired by Professor R.B.Jack, reported on the law and practice of banking services[12]. Among its wide-ranging recommendations were a number directed to the banks, asking them to establish standards of best practice for a range of their services, especially those involving EFT (Electronic Funds Transfer). The Review Committee also recommended that these standards of best practice should be codified in a published Code of Banking Practice and even went as far as preparing an illustrative draft of such a code.

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[10] *Training and competence guidance*. Personal Investment Authority, London, January 1998.

[11] *PIA's approach to discipline: statement of policy*. Personal Investment Authority, London, November 1995.

[12] *Banking services: law and practice – report by the Review Committee*. Cmnd 622, February 1989.

These recommendations to banks were buttressed by a further recommendation to government that it should assess whether any code issued by the banks was an adequate response to the recommendations and that if it was not, the government should be prepared to introduce legislation to provide for a statutory code and an associated duty on banks to trade fairly with their customers.

Under this threat of having a statutory code imposed on them, the banks got their act together quickly. In a White Paper responding to the Review Committee's report, the government endorsed the recommendation that there should be a code of practice[13]. It said that the banks had agreed to produce a voluntary code which would be followed by their members and had set up a committee under independent chairmanship to oversee the preparation of a code: the issue of statutory backing "need not arise" if the code was widely adopted and complied with.

The first draft code sent out for consultation came in for some criticism, not least from the Banking Ombudsman and from consumer organisations, but an enhanced version was introduced in 1992. It has been revised twice and the current version dates from July 1997[14].

The Banking Code is based on eleven 'key commitments' expressed in fairly general terms. For example "We...promise that we will act fairly and reasonably in all our dealings with you" and "help you to choose a service or product to fit your needs". There are more detailed provisions covering information, account operations, protection (confidentiality) and difficulties and complaints. Some of these are very specific – for example "We will tell you if we provide bankers' references. If a banker's reference about you is requested, we will require your written consent before it is given." The sections dealing with payment cards are consonant with the European Commission Recommendation on payment cards[15].

The Banking Code also contains a number of requests to or obligations put on the consumer. One example is "The care of your cheque book, passbook, electronic purse, PINs, passwords and selected personal information is essential to help prevent fraud and protect your accounts. Please ensure that you..." There then follows a list of five detailed injunctions, such as "do not keep your cheque book and cards together".

The Code is monitored by and reviewed by the Independent Review Body for the Banking and Mortgage Codes. This consists of representatives from the banks and building societies as well as independent consumers and is chaired by a banker. It considers complaints about the general operation of the Banking Code, but it does not have a high public profile and has no sanctions available if the Code is breached. It publishes and annual report[16].

The Banking Code is written in plain language. From the consumer viewpoint, it represents an improvement on the previous situation, when consumers were kept in ignorance about what

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13 White Paper – *Banking services: law and practice*. Cmnd.1026, March 1990.

14 *The Banking Code*. British Bankers' Association, The Building Societies Association and Association for Payment Clearing Services, London, July 1997.

15 See separate report on *Financial services and consumer protection: European Union policy and practice*, p.13.

16 *Fifth annual report*. Code of Banking Practice Review Committee, London, 1996.

constituted normal banking practice. The public codification of banking practice and the commitment of senior management to abide by the provisions of the Code may well have led to a raising of standards in some banking services. Although it has no legal force, the Code provisions may be taken into account by the Banking Ombudsman (see below) when making determinations on individual consumer complaints.

Criticism

A major criticism of one aspect of the Banking Code by the National Consumer Council (NCC) stems from research which shows considerable resentment among consumers in reduced financial circumstances about the change in their banks' and building societies' attitude towards them. This is in spite of provisions in the Banking Code committing the financial organisations to consider cases of financial difficulty sympathetically and positively[17].

NCC's research compares banks' replies to detailed questions about their practices on bouncing cheques, arrears, prioritising payments and similar matters with the experiences of people in financial difficulty, as reported by counsellors in Citizens' Advice Bureaux. The NCC research concludes that this aspect of the Banking Code is not working. The main findings are that:

- Local bank branches do not have the authority or expertise to deal sympathetically and positively with people in financial difficulty;
- While banks send letters they see as encouraging early contact, consumers more often find these letters intimidating and off-putting;
- Banks have a conflict of interest between their roles as creditor and service provider which works to the detriment of consumers with problems;
- Bank charges levied in times of financial difficulty are out of all proportion to the service consumers get, exacerbating the original problems;
- There is little local liaison between banks and money advice agencies.

More generally, the NCC takes the view that the Banking Code should have statutory backing in that a requirement to adhere to the Code should be incorporated into the formal authorisation of banks and building societies, to be carried out in future by the new FSA[18].

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[17] *In the bank's bad books – how the banking code of practice works for customers in hardship*. National Consumer Council, London, December 1997.

[18] *The Financial Services Authority – a consumer view on the scope and objectives of the new financial services regulator*. National Consumer Council, London, April 1998, p.20.

The Mortgage Code

As has already been pointed, the conduct of most mortgage lending business is not covered by statute-based regulation, as it falls outwith the scope of the 1975 Consumer Credit Act. This continues to be a source of concern to consumer representatives, as buying a home is the largest single investment made by the overwhelming majority of consumers. Also, mortgages are often closely linked with investment products such as endowment life assurance policies and mortgage lending is frequently the occasion for selling other financial services, such as home and contents insurance.

In 1997, the Council of Mortgage Lenders – a trade association whose membership includes but is not confined to banks and building societies – introduced, after consultation, a voluntary Mortgage Code. The general tone, key commitments and some of the detailed provisions are closely modelled on the Banking Code. Some of the provisions, however, are specific to mortgage lending. One example is the definition of three levels of service – advice and a recommendation, information on the different types of mortgage product, and information on a single mortgage product only – accompanied by a commitment to explain in advance which level of service is being offered.

Along with the Banking Code, the Mortgage Code is subject to the oversight of the Independent Review Body mentioned above. In April 1998, the coverage of the Mortgage Code is being extended to cover mortgage intermediaries.

It is too early to say how effective the Mortgage Code will prove to be. The government's position is that it will wait to see how the Code works out in practice before deciding whether or not to introduce statutory control over mortgage lending and include it within the scope of the new Financial Services Authority.

4. Complaints and Redress

In the UK, the courts have not in practice proved to be an effective route for consumers to obtain redress from banks, insurers and other firms in the financial services industry. The adversarial processes of the civil law inevitably favour corporate bodies, which have considerable financial resources and legal skills at their disposal, over the individual consumer. Also, many consumer complaints only involve small amounts of money and are just not worth the trouble, uncertainty and expense of going to law. Nor does formal arbitration provide a very attractive alternative. Arbitration tends to work best in a commercial context, when the disputing parties are likely to be of roughly equivalent strength, and arbitrators do not have the investigative powers to sort out complex and often incoherent consumer complaints.

Existing Ombudsman Schemes

Recognition of this situation has in recent years seen the proliferation of alternative dispute resolution procedures in the financial services sector, usually known as ombudsman schemes[19]. First in the field was the Insurance Ombudsman Bureau in 1981, followed by the Office of the Banking Ombudsman in 1986 and the Building Societies Ombudsman scheme in 1987. Others have followed, so that there are now five sectoral ombudsman schemes and three other complaints-handling schemes across the financial services industry[20].

The terms of reference and procedures of the different schemes vary appreciably, but most share certain characteristics in common. They provide an informal procedure which is relatively speedy compared with the courts. They are free to the consumer and funded at arm's length by the industry. While any decision of the ombudsman, including any financial award, is binding on the financial services organisation or firm against which a complaint is made, the consumer can still take the case to court if dissatisfied with the outcome. Ombudsmen have no connection with the industry concerned and are not appointed by the industry. Most have powers of investigation and conciliation, as well as final determination.

Only the Building Societies Ombudsman scheme has a statutory basis. Others have either been established by the relevant industrial sectors – for example, the Banking Ombudsman scheme and the Insurance Ombudsman Bureau – or set up by regulatory bodies. There are differences, too, in whether small companies are allowed to make complaints and in the extent of their coverage of the industry.

The Banking Ombudsman Scheme

To give a more detailed idea of how one ombudsman scheme operates, the Banking Ombudsman scheme, though voluntary, covers all high street banks in the UK, involving 99 percent of retail customers. Its scope covers banking services (including mortgage lending), payment cards, executor and trustee services, and advice and services relating to taxation, insurance and some aspects of investment. It does not deal with complaints about a bank's general policies or its interest rate policies. It does not accept a complaint which involves a claim for more than £100,000 (c.C$235,000) or which is going through the courts, unless the bank concerned agrees. Also, it will not accept a complaint about commercial judgment relating to lending or security unless maladministration or unfair treatment are involved. The Banking Ombudsman may decline to deal with frivolous or vexatious complaints.

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[19] The word ombudsman has been borrowed from Scandinavia, but its meaning has altered somewhat in crossing the North Sea. In Scandinavia, ombudsmen do not normally resolve disputes between consumers and financial services organisations, though they may use a consumer complaint as an instance for examining commercial practice – see the accompanying report on Denmark and Sweden.

[20] There is a comprehensive guide to all ombudsman schemes in Britain and Ireland, including the financial services industry as well as other public and private services, in *A-Z of ombudsmen*. National Consumer Council, London, July 1997. See also *Financial services: regulators and ombudsmen*. House of Commons Research Paper 95/129, House of Commons, London, 13 December 1995.

A complaint may be made by an individual consumer, partnership, unincorporated body or small company with a turnover of less than £1mn. (c.C$2.35 mn.), though in practice 83 percent of complaints are made by individual consumers. The complainant has direct access to the scheme, but must first complain to the bank and go through the bank's own internal complaints procedure. The bank is allowed four weeks to resolve the complaint or issue a 'deadlock' letter. The complaint must be made within six months of deadlock being reached and normally within six years of the event which is the subject of the complaint.

Complainants do not have to pay a fee, even if their complaint is unsuccessful. The maximum award that the Ombudsman may make against a bank is £100,000 (c.C$235,000), including compensation for distress. No financial award may be made against the complainant.

In the year to 30 September 1997, the Banking Ombudsman telephone helpline received 26,561 calls. There were 8,818 written complaints, an increase of 9.6 percent over the previous year. However, more than a quarter of these either fell outside the rules, were the province of another scheme or were against organisations or firms not covered by the scheme. Many of the complaints were concluded by conciliation, but 704 reached the formal decision stage. The decisions split almost equally between those in favour of the complainant and those in favour of the bank. Financial awards to complainants ranged from £21(c.C$49.35) and £90,000 (c.C$211,500), though most fell within the range £200 (c.C$470) to £10,000 (c.C$23,500)[21].

There is some protection against the dilution of the ombudsman concept provided by the British and Irish Ombudsman Association (BIOA), a quasi-professional body for ombudsmen. The BIOA has laid down detailed criteria for the validation of ombudsman schemes, covering the independence of ombudsmen, ease of access to complainants, powers, procedures and implementation of decisions. Dilution is more than a notional threat, as a number of newspapers have appointed so-called 'ombudsmen' who are in practice editorial advisers with no real powers.

The Balance Sheet

There can be little doubt that financial services ombudsmen schemes have brought considerable benefits to many consumers, who would otherwise have had little or no chance of getting their complaints heard, let alone any compensation. The sectors of the industry concerned have also benefited, not only in terms of their public image but also in the sharpened focus on internal complaints procedures within individual financial services organisations. Indeed, it can be said that financial services ombudsmen schemes have worked so well in the UK that the idea has been 'exported' to a number of other countries, including Australia, New Zealand, Ireland, Belgium and the Netherlands.

However, some problems remain. Despite regulatory and code of practice requirements that financial services organisations should publicise the schemes, awareness remains low. Only 27 percent of a sample of consumers questioned in an Office of Fair Trading study knew, even

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[21] *The Banking Ombudsman Scheme annual report 1996-1997*. Office of the Banking Ombudsman, London, 1997.

when prompted, of the existence of the Insurance Ombudsman, compared with 24 percent for the Banking Ombudsman and 22 percent for the Building Societies ombudsman (though the figures may have improved since this 1991 research)[22]. Even though speedy by comparison with the courts, many schemes seem to take a long time to deal with complaints[23]. The outcome of individual complaints remains confidential and is not in the public domain – a standard of justice appreciably lower than that provided by the legal system. Also, many schemes are only able to deal to a limited extent with complaints about cross-border financial services, an area of increasing importance as the single European market becomes a reality[24].

More importantly, though they may operate along similar general lines, important differences between the schemes persist in terms of who can make a complaint, award limits, time limits, terms of reference, procedures and governance. There is also consumer confusion about which financial services and/or organisations are covered by which schemes. The government has therefore recently decided that all the existing schemes in the financial services industry should be consolidated into a single scheme, though the legislative framework for this is not yet clear.

A New Unitary Complaints Handling Scheme

The new Financial Services Authority has expressed the view that the arrangements should be:

- Comprehensive in their coverage;
- Accessible to consumers;
- Fair and impartial as between consumers and firms;
- Capable of making binding decisions;
- Consistent in the approach to providing redress;
- Transparent and accountable;
- Flexible, simple and prompt;
- Efficient, with appropriate minimum performance standards;
- Able to provide appropriate feedback to the regulator.

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[22] *Consumer redress mechanisms*. Office of Fair Trading, London, November 1991.

[23] *Ombudsman services – consumers' views of the Office of the Building Societies Ombudsman and the Insurance Ombudsman Bureau*. National Consumer Council, London, June 1993, and various annual reports.

[24] Jeremy Mitchell and Steve Worthington. *Consumer redress in relation to cross-border payments within the European Community*. Consumer Policy Research Report no.1, International Consumer Policy Bureau, Edinburgh, 1992.

These principles should not present any serious difficulties for a consolidated scheme, as they are present either explicitly or implicitly in most of the current schemes. However, the FSA is currently in the course of consulting on four related questions[25]:

- What should be the scope, in terms of kinds of business, of the complaints-handling scheme?
- How, in the context of a compulsory scheme, can awards be made binding on firms, in a way which is fair to them?
- Should the complaints scheme be independent of or the direct responsibility of FSA, and what should the governance arrangements be?
- What should the complaints-handling process be?

While some voices – especially those of some existing Ombudsmen – have expressed doubts about the desirability and practicality of a single scheme, especially one operating in the shadow of the FSA as statutory regulator, the current general consensus, shared by the industry and consumer representatives, is that a forward move should be made in the direction of a unitary scheme. However, the consultation process is not complete at the time of writing and no timetable is yet in place.

5. Compensation

The corollary of a system of authorisation or licensing of banks, insurers and other financial services firms is that there should be compensation of consumers where firms fail to meet their liabilities. Consumers are not in a position to make an assessment of the probity and financial status of every financial services organisation with which they deal. Inevitably, they are compelled in practice to rely on the regulatory body's assessment of the firm's fitness and properness, as well as its continuing prudential supervision of the firm's financial soundness.

This is the primary justification for the establishment of compensation schemes. However, compensation schemes also help to protect financial markets, in that their existence reduces the risk of knock-on consequences arising from the failure of a single financial firm. If consumers know they will be compensated when a firm fails, there is less likely to be a run (withdrawal of deposits or investments) on other firms.

Existing Compensation Schemes

There are a number of compensation schemes at present in the UK, usually established by statute and on a sectoral basis[26]:

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[25] *Consumer complaints*. Consultation paper 4, Financial Services Authority, London, December 1997.
[26] *Consumer compensation*. Consultation paper 5, Financial Services Authority, London, December 1977.

- The Deposit Protection Scheme covers bank deposits. If a bank fails, the consumer is entitled to a maximum of £18,000 (c.C$42,000), limited to 90 percent of the total in all the deposit accounts the consumer has with a bank (that is, not a maximum of £18,000 on each account). A total of £153 mn. (c.C$360 mn.) has been paid out in respect of the insolvency of 29 banks and, although the scheme is essentially funded by banks rather than by public money, £110 mn. has been recovered from liquidators;
- The Building Societies Investor Protection Scheme, which operates on a basis roughly equivalent to the bank scheme. This scheme has never needed to be brought into operation. If a building society has looked like getting into financial difficulties, the regulatory body, the Building Societies Commission, has always been able to arrange a merger or takeover;
- The Policyholders Protection Scheme, covering non-life insurance and life assurance written by most insurers. There is no cash limit, but compensation is limited to 90 percent except for compulsory insurance, when it is 100 percent. A total of £220 mn. (c.C$517 mn.) has been paid out in compensation. The scheme is funded by statutory levies. Insurance carried on by friendly societies is currently being brought within the scheme's scope;
- The Investors Compensation Scheme, covering investment business within the scope of the 1986 Financial Services Act. An approved claim is paid in full up to £30,000 (c.C$70,000), plus 90 percent of the next £20,000 (c.C$47,000) up to a ceiling of £48,000 (c.C$113,000). The scheme covers negligence claims against regulated firms as well as theft and fraud. Up to 30 November 1997, 340 firms have been declared in default, involving a total of £125 mn. (c.C$290 mn.) compensation paid to 10,500 investors, of which £14 mn. was recovered from liquidators;
- Recognised Professional Bodies (see above) also have schemes for investment business carried out by their members. These terms of these are at least comparable to those of the Investors Compensation Scheme.

As can be seen, the existing sectoral compensation schemes vary considerably in their limits. Their procedures also differ. While consumers have undoubtedly benefited from the compensation payments made, the sectoral approach is becoming increasingly unrealistic in an era of financial conglomerates. Also, funding compensation in respect of failed firms by way of a levy on surviving ones prompts the persistent question as to why the 'good' should subsidise the 'bad'. There are also problems of cross-subsidisation in the levy arrangements and their undue impact on small firms.

Possible Changes

The new FSA has launched a review of the compensation arrangements, but its proposals fall short of a blueprint for a completely unified scheme. At the time of writing, its expressed preference is for a single scheme encompassing several sectoral sub-schemes, with a greater degree of harmonisation than exists at the moment. However, the consultation process has not been completed at the time of writing and the eventual outcome is still uncertain.

6. Consumer Representation

The market for retail financial services is complex, with a wide variety of different types of financial product and a large number of product providers. For many financial services – mortgages, for example – an individual consumer is a rare buyer in the market place and cannot be expected to keep up with the rapid pace of change. Also, the value for money of many products does not become apparent until many years have passed and there is little or no short-term feedback to the market of consumers' experience. All these are characteristics of a market which is highly imperfect in terms of consumer information and point to the need for a regulatory system which is especially sensitive to the interests of consumers.

Also, a regulatory system does not work in a vacuum. The various sectors of the financial services industry in the UK are well-organised to watch out for their own interests in the regulatory process, through representations by individual firms, trade associations and other bodies. the interests of consumers cannot be assumed to be identified and represented in a similar way. Individual consumers usually do not know how the policy-making process works and in any event may not be aware of the long-term impact of policy proposals on their own financial situation. While the quality of work of the two main UK consumer organisations, Consumers' Association and the National Consumer Council, is high, they lack the human and financial resources to deal with every issue which has a potential impact on consumers.

In recent years, there has been a growing awareness of the need to ensure that the interests of consumers are effectively identified and represented in issues of public and regulatory policy concerning financial services. Public consultation is the norm before major decisions are taken. Consumer interest representatives, as well as broader public interest representatives who are independent of the industry, are now found on a wide variety of bodies[27]. For example, the Councils which govern the various ombudsman schemes all have a majority of independent public interest members, including many consumer interest representatives. The Personal Investment Authority Board has equal representation of industry and independent public interest members, including three from the consumer movement, one of whom is Deputy Chairman of the Board.

The PIA Consumer Panel

The most institutionalised form of consumer representation in the financial services sector is the PIA Consumer Panel, which has fourteen members representing a broad range of consumer interests. The Panel Chairman is a Board member and the Panel reports directly to the Board. The Consumer Panel was set up to advise the Board on the interests and concerns of private investors and on PIA's performance in securing investor protection. It is consulted by the PIA Board on investor protection proposals but also raises its own concerns and has its own research programme on consumers' experiences and needs. As well as its direct line to the Board of the

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[27] 'The consumer interest' and 'the public interest' are not identical. The concept of the public interest includes the interests of consumers, but is much broader. It also takes in the interest of financial services firms, employees in the industry, the health of the economy and the vaguer but no less important idea of the general good of society.

regulatory body, the PIA Consumer Panel has its own public voice. It publishes its own annual report, which gets wide media coverage, and has the freedom to express publicly its views on PIA policies and practices, disagreeing with the Board if necessary[28].

With the work of the PIA currently being incorporated into the new Financial Services Authority, there have been doubts as to whether the form of consumer representation developed by the PIA would survive. However, the PIA has now put out a consultation document saying that the FSA "...has been impressed...by the effectiveness of the PIA Consumer Panel and believes that it provides an appropriate model for the FSA"[29]. It proposes that the future FSA Consumer Panel should have much the same composition, powers and procedures as its PIA predecessor.

7. Consumer Credit

The origins of the UK's regulatory and consumer protection regime in this sector go back to the 1971 report of a government-appointed committee chaired by Lord Crowther, which recommended a new and comprehensive legal framework to regulate consumer credit[30]. The main recommendations were incorporated by the government in the 1974 Consumer Credit Act. This remains substantially the same as it was then and the system put in place at that time will not be affected by the major reorganisation that is currently going on in other parts of the financial services sector.

The Act confers statutory powers – apart from powers to introduce secondary legislation in the form of Regulations, which remain with the government – on the Director General of Fair Trading, who is supported by the Office of Fair Trading. The Director General's main duties under the Act are to:

- Administer the consumer credit licensing system;
- Supervise the working and enforcement of the Act and its regulations;
- Enforce the Act and its regulations when appropriate, though in practice most day-to-day enforcement is carried out by local authorities.
- The Director General has other powers and responsibilities in consumer protection and competition policy, which are not relevant here.

The Act defines the types of credit that fall within its scope and establishes a licensing system based on applicants satisfying the Director General that they are fit to hold a license. Existing licence holders may have their licence suspended or revoked where it appears they are no longer fit and proper. The number of licences in force currently runs into hundreds of thousands, swollen by large numbers of automobile dealers, since the system covers the arranging as well as the provision of credit.

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[28] *Consumer Panel Report*. Personal Investment Authority, London, 1997.

[29] *Consumer involvement*. Consultation paper 1, Financial Services Authority, October 1997.

[30] Crowther Committee *Report of the Committee on Consumer Credit*. HMSO, London, 1971.

Other significant consumer protection provisions under the Act and its Regulations cover:

- Advertising, in particular ensuring that credit advertising does not mislead. Also, full advertisements and quotations for credit must include certain information which a consumer needs before entering into a credit agreement;
- Disclosure of the total charge for credit and the annual percentage rate of charge (APR);
- Prescribed essential information in credit agreements which a consumer needs to appreciate the nature and consequences of the transaction;
- Copy documents and cancellation notices;
- Early settlement provisions, setting down a standard and equitable way of calculating the rebate due if a consumer wants to terminate the credit agreement early;
- Rules governing a consumer's access to her or his credit reference files;
- Rules relating to the reopening by the courts of 'extortionate' credit agreements (which have been rarely used in practice).

The Consumer Credit Act and its Regulations are fully consonant with the European Union Consumer Credit Directives – indeed, the UK's experience was very valuable when the Directives were being prepared. However, the UK licensing system provides a tighter regulatory framework than EU legislation requires.

8. Conclusion

From the consumer viewpoint, it looks as though the new arrangements will represent a very much simplified and less confusing system than the current one, with a single regulator and a single point of access for complaints and compensation claims. Whether they will deliver enhanced consumer protection in terms of higher industry standards, especially in relation to conduct of business, remains to be seen, not least because significant financial services will remain outside the scope of statute-based conduct of business regulation. These include deposit-based services, protection-only life assurance, non-life insurance and most mortgage lending – though the government has committed itself to keeping the last of these under review. It also remains a curious anomaly that consumer credit, which has been subject to statute-based licensing and conduct of business regulation since 1975, will continue to be regulated by a different public body, the Office of Fair Trading.

Annex: Tying-in Sales

Tying-in sales have been on the UK agenda as a consumer issue for some time. The typical situation is an offer of mortgage credit at a discounted rate of interest for, say, the first two years, on condition that the consumer also arranges buildings and contents insurance through the mortgage lender, invariably at higher premiums than could be obtained elsewhere.

The best factual assessment of the situation is a 1994 Office of Fair Trading Research Paper[31]. The main conclusion is that "...a substantial proportion of those consumers with packaged mortgages [that is, mortgages and, usually, insurance products in a combined package] had been dissatisfied with tied products and had tried to change their provider. [The research]... also found that these same packaged mortgage holders found it more difficult to change the provider of such a product than did those with free-standing mortgages...These results strengthen the argument for greater transparency in the mortgage market, with better information provision about the components of packaged mortgages, and other terms and conditions, at a stage early enough in the mortage process for competition and consumer decision making to be both enhanced." Another interesting outcome of the research was that "A number of borrowers received information about packaged mortgages only, and some also felt that they were given no choice other than a packaged mortgage, even though they initially sought a free-standing mortgage."

In fact, the problem had been recognised some time before 1994 and statutory powers to deal with it were taken in the Courts and Legal Services Act 1990 (very much a 'miscellaneous provisions' piece of legislation). The purpose of s.104 of this Act is to ensure that lenders give house buyers all the information they need to choose between a 'free-standing' mortgage and a mortgage offered with tied-in services such as insurance.

Subsections (2) and (3) of s.104 provide that, before taking a "relevant step" (to be defined by order) a mortgage lender must tell prospective borrowers in writing:

- That the loan and each of the connected services are separate;
- Whether the terms of the loan can subsequently be varied by the lender;
- The price of each of the connected services and whether the terms of the loan would differ if he provided it without any of those services;
- If the borrower declines any of the connected services offered he will not, on that account, be refused the loan.

Subsection (4) of s.104 empowers the Secretary of State for Trade and Industry to make regulations as to information which must, or must not, be given by lenders in advertising or promoting mortgage packages.

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[31] *Packaged mortgages: results of consumer surveys*. Office of Fair Trading, London, 1994.

In February 1991, the Department of Trade and Industry issued a consultative document on the issue[32]. The responses from both the industry and consumer sides were critical of some aspects of s.104, notably because they were limited to mortgages obtained directly from lenders and excluded home loans negotiated through brokers and other intermediaries, not to mention home improvement loans and top-up mortgages. It was also argued that these provisions would not, in practice, give consumers sufficient relevant information early enough in the transaction for them to exercise real choice, because precise price information on items in a package could not be given until the property concerned had been identified and valued. This would limit what could be advertised and would mean that the "relevant step" – however defined by order – might not in practice be early enough in the sales process before the formal offer of a mortgage. The idea of making regulations under the Consumer Credit Act 1974 was intended to meet these criticisms, even though such regulations could not require the provision of price information as specifically as could regulations under section 104 of the 1990 Act, or prevent lenders from refusing a mortgage because a prospective borrower wished to buy connected services elsewhere.

In general, mortgage lenders regarded the provisions of s.104 as cumbersome and flawed – and if legislation was to be introduced they suggested either the Consumer Credit Act route or new primary legislation. However, their strong preference was for no legislation at all, as the mortgage market was highly competitive.

Most of the consumer organisations and trading standards departments [city and county authorities responsible for enforcing consumer protection legislation], as well as some firms in the insurance and insurance broking industries, thought that s.104 should be implemented, either as it stood or with amendments, made through primary legislation, to overcome the limitations. They said that legislation was essential, given the extent to which other services such as insurance were tied-in with mortgages. Information to borrowers was not transparent enough.

The Department of Trade and Industry did not take the matter any further at the time. However, an August 1993 Office of Fair Trading consultation document[33] resurrected the issue and again put the question as to whether implementation should be via Statutory Regulations made under the Courts and Legal Services Act itself, or by Statutory Regulations made under s.52 of the Consumer Credit Act 1974.

In passing, it should be noted that a certain amount of legislative confusion has arisen because of the variety of Government departments involved. Until recently, the Department of Trade and Industry has been the 'policy' department for the Consumer Credit Act, while the Office of Fair Trading is responsible for implementation of the Act. However, the Courts and Legal Services Act is the province of the Lord Chancellor's Department (generally responsible for the civil law) and the Treasury has an overall responsibility for financial services.

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[32] *Tying-in of services to residential property loans: proposals for subordinate legislation*. Department of Trade and Industry, London, 1991.

[33] *Consultation document on the working and enforcement of the Consumer Credit Act 1974*. Office of Fair Trading, London, August 1993.

The summary of the responses to the Office of Fair Trading's consultation on this point shows that the various positions taken up had not changed significantly from the previous Department of Trade and Industry consultation[34]:

> *"A wide range of views was expressed about the substance and objectives of section 104 of the Courts and legal Services Act. In general, the view of the credit industry was that section 104 was flawed and should not be implemented. In particular, there was concern that the section did not cover remortgages, further advances or business introduced by brokers. On the other hand, some respondents from the insurance and insurance broking sectors strongly supported the implementation of section 104.*
>
> *"Opinions then differed over whether the objectives of section 104 could be met by regulations made under section 52 of the Consumer Credit Act or, the industry view more commonly expressed, whether there was any need for statutory intervention at all. The view was put forward that there was no evidence of the alleged 'tying-in' abuse that section 104 was intended to prevent.[N.B. this view was expressed before the OFT research report mentioned above]. Another view was that regulation of 'tying-in' should be unnecessary in a competitiive market.*
>
> *"Consumer organisations agreed that section 104 was imperfect but argued either that the legislation should be amended to correct this and then implemented, or that the objective should be met to the extent possible through regulations made additionally under the Consumer Credit Act. In support of this line, they stated that there was a significant transparency problem to be addressed and research was presented by one body to show the incidence of the tying-in of other services to mortgages.*
>
> *"The same line was taken by other consumer advisers and by a number of trading standards departments. It was argued that all the elements of a mortgage package should be separately priced and separately available. The point was also made that problems associated with the tying-in of services might not emerge until some time after entry into the agreement, although this point was not developed in any great detail."*

In his conclusion on this point, the Director General of Fair Trading pointed out that the objective of s.104 of the 1990 Act was not "rightly in my view" to prohibit the offer of mortgage packages, but to facilitate borrowers' informed choice between packages and free-standing loans and to ensure the continued availablity of the latter if borrowers wished to choose them. In view of the dispute about the extent of tying-in sales, he had commissioned the research mentioned above, from which he inferred that the findings "...add weight to the view that there may indeed be a certain lack of transparency about the nature of some packaged products and about the availablitiy of free-standing mortgages offered by both lenders and intermediaries, and perhaps

[34] *Consumer Credit deregulation: a review by the Director General of Fair Trading of the scope and operation of the Consumer Credit Act 1974.* Office of Fair Trading, London, June 1994.

also a lack of awareness about them on the part of consumers. There are clearly considerable pressures upon some consumers to take tied-in services without their being able in practice to assess the value of those services by shopping around."

The Director General then recommended to the Government that subsections (1)-(3) of s.104 of the 1990 Act should be implemented. He recognised that, because of the wording of the Act, this would impact only on mortgages arranged directly with lenders, and not those negotiated through intermediaries, but he thought that nevertheless this would represent a significant advance in transparency. He did not recommend following the Consumer Credit Act 1974 route, as it could not prevent lenders from refusing to grant a mortgage solely because a borrower wanted to take a connected service from another source.

However, the Director General's 1994 recommendation has itself not been implemented. The impression is that it has been caught up in wider issues about the regulation of the mortage market. These are dealt with more fully above (see 3.3), but briefly the position is that, because of the potential for mis-selling associated with mortgage transactions, consumer organisations consider that mortgage business should be regulated on a par with investment business and should be brought within the regulatory scope of the new Financial Services Authority. This is being strongly resisted by the mortgage lending industry, who have, for the moment at least, staved off statutory regulation of their conduct of business by launching a Mortgage Code of Practice.

Specifically in relation to tying-in, the self-regulatory mortgage code states:

- "When providing information to help you to choose a mortgage...we will give you the following...

- a description of any insurance services which we can arrange (for example, buildings, contents, mortgage payment protection and life insurance);
- whether it is a condition of the mortgage that such insurance be taken out and whose responsibility it is to ensure that it is taken out;
- whether it is a condition of the mortgage that such insurance must be arranged by us."

Self-evidently, this falls a long way short of what consumer organisations have been asking for – and, indeed, of the unimplemented provisions of s.104 of the 1990 Act. There is no requirement to itemise the prices of the different components of the package, no commitment not to refuse a loan if the consumer wants to buy the tied-in services elsewhere and no commitment to offer a free-standing mortage as an alternative to a tying-in package.

In April 1998, the Government announced that it would give the voluntary mortgage code two years to prove its worth and would then review its operation to see whether statutory control of mortgages was necessary.

From this lengthy and inconclusive debate, from the consumer viewpoint it would seem to be highly desirable that the following legislative strategy should be used in relation to tying-in of other financial services to offers of credit:

- No absolute prohibition of tied-in packages, because they may offer advantages to some consumers. However, there should be strong disclosure provisions;
- A requirement that, if a tied-in package is offered, there should also be an offer of free-standing credit, so that the consumer can make her or his own choice;
- A requirement that the different components of a tied-in package should be itemised, with their separate prices;
- Careful thought needs to be given to the timing aspect of the disclosure requirements – that is, that disclosure needs to be sufficiently early in the transaction process to influence the consumer's decision – and to the implementation of disclosure in advertising in all media and in marketing literature;
- A requirement that, if the borrower refuses any or all of the tied-in services, this should not be a pretext for withdrawing the offer of credit;
- Legislation should cover offers made through brokers and other intermediaries, as well as direct offers by lenders;
- Legislation should cover all types of mortage and consumer credit. While most of the UK debate has focused on mortgage lending, there are grounds for concern about offers of other types of credit – for example, the tying-in of purchase of extended warranty periods with credit sales of household durables.

Chapter 2

Information Transparency and Redress – United States Experiences

Part I: Information Standards: Needs of Consumers in Financial Services Transactions

Part II: Achieving Redress

by
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Part I

Information Standards: Needs of Consumers in Financial Services Transactions

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1. Introduction

Consumers contemplating entering into routine financial services relationships with providers of such services are ultimately parties attempting to enter into contractual arrangements. While economic notions of supply and demand may largely drive the prices, terms, and availability in various markets for these services, legal notions of contract are implicit in such consumer efforts. That is to say, any relationship between a consumer and a provider of financial services is ultimately founded upon contractually imposed duties on the part of both the consumer – typically, to pay the fee or charge according to the contract governing the relationship – and the institution – for example, to make the payment, to provide the insurance coverage, the securities services, the credit, etc. sought by the consumer.

Conceptually, all contractual relationships are founded upon some semblance of relative equality of bargaining power between the prospective parties to the agreement. Theory envisions negotiation between provider and consumer, as to terms, as to price, as to means for enforcement, etc. And, for meaningful negotiation to occur, there must be relative power or capability as between the parties. Given the realities of consumer Financial services markets in an advanced economy such as the United States, however, there exists in fact very little if any actual negotiation between buyer and seller. With rare exception, products and services are offered on a "take it or leave it" basis.[1] While some vendors will make individualized adjustments for particular consumers when problems arise or requests are made, this almost invariably is limited to situations where contractual relationships already exist[2], rather than in situations where vendor and consumer are contemplating entering into such a relationship. It is an extremely rare phenomenon in the US for providers of mass consumer services to negotiate individualized terms with specific consumers during contract formation.

In large part, this phenomenon stems from the underlying economics of making such products available to consumers at attractive prices and with compelling terms. Routinization is essential to achieve such economic efficiencies. It is simply not realistic to expect millions of consumers to be allowed to negotiate on their own behalf with respect to particular terms of any given financial services product. Additionally, there are, of course, wide disparities between the levels of understanding and sophistication which most consumers have of such products and that possessed by vendors. As such, even were negotiation feasible, it would likely not occur in any meaningful form or to any great extent, and almost certainly not to the degree contemplated by contractual theory reflecting relatively equal bargaining power.

Thus, the theoretical element of negotiation inherent in contractual theory is essentially lacking in practice. Since the parties – consumer and provider – in no meaningful way possess anything approaching equality of bargaining power, the potential for consumer abuse is thus significant, particularly given the nature of many consumer Financial services which are virtual necessities to

[1] This is not to suggest any pejorative motives on the part of vendors. Rather, it merely reflects a statement of fact in light of the underlying economic forces dominating most consumer financial services markets.

[2] For example, by waiving or reducing a contractual fee or charge upon request, most typically in the interest of promoting customer relations.

consumers. Not only do many, if not most, consumers lack the capacity to negotiate with vendors, there are often circumstances such that they are effectively not free to decline to accept the services on less than attractive terms, e.g., insurance is required, or credit is essential The services are necessary, and the search costs of obtaining alternatives may be (or be seen as being) overwhelming.

As a result, there is a wealth of regulatory intervention into consumer financial services markets in the US. It is primarily to redress this imbalance as between buyer and seller upon which this intervention is conceptually predicated.

There exist two primary forms of regulatory intervention – mandates or prohibitions on specific practices or terms, and disclosure requirements. This paper focuses on the latter type of regulatory intervention, and examples of what are considered positive or effective disclosures.

2. Mandated Information Practices Generally

Given the complexities of various financial services products, and the mushrooming proliferation of new, unfamiliar products among which consumers can choose, consumers could not hope to make intelligent or informed decisions without adequate information. And, given the mass nature of consumer markets, experience has shown that market forces will generally not act adequately to ensure that comprehensible, timely information will be broadly available to consumers to such end.[3]

While to some extent, one might expect vendors to provide good, complete, timely information in order to attract consumers to purchase from them, these same vendors are also impelled to provide such information as most effectively attracts consumers regardless of its objectivity, accuracy, or even basic fairness. That is to say, absent controls, vendors of products or services have obvious incentives to provide self-serving or otherwise unhelpful information simply to "make the sale." Some, sad to say, have been unable to resist such temptations. Thus, it may not be (indeed, experience shows it almost certainly is not) safe – if consumers are to be protected adequately – solely to rely upon vendors to provide adequate information.

Better, more complete information will, in economic theory, lead to lower prices for consumers. As such, consumers would be expected to seek out such information. But, if they lack sufficient marketplace power to compel the provision of such information, the theory collapses. In all likelihood, it is simply not realistic to expect consumers to take the time (and thus, incur the costs) to obtain adequate information[4], particularly in light of the questionable assumption they could adequately distinguish among various complex pieces of information even once assembled.

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[3] Indeed, whether or not consumers can act adequately to promote their own self-interests even with relatively good, timely information is, in the minds of many, still questionable.

[4] Indeed, many observers have concluded that the nearly unparalleled breadth of financial services regulation in the US is a direct reflection of the frequency with which vendors are perceived by many to have abused consumers of such services.

History is replete with examples of consumers being taken advantage of by unscrupulous vendors of financial services products and services.[5] Not only are these consumers thus injured, but legitimate vendors are competitively disadvantaged vis-à-vis their less savory competitors. This leads then to marketplaces malfunctioning. Thus, regulatory marketplace intervention is both acceptable from a policy standpoint and widespread in practical terms.

The purpose of such intervention then is the promotion of market transparency. One well-known consumer economist has defined this to mean, "a condition in which consumers 'see through" markets and accurately discern all the relevant magnitudes – the existence of products, product varieties (brand-model combinations), retailers, prices, commodities".[6]

There exists in the US a wide array of regulatory intrusions into the operations of consumer financial services markets to control for the information provided to consumers, ie. to promote transparency. There are, for example, extensive laws requiring various disclosures dealing with credit[7], or industry standards addressing the same needs, involving, for example, insurance[8]. All such requirements are ultimately intended to ensure that pertinent information is provided to consumers in meaningful formats and at appropriate times so as to enable them to elect among various competing products or services in an informed manner.

This approach intends two primary outcomes:

1. individual consumers will be provided with information armed with which they can then maximize their own self-interests in selecting optimally appropriate products or services, ie. micro-economic consumer protection; and,

2. markets will operate more efficiently by rewarding providers of products or services with greater appeal or attraction to consumers, ie., providers of "best practices", and thereby benefiting consumers generally, ie., macro-economic consumer protection.

A number of policy goals are subsumed within these two broad notions; for example, disadvantaging high-cost, less attractive providers; protecting legitimate providers from unfair practices of competitors; improving consumers perceptions of their own marketplace participation; reducing overall prices so as to maximize the ability of consumers to participate in such markets, etc.

The entire notion of marketplace intervention by regulation must be viewed in light of the undeniable costs to vendors of such disclosure requirements. Compliance costs can be substantial Consumer welfare must be assessed then in light of the trade-offs between the costs to vendors (and, of course, ultimately to consumers themselves) of providing mandated information and the

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[5] As a former senior editor of Money magazine pithily put it: "Life it too short to shop for everything!"
[6] Maynes, E. Scott (1986), "Towards Market Transparency," *Price Information and Public Price Controls, Consumers and Market Performance* , Proceedings of the Fourth European Workshop on Consumer Law, M. Goyens, ed. Brussels: Bruylant.
[7] E.g., The federal Truth-in-Lending Act, 15 U.S.C. 1601 et seq
[8] E.g., The Model Readability Act of the National Association of Insurance Commissioners (1981), NAIC, Kansas City, Mo.

benefits of avoided consumer injury and improved efficiencies in markets. While important, this trade-off is nonetheless beyond the scope of this paper. Rather, we here focus on what types of practices seemingly work best (or, are perceived as working best by various interested persons) to promote information transparency regarding financial services.

3. Relevant Components of Information Practices

There are several obvious groupings of relevant issues involved in providing adequate information to consumers which promote transparency. Among these are:

Timing

There are several distinct points in time during the overall financial services relationship between consumer and provider at which providing complete, reliable information can be crucial to promoting consumer well-being via enhancing transparency. Among these are:

- during general information searches, e.g., in advertising and promotional pieces
- during contract formation, e.g. on the note or other document evidencing the binding legal obligation between the parties
- during the ongoing relationship, such as on periodic billing statements in credit arrangements, or when filing a claim under an insurance agreement
- when inquiries or disputes arise, regarding, for example, substantive claims or procedural rights involving the processing of such inquiries or disputes.

Content and Format

In light of the complexity of many modern consumer financial services products, consumer comprehension can be promoted by identifying and highlighting particular terms or conditions which are (or ought to be) of highest priority to consumers in terms of price, risk, etc. And, after the most crucial components or elements are identified, there are a variety of possible ways in which to optimize the communication of such elements to consumers. Thus, there must be consideration of such issues as:

- highlighting the most critical terms or elements of the service in disclosure documents or in underlying evidentiary agreements
- use of examples of how future contingencies might affect consumer obligations, for example, regarding interest rate changes in credit agreements, market value fluctuations in securities contracts, etc.
- the desirability of providing information on past performance histories of the vendor, for example, regarding mutual fund accounts.

Presentation

There also must be consideration of how to optimize the utility of the provided information to consumers in terms of balancing its comprehensiveness with its comprehensibility, e.g.,

- Plain language" requirements
- disclosures tailored to particular needs for particular sub-groupings of consumers with special needs, e.g., disclosures in less commonly used languages, etc.

4. Specifics Forms, Contracts and Terms – Examples

What is attempted here, then, is a presentation of:

1. a number of specific contracts from selected vendors, reflecting several basic consumer financial services contracts, including:
   - "smart card" agreements
   - deposit accounts, including:
     - transacting accounts (checking) accessible by paper, or by electronic device, or both
     - savings accounts
   - credit card accounts and installment notes
   - property/casualty insurance contracts,
   - mutual funds accounts, and,
2. a variety of the model forms developed by the Federal Reserve Board, pursuant to statutory directive[9]

A variety of resources were consulted, including consumer advocates, financial services regulators, specific financial services providers, trade association officials, academics, and journalists. These individuals were surveyed to obtain both specific accounts reflecting what they felt to be particularly effective examples of agreements and other informational pieces regarding such services. They were also surveyed generically regarding the most problematic issues involved in providing consumers with manageable, meaningful information from their various perspectives. These observations form the basis for the criticisms and suggestions in the text. The interpretations are those of the author.

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[9] These forms, while being limited primarily to credit-related products and services, were nonetheless widely hailed and recognized by a broad cross-section of interested parties as being both comprehensive and comprehensible, generally striking the elusive balance between giving consumers enough information to enable meaningful discriminations while not overwhelming them with unnecessarily detailed or complex, often highly technical language or terminology.

A few notes generally about the observations made are necessary. Consumer representatives tended to be more critical of forms generally, focusing on changes or amendments in particular forms which they would prefer to see. Given the inherent balance between completeness and comprehensibility, it is my opinion, that making some of the changes suggested regarding particular forms to achieve a greater degree of one or the other of these ends would likely lead to suggestions from these same observers for countervailing changes in the other direction.[10] In other words, most consumer advocates, and to a lesser extent, some regulators, tended to view most forms as "glasses" that are "half-empty, rather than "half-full."

Similarly, several industry representatives were only grudgingly complementary regarding several of the model forms from the Federal Reserve Board, preferring to focus again on what the forms supposedly failed to accomplish rather than what the forms may have successfully achieved regarding effective disclosures. A number complained that the model forms would lead to unnecessary or undesirable standardization of disclosure forms, and resultant stilling of innovation in developing new and better ways in which to make disclosures.

Trade association representatives were particularly wary of either offering commendations or criticisms of particular forms, presumably reflecting a reluctance to be put in a position of being charged with criticizing the forms of a particular member of the trade association. Thus, while some offered examples of forms, they were noticeably less willing to offer editorial comments or assessments of such forms.

In general, consumer representatives were strongly inclined to favor more comprehensive and complete information. One candidly admitted to at least two motivations for such a preference: 1) in the interest of completeness to support truly informed decision making on the part of consumers[11]; and 2) the greater care required by disclosing institutions to comply with the more detailed requirements generally led to better disclosures for consumers.

That is to say, with more detailed disclosures required, there exists more potential for noncompliance; given the private enforcement structure under the Federal acts[12]; as such, vendors operating in an environment where detailed disclosures are required would generally take greater care to comply and thus provide information more closely aligned with that envisioned by the rule-making agencies, which (at least in the eyes of consumer representatives) are seen as being more objective, even-handed, and equitable.

Financial institution representatives, on the other hand, were more concerned with "information overload" and whether or not prospective customers might be inundated with information to the point of confusing or discouraging them or both.

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[10] In significant part, this undoubtedly reflects the often contentious, often highly political environment in which much of the regulation shaping disclosures occurs.

[11] This particular individual admitted quite candidly that the likelihood of a large percentage of consumers relying upon such complete information to a significant degree was relatively small.

[12] Typically, actual damages, statutory penalties, **and** attorney fees, together with court costs. E.g., Truth-in-Lending, 15 U.S.C. 1640.

What follows then is a discussion of a variety of consumer agreements and informational pieces associated with various Financial services products mentioned above. This paper does not attempt to recite all relevant laws, state or federal, which may (but need not necessarily) have contributed to the inclusion of the specific language or its format in the selected documents. Rather, it makes observations as to what may be the relative strengths and weaknesses of the selected items from the standpoint of promoting informational transparency to consumers affected by these documents.

5. Specific Institutions Forms and Agreements

Smart Card Agreements – Documents 1(a), 1(b), 1(c)

As contrasted with the Canadian experience, smart cards are relatively new and generally not widespread in the US. As such, there are very few documents upon which to draw. Three are included herein, of which two relate to the same product. There is virtually no applicable law to date governing mandated disclosures of such products, except to the extent that they might be “reloadable” through Automated Teller Machines drawing on checking or credit accounts. In those instances, the general disclosure laws applicable to debit cards[13] or credit cards[14] would be applicable.

[All documents are referenced in Appendix I.]

Document 1 (a) – This document is the applicable governing agreement concerning the Visa Cash Card given trial concurrent with the 1996 Olympic Games in Atlanta by First Union Bank, one of the largest banks in the US. The agreement is relatively straightforward and clear. It highlights the provision that loss of the card will not be reimbursed.

It was viewed as being inadequate by several commentators, however, in that: a. it provides for a "processing fee" in connection with any refunds sought by the consumer, but fails to disclose what the fee is, or how it might be determined, and, b. it provides for "inactivity charges" following the expiration date, but similarly falls to disclose the amount or terms of such charges.

Further, in what is one of the specific terms found most objectionable by consumer representatives, it indicates (and even then, only at the conclusion of the item, in a relatively inconspicuous position) that "[The issuing bank] may change the terms and conditions at any time without prior notice." Recognizing that some of the objection is based upon the substance of such term, it is nonetheless also objectionable from a disclosure standpoint in that

- it fails to provide for any disclosure of possible changes in terms, and,
- it is relatively inconspicuous.

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[13] The federal Electronic Funds Transfer Act, 15 U.S.C. 1691
[14] The federal Truth-in-Lending Act, 15 U.S.C. 1601 et seq.

Such a potentially controversial substantive provision seemingly should, of a minimum, be highlighted in some manner, such as by use of bold type, more prominent placement, segregation from other terms, etc.[15]

Document 1(b) – This document is the actual physical container in which Chase Mondex cards are delivered to consumers in the current pilot project being operated by Chase Manhattan Bank and Citibank an the Upper West Side of Manhattan in New York City.

Rather than being the controlling document governing the relationship between the issuer and the consumer, it is more of an informational/promotional piece primarily describing basic steps for using the card, and the consequences which might follow in the event the card is lost, stolen, or damaged. This was felt by some of the financial institution respondents to capture the most commonly raised concerns, based upon their consumer research.

Document 1(c) – This document is the actual governing agreement controlling the use of the Chase Smart Card referred to in 1(b), supra. Some of the consumer representatives had significant objection to this item, however, upon delving into the particulars, it became clear that their objections were primarily substantive, i.e., they objected, for example, to the clause allowing unilateral amendment of the terms, times, and conditions, as above with the Olympic card. Their objections as to the format were primarily focused on the size of the type face, and the relatively congested appearance of the document as a whole.

Deposit Accounts – Documents 2(a) and 2(b)

In general, most of the interested parties applauded the relatively comprehensive approach taken in the following two disclosure documents. Both are from large banks operating nationally. [2(a) – Citibank, NA; and 2(b) – Wells Fargo Bank, NA] The Primary distinction between the two is the degree of detail, with the Citibank brochure being more concise and abbreviated (though still quite extensive), while the Wells Fargo disclosures (consisting of two fairly substantial booklets and an addendum) are obviously much more comprehensive. These were selected as being more comprehensive, usable, and appropriate than the generally more limited disclosures from more localized institutions. Other gathered contracts were not nearly so comprehensive nor, in the view of most reviewers, as useful as the offered agreements, as such, they are not included herein.

Despite many differences, the number of similarities in format in the two documents is also noteworthy.

1) They both favor the approach of including disclosures for all deposit accounts within a single document.[16] Despite having an extremely wide variety of deposit accounts at both

[15] Such a recommendation, for example, was included in the so-called "Jack report", "Banking Services: Law and Practice Report by the Review Committee," Feb. 1989, presented to Parliament and the Bank of England: "A standard of best practice should require a bank... to ensure... [the customer is given] reasonable notice of any proposals for variation of those terms." Recommendations, Sect. A 6(3), at 151

[16] Indeed, the information from Wells Fargo is so extensive as to be packaged in two fairly hefty brochures

institutions, most respondents indicated this approach was preferable to having numerous distinct information pieces, which could require some effort in keep the pieces arranged in a usable order, or might otherwise lead to consumer confusion. Thus, they include checking account information and savings account intimation. Financial Institution representatives were particularly supportive of this approach in light of a generalized preference favoring “consumer choice”, ie., an extensive ranges of products was viewed as being inherently beneficial for consumers.

2) Both also highlight on the first page ways in which to contact the banks so as to obtain additional or clarifying information. Several of the consumer representatives in particular felt this was critical so as to enable consumers easily to ‘speak with a live individual." This was viewed as particularly critical in light of the mushrooming number of distinctive offerings available from each institution. It should be noted that several of the toll-free numbers listed led to such a "live individual" only after proceeding through an extensive (and, presumably to some consumers, frustrating) telephone tree answering service.[17]

3) Both disclose early on the fact that selected services, such as security products or annuities, are not insured through the Federal Deposit Insurance Corporation. This issue was considered particularly important by several of the consumer and elderly advocate representatives, presumably in light of the numerous instances of consumers being defrauded in the late 1980s and early 1990s by institutions which did not adequately disclose that various security and annuity products they offered were not federally insured as most consumer bank products have historically been in the US.

It is also worth noting that the bulk of this material provided regarding deposit accounts not subject to legal mandate, but rather represents a decision on the part of the bank to compile and format the information as presented, presumably for customer relations and competitive purposes.

Consumer Loan Accounts: Credit Cards Accounts and Installment Notes – Documents 3 and 4

Disclosures regarding consumer credit are probably the most extensively regulated of all consumer financial services in the US. Disclosures regarding open-end credit accounts have generally been criticized by consumer representatives as being less helpful to consumers than are those for closed-end credit (typically, installment notes).[18] The typically contingent and flexible

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[17] One industry attorney even observed that this placement of a means for gathering elaborative or other additional information on the first page, i.e., in a highly prominent position, could be viewed as at least a partial, implicit admission of the inevitable futility of attempting to reach an optimal balancing between comprehensiveness and comprehensibility.

[18] For example, "TIL [truth-in-lending] disclosure rules for open-end and closed-end credit arc very different. One [closed-end] gives useful information in a comparatively comprehensive way. The other one doesn”t." K. Keest, Asst. Atty. General, Deputy Administrator, Iowa Consumer Credit Code, "Lending Practices: Consumer Credit Litigation as a Search for the Balance.- @ p. 4 private monograph an file with the author.

nature of the open-end amount undoubtedly contributes to the difficulties in attempting to design a meaningful form which is at once complete and yet still useful for most consumers. In particular, consumer representatives object to the general lack of any disclosure as to the length of time to repay a relatively modest loan on a typical open-end credit account when making the minimum payment required by the underlying contract agreement between issuer and consumers.[19]

Further, the relaxation of various state laws which previously limited or prohibited various charges and practices associated with such accounts has led to the widespread imposition of numerous features and charges, thus vastly increasing the complexity of such agreements. The resultant forms have been similarly complex, and thus challenging to the end of promoting adequate and useful disclosures to consumers.

In large part stemming from this dichotomous treatment between installment and open-ended credit, an unfortunate practice has arisen recently in the US where some creditors have structured what are functionally installment loans for major items, such as home entertainment centers or water purification systems, as open-end agreements, notwithstanding that no ongoing transactions are contemplated, Some consumer representatives have accused some vendors of purposefully transforming what are functionally installment credit obligations into putative open-end arrangements, in part to mask the true costs and terms of the arrangement behind the relative complexity of open-end disclosures. Several prominent lawsuits challenging such practices are currently pending. This practice is mentioned to point out the dangers in designing dramatically different disclosure regimens for what can be functionally (at least, nearly) interchangeable products.

A particularly compelling display of the differences between such accounts under federal law is contained in documents No. 3(a) and (b). In the view of several reviewers, document 3(a) reflects a “poor practice” – though, it should be noted, not necessarily primarily as a matter of disclosure. While it is composed of relatively small, difficult to read type, it is generally complete and in compliance with applicable legal standards.

As a matter of disclosure, it is fairly typical, reflecting the extensive body of federal law governing such disclosures. It is contained on one page, which is generally viewed as being desirable. It highlights, by using bold type, the provisions allowing for unilateral changes in terms. It highlights, both by use of bold type and by segregation within a bordered box, the key price terms, namely, the Annual Percentage Rate and applicable additional fees. Several other credit card agreements obtained were not significantly different regarding these factors.[20]

The difficulties in providing a “best practice” for open-end credit are probably most compellingly demonstrated by what is generally considered a better disclosure document from American

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[19] For example, $1000 borrowed on such an account, with a mandated *minimum* payment of 2% per month (or, $10 if less), at 18% APR, with a $20 annual fee capitalized into the outstanding balance would take approximately *10 years (!)* to repay, and entail almost $800 in finance charges.

[20] See, for example, Appendix No. 3(c),

Express Company.[21] [document No. 3(d)] Notwithstanding such desirable features as including a disclosure to the consumer regarding the vendor's intentions with respect to the use of the account information, and the consumer's right to request removal of his or her personal information from such general circulation, the disclosure is still quite lengthy and, for some consumers, in undoubtedly somewhat intimidating. Nonetheless, AMEX is (and has been) widely hailed for endeavoring to (and generally succeeding in) making its informational practices among the best in the industry.

As an alternative, document no. 3(e) represents what might be characterized as a 'shortform" credit card disclosure form. This form is from Bank One, an Ohio-based nationwide national bank issuer of credit cards, and one of the 5 largest issuers in the country. While the disclosure form (on the back side of an application form) is relatively clear and understandable, it does not contain all applicable rules and terms of the account. Thus, it represents a trade-off in terms of greater comprehensibility, but at the expense of being less than complete. Where to strike this balance is, of course, one of the thorniest of public policy problems.

As with deposit accounts, supra, there is thus a dichotomy [between documents 3(d) and 3(e)] – ie., between a full and potentially overwhelming disclosure on the one hand, and a shortened, more easily understandable, but potentially incomplete disclosure on the other. This balance is complicated by the common (though not universal) practice of providing the full rules and regulations governing the account only following approval of the application, typically contemporaneously with the actual issuance of the card. Obviously, the timing of such disclosures cannot, by definition, assist consumers in assessing and choosing among competing products. And, clearly, once a consumer has invested the time and effort in applying, and has been approved, with the nearly inevitable gratification which often accompanies such approval, the likelihood of the consumer repeating the process to obtain more favorable terms or conditions subsequently may well be relatively small. Accordingly, a "best practice" would seemingly envision a conscious determination as to the extent of required disclosures prior to submission of an application by the consumer.[22]

By comparison, installment notes are generally easier to make "consumer-friendly", although they still often remain quite lengthy. A good example comes from Firstar Bank, NA (a medium-size regional lender headquartered in Milwaukee, WI) (document No. 4). This note reflects a number of terms and conditions required under both federal and Wisconsin law.

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[21] A "good (if not best) practice"?

[22] Whether or not the full rules should be disclosed prior to submission of an application is a difficult question, with competing considerations on either side, and is, unfortunately, beyond the scope of this paper. What is suggested, however, is that policymakers establish with precision the degree to which relevant account information (if any) can be provided to a consumer subsequent to the filing of an application upon which final decisions can be taken by the vendor.

Among the provisions which make this especially helpful are:

- highlighting the key price terms – APR, Finance Charge, Amount Financed, and Total of Payments – by use of bold type and containing in a separate, prominently featured box,[23]
- highlighting the actual promise to pay made by the consumer, by placement at the very top of the front page, thus underscoring the nature of the obligation being undertaken by the consumer,
- segregation of credit insurance provisions, thus hopefully reducing any suggestions as to potentially misleading contentions as to the generally voluntary nature of such features,[24]
- separate itemization of the "amount financed", which flows in a logical and comprehensible order,
- removal of important but nonetheless secondary terms and provisions to the rear side of the document, and,
- use of easy to understand language.

Note also that a number of different features customizing diverse loan products can be accommodated by this single, all-purpose form, through use of a series of boxes to be checked where applicable, reflecting features such as variable rates, demand notes, differing forms of collateral to be offered by the borrower, etc. Over time, use of such standardized forms should increase consumer familiarity with such forms generally, and thus, hopefully, the comfort levels of and utility for consumers.

Property/Casualty Insurance Contracts

Property and casualty insurance contracts (generally, automobile and homeowners" policies) are significantly more varied than most agreements from depository financial institutions in the US, due in large part to the fact that insurance companies are regulated primarily at the state level, unlike with banks and other depositories which are increasingly predominantly governed by federal standards. Thus, there is in practice considerably more variation in the content of various contracts in light of the often substantial differences between the substantive laws of the several States.[25]

Several policies were reviewed[26] which were generally thought to be quite well thought out, designed, and generally worded to promote consumer comprehension.

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[23] Entitled, "Federal Truth-in-Lending Disclosures"; such highlighting of key terms is required under federal law.
[24] Again, this segregation is **required** by applicable federal law.
[25] For example, some states (e.g., Michigan, Florida, New York, et al.) allocate primary responsibility for various auto accident damages on a first-party basis, while the majority continue to allocate such responsibility on traditional tort principles. As such, the underlying contracts will, of course, differ substantially.
[26] Documents, Nos. 5(a) – (f)

Document Nos. 5(a)-(c): These documents were automobile insurance polices obtained from the State Farm Insurance group, the largest automobile carrier in the US, a mutual insurer, and generally recognized as one of the preeminent companies in terms of concerted efforts to attempt to make their policies comprehensible and "user-friendly." Examples are offered from 3 separate states – Illinois, Minnesota, and Pennsylvania. Separate examples are given, reflecting:

a. a traditional, tort-based liability system (Illinois)

b. a system with Personal Injury Protection coverage, i.e., a so-called "no-fault" type of system (Minnesota)

c. a hybrid system with numerous, statutorily-mandated first party benefits (Pennsylvania).

Since many disputes involving auto insurance contracts entail disputes over coverage, all of these policies begin with an index of defined terms. These terms are printed in bold-face type and defined using relatively easy to understand language. A subject matter index is prominently displayed on the rear cover of the policy, enabling easy location of particular topics.

Relatively simple techniques can be incorporated to enhance the consumer's ability to use these policies. For example, in documents 5(a) – (c), the definitions are listed in alphabetical order. While this may seem simplistic, it can apparently not be assumed. For example, in contrast, in the policy noted as document 5(d), (Family Car Policy, SECURA Insurance) several of the definitions are listed in an order other than alphabetical. While the intent obviously is to group terms which are substantively related, it was pointed out that this may create difficulties for consumers simply attempting to find applicable definitions, as many would presumably expect any index to be alphabetical in order.

All these policies are written in relatively simple language. Doing so involves a significant effort in light of the underlying complexity of the products. However, virtually all observers surveyed felt that these were generally quite successful efforts to promote consumer comprehension.

Two other examples which commentators both within the industry and among regulators felt did a generally good job presenting important information in a clear and concise manner are policies from Allstate, a major national stock carrier (document 5(e)) and from a relatively small, regional carrier, General Casualty (document 5(f)). Again, note that all are written in relatively straightforward, direct language.

Timing: While these agreements were generally considered to be fairly successful efforts to render complex products reasonably comprehensible, a major concern stems from the timing of their delivery to the consumer. These documents represent the final, binding agreement between the carrier and the consumer. They are not, however, generally provided to the consumer prior to agreeing to coverage. Rather, they are typically provided to the consumer after a decision has been made to select a particular carrier and policy, after a binder has been obtained, and, most importantly, after a premium has been paid. Thus, their usefulness to the task of enhancing comprehension so as to enable the consumer to select the most suitable coverage and carrier is

generally nil. They may well be helpful in assisting the consumer in assessing his situation, most typically when a potential claim arises or when renewal is contemplated, but they will not assist the consumer in selecting the policy ab initio.

Several examples of similarly formatted Homeowner's Liability Policies were also reviewed.[27]

Language Format – Regulatory and Industry Standard Approaches

Given the complexity of insurance generally, mandating efforts to simplify the actual language utilized seems especially helpful.

In 1981, the National Association of Insurance Commissioners (NAIC), the trade association for the chief insurance regulators among the 51 jurisdictions in the US, developed a model readability act[28]. Its express primary purpose is to, "...establish minimum language and format standards to make property and casualty policies easier to read. "[29] The actual standards incorporated in the statute are quite general, indicating that policies are to be 'simplified, taking into consideration the following factors:

- use of simple sentence structure and short sentences;
- use of commonly understood words;
- avoidance of technical legal terms wherever possible;
- minimal reference to other sections or provisions of the policy;
- organization of the text, and,
- legibility.'

These factors are elaborated upon in the accompanying model regulation (attached to the model act). While the statutory factors are obviously not terribly specific, the model regulation associated with the act is considerably more precise, adopting, among other features, the "Flesch Reading Ease test", which is a recognized mechanism for assessing quantitatively the readability of textual material. An example of a specific state's statutory adoption of the substance of the NAIC Model Act is noted in Florida's insurance laws.[30]

Many national carriers, such as State Farm, USAA, and Allstate, have attempted to conform their policies generally to these standards, notwithstanding the significant variations in legal requirements across the 51 jurisdictions in the US. There seems little doubt, based on the

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[27] Documents, Nos. 6(a) – (c)
[28] *Property and Casualty Insurance Policy Simplification Model Act, Nonpersonal Lines Property and Casualty Insurance Policy Simplification Model Regulation,* April 1981, National Association of Insurance Commissioners (Forms 730, 745)
[29] ibid.

[30] Insurance Rates and Contracts, Chapter 627, Florida Statutes

exemplary policies previously referred to, that merely highlighting such factors, and requiring companies to consider them, can be beneficial in achieving greater readability.

Mutual Fund Accounts

Without question, there was a greater unanimity among those surveyed that of all types of consumer financial services, the clear standard-setter in terms of best disclosures and best information practices for consumers was the Vanguard Group of mutual funds. Consumer representatives, regulators, academics, journalists, and fee-only certified financial planners[31] all agreed that this group engaged in the "best" informational/disclosure practices. In fact, the only individuals surveyed who did not specifically mention the Vanguard group were members of industry trade associations, who could hardly be expected to single out specific companies within their memberships for such applause.

The consensus was that this particular Fund Group struck the best balance in achieving an overall disclosure pattern likely to benefit consumers, specifically addressing the needs of consumers for:

- clarity in risk disclosure,
- appropriate timing and readability of disclosures,
- functional correlation between disclosures and fund practices, and,
- controls on suitability of selected funds appropriate for specific consumers.

The informational pieces from the Vanguard Group contained:

- a description of the various funds available, categorized by risk level,
- applications for opening accounts, both directly and through an investment advisor, and,
- information on obtaining prospectuses.

Risk Disclosure

Unlike most depository accounts, where there is typically federally-backed insurance supporting the deposit, mutual fund accounts pose special concerns for consumers in terms of relative riskiness. To accommodate differing objectives, most fund groups offer a variety of individual funds which explicitly contemplate greater or lesser degrees of risk as an investment strategy. As such, it is essential that risk be adequately disclosed to consumers. To that end, several observers[32] suggested:

- that risk disclosures be segregated and highlighted within fund prospectuses
- that risk descriptions be related to stated investment goals, and,

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[31] I.e., planners whose primary compensation is **not** calculated on a commission basis.
[32] Consumer representatives, financial journalists, and regulators in particular.

- that past quantitative measurements of fund performance, while important, not be allowed to overwhelm narrative descriptions of fund objectives and strategies.

6. Model Forms – from Regulators

There are a number of federal statutes governing disclosure as regards various common consumer financial services. Examples include the following acts: Truth-in-Lending (regarding credit), Truth-in-Savings (savings accounts), and Electronic Funds Transfer. As the complexity and variety of such products have expanded, the rate and degree of compliance with the spirit of such statutes has been, to say the least, uneven. Further, the compliance costs to vendors have been significant.

Accordingly, the Federal Reserve Board, as the statutory administrative agency assigned by the Congress under the Federal Consumer Credit Protection Act, has promulgated a wealth of model forms dealing with various types of common consumer financial services and products. These forms are intended to be usable by a financial services provider, and as a result, to provide a "safe harbor" from the statutory penalties provided for in the underlying statutes.

They have been developed and designed both to comply with the specific requirements of the various statutes and their implementing regulations, and to provide meaningful information to consumers about the relevant subject matters so as to promote market transparency. Significant efforts have been made by the Federal Reserve in developing such forms to solicit input from industry, from consumer representatives, from educators, and others.

These forms were applauded almost without exception as being examples of "best practice."

For a more complete compilation of the forms developed by the Federal Reserve Board, please see Commerce Clearinghouse *Consumer Credit Guide*; for example, Vol 1, Appendix G – Open-End (Credit) Model Forms and Clauses [@para.3500], Appendix H-Closed-End Model Forms and Clauses [@para.3520]; "When Your Home is On the Line" – A Home Equity Handbook, ibid, [@para.3785], et seq.

Appendix I – List of Documents Reviewed

Document number and reference:

1(a) "Disposable First Union VISA CASH CARD AGREEMENT," First Union Bank (Form 536599)

1(b) Information packaging for Chase Smart Card, The Chase Manhattan Bank, 1997, (Form 01 1803 (9/97))

1(c) "Chase Standalone Smart Card Agreement" The Chase Manhattan Bank, 1997, (Form 03 9637 (10/97)

2(a) "Citibank Consumer Accounts, Account Information" Citibank, 1997 (Item 253286)

2(b) "Consumer Disclosure Statement Rules Governing Deposit Accounts", Wells Fargo Bank, 1997 (UNI 401 12/97)

"Schedule of Account Terms and Fees, California, Effective December 1, 1997, Wells Fargo Bank, 1997

"Schedule of Account Terms and Fees, California Addendum, Effective January 1, 1998", Wells Fargo Bank, 1997

3(a),(b) "Cardholder Agreement and Disclosure Statement", Household Bank, (Nevada)

3(c) "Cardholder Agreement and Disclosure Statement", Household Bank (Illinois) (6022-277-39-US)

3(d) "Agreement Between Hilton Optima Cardmember and American Express Centurion Bank" American Express Centurion Bank, (CD 50138 Rev.3/97)

3(e) "Bank One Credit Card Application" Bank One, 1997 (Catalogue No. 10835 (7/97)),

4 "Loan Note and Security Agreement", Firstar Bank, 1997 (UN5000B (UNIV) 3/97)

5(a) "Your State Farm Car Policy, Illinois", State Farm Mutual Automobile Insurance Company, (Policy Form 9813.8)

5(b) "Your State Farm Car Policy, Minnesota", State Farm Mutual Automobile Insurance Company, (Policy Form 9823.5)

5(c) "Your State Farm Car Policy, Pennsylvania", State Farm Mutual Automobile Insurance Company, (Policy Form 9838.6)

5(d) "Family Car Policy" SECURA Insurance, (FCP-0001-8701)

5(e) "Allstate Automobile Policy", Allstate Insurance Company (AU 148)

5(f) "PERSONAL AUTO POLICY" and "AMENDMENT OF POLICY PROVISIONS – WISCONSIN", General Casualty Companies (GPA 0001(0687)) (GPA 0048(1188))

6(a) "WISCONSIN HOMEOWNERS POLICY", American Family Mutual Insurance Company (Form No. HO-3 (WI) Ed 10:84) (Stock No. 01495 Rev. 12,88)

6(b) "YOUR STATE FARM HOMEOWNERS EXTRA POLICY", STATE FARM FIRE AND CASUALTY COMPANY (FP-7925 (12/90))

6(c) "Allstate Deluxe Homeowners Policy" and "Coverage Update", Allstate Insurance Company (AU1774) (X3101)

Part II

Achieving Redress

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1. Introduction

The overwhelming majority of consumer financial services transactions in the United States are (and historically have been) handled relatively smoothly, without confusion or complaint, typically resulting in the mutually beneficial ends contemplated and desired by both provider and consumer. And, indeed, as routine consumer financial services have become increasingly mechanized – with the resultant declining per transaction margins – the economic pressures on service providers to prevent relatively costly redress or inquiry situations increase. But, inevitably, with literally tens of billions of such transactions occurring annually – and with a proliferation of new and unfamiliar financial products and services being offered to consumers – even a small fraction of such transactions involving confusion or claims of unfair treatment, inexorably lead to relatively large numbers of inquiries or disputes.

For a variety of reasons outlined below, structural changes occurring in diverse financial services markets across the US have prompted various legislative, regulatory, and private sector responses intended to promote equitable resolution of such situations. Further, as consumers deal with what are often (literally and figuratively) more distant and thus less physically accessible sellers, via emerging, unfamiliar and often relatively intangible transacting mechanisms, it is reasonable to expect that such situations will continue to arise, perhaps with even greater frequency. Thus, developing appropriate redress means is likely to become even more important to the ends of consumer protection going forward.

2. Essential Elements of An Ideal Redress System

There are a number of crucial components which any redress system ought to contain to protect consumers adequately. Among these are:

- accessibility
  - can consumers easily (and at an equitable cost) access any such system?
  - are all financial institutions in a given market participating?
  - is it relatively obvious as to procedures used?
  - is it reasonably prompt in investigating disputes and rendering decisions?
- fairness
  - is it reassuringly (and thus credibly) independent and balanced?
  - is it sufficiently potent insofar as being able to secure pertinent or necessary evidence or other information?
  - is it adequately overseen, e.g., open to scrutiny or audit?
- effective
  - are outcomes or decisions satisfactory to consumers enforceable or otherwise achievable in practice?

These constitute the basic criteria against which any redress regimen ought to be assessed.

3. Prospective and Remedial Consumer Protection Needs

Conceptually, consumer financial services problems (or perceived problems) can be characterized as occurring either:

1. during the period leading up to consummation or performance – most prominently during the information gathering (including advertising or promotion) or contract formation steps on the part of the consumer; and,

2. following performance, when typically the consumer feels confused, deceived, aggrieved, or otherwise unfairly treated.

Perceived problems in the first set of circumstances which do not result in performance or in creation of binding obligations generally do not typically lead to actual damages to consumers. That is to say, while such consumers may (or may not) have received fair or adequate information, they have also not generally suffered economic loss (other than perhaps some lost time.) And, as such, their need for effective means of redress is qualitatively different from situations where they have actually suffered direct harm[1].

Thus, while there may be (indeed, there almost certainly is) a societal imperative to eliminate or ameliorate misleading or other potentially harmful behavior in financial services markets generally, the impetus for actions to that end would be largely the avoidance of prospective injury. Most typically, action to that end in the United States has been undertaken in the form of governmental regulatory or enforcement actions, legislative amendments, and only less frequently, through private legal actions, either individual or class in nature. Put another way, such actions have generally sought such systematic remedies as statutory interpretations, legislative or regulatory reform, or injunctive relief.

On the individualized level, however, where consumers have (or perceive themselves to have) actually suffered loss, a variety of responses have been developed to facilitate redress. These have taken both private forms – either contractual in basis or reflecting evolved industry standard – and legally mandated forms.

Privately Created Means of Redress

While certain models exist for private establishment of redress mechanisms, these constitute the definite minority of situations in the US. The US experience has been significantly different than that found in many of the European countries where a number of less formalized dispute

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[1] At this stage, there is every economic incentive for the provider of the service to respond to confusion or other inquiry on the part of the consumer, as failure to do so will lead, not just to the failure to provide the service itself (on what the provider presumes will be a profitable basis), but also the engendering of negative perceptions of the service or the provider or both on the part of the consumer, with the attendant likelihood that the consumer would not elect to use the service in the future. Singly, or taken together, these factors make it likely that most providers would be expected to develop sufficient redress means to address inquiries equitably at this stage.

resolution mechanisms exist, including statutory tribunals (often with a mix of expert and "lay" representatives), statutory ombudsman schemes, and voluntary ombudsman schemes.

Specifically, in the US, private means for redress are usually contractually-established and most commonly involve arbitration clauses in underlying agreements. in general, they are most typically found in those types of financial services which involve more qualitative types of questions or disputes. These types of clauses are most commonly found in the United States in securities agreements, and, less frequently, in insurance contracts. Given the nature of the most common types of disputes which consumers experience in these areas, this is hardly surprising.

Disputes in insurance or securities agreements often revolve around interpretive issues, e.g., scope of coverage (for insurance) or suitability (for securities agreements). These. notions – especially suitability – are in general more qualitative in nature[2]. Accordingly, it is much more difficult as a matter of public policy – when compared to payments or other banking services – to attempt to define via regulation performance standards for product or service providers. As such, most consumer securities agreements and many insurance contracts explicitly provide for arbitration as a means of dispute resolution.

Despite the considerable potential appeal of such clauses to financial institutions[3]they have been broadly attacked as generally lacking in public credibility (and thus political feasibility), primarily due to the fact that financial services contracts and agreements are generally seen, and as a result criticized, by consumer representatives and by much of the public as functionally being contracts of adhesion. That is to say, they are written by the financial services provider and in no meaningful way reflect anything approaching a real or equitable bargaining or balancing of interests between provider and consumer. in some instances, some agreements have been judicially held to be partially or wholly non-enforceable on similar grounds.

They contain provisions that either: 1) actually favor providers to a politically unacceptable degree; or, 2) are perceived by consumers as unfairly favoring providers. Thus, various mandated arbitration provisions contained in selected account or loan agreements are often objectionable. The use of such clauses is generally most widespread in the securities industry, where basic agreements to arbitrate have frequently (though not universally) been upheld judicially, and to a lesser extent in selected property and casualty insurance contracts.[4]

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[2] By contrast, in payments and other types of banking services, disputes are frequently more **quantitative** in nature.

[3] For example, in contractually-based arbitration in the securities industry, there is typically no review by a jury, there is less pre-hearing discovery, proceedings are usually confidential, there is often no right to be represented by counsel, recovery of costs and fees is often limited (or even non-existent) and, most crucially to financial institutions, there is generally no potential for class action consideration.

[4] A representative arbitration clause from what is widely recognized as an otherwise exemplary securities agreement.

Sample: Mutual Fund Account Arbitration Clause

I understand my account will be carried in accordance with this agreement.

ARBITRATION – THE FOLLOWING INFORMATION CONCERNS ARBITRATION OF CONTROVERSIES PROVIDED IN THE NEXT PARAGRAPH

- Arbitration is final and binding on the parties.
- The parties are waiving their right to seek remedies in court, including the right to jury trial.
- Pre-arbitration discovery is generally more limited than and different from court proceedings.
- The arbitrators' award is not required to include factual findings or legal reasoning, and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.
- The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

The undersigned agrees, and by introducing an account for the signed you agree, all controversies which may arise between us concerning any transaction or the construction, performance, or breach of this or any other Agreement between us, whether entered into prior, on or subsequent to the date hereof, shall be determined by arbitration. Any arbitration under this Agreement shall be determined pursuant to the then current rules and constitution of the New York Stock Exchange, Inc., or the code of arbitration procedure of the National Association of Securities Dealers, Inc., or the provisions of the arbitration facility provided by any exchange of which you are a member and on which a transaction giving the rise to such claim took place, as the signed may elect. Such election is to be made by registered mail, addressed to Wheat, First Securities, Inc., Home Office, 707 East Main Street, Richmond, Virginia 23219, Attention: Legal Department; and Vanguard Marketing Corporation, 100 Vanguard Boulevard, Malvern, PA 19355, Attention: Legal Department. The notice of election is to be post-marked five days after the date of your demand to make such election. At the expiration of the five days, you are authorized to make such election on the undersigned's behalf. Any judicial proceeding relating to the arbitration or to this Agreement shall be conducted in the State or Federal Court in Philadelphia, Pennsylvania, and the signed agrees (a) to submit to the jurisdiction of such courts, (b) that such courts constitute a convenient forum, and (c) that process may be served by certified mail return receipt request at the signed's last address know to you. No person shall bring a putative or certified class action to arbitration, nor seek to enforce any predispute arbitration agreement against any person who has initiated in court a putative class action; who is a member of a putative class who has not opted out of the class with respect to any claims encompassed by the putative class action until:

(i) the class certification is denied;

(ii) the class is decertified; or

(iii) the customer is excluded from the class by the court.

Such forbearance to enforce an agreement to arbitrate shall not constitute a waiver of any rights under this Agreement except to the extent stated herein.

Primarily to limit potential class action exposure, a limited number of major financial banking institutions have recently begun including such clauses in their loan agreements.[5] These agreements might establish, among other terms, the identity of the arbitrator, the location of the arbitration proceeding, the procedural rules governing the arbitration, the time frames, rights (if any) to counsel or cross-examination, to compel production of documents, to trial de novo, the applicable standards against which the complained of behavior is assessed, etc.

Necessary Components to Achieve Credibility

That is not to say that such means might not potentially be both acceptable and beneficial – indeed highly beneficial – as a means for redress. Traditional litigation is usually not satisfactory for resolving most consumer disputes.[6] It does suggest, however, that, as with other allocations of rights for redress between consumer and provider, arbitration agreements are credible *only* when they are *perceived* as being credible. And, to achieve this credibility (at least in the US experience) requires an oversight mechanism which is seen as being both independent in outlook and vigorous in policing the evenhandedness of any such system. In essence, the terms by which redress is pursued generally must be perceived as being balanced to be credible.

As a minimum, there are then various terms and conditions which any arbitration provision seemingly should satisfy to rise to this level in order meet reasonable consumer needs. Among these terms are:

- clear disclosure of the applicability of arbitration
- clear disclosure of any substantive limitations inherent in arbitration as contrasted with traditional litigation, e.g., punitive damages, attorney fees and court costs, etc.
- clear establishment of issues or disputes subject to arbitration
- clear and equitable selection of credible, independent arbitrator(s), preferably with credible, discoverable procedures and practices, e.g., a recognized arbitration organization
- at least a semblance of balance as to any consideration offered by the consumer and the financial institution legally to support the arbitration
- a close relationship between the standards to be imposed by the arbitrator and those created in the extensive body of statutory and common law discussed below
- clear disclosures of the unavailability of class action relief.

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[5] Among major US banks or finance companies, which have utilized such clauses are Bank of America, Green Tree Financial Corp., Beneficial National Bank USA, ITT Consumer Financial, PNC Bank, Wells Fargo, First Union, and Norwest Financial.

[6] As a noted practicing trial lawyer put it, "Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser -- in fees, in expenses, and waste of time." – Abraham Lincoln, 1850.

This then suggests that arbitration could certainly be a preferable alternative to the typical redress system experience described below. However, the minimum standards for any arbitration agreement to achieve the public credibility and acceptance would need to be established (or enforced) by an entity with the requisite public trust in the US (as described below), this entity has generally been the federal government.

As indicated, what is ultimately critical to achieving credibility for any redress mechanism is an accepted oversight system creating the relative substantive rights as between consumer and financial institution, which are perceived to be even-handed and disinterested. As described below, that oversight system, in the US, has generally entailed *governmentally-established* substantive standards, coupled with the potential for private sector enforcement, most commonly through litigation.

4. Legislatively Created Means of Redress

> *"Better a fence at the top of the cliff than an ambulance at the bottom."*
> - The Consumers' Union of the United States

The bulk of meaningful, credible redress in consumer financial services markets in the United States is (and has been) ultimately founded upon rights and enforced through procedures created through legislation or regulation.

For a variety of cultural, political, demographic, and legal reasons, to achieve adequate redress for consumers of financial services, the strong preference in the US is seemingly for:

1. legislative (as opposed to contractual) creation of substantive rights tailored to particular financial services, together with,

2. mandated procedural enforcement rights, taking such forms as notices of fights, often relatively specific investigation and error correction procedures, etc.; and undergirded by

3. the effective potential for vigorous enforcement actions, primarily through private litigation.

There has been an increasing standardization of redress as a result. No opinion is offered as to whether or not this development represents optimal public policy. It is, however, the clear trend within the US, and is likely to continue apace into the foreseeable future.

A brief overview of some of these efforts constitutes the remaining (and primary) focus of this report.

5. Background

The Emergence of Nationwide Networks: Primacy of Federal Regulation over State Regulation

The US experience is undoubtedly colored by this country's so-called "dual" banking system. Under this system[7], banks acquire charters specifying their permissible powers either from the various States, or from the federal government. Federally chartered banks ("national" banks) have historically enjoyed various legislated preferences.[8] Included among the most significant of these are partial or complete statutory exemptions from various state-imposed mandates, including in some instances, consumer protection standards.

These preferences have been reinforced and expanded upon judicially over the past few decades by a series of court decisions preempting in whole or in part various state regulatory regimens as they relate to national banks. As a result, in the name of competitive parity, state chartered banks have sought (often with considerable success) parallel legislative relief in the numerous state legislatures from various state-mandated provisions.

With the application of new technologies involving electronic data processing techniques and telecommunications capabilities, individual institutions and networks connecting such institutions spanning the country (and indeed, the globe) have proliferated. The economies of scale inherent in the use of such technologies have driven what is by US standards an enormous concentration within the banking industry.

Thus, US banks, though far more numerous than their Canadian counterparts, are increasingly becoming, like their major northern brethren, national in scope. And, as a result, consumer markets which are functionally national in scope have simultaneously emerged. To minimize the impacts and costs of "balkanized" regulation by the individual States, these markets have been increasingly subjected primarily to national (and thereby, uniform) regulation.

In large part due to the proliferating national nature of consumer markets then, the relative balance between state regulation and federal regulation has shifted dramatically toward a model involving federal primacy, notwithstanding many contrary political trends embracing so called 'states" rights"[9]. Given the increasingly national nature of consumer financial services markets, this is seemingly inevitable, and, likely to continue[10]. Under the circumstances, this is generally

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[7] Created by the National Bank Act in 1862 (and enacted primarily to finance the American Civil War.)

[8] E.g., in terms of powers and authorities, branching flexibility, etc.

[9] The sheer economic impacts of increasingly *national* consumer markets have thus overpowered the *political* impulses to retain regulatory authority closer to affected consumers, i.e., at the state level.

[10] Preemption of state regulation of financial services protection efforts has accelerated dramatically since the 1970s, following the Marquette case before the US Supreme Court, which preempted the applicability of state-imposed usury ceilings to interstate lending by national banks. 439 US 299 (1978)

desirable to the ends of promoting efficiency, certainty, and uniformity. As such, for purposes of this report, the focus below is primarily on national regulation.[11]

The following summary of some of the legally specified remediation mandates demonstrates what is, and clearly has been, the preference in the US for legislated standards. However, current developments in emerging means for transacting (such as via the Internet) raise at least the possibility that this trend may have peaked, at least temporarily. Government seemingly may be less inclined to standardize such means via regulatory mandate in the near future (at least, as to emerging payment and transacting means). Nonetheless, it is clear that the primary US model has involved a *legislated* approach to promoting and implementing remediation.

It also demonstrates through several topical examples, the essential inseparability of the legislative creation of substantive consumer rights and parallel procedural and enforcement methods to assert such rights as an overall approach to achieving redress. That is to say, in the US, much of the effective redress available to consumers of financial services stems from the legal assignment of relatively specific substantive rights to various parties in the payment, financing, and other mechanisms associated with consumer financial transactions. These substantive fights are then most typically enforced through private litigation procedures (either commenced or threatened), and secondarily, through regulatory agency investigation, mediation, and (occasionally) prosecution. Coupled with emerging marketplace trends, this regimen in effect harnesses market forces to provide powerful incentives to financial services providers to prevent or avoid problems from occurring. A number of important outgrowths of this policy are then briefly assessed at the conclusion.

The legislatively created substantive rights are relatively specific. That is to say, they place certain mandates or prohibitions upon providers. The result is also, however, that this relative specificity has lead to a concomitant decline in the application of relatively subjective, common-law types of notions by which to assess whether consumers have been treated acceptably. Thus, traditional notions of "fairness", "unconscionability", "good faith", etc. have been less frequently relied upon by consumers in attempting to seek redress for perceived mistreatment.[12] The inherently relatively imprecise nature of such standards, obviously, does not lend them to cost-effective, judicial enforcement in meaningful senses for most violations.

Various consumer financial services are reviewed, followed by a brief discussion of enforcement means, and a variety of background considerations essential to assessing the effectiveness (and ultimate desirability, or lack thereof) of such a redress system.

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[11] While numerous instances of similar state efforts could be cited, for purposes of assessing the effectiveness of redress, many of the dynamics remain largely the same in considering specific state proposals.

[12] While claims based on alleged violations of such relatively subjective standards do in fact continue, they are often measured against statutory or regulatory attempts to define such notions, as, for example, "unconsionability" as in WI Stats. Sect. 425.107

Payments

The accuracy of the vast majority of payment directives is tacitly assumed by most consumers. Indeed, the widespread acceptance by consumers of various payment means is predicated on such a (usually unspoken) assumption.[13] Value transfers in cash, by check or draft, by credit card, or by debit card occur regularly, and generally as contemplated by initiating payers. Consumers assume (and their experience generally supports such assumptions) that payments will be made in the correct amounts, to the desired payee(s); and in a timely manner. Nonetheless, a wide variety of legal structures have evolved, giving significant substantive rights to inquire, challenge, withhold, and even rescind previously-made payment directives.

The redress which consumers seek regarding payments typically involves:

a. inquiries or disputes as to the accuracy of the payment.

- was it made to the right party?
- was it made in the correct amount?
- was it made (or not made) in a timely manner so as to avoid unintended consequences?

or,

b. attempts to retain or recapture control of the subject funds, thereby increasing the consumer's leverage in any underlying dispute with a provider or goods or services, most typically as to the quality or terms of a purchase.

The former most typically involves efforts seeking redress against parties in the payment network itself; the latter seeks redress against creditors or other payees of the consumer (which may be, though more frequently are not, financial institutions) for a variety of alleged failures to perform equitably or as contemplated, as alleged by the consumer, and often is founded on providing the consumer with certain rights to deny or withhold finality of payment to a payee.

Cash

When payments are made in cash, settlement as between the parties is immediate. Absent any legal structure mandating otherwise, the burden is then on the consumer having initiated the transfer to take actions to rescind or otherwise undo such a transaction by asserting underlying rights. The typical remedy would be remission, accompanied by either refund or performance. For relatively small dollar amounts, the costs to on consumers of pursuing redress was generally so large as to render aggressive complaint remediation effectively unobtainable.

Any redress available to a consumer making a cash transaction was typically (a) founded upon legal doctrines external to the payment system such as contract, or, (b) at the discretion of and dependent on the amenability of the payee to reconsidering and remediating the transaction,

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[13] This notion regarding the importance of consumer expectations is demonstrated (in the converse) by the relatively glacial pace of consumer acceptance of payments over the Internet, where consumer confidence is largely lacking, at least as to this point in time.

presumably for customer relations or competitive reasons. Cash payments were final. Any redress was contingent on enforcement of contractual or legislated rights which might have been breached, generally through formalized court proceedings. In these types of transactions, consumers often might be seeking redress against providers of goods and services.[14] But, as noted, litigation was generally not a particularly effective (or even feasible) means for seeking remediation in these instances.

Checks

In the case of checks or other drafts, finality of payment is not immediate, ie., it is contingent upon presentment of the draft to the payer bank, and payment thereupon. Accordingly, the relative position between the payer and payee is different. So long as the payee had not received payment, payment-initiating consumers could, to the extent they could defer final payment, exert economic pressure against payees, by shifting the burden to seek redress to such parties. Once payment has been made, of course, the burden of seeking redress shifts directly back onto the paying consumer to initiate action for recovery, as with cash.

In payments via draft, the Uniform Commercial Code[15] allowed that transactors initiating payments could direct the paying bank to stop payment on the issued check, provided that such "stop" instruction was received by the paying bank in a timely manner so as to enable the bank to effectuate the revised payment instructions of the draft.[16] These state laws[17] provided consumers certain degrees of control, and thus leverage as payers seeking ultimate redress, which did not generally exist in the context of cash payments. Such provisions were only feasible since finality of payment was not immediate. This right gave the paying consumer leverage as against the putative payee by effectively allowing the paying consumer to retain control over the funds. As such, the payee as obligor continued to carry the economic burden to pursue the consumer for payment on the underlying alleged obligation.

Policymakers also recognized that many consumer disputes were of such a nature that the only effective means by which some, indeed many, legitimate claims could be redressed must, of necessity, involve the payment mechanism as a means for asserting substantive rights, as in the case, for example, where distant merchants might provide goods which failed to perform as reasonably expected by consumers, but where such failure became known only after payment had been made. By definition, withholding payment already made was meaningless as a tactic to achieve redress. Further, the fact of the physically inaccessibility of such merchants, coupled with the other barriers inherent in traditional common-law litigation, rendered traditional redress

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[14] Although, with the proliferation of mechanized, electronic means for obtaining cash, i.e., from ATMs, disputes can arise with the financial network itself, for example, as to whether or not an ATM accurately dispensed the requested amount of currency.

[15] Enacted initially in New York State in 1929, and subsequently in all other states (save Louisiana, where the functional equivalent exists).

[16] See generally, Uniform Commercial Code, Section 4-403. An extensive body of law has developed describing the terms, conditions, and liabilities of the parties for the amending of such payment instructions.

[17] While the UCC was a state enactment, it effectively functioned as a uniform national standard, due to its essentially identical enactment in virtually every jurisdiction.

through court or other forms of action effectively impossible for many purchasing consumers. As such, the payment mechanism itself was dragooned into the broader arena of consumer redress generally (as opposed to redress involving financial transactions only) by means of statutorily assigning responsibilities to various parties within the payment system for the actions of merchants or other payees external to the payment system.

In the case of commercial paper, then, special legal statuses[18] were created which defined when an acquirer of a note took the note free of or subject to any claims which the maker of the note might have against a selling merchant who might have taken the note in payment of the underlying obligation and subsequently transferred the note. Consumers obviously generally don't deal in commercial paper; however, the legal concept is important, indeed, crucial, in designing a consumer redress regimen in a widely dispersed consumer marketplace. It represents the policy determination to utilize the payment system as a means for recasting the ability to assert underlying substantive rights between buyer and seller. Substantive rights between buyer and seller – whether founded on statutory bases, industry practices, or contractual provision – could now be invoked via the payment system to give consumers more effective redress capability generally.

In the consumer financial services context, this notion was implemented by rule of the Federal Trade Commission[19] which essentially provided that certain common consumer credit contracts (ie., typically installment notes) had to contain a prominent provision establishing the consumer's substantive right to assert claims and defenses which might exist as to the underlying seller against subsequent parties acquiring such contracts. That is to say, a crucial redress right was embedded into contracts as a matter of regulatory enactment.

Many sellers of important "large ticket" consumer goods[20] were (and remain) largely dependent on credit to facilitate sale of their goods. Thus, the rule allowed consumers to assert underlying substantive claims stemming, for example, from the quality of the goods or the terms of or practices in the sales transaction, against acquiring financing entities. Equally importantly, this in turn also gave those financing entities meaningful incentives to take steps to minimize the likelihood of the occurrence of situations giving rise to consumers asserting claims for redress on the underlying transactions. Thus, the legal system was structured intentionally so as both to establish substantive rights and to reduce the likelihood of disputes occurring in the first place.[21] One of the strengths of this notion was to marry the prophylactic impacts with the remedial, as envisioned by the Consumers Union.[22]

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[18] E.g., that of a so-called "holder in due course", Uniform Commercial Code, Section 3-302.

[19] 16 C.F.R. Ch. I, subch. D, part 433, effective 5/14/76

[20] For example, automobiles, household appliances, furniture, etc.

[21] While much of the academic discussion (and, in general, criticism) of the proliferation of such statutes and regulations has focused on its overt costs, there has been undeniable, substantial consumer benefit in the form of avoided consumer problems through actions taken by financial institutions so as to minimize their legal exposure to consumer claims.

[22] Supra, @ p. 6.

The critical notion underlying this approach to providing consumer redress ultimately stems from the presumed greater ability of payment services providers[23] to monitor and/or police merchant activity. Because financial institutions faced the possibilities of investigating disputes, and, in some circumstances, even bearing ultimate responsibility for certain merchant practices, they had considerable economic (as well as customer relations) incentive to act responsively to exercise such controls to avoid legitimate consumer problems.

Credit Cards

With the proliferation of the credit card system in the US, finality of payment was complicated in several manners, thus affecting the ability of consumers to utilize the withholding of payment as a tool for achieving redress. First, while providers of goods and services generally receive payments through the bank card systems quite quickly following presentment to their acquiring banks, the very nature of the credit card system allows that the issuing bank[24] has economically acquired the underlying claim for payment through the bank card network from the merchant providing the subject goods or services. That is to say, the obligation has been transferred, not extinguished. How, when, and under what terms the consumer pays the obligation to the issuing bank is governed by both legislative mandate and by the contractual terms of the consumer-card issuer agreement. Absent affirmative legislative steps then, the selling merchant[25] was out of the picture.

The credit card networks linked literally millions of merchants around the world. While providing immense benefit to consumers in terms of variety, products, and a generalized enhancement of pro-consumer competition, the prospects for confusion or disputes with often distant, unfamiliar merchants – often dealt with in impersonal ways – obviously increased. This distance or unfamiliarity could make assertion of claims or disputes more difficult if not impossible for consumers, as contrasted with situations involving local merchants where face-to-face meeting (and the resultant potential to asset substantive rights) was at least feasible. As such, to protect consumers in asserting claims or disputes with such merchants – and as with the right to assert claims and defenses against certain holders of paper drafts – the payment system itself, and its various participants, were again legislatively imbued with certain liabilities and responsibilities for the actions of others.

In the early 1970s, the Federal Fair Credit Billing Act was enacted.[26] This legislation represented the initial major foray by the Congress into the process of specifying relatively particularized

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[23] E.g., in the credit card systems, the "acquiring" bank, i.e., the bank sponsoring the selling merchant into such system. The claim asserted by the consumer against his or her card-issuing bank (the "issuer") was passed back through the card associations, per their internal operating rules, to the acquirer. Similar liability exposure passes through the check-clearing system by means of UCC-based warranties to the bank accepting the consumer's check from the selling merchant.

[24] I.e., the bank which provided the consumer with the device for accessing a line of credit, most typically by means of a magnetically-embossed (credit) card.

[25] Note that the term "merchant" includes both sellers of goods and services and financial institutions, e.g., the placer of an automated teller machine through which the consumer might obtain a cash advance on an open-ended line of credit.

[26] 15 U.S.C. 1666

responsibilities for financial institutions in investigating and resolving consumer inquiries and complaints.

The Act, together with its implementing regulations, details consumer rights and creditor responsibilities to protect the consumer in the event that "errors" occur, primarily in connection with credit card accounts. The "occurrence" of "errors" was tied to their appearance on the (mandatory) periodic billing statements sent in connection with such accounts, as this was often the triggering event which gave the consumer effective notice of an alleged problem.

The law defines such "errors" to include, among other things, allegations or claims involving:

- extensions of credit made without the consumer's authority;
- extensions of credit which are inadequately described according to other legal criteria;
- extensions of credit for property or services not accepted by the consumer or not delivered properly;
- failures to properly credit payments made by consumers;
- computational or accounting errors made by the creditor; and,
- extensions of credit regarding which the consumer is seeking clarifying information or documentation.

Significant substantive rights regarding underlying obligations were thus statutorily created. Equally important, however, these rights were combined with specific procedural investigation and correction responsibilities imposed upon the credit card system itself.

The law provides among other things: that periodic (ie., semi-annual) notices of a summary of these rights to dispute errors be provided to accountholders; that each billing statement provide a notice of the manner in which to contact the card issuer to raise alleged errors; that accounts may not be restricted or closed while investigations are ongoing; that investigations and reports be conducted within certain time frames; that finance charges may not accrue during investigations, etc.[27] The specificity of such substantive and procedural rights created by statute increased dramatically with this federal enactment.

Debit Cards

With the proliferation of debit cards in the early and mid-1970s, the federal government again acted to combine substantive consumer protection rights with redress-enhancing procedural mandates. The Electronic Funds Transfer Act[28] specifically established procedures for resolving alleged errors.[29] Various time periods for complaint investigation and remedial action were established.

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[27] See generally, ibid.
[28] 15 U.S.C. 1693
[29] 15 U.S.C. 1693f

This particular manifestation of legislated redress reflected an evolution in that it expressly gave to a financial institution receiving notice of an alleged error from a consumer the option between:

1. investigating and reporting to the consumer on the results of the investigation within certain relatively short time periods, or,

2. provisionally recrediting the consumer's account for the disputed amount and as a result obtaining lengthier time periods in which to conduct the required investigation and provide a report on the results of the investigation.[30]

Among the types of "errors" contemplated for which consumers might be seeking redress are: unauthorized or incorrect electronic funds transfers, computational errors, incorrect disbursements of cash from ATMs, or requests for clarifying information or documentation.

It was also groundbreaking in that it specifically provided standards for providing explanations of the findings of investigations which revealed no error to have occurred.[31] Thus, not only can a consumer request an investigation, that investigation must deliver an explanation of its findings in a timely manner, and, where requested by the consumer, provide the consumer copies of all documentation relied upon in reaching the conclusion that no error had in fact occurred.

Other Financial Services Areas

Although the menu of substantive and procedural redress rights created by statute is most evolved in the payments arena, there are other important consumer financial services sectors following the model in the payments arena, where significant substantive consumer rights are created by statute, and combined with attendant enforcement mechanisms, to the end of providing consumers with rights of redress.

Credit Reports

Increasingly, credit reports can be the source of consumer confusion or problems or disputes involving a variety of (often financially-based) services. These reports are compiled, collected, disseminated, and relied upon widely regarding millions of consumers. They often reflect personally sensitive as well as economically-indicative information. They are often utilized in whole or in part as the basis for crucial decisions involving consumer well-being, such as credit, rental, or insurance applications, or employment determinations. As such, the accuracy and completeness of such reports is essential – to individual consumers, to the various economic entities which increasingly rely upon them in making decisions affecting consumers, to the systemic efficiency essential to complex marketplace systems, and to the confidence which consumers have in such systems.

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[30] 15 U.S.C. 1693f(c) This trade-off was founded upon the notion that with a debit card accessing a demand deposit (i.e., checking) account, the use of the funds in question was lost to the consumer, whereas with a credit card account, the amount in dispute was typically owed to the card issuer, i.e., its use was not yet lost to the consumer, who could presumably continue to pay day-to-day obligations.

[31] 15 U.S.C. 1693f(d)

Again, the US policy response entailed the creation of substantive rights, melded with procedural means by which to assert such rights. Extensive and detailed investigation standards and procedures as to the accuracy of information contained in such reports, and the consumer's rights to obtain such information and challenge it, were statutorily established.[32] For example, consumers were given substantive rights to include in their credit reports information disputing or explaining information compiled by credit reporting agencies.[33] Further, parties relying on such reported information in making decisions adverse to consumers must inform consumers of such reliance and, among other things, advise consumers of their rights to dispute the accuracy or completeness of the relied upon information and the procedures therefor.[34]

Savings Accounts

In general, redress is obtained regarding disputes involving savings products through traditional litigation, either individualized or class in nature. Various standardized requirements, especially with regard to means of computation and advertising, are imposed by federal law.[35] Unlike many of the payment means, supra, however, there are no specific provisions mandating investigation or resolution of alleged errors or other consumer concerns. That is to say, enforcement is essentially left to traditional litigation, without an intermediate, mandated institutional investigation procedure.

Conceptually, this is not particularly surprising. Since the Truth-in-Savings Act is intended to standardize disclosure of quantitative matters, most specifically deposit account yields, such alleged "errors" as might occur are less likely to be of the qualitative type outlined with respect to credit card or debit card accounts. I.e., either the calculations were correctly made or not, or, the disclosed yields were within permissible tolerances or not. And, contrary to the situation with payment devices, there is typically no third-party merchant which may be the ultimate source of the consumer's complaint. Thus, the need for formalized investigation procedures by deposit-taking institutions is seemingly less pressing.

Debt Collection

By contrast, debt collection activity is, by its very nature, often both much more subjective and much more fact-intensive. Notwithstanding this subjectivity, significant federal legislation exists, which outlaws a variety of relatively specific practices in connection with various debt collection activity. The Fair Debt Collection Practices Act[36] specifies a relatively large number of practices in which covered debt collectors may not engage.[37] And, enforcement follows the model established by earlier enactments and discussed immediately below.

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32 15 U.S.C. 1681i
33 15 U.S.C. 1681i(c)
34 15 U.S.C. 1681m(a)(3)(B)
35 See generally, the "Truth-in-Savings" Act, 12 U.S.C. 4301 et seq.
36 15 U.S.C. 1692
37 15 U.S.C. 1692f,

Enforcement Mechanisms

The mere existence of substantive fights, however, is meaningless without adequate systems in place likely to lead to compliance and, where necessary, enforcement. In the US scheme, the primary means for enforcing rights within these areas is founded upon private litigation. [Any consideration of the various means of redress clearly demonstrates how the notion of prevention of situations requiring redress is inextricably intertwined with the created substantive rights of redress. Thus, any policy consideration must view redress in this broader context.]

Beginning with the Truth-in-Lending Act[38], effective in 1969, statutorily-created private legal causes of action to recover both actual damages and statutory penalties in common credit transactions and other financial services relationships have generally been available under a variety of federal laws. To facilitate the feasibility of bringing such actions, these Acts usually provide for the recovery of attorney fees and court costs by consumers successfully prosecuting actions against financial services providers. Subsequent Titles within the Federal Consumer Credit Protection Act dealing with numerous other statutory regimens of consumer rights have similarly allowed for costs and fees to successfully suing consumers.[39] On occasion, the statutory penalties are multiplied, thus increasing the likelihood of a consumer being able to obtain representation to prosecute such an action.[40]

Whether all consumers alleging error can effectively access this enforcement procedure is, of course, suspect. However, most financial institutions would likely be of the opinion that the threat of such litigation is serious enough as to justify significant expense so as to achieve substantial compliance. There is little doubt that even isolated instances of specific litigation have had significant impacts in changing creditor behavior toward compliance with the substantive terms at issue. Indeed, there is substantial "networking" among the creditor bar to share information regarding pending litigation so as to avoid adverse (from the viewpoint of creditors) outcomes.[41] Thus, this redress mechanism also works in a preventative manner, thereby benefiting market activity generally.

Similarly, there is a wealth of case law under many of these particular titles.[42] The breadth of such litigation suggests that the Congressional purposes of attempting to give consumers meaningful access to both the potential and the actuality of litigation as an enforcement tool has been substantially achieved.

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[38] 15 U.S.C. 1640

[39] For example, consumer leasing [15 U.S.C. 1667d(a), cross-referencing the civil liability provisions of the Truth-in-Lending Act generally, @ fn.39]; credit reporting [15 U.S.C. 1681n and 1681o]; credit discrimination [15 U.S.C. 1691e]; debt collection practices [15 U.S.C. 1692k] et seq.

[40] For example, regarding electronic funds transfers, 15 U.S.C. 1693f(e) provides for treble damages where it is determined that a financial institution did not investigate an alleged error in good faith, or failed to provisionally recredit the consumer's account as envisioned in the substantive section.

[41] For example, the American Bar Association, Section on Business Law, Committee on Consumer Financial Services meets on a quarterly basis to inform financial institution counsel nationwide of pending developments to minimize future litigation exposure

[42] See, for example, the extensive CCH Consumer Credit Guide reporter service, which runs [currently] to 6 loose-leaf binders and is published bi-weekly.

While the cost of this regulatory complexity (and the attendant burden on financial institutions of complying) has engendered much criticism, this system has also undeniably engendered considerable consumer benefit in the form of avoided consumer problems as financial services providers have taken numerous and often extensive steps to conform their practices to the statutory and regulatory mandates.

Responses to Complexity Concerns

The credibility of the redress system is thus founded, in large part, on the meaningful threat of litigation as a response against a non-complying institution. But, as the range and sophistication of consumer financial products and services has grown, the complexity of the implementing regulatory standards has mushroomed; and, with it, the attendant costs of compliance.

In response, policy makers have employed a variety of legislative tools.

Model Forms

A variety of federal statutes direct that appropriate regulatory agencies develop so-called "model forms." Use of this device entails many benefits for providers and consumers.

Pertinent information enabling consumers to choose among products more effectively can be prioritized and stressed or segregated as appropriate, thus promoting informed consumer choice. For example, various disclosures involving credit insurance purchased with loan products are segregated in the so-called "federal box" on loan contracts. This highlights the distinction between such insurance products and the underlying loan product, reducing problems of "tieing," i.e., conditioning loan approval on the additional purchase of credit insurance.

Similarly, recent amendments to the Consumer Leasing Act creating a model lease form[43] in its entirety will provide a uniformity in calculating periodic lease payment terms. This should, over time, serve: to increase consumer understanding of and familiarity with the complex terms of such leases; and, to enhance the perceived equity of such contracts, as they are developed (and noted as such) by the Federal Reserve Board – the respected and credible primary regulator of the Federal act.

Among numerous other "model" forms promulgated by the Federal Reserve Board are forms dealing with such diverse topics as:

- Billing Error Rights (both "long" form and alternative)[44] for credit cards
- Recission[45] rights for real-estate secured loans
- Applications and Solicitations for Credit Cards[46]

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[43] CCH Consumer Credit Guide, Paragraph 3761; 62 Federal Register 15364
[44] ibid, Paragraph 3503 et seq
[45] ibid, Paragraph 3506

- Credit Sales[47]
- Variable Rate Mortgages[48]

and a wide range of other forms.

“Safe Harbor” Provisions

By utilizing so-called “Safe Harbor” protections properly, creditors "... will be deemed to be in compliance with the regulation with regard to those disclosures. Creditors may make certain changes in the format or content of the forms and clauses and may delete any disclosures that are inapplicable to a transaction or a plan without losing the act’s protection from liability. ..."[49]

Thus, the clear goal is prevention of disclosure violations, while facilitating the provision of clear, concise information, deemed as such by an agency with the perceived evenhandedness and credibility of the Board of Governors of the Federal Reserve System.

Mandated Information Pieces

Additionally, the Federal Reserve has, under statutory mandate, developed a series of informational pieces which can (and under some circumstances, must) be distributed to assist consumers in their assessment process; for example, regarding Home Equity Secured Lines of Credit[50] or Automobile Leasing.[51]

All of these devices are intended to provide financial services providers with means by which to satisfy the legislatively-mandated directives involving giving consumers equitable rights, both substantive and procedural. Importantly, all are founded (at least, by implication) on the widely-perceived credibility of the Federal Reserve System. And, all represent important components of an overarching system of redress.

Other Factors

Other marketplace developments are likely to exacerbate the need for relatively specific rights and attendant forms of redress. For example, many newly emerging forms of “money” are purely electronic or magnetic in form. As such, they cannot be physically seen or observed. It will not be immediately obvious to either consumers or merchants as to the quantity of value they possess at any given time. Consumer confusion (or, at a minimum, unfamiliarity) seems inevitable. Further,

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[46] ibid, Paragraph 3511
[47] ibid, Paragraph 3521
[48] ibid, Paragraph 3534
[49] For example, regarding open-end credit disclosure model forms, FRB Official Staff Commentary to Appendix G- 1.01
[50] ibid, Paragraph 3516 and 3518A
[51] The developed piece, which is available in both printed version and via download off the Internet at http://www.bog.frb.fed.us.

since the quantity of value represented will be variable (subject to reloading, decrementing, or both), the likelihood for confusion or disputes or both seems even greater.

In an increasingly deregulated and competitive environment, history suggests that marketing and promotional efforts will likely increase. While these developments clearly can benefit consumers through expanded choices, they can also be expected to give rise to increasingly frequent instances of misunderstood, misleading, deceptive, or even fraudulent activity. Combined with a generalized lack of familiarity with a burgeoning range of products, one need not be a Cassandra to foresee potential increases in consumer injury or abuse. This will likely in turn contribute to heightened needs – both actual and political – for redress mechanisms, broadly defined.

Mechanization (and rountinization) of financial services will likely increase just as demographic changes evolve in the population suggesting that consumers will reach the point in life where they are more resistant to changes from the procedures with which they have become familiar and comfortable at roughly the same time that change becomes more insistent.

Further, the increasing mechanization of the delivery of financial services will shrink financial institutions" margins on a "per transaction" basis. As such, the relative costs of redressing specific, individualized consumer inquiries or complaints, often entailing expensive human intervention, will increase. This suggests that providers will be more anxious to obtain relative certainty as to regulatory compliance in their practices, forms, informational pieces, agreements, etc., so as to avoid such potentially expensive situations, Such certainty is maximized, of course, through national standard setting. The least desirable situation in such an environment could thus be one in which terms and practices are assessed against relatively amorphous and fluid concepts such as reasonableness, unconscionability, good faith, etc., regardless of how enforced.

In other words, marketplace developments are proceeding which will increase the appeal and the attractiveness of a national, standardized approach in mandating substantive rights to consumers and mandating error investigation and resolution responsibility to providers of financial services, notwithstanding the historical philosophical distaste with which businesses and financial institutions have traditionally viewed regulation. The author believes that these factors will combine to suggest that more, rather than less, national standard setting, together with mandated redress means, will be viewed as desirable by policymakers.

In sorting out claims between consumers and financial institutions, the US experience is such that the legitimacy of any error investigation or dispute resolution mechanism will have credibility only where the arbiter of "fairness" is widely seen as relatively independent of the financial services sector. In the US, this role has historically been filled – and likely will be, into the foreseeable future – by the federal government.

Whether this model is transferable to Canada is, of course, open to debate. Nonetheless, the utilization of mandated error investigation and resolution procedures involving questions of substantive rights, founded upon credible enforcement mechanisms, is clearly the 'US' version of a "best practice."

Chapter 3

Reform of Consumer Protection in the Australian Finance Sector

by
Peter Kell
Australian Consumers' Association

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1. Introduction

Scope of the Report

This report deals with the following issues:

- Arrangements through which consumers and consumer organisations can participate in ongoing improvements to the financial services sector
- A critical review of the consumer measures in the finance sector prior to the FSI from the perspective of good practice and the elements of effective service to the consumer of financial services
- An analysis of the implications of the FSI recommendations for consumers in the financial services marketplace (especially transparency conditions and redress).
- Particular attention is paid to disclosure and transparency issues throughout the report.

(All amounts are in Australian dollars unless otherwise stated).

The Australian Financial System

Australia is a federation of six states (in descending order of population):

- New South Wales,
- Victoria,
- Queensland,
- Western Australia,
- South Australia,
- Tasmania and two territories,
- Australian Capital Territory (including Canberra, the capital), and
- Northern Territory.

The regulation of the financial system is a mix of state and federal laws and regulators. A key result of the FSI will be to move the regulation of almost all areas of the financial system onto a national basis. The major exception will be the regulation of the provision of credit. However, credit regulation will be reviewed in two years time, and the state-based regulation of credit is now close to a national model due to the introduction of the Uniform Consumer Credit Code in each state (more about the regulation of credit below).

The total size value of assets held by financial intermediaries was around $931 billion in 1995. This represented about 204 percent of GDP. Just under half of these assets are held by licensed banks.

The total cost of the financial system in Australia is around $41 billion (1995 estimate) – this is a measure of the total revenue generated in the system, and represents the cost to end users. Around 322,000 people were employed in the finance sector, representing about 4 percent of total employment.

Consumers and the Finance Sector – Overview and Trends

Most Australian consumers have a relationship with a deposit taking institution. This is usually with banks, which hold around 80 percent of deposits. Deposits remain a large but declining portion of total household assets, falling from 33.9 percent to 30.3 percent between 1989 and 1995.

The managed funds area is growing as a proportion of total financial system assets, increasing from 30 percent to 35.4 percent between 1988 and 1995. The growth has been especially notable in superannuation, which is now compulsory for most employees. The stock of superannuation is growing at around twice the rate of growth of the economy, and is expected to reach around $500 billion (real) in 2005. As the FSI pointed out, the implication of this shift is that consumers are increasingly taking on investment risk in financial transactions.

In Australia cheques continue to play a large role in consumer payments, but like most developed countries most of the growth in non-cash payments is in electronic payments. Australians have been enthusiastic users of electronic payment technologies, including transaction cards and telephone bill paying. There has been a rapid growth in the number of EFTPOS terminals (electronic funds transfer at point of sale).

For risk-related insurance products, there has been a shift towards unbundling of products. Traditional products (eg whole-of-life policies with an investment component) have been declining in favour of single premium products (eg term life, disability insurance). As the FSI notes, "this likely reflects improved commission disclosure and a greater level of consumer awareness of alternative avenues for investment."

On the distribution side, there has been rapid growth in investment advisers, securities dealers and their representatives. There has been a substantial decline in the numbers of tied agency sales forces.

2. Consumer Regulation in the Finance Sector – Pre-Financial System Inquiry

Problems in the Finance Sector and the Development of Consumer Protection Regulation

It is important to have some understanding of the history of consumer protection regulations to assess their effectiveness and efficiency. That is, regulation should not only be compared to "ideal" models, but also to historical market practice, which helps explain why it emerged, and the aspects of market conduct it has sought to promote or prohibit.

During the 1980s, especially the later part of the decade, and into the 1990s, there have been a range of consumer protection regulations introduced into the Australian financial services market. These have involved both government and industry regulatory regimes and regulatory organisations. Some of the major initiatives have involved "co-regulation" such as the Banking Code of Conduct and various industry alternative dispute resolution schemes. A list from the FSI report is attached.

There has also been a effort to improve disclosure. This started with the provision of credit, but was also a major part of the reform of the Life Insurance and superannuation industry in the early 1990s, where inadequate or non-existent commission disclosure was a particular problem.

The initial focus was to reveal commission, fees and charges and other product features to ensure that consumers were aware how much they were actually paying and to reduce industry mispractice. More recently there has also been an emphasis on improving the comparability of products to facilitate competition (this issue will be discussed more fully in section 3).

Pre-FSI Consumer Protection Framework – An Overview

Prior to the FSI, consumer protection largely had a institutional focus. There were several national regulators divided along industry lines that had there own set of consumer protection responsibilities

Reserve Bank of Australia

Through the Payments System Board it had responsibilities for the codes of conduct governing banks, credit unions etc, which included disclosure provisions. The Reserve Bank is generally regarded as having taken a very "light touch" approach to consumer protection issues

Insurance and Superannuation Commission

Responsibility for consumer protection in super, life and general insurance. Took a reasonably prescriptive approach to disclosure regulation but was relatively light-handed when it came to enforcement. A key problem was the disclosure practices of life insurance agents.

Australian Securities Commission

The ASC, a relatively recent creation resulting from the amalgamation of state corporate affairs agencies, was responsible for the stockmarket, unit trusts and the securities advisory industry. Responsible for the Corporations Law, the ASC took a more descriptive approach to disclosure regulation (broad laws requiring all relevant disclosure rather than detailed prescription) but with a greater focus on "user testing" to ensure proper outcomes for consumers. Arguably was not focussed strongly on consumer protection issues until more recently.

Australian Competition and Consumer Commission

The ACCC was not a finance sector specific regulator, but rather has strong, economy-wide consumer protection provisions under the Trade Practices Act. The disclosure provisions of the Trade Practices Act, prohibiting misleading and deceptive conduct, are simple and strong – there is a "strict liability" regime, meaning no legal defences (for civil matters). Thus the ACCC, when it chose to become involved in finance sector issues, was often effective, in particular in the life insurance and superannuation industry where it took several major institutions to court or achieved positive settlements as a result of misleading disclosure. The ACCC played a major role in the reform of this industry. The ACCC has also played a role in improving disclosure in the credit area, especially for products aimed more traditionally at lower income or less sophisticated end of the market (eg credit insurance, an area of abuse in the car sales industry).

State Based Agencies

A range of state based agencies also had responsibility for consumer financial issues, most notably state based "Offices of Fair Trading". These were most notably seen in credit area – rarely involved in other sectors of the finance industry.

Consumer Regulation Pre-Financial System Inquiry – Some Consumer Observations

The 10-15 years in Australia following the major financial deregulation of the early 1980s had seen a variety of consumer protection measures introduced, usually in belated response to market problems. However, there was still considerable dissatisfaction on the part of both industry and consumer groups about the state of consumer protection regime.

Focus of Regulations

As noted above, consumer regulation in the finance sector has largely had an "institutional" focus, in contrast to the more "functional" approach advocated in the FSI. That is, some products are regulated for disclosure on the basis of the institution that offers them rather than the nature of the product itself. The "Institutional model" meant that for some products which were very similar in terms of what they offer consumers the nature of disclosure to consumers was very different.

For example, bank cash management accounts and cash management unit trusts are very similar but are disclosed differently. Further the different codes for different industries are not entirely consistent on disclosure issues (and in some cases may be non-existent – for example banks are covered by a banking code whereas mortgage companies have no such code despite the fact that they both provide home loans). Financial advisers providing advice on securities were regulated under a different regime to life insurance agents providing advice on superannuation, although there was substantial overlap.

Regulators

It is also important to look at the performance of regulators as well as regulation. On this score, there were strong criticisms of the inaction of some of the finance specific regulators on consumer protection issues, despite the powers that were available to them. The Insurance and Superannuation Commission had come in for particular criticism in the 1990s.

A major aim of the consumer movement during the FSI was to ensure that the issue of regulatory performance was given as much prominence as regulatory structure, given the failure of regulators to address major consumer problems in a timely fashion.

The Growth of Finance Alternative Dispute Resolution Schemes

Starting with the establishment of the Australian Banking Industry Ombudsman in 1989 there has been proliferation of alternative dispute schemes (ADRs) in the finance sector as an alternative to formal legal dispute resolution. These schemes have grown in response to pressure from consumers and regulators arising from the growth of consumer problems in a deregulated financial environment and the increasing difficulty that consumers face in accessing the legal system because of cost and the long timeframes. The schemes include:

- Australian Banking Industry Ombudsman,
- General Insurance Enquiries and Complaints Service,
- Life Insurance Complaints Scheme,
- National Institute of Insurance Brokers Dispute Facility,
- Credit Union Dispute Reference Centre,
- Financial Planning Association Complaints Resolution Scheme,
- Superannuation Complaints Tribunal.

In most cases industries have adopted non-statutory ADRs because of three broad reasons. Two reasons are negative, one is positive:

- The alternative to industry ADRs – additional legal regulation – has been perceived by industry as a less attractive option. Industry run schemes can be controlled to a greater extent by the industry itself.

- The cost of legal action for all parties has been increasing, even though such actions are largely avoided by consumers. ADRs can help reduce the costs of dispute resolution for all parties. Although all schemes leave open the opportunity for consumers (not industry participants) to take their dispute to court if they are not happy with the ADR decision, this is an extremely rare occurrence.
- There is also the important case that the establishment of such schemes presents a more positive and responsible image for the industries involved.

The Superannuation Complaints Tribunal is qualitatively different to the other ADRs in that it has a statutory base. The need to give the SCT a legal framework was seen to arise from the special nature of superannuation in Australia – it is compulsory. However, the SCT is not a court, and does not operate on a formal legal process.

The growth of such schemes is generally perceived as a positive development in consumer protection regulation in Australia. It has provided much cheaper dispute resolution for consumers, and has helped contribute to improved industry standards. However, there are some system-wide problems with the current arrangements that the FSI tried to address (leaving aside any problems with particular schemes) – these are discussed in the next section.

3. Consumer Protection Regulation of the Finance Sector – Post Financial System Inquiry

FSI Proposals and the Objective of the Financial System

There are 115 recommendations in the FSI Report. Many of these directly address consumer protection regulation, while others have implications for consumers but do not propose direct changes to consumer protection laws. This paper will only discuss the latter recommendations where they significantly affect consumer regulation.

ACA supported the broad aims of the Wallis Inquiry. The Report argues that financial markets will only deliver improved outcomes where "competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system." The outcomes sought by the Inquiry include:

- more flexible and responsive regulatory structure,
- increased accountability of regulators,
- greater competition in the finance sector,
- a more contestable, efficient and fair financial marketplace with reduced costs for consumers.

However, it is critical that regulators and industry can deliver on these aims. ACA believes that many of the suggested reforms will deliver benefits, but there are a few recommendations that pose problems for the objective of a better finance sector for Australian consumers.

An Assessment of the FSI Proposals

The FSI recommendations are looked at below under the following headings:

- consumer protection structure and powers,
- financial advisers and licensing,
- competition,
- prudential.

Disclosure and transparency proposals and consumer redress are dealt with in more depth under separate sub-sections.

Consumer Protection Structure

The proposal to establish an integrated consumer protection regulator, the Corporations and Financial Services Commission, was supported by ACA. It is important to have consumer

protection powers that are specific to the finance sector "under the one roof". The CFSC will be based on the Australian Securities Commission and will take on the Insurance and Superannuation Commission's consumer protection powers as well as those with the Reserve Bank Payments Systems Board and the ACCC's role in this industry. The danger is that the ASC will not get the resources to undertake its expanded role. (The CFSC name has been changed subsequent to the FSI Report and it will now be known as the Australian Securities and Investment Commission (ASIC)).

The removal of the ACCC's role is the key recommendation that has generated concerns for ACA. Recommendation 3 proposes that the CFSC has sole responsibility for administering consumer regulation in the finance sector. The ACCC loses its economy wide "backstop" consumer protection functions as they apply to the finance sector. The ACCC had a good track record in enforcement and driving industry reforms, and has developed the link between competition and consumer protection regulation. Furthermore, there was no evidence presented to the Inquiry that the ACCC's consumer protection role in the finance sector is posing any meaningful difficulties for industry.

Financial Advice and Licensing

The proposals concerning financial advice and disclosure should help to rationalise and improve standards in this industry. These propose a single licensing and disclosure regime for financial advisers, and single minimum competency standards are being developed by the ASC.

Competition

Many FSI recommendations seek to open up the finance sector, in particular the banking industry, to greater competition. Proposals which facilitate wider participation in the payments system are welcome, as more meaningful competition is overdue in this industry. The challenge is making sure that competition works! ACA also supports greater choice in the superannuation area (Recommendation 88), but much depends on how this is achieved. In particular, it must be real choice for the fund member.

It is also important from a consumer perspective to recognise that the benefits of competition will not be evenly distributed. Lower income consumers are not the customers that new entrants to the finance sector generally seek to "cherry pick" with innovative new products. However, the FSI saw no role for regulation for social purposes such as community service obligations. Instead it recommended that governments take up this role. However, ACA believes there was scope for more innovative thinking on this important community issue – for example, through joint government/industry access programs such as Creditcare, which sets up credit unions is rural and remote communities.

ACA also believed that the Government has an important role in price monitoring to ensure properly competitive markets where financial markets work in ways which do not deliver efficient pricing with proper disclosure.

Prudential Regulation

The Wallis Report also proposes the establishment of a new prudential regulator, the Australian Prudential Regulation Commission (APRC). ACA supported the rationalisation of prudential regulation, in particular moving credit unions and building societies from a state to a national basis. Interestingly, the new UK government has moved the prudential supervision of banking from the Bank of England, which is consistent with the Wallis Committee approach.

Transparency and Disclosure

The general approach of the Wallis Inquiry, and also other parallel policy processes such as the Corporations Law Economic Reform Program (CLERP), has had four objectives in relation to disclosure issues:

- a greater reliance on disclosure regulation as a mechanism for protecting consumers in the finance sector,
- achieve greater uniformity, and less regulatory overlap, in disclosure regulation,
- achieve a less prescriptive and less detailed approach to disclosure regulation,
- a lighter liability regime for industry where there is a "positive duty to disclosure" (ie certain disclosures are mandated by regulation, rather than simply relying on a prohibition against misleading conduct to ensure adequate disclosure).

There are potentially some major benefits, as well as significant dangers, in the FSI approach to disclosure and transparency. Much will depend on the ability of regulators to perform their role effectively, which has led to calls for adequate resourcing for the new consumer protection regulator "post-Wallis".

At the outset it must also be noted there has been a confusion within industry whereby less overlap and less prescription are seen to be synonymous with less resources for disclosure. This is true to some extent, but there are important qualifications that must be taken into account.

The CLERP is now the policy vehicle which is delivering many of the FSI reforms in Australia. Issues around disclosure are currently being considered in this context.

The FSI reccomendations with the most direct relevance to disclosure issues are set out below, followed by a discussion of the FSI approach to disclosure.

FSI – Disclosure Related Recommendations

Recommendation 8: Disclosure requirements for retail financial products, payments instruments, securities, collective instruments, superannuation and insurance products) should be reviewed by the CFSC to ensure they provide information that enables comparison between products.

This information should:

- be comprehensible and sufficient to enable a consumer to make an informed decision relating to the financial product,
- be consistent with that for similar products regardless of which institution offers them; and,
- appropriately disclose remuneration or commissions paid to advisers.

The disclosure codes of conduct applying to banking, building societies and credit unions should be made consistent wherever possible.

The effectiveness of disclosure requirements should be monitored regularly, using complaints handling data and user testing.

Recommendation 9: Profile statements should be introduced for more effective disclosure.

The law should be amended to require the issue of succinct profile statements about offers of retail financial products, including initial public offerings. These statements must contain:

- a brief description of the characteristics of the product,
- a clear and unambiguous statement of the risks involved a clear and unambiguous statement of applicable fees, commissions and charges in a form which enables comparison with similar products,
- such other disclosures for specific products as the regulator considers appropriate.

Beyond this, the contents of a profile statement should not be prescribed by regulation, except in cases where the CFSC believes that prescription is required to provide a balanced representation of the product. The formal should be developed by the CFSC in consultation with industry groups.

Recommendation 10: Shorter prospectuses should be encouraged. The CFSC should work with industry and professional groups to promote more effective disclosure in prospectuses, including the use of consumer testing to eliminate information overload. In particular, for smaller offerings the CFSC should encourage the use of shorter prospectuses and abridged due diligence procedures commensurate with the size of those offerings.

Recommendation 4: Due Diligence defences should apply to positive disclosure requirements. The due diligence defences associated with a positive duty to disclose such as under the Corporations Law and the Superannuation Industry (Supervision) Act 1993 should have full effect, notwithstanding s.995 of the Corporations Law and s.52 of the Trade Practices Act.

Greater Reliance on Disclosure

There was concern both within industry and consumer groups that the FSI Inquiry would travel down a "disclosure-only" path for consumer protection. This concern arose in response to initial Wallis Inquiry discussion paper and especially the Australian Treasury's submission. There were particular concerns that such an approach would be extended to prudential issues, so that consumers would rely on, for example, balance sheet disclosure to assess the prudential integrity of the institution with which they deposited their money. For the vast majority of consumers this would of course be an unrealistic requirement. Sensibly this was not the recommendation of the FSI, and substantial prudential safeguards still remain (and in some instances have been strengthened as a result of the Wallis Inquiry).

But while this extreme approach was not taken, there was clearly a philosophical preference for disclosure, rather than mandated safeguards, as the key component for consumer protection outside of the prudential arena. The desire for a explicitly description of risk in every product is clearly aimed at furthering a "buyer beware" approach to consumer protection.

There are significant benefits for consumers if the quality of disclosure can be improved as a result of its increased importance within the regulatory regime. This is not only for individual consumers but also for regulators and consumer groups who should be more easily be able to assess the features of financial products. This, as much as individual consumer choice, will be a driver for reform.

However, it must be remembered that for many less sophisticated consumers, complex financial products will not be easily understandable whatever the level of disclosure. Like other Western countries, surveys in Australia reveal disturbingly low levels of numeracy among adults, which certainly undermines the ability to push this approach too far. This will clearly have to be taken into account in the new regime.

Greater Uniformity and Less Regulatory Overlap

ACA has supported the objective of greater uniformity, especially for similar products. The disclosure required of financial advisers, for example, has been an area where the approach of different regulators and different laws has contributed to consumer confusion.

The biggest challenge relates to a "clear and unambiguous statement of the risks involved". Despite a subsequent CLERP discussion paper that has looked at this issue, there has been little progress towards this particular disclosure aim. Part of the problem is that there is no simple meaning for risk – a recent Financial Planning Association discussion paper on risk disclosure outlines several different types of risk that can be covered, some of which are very different in their implications for consumer action (eg the risk of greater volatility vs the risk of not matching inflation in investments).

A simple "risk-grading" system is one idea that ACA is looking at in response to this issue. While it would inevitably raise some difficulties at the margin, there is much desire for such an approach among consumers.

Finally, there is recognition within the Wallis Inquiry that there will still be important differences between the disclosure required for qualitatively different products. For example, a simple bank account should not require the same level of disclosure as a superannuation master trust. Uniformity has its natural limits.

Less Descriptive and More "Outcome Focussed" Approach to Regulation

This issue is at the core of the new approach to disclosure in Australia. It has two elements:

- shorter disclosure documents,
- less prescriptive disclosure requirements backed by "user testing".

The first of these elements is likely to be easier to deliver on. The objective of further use of "profile" or "key features" statements has almost universal support amongst all stakeholders as a positive reform. The ASC has been trialing such an approach in the managed funds market (initially for cash management trusts – a low risk, low return unit trust). The results have been generally favourable.

In relation to less prescriptive disclosure regulation, the Australian finance sector in the relatively early phase of an experiment will determine whether such an approach can deliver benefits to industry and consumers, or whether it is a "nice idea" that will be defeated by the reality of a complex marketplace with substantial information imperfections.

In broad terms, while there will still be substantial prescription in the disclosure regime, there will be increasing scope for industry to come up with their own disclosure format and approaches. The quid pro quo is that consumers must be able to achieve an adequate level of understanding as a result of the disclosure process.

This requires a new approach to disclosure design, the implications of which are still being thought through by industry and regulators. Most notably, it requires substantial resources to user testing. While user testing is of course not new to this industry, the key difference is that the traditional focus has been on whether consumers would like and buy the product, rather than whether they understood its key elements, including the full costs and the risks.

There is another tension in this approach. Prescription may be inflexible, but it can facilitate comparability across products. Less prescription may reduce information overload and allow better design, but it may undermine comparability. A lack of comparability inhibits competition through undermining the process of "shopping around". It is therefore likely that there will always be some level of prescription to ensure that basic comparability can be achieved.

Lighter Liability Regime

Recommendation 4 of the FSI proposes the extension of so-called "due diligence" defences for industry against claims of misleading and deceptive conduct. As noted, the Trade Practices Act in particular did not allow such a defence – if loss could be proved as a result of misleading

disclosure, then compensation could be claimed. This proposal is obviously a weakening of consumer protection in the disclosure area, as every company accused of such practices will seek to employ this defence. The rationale behind the proposal is that it sets up a better balance between investor protection and corporate fundraising objectives.

Liability and Redress

The discussion below focusses on finance sector alternative dispute resolution schemes. Liability in relation to disclosure documents is discussed above (3.3).

While ADRs have been an important positive development in the finance sector, there are still problems associated with this system that the FSI addressed. The problems with finance sector ADRs can be divided into four categories:

- accessibility,
- consistency,
- coverage,
- accountability.

Accessibility and Consistency

The FSI made two recommendations about finance sector ADRs. The first (Recommendation 25) said that the new consumer protection regulator should facilitate the creation of a "central gateway" for consumers wanting to use ADRs.

Consumer groups had been calling for such a "gateway" service for several years. While the growth of such schemes was welcomed, the range of schemes has arguably led to diseconomies of scale in promotion and education. Even the highest profile schemes, such as the Banking Ombudsman, have a low level of consumer recognition, and this recognition is disproportionately weighted towards consumers on higher incomes with higher education levels.

Although there was no formal survey of consumer satisfaction with "ease of entry" into these schemes, informal evidence suggested that a considerable problem existed. The number of "incorrect" calls to ADRs that were referred onto other ADRs, the confusion expressed by consumers about where to go when contacting consumer groups, and the surprisingly low level of knowledge about such schemes within government departments responsible for consumer protection were some of the indicators of a problem of access. Nonetheless, there was some vigorous opposition to a consumer single gateway from some industry sectors, most notably the general insurance industry, who perceived it as usurping the role of the ADRs – never the intention of the proposal.

ACA has called for a rationalisation of some of the ADRs. For example, it does not seem sensible from a consumer perspective to have several different schemes that each handle home mortgages (Banking scheme, Credit Union scheme, proposed Mortgage Industry scheme). Each

has different monetary limits, complaints procedures etc. However, it appears the prospects for rationalisation in the short term are very limited. Instead, it is hoped that the establishment of a gateway and more formal communication between the schemes may put pressure on for increasing consistency in minimum standards for treatment of consumers.

It was very positive then to see the Government take up the issue of the "single gateway" very vigorously and quickly post-FSI. The "Finance Complaints Referral Centre" was launched in February and has been housed within the ASC, who have agreed to run the centre for one year after which its operation will be reviewed.

The Australian approach is an interesting contrast to the UK approach, where all ADRs have been brought under the one roof to form a "super ombudsman".

Coverage – Industry

The coverage of ADRs across the finance sector is uneven, although certainly the major areas are now covered. The following areas are not covered properly or at all:

- Finance Companies,
- Building Societies,
- Mortgage Brokers,
- Stockbrokers,
- Real Estate Agents advising on investment property.

The FSI explicitly addressed one of these areas, in that it made a recommendation that coverage should be extended to finance companies. (Recc. 26). This was welcomed by consumer groups, as finance companies have generated a disproportionate level of consumer complaints about credit matters in Australia. Their retail consumer client base is predominantly low income and less financially sophisticated, and the conditions and cost of the credit they provide typically are more severe than, for example, major banks or credit unions. However, the regulation of finance companies is at a state level, and thus the ability of national consumer protection regulators to implement this recommendation is currently limited. Nonetheless, consumer groups are pursuing this issue and are discussing the development of a finance company ADR informally with individual companies.

The FSI also made a recommended about real estate agents offering investment advice. Investment property is a particular obsession of Australian consumers despite being in appropriate for many or, at best, a less sensible investment option that, for example, equities or superannuation. The recommendation suggests that real estate agents offering investment advice should be regulated in the same way as other financial advisers. Although not saying so explicitly, this implies that this industry would also have to establish an ADR scheme, as membership of such a scheme will soon become mandatory for financial advisers. However, real estate agents are also regulated on a state basis, and thus similar problems arise for national regulators in reviewing and reforming this industry. Hence the ASC has shown no enthusiasm for

taking up this particular FSI recommendation despite support from both consumer groups and established financial advisers.

Coverage – Customers

The second issue that was addressed in Recommendation 26 concerned the ability of small businesses to use ADRs. Some schemes already allowed small business access (eg the Financial Planners scheme). The major exception was the Banking Ombudsman. This issue has now been addressed, although the final details of access have yet to be worked out. The Federal Government pushed this reform both through its FSI response and a separate policy process dealing with small business issues that was launched at around the same time.

Consumer groups have supported small business access, with one qualification – it must be accompanied by an increase in funding for ADRs. While small business disputes are generally of a similar type to consumer disputes, they are almost always more complex, and therefore more costly to deal with. Allowing such access in the absence of appropriate funding arrangements will have a negative impact on the ability of these schemes to handle consumer disputes in a timely fashion.

Accountability

Finally, there is the perennial problem of accountability in industry schemes. Most schemes have a council and/or board that has some sort of consumer representation. However, in an era of declining resources for independent consumer and community groups, it becomes increasingly difficult to assess the operations of such schemes on an ongoing basis. Consumer representatives within schemes can become "isolated" if there is limited access to expertise on consumer perspectives from outside of the scheme. Similarly, systemic complaints trends are more difficult to address. This problem has not been adequately dealt with as yet, and will require a more vigilant role on the part of the regulator.

4. Consumer and Consumer Organisation Participation in Financial Regulation

Pre-FSI

Formal consumer participation in the financial regulation is a recent development in the Australian financial system, and is already experiencing difficulties due to the resource requirements this imposes upon groups or individuals.

Representation included membership of bodies such as the following:

- Reserve Bank Payments System Council,
- ASC National Investor Liaison Committee,
- Alternative Dispute Resolution Schemes Governing Councils.

However, there are a much greater number of less formal arrangements and consultation processes. Consumer groups are regular participants in reviews of consumer protection laws, disclosure arrangements.

There is also regular contact between some consumer groups and industry representatives, especially industry "peak" organisations.

Post-FSI

There is very little immediate change to the ability of consumers to have input into financial system regulation post-FSI. Certainly there are no improvements as a result of the Inquiry, and the prospect is for less input.

The Payments System Board (replacing the Payments Systems Council) will no longer have consumer representation. The Treasurer’s Financial Services Advisory Council has been established as a result of the FSI. However, the eight members of FSAC are all industry representatives, five from banks, and most of them from very large financial institutions. It is not a promising sign of the breadth of advice on financial systems matters from the current Government.

Appendix 1. Extract from FSI Report

Most Consumer Protection Regulation was Created in the 1980s and 1990s…

Table 16.1: Consumer Protection Regulation Timeline[a]

Year	Legislation/Regulation Update	New	Update
1972	SA Consumer Credit Act (since replaced)	X	
1974	Trade Practices Act (TPA)	X	
1981	Securities Industry Code commenced	X	X
1983	Prices Surveillance Act	X	
1984	Insurance Contracts Act	X	
	Insurance Agents and Brokers Act	X	
	NSW, VIC and WA Credit Acts (since replaced)	X	
1985	ACT Credit Act (since replaced)	X	
1986	TPA unconscionable conduct provision	X	
	Electronic funds transfer (EFT) Code of Conduct (first of The consumer protection codes)	X	
	Futures Industry Code	X	
	Fidelity Fund for Futures Brokers		X
1987	National Guarantee Fund for ASX Brokers		X
	Qld Credit Act (since replaced)	X	
1989	Banking Ombudsman Scheme	X	
1990	Credit Union EFT Arbitration Scheme (since replaced)	X	
	Part III A of the Privacy Act 1988	X	
1991	Corporations Law commenced	X	
	General Insurance Inquiries and Complaints scheme	X	
	Life company product disclosure	X	
	Life Insurance Complaints Service	X	
1992	TPA unconscionable conduct for business provision	X	X
1993	Banking Code of Practice (fully operational 1996)	X	
1994	NSW Farm Debt Mediation Act	X	
	Superannuation Complaints Tribunal	X	
	Life company product disclosure upgrade		X
	Building Society Code of Practice (fully operational 1996)	X	
	Credit Union Code of Practice (fully operational 1996)	X	
	General Insurance Code of Practice (fully operational 1995)	X	
1995	Life Insurance Code of Practice on advising, selling, complaints handling	X	
	Financial Planning Association's Complaints Resolution Scheme	X	
1996	General Insurance Brokers' Code of Practice	X	
	Uniform Consumer Credit Code	X	X
	Credit Union Dispute Reference Centre	X	X
	Insurance Brokers Dispute Facility	X	

[a] Includes both government regulation and self-regulatory initiatives.

Appendix 2. Australian Regulatory Structure

Structure of Regulation

Like Canada, financial sector regulation in Australia contains a mix of state and federal regulations. There are also economy-wide laws. Below is a discussion of some of the more important parts of the law affecting consumer protection in the finance sector.

The Australian Competition and Consumer Commission – The Trade Practices Act (TPA)

The TPA is concerned with the promotion, maintenance and protection of competition and also protection of consumers in their dealings with business by prohibiting certain kinds of conduct by corporations. This latter part (Part V) has been the subject of considerable scrutiny during the FSI. It is mirrored by state and territory fair trading acts, the only significant difference being that these laws can also deal with individuals as well as corporations.

The TPA is administered by the Australian Competition and Consumer Commission (ACCC), whose responsibilities are economy wide. The benefit from having the ACCC involved in consumer protection has been that it is not an industry specific regulator, and has proven considerably less prone to "industry capture". It has played a very important "backstop" role in the finance sector, occasionally taking a lead role on key industry reforms, such as occurred in the life insurance industry. The TPA has simple and strong civil provisions that, inter alia, prohibit corporations in trade and commerce from

- engaging in misleading or deceptive conduct,
- engaging in unconscionable conduct in relation to the supply of goods or services,
- making false representations in relation to quality, sponsorship, performance, price, warranties, conditions and guarantees,
- engaging in conduct likely to mislead the public about the nature, characteristics, similarity of purpose and quantity of services.

In its civil provisions the TPA imposes strict liability – that is, there are very limited due diligence defences against claims of misleading and deceptive conduct. These provisions were instrumental in the ACCC's efforts in reforming the life insurance and superannuation industry during the early 1990s, but have been under attack from industry during the FSI.

The ACCC has provided guidelines to some sections of the finance industry as to how they can comply with the TPA as it applies to disclosure issues in particular.

- The nature and extent of cover should be readily attainable from the policy document and promotional materials.
- Unusual terms, exemptions and qualifications should be drawn to the attention of consumers.
- Premiums payable should be clearly identified to customers.

- Different characteristics of the different types of policies should be clearly advised to customers.
- Comparative advertising must be accurate.

Finance Sector Specific Laws

State Government Consumer Protection – Uniform Consumer Credit Code

At the state level, the key law is that relating to the provision of credit – the Uniform Consumer Credit Code (UCCC). The UCCC was implemented after lengthy negotiation in 1996, and has made credit regulation uniform across all states and territories (with some minor exceptions).

The UCCC includes coverage of disclosure, documentation requirements and dispute resolution. There are state/territory tribunals that deal with complaints under the UCCC in some states.

Federal

Australian Securities Commission – securities trading and financial advice.

As well a general provisions concerning matter such as directors duties and takeovers, the Corporations law covers the finance sector specific licensing of securities dealers and investment advisers, the giving of appropriate advice, disclosure of commission, and prohibitions against misleading conduct by these intermediaries.

The Corporations law is administered by the Australian Securities Commission, a relatively recent creation formed from the amalgamation of state based corporate affairs commissions. It has not, until quite recently, had any profile in consumer protection issues.

Life and General Insurance – The Insurance and Superannuation Commission

The Insurance Contracts Act, the Life Insurance Act, the Insurance (Agents and Brokers) Act, and the Superannuation Industry Supervision Act are all administered by the Insurance and Superannuation Commission (ISC).

The ISC also issues "Circulars", the most important of which in the consumer protection area concerns disclosure. Circular GI1 sets out the requirements for disclosure for life insurance and personal superannuation policies, and is part of the regulatory response to the difficulties experience in this area in the 1980s and early 1990s. The centrepiece is a "Key Features Statement", which at a maximum five pages is designed to give consumers a summary statement about these products, which are often quite complex. The circular is relatively prescriptive in its approach.

The Reserve Bank of Australia – Banking

The Reserve Bank (RBA) is primarily concerned with prudential and monetary policy matters, but does have a limited role in direct consumer protection.

At this point it is worth noting that Australia does not have an explicit depositor protection scheme, although the actual arrangements pertaining to the "rescue" of major banks leave considerable discretion to the RBA. It is, however, a widespread misconception of the part of most consumers that banks will be supported by Government in the event of any major financial difficulties.