Reshaping Institutional Structure for Financial Consumer Protection

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Abstract

The article presents the significance of proper consumer protection for the stability of the financial market. It presents the basic assumptions of such protection and the direction of changes introduced as a result of the crisis of 2007 and the following years. It discusses the change of the consumer protection paradigm from the disclosure obligation to institutional and supervisory protection. It presents the adopted supervision models, including the twin peaks supervision, as well as the objectives that a proper supervision should execute in terms of financial services consumer protection.

Keywords

financial services; consumer protection; financial stability; twin peaks supervision

1 Introduction

Economic integration within and across the European Union countries, deregulation, advances in technology, the growth of the Internet and wireless communication technologies are changing the structure and nature of financial services. Technology is revamping the ways in which financial services are produced and delivered. The complexity of many financial products poses substantial challenges to consumers. The area of financial services is very complex and involves serious risks for consumers, especially when they are unable to understand the complex financial products, or when they take out inappropriate loans based on uninformed choices. This holds, in particular, for countries where financial literacy is low and where households have not gained long-term experience with making financial decisions.

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Inadequate consumer protection not only led to considerable consumer detriment, but was a major contributor to the global financial crisis. One of the key causes of the great financial crisis of 2007 was the misselling of subprime mortgages in the USA and their securitisation which spread the sub-prime crisis throughout the world. The crisis has highlighted the importance of consumer protection for the stability of the financial sector and provided an opportunity to carefully rethink the existing legislature and regulation. It revealed many irregularities in the operation of the financial system, in particular in the banking and insurance sector. Considering the significant potential detriment that financial services can cause to individual consumers and financial markets, consumer and investor protection are important functions of the public policy. There is a general consensus among policy-makers that stronger consumer protection, together with an enhanced financial education, is an essential pillar of well-functioning financial markets. It is required because consumers are often not capable of understanding the complexity and risks of certain financial products. Sole financial education, however, while important, is insufficient to protect consumers. It is very important that public authorities provide adequate protection. The objective of this paper is to present changes in the institutional structure for the financial consumer protection and to present the reasons and directions of such changes.

The main hypothesis adopted in the article is that a proper and adequate consumer protection is necessary for maintaining the stability of the financial market. Strong and competent public authorities should constitute an element of such protection. In the author's opinion, attention should be paid to the twin peaks supervision model, in which there are two independent entities present. One of them exercises micro-prudential supervision over the financial institutions, the other one supervises the provided services and offered products. The study uses mainly the dogmatic and legal method by analysing legal acts and the literature of the subject.

2 The Importance of Financial Consumer Protection for the Financial Market and Its Stability

Stability is an indispensable value for the proper functioning of the financial market in the European Union. The stable functioning of the financial system is a precondition for sustainable economic growth. A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events (Schinasi, 2004: 8).

The stability of the financial market is not its natural feature. In case it is violated, a deep intervention of the authorities, involving huge public investments, is required, aiming at balance restoration. Finding the answer to the question how to protect the financial markets against other crises or relatively limit their effects, has become important. The concept of financial market supervision has undergone a profound transformation. The principles of the new security architecture of the market has been established in the scale of the European Union, but also the entire world. The protection of the financial system against destabilisation, which could disrupt the functioning of the entire economy, has become one of the main aims of the policies of individual countries and the entire European Union (Jurkowska-Zeidler, 2008: 166–167).

The financial crisis has led to the loss of confidence in the financial market and undermined the opinion about banks as institutions of public confidence. Thus, apart from supporting the solvency, the second main area of activities aimed at overcoming the crisis was to restore the confidence in the financial system. It is one of the crucial conditions for the stable functioning of the financial market (Szustak, 2014: 115). It transfers to the quantity and quality of transactions concluded, and also to the proper execution of the concluded contracts. Equally crucial is the confidence of the market participants in the public law bodies equipped with the control and supervision competences. The level of confidence is a value difficult to measure, and yet it has a significant impact on the shape of the financial market. Both too low, as well as excessively high level might bring negative consequences to the individual client, financial institution and even the entire financial system. Loss of confidence makes clients seek alternative markets, sometimes situated outside the state control or even protection. Too high level of confidence that is not accompanied by an adequately high level of client knowledge may significantly reduce the caution in making financial decisions, which sometimes leads to very serious consequences.

Therefore, for the proper functioning of the financial market, it is necessary to establish a proper protection of the market participants, with a particular emphasis on the consumers. This is to prevent the use of complex legal relations between various entities in order to dilute the liability for inadequate performance of services or even to pass the liability on the user. Consumer protection on the uniform financial market is part of the more broad consumer protection policy as the party economically weaker, executed by the European Union.

3 A New Approach to Consumer Protection

The system of consumer protection is a system of interrelated institutional and procedural solutions, and also principles of the substantive law, the primary objective of which is to ensure a proper level of security to clients, and in a broader sense to all participants of the financial market. This objective is not executed through favouring the position of one of the parties, but through restoring balance in the scope of information possessed by all participants of the financial market, compensating the lack of knowledge and limiting the excessive risk imposed on the client. The essence of protection is not to refrain clients from concluding unfavourable contracts on the financial market, but enabling them to make informed decisions in the conditions of full information, on a market free of deception and fraud. The client protection system should prevent panic on the financial market and eliminate the so-called contagion effect, which means transferring, sometimes hidden, risks to individual participants of the financial market. It should also reduce the risky and sometimes aggressive sales of financial services, in order to obtain unilateral benefits by a financial institution or its employees, at the expense of legitimate rights and interests of the client (moral hazard).

This system is one of the essential elements of the financial safety net, the objective of which is to maintain the financial market stability. It should be effective, which means it should cover every protection area in a way that at the same time excludes the competence injunctions. Institutions that constitute its links should possess appropriate competences, and where deemed necessary, also the power to intervene in the activities of the individual financial market participants, but with respect to the principles of the free market, including the freedom to conduct business activity and the principle of freedom of contract.

The system of client protection on the financial market undergoes evolution and its shape is constantly changing. It is in part connected to the gained experience, both as part of the European market, as well as the global markets. It should also adopt to new conditions, including those resulting from the dynamic technological development and the rise of a new market segment, referred to as Fin Tech and the related challenges (Świeszczak, 2017: 143).

At the beginning, the consumer protection system was a secondary subject of regulation. On the basis of the paradigm of the free market principles, it was recognised that free market and competition would be sufficient factors guaranteeing the proper protection of clients and an appropriate balance between them and the financial institutions. Therefore, it seemed sufficient to introduce an appropriate micro-prudential supervision, which did not interfere with the internal corporate order or the assumed business model of the supervised institutions. It was to ensure stability, which was considered a natural feature of the free financial market. It turned out, however, that this assumption was flawed. Therefore, in the Council Resolution of 14 April 1975 on a preliminary programme of the European Economic Community for a consumer protection and information policy the primary principles, on which the protection of the consumer economic interests should be based, were formed. The Treaty on European Union, signed on 7 February 1992 recognised consumer protection as the essential aim of the Communities and introduced a new title "Consumer Protection". From that moment, consumer protection started to develop as a separate and autonomous objective adopted and executed by the European Union.

Another paradigm of protection through information was based on the obligation to provide clients with information essential for them to make an informed and rational financial decision. This was the stage of introducing a series of standards defining the scope and method of disclosing information. Clients, especially consumers, were equipped with a series of legal instruments, including, among others, the right to withdraw from a contract concluded at a distance or outside the entrepreneur's registered office. This extended the time for reflection even after the conclusion of the contract. The 2007 crisis questioned the premises of rationality of the clients' behaviours. Consumer preferences are influenced by emotions and psychological experiences, sometimes leading to poor decision-making. Biases and cognitive limitations may be particularly important in financial markets. Some aspects of human behaviour are not rational, like hyperbolic discounting, over-optimism and framing effects. Though improved financial literacy benefits consumers, the study and the latest research on financial education highlight that, on their own, policies aimed at raising financial literacy are not enough.

This gave rise to the new regulatory and supervisory paradigm, based on the assumption that the financial market is unstable and pro-cyclical, with a tendency to irrational, "herd" behaviour of its participants (Monkiewicz, 2015: 6). Instability is further deepened by the complexity of financial systems and applied business models and financial innovations. In such a paradigm, the main role is played by the institutional limitations and counteracting systemic risk. The burden of client protection should lie on the institutions understood as entities of public law, less commonly private law, equipped with supervisory competences, which influence the shaping of the clients' legal environment. If we are abandoning the dogma of a rational man, who acts in a logical and economically optimal way, on the basis of all available information, for a man guided more often by emotions rather than a cold analysis, who sometimes places immediate gratification (e.g. from the received money) above the incurred costs (e.g. high costs of a loan), the functioning of strong and competent institutions is necessary. They should have appropriate control and supervision competences, fitting the current situation, and also the possibility to enforce the substantive law that allows flexible reaction to the emerging threats to protected values. Within the framework of their operation, the principles of monitoring the market and the behaviours of entrepreneurs who offer financial products should be specified, including in terms of compliance with the adopted soft law principles, codes of conduct or public authorities' recommendations. The possibility to inspect contract templates, entrepreneurs' activities related to offering financial services and identification of client's interest infringements is important. Such institutions, as the executors of the established law, should have the possibility to influence its content through the participation in the legislative process. Such understanding is in contrast with the new regulatory and supervisory architecture, in particular the designing and constructing of the Banking Union (Monkiewicz, 2016: 59).

However, important questions emerge as to how deep the regulatory and institutional protection can and should interfere with the free market, including its fundamental principle of freedom of contracts and *pacta sunt servanda*. Two views of consumer protection seem to exist. One view holds that consumers must be protected from other parties, for example possibly hazardous products or misleading advertising and aggressive sales strategies. The other view holds that consumers must be protected from themselves. Even when given full information, a wide range of products and services, as well as access to valuable advice, consumers will make choices that are not in their own long-term interest. The doubts concerning the concept of clients protection itself, in particular whether it should be made possible for them to undertake financial activity, sometimes risky, but under conditions of full knowledge and awareness of the risk taken, or whether in the form of imposed bans to prevent them from being offered those services which are provided under conditions considered unfair. The answer to such questions requires a multidimensional analysis of objectives, which protection is to serve them and the effects that an excessive interventionism could bring. It is based not only on logical arguments, but also on axiological arguments, in particular values considered priorities. Finally, it requires the redefining of the adopted consumer model (Nieborak, 2016: 95 et seq.).

4 Financial System Regulations

The change of paradigm into the regulatory and supervisory raises the significance of the adopted supervision model over the financial market. It becomes responsible not only for the proper functioning of the supervised units, but also for the quality of the services they provide. The European laws do not indicate a universal model of the financial supervision, leaving it up to the individual Member States.

There are four main approaches to financial system regulations. The institutional approach tends towards a heavily fragmented regulatory environment.[2] Each regulator is responsible for both financial system stability and market conduct and consumer protection issues. This approach is regarded as least capable of dealing with financial conglomerates, the activities of which blur the boundaries between different types of financial institutions. The functional approach focuses on the types of transactions or products under regulation.[3] Each regulator is responsible for the safety and soundness of the financial institutions, as well as the business conduct of the institutions, as it applies to each type of product covered by the jurisdiction of each regulator. This system may be effective, provided there is a high degree of communication and co-operation between regulators.

In the intergrated approach, there is a single financial regulator responsible for safety, soundness and business conduct considerations as well as consumer protection.[4] The financial conduct regulator usually resides in the same agency as the prudential supervisor, although the two functions are commonly performed by separate units within the agency. In these jurisdictions, the safety and soundness of the banking system is considered hand-in-hand with consumer finance protection. In some cases,

[2] This mode of financial system regulation is used in China, Mexico and Hong Kong.
[3] This approach is currently employed in Italy, France and Brazil.
[4] The integrated approach is currently employed in Japan, Singapore, Germany, Poland and the Scandinavian countries.

there is a consolidated regulator of markets, conduct and consumer/investor protection, separate from the prudential supervisor for banking and insurance. There are also cases where the responsibility for consumer finance protection is spread across a number of agencies. Responsibility is usually assigned based on factors such as business segments.

The analysis of the reasons for the 2007 crisis has underlined the significance of an appropriate consumer protection on the financial market. It proved that inappropriate protection generates a significant systemic risk and can disrupt the financial stability of not only a single country, but it can spread to the remaining financial markets as a result of the so-called domino effect. This led to the increased interest in the supervision model, which would pay appropriate attention to consumer protection in a way independent from the micro-prudential supervision. This led to the formulation of the basis for the fourth supervision model.

Twin peaks supervision was first suggested by Michael Taylor, in 1995. It was principally a reaction to the "blurring of the boundaries" phenomenon in the financial services sector in the UK (Taylor, 1995). Since its introduction in Australia in 1998, the model has been adopted in a number of countries, also in Europe (Wymeersch, 2007: 14). A twin peaks regulatory model comprises two peak regulators. One is responsible for the financial system stability, the other for market conduct and consumer protection. The separation of the consumer protection function from the system stability function is the cornerstone and, supposedly, one of the principal advantages of a twin peaks system. Of the total of four financial regulatory systems currently in use, twin peaks has garnered the most interest, and gained widespread recognition. In this approach regulators can be more effective, with each having clear objectives that do not overlap. As a result, they can be more accountable and more focused. It creates checks and balances between agencies, and their objectives. It allows each regulator to create its own culture that best suits its objectives (Goodhart, 2013: 156). The twin peaks supervision takes into consideration that the protection of the financial market against destabilisation and client protection may potentially be in conflict, therefore, they should not constitute the competences of a single entity.

5 Conclusion

Consumer protection has proved to be one of the important pillars on which the stable financial market is based. Financial products and services are considered to have the potential to be highly disruptive to financial markets. While improved financial literacy will benefit consumers, policies aimed at raising financial literacy are not enough. Financial sector regulators and institutions responsible for consumer protection in financial markets should adopt a more pro-active approach to ensure that financial markets work well for consumers, to rebuild consumer trust in financial markets. Regulators should actively aim to prohibit retail financial products which they view as being too complex for consumers to be able to understand, too risky for consumers or involve unexcused high transaction costs.

The necessity for an increased involvement of the supervisory institutions not only in the micro-prudential supervision, but also the supervision over the provided financial services and the products offered, becomes more and more recognised. A tendency to distinguish the institutions responsible for appropriate protection of financial services of consumers can be observed. Those changes led to the creation of a new model of supervision, based on two, mutually complementary supervisory bodies. It is the answer to the previous negligence of consumer protection, which is one of the major causes of the recent crisis. Its solutions are surely worth considering.

Although, the twin peaks model was not adopted by many countries, tendencies can be observed that change the national supervision models taking into consideration the necessity to ensure institutional and supervisory support to the consumers of financial services. Poland is an example. A model of integrated supervision over the financial market was adopted. Equipping the consumer protection institutions (Office for Competition and Consumer Protection, in particular) with new competences and establishing new institutions, the sole objective of which is to protect consumers on the financial market, results in an increasingly strong, complementary supervision over the services provided on the financial market.

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