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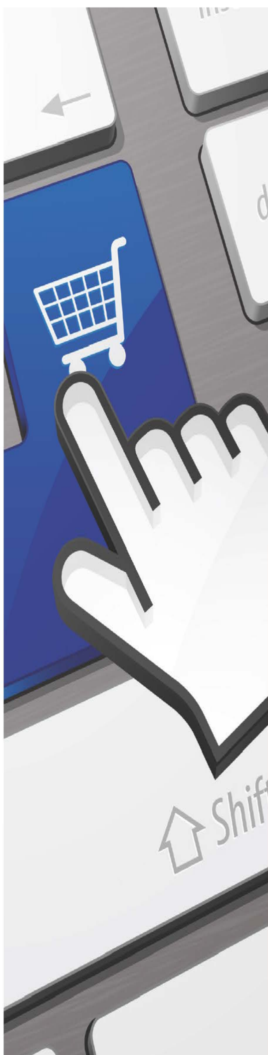

Consumer Protection Aspects of Financial Services

STUDY

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2014

Consumer Protection Aspects of Financial Services

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Consumer Protection Aspects of Financial Services

STUDY

Abstract

Inadequate consumer protection, especially in the U.S. mortgage market, not only led to considerable consumer detriment but was a major contributor to the global financial crisis. In the EU, mis-selling of financial products has also resulted in significant consumer harm. Considering the significant potential detriment that financial services can cause to individual consumers and to the Single Market, consumer protection policy needs to properly focus on this area. Improved transparency and better informed transactions resulting from such policy will lead to better solutions for consumers and greater market efficiency. A number of recommendations to strengthen consumer protection in the area of financial services are put forward in this study.

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CONTENTS

LIST OF ABBREVIATIONS

APR	Annual Percentage Rate
ASF	French Association of Financial Companies (Association Française des Sociétés Financières)
BaFin	German Federal Financial Supervisory Authority (Bundesanstalt für Finanzaufsicht)
BdE	Bank of Spain (Banco de España)
CAPs	Continuous Payment Authorities
CAU	Consumer Affairs Unit (of the Maltese financial regulator)
CCMA	Irish Code of Conduct on Mortgage Arrears
CDOs	Collateralised Debt Obligations
CLCV	Consommation Logement et Cadre de Vie
CNB	Czech National Bank
CSA	Romania Insurance Supervisory Commission
DBA	Danish Bankers Association
DFSA	Danish Financial Supervisory Authority
DGSFP	Spanish General Directorate of Insurance and Pensions (Dirección General de Seguros y Fondos de Pensiones)
DTI	Debt-To-Income
EBA	European Banking Authority
ECB	European Central Bank
ESIS	European Standardised Information Sheet
HFSA	Hungarian Financial Supervisory Authority
IRHPs	Interest Rate Hedging Products
LTV	Loan-To-Value and
MARP	Irish Mortgage Arrears Resolution Process
OFT	United Kingdom Office of Fair Trading
PAYG	Pay As You Go
PPI	Payment protection insurance
PSD	Payment Services Directive
SECI	Standard European Consumer Credit Information
SEPA	Single Euro Payment Area
SFS	Irish Standard Financial Statement
SMEs	Small and medium enterprises
UCIS	Unregulated collective investment schemes
UKFSA	United Kingdom Financial Services Authority

MEMBER STATE ABBREVIATIONS

AT	Austria	LU	Luxembourg
BE	Belgium	LV	Latvia
BG	Bulgaria	MT	Malta
CY	Cyprus	NL	Netherlands
CZ	Czech Republic	PL	Poland
DK	Denmark	PT	Portugal
DE	Germany	RO	Romania
EE	Estonia	SK	Slovakia
EL	Greece	SI	Slovenia
ES	Spain	SE	Sweden
FI	Finland	UK	United Kingdom
FR	France		
HR	Croatia		
HU	Hungary		

LIST OF BOXES

LIST OF FIGURES

LIST OF TABLES

EXECUTIVE SUMMARY

One of the key causes of the great financial crisis of 2007/2008 was the mis-selling of sub-prime mortgages in the USA and their securitisation which spread the sub-prime crisis throughout the world.

In fact, if consumers in the US had been better protected against predatory lending practices and mis-selling of credit products, especially mortgage products, the whole sub-prime market would not have developed as it did and would not have been able to feed the securitisation activities as it did, especially from 2003 to 2007.

More generally, the financial crisis clearly showed that consumer protection in some financial markets was highly deficient in the run-up to financial crisis of 2007/2008. There is now a general consensus among policy-makers that stronger consumer protection, together with better financial education, is an essential pillar of well-functioning financial markets. Financial education, while important, alone is insufficient to protect consumers and empower them.

The analytical framework adopted for the present study is articulated around the four key stages of a consumer's relationship with a financial product.

- During the first stage, a consumer wishing to acquire a new financial product may undertake some research into the financial product of interest and providers of such products with a view to find the offer which provides the best value for money.
- During the second stage, the consumer undertakes the actual acquisition of the financial product of interest.
- During the third stage, the consumer holds the product. The duration of this stage varies depending on the product. Some financial products have a finite duration (for example, a personal loan or a mortgage loan, or a credit card) while other financial products have an unspecified duration (for example a bank account or an investment in equities).
- Finally, for the products with pre-defined duration, the financial product matures or is liquidated (for example, a personal loan or a mortgage is fully repaid, or a pension pot is converted into annuities). In a number of cases, the liquidation of the financial product may not be voluntary (for example, when a borrower is unable to meet her/his financial obligations) and the holder of such a financial product may suffer serious financial consequences.

The market for retail financial products is characterised by a number of features which imply that the retail financial markets do not always work to the benefit of consumers.

- First, most consumers buy only infrequently new financial products and services. Therefore, when buying a new financial product or service, they do not have much past knowledge or experience to rely on for taking decisions.
- Second, many financial products and services can be rather complex, and putting together the information required for making an informed choice is costly in terms of time. As a result, consumers may acquire new financial products or services based on only limited information. Often such information is given by the financial service provider selling the financial product or service. In contrast, financial service providers are usually well informed about the product and services they are selling.

Third, typically individual consumers have little bargaining power in retail financial markets as, in many retail financial markets, they generally face large financial service providers.

- Fourth, many financial products and services have a relatively long duration, and the problems and issues that they may potentially cause for consumers, manifest themselves only with a long lag. It is therefore difficult for consumers to properly asses the true cost of a financial product and its riskiness.
- Fifth, the avenues open to consumers to address financial problems once they have occurred, such as, for example, formal debt discharge or debt reduction processes, may be close to nil in some cases or may be costly, take a long time and yield a result which is uncertain at the outset.
- Sixth, a number of consumers also have limited financial literacy skills and exhibit behavioural biases which tend to amplify the issues described above.
- To inform the study, a large-scale information gathering exercise (stakeholder consultations, literature review, etc) was undertaken to identify financial products and services which have a significant potential to be highly disruptive or beneficial for consumers or the Single Market:
- Financial products and services are disruptive for consumers when the economic and financial consequences of mis-selling, inappropriate selling, the crystallisation of the risk(s) embodied in a financial product or service, and the non-respect of the contractual obligations by the consumer may be such that the financial health of consumers is seriously impaired, and consumers may be pushed into a state of financial vulnerability.
- Many financial products and services differ from non-financial goods and services in the sense that the consequences of any issues and problems are typically much more drastic, and strong consumer protection is required in financial markets to prevent such disruptive impacts.
- Financial products and services are considered to have the potential to be highly disruptive to the Single Market if the consequences of inappropriately selling or mis-selling have the potential to:
    - cause financial instability in the Single Market – in some cases a particular product may have the potential to result in both significant financial harm for some consumers and wider financial instability; or,
    - affect a large number of individual consumers in national markets – while the financial health of individual consumers may not be impacted to the same extent as in the first case, the large number of potentially affected consumers implies that aggregate consumer demand for goods and services may be negatively impacted, and hence cross-border trade and the functioning of the Single Market; or
    - directly impact negatively on cross-border trade in financial services.

Financial products and services which are beneficial to consumers and the Single Market are those which either yield directly substantial benefits to consumers and/or benefit the Single Market by contributing to financial stability, avoiding depressing consumers' purchasing power or stimulating cross-border trade.

The results of the stakeholder survey and the review of the literature suggest that, in general, the main financial products with a high potential of being disruptive to consumers include those which:

- carry risks which consumers may not fully understand when signing a contract for such products and which may create serious financial problems for consumers if the risks materialise (i.e., such financial products put a consumer or an SME in a financially disruptive situation) – this is the case, in particular, for a number of mortgage products such as variable rate mortgages, high loan-to-value and debt-to-income mortgages, foreign currency mortgages and mortgages sold with interest rate hedges and swaps;

- carry high interest rates whose effects may not always be fully understood by some consumers such as for example credit products carrying high interest rates, in particular payday/instant loans and credit cards with high rates combined with high limits. This may trap some consumers, especially more vulnerable consumers, into spiral of ever-growing debt;
- are subject to high fees and charges which the consumer may not have properly understood when signing the contract. Such high fees and charges may impose a cash cost burden on consumers and, more critically, in the case of savings, investment and pension products may erode the returns on such products and leave the consumer with a much lower than expected future income stream; or
- are subject to high costs in the case of non-respect by the consumer of her/his obligations (for example, high charges and fees in the case of non-repayment of payday loans or repossession of a principal residence in the case of non-respect by a mortgage holder of his/her obligations).
- The absence of a fair and cost-efficient exit from over-indebtedness through voluntary arrangement and/or personal bankruptcy amplifies the detriment suffered by consumers when they become unable to meet their financial obligation as they may be saddled with high proceeding costs and/or an on-going debt burden. The lack of such exit mechanisms in a number of countries, in particular Hungary, Romania and Spain, causes serious hardship as it prevents consumers who can no longer meet their financial obligations to be given a second chance and restart with a clean slate.

While improved financial literacy will benefit consumers, the study and the latest research on financial education also highlight that, on their own, policies aimed at raising financial literacy are not enough.

Even in the absence of mis-selling and inappropriate selling, the purchase of many types of financial products or services will continue to be challenging for consumers because a) consumers only infrequently purchase such products and services and do not have a good knowledge of them, especially of newer products and services, b) the products and services may be very complex, opaque and their risks may be difficult to assess, especially in the case of long duration financial products and services and c) consumers have no or little bargaining power in retail financial markets. These characteristics lead to significant information asymmetries in financial services. Correcting these asymmetries is in the interest of both consumers and the Single Market.

Improved protection on consumers in financial markets is a key preoccupation of the European Parliament. For example, recent European Parliament resolutions call for better financial education and improved financial literacy, improved information provision and stronger consumer protection from misleading and inaccurate information and from financial products which may be highly detrimental to consumers. Similar issues are addressed by the 2014-2020 Consumer Program proposed by the European Commission and currently debated by the European Parliament. Moreover, a number of specific measures, which will enhance consumer protection in the areas of mortgage credit and consumer credit, and strengthen consumer rights in financial markets, have already been adopted or are in the process of being discussed by the European Parliament. Policy indications formulated in resolutions of the European Parliament should be promptly followed by legislative proposals from the European Commission. It should be recognised that consumer protection is a fundament upon which proper development of financial services should be built, to the same extent as regulation of the financial industry itself as well as the economic policy making.

The overarching recommendation of the present study is that consumer protection in the area of financial services should be strengthened and consumers' financial capabilities should be raised. Considering the **significant potential detriment that financial services can cause to individual consumers and to the Single Market**, consumer protection policy needs to properly focus on these services. Improved transparency and better informed transactions resulting from such policy will result in **better solutions for consumers and greater market efficiency**. This is particularly important, since European consumers have very limited access to financial services in other Member States, where these services could be more beneficial and offer more protection (according to recent Eurobarometer survey, 94% of respondents in the EU27 have never purchased a financial product in an EU Member State outside their home country). Nine detailed recommendations to achieve these twin overall objectives are set out below.

The first three recommendations aim to reduce the information asymmetry between consumers and financial service providers. A good understanding by consumers of the financial transactions they enter into enhances the efficiency of that transaction and more generally improves market efficiency.

Recommendation 1

Consumers should always receive from the seller accurate, simple, comparable information of a financial product or service before and after buying it.

In this regard, it is important to note that simply increasing the quantity of information disclosed to consumers, even if it is simplified, does not resolve the complexity challenge faced by consumers in a number of cases. Due to bounded rationality, a large volume of information results in information overload and is not processed properly by many consumers. The quality, simplicity and completeness of information should allow consumers to 'learn as they buy' and make sure that consumers enter into transactions they fully understand. An obligation to inform a consumer fully and understandably about the transaction and its potential consequences under different scenarios and in practical, outcome-focused terms, should rest with the service provider, with legal consequences in cases where such information is lacking or is not comprehensible.

Standardisation and commoditisation may help. Recommendation 2 builds on this point.

In terms of how to simplify the financial information, it is essential to rely on consumer feedback on what particular pieces of information they would find most useful to assess particular financial products and services. Otherwise there exists a significant risk that any simplification exercise ends up not assisting consumers greatly.

Recommendation 2

The literature on consumer behaviour also suggests that information can be improved by presenting average consumer experience. Indeed, the literature on using "descriptive norms" which describe what most other people are doing has been found to encourage recycling, energy and water efficiency and reducing littering.[1] It would be useful to test whether reliance on "descriptive norms" and the provision of best and worst case scenarios can contribute to improve consumers' financial decision even if their financial literacy and

[1] See Cabinet Office (2012) and Schultz et al. (2007).

capability is not perfect. In the case of credit agreements, the information provided to consumers should also be very explicit about the consequences of defaulting, the penalty fees and charges that the lender may apply in case of default and any other steps the lenders may take such as repossession, the potential legal costs that a defaulting borrower may have to bear, etc.

Recommendation 3

In light of the findings from the literature on consumer behaviour in financial markets, consideration should be given to implementing a system whereby consumers would be encouraged by lenders to seek independent financial advice from a third party provider for more complex products which have the potential to result in significant harm to consumers. The set of such products could include, among others, more risky mortgages (for example, variable rate, high loan-to-value, and foreign currency mortgage products). The precise list of products for which prospective borrowers would be encouraged to seek independent advice could be established by the regulator.

Various funding models for the provision of advice could be considered ranging from government funding to industry funding or consumer fees. Each of these approaches has a number of advantages and disadvantages, and these would need to be further assessed in greater detail if the basic idea of an advice scheme is taken forward.

The fourth recommendation aims to better equip consumers to deal with financial matters.

Recommendation 4

Many Member States have implemented financial education and capability programs. However, in light of the poor results of the recent OECD financial literacy and capability survey, considerably more efforts and resources should be devoted by governments, the financial sector and civil society to this activity.

As well, greater efforts should be made to learn from the various programs already implemented in various countries, especially with regards to the effectiveness and efficiency of such programs. For example, all ex-post evaluations and impact assessments of financial literacy and capability programs should be made available on or accessible through the International Gateway for financial education.

The next three recommendations aim to better protect consumers by encouraging regulators to adopt a much more pro-active, preventative approach to retail financial markets, more robustly and vigorously deter financial service providers from harming consumers and sanction more forcefully mis-behaviour.

Recommendation 5

Financial sector regulators and institutions responsible for consumer protection in financial markets adopt a pro-active approach to ensure that financial markets work well for consumers rather than responding to consumer complaints reactively and addressing mis-behaviour or inappropriate behaviour. Such a pro-active approach could contribute considerably to rebuild consumer trust in financial markets and prevent the emergence of problems down the road.

To identify more proactively issues faced by consumers in financial markets, national authorities should make regular use of a) consumer satisfaction survey to identify those products and markets which consumers views as failing them and b) mystery shopper exercises to gather actual information on the behaviour of sellers of financial products.

For example, the Belgian Parliament is currently considering a law, which among others, would allow a) mystery shoppers to pretend to be real customers without telling the institution they are visiting that they are working for the Belgian Financial Services and

Markets Authority and b) the regulatory authority to use the information gathered during the mystery shopping exercise. In the UK, the Financial Conduct Authority uses mystery shopping exercises when it wishes to look at business or selling practices in context. A recent mystery shopping exercise, focused on advice for a lump sum investment, found that approximately three-quarters of customers received good advice. However, the Authority had concerns with the quality of advice provided to the other quarter of consumers. In 11% of mystery shops the Authority felt the advice was unsuitable for the customer and in a further 15% the adviser did not gather enough information to make sure their advice was suitable – so that it was not possible to determine whether the customer received good or poor advice.

In addition, regulators should actively aim to prohibit retail financial products which they view as being too complex for consumers to be able to understand or as being too risky for consumers. For example, in 2010 the Swedish FSA (Finansinspektion) introduced guidelines limiting mortgages to a maximum loan-to-value (LTV) ratio of 85% and in 2011, the Dutch Financial Markets Authority (AFM) prohibited interest-only mortgages exceeding 50% of the market value of the mortgaged property. More recently, The UK Financial Conduct Authority banned in June 2013 the promotion of Unregulated Collective Investment Schemes (UCIS) and certain close substitutes (together to be known as Non-Mainstream Pooled Investments (NMPIs)) to the vast majority of retail investors in the UK.

Recommendation 6

In their market monitoring, regulators should also identify those financial products which involve high transactions costs (explicit or implicit) in terms of fees, charges, etc and actively use their regulatory power to a) ensure that any transactions cost charged to consumers reflect the actual cost incurred by financial services providers and b) prevent the imposition of high charges arising from steering to more expensive products or from excessive number of transactions related to the product such a churning of investment funds.

Recommendation 7

In addition, the sanctions (financial penalties, probation to undertake certain activities for a certain period, etc.) for mis-behaviour or inappropriate behaviour by sellers of retail financial products should be made more exacting so as to increase the deterrence effect and incentivise financial firms to treat their customers fairly and honestly. Financial institutions should also be systematically liable for adequately compensating consumers who suffered detriment as a result of mis-selling or inappropriately selling of financial products or services. For example, in the case of the mis-selling of payment protection insurance in the UK, financial institutions found to have mis-sold such a product were fined and consumers who bought such a product are eligible to recover all the premiums paid with interest added. Moreover, compensatory collective redress (by a State institution or a private organisation) should be facilitated throughout the EU by the speed implementation of the EC Recommendation of 11 June 2013 on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law.

Moreover, in order to provide the proper incentives at the level of the actual interaction between a customer and an official of a financial institution, the latter should also be subject to stringent penalties for mis-selling or inappropriate selling of particular products.

In light of the fact that, for certain financial products, the risk is long-tailed, the individual liability and the institution’s liability should also be of a long duration.

The eighth recommendation aims to ensure that, in case of problems, consumers can easily obtain redress.

Recommendation 8

In light of the findings of the study identifying a number of unfair practices and the high legal costs of resolving disputes between a consumer and a financial service provider, consumers should have access to an independent, fast, efficient and inexpensive dispute resolution mechanism to address any unresolved disputes with financial institutions. While in a number of EU countries an independent ombudsman for financial matters or a similar institution already exists, this is not yet the case in all Member States.

In this regard, the recently adopted Directive on alternative dispute resolution mechanisms and Regulation on online dispute resolution for consumers will also be of assistance to consumers once implemented.

The last recommendation is that consideration should be given to develop better mechanisms and processes for dealing with excessive personal debt burdens.

Recommendation 9

Finally, despite all the measures aiming to ensure that consumers only buy financial products whose risks are commensurate to their capacity to bear such risk, there will be cases where consumers will find themselves in a situation where they are no longer able to meet their financial obligations due to unexpected events such as loss of income due to unemployment or bad health. In such circumstances, consumers should have access throughout the EU to easy, fair and cost-efficient exit mechanisms which allows them to escape from over-indebtedness and be given a second chance. Such mechanisms involve voluntary arrangements and/or personal bankruptcy regimes which are present in many but not all Member States.

In practical terms, serious consideration should be given to the adoption across the EU of the best practice model for dealing with excessive personal debt which has been developed recently for the Financial Services Users Group (set up by EC DG Internal Market and Services):

- Debt cancellation is not, and should not be, an automatic right, but it should be presumed that someone applying should have access to it unless a lender can demonstrate objective evidence of 'bad faith' by the borrower. The application process should give lenders a time-limited opportunity to raise concerns about an applicant's behaviour, so administrators can reject applicants whose behaviour has been found wanting.
- The creditor must be protected when the debtor has acted in bad faith, but in return for this creditors must accept the responsibility where inappropriate lending has helped cause the problem of over-indebtedness they should bear some of the costs of resolving this problem. Best practice requires a compromise between the debtor and creditor; the debtor must pay what he can and the creditor must accept that as the best resolution they can receive, so it is better for them to cut their losses, stop paying legal fees and allow a rapid discharge of unrecoverable debts.
- The use of stigmatising labels should be ended, and the pejorative term 'bankruptcy' should be replaced with the more neutral 'debt adjustment'.
- Debt cancellation should be delivered by an administrative body without recourse to a judicially-led court-based process except for appeals against the mis-application of the due process, as exists in Sweden and France, transparently applying clear rules quickly and efficiently. Creditors and consumers should have the right to appeal to a

court on the grounds of compliance with the process.

- The debt counsellor who leads the administrative process should determine the solution applicable to the case, rather than the consumer or the debtor; have the power to attach earnings. There should be transparent rules on exempt income based on social benefit levels, taking account of the number of children and/or a partner, and the impact these have on social allowances; only have the right to liquidate assets worth over a substantial threshold; have the right to impose a 'cram-down' on creditors; have the power to impose a 'zero-plan' where there is no chance of the consumer being able to make payments, with immediate discharge if a consumer cannot over three years repay either 10% of their total debt or EUR 10 000, whichever is lower, in line with recent practice in the Netherlands.
- As in Denmark and the UK, discharge should occur one year into a three-year payment plan, aligning discharge at the lowest common denominator whilst still ensuring creditors have access to excess earnings for three years.
- There are some debts which consumers should not be able to escape. Child/dependent maintenance payments deserve inclusion in this exemption. Student loans do not merit exemption from debt cancellation. There is a case that society would benefit most if unpaid taxes were given a priority in payment plans over private debts.
- Obviously, more in-depth research would be required to ensure that any changes to the bankruptcy regime applying to consumers strikes a proper balance between consumer protection and the rights and obligations of financial service providers.

1. INTRODUCTION

KEY FINDINGS

- One of the causes of the great financial crisis of 2007/2008 was the mis-selling of sub-prime mortgages in the USA and their securitisation which spread the sub-prime crisis throughout the world.
- In fact, if consumers in the US had been better protected against predatory lending practices and mis-selling of credit products, especially mortgage products, the whole sub-prime market would not have developed as it did and would not have been able to feed the securitisation activities as it did, especially from 2003 to 2007.
- The financial crisis clearly showed that consumer protection in a number of financial markets was highly deficient in the run-up to financial crisis of 2007/2008.
- There is now a general consensus among policy-makers focusing on financial stability that stronger consumer protection, together with better financial education, is an essential pillar of financial stability.
- Financial education, while important, alone is insufficient to protect consumers and empower them.
- Strong consumer protection in financial markets is required because consumers are often not capable of understanding the complexity and risks of certain financial products, are poorly equipped to identify cases where they are deliberately mis-sold inappropriate financial products and often, for a variety of reasons, do not properly assess or understand the potential financial consequences for them when things do not turn out as expected or planned.
- There is a broad consensus in the literature that consumer preferences are influenced by emotions and psychological experiences sometimes leading to poor decision-making. In financial markets, such issues can have dire consequences for consumers.
- Overall, consumer biases and cognitive limitations are likely to affect consumers differently across different financial products and services depending on the complexity of the product, the experience with the product, etc.
- It is therefore not surprising that, among the financial markets monitored by the Consumer Markets Scoreboard, the financial markets with the most complex financial products, such as 1) mortgages and investment products and 2) private pensions and securities, are the two services markets showing the lowest consumer satisfaction in the EU27 among the 30 services markets covered by the scoreboard.

1.1. Background

The global 2007/2008 financial crisis, whose consequences are still felt nowadays, had a number of root causes such as, among others, excessive leveraging and over-reliance on short-term financing by some of the major financial institutions, underestimation of credit and counterparty risk by both the financial sector and investors, especially risk of new financial products developed during the heydays of the financial boom, extensive interconnectedness, and inappropriate or deliberate mis-selling of financial products, especially mortgages, to consumers in a environment where consumer protection in financial markets was weak and/or poorly enforced[2].

One particular financial product which contributed in major way to the financial crisis was the sub-prime mortgage in the US. The first expansion in US sub-prime mortgages occurred during the late 1990s, with the volume of subprime lending rising to USD 150 billion, making up some 13% of the total annual mortgage originations. This came to a halt with the dotcom crisis of 2001.

A second expansion phase began in 2002 until 2006, when the sub-prime component of mortgage originations rose from USD 160 billion in 2001 to USD 600 billion by 2006 representing over 20% of the total annual mortgage originations[3]. Moreover, much of the sub-prime mortgage business in the years preceding the 2007/08 financial crisis was securitised spreading the mortgage sub-prime risk to financial institutions throughout the globe.

While some of the problems in the securitised US sub-prime mortgage markets reflected issues in the relationships between mortgage originator, securitisation arranger and investor in the securitised sub-prime mortgages, others manifested themselves directly in the interaction between the mortgage borrower and the mortgage arranger (mis-selling, predatory lending[4], etc).

The consequences for the financial crisis for the sub-prime mortgage borrowers were dire and millions of homeowners were at risk of losing or actually did lose their homes. Over the period 2008 to 2012, foreclosures averaged 3.2 million a year in the United States while they amounted to 1.3 million in 2006[5]. As of spring 2013, the percentage of homes in foreclosure exceeded 4% in 7 States. It stood at almost 10% in Florida[6].

The issue of sub-prime mortgages is only one example, albeit a crucial one, of the many problems faced by consumers in financial markets in the run up to the financial crisis.

In fact, policy-makers recognise nowadays that insufficient attention to consumer protection in financial markets during the decade preceding the great financial crisis (GFC) of 2007/2008 and mis-selling or inappropriate sales of financial products to consumers were major contributing factors to the financial crisis[7].

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[2] See, for example, Stiglitz (2009) and US Financial Crisis Inquiry Commission (2011). The Commission was established as part of the Fraud Enforcement and Recovery Act (Public Law 111-21) passed by Congress and signed by the President in May 2009. This independent, 10-member panel was composed of private citizens with experience in areas such as housing, economics, finance, market regulation, banking, and consumer protection.

[3] See, for example, Mizen, P. (20), Subprime Mortgage Lending and The Credit Crunch, Centre for Finance and credit markets, Current Issues Briefing and Calomiris, C. W. (2008), Not (yet) a "Minsky moment" in Andrew Felton and Carmen Reinhart (Eds) The First Global Financial Crisis of the 21st Century, available at voxeu.org.

[4] For example, a recent US study by Agarwal and Evanoff (2013) on loan product steering towards a subprime lender in mortgage markets found, in an analysis of data on loans from the top ten services and representing about 2/3 of the mortgage market, evidence of steering which resulted in consumers paying 40 to 60 basis points more than similar consumers who had not been steered.

[5] See, for example, Stiglitz(2009). Data on foreclosures are from Bloomberg.

[6] See CoreLogic, National Foreclosure Report April 2013.

[7] Mis-selling of financial products involves the sale of financial product which yield no or very limited benefit to the buyer (such as, for example, payment protection insurance in many cases) or the steering of the consumer to certain products which are less beneficial for the consumer than other product (such as the steering of consumers towards the sub-prime mortgage market while they would have qualified for regular mortgage products). Inappropriate sales involve the sale of products which do not adequately take account of the consumer's risk appetite and risk bearing capacity (such as, for example, variable rate and /or foreign currency mortgages in a number of cases).

For example, Sheila Bair, chairperson of the US Federal Deposit Insurance Corporation, noted in her testimony to the Financial Crisis Inquiry Commission set up by the US Government that " *poor-quality loans pulled market share from traditional banks and "created negative competitive pressure for the banks and thrifts to start following suit. [Subprime lending] was started and the lion's share of it occurred in the nonbank sector, but it clearly created competitive pressures on banks. I think nipping this in the bud in 2000 and 2001 with some strong consumer rules applying across the board that just simply said you've got to document a customer's income to make sure they can repay the loan, you've got to make sure the income is sufficient to pay the loans when the interest rate resets, just simple rules like that . . . could have done a lot to stop this*".

In its comprehensive assessment of the root causes of the GFC, the Financial Crisis Inquiry Commission concluded that during the years preceding the GFC "*there was untrammelled growth in risky mortgages. Unsustainable, toxic loans polluted the financial system and fuelled the housing bubble. Subprime lending was supported in significant ways by major financial institutions. ....Regulators failed to rein in risky home mortgage lending. In particular, the Federal Reserve failed to meet its statutory obligation to establish and maintain prudent mortgage lending standards and to protect against predatory lending*"[8].

Moreover, according to the Financial Crisis Inquiry Commission" ...*Loans were often premised on ever-rising home prices and were made regardless of ability to pay*"[9].

In the same vein, the OECD noted in 2009 that[10]:

"one of the features of the financial crisis is the emergence of inadequately regulated alternatives to traditional credit products, which have exposed vulnerable consumers to unsuitable offers, unfair sales practices, and the purchase of credit products that were clearly inappropriate for them".

Moreover, the same OECD report continued by noting that:

"*This calls for a balanced policy focus on financial education and consumer protection, and reinforces the importance of financial literacy as a necessary complement to (rather than a substitute for) a sound framework for financial market regulation and prudential supervision*".

Poor consumer protection and irresponsible lending practices do not only create financial instability in the countries characterised by such circumstances. The financial crisis of 2007/2008 has clearly shown that, through securitisation and interconnectedness of financial systems, the negative consequences of poor consumer protection and irresponsible lending practice have spread across the globe and resulted in financial instability in jurisdictions at a far distance from the jurisdictions in which the problems originally aroused[11].

In response, the G20 has given the mandate to a G20/OECD taskforce on financial consumer protection to develop a set of effective approaches to the ten High-Level Principles on Financial Consumer Protection endorsed by the G20 leaders in 2011. These principles are provided at Annex 1.

[8] Report of the Financial Crisis Inquiry Commission (2011) p. 101.

[9] Report of the Financial Crisis Inquiry Commission (2010) p. 125.

[10] OECD (2009).

[11] See, for example, Financial Stability Board (2011).

Financial literacy is considered by policy-makers[12] as "*life-skill for the 21st century*" and as a "*complement to financial inclusion and consumer protection policies*" and as such contributes to financial stability.

Unfortunately, financial illiteracy is widespread even in well-developed financial markets such as, among others, those of Germany, Italy, Netherlands and Sweden in Europe and Japan and the USA[13].

The academic literature consistently finds that many individuals perform poorly on test-based measures of financial literacy and identified a positive correlation between poor financial literacy and suboptimal financial outcomes. Yet, there is little consensus in the academic literature on the overall efficacy of financial education[14]. The latest analysis of the impact of financial literacy programs concludes that, "*while financial literacy and capability interventions can have a positive impact in some areas (increasing saving and promoting financial skills) but not in others (credit default)*"[15].

The limited financial literacy of consumers calls for strong consumer protection in financial markets as consumers empowerment through information disclosure and financial education is likely to be insufficient to adequately protect all consumers, especially in light of the recent findings from behavioural studies showing that consumers' ability to make rational and informed choices is limited[16].

The present study explores in greater detail how consumers in Europe may be hurt by or benefit from particular financial products and how such consumer detriments/benefits may be so significant that they also impact the functioning of the Single Market, either the Single Market in financial services or, more generally, the Single Market in goods and services.

More particularly, the study:

- identifies and describes major cases of bad advice, inappropriate and mis-selling in Member States;
- identifies financial services and products with potential serious disruptive impacts on individual consumers;
- identifies financial services and products with substantive beneficial effects for the operation of the Single Market and consumers, and conditions under which such impacts can be maximised;
- identifies efficient policy options to address disruptive effects and boost positive effects of financial services.

The report is structured as follows:

- chapter 2 sets out the analytical framework employed by the present study to assess the potential detriments and benefits to consumers and the Single Market of various financial products;
- chapter 3 reviews financial services and products with potentially serious disruptive impact for individual consumers and SMEs;

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[12] See Russian G20 Presidency and OECD (2013).

[13] See Lusari and Mitchell (2011) and Atkinson and Messy(2012).

[14] See Hastings, et al. (2012).

[15] See Miller et al. (2014).

[16] See Mak, V. (2013).

- chapter 4 discusses financial services with potentially serious disruptive impacts for the Single Market;
- chapter 5 presents financial services and products with substantive beneficial effects for individual consumers and SMEs;
- chapter 6 examines a number of financial services and products with substantive beneficial effects for the Single Market; and
- chapter 7 sets out conclusions and recommendations.

The detailed results of a stakeholder survey on major cases of bad advice, inappropriate and mis-selling in Member States are presented in the Annex.

2. METHODOLOGY

KEY FINDINGS

- The analytical framework adopted for the present study is articulated around the four key stages of a consumer's relationship with a financial product.
  - During the first stage, a consumer wishing to acquire a new financial product may undertake some research into the financial product of interest and providers of such products with a view to find the best value for money offer.
  - During the second stage, the consumer undertakes the actual acquisition of the financial product of interest.
  - During the third stage, the consumer holds the product. The duration of this stage varies depending on the product. Some financial products have a finite duration (for example, a personal loan or a mortgage loan, or a credit card) while other financial products have an unspecified duration (for example a bank account or an investment in equities).
  - Finally, for the products with pre-defined duration, the financial product matures or is liquidated (for example, a personal loan or a mortgage is fully repaid, or a pension pot is converted into annuities). In a number of cases, the liquidation of the financial product may not be voluntary (for example, when a borrower is unable to meet her/his financial obligations) and the holder of such a financial product may suffer serious financial consequences.
- The market for retail financial products is characterised by a number of features which imply that the retail financial markets do not always work to the benefit of consumers.
  - First, most consumers only buy infrequently new financial products and services. Therefore, when buying a new financial product or service, they do not have much past knowledge or experience to rely on for taking decisions.
  - Second, many financial products and services can be rather complex, and putting together the information required for making an informed choice is costly in terms of time. As a result, consumers may acquire new financial products or services based on only limited information. Often such information is given by the financial service provider selling the financial product or service. In contrast, financial service providers are usually well informed about the product and services they are selling.
  - Third, typically individual consumers have little bargaining power in retail financial markets as they generally face large financial service providers in many retail financial markets.
  - Fourth, many financial products and services have a relatively long duration, and the problems and issues that they may potentially cause for consumers, manifest themselves only with a long lag. It is therefore difficult for consumers to properly asses the true cost of a financial product and its riskiness.
  - Fifth, the avenues open to consumers to address financial problems once they have occurred, such as, for example, formal debt discharge or debt reduction processes, may be close to nil in some cases or may be costly, take a long time and yield a result which is uncertain at the outset.
  - Sixth, a number of consumers also have limited financial literacy skills and exhibit a number of behavioural biases which tend to amplify the issues described above.
  - Overall, because of these various market features, strong consumer protection is essential to ensure that consumers do not suffer detriment in financial markets.

- To inform the study, a large-scale information gathering exercise (stakeholder consultations, literature review, etc.) was undertaken to identify financial products and services which have a significant potential to be highly disruptive or beneficial for consumers or the Single Market :
  - Financial products and services are considered to be disruptive to consumers if the consequences of inappropriately selling or mis-selling have the potential to cause major financial harm to individual consumers.
  - Financial products and services are considered to have the potential to be highly disruptive to the Single Market if the consequences of inappropriately selling or mis-selling have the potential to:
    1. cause financial instability in the Single Market – in some cases a particular product may have the potential to result in both significant financial harm for some consumers and wider financial instability; or
    2. affect a large number of individual consumers in national markets – while the financial health of individual consumers may not be impacted to the same extent as in the first case and financial stability is not impacted, the large number of potentially affected consumers implies that aggregate demand may be negatively impacted, and hence cross-border trade and the functioning of the Single Market; or
    3. directly impact negatively on cross-border trade in financial services.
- Financial products and services which are beneficial to consumers and the Single Market are those which yield directly substantial benefits to consumers and/or benefit the Single Market by contributing to financial stability, avoiding depressing consumers' purchasing power or stimulating cross-border trade.

2.1. A framework for assessing the potential detriments and benefits to consumers and the Single Market of various financial products

2.1.1. Key background facts

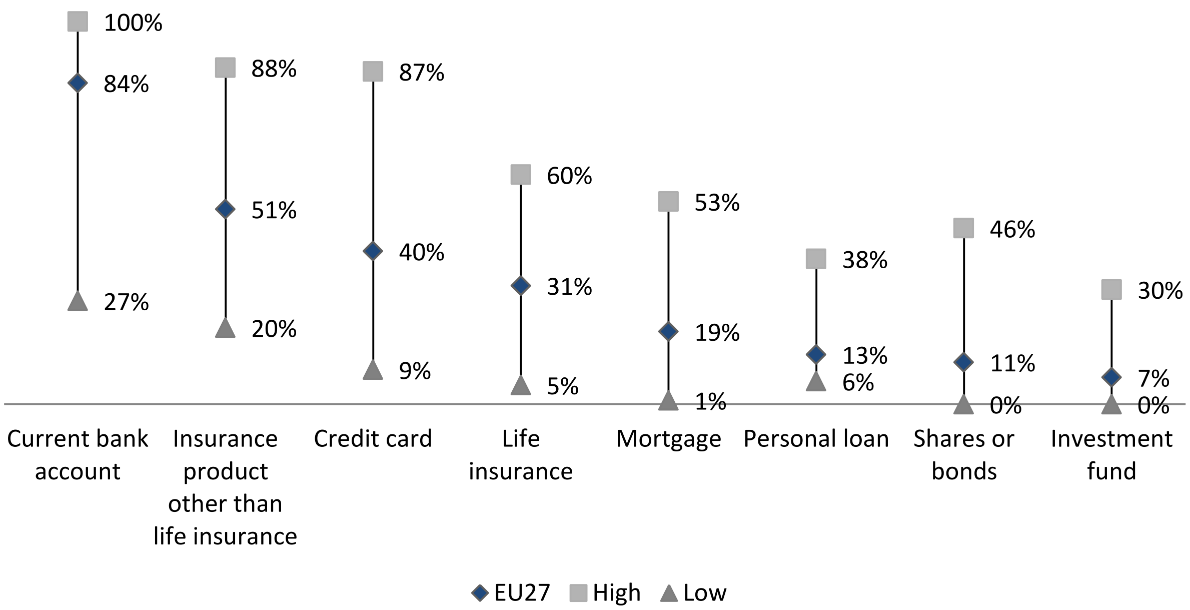
In order to be able to assess the potential detriments and benefits to consumers and the Single Market of various financial products, it is useful to consider the various life-cycle stages of a consumer's relationship with a particular financial product.

However, before considering these various life-cycle stages, it is important to note first that <u>ownership of various financial products varies greatly across types of financial products and EU Member State</u>.

For example, according to the special Eurobarometer on financial services, ownership across the EU27 of financial products ranged from 84% to 7% for investment funds (see Figure 1). Moreover, the Eurobarometer results also show a great deal of variation across the EU27 Member States in ownership of the various financial products covered by the Eurobarometer survey. For example, in the case of bank account ownership rates range from a low of 27% in Romania to a high of 100% in Denmark, and in the case of investments funds, the ownership rate ranges from 0% in Bulgaria and Romania to 30% in Sweden[17].

[17] A zero ownership rate reported in the Eurobarometer report does not mean that ownership of a particular financial product is absolutely nil in a given country. However, it implies that the ownership rate is very small, in fact so small that it cannot be identified in the survey sample.

Figure 1: Ownership rate of different financial products in the EU27



Note: Fieldwork was done in September 2011.

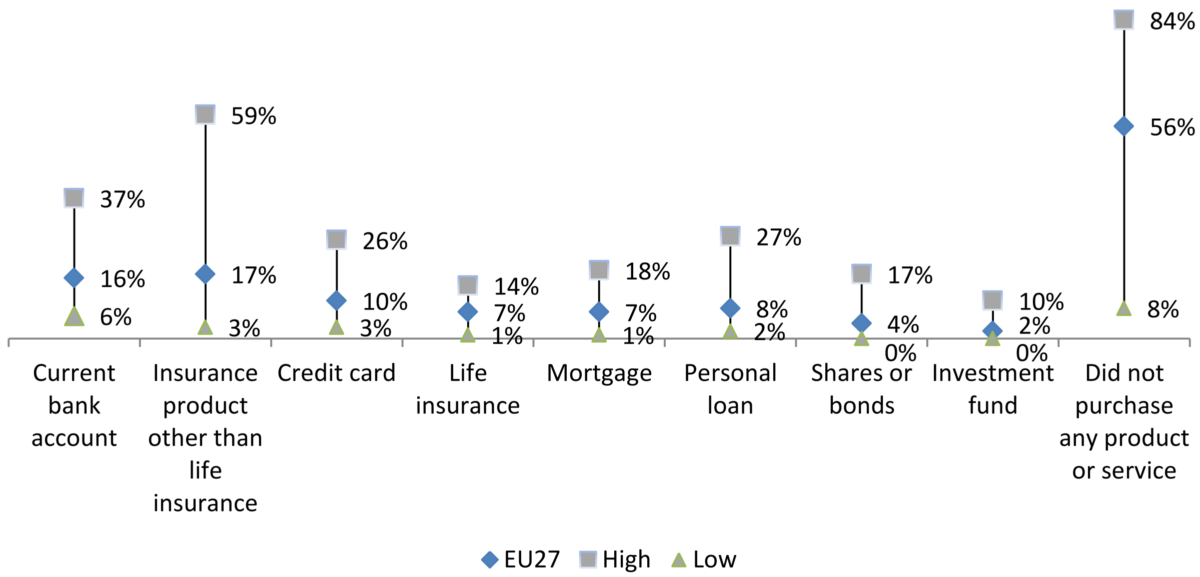
Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

A second and very important point to note is that <u>consumers do not buy frequently financial products</u>. For example, the same Eurobarometer report shows that, of all EU27 respondents to the Eurobarometer survey, 56% did not purchase any of the financial products covered by the survey over the 5 years preceding the survey.

Moreover, a more detailed analysis of purchasing frequency across the different financial products covered by the Eurobarometer study shows that, across the EU27, the proportion of consumers who have bought such products is very low, ranging from 2% in the case of investment funds to 17% in the case of insurance products other than life insurance (see Figure 2).

The fact that consumers buy financial products only very infrequently means that they have very little experience and knowledge in buying such products.

Figure 2: Share of respondents to 2011 Eurobarometer survey who have purchased a financial product or service during the 5 years preceding the survey

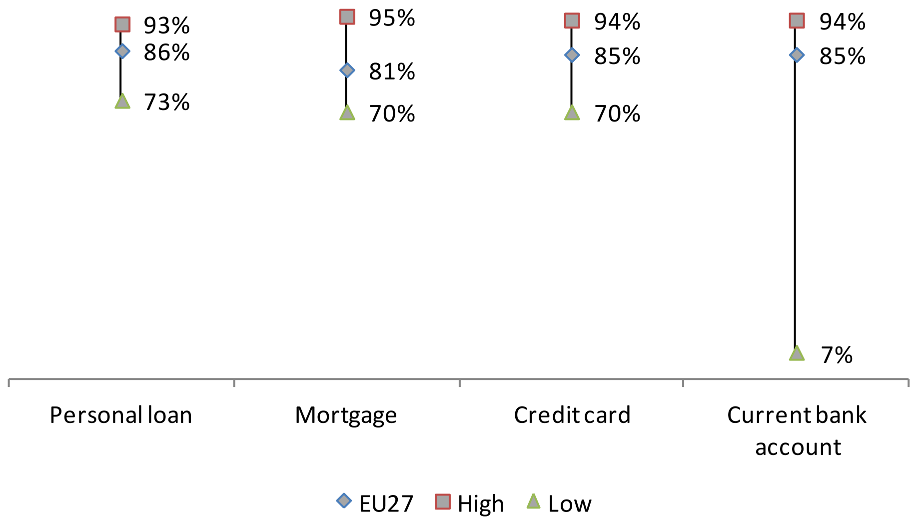


Note: Fieldwork was done in September 2011. High, low among EU27 Member States.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

Third, a final important point to note is that generally consumers do not tend to switch financial service provider. For example, according to the Eurobarometer report on financial services, 81% to 85% survey respondents across the EU did not switch service providers during the 5 years preceding the Eurobarometer survey (see Figure 3).

Figure 3: Share of respondents to 2011 Eurobarometer survey who did not switch or did not try to switch financial service provider during the 5 years preceding the survey



Note: Fieldwork was done in September 2011. High, low among EU27 Member States.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

The three characteristics described above, namely low ownership rates in the case of some products, infrequent purchases of financial products and low service provider switching rates imply that consumers may face a number of disadvantages when they venture into financial markets. This point is explored in greater detail below in the context of the life-cycle analysis of a consumer's relationship to a financial product.

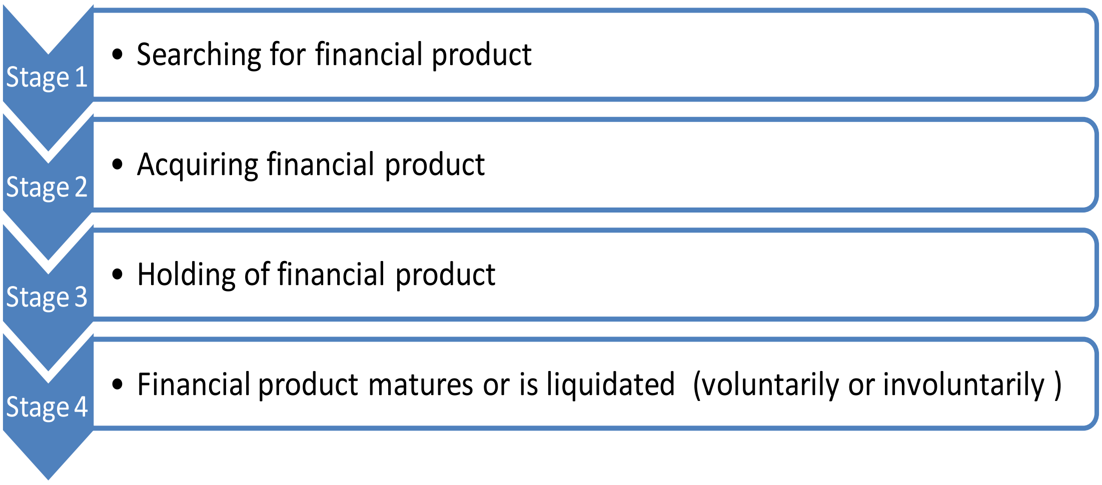
2.1.2. The life-cycle of a consumer's relationship to a financial product

In the most simplified terms, one can distinguish four main stages of the life-cycle of a consumer's relationship to a financial product:

- During the first stage, a consumer wishing to acquire a new financial product may undertake some research into the financial product of interest and providers of such products with a view to find the best value for money offer.
- During the second stage, the consumer undertakes the actual acquisition of the financial product of interest.
- During the third stage, the consumer holds the product. The duration of this stage varies depending on the product. Some financial products have a finite duration (for example, a personal loan or a mortgage loan, or a credit card) while other financial products have an unspecified duration (for example a bank account or an investment in equities).
- Finally, for the products with pre-defined duration, the financial product matures or is liquidated (for example, a personal loan or a mortgage is fully repaid, or a pension pot is converted into annuities). In a number of cases, the liquidation of the financial product may not be voluntary (for example, when a borrower is unable to meet her/his financial obligations) and the holder of such a financial product may suffer serious financial consequences.

Each of the four stages is discussed in detail below.

Figure 4: Four main stages of consumer relationship with a financial product



Source: London Economics.

2.1.3. Searching for a financial product

As was already noted above, consumers generally do not frequently buy financial products. This implies that consumers have little experience and knowledge of the product and would need to devote significant resources in identifying the precise product and provider which would meet their needs the best.

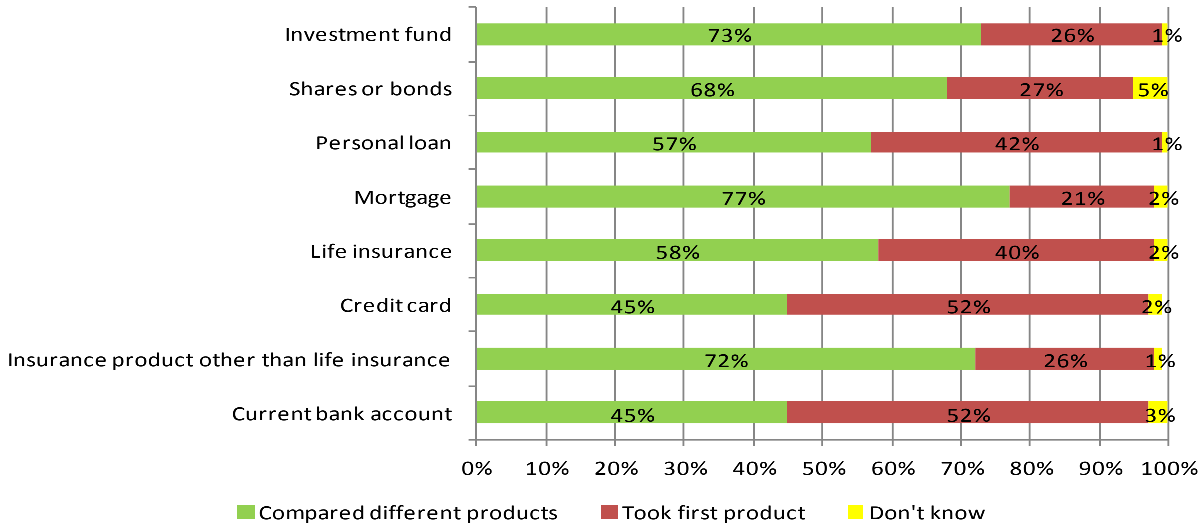
In contrast, by definition financial service providers are regularly engaged in selling the financial products of interest to consumers and thus have a superior knowledge about these products.

This creates an imbalance in the relation between the buyer and the seller of the financial product in favour of the seller, even if the consumer is fully rational and undertake a significant amount of searching (which is costly in terms of her/his time and financial resources)[18].

As will be seen in the discussion of the acquisition stage (stage 2), the consumer is not fully rational and generally suffers from a number of behavioural biases.

Overall, and possibly as a result of such behavioural biases, many consumers may undertake only limited searching. Depending on the financial product, between 21% (investment fund) and 52% (current account) took the first product that they found (see Figure 5).

Figure 5: Frequency of shopping around for financial product



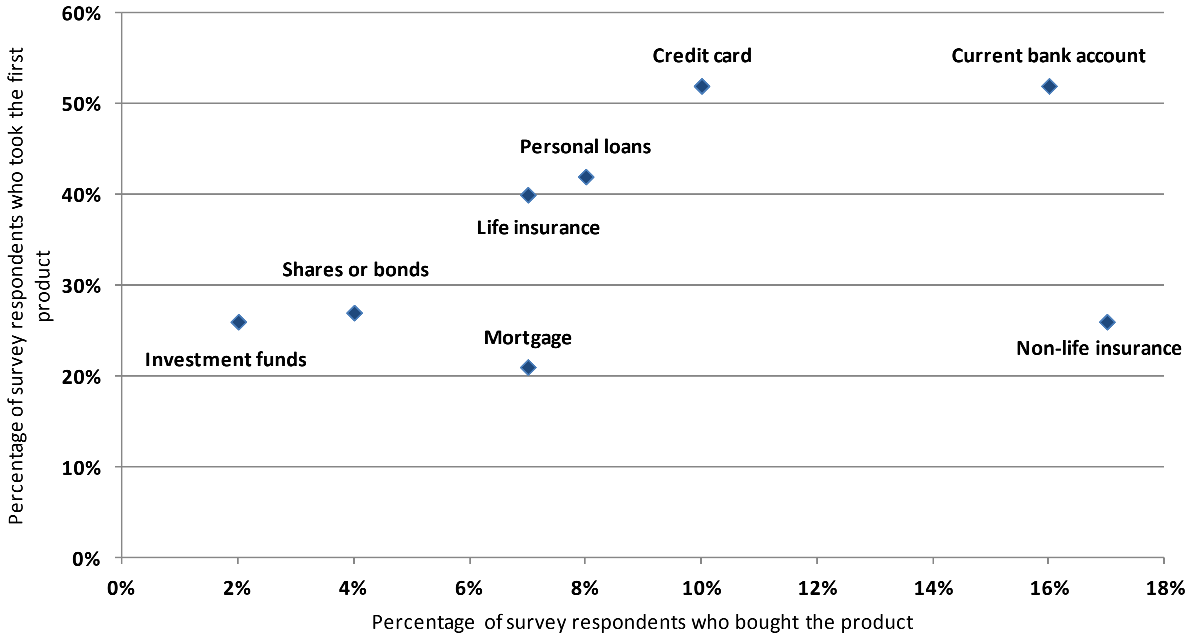
Note: Fieldwork was done in September 2011.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

Interestingly, the products which the fewest survey respondents reported having bought over the five years preceding the Eurobarometer survey are those which show the highest shopping around rates, possibly reflecting the complexity of these products.

[18] Price comparison websites (PCWs) facilitate shopping around. For example, in the UK, according to the UK Financial Conduct Authority, "almost half of all Internet users have used PCWs to research motor insurance, with four out of five going to buy insurance through this channel. A quarter of all internet users have bought home insurance through a PCW". However, at the present time, it is not clear whether the information of such PWCs is sufficiently transparent and accurate and consumers are not overly focusing on price in their comparison and selection of product at the expense of scope of coverage, and other terms and conditions (See 24 November 2013 announcement by the UK Financial Conduct Authority of a thematic review of insurance PCWs).

Figure 6: Intensity of shopping around for financial product and frequency of purchase of financial product among Eurobarometer survey respondents



Note: Fieldwork was done in September 2011.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

2.1.4 Acquisition of the financial product

While a number of consumers shop around before buying a financial product, a substantial proportion of the Eurobarometer survey respondents did so without receiving any recommendation.

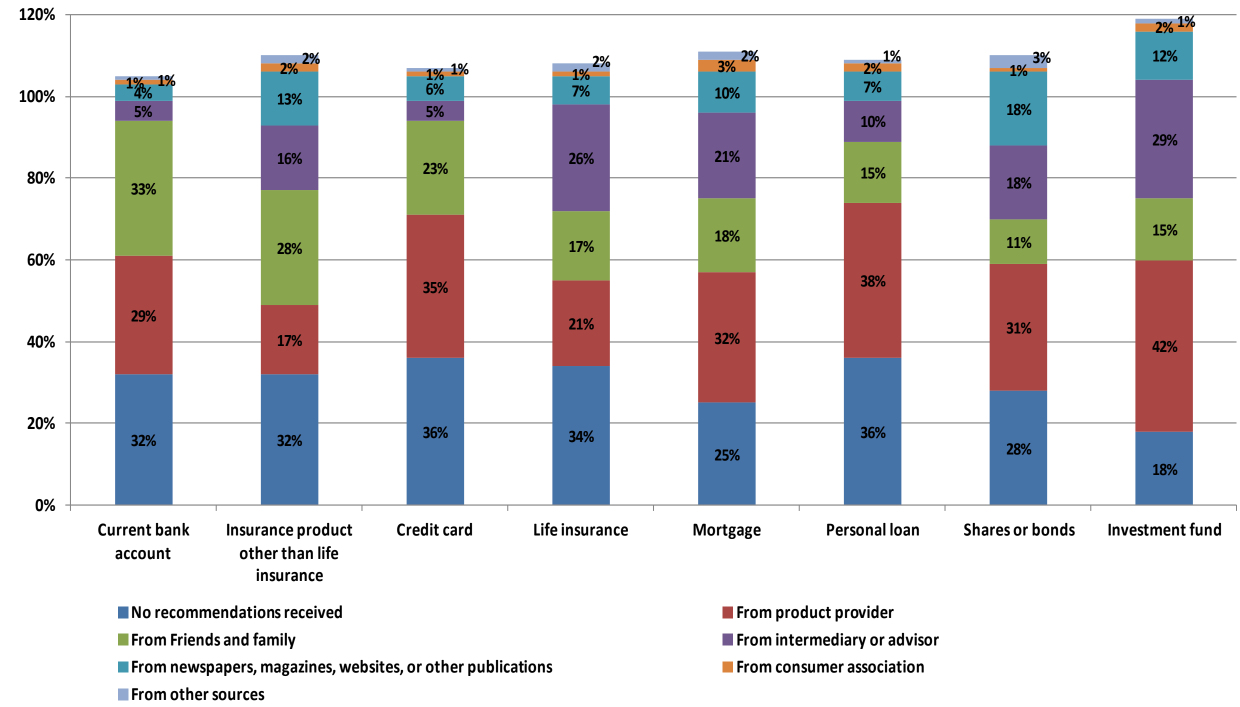
For example, depending on the financial product, between 18% and 36% of the respondents to the Eurobarometer survey did not receive any recommendation before buying a financial product (See Figure 5).

Moreover, 17% and 42% of survey respondents received a recommendation from the service provider.

Only between 5% and 29% of survey respondents received a recommendation from an intermediary or an advisor[19].

[19] Survey respondents could give multiple answers to the question "Did anyone recommend a particular product to you or dud you read any recommendations anywhere?". However, as the sum of the proportion of the different responses ranges from 105% to 110% (with the exception of investment funds for which the sum of the proportion of responses is 120%), most of the survey respondents identified only one recommendation source.

Figure 7: Source of recommendations for purchase of financial product or service



Note: Fieldwork was done in September 2011.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

When the consumer buys a financial product she/he faces a number of challenges even when she/he acts on the basis of recommendations and a wrong decision may have financially catastrophic consequences for the consumer and give rise to considerable consumer detriment[20].

Unfortunately, the occurrence of a consumer buying a financial product which is inappropriate or excessively risky given the consumer's circumstances is not infrequent.

Such a situation is due to:

- market failures,
- regulatory failures,
- consumer behavioural biases,
- financial institution behaviour.

a) Market failures

The previous section reviewed the various sources of consumer detriment, some of which arise from potential market failures which include among others:

- The *market power* of financial institutions – this is particularly an issue in the case of the retail financial sector where individual consumers deal with typically large entities. In such circumstances, the financial institution has most of the bargaining power.

[20] See Annex 1 for a more general discussion of consumer detriment.

  - Maudos and Guevara (2006) estimated the impact of market power in the loan and deposit markets was a welfare loss in 2002 in the EU-15 of 0.54% of the GDP. However, according to de Guevara et al (2005) the degree of competition varies vastly depending on the banking product considered (consumer loans, mortgage loans, deposits and so on), meaning that consumer detriment varies across the sector. Contrary to Maudos and Guevara's findings, the OECD (2010) notes that less intensive competition and increased market power for individual banks may potentially encourage financial innovation by reducing the free-rider problem. This then may result in expanded access to credit for borrowers by decreasing the degree of credit rationing.

- *Asymmetric information and agency costs* - infrequent acquisitions of certain financial sector products such as mortgages, pension products and other investment products. As the consumer buys such products only infrequently he/she has less knowledge about them than the financial institution selling the product which deals very frequently in such products. This situation may be compounded by problems of ascertaining the quality at the point of purchase. The asymmetric information can be used to exploit the consumer.

- *Information costs* – a related point is that it is costly (in terms of time and from a financial point of view) for a consumer to gather the information required to take a properly informed decision. This is especially the case for more complex products. As a result, the consumer may not undertake a comprehensive information search while the financial institution will have extensive information on the products it and its competitors sell.

  Davies (1998) argues that two forms of information asymmetry are particularly prevalent in financial markets:

  - Complexity of contracts is common among financial products[21].
  - Difficulties in judging the soundness of firms as a second information problem.

  Information costs may result in under-investment in information and free-rider problem whereby consumers assume that others have undertaken the necessary due diligence.

- *Principal – agent problem and issues related to conflict of interest.*
- *Imprecise definition of products and contracts.*

- Asymmetric distribution of costs and benefits of deficient financial product – in some cases, the cost borne by a consumer as a result of a deficient financial product may be small and, therefore, the consumer may not seek any redress. However, the benefits arising from this deficiency may be large to the financial institution if many customers were impacted.
- Cost of seeking redress – depending on the legal environment and the availability of cost-efficient redress mechanism, the consumer may be discouraged from seeking redress.

[21] Also highlighted by the Sandler Report (2002) which found complexity problematic with regards to retail savings products, relative to other consumer goods.

b) Regulatory failures

Regulatory intervention can result in consumer detriment, either as an act of omission or as an act of commission. Unfortunately, for the financial sector, this is less exhaustively covered in the literature.

One key study is the Oxera report '*A framework for assessing the benefits of financial regulation*' (2006) by the UK Financial Services Authority. The authors outline the potential benefits of regulation in mitigating consumer detriment in financial markets. This is illustrated by a table on the potential consumer detriment that may be experienced when regulation is under-provided or lacking.

Figure 8: Consumer detriment and regulation

Types of consumer detriment in the absence of regulation	Example/explanation of detriment	Potential benefits of regulation
Sub-optimal choice	'Mis-buying' of financial products (eg, when poorly informed consumers decide to buy a product not suitable for them)	Value that consumers derive from better choice (ie, more optimal fit between what they buy and what they need)
Reduced choice	Lack of consumer confidence may make it not worthwhile for firms to offer certain types of product, reducing the choice set available to consumers	Value that consumers derive from increased choice (ie, reduction in opportunity cost of not being able to buy what could be available)
Higher costs—from operational risks	Losses that arise to consumers as a result of an operational failure by a firm (eg, 'mis-selling' or other negligent advice, fraud, systems breakdown); higher prices if failure is compensated by the firm and cost passed on to consumers	Reduction of expected losses and other costs associated with operational failure
Higher costs—from financial risks	Losses that arise to consumers as a result of the default of a firm (eg, deposited funds cannot be returned, losses from operational failures cannot be compensated)	Reduction of expected losses and other costs associated with financial failure
Higher costs—from systemic risks	Costs incurred by consumers due to widespread failures of the financial system	Reduction of expected losses and other costs associated with systemic failure
Higher prices—from market power of firms	Consumers pay excessively high prices to a firm exercising its market power	Reduction of excessive prices
Higher costs—from transaction/ system inefficiencies	Consumers incur higher transaction costs (eg, due to the need to monitor financial intermediaries if there is no regulator to perform this function)	Reduction of transaction costs/prices arising from inefficiencies, including consumer search costs
Financial exclusion	Even if markets were efficient, some consumers may not be able to gain adequate or affordable access to financial services	Value consumers derive from improved access to financial services

Source: Oxera (2006).

The authors identify sub-optimal and reduced choice, higher costs from operational, systemic and financial risks as well as higher prices (resulting from market power and system inefficiencies) and potential financial exclusion as types of consumer detriment that could be mitigated by regulation. Where the consumer detriment types listed remain present, this may be considered a regulatory failure as it constitutes an act of omission.

The other regulatory failure giving rise to consumer detriment is when proper regulatory regimes are lacking or inefficient. For example, London Economics (2013) reviews consumer bankruptcy and debt collection regimes across Europe, and identifies the impact that different legislative and regulatory designs have on consumers, including over long periods of repayment, a lack of opportunity to address problematic debt and failures to take best practice into account.

c) Consumer behavioural biases

Behavioural studies identify a number of reasons why consumer may take erroneous decisions in financial markets[22]:

- many products are inherently complex for most people;
- many products involve trade-offs between the present and the future;
- decisions may require an assessment of risk and uncertainty;
- decisions can be emotional;
- some products permit little learning from the past.

Biases in consumer decisions arise because consumer preferences are influenced by emotions and psychological experiences, the use of rules of thumb can lead to incorrect beliefs and consumer use short-cuts when making decisions[23].

In fact, the literature on behavioural biases as a source of consumer detriment in financial markets is relatively broad, addressing many expected aspects – cognitive limitations, inertia, discounting and projection bias.

- The effects of cognitive limitations on consumers' choices in financial markets have widely been observed. One issue is that consumers underestimate future repayments (see Ramsay (2005) as well as Ausubel (1991) in a study on the credit card market). Similarly, Ausubel (1999) observes that consumers often underestimate future use of credit. This presence of limited foresight can also be related to myopia, which has been discussed in the context of the observed practice of firms charging high prices for add-on products and obscuring them to customers (Gabaix and Laibson, 2006; Baker and Siegelman, 2013).
- With regards to discounting, Gabaix and Laibson (2006) argue that consumer behaviour in this context is explained by their failure to engage in Bayesian updating. Partially supporting this finding, Bertrand (2005) finds that additional information tends to distract consumers and cause them to make poorer, sub-optimal choices due to cognitive limitations.
- Projection bias constitutes another known problem in retail financial markets. Loewenstein, O'Donoghue, and Rabin (2003) first labelled the tendency to systematically underestimate the magnitude of changes in their tastes or preferences projection bias. Evidence of such issues in the financial sector has been identified by Della Vigna and Malmedier (2006) who have shown that self-control problems can lead to lower consumption of investment goods and higher consumption of leisure goods, caused by time-variant preferences on market interactions. As the benefits of investment goods are delayed whilst the costs are not, the authors conclude that these are less attractive for consumers suffering from projection bias. Financial products such as credit cards, however, where costs are delayed and benefits are immediate, therefore appeal more to consumers.
- Another issue to financial products is inertia - even if better products exist, consumers fail to switch. Madrian and Shea (2001) investigate the effects of inertia with reference to automatic enrolment in savings plans and find that under automatic enrolment employees tend to stick to the default rate set, rather than adjusting it over time.

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[22] Financial Conduct Authority (2013).

[23] This point is further discussed in chapter 3 in the section on the causes of consumer detriment.

d) Financial institution behaviour

The academic literature in relation to this topic is relatively scarce. A few issues have already been touched upon in the section on behavioural biases as both are closely interrelated: intentionally or unintentionally firms often seem to exploit consumer in their selling of financial product (for example Bertrand, 2005 or Gabaix and Laibson, 2006 or de Meza and Reyniers, 2012).

However, some further material exists within the 'grey literature', as this issue has received more attention after the rapid growth of complex residential mortgage products which were sold to poorly informed parties,[24] and were a significant factor in the financial crisis of 2007/2008. The latter developments shifted attention towards the supply-side's practices contribution to personal consumer detriment. For example, the UK Financial Conduct Authority notes that, based on their experience, issues in financial markets often arise because firms' product design and sales processes may accentuate rather than mitigate the effects of consumer behavioural biases (FCA, 2013)[25].

Misleading advertising as a stand-alone issue has received some attention. For example, the Australian Securities and Investment Commission notes that advertisements that do not fairly represent financial products or its key features and risks, or the nature and scope of the advice service, can be misleading and create unrealistic expectations for the consumer that may in turn lead to poor financial decisions (Australian Securities and Investment Commission, 2012).

Misleading claims are also highlighted as a key source of consumer detriment in the retail banking sector in a report by HM Treasury (2013).

However, consumers' behavioural biases and firm behaviour are closely related (FCA, 2013). The presence of behavioural biases can encourage firms to compete in ways that are not in consumers' interests, for example by offering products that appeal to the consumer because they play to biases. Whether these practices grouped as 'potential lender (mis)behaviour' are intentional is difficult to judge and often problems with products may arise unintentionally. It is also important to note that behavioural biases by themselves may already lead to significant consumer detriment, without any specific lender mis-selling.

e) Trust in financial service provider

As a result of the many problems and issues which have manifested themselves in retail financial markets in recent years, consumer trust in financial service providers is among the lowest of all the markets covered by the Consumer Markets Scoreboard produced regularly by EC DG for Health and Consumers.

Only 33% to 40% of consumers have a high degree of trust in financial service providers and 19% to 23% have no or very limited trust (see Figure 9). Yet, paradoxically, many consumers do not have any recommendation or rely on the recommendation of the service provider when they buy a financial product.

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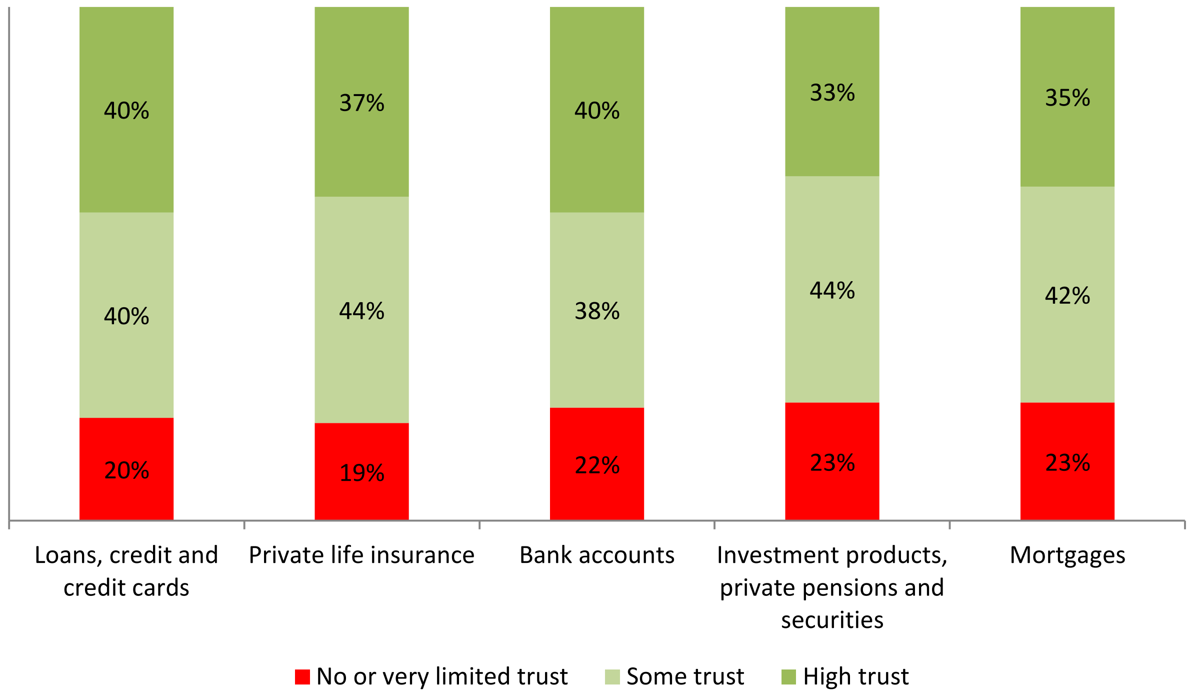
[24] For example World Bank (2010).

[25] For example, the UK Financial Conduct Authority fined a number of financial institutions (Lloyds TSB bank and Bank of Scotland (both part of the Lloyds Banking Group) in December 2013 for employing retail staff incentive schemes that "*led to a serious risk that sales staff were put under pressure to hit targets to get a bonus or avoid being demoted, rather than focus on what consumers may need or want*". "*Seven out of ten advisers at Lloyds TSB and three out of ten at Halifax (part of the Bank of Scotland) still received their monthly bonus even though a high proportion of sales were found by the firms themselves to be unsuitable of potentially unsuitable*" (FCA press communiqué of 11 December 2013).

Figure 9: Trust in financial service provider



Note: Rating scale of 1 to 10. No or very limited trust is a rating of 0 to 4, some trust is a rating of 5 to 7 and high trust is a rating of 8 to 10.

Source: 8th Edition of Consumer Markets Scoreboard – Making markets work for consumers, December 2012.

2.1.4 Holding of financial product

Typically, the holding period of a financial product is relatively long. The long duration combined with the various behavioural biases described earlier means that the consumer is often not able to fully assess the risk or the financial consequences of a particular financial product.

In particular, the risk of adverse events that may occur in a more distant future is likely to be underestimated due to optimism bias.

Moreover, even small but recurring problems with a financial product can give rise to considerable consumer detriment over the longer run and the financial consequences can be substantial.

The issue of a small recurring problem with large financial consequences affects all financial products subject to a monthly or annual charge or fee.

Savings and investment products are particularly subject to such recurring charges. But, other financial products such as bank accounts, insurance products and credit products may also in some cases be subject to recurring charges which may not seem to be very high but which over the life of the financial product can cumulate to significant amounts.

The box overleaf illustrates this point for the case of annual management charges levied by providers of defined contribution pension saving products. A difference in the annual management charge of 1 percentage point, i.e. the difference between annual management charges of 0.5% and 1%, reduces by almost ¼ the pension pot that is available for retirement at the end of the contribution period.

A consumer may not perceive a 1 percentage point difference as being large and worrisome and, therefore, may not take action to address this issue. Yet, over the lifetime of this financial product, the small annual difference will cumulate and result in major financial consequences for the whole period the consumer will spend in retirement.

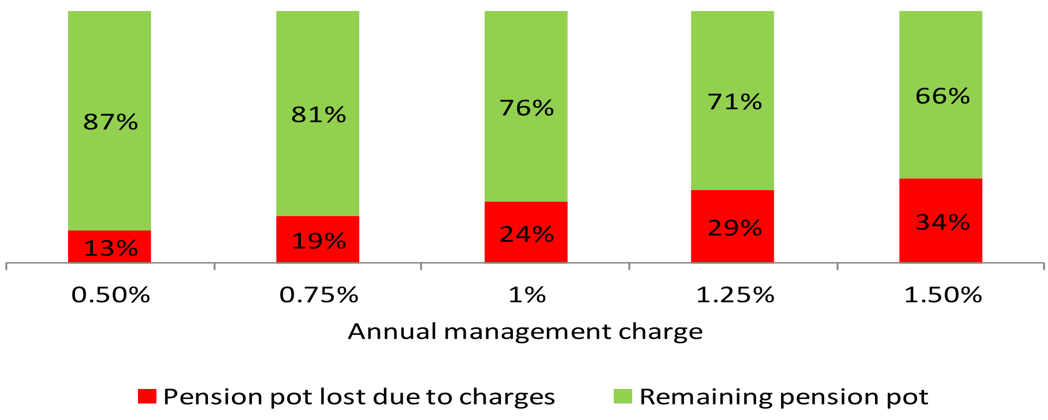
Box 1: Impact of the level of annual charges on the ultimate level of pension savings

The example below is drawn from a recent consultation document from the UK Department for Work Pension. In the example, an individual is assumed to make pension contributions during 46 years. The initial contribution is EUR 1 200. Assumed investment growth and annual contribution growth are 7% and 4% respectively. After 46 years of saving, the total pension pot that in the absence of any annual management charges would have been accumulated by the time the individual starts to draw pension income from the pot is EUR 701 800.

However, in practice, the pension service provider will levy an annual fee for the management of the pension contributions of the consumer. The figure below shows vividly that the level of the annual management charge has a major financial impact on the amount of pension income - an annual management charge of 0.5% reduces the pension pot by 11% relative to the size of the pension in the absence of any charges while an annual management charge reduces the pension by more than 1/3 (Figure 10).

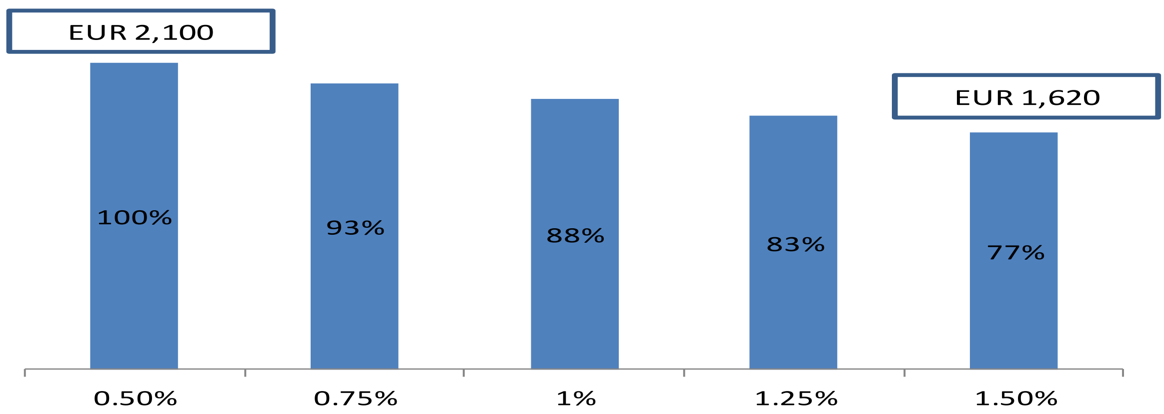
This implies that, with an annual management charge of 1.5%, the monthly pension income (i.e. the monthly annuity) of the retired consumer would be only EUR 1 620 while with a management charge of 0.5%, the monthly pension income would be EUR 2 100 or 33% higher (Figure 11).

Figure 10: Distribution of pension pot between charges and funds available for retirement under different annual management charges



Source: London Economics based on UK Department for Work and Pensions (2013).

Figure 11: Monthly pension under different annual management charges during pension savings period



Source: London Economics based on UK Department for Work and Pensions (2013).

2.1.5 Financial product matures or is liquidated (voluntarily or involuntarily)

In many cases, financial products with a defined duration mature with no particular problem. For example, credit extended to a consumer is fully repaid on schedule.

However, in certain cases, a borrower may not be able to fulfil her/his financial obligations and defaults on a credit.

The literature on the main causes of over-indebtedness identifies three broad categories of factors:

- Persistent low-income. Those who live on low income often find themselves in debt simply because living at such a low-level of income is unsustainable.
- Negative shocks. This could be due to several 'significant life events' such as job loss or redundancy, relationship breakdown, bereavement and illness/disability all of which result in a sudden lower level of income and/or increased expenditure. An unanticipated increase in expenditure can be due to other factors, e.g. the need to replace unexpectedly an appliance or a car. However, Kempson (2002) found that job loss was the largest factor contributing to debt problems.
- Poor money management/lack of financial understanding/over-commitment of credit – some debt advice seekers cited the 'build up of credit over time' as a cause of debt, others lacked the skills to manage their money or were financially excluded.

For the purpose of the present report, it is the second cause, i.e., the negative shock, which is of particular interest.

Even if consumers understood the characteristics of the financial credit product they bought and there was no mis-selling or inappropriate selling by the lender, they can still find themselves in a situation where they are no longer able to afford the credit because of income loss due to unemployment, ill health, etc.

In most EU Member States, there exist formal processes (such as personal bankruptcy for example) which allow a borrower, who is no longer able to meet contractual financial obligations, to benefit from a significant reduction in the debt burden she/he carries to a level commensurate with the borrowers' new economic and financial circumstances and be given a second chance.

Unfortunately, the legal process that a defaulting borrower has to undergo to achieve such a debt reduction burden may be, in a number of cases, complex, costly and possibly uncertain in terms of outcome, a situation which will impact negatively on the defaulting borrower's welfare.

More importantly, in a few countries (Hungary, Romania, Spain) there exists no formal mechanisms for honest borrowers who default on their financial obligations to extract themselves from over-indebtedness and be given a second chance.

As a result, a borrower defaulting on a mortgage loan may not only lose the savings used together with a mortgage to acquire a residential property. But, depending on the evolution of house prices since the acquisition of the property and the level of default penalties charged by the lender, the individual may by burdened by substantial on-going debt even after liquidation of the property (see example in Box 2 below)[26].

Box 2: Impact on consumer of default on mortgage obligation with no mortgage debt relief and penalty charges - the Spanish mortgage market

A key feature of the Spanish mortgage market is that, contrary to the case in most EU Member States, a mortgagee who defaults on her/his mortgage obligations and whose property is repossessed by the mortgage lender remains liable for the difference between the value of the mortgage at the time of default and the value of the repossessed property when it is sold on the market.

When the mortgage lender is unable to sell the property because of lack of buyer interest, the mortgage lender can legally write down the value of the property by 50% relative to its value at the time the mortgage was granted.

In addition, the mortgage lender is allowed to charge a penalty rate on the mortgage outstanding at the time of default.

The example below, based among others on the detailed information available in a recent European Court of Justice case on a Spanish mortgage[27], shows that the combination of a) lack of proper exit mechanism through a formal process for writing-off at least in part if not in full the mortgagee's liability when she/he cannot meet her/his financial obligations, b) declining house prices and c) penalty rates for defaulting can have catastrophic consequences for the consumer.

For illustrative purposes, it is assumed that a consumer bought a house in January 2007 for EUR 200 000 with the help of a EUR 160 000 mortgage amortised over 30 years at a fixed rate 5.5%[28]. The consumer defaults in January 2011. Assuming a constant mortgage repayment schedule, the consumer will have reduced the principal amount outstanding by almost EUR 8 700 at the time of the default.

The financial consequences for the consumer of defaulting on her/his mortgage obligations depend on the extent of the house price decline and the level of penalty rate applied by the mortgage lender.

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[26] The need for a proper personal bankruptcy regime is also highlighted in the latest IMF report on the financial sector reform in Spain (see IMF 2013). For a more general discussion of how to deal with the personal debt overhang in Europe see London Economics (2013) and Liu and Rosenberg (2013).

[27] See Court of Justice of the European Union, press release No. 30/13, 14 March 2013, Spanish legislation infringes EU law to the extent that it precludes the court which has jurisdiction to declare unfair a term of a loan agreement relating to immovable property from staying the mortgage enforcement proceedings initiated separately.

[28] Almost all mortgages in Spain are variable rate mortgages. The fixed rate assumption is only used to simplify the calculations of the residual value of the mortgage at default.

Three different situations will arise:

- First, the defaulting mortgage holder will come out whole out of the default only if the house price does not decline and the penalty rate is nil or small - these are the two cases shown in italics in the table below.
- Second, the defaulting mortgage holder loses partially or fully her/his savings (EUR 40 000) used for the purchase of the property. But, she/he does not end up with an on-going liability. Such circumstances arise when the house price decline is relatively limited and/or the penalty rate is small.
- The third situation arises when either penalty rates are high and/or house price declines are large. In such circumstances, the defaulting mortgagee does not only loose all her/his savings used for the purchase of the property but also ends with an on-going liability which can be very large if the house price decline is substantial and the penalty rates applied by mortgage lenders are high. These cases are shown in bold in the table below.

Table 1: Asset (+) /liability (-) of mortgage holder defaulting in Spain under different house price and penalty rate assumptions

Penalty rate	0%	5%	10%	15%	20%
Change in house price value					
0%	*+48,651*	*+41,083*	+33,516	+25,948	+18,381
-5%	+38,651	+31,083	+23,516	+15,948	+8,381
-10%	+28,651	+21,083	+13,516	+5,948	**-1,619**
-20%	+8,651	+1,083	**-6,484**	**-14,052**	**-21,619**
-50%	**-51,349**	**-58,917**	**-66,484**	**-74,052**	**-81,619**

Source: London Economics.

2.2 Financial retail products and services which may be problematic for consumers and the Single Market

The results of the survey of stakeholders reported at Annex V show that a number of financial products or services have been inappropriately sold or mis-sold and caused considerable harm to groups of consumers (Table 2).

Table 2: Financial products and services with potentially large disruptive effect for consumers/SMEs or the Single Market

Financial product/service issue identified by stakeholders	Potentially disruptive to consumer/SME	Potentially disruptive for Single Market
Foreign currency mortgages (and variable rate mortgages)	✓	✓
Mis-selling of interest rate hedging products to consumers and SMEs	✓	✓
Products that carry high charges and fees	✓	
Credit products with high interest rates	✓	
Savings, investment and pension products yielding lower than expected returns	✓	
Mis-selling of payment insurance protection		✓
Sales of unsuitable investment products	✓	✓
Insufficient information regarding life insurance		✓

Source: London Economics analysis of results of stakeholder survey.

For the purpose of the present report, the following approach has been adopted:

1. Financial products and services are considered to have the potential to be highly disruptive for consumers if the consequences of inappropriately selling or mis-selling has the potential to cause major financial harm to individual consumers;
2. Financial products and services are considered to have the potential to be highly disruptive to the Single Market if the consequences of inappropriately selling or mis-selling has the potential to:
   a. cause financial instability in the Single Market – in some cases a particular product may have the potential to result in both significant financial harm for some consumers and wider financial instability; or,
   b. affect a large number of individual consumers in national markets – while the financial health of individual consumers may not be impacted to the same extent as in the first case and financial stability is not impacted, the large number of potentially affected consumers implies that aggregate demand may be negatively impacted, and hence cross-border trade and the functioning of the Single Market; or
   c. directly impact negatively on cross-border trade in financial services.

Financial products and services which are beneficial to consumers and the Single Market are those which either yield directly substantial benefits to consumers and/or benefit the Single Market by contributing to financial stability, avoiding depressing consumers' purchasing power or stimulating cross-border trade.

2.3 Benefits of financial sector regulation, especially of retail financial markets

Well functioning retail financial markets benefit consumers in many different ways. Among others, they allow consumers to:

- smooth their life-cycle earnings by providing a variety of savings instruments to accumulate funds to provide income during retirement;
- overcome their short-term budget constraints through borrowing for the acquisition of consumer goods and services, property, financial assets, etc.;
- protect themselves from various risks through insurance;
- economise on the need for cash through the use of alternative store of values (such as, for example, a current account) and payment instruments (such, as for example, direct debits or credit cards).

While the potential benefits of well-functioning retail financial markets are many, the preceding discussion identified a range of potential market failures and sources of consumer detriment in financial markets. In practically all cases, proper regulation and strong consumer protection can help overcome or at least mitigate these issues.

However the benefits from good regulation of financial markets and strong consumer protection are much wider.

At a high level, financial sector regulation aims to address the systemic risks posed by key financial institutions and avoid contagion of failure through the financial system. The new measures under Basel III and CRD IV together with a much rigorous assessment by regulators of the quality of the financial institution's reduces, but does not eliminate, the risk to extending credit (mortgage and consumer loans) to consumers which face a high risk of running into difficulties if the interest rate on such products increases or if their income is reduced substantially.

Consumers also benefit from such regulation focused on the avoidance of systemic shocks to the financial sector as it reduces the future risk of financial crisis and increases the stability of the economy.

Regulation also aims to reduce the risk of failure of individual financial sector firms. It is frequently argued in the literature that, for a variety of reasons, the failure of a financial firm can be more disruptive to a consumer than the failure of a non-financial firm. For example[29]:

- the amounts involved with financial firms are often greater;
- there are problems in information transfers (for example, shifting an account to another firm may not be frictionless or costless);
- financial firms are often involved in long-term relationships with customers; and,
- the financial firm has a fiduciary commitment to the customer.

[29] The list of factor is taken from Llewellyn (1999).

Well designed regulation also aims to address all the market failures discussed in the previous sub-section.

An important positive externality of regulation for consumers is the *increased confidence in financial markets and financial institutions* that good regulation gives to consumers.

Finally, good regulation of the financial sector also aims to *prevent situations where, because of competitive pressures, financial sector firms adopt hazardous strategies vis-à-vis their customer base to secure short-term advantages* even, if in the long run, such activities are not beneficial for their customers.

In concluding this section, it is important to note that, while all the discussion above focused on the benefits for consumers of robust and effective regulation of retail financial market, there exists an important, positive feedback loop from good consumer protection in financial markets to overall financial stability and reduced riskiness of individual institutions and the overall financial sector. This is due to the fact that such robust and effective consumer protection prevents financial institutions from taking excessive consumer lending risks.

3. FINANCIAL SERVICES AND PRODUCTS WITH POTENTIAL SERIOUS DISRUPTIVE IMPACT FOR INDIVIDUAL CONSUMERS AND SMES

KEY FINDINGS

- Financial products and services are disruptive for consumers when the economic and financial consequences of mis-selling, inappropriate selling, the crystallisation of the risk(s) embodied in a financial product or service, and the non-respect of the contractual obligations by the consumer may be such that the financial health of consumers is seriously impaired, and consumers may be pushed into a state of financial vulnerability.
- Many financial products and services differ from non-financial goods and services in the sense that the consequences of any issues and problems are typically much more drastic, and strong consumer protection is required in financial markets to prevent such disruptive impacts.
- The main financial products with a high potential of being disruptive to some consumers are those which:
  - carry risks which consumers may not fully understand when signing a contract for such products and which may create serious financial problems for consumers if the risks materialise or if borrowers can no longer meet their financial obligations;
  - carry high interest rates whose effects may not always be fully understood by some consumers;
  - are subject to high fees and charges which the consumer may not have properly understood when signing the contract. Such high fees and charges may impose a cash-cost burden on consumers and, more critically, in the case of savings, investment and pension products may erode the returns on such products and leave the consumer with a much lower than expected future income stream;
  - are subject to high costs in the case of non-respect by the consumer of her/his obligations (for example, high charges and fees in the case of non-repayment of payday loans or repossession of a principal residence in the case of non-respect by a mortgage holder of his/her obligations); or,
  - trap some consumers, especially more vulnerable consumers, into a spiral of ever-growing debt.
- The specific financial products and services, that the research has identified as being potentially highly disruptive, include the following:
  - a number of mortgage products such as variable rate mortgages, high loan-to-value and debt-to-income mortgages, foreign currency mortgages and mortgages sold with interest rate hedges and swaps – these products can be very risky for consumers;
  - loan products which carry a high risk of a substantial residual liability for a borrower because of lack of proper debt discharge or reduction mechanisms;
  - credit products with high interest rates, in particular payday/instant loans and credit cards with high rates combined with high limits – such products may push some consumers into a debt trap from which it is very difficult to escape without a formal debt reduction or discharge process;
  - savings, investment and pension products with high charges which reduce net returns to savers;
  - complex hedging products which carry high risk for the purchasers of such hedges.

3.1 Introduction

This chapter identifies and discusses financial products and services that have the potential to cause serious disruptive impacts for individual consumers and SMEs. A disruptive impact is defined as a financial impact which significantly affects the financial health of consumers, sometimes catastrophically so.

In the case of vulnerable consumers[30] and low-income earners, the financial quantum of the impact may be small but nevertheless very disruptive as such consumers have no capacity to absorb any financial shock.

The main financial products with a high potential of being disruptive to some consumers include those which:

- carry risks which consumers may not fully understand when signing a contract for such products and which may create serious financial problems for consumers if the risks materialise (i.e., such financial products put a consumer or an SME in a financially disruptive situation);
- carry high interest rates whose effects may not always be fully understood by some consumers;
- be subject to high fees and charges which the consumer may not have properly understood when signing the contract. Such high fees and charges may impose a cash-cost burden on consumers and, more critically, in the case of some savings, investment and pension products may erode the returns on such products and leave the consumer with a much lower than expected future income stream.

Based on the survey of stakeholders and the review of the literature (both academic and grey as well as the reports, studies, notes, etc from stakeholders), the main such products include:

- specific types of mortgage products; products that carry additional or penalty fees and charges; credit products with high interest rates; investment products with lower than expected returns; and complex products sold to SMEs;
- loan products which carry a high risk of a substantial residual liability for a borrower because of lack of proper debt discharge or reduction mechanisms;
- credit products with high interest rates, in particular payday/instant loans and credit cards with high rates combined with high limits;
- savings, investment and pension products with high charges;
- complex hedging products.

Ideally, in order to assess the magnitude of the potential detrimental impact of various financial products and establish a ranking of such products in terms of potential harm, one would need to have access to data on the distribution by income levels of a particular product and the effect of shock to such a product, say foreign exchange depreciation. Unfortunately such granular data are not publicly available although credit bureaux typically hold such very detailed information.

However, anecdotal evidence suggests that foreign-currency mortgages had a detrimental impact on a large number of mortgage holders in a number of countries while in other countries the inadequate assessment of borrower's capacity to repay a mortgage in case of an economic downturn resulted in financial hardship for many borrowers. As a mortgage is

[30] For a more general discussion of consumer vulnerability, see European Parliament (2012a).

held by a very large number of consumers, this product is probably the one which, depending on its characteristics, may have the largest significant negative impact among consumers.

That said, it is probable that some other financial products may be the cause of greater financial harm for particular groups of consumers such as, for example, payday/instant loans in the case of vulnerable consumers.

3.2 Mortgage credit products

Various types of mortgage product have been identified as having the potential to cause serious disruptive impacts for consumers and SMEs. These include:

- variable rate mortgages;
- high loan-to-value and debt-to-income mortgages;
- foreign currency mortgages;
- mortgages sold with interest rate hedges and swaps;
- mortgages with no debt write-off mechanisms in countries with no formal debt reduction or discharge mechanisms available to individual consumers; and
- mortgages with high fees and charges.

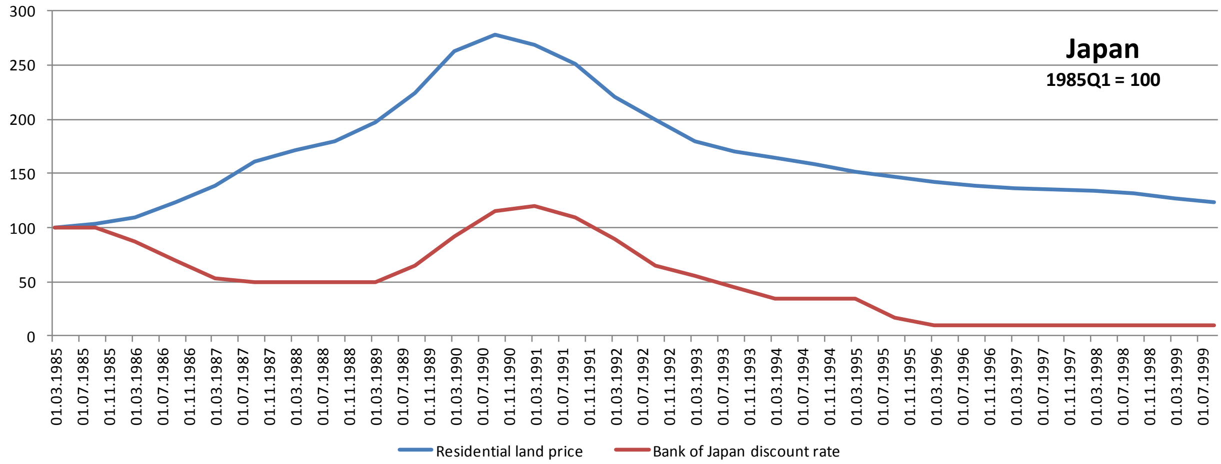
3.2.1 Variable rate mortgages

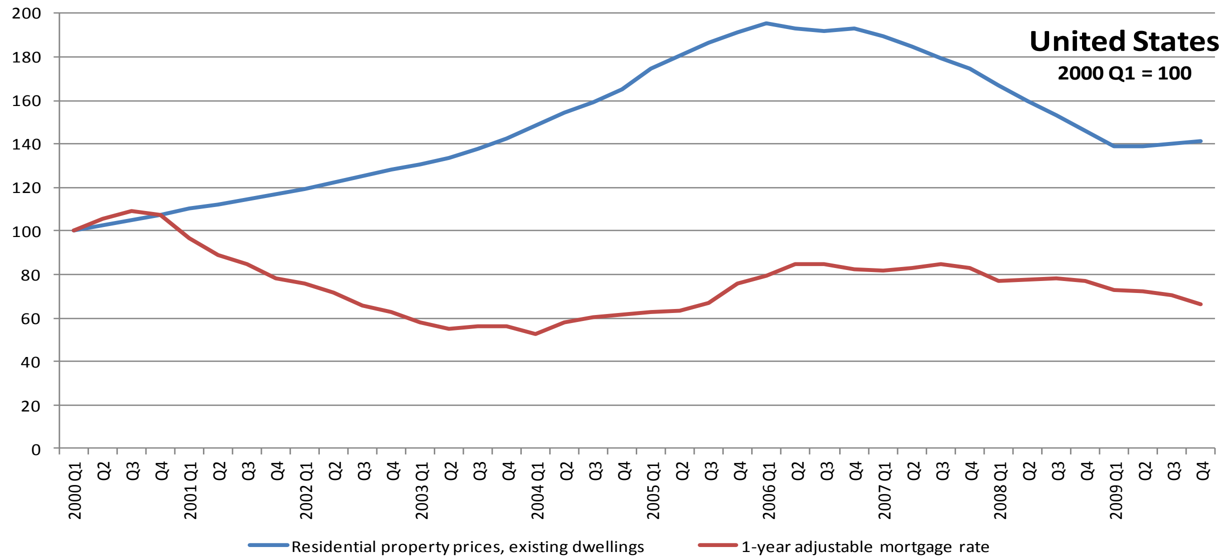
For some consumers, taking a variable rate mortgage may be highly financially disruptive in the long run, since repayments can potentially rise to close to or above what they can reasonably afford to pay.[31] At the present time, interest rates are at historical lows and will rise once central banks start to gradually reduce the provision of liquidity to financial institutions. In fact, the euro, sterling and US $ yield curves all currently embody over the coming years rising short-term interest rates which typically determine the level of variable mortgage interest rates. Depending on the general economic conditions prevailing at the time and the speed of the increase in interest rates, the rate of house price increases may slow down or house prices may actually decline from the levels prevailing just before the increase in interest rates. Whether a house price decline results in negative equity for a borrower will depend on the magnitude of the decline and the price paid for the property by the borrower.

In the case of the Japanese property boom of the early nineties and the US housing bubble of the middle of the last decade, an increase in interest rates (together with other measures aiming to rein in credit expansion in Japan) was followed by a sharp decrease in property prices.

[31] Variable rate mortgages may be a beneficial option for some consumers who are aware of the risks involved and have sufficient means and income to cover higher repayments if underlying market interest rates rise, since banks often reward customers that take on the risk of these loans with lower initial rates.

Figure 12: Interest rates and residential property prices in Japan and the United States





Source: BIS (property prices), Bank of Japan (discount rate) and Freddie Mac (mortgage rate).

Consumers may opt for a variable rate mortgage when it is not in their best interest because they do not fully appreciate the risk of interest rate rises, or they overestimate their own future earning potential. These miscalculations may be driven by consumers' behavioural biases (e.g. over-optimism), practices of financial institutions, particular characteristics of variable rate products on offer, or a combination of these factors. When the risk of an increase in interest rates is not properly taken into account in an assessment of a potential borrower's debt servicing capacity, the higher mortgage payments may create financial hardship for the borrower.

In some cases, the borrower may have to sell the property if the debt service burden proves unmanageable. If at that time, because of general market conditions, the selling price is lower than the mortgage to be repaid (including most likely some early repayment fees), the borrower ends up with a debt which still has to be served even though the property is no longer hers/his.

According to stakeholders and the literature, situations where variable rate mortgage products may cause disruptive impacts for consumers include the following:

- When banks and intermediaries do not take necessary measures to ensure that these products are suitable for customers and to assess borrowers' ability to repay. For example, analysis by the Finnish regulator in 2011 found that housing loans were granted despite borrowers' poor repayment capacity. Stress tests revealed that if interest rates were to rise to 6% debt servicing costs would be too high (i.e. in excess 40% of net household income) for around a quarter of first-time buyers, leading to financial distress. According to the regulator in some of these cases the bank should not have granted the loan[32]. In Ireland intermediaries did not undertake satisfactory suitability assessments in order to check that clients were purchasing appropriate variable rate 'tracker' mortgages. Their processes were found to be generic, rather than specifically geared towards the individual consumer[33]. In response to our survey the Romanian regulator reported that banks eased lending conditions during the boom of 2005-2008, which was possible since regulation was relaxed and banks found ways to sidestep important safeguards. Banks introduced on a large scale mortgages with low introductory rates fixed for 3 months to a year, without any indication of how the rate would fluctuate afterwards[34].
- When these products are provided without sufficient information on the risks and the terms of the agreements. For example, the Dutch regulator reported that consumers believe they are not given sufficient information in order to make informed decisions about variable rate mortgages (e.g. the risks that accompany them and what outside factors influence the rate)[35]. In Ireland when customers switched to variable rate tracker mortgages they were not given an indication that they would not be able to switch back. In this case consumers might calculate that such a product is appropriate based on a belief that they can switch back (as this possibility implies that the interest rate risk is limited) and then be placed in a financially disruptive situation when this belief turns out to be false. The regulator judged that firms had obscured important information by failing to indicate that switching back may not be possible[36].
- Where terms in mortgage agreements are unclear or ambiguous. For example, this may leave the precise interest rate to be charged at the discretion of the lender. This was the case in Spain, where repayment amounts on some mortgages were unclear because they depended on how the link to the underlying market rate (Euribor) was applied. The application of this link was often at the banks' discretion, resulting in higher repayments for borrowers[37].
- Where firms surreptitiously introduce unfair contract terms. For example, in Spain financial institutions issued thousands of mortgages with a so-called 'Floor and Cap' clauses, which prevented consumers and SMEs from taking advantage of the steep decrease in Euribor. As a result, many customers were paying "abusive" interest

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[32] Finnish Financial Supervisory Authority, Annual Report 2011.

[33] Irish Financial Regulator (2010), *"Issues identified in themed inspections into mortgage referrals, home insurance claims and motor insurance renewals"*.

[34] Survey response of the Romanian Financial Supervisory Authority.

[35] Dutch Authority for the Financial Markets, Annual Report 2009.

[36] Irish Financial Regulator (2010), *"Desk Based Review of Tracker Rate Mortgage Switches"*.

[37] Banco de España complaints service, Annual Report 2008.

rates of more than 6% while Euribor was at just over 1%[38]. According to the Banco de España, in some cases the minimum interest rate was not stated in documents, customers were not given relevant information on how these clauses would operate, or financial institutions did not honour verbal agreements with customers about the minimum interest rate that would be applied[39].

- Where mortgages are issued with high loan-to-value (LTV) and/or debt-to-income (DTI) ratios. High LTV/DTI ratios exacerbate the risks associated with variable rate mortgages. For example, a borrower may be unable to sell if the value of the loan is greater than the value of their property, and so would have no option but to pay higher repayments if rates were to rise. High LTV/DTI mortgages are discussed in the next section.
- Where consumers are over-optimistic about future interest rate levels and/or their future earnings. Due to over-optimism bias consumers may have excessive expectations about their future earnings, either because they overestimate future wage levels or they underestimate the probability of a spell of unemployment.

3.2.2 High loan-to-value and debt-to-income mortgages

High loan-to-value (LTV) and debt-to-income (DTI) mortgages have special potential to cause serious disruptive impacts for consumers and SMEs. Disruptive impacts that are particularly likely to be caused by such mortgages include:

- A situation of negative equity (i.e. where the value of a property used to secure a loan is less than the balance of the loan) is especially likely to occur with high LTV mortgages. Borrowers with high LTV mortgages can easily be pushed into negative equity by (even relatively modest) property price falls, which occurred in many EU countries during the financial crisis. For example, in 2009 the Dutch regulator identified the high risk of negative equity associated with high LTV mortgages coupled with falling house prices, citing the fact that at that time 27% of Dutch mortgage borrowers had LTV between 100-112% while 16% had LTV above 112%[40].
- Related to the point above, if value of the property is not sufficient to repay the mortgage debt then the lender may prevent the sale of the property. For example, according to the Belgian Financial Ombudsman when many consumers who found themselves in financial difficulties (due to job losses) and could not make their monthly repayments tried to sell their properties they were blocked by the banks for this reason[41]. This in turn may lead to various other disruptive impacts (including financial and non-financial impacts), such as having to cover higher repayments if the loan is a variable rate mortgage and market interest rates have risen, or being unable to relocate for employment reasons.
- If interest rates rise sharply then borrowers with high DTI mortgages are at particular risk of financial distress due to excessive debt servicing costs. For example, based on stress tests the Finnish financial regulator found that if interest

38 Expert Forum of Financial Services Users (2010), *"FIN-USE opinion on national experiences on unfair commercial practices in the EU"*.

39 Banco de España complaints service, Annual Report 2009.

40 Dutch Authority for the Financial Markets, Annual Report 2009.

41 Belgian Financial Ombudsman, Annual Report 2012.

rate were to increase to 6% debt servicing costs would quickly become too high for a significant share of households (i.e. more than 40% of net household income)[42].

- Related to the point above, high DTI mortgages are especially likely to result in repayment arrears and defaults, which can have significant long-term consequences for borrowers. For example, 144 000 (18%) private residential mortgage accounts were in arrears in Ireland at the end of 2012, of which 94 000 (12%) were in arrears for more than 90 days. Many of these consumers were not making restructuring arrangements with their mortgage providers, or were making only short-term restructuring arrangements such as interest-only repayments[43].

3.2.3 Foreign currency mortgages

Foreign currency mortgages have the potential to cause serious disruptive impacts for consumers and SMEs due the exchange rate risk that borrowers are exposed to through these mortgages. If the value of the borrower's domestic currency falls sharply relative to the currency in which their debt is held, the outstanding balance of the loan and the debt servicing costs greatly increase in domestic currency terms, putting the borrower into a financially disruptive situation. In recent years these products have caused serious problems for customers in a number of Member States, including Hungary, Croatia, Poland, Austria and the UK.

- The **Hungarian** regulator reported a sharp rise in complaints about foreign currency loans as the forint weakened in 2008. According to the regulator's 2008 annual report 69% of all household debt was held in a foreign currency, primarily the Swiss franc [44]. The Financial Times recently reported that at the end of March 2013 outstanding foreign currency mortgages in Hungary amounted to Ft3.55tn (EUR 11.9 billion), corresponding to 12% of GDP, and that over 20% of these mortgages by value had repayments more than 90 days overdue [45]. In addition, the residential properties of many SME business owners served as a collateral for foreign currency loans, and the high repayment instalments brought these businesses close to bankruptcy and put their owners' properties at risk[46]. As noted earlier, the Hungarian government took a number of measures to mitigate the impact of the depreciation of the Hungarian Forint on foreign currency mortgage holders and is aiming to phase out foreign currency mortgages. However, some of the measures only benefited those who were able to repay their mortgage loan in full.

  To illustrate the impact of the crystallisation of the risk of foreign currency credit products in the Hungarian case, it is useful to consider what the current value of the outstanding mortgage loans would be if the Swiss Franc had not depreciated by 50% from December 2007 to June 2013.

  Instead of HUF 3.844 billion, the HUF value of outstanding mortgage loans would have been HUF 2.556 billion, or 33% lower. This difference of HUF 1.297 billion is equivalent to 4.4% of nominal GDP in 2103.

[42] Finnish Financial Supervisory Authority, Annual Report 2011.

[43] Central Bank of Ireland (2013), *"Review of the Code of Conduct on Mortgage Arrears - Consultation Paper CP 63"*.

[44] Hungarian Financial Supervisory Authority, Éves Jelentés 2008 (Annual Report 2008).

[45] http://www.ft.com/cms/s/0/6c27cfbc-f50b-11e2-94e9-00144feabdc0.html#axzz2f2t0daC1.

[46] Survey response of the Hungarian Banking Association.

- In **Croatia**, the interest rate and outstanding value of mortgages tied to the Swiss franc increased substantially in 2010/11 as the Kuna depreciated relative to the franc, significantly increasing the debt burden of borrowers who had taken these loans[47].
- Depreciation of the zloty from mid-2007 caused a significant rise in **Polish** household's foreign currency mortgage debt. The regulator identified a sharp increase in mortgages "under observation" (78.4%) and "under threat" (33%) in its 2008 Banking Report[48].
- The **Austrian** government, the **French** ASF and Garanti Bank in **Romania** all identified foreign currency loans (in particular so-called "bullet loans" in the Austrian case) as a product that has proved harmful for consumers, citing of exchange rate volatility and high debts[49].
- **UK** consumers with foreign currency mortgages suffered when the pound fell against the Swiss franc and Japanese yen (although this mainly affected more affluent individuals who typically use the private banks that sold these products)[50].

3.2.4 Mortgages sold with interest rate hedges and swaps

Mortgages sold with interest rate hedges and swaps have the potential to cause disruptive impacts for consumers, as shown by the Spanish example. Spanish banks sold swaps on interest rates (carrying various commercial names) alongside mortgages extensively between 2007 and 2008, telling buyers that these swaps were insurance to prevent the interest on their loans from rising as underlying market rates (e.g. Euribor) increased.

Borrowers with mortgage deals that included these swap contracts faced large swap payments on top of their monthly mortgage repayments when the underlying market rates subsequently fell as a result of the financial crisis. Furthermore, if these borrowers wished to cancel the swap contract, they had to pay large cancelation fees exceeding EUR 10 000. As a result, these consumers were placed in financially disruptive situations[51].

3.2.5 A note on the special case of Spain

In Spain, high unemployment is a major cause of mortgage defaults. For example, according to AFES[52], 65% of the cases on non-payment of mortgages are due to unemployment. The number of new foreclosure proceedings has been growing very rapidly.

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[47] Croatian National Bank, Godisnje Izvjesce 2012 (Annual report 2012).

[48] Polish Financial Supervision Authority, *'Raport o sytuacji banków w 2008 roku'* (Banking Report 2008).

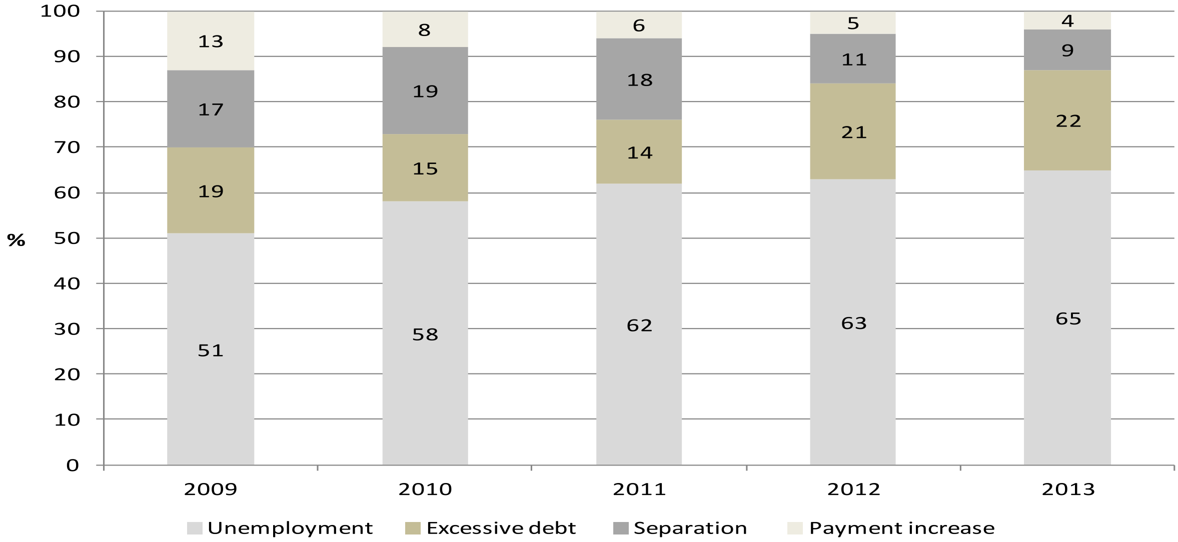
[49] Survey responses of Austrian Ministry of Labour, Social Affairs and Consumer Protection, the French ASF, and Garanti Bank in Romania.

[50] Financial Times article, 15th March 2013: http://www.ft.com/cms/s/0/4637a946-87fe-11e2-8e3c-00144feabdc0.html#axzz2dMszUxQR.

[51] Expert Forum of Financial Services Users (2010), *"FIN-USE opinion on national experiences on unfair commercial practices in the EU"*.

[52] Asociación de Afectados por Embargos y Subastas.

Figure 13: Reasons for mortgage payment delinquency - Spain

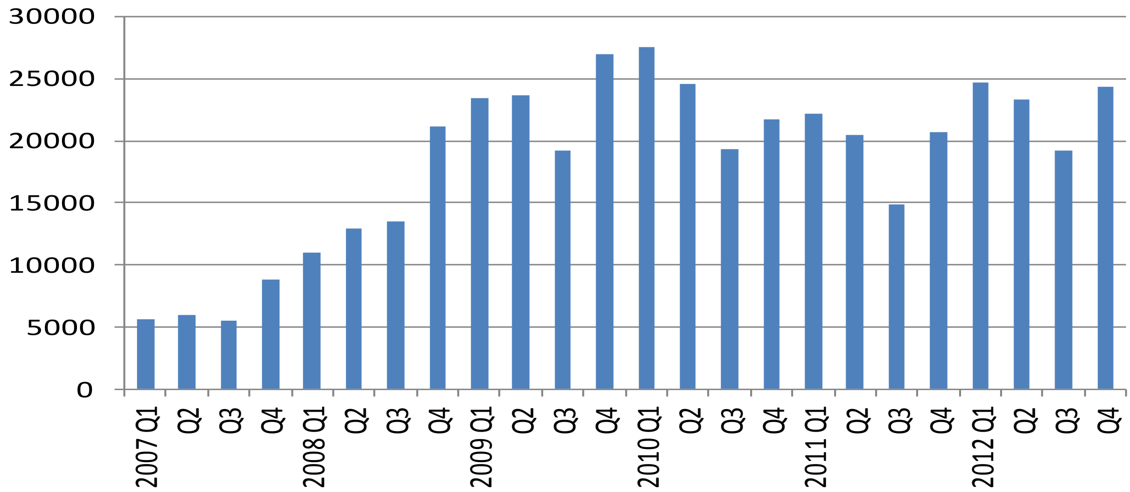


Source: Asociación de Afectados por Embargos y Subastas (AFES).

So far, the rate of mortgage delinquency has remained relatively low, in large part because of forbearance by Spanish banks. However, as the banks are under pressure from the regulatory authorities to clean up their balance sheets, the mortgage delinquency rate and the number of foreclosures will rise significantly in the near future[53].

In response to the difficulties faced by many mortgage holders, the Spanish government introduced a number of measures aiming to mitigate the impact of the mortgage debt crisis such as, for example, providing for a two-year moratorium on evictions of families considered to be especially vulnerable[54].

Figure 14: Number of new foreclosure proceedings - Spain



Source: CGPJ (estadistica judicial).

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53 As of June 2013, the reported delinquency rate stood at 4.9%, up from 3.8% in December 2012 and 2.9% in December 2011 (see Asociación Hipotecaria Española, 2013).

54 Law 1/2013 of 14 May 2013. Further measures to strengthen the protection of mortgage debtors are set out in Royal Decree-Law 27/2012 and Royal Decree-Law 6/2012.

According to Fuentes et al. (2013), the annual number of repossessions of properties in Spain has risen from somewhat less than 30 000 in 2008 to almost 60 000 in 2011.

Unfortunately, in the case of a repossession of a property because of non-payment of mortgage obligations, any excess of the debt over the value of the sale of the repossessed property remains due by the original mortgage holder or the guarantor of the mortgage. There exists no exit mechanism at the present time except the *in datio* procedure whereby the mortgage holder returns the property to the lender and the latter extinguishes the debt.

The central bank of Spain has started in 2012 to collect more detailed data on repossessions. Information for 2012 from banks that account for more than 85% of the mortgage credit extended to households for a house purchase show a lower number of repossessions than one would expect on the basis of the figures cited by Fuentes et al. (2013). Nevertheless, these statistics provide an interesting insight into the implications of repossessions for consumers. Repossessions of principal residences in 2012 stood at about 0.5% of the number of outstanding mortgage contracts (see table below). Of these repossessions, judicial repossessions accounted for 44% of total repossessions of principal residences and of the latter, 17% were of occupied houses.

Table 3: Details of repossessions in Spain in 2012

	Principal residence	Other home	Total homes
1. Number of mortgages to households for house purchase as of 31.12.2012	6,140,645	629,438	6,770,083
2. Repossessions	32,490	6,677	39,167
2.1 Voluntary repossessions	18,325	2,647	20,972
Of which in datio	14,110	1,716	15,826
2.2 Judicial repossessions	14,165	4,030	18,195
Judicial repossessions of unoccupied house	11,760	3,476	15,227
Judicial repossessions of occupied house	2,405	563	2,968

Source: Banco de España (2013a).

3.2.6 Mortgages with high fees and charges

Fees and charges associated with mortgage products include early repayment charges, arrears charges, and fees for transferring mortgages between banks, handling fees, and commissions for converting mortgages between currencies.

- The **Hungarian** regulator found that the way in which one bank unilaterally raised its mortgage loan charges was not in line with the general terms and conditions set out in contracts. The HFSA found that the activities of the bank infringed the law and imposed a significant fine. Another bank unlawfully charged customers a conversion commission, equal to 1% of their monthly payments, plus a handling fee, for repaying foreign currency mortgage loan in forints. Customers paid HUF 289 million in total as a result. The bank was subsequently ordered to reimburse these charges to clients. A third bank charged 3-4% commission on early repayment, contrary to legislation that prescribes a significantly lower fee or no fee at all. As a result, clients paid HUF 43.8 million in undue charges, which the regulator ordered the bank to reimburse[55].

- The **UK** regulator found evidence that lenders try to use mortgage arrears charges to recoup costs from other parts of their business, contravening the principle that such charges should be a fair reflection of the administrative cost to the lender. Due to the "obvious unfairness" of some charges, the regulator proposed to consult on banning the "continued application of a monthly arrears administration charge where a consumer is adhering to an arrangement to repay arrears" and "the charging of early redemption charges on arrears fees and charges"[56].
- The **Czech** regulator cited problems relating to contractual fines upon early repayment of mortgage loans in 2010[57].
- In **Italy**, one bank introduced a payment for the transfer of a mortgage to another bank equivalent to the last mortgage payment due. This caused a major disruption in the ability of consumers to transfer mortgage contracts from one bank to another[58].
- In **Slovakia**, the level of bank charges for mortgage loans and mortgage loan repayment charges are among the common sources of complaints in the banking sector[59].
- According to the **Romanian** regulator mortgage contracts "were constructed in a discretionary manner that permitted banks to change unilaterally the costs and other characteristics of mortgages, without the possibility for consumers to refuse"[60].

3.3. Products that carry additional fees and charges

Many financial sector products carry additional fees and charges. That is, costs (or cost increases) associated with using a product or service, in addition to the primary, upfront cost, that are levied from time to time on the customer, on a regular basis or in connection with a particular event[61].

These products have the potential to be seriously disruptive for consumers and SMEs because fees and charges can cause sudden and potentially unexpected shortfalls in customers' finances, possibly leaving insufficient funds to cover other outgoings. As noted by one national regulator[62], many consumers focus on headline rates or initial payments rather than features of products such as fees and charges, especially when these are incurred post-sale. Cumulatively fees and charges can cause significant shortfalls relative to what the customer had expected, and so affect their future plans.

Regulators surveyed by the EBA in 2011 and 2012 identified concerns relating to excessive and non-transparent fees and charges. In 2011 bank account fees and charges were highlighted in particular, including unclear or inaccurate pricing and overcharging (followed

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55 Hungarian Financial Supervisory Authority, Annual Reports 2009 and 2012.

56 UK Financial Services Authority, Mortgage Market Review 2009.

57 Czech National Bank, Financial Market Supervision report 2010.

58 Italian Antitrust Authority (Autorita' Garante della Concorrenza e del Mercato) (2010), *"Relazione annuale sull'attivita' svolta"*.

59 National Bank of Slovakia, Annual Report 2012.

60 Survey response of the Romanian Financial Supervisory Authority.

61 For example, 'fees and charges' would include additional charges for late payment of a loan instalment, but not the primary interest on the loan (since the interest is the main upfront cost of the product).

62 UK Financial Services Authority, Mortgage Market Review 2009.

by refunds), whereas in 2012 the issue widened to include the transparency and levels of charges in general, for example fee increases and new 'administrative' charges for certain loan repayments[63].

Fees and charges and associated problems are identified in relation to a wide range of financial products by regulators across Europe. In some cases charges are considered to be 'excessive' (i.e. disproportionate relative to the underlying cost to the financial institution that the charge is intended to cover), and in some cases fees and charges are a 'penalty', e.g. for missing a payment or defaulting on a loan, and are therefore likely to compound an already difficult financial situation for the consumer. Furthermore, in some instances the fees and charges are unavoidable for consumers. Based on evidence gathered from published reports and responses to our survey, the following sub-sections discuss fees and charges associated with four types of financial product, namely consumer credit products, mortgage credit products, and basic banking products, and investment and life insurance and products.

3.3.1. Consumer credit products

Fees and charges associated with consumer credit products have arisen in different circumstances across various Member States. These include charges triggered by non- or late repayment of loans, fees triggered by going overdrawn, 'administrative' charges, fees for 'notifications' and 'reminders', and pass-through of extra costs of loan refinancing. There are examples of charges associated with loans (including foreign currency loans and payday loans), credit cards and overdrafts.

Fees levied on consumers in relation to missed or late loan repayments are identified most often (including warning notice fees, missed payment fees, default fees and fees for issuing debt collection letters) – examples of such fees are identified in Croatia, Italy, Lithuania and the UK. In some countries, namely Germany and Austria, there has been some dispute in the courts over whether the charges were justified or not.

- In **Croatia**, some banks used the salaries of loan guarantors to pay back loans when the debtor could not keep up repayments ("garnishments"). At the same time, they charged a "penalty interest" of 15% to the debtor. According to the World Bank, this constitutes an "abuse of debt recovery practices". However, according to the Croatian regulator this practice is uncommon[64]. In addition, one bank charged excessive fees on warning notices that could not be justified by the actual cost of producing and sending these notices to customers who were experiencing difficulties repaying debt. According to the regulator the bank must compensate consumers for excessive charging of warning notices[65].
- In **Germany**, the regulator received complaints relating to administrative handling of charges for consumer loans. These charges were judged inadmissible by the Higher Regional Court of Dresden. The court argued that the charges impose disadvantages on customers, and the administrative activities (for which the charges are levied) are primarily a tool for checking the soundness of collateral

[63] For a summary of regulators' survey responses from 2011 and 2012 see EBA (2013) *'Report on Consumer Trends: Supervisory Concerns Regarding Protection Issue in 2012/13'*.

[64] The World Bank, Private and Financial Sector Development Department, Europe and Central Asia Region. 'CROATIA – Diagnostic Review of Consumer Protection and Financial Literacy. Volume II: Comparison against Good Practices,' February 2010.

[65] Croatian National Bank, 'Rjesenje o prihvatu mjera, uvjeta i rokova poduzetnika Privredna Banka Zagreb d.d. (Solution on the acceptance of measures, conditions and deadlines to the entrepreneur Privredna Banka Zagreb)', 2013.

offered by the customer, and therefore serve the bank's interest rather than those of customers[66].

- In **Austria**, foreign currency loans became more expensive to refinance due to the financial crisis. Several banks attempted to pass on the cost increase to their foreign currency loan customers using particular clauses in their loan contracts. These clauses stated that in circumstances that increased the costs of provision, maintenance or refinancing of these loans, the bank would have the right to pass the cost increase on to customers[67]. A consumer protection association initiated court proceedings and were successful on the basis of four arguments: the clauses did not adequately specify circumstances in which an increase was allowed; in practice the refinancing was carried out on an aggregate basis, not on a per-contract basis; the charges were of the banks' volition rather than unavoidable; and it caused the consumers considerable disadvantage[68].
- In **Italy**, delay in credit card payments or going overdrawn caused the imposition of extremely high interest rates on customers. The calculation of the interest due was based not only on the payments overdue but also on the residual credit on the card[69].
- In the **UK**, payday loans were criticised by the OFT for having high fees and charges associated with them. One lender charged GBP 179 on average in the 35 days after a missed payment, which included an initial missed payment fee, a further non-payment fee after seven days, and a default fee after 35 days and additional charges for issuing debt collection letters.[70]
- In **Lithuania**, consumers complained about fees for written notifications regarding their debt. Lenders require that consumers cover the cost of the reminder letters regarding the debt[71].

3.3.2. Basic banking products (i.e. bank accounts)

Types of fees and charges associated with basic banking products are account 'management' and 'maintenance' fees, charges relating to non-payment of direct debits, charges relating to unauthorised overdrafts, and fees for closing accounts. In particular, an investigation conducted by one regulator based on a representative set of customer profiles found that high charges are most likely to arise due to unpaid direct debits and fees on overdrafts.

- In Spain, a number of customers questioned changes to their bank account maintenance fees and the introduction of new charges. Banco de España stated that the law allows banks to change these fees after informing their customers individually and in an understandable manner no later than two months before the changes are introduced. However, financial institutions applied the changes immediately after informing their customers, and thus did not comply with the two-month timeframe stipulated by law[72].

[66] Court document: Oberlandesgericht Dresden (2011). '8 U 562/11'.

[67] Verein für Konsumenteninformation (2012), *'Bericht zur Lage der Konsumentinnen, 2009-2010'*.

[68] Court documents: Oberlandesgericht Graz (2010). '3 R 183/09w'; Handelsgericht Wien (2010). '22 Cg 11/10 a'

[69] Press source http://www.sostariffe.it/news/2010/04/10/bankitalia-blocca-american-express-e-diners/.

[70] OFT Payday Lending Compliance Review Final Report.

[71] National Consumer Rights Protection Board, 'Annual review of consumer complaints' 2009.

[72] Banco de España (2011), 'Annual report of the Banco de España complaints service'.

- In **Germany**, after the transposition into law of the Payment Services Directive banks started charging consumers for notification of non-payment of a direct debit[73]. The Federal High Court of Justice ruled that it is a legal obligation for banks to give notice to customers that a direct debit transaction failed due to insufficient funds. Therefore this does not constitute a chargeable additional service. As a result, it was ruled that the costs of providing this service cannot be passed on to customers, who would be disadvantaged to an inappropriate extent if such an approach were followed by their banks[74]. However, in July 2012 this prohibition was removed due to the introduction of the Single Euro Payments Area basic direct debit, meaning that banks would, in the future, be allowed to charge a fee for notification of non-payment[75]. A second case in Germany related to P-accounts, a type of government-endorsed bank account for consumers who are highly indebted. Part of the money in these accounts is ring-fenced so that it cannot be accessed by creditors. At the time, these accounts were subject to larger management fees than standard current accounts and complainants questioned whether such fees should be permissible. The Federal High Court of Justice ruled that higher fees should not be permissible, as the customers in question were legally obliged to open such accounts and the banks were legally obliged to provide them[76].
- In **Croatia**, the regulator found that since the introduction of current accounts in the early 2000s, there had been various detrimental practices. Regarding fees and charges, some banks, typically smaller ones, charged unnecessary fees if a consumer wanted to close a current account that was tied to other products or services. This practice effectively increased the cost to consumers of switching between banks[77].
- The **Irish** Central Bank conducted a review into bank charges. It wanted firstly to improve its own understanding of the costs to consumers of running a personal current account, and secondly to improve transparency around these charges for others. The Bank created a set of fictional representative users' profiles and calculated costs for them over the course of a year. The research found that high bank charges result from activity such as unpaid direct debits, surcharge interest and over-limit or referral fees (the latter two refer to fees for unauthorised overdrafts)[78].
- According to the **French** CLCV[79], banking charges (e.g. intervention commission and charges for cheque rejection) are often very high and many of these charges have no economic justification. They weigh heavily on consumers' budgets and aggravate already critical financial situations[80].

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[73] Bundesanstalt für Finanzaufsicht (2011). 'Annual Report 2010'.

[74] Court verdict: Bundesgerichtshof (2011). 'IV ZR 199/10'.

[75] Bundesanstalt für Finanzufsicht, 2013; Focus Money Online, 2012.

[76] Court verdicts: Bundesgerichtshof (2012a). 'Urteil AZ XI ZR 500/11'; Bundesgerichtshof (2012b). 'Urteil XI ZR 145/12'.

[77] Croatian National Bank (2011). 'Research on consumer mobility in the banking market for current accounts'.

[78] Central Bank of Ireland (2011). 'A review of personal current account charges'.

[79] Consommation Logement et Cadre de Vie.

[80] Survey response of the CLCV.

3.3.3 Investment and life insurance and products

Fees and charges associated with investment and life insurance and products include product negotiation fees, charges for acquisition costs, and early cancellation charges. A problem identified in chapter 2 in relation to these products is that insufficient information may be provided to customers about them, including information on the share of premiums that go on fees rather than investment. Furthermore, some fees may be concealed or non-transparent. Consequently consumers may overestimate the net financial benefits of these products after fees and charges, especially when contracts are terminated early.

- In **Germany**, contract clauses used by life insurers relating to cancellation fees and loading acquisition costs onto initial premium payments were ruled ineffective by the Federal High Court of Justice, since these clauses put the consumer at an inappropriate disadvantage or lacked transparency[81].
- In Finland, the regulator found deficiencies in the presentation of the price and costs of unit-linked insurance products, partly because the fee structure can be difficult to comprehend[82].
- Life insurance is often the subject of a high number of complaints in the Czech Republic, with one problem being hidden costs in the form of product negotiation fees that are deducted at the start of the insurance cycle (and which the intermediary does not usually inform the consumer about)[83].
- In France, investors in structured funds only received their guaranteed capital excluding subscription fees at maturity[84].
- In Hungary, consumers paid charges that they could not anticipate in relation to unit-linked products, since one company had used unclear phrasing in contract terms and conditions[85].
- In Spain, charges were applied in relation to unit-linked products even though these charges were not stipulated in contracts. As a result, customers received less than expected upon maturity and in some cases less than their initial investment[86].
- According to the Slovenian Consumer Association, buyers of life insurance are promised high returns but are unaware of the fees and potential losses if they decide to end these contracts prematurely. The Association also notes that products sold are often those with the highest commission rates for the sellers[87].
- In Slovakia, according to the regulator's annual reports between 2008 and 2012, fees often caused complaints in the capital market, supplementary pension saving sector, and securities market. Regarding the capital market most complaints concerned service fees, in the supplementary pension saving sector it was withdrawal fees and termination settlements, and in the securities market most complaints related to fees charged for cancelling securities accounts[88].

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[81] German Federal High Court of Justice (2012), 'Bundesgerichtshof zur Unwirksamkeit von Klauseln in Lebens- und Rentenversicherungsverträgen'.

[82] Finnish Financial Supervisory Authority, Annual Report 2010.

[83] Czech National Bank, Financial Market Supervision Report 2011.

[84] French Financial Markets Authority Ombudsman, Annual Reports (Rapport annuel du Médiateur) 2008 and 2009.

[85] Hungarian Financial Supervisory Authority, Consumer Protection Risk Report 2010/II.

[86] Spanish General Directorate of Insurance and Pensions, *'Seguros y fondos de pensiones: Informe anual del servicio de reclamaciones'* (Annual report of the complaints service), 2009.

[87] Information provided by the Slovenian Consumer Association via email.

[88] National Bank of Slovakia (Národná banka Slovenska), Annual Reports 2008-2012.

3.4 Credit products with high interest rates

3.4.1. Payday/instant loans

'Payday' and 'instant' loans have been identified as potentially disruptive for individual consumers by regulators, the EBA and previous studies for the Commission. These specialist forms of consumer credit typically involve relatively small borrowing amounts for each loan, short payback periods (e.g. less than 3 months), and high interest rates. For example, annual interest rates on these loans amount to nearly 1 000% on average in Finland[89], whereas in the UK market leading providers charge APR of several thousand percent[90].

The loans are highly accessible, both in terms of credit worthiness checks, which are often limited and relaxed, and in terms of the practicalities of obtaining credit. For example, loans are often granted via text message or over the internet, and money is lent at very short notice, sometimes within minutes. Another relevant characteristic is that this type of credit is commonly provided by non-bank credit intermediaries.

The payday/instant loan product category includes so-called 'SMS-loans', which became prevalent in Finland and Sweden from around 2006, and 'Flitskrediet' (flash credit), which was introduced in the Netherlands in 2007.

In some EU countries the outstanding value of this type of credit held by consumers has grown dramatically in recent years (and is now relatively high). For example, in Finland despite the fact that instant loan credit is relatively new the outstanding amount stood at 320 million in 2011[91].

Reports and survey responses from regulators and other official agencies in Finland, the Netherlands, Sweden and the UK identify this type of credit as a product that may cause disruptive impacts for consumers[92]. In addition, these loans are also identified as problematic in various other studies and pan-European investigations: the EBA mentioned quick loans in a recent report on consumer protection issues in Europe; a study for the Commission (Reifner et al, 2010) identified SMS and payday loans as products that are particularly associated with high credit costs and consumer detriment based on a survey of stakeholders and experts from across the EU; and studies have noted that SMS loans are causing issues in some Eastern European countries[93].

Particular issues and problems raised in relation to this type of financial product are:

- Financial difficulties caused by high interest rates attached to payday/instant loans are highlighted in reports from regulators and other national agencies as well as

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89 Finnish Commerce Committee (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp).

90 http://www.thisismoney.co.uk/money/cardsloans/article-2345670/Wonga-pushes-typical-APR-5-853-cent--says-borrowers-pay-payday-loans.html.

91 Finnish Commerce Committee report (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp).

92 Pay-day loans in the UK will be regulated by the UK Financial Conduct Authority (FCA) from April 2014 onwards and, under the new regulatory regime, loan rollovers will be limited to 2, the attempts by a lender to use a continuous payment authority to pay off a loan will be limited to 2, information on where to get free debt advice is to be given to a borrower who rolls over a loan and clear risk warnings are to displayed on all adverts and promotions along with more information about debt advice (Press release of the FCA of 3 October 2013). In addition, like all credit providers, pay-day lenders will have to undertake affordability checks to ensure that only consumers that can afford a loan can get a loan. Moreover, the FCA will be given the power to cap the cost of pay day loans (Press release of HM Treasury of 25 November 2013).

93 Saare et al. (2010) write that "SMS borrowing developed into an escalating social issue in Estonia", citing warnings from the Estonia Financial Supervision Authority and Consumer protection Board.

pan-European studies. According to authorities in Finland, Sweden and the UK, the high cost of short-term loans provided to low income groups and young people is a particular problem[94]. Reifner et al (2010) report that similar information comes from experts in Ireland, Poland, Latvia and Hungary, and experts from Austria, Czech Republic, Denmark and Estonia mentioned products with very high interest rates as "a driver of over-indebtedness", with the Danish expert citing SMS loans in particular.

- High rates of loan roll over among payday/instant loan borrowers. This involves refinancing an existing loan with a new loan from the same provider or by taking another short term loan with another provider. In the UK, borrowers who sought help from debt advisors about payday loans had on average rolled over their debts at least four times, around one in three loans are paid back late or not at all, and the revenue streams of providers are heavily dependent on roll over and refinancing of loans. The UK Office of Fair Trading (UK-OFT) also reports that firms provide harmful advice by encouraging their customers to roll over their loans when they would be better served by a repayment plan[95].
- Related to the above issue is the fact that often multiple loans are granted to a single individual by different providers. In the UK, on average consumers seeking advice about payday loans had six separate payday loans and in the last four years the Citizens Advice service has had a tenfold increase in the share of its clients with multiple debts that include a payday loan[96]. According to the survey response of the Federation of Finnish Financial Services, courts have reported an increased level of consumer defaults based on high numbers of small loans granted by numerous service providers to a single person. Some evidence suggests that many pay-day loan borrowers resort to such form of credit when they are already carrying a heavy debt burden[97] and the only way to escape from their financial trap is to sell some of their assets (such as their car) or enter a formal debt reduction process (such as, for example, bankruptcy).
- The use of 'continuous payment authorities' (CAPs) by payday/instant lenders in order to regularly take money from their borrowers' accounts. There is evidence from the UK that this repayment arrangement is being misused since CAPs are poorly explained to customers and are used when it is not in the best interest of the customer (i.e. when they would be better served by a repayment plan).
- Insufficient information is given to borrowers by payday/instant credit providers. For example, these firms provide insufficient information relating to the risks of taking out such loans, the cost of borrowing, the consequences of non-payment, and terms and conditions[98].

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94 Finnish Commerce Committee report (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp); survey response from the Finnish Financial Ombudsman; UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*; Swedish Consumer Agency (Konsumentverket) (2008), *"Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet)"*.

95 UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*.

96 UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*.

97 See Money Advice Service (2013).

98 Swedish Consumer Agency (Konsumentverket) (2008), *"Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet)"*; UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*; World Bank (2009), *"Romania: Diagnostic Review of Consumer Protection and Financial Literacy – Volume I Key Findings and Recommendations"*.

- There are examples of misleading and aggressive marketing by payday/instant lenders. For example, the Swedish Consumer Agency reported aggressive advertising campaigns targeted at the young that mis-sell these loans as reliable and safe (in addition to easily accessible), and the UK-OFT found that many websites made claims that the agency considered to be potentially misleading[99].
- These loans may exploit the behavioural biases of particular groups of consumers. Whereas traditional economics relies on an assumption that consumers behave rationally (implying that they would only accept credit if it is in their interest), behavioural economics identifies various biases that cause individuals to act irrationally (and take decisions that are not in their interest), including over-optimism which may cause consumers to underestimate the negative consequences of a loan. There is some evidence that such biases may be particularly exploited by high-cost, short-term credit. For example, Attanasio et al (2008), as cited in Reifner et al (2010), find that low income consumers are highly insensitive to interest rate levels, and so may accept credit even under conditions that mean doing so is not in their interests.
- Similarly, lenders' incentives may be distorted by the characteristics of the payday/instant loan market, namely high roll over rates and common use of continuous payment authorities described above. The UK-OFT noted that these characteristics may encourage lenders to extend loans to consumers who cannot realistically afford to repay them first time.

The disruptive impacts of this type of credit can be very significant for consumers:

- These loans have contributed to a significant growth in arrears and defaults. For example, in Finland instant loans have contributed significantly to the increasing number of payment default entries, especially for young people and those who already have serious debt problems. The number of payment default entries rose from around 400 000 in 2005 to 1.7 million in 2012 (for approximately 350 000 individuals) and courts have reported an increased level of consumer defaults due to multiple small loans granted to single individuals[100]. In the UK debt advice charities report high and growing numbers of visitors having payday loans. For Citizens Advice payday loans represented 1% of visits in 2010 and 10% in 2012[101]. Defining default as a customer failing to keep to the terms of their agreement, for example by failing to repay their loan on time or at all, data provided by 21 UK payday lenders revealed an average default rate of 20% in 2011/12[102].
- These loans have done significant damage to individual's credit records, and therefore have long-term consequences for these consumers in terms of their future ability to access credit and benefit from financial products and services[103].

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[99] Swedish Consumer Agency (Konsumentverket) (2008), Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet); UK Office of Fair Trading (2013) report on payday lending *"Payday Lending Compliance Review Final Report".*

[100] Finnish Commerce Committee report (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp); survey response from the Federation of Finnish Financial Services.

[101] UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*.

[102] Annexe A – Quantitative Findings, UK Office of Fair Trading (2013), *"Payday Lending Compliance Review Final Report"*.

[103] Swedish Consumer Agency (Konsumentverket) (2008), Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet); Finnish Commerce Committee report (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp).

- Payday/instant loans can be especially harmful for certain groups, namely the young and those who already have serious debt problems. The financial difficulties of consumers who are already struggling are often exacerbated when they are given these loans[104]. According to a 2006 study in Ireland, as cited by Reifner et al (2010), "four out of 10 people on social welfare are in the grip of moneylenders, who are charging interest rates as high as 188 per cent", and according to the survey response from the Finnish Financial Ombudsman this type of credit easily "destroys" the finances of "weak" consumers. In Finland and Sweden the authorities have identified that these loans are especially harmful for young consumers[105], and the Swedish Consumer Authority reported that marketing campaigns actually target this group as well as the financially vulnerable[106].

3.4.2 Credit cards

Credit cards are a form of 'revolving credit', since the consumer does not have to repay the outstanding sum used in a fixed number of payments. In general, the creditor offers a limited credit reserve to the consumer, who repays the sum used according to the terms agreed in the credit contract. Repayment mechanisms include repaying a certain percentage of the amount outstanding regularly, payment of interest charges regularly with the repayment of the credit at the end of the contract life, or fixed repayments with predetermined regularity (e.g. in each month of the agreed contract).

Prior to the recent financial crisis, the market for credit cards experienced substantial growth. The number of cards issued with a credit function *only* in the EU27 increased by approximately 14.4 million from 2006 to 2008 – a growth of 11.4%. After reaching a peak of over 141.5 million in 2008, the number of such cards issued has fallen by 17.0% over the period from 2008 to 2012[107].

The UK is the main contributor to the number of cards issued in the EU, accounting for more than half of the total in 2012, followed by France which accounts for a quarter of the total[108]. Moreover, data from the British Banker's Association released in July 2013 reveals that roughly GBP 56.8 billion of credit remains outstanding in the UK credit card market[109].

Reports and survey responses from regulators and other official agencies identify credit cards as a product that may cause disruptive impacts for consumers. Furthermore, the 8th edition of the Consumer Market Scoreboard highlights concerns over the functioning of the 'loans, credit and credit cards' market, since it ranks 19th out of 30 service markets in the EU as a whole in terms of how well it functions for consumers[110].

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[104] As noted by the UK-OFT in its 2013 report on payday lending *"Payday Lending Compliance Review Final Report"*.

[105] Finnish Commerce Committee report (2012), *"Talousvaliokunnan mietintö 15/2012 vp"* (Finance Committee Report 15/2012 vp); Swedish Consumer Agency (Konsumentverket) (2008), Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet).

[106] Swedish Consumer Agency (Konsumentverket) (2008), Analysis of Development within the Field of Consumption (Analys av utvevecklingen inom konsumentområdet).

[107] Payments and Settlement Systems Statistics, ECB.

[108] Payments and Settlement Systems Statistics, ECB.

[109] BBA (July 2013) – Credit card market. http://bba.org.uk/statistics/article/july-2013-credit-card-market/credit-card-market/.

[110] European Commission (2012), Consumer Markets Scoreboard – Making markets work for consumers, 8th edition, December.

Particular issues and problems raised in relation to this type of financial product are:

- High interest rates on credit cards have been identified as causing financial distress for consumers in the EU in various reports and pan-European studies. Key stakeholders and experts from across Europe who were surveyed as part of a study by Reifner et al (2010) rated credit cards as the second most problematic form of credit (after SMS loans). This is supported by the Greek Consumer Protection Association (KEPKA), who cited in their survey response high interest rates on credit cards as a cause of harmful effects on consumers.

- The growing complexity of terms and conditions in credit card contracts, in particular with regards to instalments, has increased the potential for negative impacts on individual consumers. In response to our survey, the Romanian regulator highlighted that a lack of proper regulation and low levels of financial literacy amongst consumers has led to instances of "over-indebtedness".

- Credit cards, as well as debit cards, have faced scrutiny over high interchange fees. These fees are paid by businesses to banks when handling transactions carried out by the consumer using his/her card. High interchange fees are indirectly passed on to consumers through higher retail costs by businesses. This has been identified by the European Commission and plans to establish caps on such fees are underway at the time of reporting[111].

- Consumers have also raised concerns relating to the lack of clarity about certain aspects of credit contracts. In particular, the 2012 Annual Report of the Belgian Financial Ombudsman notes that the presence of a tripartite relationship between the consumer, the bank as intermediary and the finance company caused difficulties in ending lines of credit, since consumers were unaware of the procedure to do so[112].
- The tying of credit cards to other products has also arisen as an issue. For example, the Czech National Bank reported that consumers were issued a credit card without knowing when purchasing other products, which led to numerous complaints[113].

The main disruptive impact of credit cards on consumers has been the increased possibility of high/problematic debt, which has mainly arisen due to the growing complexity of the product and low levels of financial literacy on behalf of the consumers.

3.4.3 Consumer loans

Consumer loans are a common form of consumer credit[114], covered by the Consumer Credit Directive in the EU[115]. In general, this form of credit is provided to the consumer on the basis of an agreement which specifies the total amount taken out and its repayment method. In particular, it is not directly linked to the purchase of any particular good and/or

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[111] European Commission (2013). 'Introductory remarks on proposal for regulation on interchange fees for cards, Internet and mobile payments', Joint press conference by Commissioner Barmier, responsible for Internal market and services, Brussels, 24 July 2013.

[112] Belgium Financial Ombudsman, Annual Reports 2011.

[113] Esker Maroni Banka, Financial Market Supervision Report 2009.

[114] Consumer credit is unsecured lending to households other than mortgage loans and other loans obtained for the purpose of acquiring or improving a property.

[115] For an overview of the implementation of the Consumer Credit Directive in the EU, see European Parliament (2012b).

service. In recent years, various problems have arisen in relation to these products across different Member States:

- In **Lithuania**, the Consumer Rights Protection Board reported consumer complaints about excessively high interest rates on consumer loans, which increased the difficulty of repaying loans, as well as potentially damaging personal finances of consumers [116]. Reifner et al (2010) provide information on interest rates for consumer credit products of various maturities in different EU Member States. For consumer credit with a floating rate for 1-year, the median interest rate in Lithuania is reported to be 13.9%, which is lower than in five other Member States, namely Bulgaria, Czech Republic, Hungary, Latvia and Romania. Similar concerns were also mentioned by the **Greek** Consumer Protection Association in response to our survey.
- Other problematic situations have arisen due to various fees related to consumer loans. In 2011, a large number of consumers in **Germany** were dissatisfied with the levying of administrative handling charges on their personal loans. A regional court found that these charges were inadmissible [117]. In **Croatia**, one bank charged excessive fees on warning notices relating to debt repayment on consumer loans and had to compensate consumers[118]. The **Lithuanian** consumer protection body received complaints which related to the actions of banks when consumers attempted to make an early repayment of their loan. Banks requested consumers to offset the losses it would incur due to the early repayment; even though there was no term relating to such a fee in the loan agreement. After an investigation, it was found that fees relating to early repayment were ambiguous and non-transparent[119].

These particular issues and problems faced by consumers with personal loans have potential disruptive impacts. Mainly, consumers experienced increased difficulties in attempting to repay their debts and, in some cases, may have paid more than what was agreed in their credit contract. This also had a potentially negative impact on their credit record, which is likely to cause issues if they want to borrow in the future. In other cases, the incentive to make an early repayment on loans was lacking given the existence of charges to cover the losses made by the loan provider.

3.5. Savings, investment and pension products with lower than expected returns

Consumers often receive only a small proportion of the amount they expect to receive from investment products. Occasionally this is because the product was mis-sold in some way, meaning that the consumer was not aware of the risks. In some cases, consumers unexpectedly lose some or all of their original investment when they believed that their capital was guaranteed.

Since consumers plan their future finances based on the returns they expect to get from their investments, investment products that deliver lower than expected returns or result in unexpected loss of capital can have serious disruptive impacts.

The greatest risk of disruption arises when relatively complex products are sold to less experienced investors. Examples identified in Member States relate to perpetual bonds,

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[116] National Consumer Rights Protection Board. Annual review of consumer complaints. 2009.

[117] Oberlandesgericht Dresden, 2011.

[118] Croatian National Bank – 'Rjesenje o prihvatu mjera, uvjeta i rokova poduzetnika Privredna banka Zagreb d.d.'.

[119] National Consumer Rights Protection Board. Annual review of consumer complaints. 2011.

structured products, convertible bonds, mixed bond/insurance products, equity-linked bonds, CDO-securities, and interest rate derivatives:

- In **Belgium**, consumers who bought in 2004 and 2005 have not received the expected return due to the financial crisis. In several cases, customers received insufficient advice and information prior to these investments and many of them were unaware that the bonds were perpetual[120].
- In **Spain**, consumers with structured deposits were paid interest less frequently than expected and could not recover their deposits in the short-term (which they could not have predicted due to the incomplete information provided to them)[121]. In addition, Spanish investors also lost EUR 300 million from collective investment schemes as a result of the collapse of Lehman Brothers[122].
- In **France**, consumers who invested in structured funds in 2001 and 2002 without being aware of the risks only received their guaranteed capital excluding subscription fees at maturity, around half of what they expected based on promises made to them[123].
- In **Italy**, consumers who invested in a 'mandatory convertible' bond issued by a particular bank lost significant amounts of their investment when the bank's share price fell. According to a consumer association, customers were not provided with sufficient information about this complex product.
- In **Ireland**, bonds with an insurance 'wrap-around' (so-called 'ISTC bonds') worth around EUR 40 million that were sold to retail investors and credit unions became worthless when the financial institution backing them collapsed[124].
- In **Lithuania**, customers of a particular bank who invested in a complex scheme involving equity-linked bonds incurred significant losses totalling 100 million Litas (nearly EUR 30 million). According to a court, the bank raised unrealistic expectations among clients by presenting the investment as profitable in all regards[125].
- In **Finland**, consumers who invested in CDO-securities (the so-called "Mermaid bond") claimed that the product was marketed as capital-guaranteed when in reality they lost their capital[126]. According to media reports, around 1 500 investors lost a total of EUR 140 million from investing in these bonds[127].
- In **Denmark**, consumers (primarily) and SMEs who invested in an interest rate derivative (which gambled on the spread between the interest rate on Danish government bonds and mortgage bonds) lost around 85% of their capital. The DFSA

120 Belgium Financial Ombudsman, Annual Reports 2011.

121 Banco de España Complaints Service, Annual Report 2009.

122 Spanish National Stock Markets Commission (Comisión Nacional del Mercado de Valores), Annual report on the securities markets and their performance 2008 (*"Informe anual sobre los mercados de valores y su actuación 2008"*).

123 French Financial Markets Authority Ombudsman, Annual Reports (Rapport annuel du Médiateur) 2008 and 2009.

124 Irish Financial Services Ombudsman (2009), 'Annual Report 2008'.

125 The description of this case is drawn from several press stories: http://www.ve.lt/naujienos/ekonomika/ekonomikos-naujienos/teismas-patvirtino-dnb-banko-rekomendacijomis-investuotojams-padarytos-zalos-pagristuma-987570/; http://vz.lt/article/2013/3/25/dnb-norvegijoje_pralaimejo_byla_del_platintu_obligaciju; http://www.sazininga_bankininkyste.lt/lt_pranesimai-dvi_svarbios_nutartys.html.

126 Finland Financial Supervisory Authority, Annual Report 2009.

127 http://www.talouselama.fi/sijoittaminen/ei+se+ollut+nordean+vika/a2071444.

found that marketing material did not describe the risk profile of this product properly. In addition, Danish consumers and SMEs also suffered major loses on their investments in "Scandinotes" (a type of CDO), due to the collapse of some Danish banks. According to the DFSA these products were mis-sold to retail investors[128].

- In **Austria**, investors in "snowball-bonds" were locked into zero interest rates by specific contract clauses. Other clauses gave institutions the right to terminate these contracts whereas bondholders were bound for several years. The Austria Supreme Court ruled that these terms were illegal[129].
- In **Lithuania**, consumers who purchased bonds issued by Snoras bank lost their investments when the bank became insolvent due to alleged fraud and misappropriation of assets[130].

3.6. Complex products sold to SMEs

Interest rate hedging products (IRHPs, or 'interest rate swaps') include a range of financial instruments that are sold to businesses alongside loans as a form of insurance to protect them against interest rate risk. These products can be advantageous for SMEs because they provide customers with greater certainty about the level of their future loan repayments. However, these complex products also have the potential to cause serious disruptive impacts for unsophisticated SMEs, as shown by the UK example.

Due to their complexity these products are susceptible to mis-selling, which was widespread in the UK. Mis-selling issues related to inadequate information provision, poor advice on exit costs, deceiving customers that they must purchase IRHPs with loans, provision of advice in non-advisory sales, and selling of over-hedged products.

In the UK, SMEs purchased these products in order to protect themselves if interest rates on their loan repayments were to rise. However, when market interest rates were cut sharply after the onset of the economic crisis many businesses that had taken out IRHPs saw their repayments increase significantly. As a result, thousands of SMEs were left repaying their debts at considerably higher cost than they otherwise would have been. In addition, terms in their contracts often meant that businesses were unable to end these agreements without paying large exit fees.

So far (at the end of August), 213 cases have been fully assessed during the UK regulator's review process and redress is due in 179 of these, of which 154 will see the SME receive a full refund of all payments on their IRHP[131]. Ten redress offers, totalling GBP 500,000, have been accepted and the regulator expects this figure to rise quickly in coming months[132]. Estimates quoted in the press put the total potential cost to banks of providing redress to customers at GBP 1.5-2.5 billion[133].

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[128] Survey response of the Danish Financial Supervisory Authority.

[129] Verein für Konsumenteninformation (the main consumer organisation in Austria) (2012), *"Bericht zur Lage der KonsumentInnen 2009-2010"*.

[130] International Monetary Fund Country Report No.13/081 (2013), *"Republic of Lithuania - 2013 Article IV Consultation"*.

[131] An overview of the UKFSA's redress process is available at: http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products. Figures on the number of cases handled so far are available at: http://www.fca.org.uk/static/documents/aggregate-progress.pdf.

[132] http://www.fca.org.uk/news/update-on-the-banks-reviews-of-sales-of-interest-rate-hedging-products.

[133] http://www.thisismoney.co.uk/money/news/article-2271140/Banks-hit-1-5billion-FSA-finds-mis-sold-90-rate-swaps-SMEs.html. http://realbusiness.co.uk/article/21713-are-interest-rate-swaps-the-next-ppi-scandal-for-smes. http://www.ifaonline.co.uk/ifaonline/news/2292518/fca-banks-pay-out-just-gbp500k-over-interest-rate-swap-misselling.

In addition to higher interest payments and fees for terminating IRHP agreements, many businesses may also have suffered 'consequential losses' – i.e. losses that were an outcome of the IRHP. There is no comprehensive list of (potential) consequential losses from IRHPs, but the UKFSA sets out some of the more frequent claims it has seen so far[134]:

- Bank charges: charges and penalties that would not have been incurred but for payments in relating to an IRHP.
- Legal and professional fees: fees arising as a result of dealing with the consequences of an IRHP.
- Loss of profits: missed opportunities where the company could have used the money spent on IRHP payments to generate more profits.
- Wasted management time: where diversion of management time caused extra costs for the company.
- Mental distress, physical inconvenience and loss of amenity (although according to the UKFA firms are unlikely to be able to claim for these factors).

3.7. Costly assistance to consumers in debt

In the UK, the OFT investigated the extent that companies in the debt management sector comply with OFT's guidelines. The OFT argued that debt management services are "a classic 'distress' purchase", since consumers who use these services are typically "overindebted, vulnerable and desperate for help". This means that such services, if found to be detrimental, are likely to affect the most vulnerable consumers adversely. Issues identified in the review include insufficient price transparency, misleading advertising, poor quality advice and information, and failure to comply with the Financial Ombudsman's rules on consumer redress. Consumers can be left in a worse financial position by some debt solutions, and in the worst cases this can lead to the loss of their home.

[134] http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products/fair-and-reasonable-redress.

4. FINANCIAL SERVICES WITH POTENTIAL SERIOUS DISRUPTIVE IMPACTS FOR THE SINGLE MARKET

KEY FINDINGS

- At the present time, European consumers do very little cross-border financial services shopping. For example, according to a recent Eurobarometer survey, 94% of survey respondents in the EU27 have never purchased a financial product in an EU Member State outside their home country and only 11% would consider a cross-border purchase.
- Nevertheless, particular financial products or services may have a serious disruptive impact on the Single Market. These financial products and services may involve mis-selling, opaque pricing and incomplete or difficult-to-understand information about the characteristics and risks of the product.
- The disruptive impact of particular financial products or services on the Single Market impact may manifests itself in three different ways:
  - First, the disruptive impact may be of such magnitude that it imperils financial stability and hence perturbs the context in which the Single Market operates.
  - Second, some of the financial products may have detrimental impacts for particular groups of consumers who, as result of these negative impacts, curtail some or all their cross-border activities (such as purchases of goods, services, property and other investments, travel, cross-border moves, etc.).
  - Third, some the products may impact many consumers even though the magnitude of the impact is relatively small for each individual consumer.
  - Fourth, discrimination by financial services providers may also hamper the functioning of the Single Market.
- Due to the high level of mortgage debt in both total household debt and on the balance sheets of many financial institutions, and the issues that certain mortgage products raise, it would appear that mortgages, if not well regulated and sold prudently, are the consumer financial product with the largest potential detrimental impact for financial stability and the overall performance of the financial market.
- An example of a financial product which caused considerable detriment to a very large number of consumers is payment protection insurance although the actual financial harm for each individual consumer was much smaller than potential or actually financial harm caused by mortgages to some consumers.
- Regulators and consumer organisations identified examples of discrimination in the insurance, mortgage, basic banking, securities and consumer credit markets. Across these sectors there is evidence of discrimination or effective discrimination on the basis of age, gender, health status, disability, internet access, employment status, and residency.

The present chapter identifies financial products which may have the greatest disruptive impact on the Single Market.

As noted earlier in the report, a disruptive impact may manifest itself at three different levels:

- First, the disruptive impact may be of such magnitude that it imperils financial stability and hence perturbs the context in which the Single Market operates.
- Second, some of the financial products may have detrimental impacts for particular groups of consumers who, as a result of these negative impacts, curtail some or all of their cross-border activities (such as purchases of goods, services, property and other investments, travel, cross-border moves, etc.).
- Third, some the products may impact many consumers even though the magnitude of the impact is relatively small for each individual consumer.
- Fourth, discrimination by financial services providers may also hamper the functioning of the Single Market.

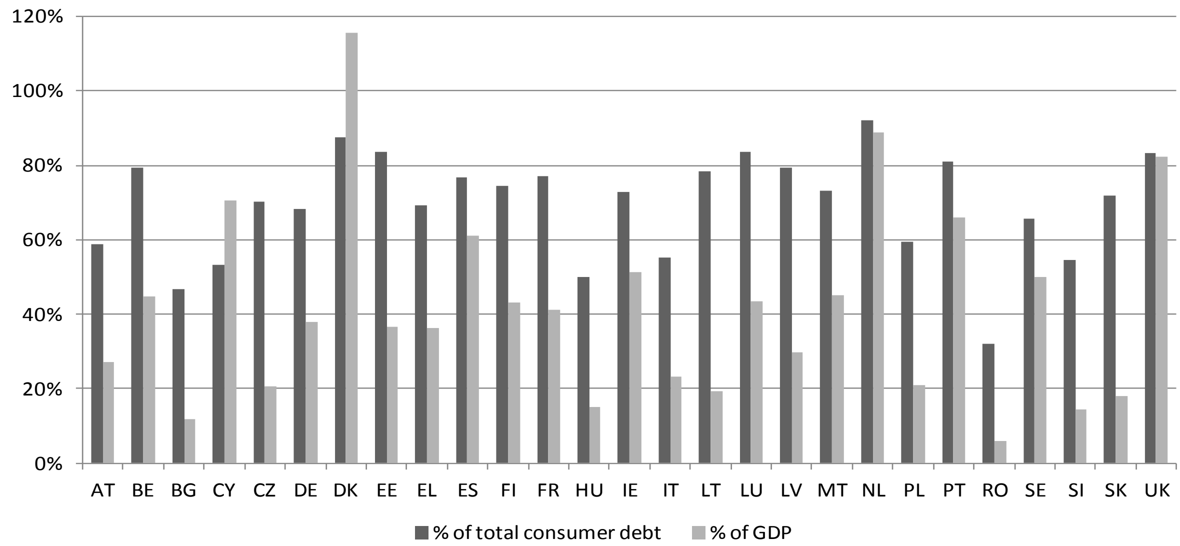
It is important to note that the survey of stakeholders and the review of the literature and reports, studies, etc. from regulators, financial ombudsmen, central banks, etc. did not identify any financial products with such potential disruptive consequences. In contrast some discriminatory practices were identified by stakeholders in their survey responses.

Thus, the analysis below is based on a subjective assessment of the potential consequences rather than hard evidence. However, the assessment is not entirely subjective as it takes account of the developments over the last years in the USA.

4.1. Potential disruptions affecting financial stability

Mortgage debt accounts by far for the largest share of consumer debt in all the EU countries (see figure below) with the share of mortgage debt in total consumer debt ranging from 47% in Bulgaria to 92% in the Netherlands at the end of 2011. As a percentage of GDP, mortgage debt ranged from 6% of GDP in Romania to 116% in Denmark[135].

Figure 15: Consumer housing loans and mortgage debt as % of total consumer debt and % of GDP (end of 2011)



Source: ECRI database.

[135] For a review of household indebtedness in the run-up to the financial and economic crisis, see European Parliament (2010a).

In light of the high level of mortgage debt carried by consumers and on the balance sheets of financial institutions, of all consumer-focused financial products and services, this particular financial product has the greatest potential to create financial stability risks and impact negatively on the performance of the Single Market if not well regulated and sold prudently to consumers.

4.2. Financial products with the potential to affect a large number of consumers in various national markets

4.2.1 Mis-selling of payment protection insurance

PPI mis-selling has brought about consumer detriment in at least three Member States (the UK, Spain and Ireland) and, with reference to the theory, is due, at least in part to a mix of behavioural biases (insofar as consumers did not understand fully the terms and conditions of the product they were being sold) and firm behaviour (due *inter alia* to remuneration structures, sales people of PPI were not necessarily acting in the best interest of consumers). In a cross-border context, these issues are likely to be more problematic. For instance, if foreign consumers face a language barrier they are even less likely to understand the terms and conditions of the product being sold. Moreover, the credit institution has more scope to claim consumer understanding was the problem in cases that arise rather than firm behaviour. This has issues for resolving disputes successfully.

Mis-selling of PPI has been the largest mis-selling scandal in UK financial history, with about GBP 18.8 billion set aside by banks for compensation payouts as of August 2013. This GBP 18.8 billion is equivalent to 1.2% of UK GDP (in current prices) in 2012.

4.2.2. Insufficient information on life insurance products

Insufficient information on life insurance products has been observed in a number of Member States[136]. In terms of the issues it gives rise to, there are similarities to the mis-selling of PPI case. What is interesting about the life insurance products case is that it appears that in a number of Member States firm behaviour is highly relevant - fees are non-transparent, the financial benefits of the products are unclear, etc. To the extent that firms undertaking these bad practices can gain market share in other Member States, further integration of the Single Market in financial services will arise in a form that is detrimental to consumers.

4.2.3 Insufficient information provision and lack of suitability of investment products

Information provision and the suitability of investment products is a problem area in a large number of Member States.

Information provided by sales staff to consumers has been deemed to be lacking in detail on risks, duration of investments, key terms within agreements, etc. Further, with regard to complex products, staff appear also to be failing to undertake proper assessments of consumers' financial sophistication before making sales. Instances of pressure selling and other practices were also observed.

As in other cases, these problems are likely to be keenly felt in a cross-border context. More specifically, however, if individual expectations of sales quality is high in their home Member State and low sales quality is experienced in other Member States (that is, abroad) then consumers may be reticent to carry out further cross-border transactions. This suggests that it may be important for consistency of standards to be established in sales of

[136] *Inter alia* Austria, Czech Republic, Finland, Germany, Hungary, Italy, Slovenia and Spain.

investment products across Member States, as certain initiatives already underway (for example, in the area of PRIPs) consider.

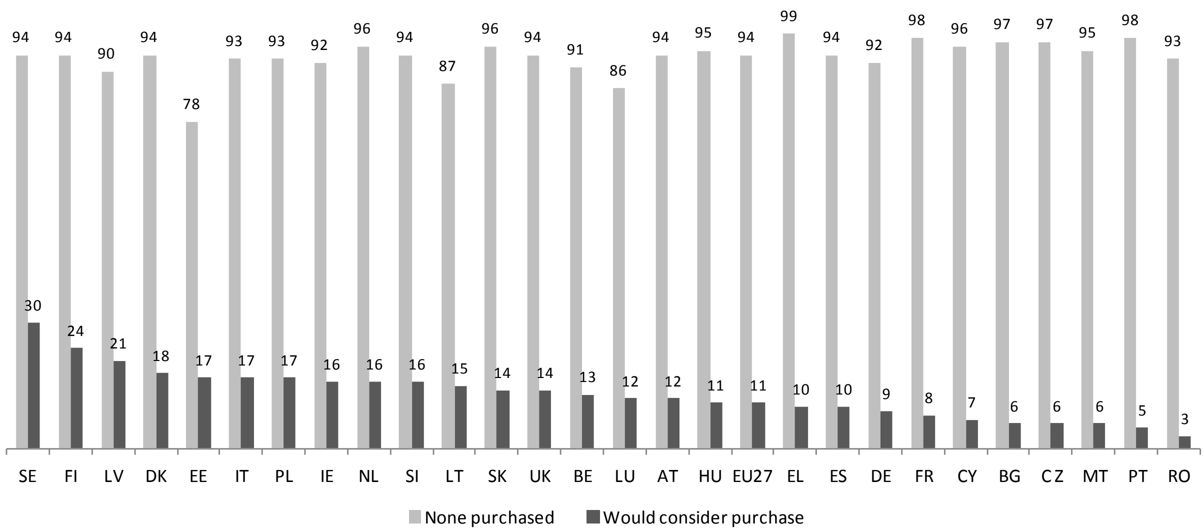
4.3 Potential disruptions affecting cross-border activities of consumers in the financial sector

Before reviewing the potential disruptions to financial cross-border activities[137], it is important to note that European consumers engage in very little cross-border trade in financial services.

According to a recent Eurobarometer survey[138] run in September 2011, 94% of survey respondents in the EU27 have never purchased a financial product in an EU Member State outside their home country. Moreover, only 11% indicated that they would consider buying a financial product in another EU country in the future. The main reason is most survey respondents did not see a need to do so as they can purchase all the financial products they require at home or they prefer to do so.

This general result applies also at the level of Member States with more than 90% of respondents in all EU27 countries but Estonia, Lithuania and Luxembourg reporting that they did not purchase cross-border a financial product or service. In these last three countries, respectively 22%, 13% and 14% of survey respondents reported having engaged in a cross-border purchase of a financial product or service.

Figure 16: Percentage of Eurobarometer survey respondents who have not purchased a financial product cross-border and who would consider doing so – by Member State 2011



Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

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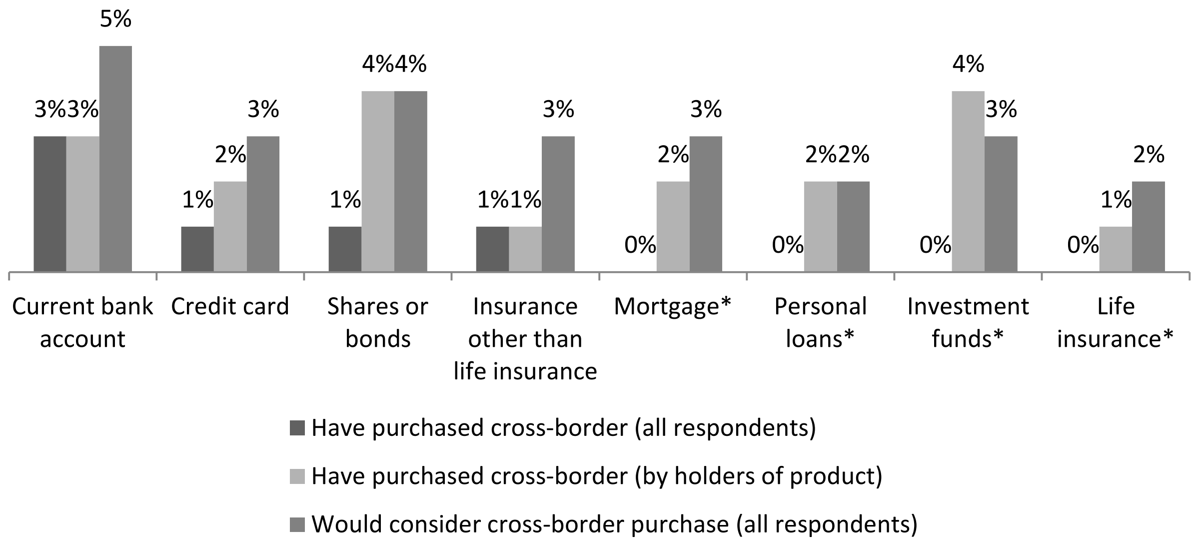
137 A cross-border transaction is defined for the purpose of the present report as involving either a) a consumer and a supplier in an EU country other than the consumer's home country or b) a consumer and foreign provider supplying a financial product or service in the consumer's home country under the passporting regime.

138 Special Eurobarometer 373 (2012), Retail Financial Services, March. The survey was undertaken in September 2011.

Among the various financial products considered in the survey (current bank account, shares and bonds, credit card, non-life insurance, mortgage, personal loan, investment fund life insurance), the current bank account was the financial product for which the highest share, albeit very small, of survey respondents (3%) reported having bought such a product in an EU Member State other than their home country. The other three financial products which a very small proportion of survey respondents reported to have bought cross-border are shares or bonds, credit cards and non-life insurance. In each case, only 1% of survey respondents indicated having done so.

The proportion of survey respondents who would consider buying a financial product is also very small across the various financial products, ranging from 5% for current bank accounts to 2% for personal loans and life insurance.

Figure 17: Percentage of Eurobarometer survey respondents who have purchased a financial product cross-border or who would consider doing so – by financial product 2011



Note: * = less than 0.5%.

Source: Special Eurobarometer 373 Retail Financial Services, April 2012.

Concerns by consumers about consumer protection may hold back the pace at which the further integration of the Single Market in financial services takes place.

Whether consumers transact with foreign credit institutions in their home Member State or abroad, it is likely that bad experiences would reduce the likelihood of consumers engaging in future cross-border transactions, which in turn stifles the development of the market for cross-border financial services. This is the central basis for appreciating that each of the cases considered within this report has a cross-border dimension.

Chapter 2 listed a number of channels through which consumer detriment in financial markets may arise: market failure, regulatory failure, behavioural biases and firm behaviour. In a cross-border context, the impacts of these channels on consumer detriment may be more severely affecting the further integration of the Single Market:

- **Market failure**: One reason that market failures arise is due to problems of trust between consumers and credit institutions. These issues may be more severe if consumers are interacting with unfamiliar credit institutions (for example, new entrants from other Member States) because one bad experience may prevent further uptake of financial services from foreign institutions.

- **Regulatory failure**: Numerous examples of regulatory failure have been outlined through this report. In a cross-border context, regulatory failures are likely to be felt due to inconsistencies in regulation across national Member States. Particularly if consumers have high expectations of regulatory quality at home and these standards are not met abroad, consumers may be reticent to carry out further cross-border transactions.
- **Behavioural biases**: Behavioural biases are abundant but are probably made more severe when consumers are transacting outside of their home Member State (for example, in a foreign language).
- **Firm behaviour:** Lastly, it is not necessarily the case that all forms of cross-border credit intermediation are beneficial. A case in point is if credit institutions that undertake not to act in the best interest of consumers at home establish a presence in a foreign Member State – the outcome is likely to be that the foreign Member States end up 'importing bad practises'.

4.4. Discrimination of a group of consumers or SMEs

Besides the various issues affecting Single Market integration which was identified above, discrimination by financial service providers does also affect negatively the performance of the Single Market.

The stakeholder survey questionnaire included questions about potential discrimination, and, in response, regulators and consumer organisations identified examples of discrimination in the insurance, mortgage, basic banking, securities and consumer credit markets. Across these sectors there is evidence of discrimination or effective discrimination on the basis of age, gender, health status, disability, internet access, employment status, and residency. Details are set out below by sector.

4.4.1. Insurance market

In the insurance market, there is a trade-off between economic efficiency and socially desirable non-discriminatory pricing (and as a result some interventions prevent discrimination on the basis of certain individual characteristics). This is reflected in the examples of discrimination identified by regulators and consumer associations.

Organisations from several countries discuss examples of discrimination that may also be considered to be examples of risk-based pricing, including higher life and health insurance prices for the elderly, disabled, women and those in poor health, and higher car insurance prices for males (although a European Court of Justice ruling in 2011 now prevents discrimination on the basis of gender in the insurance sector).

In addition, examples are identified of effective discrimination against those who wish to hold products only for short periods, those who are self-employed or unemployed and existing customers relative to new customers. Finally, one organisation reported that the elderly are targeted by life insurance sellers since they are considered to be easier to convince to purchase these products.

- In Austria, a number of travel health insurance providers were accused of discriminatory behaviour relating to the access conditions to their insurance coverage. In one case, a court ruled that the conduct of a provider constituted indirect discrimination based on disability, and the policyholder was granted compensation of EUR 1 500. In response, the insurer changed its general terms and conditions, which now require medical checks for disabled policyholders. The Klagsverband considered this response another type of indirect discrimination based on disability. The VKI considered that the complaint was not a unique case, but seemed to be a systematic business practice of the insurer, as shown by the inclusion of discriminatory clauses in the firm's general terms and conditions.

- In response to the stakeholder survey, the Danish regulator reported that group life insurance products become cheaper between the first period and the last period in which the consumer holds the product. Therefore, the products can discriminate against a group of consumers who only hold the product for a short period. In addition, it can be difficult or impossible for Danish consumers to enter a new group life insurance contract, as these are often linked to a job position. Therefore consumers who work for themselves or are unemployed are disadvantaged in this market.

- A French consumer association reported discrimination based on age and state of health for payment protection insurance. For the same amount of borrowed money and the same repayment period, the cost of this insurance varied between policyholders.

- In Germany in 2008, the financial regulator anticipated that the introduction of flat-rate risk premiums for switching tariffs in private health insurance would disadvantage existing customers, while benefiting new customers entering the schemes. This belief was based on the fact that the levy did not lead to any savings for existing customers through shifting from old schemes to the new insurance, even for low-risk customers. In contrast, new customers entering the policies benefited from low basic insurance fees. As a result, the change in the policy rules discriminated in favour of new customers. Following several court proceedings, the German Federal Administrative Court prohibited insurers from charging a risk mark-up for tariff switching in private health insurance.

  During the following year, the German regulator received a number of complaints regarding maximum age limits on eligibility for comprehensive insurance policies, as applied by two insurers. This clearly has the potential to discriminate against older customers. The insurers argued that even after the introduction of the General Equal Treatment Act (Allgemeines Gleichbehandlungsgesetz), their setting of a maximum eligible age of 65 was legally permissible, since this approach would be covered by the principles of risk-commensurate calculation, and would therefore be in compliance with the relevant laws. However, the regulator disagreed on the basis of insufficiency of the insurers' statements, which lacked the precise calculations, derivations and criteria required to support the determined maximum age. As a result, the insurers removed their maximum age limit for medical expenses and daily hospital allowance insurance.

- According to the Slovenian consumer association sellers of life insurance targeted certain groups, such as the elderly, that they considered would be easier to convince to purchase these products.

- The Spanish financial services consumer association reported that health insurance is subject to discrimination on the basis of at least age and gender. Children and the elderly receive higher health insurance quotes than other consumers, on the basis that the likelihood of their requiring treatment under the policies is statistically higher. Women face higher quotes than men for the same reason. The association also notes that, in common with other countries (and noted by the French consumer association in its response), men and women who were identical in all other respects would have until recently paid different prices for car insurance. For life insurance products, age-based discrimination is a feature in the market, as quotes rise markedly for consumers above 60 and continue to rise progressively with every year above that age.

4.4.2. Mortgage market

In the mortgage market, regulatory documents and survey responses reveal examples of discrimination against existing clients relative to new clients (in terms of eligibility for discounts), against those who wish to live in rural areas (in that it is harder to obtain finance for properties in rural locations), and against non-residents (who have restricted access to loans).

- The Danish regulator reported that it can be more difficult for an individual to obtain a loan to finance the construction or purchase of a house if the house is in a rural location. This is due to the fact that approval for a loan is not only based on the borrower's ability to repay, but also on the marketability of the house. Therefore those who wish to live in rural areas can experience discrimination in relation to this product.
- The financial regulator in the Netherlands reported that in the case of some mortgage providers new clients are eligible for discounts that existing clients cannot access. Thus, existing clients have to pay higher interest rates than new clients. While existing clients can switch providers, this is often costly and complex. The regulator has approached some of these providers to alert them to the problem as it believes this type of price discrimination to be undesirable.
- According to one Romanian bank, mortgage loan legislation restricted mortgage loans such that non-resident individuals could not buy land or property in Romania.

4.4.3. Basic banking

In the area of basic banking[139], examples of discrimination include higher fees for those who do not do bank electronically (a group with a disproportionate share of elderly consumers) and unavailability of bank accounts for non-residents.

- The Irish Central Bank conducted a review into bank charges. Based on a hypothetical set of representative profiles it calculated the costs for users over the course of a year. Manual transactions incur fees for current account holders. The Bank therefore concluded that those who undertake more manual transactions incur higher fees than those who do these transactions electronically. Hence those who do not use the internet, a group that includes a disproportionate number of older people, are thereby at a disadvantage.
- The Spanish consumer association reported that the increasing use of online banking services excludes a large part of the population that do not use the internet, especially those aged 55 and over. For example, in some cases the customer is forced to pay a fee to use postal rather than online banking, which is discriminatory towards those who are not familiar with new technologies.
- The French consumer association reported that, in France, the right to have a bank account does not apply to non-residents[140]. Obviously, this restriction to the right to a bank account creates complications for residents of other EU Member States who work in France without being domiciled there and are denied a bank account by banks in France. In such circumstances, any French work income has to be paid to

[139] For a general overview of the provision basic banking services in Europe, see European Parliament (2011).

[140] According to the article L 312-1 of the Code monétaire et financier.

an account held outside France, most probably in the worker's home country. Such restriction would be abolished under the European Parliament's proposal that anyone legally residing in the EU should have the right to open a basic payment account, and this right should not be denied on grounds of nationality or place of residence[141].

4.4.4 Securities

Mis-selling of securities can be a problem for any inexperienced investor, but there is some evidence from a small number of countries that the elderly may be especially at risk of being sold unsuitable investments or targeted by aggressive sales tactics. In one case, older people were the typical victims of pressure selling. In another example, companies did not take necessary measures to assess the suitability of products for older customers, failing to take into account their specific needs, preferences and risk profiles. In a third example, a majority of complaints to a particular bank came from older people who were worried about the unsuitability of bonds and investment products.

- In France, the financial market regulator (the AMF) received numerous complaints regarding debt securities, with the typical victim being elderly (over 80) with no knowledge or experience of finance. Advisors visited potential customers at their homes or saw them at the agency in the presence of several other advisors. The regulator described the sales techniques as "fairly aggressive". Salespeople pushed potential clients to purchase these products during the course of a visit, even if they did not correspond to their needs. Clients complained that they received insufficient and misleading information and were not aware of product specifications.
- In 2010, the Irish regulator carried out an examination of selected credit institutions, life insurance firms and investment and stockbroking firms in relation to the suitability of investment products sold to older consumers, and found a number of "issues of concern". Financial companies often did not have a definition of older customers, such as the regulator's recommended "benchmark" of 60 years of age. Companies were not making an effort to ascertain potential customers' risk profiles, and were not using the lowest risk profile as the default (as they should have been). Companies were not offering older customers the option of having a third party present when they had no previous investment experience. They did not offer advice on emergency funds to be kept aside for unforeseen events or possible medical costs, which the regulator recommends they do. Advice was often generic in nature rather than, as is required by Irish consumer law, setting out why the product is suitable for the customer. Finally, in four cases, discussions took place between providers and the regulator's mystery shoppers regarding products that could not be accessed for up to six years, which may not have been suitable given the age profile of the consumers in question.

The UK regulator conducted an industry-wide review into complaints handling. As a result, one bank was fined for wrongly rejecting complaints from customers about retail investment products. These included complaints relating to mis-sold bonds, savings and investment products. Many of the complainants were older people concerned about the suitability of the products. More than half (55%) of the complaints that the bank had handled were from customers over the age of 60, and almost four-fifths (77%) came from inexperienced customers. Around GBP 17 million is due in redress from the bank and other banks have been fined for similar activities.

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[141] See http://www.europarl.europa.eu/news/en/news-room/content/20131206IPR30037/html/Basic-bank-accounts-for-all.

5. FINANCIAL SERVICES AND PRODUCTS WITH SUBSTANTIVE BENEFICIAL EFFECTS FOR INDIVIDUAL CONSUMERS AND SMES

KEY FINDINGS

- The key characteristics of the financial products identified by stakeholders as being beneficial to consumers are that they improve consumer welfare through:
  - better tailoring of products to consumers' individual needs, rather than them having to use a more generic product such as mortgage products, tailored consumer credit and auto-enrolment pensions;
  - offering consumers greater flexibility in meeting the terms of the agreement such as, for example, P-accounts in Germany or credit agreements offering the possibility to skip one or a few payments with no penalty on outstanding credits;
  - providing better accessibility of products and services and/or utilising better security such as Internet and electronic banking, including the use of mobile devices, cardless and PIN-less transactions and debit and credit cards;
  - offering consumers lower prices such as the products consolidating existing loans into lower interest, longer term vehicles and a range of state-subsidised savings and loan regimes;
  - offering a higher quality of service such as private health insurance; and,
  - providing simpler products and services where more complex products are not required such as a basic bank account.

5.1. Overview

As noted in Chapter 2, well designed financial products and services help consumers:

- smooth their life-cycle earnings by providing a variety of savings instruments to accumulate funds to provide income during retirement;
- overcome their short-term budget constraints through borrowing for the acquisition of consumer goods and services, property, financial assets, etc.;
- protect themselves from various risks through insurance;
- economise on the need for cash through the use of alternative store of values (such as, for example, a current account) and payment instruments (such, as for example, direct debits or credit cards).

This chapter identifies those financial products which according to stakeholders and the literature have delivered substantive benefits to individual consumers or SMEs.

These financial products have in common that they contribute positively to consumer welfare through:

- Products and services which offer consumers greater flexibility in meeting the terms of the contract;
- Better tailoring of products to consumers individual needs, rather than them having to use a more generic product;

- Better accessibility of products and services, utilising better security;
- Products and services that offer consumers lower prices;
- Product or services which offer a higher quality of service; and,
- Simpler products and services where more complex products are not required.

Within these six categories we have identified the following key product characteristics[142]:

1. Better tailoring of products to consumers' individual needs, rather than them having to use a more generic product. Such products include, for example,:
    - *Mortgage products* when well regulated
    - *Tailored loan products,* such as specific car loans
    - *Auto-enrolment pensions*, using behavioural insights to ensure that consumers save for their retirements, which they would do in the absence of discounting biases
2. Products and services which offer consumers greater flexibility in meeting the terms of the agreement
    - *P-Accounts* in Germany, allowing consumers greater flexibility when facing garnishments
3. Better accessibility of products and services, utilising better security
    - *Internet and electronic banking, including the use of mobile devices, cardless and PIN-less transactions*
    - *Debit and credit cards*
4. Products and services that offer consumers lower prices
    - *Consolidation of existing loans into lower interest, longer term vehicles*
    - *Range of state-subsidised savings and loan regimes* – varying by country – either through subsidies or tax breaks
5. Product or services which offer a higher quality of service
    - *Private health insurance*
6. Simpler products and services where more complex products are not required
    - *Basic bank account*

It is worth noting that this list, whilst reflective of the views and opinions garnered through the survey of stakeholders, may appear counter-intuitive in some cases, for the following reasons:

- It contains some services and products which earlier in the report had been identified as being potentially detrimental or actually mis-sold.
- It is subject to very different perceptions of what services and products are 'standard' and which are delivering 'benefit' to consumers over and above that which could otherwise be expected. In short, 'benefit' appears to be correlated in people's minds with 'innovation' and 'how recently the product was made available'. For example, very few respondents from Western Europe identified or discussed the

[142] Interestingly a number of areas you might expect to see emerge, in terms of delivering benefits, such as Islamic finance and international payment services, were not referred to in responses, and have therefore been excluded.

very substantial consumer benefits for products and services which may be taken for granted because they have been widely available for a long period of time, such as for debit cards, credit cards, cheque accounts, savings accounts and mortgages. The converse of this is that these products were regularly mentioned by respondents from the Central Europe, demonstrating how innovative and beneficial these still appear[143].

This issue is referred to as the problem of '*over-familiarisation*', where respondents are so used to a benefit being a standard part of the financial market they no longer perceive clearly how beneficial it is to consumers.

- It is illustrative of the different benefits different groups of consumers prioritise. For example, whilst (mainly though not exclusively younger) consumers may prioritise the benefits related to e-banking, banking using mobile devices, and cashless purchasing, other (mainly though not exclusively older) consumers prioritise the benefit of still being able to retain access to more traditional forms of financial service, such as recently seen in the UK where public uproar prevented the termination of the cheque as a valid form of payment.

This chapter addresses each major area in turn, presenting a broad summarisation of the main points, and then presenting country-level information and evidence.

5.2. Better tailoring of products to consumers individual needs, rather than them having to use a more generic product

5.2.1. Well regulated mortgage products

Whilst it is clear this type of product suffers from 'over-familiarisation', a number of respondents identified mortgages, or particular aspects of mortgages as delivering benefits to consumers:

- **Denmark** – A Danish respondent noted that the Danish Mortgage Model is characterised by competitive prices, stability and transparency, all of which benefit consumers. They identified the cause of this as being due to the interest rate of the loan and prepayment price being directly reflected in the price of the mortgage bonds funding the loan. Interest rates mirror the prices investors pay for the bonds and are therefore attractive due to their high security level, leading to low mortgage rates, even during the recent financial crisis. The respondent considers that the Danish mortgage model makes it possible for the majority of people to obtain a loan due to the fact that the loan is based on the value of the real estate, and not just the lender's ability to repay the loan.
- **France** – A respondent noted that the French home loans market is one in which; '*most home loans are not mortgage credits but personal loans not secured by a mortgage on real property*,' and that as such, loans are given on a loan to income ratio, not loan to value ratio, which was viewed as making them responsible lenders in this regard, indicated by home loans only being present in 7% of over-indebtedness filings[144], and with the loans under consideration being unsecured, not secured loans make foreclosure a different beast for consumers than other in other EU countries.

[143] Indeed, if a consumer took out a mortgage in 1990 for 25 years in the Czech Republic, essentially at the first opportunity, and was allowing this to run to term, they would still be paying off this 'innovative' product.

[144] Banque de France (2011b) - Banque de France (2011b): 'Enquête Typologique 2010 Sur Le Surendettement'. Available at : http://www.banque france.fr/fileaok, thanksokdmin/user_upload/banque_de_france/Mission/Protection_du_consommateur/enquete_typo2010_surendettement.pdf.

- **Ireland** - The Central Bank of Ireland undertook research into the effects of the Mortgage Arrears Resolution Process (MARP), part of the Code of Conduct on Mortgage Arrears (CCMA), by means of a survey of 209 borrowers, as a result of which the boards must consider each borrower on a case-by-case basis. MARP stipulates that:
  - lenders must explore all alternative options for repayment arrangements while a minimum list of these is defined, including interest-only arrangements, extending the term, changing the type, deferring payment for a period.
  - The CCMA also mandates the creation of an appeals board by lenders. If the lender does not agree to alternative arrangements, it must explain its decision in writing and the borrower may appeal this decisio.
  - Only after eight months and after every reasonable effort has been undertaken to find an alternative solution can repossession be applied for.
  - 71% of borrowers surveyed had entered into an alternative arrangement with their lender resulting from MARP.
  - 80% of those completing the Standard Financial Statement (SFS) had done so.
  - Of the 10% using the MARP appeals process, 60% negotiated a more sustainable arrangement with their lender.
- **Romania -** Saving-loans contracts in a collective system for housing offers people with low and medium incomes the possibility to save money, to receive a yearly State Premium and to invest the accumulated amounts, plus the loan granted by the bank, for the improvement of housing conditions, including purchase or construction of a house, renovation, rehabilitation and modernization[145]. Moreover, housing loans were also identified as being beneficial to consumers[146].

5.2.2. Tailored loan products

A respondent from France noted that the availability of loans, such as specific car loans, personal loans, and loans against property were identified as delivering significant benefits to consumers by, for example *consumption smoothing* – allowing consumers and SMEs to smooth expenditure through their lifetimes to maintain a constant standard of living. This is the type of product that clearly suffers in this chapter from 'over-familiarisation.'

5.2.3. Auto-enrolment pensions

Pensions suffer from the problem of 'over-familiarisation', as discussed above, which leads to few respondents mentioning tax efficient savings regimes to pay for consumer's retirement years in general. Instead particular innovative features of mortgages were discussed, and in particular pensions, which make use of lessons from behavioural economics to assume opting-in[147] rather than opting-out as the standard to ensure that consumers save for their retirements which they would do in the absence of discounting biases, are identified as beneficial to consumers.

[145] www.bcrlocuinte.ro.

[146] http://www.garantibank.ro/en/loans/consumer/housing_loan.html.

[147] Including, in the extreme, mandatory participation.

Examples include:

- **Romania** – Unlike the public PAYG mechanism (pay as you go), the private pension system is not based on immediate redistribution of funds and inter-generational solidarity, but on saving and investment. Each participant/future pensioner, has an account in which contributions are accumulated and capitalized, while benefiting from transparency and guarantees provided by the legislation: the participant always knows the level of contributions, the yield obtained and the default value of net assets in his account[148].

5.3. Products and services which offer consumers greater flexibility in meeting the terms of the agreement

This group of financial products includes all those products whose terms and conditions can be adjusted, at least to some extent over the life of the product to reflect changes in economic and personal circumstances. Such financial products are obviously more beneficial to consumers than non-flexible products which, in the case of non-respect of contractual terms and conditions, result immediately in default and high legal fees and charges, and possibly in bankruptcy.

Other products in this group include those that help consumers when they have run into financial problems.

One example of such a product is the garnishment protection account (known as the P-Account) introduced in Germany in July 2010. It is designed to allow debtors affected by bank account garnishment to make non-cash payment transactions, and to increase the ease with which these debtors can use the non-garnish able share of their income. In general, P-accounts constitute a basic giro account but provide consumers with protection from garnishment of parts of their income. Specifically, the accounts provide garnishment protection for a non-bureaucratic flat basic amount of income of each account holder, and allows for additional amounts to be included in this protected share, if required verifications are supplied by the respective debtor (Verbraucherzentrale Nordrheinwestfalen, 2010).

In 2011 it was recognised that the P-Account was generating a variety of consumer complaints regarding the setup and operation of the new garnishment protection accounts made to BaFin:

- A total of 96 complaints related to problems with the transfer of non-garnishable amounts from their P-Accounts.
- Another problem concerns consumers' opportunity to start a P-Account, which is dependent on the initial existence of a normal current account. Whereas clients who are already in possession of a current account are able to convert it into this new type, consumers who, for whatever reason, are not allowed to initiate a current account have no possibilities of access to a garnishment protection account.
- Further, P-Accounts involve considerably larger banking fees than regular current accounts (Verbraucherzentrale Nordrheinwestfalen, 2010), resulting in various complaints concerning permissible account management fees made to the BaFin.

[148] See: http://www.csspp.ro/publicatii/evaluarea-perceptiei-populatiei-privind-implementarea-sistemului-de-pensii-private-in-romania/8.http://www.csspp.ro/comunicate/pensiile-private-la-31-decembrie-2012/462. http://www.curierulnational.ro/Finante%20Banci/2012 06-01/Pensiile+private,+cel+mai+avantajos+beneficiu+pentru+angajat. http://www.zf.ro/pensii-private/introducerea-pensiilor-private-de-ce-este-necesara-si-ce-avantaje-aduce-3030754.

Finally, Die Welt (2011) points to some difficulties of understanding and processing the different certificates and verifications required, e.g. in order to increase the disposable account income which is protected from garnishment.

Nevertheless, the BaFin emphasises that, in spite of the above problems which customers face in opening and handling the new P-accounts, their introduction has resulted in improved consumer protection against garnishment.

5.4. Financial products which are easier to access and/or provide better security

5.4.1. Internet and electronic banking, including the use of mobile devices, cardless and PIN-less transactions

A number of respondents made reference to the benefits that internet and electronic banking deliver, both in terms of accessing accounts at all hours of day and night and in terms of the general ease with which accounts and payments could be created and managed. Reference was particularly made in relation to the importance of security in terms of making payments faster and safer.

A number of different examples were referenced by respondents:

- Respondents from Lithuania and Romania noted that banking over the internet delivered significant benefits.
- A respondent from Romania identified that 'smart ATMs' deliver additional benefits, over and above those of standard ATM, which again suffer from the problem of over-familiarisation. In the example provided the smart ATM offer the possibility of making the following transactions without using a debit or credit card, and even without being a bank customer, requiring only the deposition of money into the smart ATM[149]:
    - Invoice payments
    - Mobile number recharge
    - Euro Sell (Exchange Transaction)
    - Bonus Card debt payment
    - Money deposit
- The benefits of being able to access e-banking services via mobile devices were noted by a respondent from Romania.
- The additional security of chip and pin credit and debit cards was noted by a respondent from Romania, although contactless debit cards were not mentioned by any respondents.
- Similar advantages are delivered by further products which are not mentioned by any respondents, for example the availability of terminals in bank branches, where one can manipulate your account without waiting for a teller is a benefit, in terms of again delivering better and easier access to accounts, but again suffering from the problem of over-familiarisation.

[149] http://www.garantibank.ro/en/delivery_channels/garantibank_atms/transactions/cardless_transactions.html.

5.4.2. Debit and credit cards

The debit card was mentioned by a Romanian respondent but otherwise suffered from the problem of over-familiarisation, except in particular instances where a respondent from Denmark noted the particular features of a particular model of debit card which brought consumers extra benefit over the standard debit card.

- **Denmark** – The domestic debit card scheme, the *Dankort*, is the most widely used electronic payment instrument in Denmark[150]. In 2011 the total spend using the *Dankort* was nearly DKK 300 billion, which corresponds to an average spend per capita of approximately DKK 87 000 (EUR 11 661)[151]. The *Dankort* is the most cost efficient payment instrument in Denmark being the cheapest for both merchants and consumers. Studies show that the costs per payment are lowest for *Dankort* payments at around DKK 3 per payment, while the social costs per cash payment amounted to just over DKK 7. Payments with international cards (e.g. VISA or Mastercard) involved the highest costs per payment, and were not accepted for some transactions. Similar systems are also used in other countries, such as Germany.

5.5. Financial products that offer consumers lower prices

5.5.1. Consolidation of existing loans

The ability to consolidate loans into a larger vehicle charging lower interest rates or extending the life of the loan, to reduce the impact of problematic debt on the consumer is a key benefit to consumers. Whilst the aggregate interest costs may end up being large in total over the term of the consolidation loan, individual repayments should be lower and therefore more immediately affordable. Examples were provided by respondents from the Czech Republic and Romania[152].

5.5.2. State-subsidised savings and loan regimes

An area of benefit to consumers, but which may not be immediately obvious, are state-subsidised savings or loan regimes, either through direct subsidies or tax exemptions and relief. The ability to generate higher returns/lower repayments through state intervention was noted by a Hungarian respondent, although examples, such as ISAs in the UK, which permit tax-free savings up to published limits, can be seen across the EU. The savings products in **Hungary** include:

- Home savings funds (LTP): These state subsidized monthly savings accounts are dedicated for residential purposes (purchase, renovation, refurbishment etc.). Maturity is between 48 and 120 months, at the end of which the customer may use the money accumulated through the monthly instalments, the interest rate, and the state subsidy. The state gives a 20% (up to HUF 72 000) bonus to the savings yearly, plus the customers can get a very beneficial mortgage (HUF) up to the sum of their savings at the end of the construction.

- Long term savings account (TBSZ): a savings account which has got a 1 year accumulation period and then an investment period. If the investment period is longer than 3 years, the customer does not have to pay the full tax on interests

[150] http://en.kfst.dk/Indhold-KFST/Publikationer/Engelsk/2012/~/media/KFST/Publikationer/Engelsk/2012/The%20Danish%20Payment%20Card%20Market%202012%2031052012.pdf. https://nationalbanken.dk/C1256BE9004F6416/side/CA4E0A40D2EF3F09C12579ED00328081/$file/betaling_engelsk_samlet_web.pdf.

[151] Converted on 12th September 2013 – EUR 1= 7.46038 DKK.

[152] http://www.garantibank.ro/en/loans/consumer/general_loans_with_real_guarantee.html.

(only 10%); and after 5 years the investment is exempt from the interest rate and from the capital gains tax. If the investment period is longer than 3 years, the customer does not have to pay the full tax on interests (instead of 16%, only 10%); and after 5 years the investment is exempt from the interest rate tax.

- Retirement savings account (NYESZ): state subsidized savings and investment account for retirement purposes, the earnings and the capital is freely accessible only after retirement (lump sum or annuity) – in case of an earlier withdrawal, 120% of the previous tax and other gains have to be repaid. The state gives a 20% (up to HUF 100 000 or in case of a retirement before 2020, HUF 130 000) bonus to the savings yearly, plus the savings are exempt from the interest rate and capital gains tax.

5.6. Financial products which offer a higher quality of service

Another example of 'over-familiarisation' where respondents have not universally identified benefits is private health insurance. Romanian respondents identified that private health insurance provides consumers benefits in terms of being a vehicle to access to health services of a higher quality relative to cost than would otherwise be the case through the public sector alternative.

5.7. Simpler financial products where more complex products are not required

Basic banking services[153] yield benefits to two groups: 'financially excluded' individuals and 'cross-border mobile' individuals.

Financial inclusion can be defined as having the opportunity to access the financial services products needed to participate fully in modern society and the economy[154]. A key driver of financial inclusion is having access to basic banking services. Individuals who tend to be financially excluded are also those who tend to be the most vulnerable members of society[155]. Research points to the fact that those living on low incomes, in deprived areas, or who are lone parents tend to be those who are most likely to be financially excluded in the EU[156]. Individuals who do not have access to either a current account or a basic bank account can be defined as 'unbanked'.

'Unbanked' individuals benefit in a number of different ways from gaining access to a basic bank account[157], dependent on the range of services provided, including[158]:

- *The ability to take jobs or rent property where a bank account is required;* In countries where employers frequently pay salaries directly into bank accounts, one of the most significant advantages of having a basic account is it makes it easier to gain employment. Indeed, individuals without access to bank accounts are effectively frozen out of the job market or they have to find someone whose account they can have their wages paid into, which is a risky strategy as they therefore must trust this person with their wages[159]. The other alternative is to try and find jobs

[153] These vary across the EU, due to the different banking systems and structures in the different Member States.

[154] See HM Treasury, 2007.

[155] See Consumer Focus, 2010.

[156] See Carbo et al., 2007; Beck & Brown, 2011.

[157] See Ardic et al., 2011; Citizens Advice Bureau, 2006; House of Commons Treasury Committee, 2006.

[158] See CSES, 2010.

[159] See Datta, 2009.

which offer payment in cash. However, as a result, they are likely to end up working in jobs paying a lower wage[160].

- *Access to benefits;* A number of welfare payments, such as pensions and social security, are now being paid directly into bank accounts in some Member States. Without access to a basic bank account, individuals who are entitled to these welfare payments may not be able to claim them.
- *Access to money transmission services*.
- *Lower transaction costs on payments and receipts*.
- *Access to discounts for electronic payment*; depending on the type of services provided by the basic bank account, access to such an account may open the possibility for previously 'unbanked' individuals to purchase goods and services online that may be cheaper than in 'bricks and mortar' shops or only accessible online[161]. Lack of access to payment means required for online purchases can cause those without bank accounts to pay more for goods and services. This is sometimes referred to as the 'poverty premium', i.e. the higher price poorer families have to pay for goods and services because they cannot access the online deals that are available to households with payment means accepted for e-commerce[162]. In a number of Member States, a payment by direct debit can yield a discount on the total amount owed. For example, in several countries across Europe, including Cyprus, France, Italy and the UK, the ability to make payments by direct debit may allow consumers to take advantage of discounts offered by utilities and other suppliers when paying by direct debit[163].
- *Quicker access to funds*.
- *Increased security through lower level of cash transactions*.
- *Increased choice of goods and services through the internet.* The ability to purchase online also means that the individual has more choice.
- *Ability to pay in instalments*: Lacking access to a bank account may also prevent an individual from purchasing certain goods or services from 'bricks and mortar' shops such as, for example, goods paid in instalments through direct debits or standing orders, or services requiring direct debits or standing orders such as certain type of mobile phone or pay-TV services, etc.
- *Reduced sense of financial exclusion*.

The second group of individuals likely to benefit are 'mobile consumers' including non-residents living near a border, non-resident property owners, foreign students, expatriates, temporary workers, non-residents whose parents live abroad, people married to a foreign national and other individuals who need to access bank accounts in Member States other than their own[164]. These groups need access to a bank account in order to pay for accommodation, to receive pensions or salaries, to pay bills and other such transactions. Opening a bank account in another Member State could have the added benefit of avoiding paying systematic currency conversion charges[165].

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[160] Ibid.

[161] See London Economics, 2011a.

[162] See Blake and de Jong, 2008; nef, 2008.

[163] This information is based on research undertaken by London Economics.

[164] See European Commission, 2007.

[165] See European Commission, 2011b.

Difficulties associated with gaining access to banking services in other Member States is one factor identified by the expert group as causing a problem for the mobility of labour across the EU and addressing this issue would contribute to strengthen the Internal Market[166].

Examples of basic bank accounts cited by survey respondents include:

- **France** - Savings account and Sustainable development passbook account (Livret A and LDD) - These products are guaranteed by the state and have fixed interest rates. Consumer can make request for this regularised savings account that protects him/her from any risk of loss. These investments allow financing of social housing and SMEs. However the interest rates of these products have fallen in recent years.
- **Hungary** – 'Zero-cost' accounts - these existed until c.2013, offering banking account packages with a very minimal (close to zero or in certain cases zero) monthly and transactional banking fees. These were widely popular on the market, and became the main vehicle for banks to acquire customers in the 2000s and early 2010s because the low charges associated with these accounts were beneficial for consumers.
- **The Netherlands** – 'Basisbankrekening' (basic bank account) - The 'Basisbankrekening' was introduced by the Nederlandse Vereiniging van Banken (Dutch Bank Association) in 2001 based on the idea that every individual older than 18 should be equipped with a bank account, even if they are indebted or homeless. The services of a 'basisbankrekening' are similar to those of a regular bank account.

[166] See European Commission, 2007. *Expert Group on Customer Mobility in Relation to Bank Accounts.*

6. FINANCIAL SERVICES AND PRODUCTS WITH SUBSTANTIVE BENEFICIAL EFFECTS FOR THE SINGLE MARKET

KEY FINDINGS

- Financial markets which work well for consumers make an important contribution to the strengthening and growth of the Single Market by supporting domestic demand and economic growth, and facilitating cross-border mobility and cross-border transactions.
- The following types of financial products and services have been identified in our research as having substantial positive effects on the Single Market:
  - Financial products and services which facilitate cross-border transactions, increasing choice and competition in non-financial goods and services such as payment services, credit cards, internet banking, facilitating e-commerce;
  - Financial products and services which facilitate cross-border labour mobility such as basic bank accounts, payment service networks including ATM networks and e-money;
  - Aspects of financial services and products which facilitate cross-border transactions in the financial sector such as the provision of standardised information through the Standard European Consumer Credit Information (SECI) and the European Standardised Information Sheet (ESIS).

Financial markets that work well, especially for consumers, are a key contributor to a strong and prosperous Single Market:

- First, as has already been noted earlier in the report, well-functioning financial markets allow consumers to overcome any short-term budget constraints and plan their financial affairs and spending over a longer horizon, ideally over their whole life cycle. This flexibility stimulates economic growth by supporting consumer demand and allocating excess consumer savings to efficient uses which help expand the economies' productive capacity. Moreover, the availability of insurance increases consumers' trust in the future and reduces the need to build up precautionary savings to deal with a number of adverse shocks such as accidents and injuries, loss of property due to fire, etc.
- Second, transparent and efficient financial products and services which serve consumers well increase more generally consumers' confidence and trust in public and market institutions[167]. Such stronger trust and confidence in turn support economic growth[168].
- Third, well-functioning, secure and cost-efficient payment systems in the Single Market reduce transactions cost and facilitate both domestic and cross-border purchases, and, thus, support aggregate demand in the Single Market.

[167] See Tonkiss (2009) for a discussion of trust, confidence and the recent financial and economic crisis.

[168] For an overview of the academic literature on the links between, trust and economic growth see Volland (2010).

Very limited information relevant to this chapter was gathered from the stakeholder survey and review of the literature. In part this may be due to the fact that survey respondents may have had difficulty seeing how the interests of the Single Market and individual consumers align, except at a fairly abstract level, given the limited degree of interaction an individual consumer will have with finance providers in foreign countries.

In general terms this chapter will therefore be more discursive, based on the authors' research and knowledge of the sector and the most substantial impacts at the Single Market level.

To that end, financial products and services have been categorised as follows:

- Financial products and services which facilitate cross-border transactions, increasing choice and competition in non-financial goods and services:
  - Payment services
  - Credit cards
  - Internet banking, facilitating e-commerce
- Financial products and services which facilitate cross-border labour mobility:
  - Basic bank accounts
  - Payment service networks including ATM networks and e-money
- Aspects of financial services and products which facilitate cross-border transactions in financial sector.

6.1. Financial products and services which facilitate cross-border transactions, increasing choice and competition in non-financial goods and services

The following sections outline the major benefits from services which directly support the Single Market, delivering greater choice and competition in non-financial good and services.

6.1.1. Payment services

The Payment Services Directive (PSD) (Directive 2007/64/EC) provides a comprehensive legal framework for the provision of payment services in the European Economic Area and created a new type of payment service providers, namely payment institutions. Following the implementation of the PSD, payment services within the scope of the PSD can only be provided by credit institutions, electronic money institutions, payment institutions (the new type of financial institution created by the PSD), post office giro institutions which are entitled under national law to provide payment services, the European Central Bank, and national central banks when not acting in their capacity as monetary authority or other public authorities and Member States or their regional or local authorities when not acting in their capacity as public authorities.

London Economics (2013) came to the conclusion that the PSD has, in the short period since its introduction, reached some of its general goals[169]. Its positive impact in terms of shorter execution times and greater transparency are not only apparent in the observed practice but were confirmed by users and competent authorities. The PSD also substantially contributes to achieving an overall Single Market in payment services and provides the legal framework to achieve this objective. However, at the present time, this is still very much work in progress.

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[169] London Economics (2012), 'Study on the impact of Directive 2007/64/EC on payment services in the Internal Market and on the application of Regulation (EC) No 924/2009 on cross-border payments in the Community'.

No substantial impact of the PSD can so far be observed with regard to market entry of new providers, technical innovations, and efficiency of the provision of payment services. As a result of so far relatively limited entry by de novo payment service providers and so far relatively limited new cross-border provision of payment services, the effect of the PSD from this perspective is at the present time relatively weak.

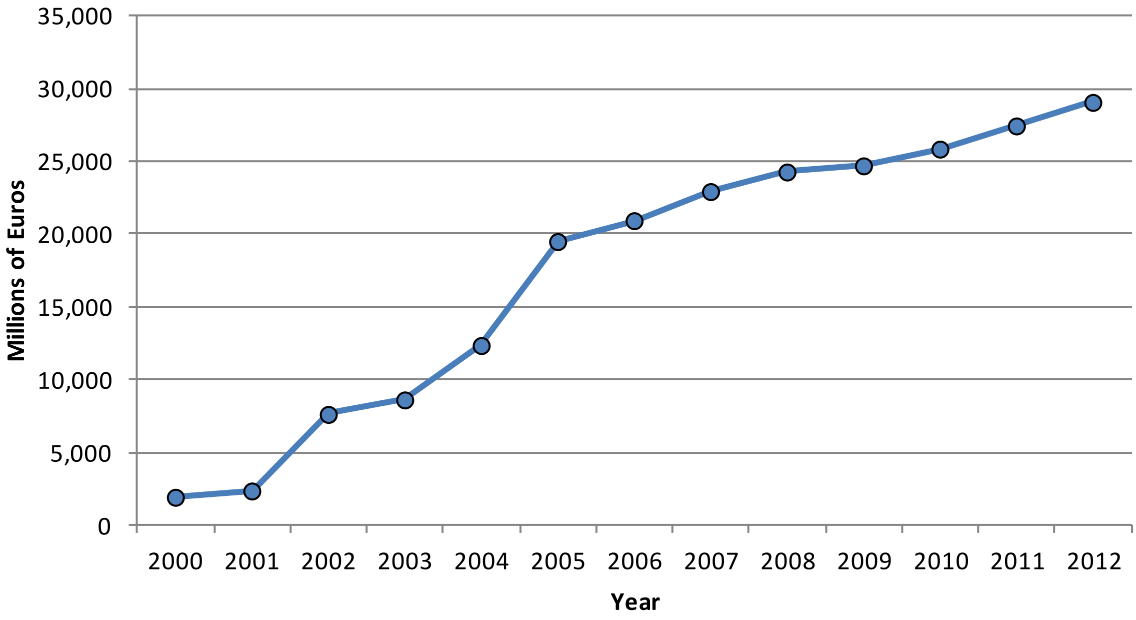
Particular benefits were identified as follows:

- **Spain** - Banco de España noted that before the application of the PSD, the dominating principle was that reception of transfers was exempt of fees. However, the Ley de Servicios de Pago (Law of Payment Services) establishes shared payment of fees between the beneficiary and the sender. However, it is possible to reach an agreement by which one of the parties (i.e. the sender) will assume all costs. This adds flexibility to the system. Taking into account the changes in the regulations, users of payment services can request the financial institution to inform them of the exact fees that will be charged and the institution is obliged to provide this information in writing or in another tangible means. This is an effort to secure the flow of relevant information in this regard. Banco de España also noted that national online transfers were subject to a bonus, which is a commercial policy that would suggest a discriminatory treatment of online cross-border bank transfers in relation to online national transfers.
- **Finland** – Payment innovations and the market entry of new payment service providers have the potential to promote competition and increase social welfare. The creation of the Single Euro Payment Area (SEPA) has the potential to increase cross-border competition in payment services and has a positive effect on payment innovations. The increasing use of cashless payment methods impacts the overall social costs of retail payments as well as social welfare (see Schmiedel et al., 2012).
- **Austria –** Faster payment transactions, lower costs, information availability for consumers, levels of security and increased mobility were noted benefits of the SEPA.
- **Hungary –** Swifter and more convenient money transfers were the noted benefits.

6.1.2. Credit cards

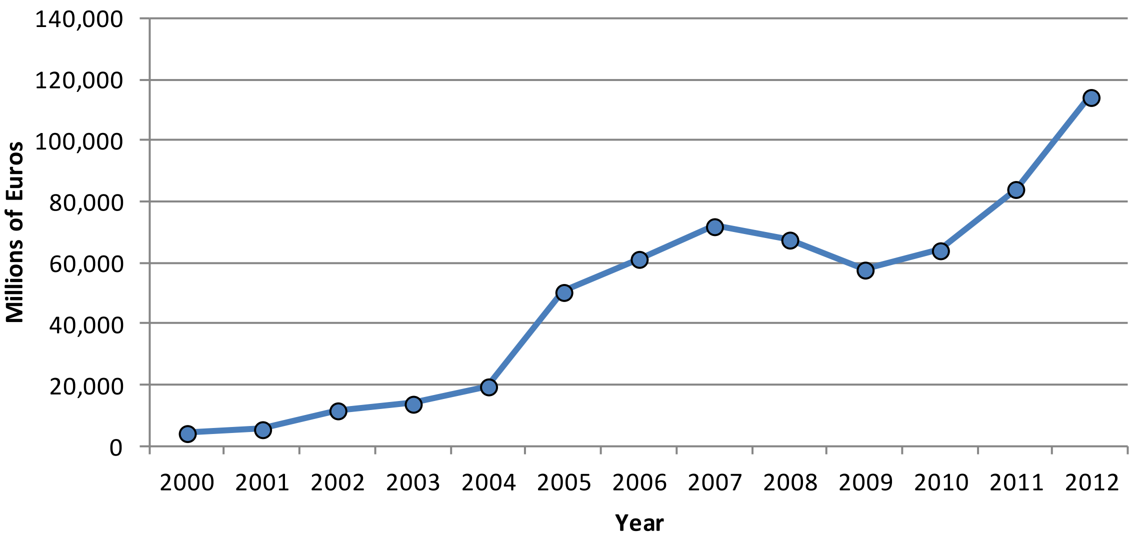
The benefits of a payment mechanism which is not affected by borders or domestic currencies in terms of widening and deepening the Single Market are clear, as can be seen by the increase in use in credit cards in non-domestic purchases, although no respondents identified this area as delivering benefits to the Single Market.

Figure 18: Value of cash withdrawals and loading/unloading transactions at terminals with non-domestically issued cards - EU27, 2000-2012



Source: Payments and Settlement Systems Statistics, ECB.

Figure 19: Value of payment transactions with non-domestically issued cards - EU27, 2000-2012



Source: Payments and Settlement Systems Statistics, ECB.

6.1.3. Internet banking, facilitating cross-border e-commerce

Internet banking is regularly cited by respondents from Germany, Lithuania, Romania, and Finland as a key gain for the Single Market, particularly where it facilitates e-commerce.

On 11 January 2012 the European Commission published 'A coherent framework for building trust in the Digital Single Market for e-commerce and online services'. Taking the definition of e-commerce as 'those services provided at a distance, electronically and at the request of a recipient of services against remuneration...[including] on-line retailing, on-line press, search engines, social networks, blogs, media streaming, on-line gambling and e-health' it is clear that Europe lags behind the rest of the developed world. In the USA 66% of internet users have made purchases on-line, in South Korea this figure is 94%. In Europe it is 57%, although Europe is growing faster than the US. This disguises massive variation. Whilst in Denmark, the Netherlands, the UK and Sweden two-thirds of individuals have ordered goods or services over the internet, in Belgium it is 38%, in Italy 15% and in Bulgaria and Romania around 5%. Just three countries, the UK, Germany and France, together account for 73% of the EUR 91 billion market in 2010.

Importantly only 9% of European consumers say they have shopped on-line cross-border in 2010. This is despite estimated welfare gains from accessing better or cheaper goods (excluding services) of around EUR 11.7 billion, or an amount equivalent to 0.12% of EU GDP. It is estimated that, if e-commerce was to grow to encompass 15% of the total retail sector, and Single Market barriers were eliminated then total consumer welfare gains would be around EUR 204 billion, or 1.7% of EU GDP.

Key barriers appear to exist on both the supplier and the customer sides, inhibiting usage. For suppliers the key issues are:

- Inconsistent ruling in cases across Member States, with different Member States finding in favour of opposing sides in cases that appear similar.
- Fragmented 'trustmarks', such as Thuiswinkel (the Netherlands) or Trusted Shops (the UK) which operate on a domestic level, do not vouch for foreign firms, and provide certification to different standards.
- Different policies in different Member States, with some states preventing entrance or banning on-line gambling and on-line pharmacies.
- Different approaches to contract law and intellectual property rights.
- Difficulties with, or refusal to deliver products to non-domestic consumers, in part based on issues with some postal services.

Consumers also appear to not purchase outside their domestic economy for a number of reasons:

- Price comparison websites do not list non-domestic providers.
- Difficulties making on-line payments with debit cards, or the barrier of surcharges on card payments being addressed by the new Consumer Rights Directive [170] that prevents these charges exceeding the cost borne by the merchant.
- Difficulties with delivery due to high costs, the refusal of domestic post suppliers to service particular geographical areas and the unreliability of the delivery service, up to and including the non-delivery of goods purchased. For example, this in part drives 'payment on delivery': citizens of some Eastern European countries use 'cash on delivery' for up to 70% of on-line transactions.
- Different patterns of demand for non-domestic purchases. Consumers in the two largest e-commerce economies (UK and Germany) make up the bulk (55%) of e-commerce, but are far less likely than the average European consumer who has purchased goods or services on the internet to have purchased from abroad.

  For example, whilst on average in the EU one in every 4.4 consumers who

[170] For an analysis of the relationship between the Consumer Rights Directive and financial services, see European Parliament (2010b).

purchased goods or services on the internet purchased from abroad, in the UK, (which accounts for 34.6% of all EU e-commerce) this figure is one in seven. In Germany (19.6%) it is one in eight. This suggests a substantial share of consumers across other EU countries is already purchasing from across the EU, and that where substantial domestic on-line markets exist consumers do not feel the need to look abroad.

6.2. Financial products and services which facilitate cross-border mobility of persons

The provision of basic bank accounts which enable workers to more cross-border and access the core financial services is a major benefit to enabling mobility within the European Union.

The provision of ATM services which can be used across the Single Market by consumers to access their account and withdraw funds throughout the EU (and more generally the world) presents clear benefits in terms of consumer cross-border mobility as it reduces the cost of cross-border mobility (no need to rely on travellers' cheques or carrying large amounts of cash).

Some of the e-money products such as foreign currency pre-paid cards have further reduced the cost of cross-border mobility as typically, when used abroad they do not incur the charges that domestic cards frequently incur when used abroad to access funds in a currency other than the home currency.

6.3. Aspects of financial services which facilitate cross-border financial transactions, increasing choice and competition in financial services

The provision of standardised information through the Standard European Consumer Credit Information (SECI) and the European Standardised Information Sheet (ESIS), both of which aim to give consumer’s clear information on the terms of each product before they sign up, allows comparability in financial products across borders.

This is a clear benefit to supporting the Single Market, and is mentioned in some responses, mostly referred to this as part of the wider PSD and SEPA landscape, for example in Spain and Austria.

7. CONCLUSIONS AND RECOMMENDATIONS

KEY FINDINGS

- The inappropriate sales or mis-selling of certain mortgage products in the USA and some EU Member States in the 2007/2008 financial crisis were a major contributing factor. This was also the case in the Nordic banking crisis of the early nineties.
- The other financial products discussed in the present report can at times be seriously harmful to some consumers but do not appear to contribute significantly to financial instability.
- Some of the products identified by stakeholders as being potentially harmful to consumers were also noted by other stakeholders as being potentially positive for consumers provided they are well regulated and not mis-sold.
- The last 15 years has seen the emergence of a substantial body of academic literature pointing out that a) financial literacy and capability is relatively weak among consumers, even in industrialised countries and b) biases and cognitive limitations may be particularly important in financial markets.
- Overall, the consumer experience from 2000 to 2007 can be characterised as a period of financial innovation and liberalisation during which consumers were offered a growing range of financial products (of increasing complexity in some cases). Yet paradoxically, many consumers were not well-equipped to make proper choices and fell prey to mis-selling or inappropriate selling.
- While improved financial literacy will benefit consumers, the study also highlights that, on their own, policies aimed at raising financial literacy are not enough.
- Even in the absence of mis-selling and inappropriate selling, the purchase of many types of financial products or services will continue to be challenging for consumers because a) consumers only infrequently purchase such products and services and do not have a good knowledge of them, especially of newer products and services, b) the products and services may be very complex, opaque and their risks may be difficult to assess, especially in the case of long duration products and services and c) consumers have no or little bargaining power in retail financial markets.
- Therefore, the overarching recommendation of the present study is that consumer protection in financial markets should be strengthened and consumers' financial capabilities should be raised. This is particularly important, since European consumers have very limited access to financial services in other Member States, where these services could be more beneficial and offer more protection (according to recent Eurobarometer survey, 94% of respondents in the EU27 have never purchased a financial product in an EU Member State outside their home country. Nine detailed recommendations to achieve these twin overall objectives are set out below:
    - The first three recommendations aim to reduce the information asymmetry between consumers and financial service providers. A good understanding by consumers of the financial transactions they enter into enhances the efficiency of that transaction and more generally the efficiency of the market.

      Consumers should always receive from the seller accurate, simple, comparable information of a financial product or service before and after buying it.

      The information provided to consumers can be improved by presenting the average consumer experience, using a "descriptive norms" approach and providing illustrative worst and best case scenarios.

Consideration should be given to implementing systems whereby consumers would be encouraged by lenders to seek independent financial advice from a third party provider for more complex products which have the potential to result in significant harm to consumers. The list of such products could be established by the regulator.

- The fourth recommendation aims to better equip consumers to deal with financial matters.

  In light of the poor results shown by the OECD financial literacy and capability survey, and the importance of financial education to empower consumers to make the right choices, considerably more efforts and resources should be devoted by governments, the financial sector and civil society to strengthening financial literacy and capability.

  As well, greater efforts should be made to learn from the various programs already implemented in various countries, especially with regard to the effectiveness and efficiency of such programs.

- The next three recommendations aim to better protect consumers by encouraging regulators to adopt a much more pro-active, preventative approach to retail financial markets, more robustly and vigorously deter financial service providers from harming consumers and sanction more forcefully mis-behaviour.

  Financial sector regulators and institutions responsible for consumer protection in financial markets should adopt a much more pro-active approach to ensure that financial markets work well rather than respond to consumer complaints and pursue mis-behaviour re-actively. This could involve the prohibition of the sale of certain products or explicit action to address high transactions costs for certain products.

  Financial sector regulators should also ensure that consumers do not face excessively high charges and fees which do not reflect actual costs when buying, holding or liquidating a product.

  In addition, the sanction (financial penalties, prohibition to undertake certain activities for a certain period, etc.) of mis-behaviour by sellers (financial institutions as well as officials of financial institutions) of consumer financial products should be made more exacting so as to increase the deterrence effect and incentivise financial firms to treat their customers fairly. Financial institutions should also be systematically liable for adequately compensating consumers who suffered detriment as a result of mis-selling or inappropriately selling of financial products or services.

- The eighth recommendation aims to ensure that, in case or problems, consumers can easily obtain redress.

  Consumers should always have access to an independent, fast, efficient and inexpensive dispute resolution mechanism to address any unresolved disputes with financial institutions.

- The last recommendation is that consideration should be given to develop better mechanisms and processes for dealing with excessive personal debt burdens.

7.1. Financial products, financial stability and potential consumer detriment

The financial crisis of 2007/2008 has clearly shown that some consumer financial products can be a major destabilising factor and contribute in major way to country-wide and even global financial and economic instability when such products are inappropriately sold to consumers who cannot afford them when circumstances change from those prevailing at the time of contract signing.

Sub-prime mortgages in the USA, foreign currency mortgages (especially in Central Europe), high loan-to-value variable interest rate mortgages are examples of products which generated or have the potential to impart serious damages to the financial system and more generally the economy while imposing considerable hardship on consumers holding such mortgages.

The 2007/8 financial crisis was not the first one in recent European history where imprudent mortgage lending played a major contribution role in a financial crisis.

- For example, of the five big financial crises over the post-war period and prior to the 2007/2008 financial crisis, 4 were in Europe (Spain 1977, Norway 1987, Finland 1991, and Sweden, 1991) (Reinhart and Rogoff, 2009).

  The so-called Nordic financial crisis of the early nineties was caused by a lending boom, primarily to housing, to commercial real estate and to the stock market[171]. According to a recent IMF study (Laeven and Valencia, 2012), the output losses[172] caused by that particular financial crisis amounted to 69.6% of GDP in Finland, 5.1% in Norway and 32.9% in Sweden and the fiscal costs[173] amounted to 12.8% of GDP in Finland, 2.7% in Norway and 3.6% in Sweden.

- Moreover, in the recent financial crisis, imprudent mortgage lending played not only a major role in the USA but also in a number of European countries. Crowe et al. (2011) note that, among a sample of 40 countries, 23 countries experienced a boom in the real estate market and in credit and 21 of these countries experienced a financial crisis and/or a severe drop in GDP growth relative to the country's performance from 2003 to 2007. Some of the EU countries in the latter group include the three Baltic States, Ireland and Spain among others.

While imprudent mortgage lending was one of the important contributory factors to the recent financial crisis in a number of EU Member States and imposed significant financial hardship on many consumers, none of the financial products which the survey of stakeholders revealed as having been, or as being, potentially detrimental to consumers played a major role in the financial crisis.

Obviously, individual consumers may have been impacted negatively by such financial products, especially in cases of mis-selling or insufficient or bad advice.

However, the consultation also highlighted the fact that some of the financial products reported as being potentially harmful to consumers could also be beneficial in the right circumstances.

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[171] See Jonung (2010).

[172] The output losses are computed as the cumulative sum of the differences between actual and trend real GDP over the period [T, T+3], expressed as a percentage of trend real GDP where T is the starting year of the financial crisis.

[173] The fiscal costs are defined as the component of gross fiscal outlays related to the restructuring of the financial sector. They include fiscal costs associated with bank recapitalisations but exclude asset purchases and direct liquidity assistance from the Treasury.

In fact none of the financial products discussed in the present study except the very complex derivative/hedging products are necessarily harmful to consumers provided they are not mis-sold and the consumer's financial capacity is properly assessed.

7.2. Financial literacy and capability: a major challenge

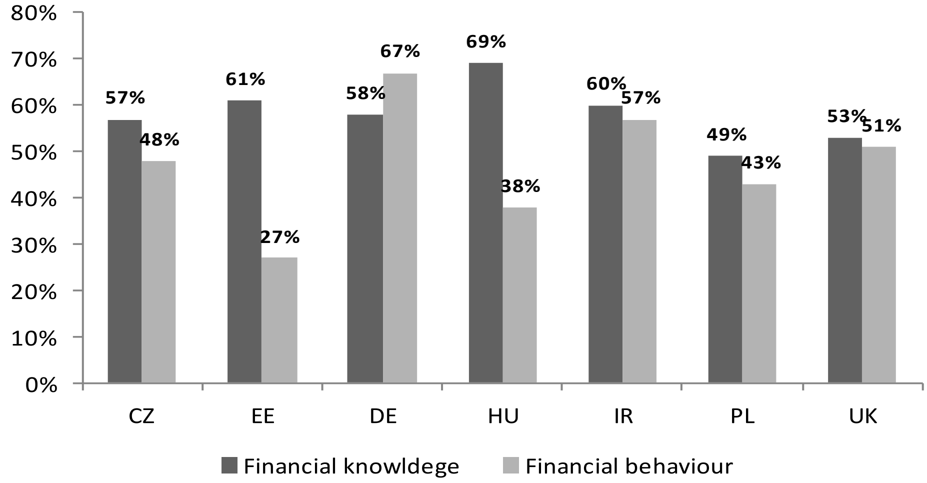
In parallel to these developments in financial markets, a growing body of academic literature has pointed out that many consumers lack basic financial literacy skills, even in industrialised countries[174].

For example, the figure shows the percentage of participants in a recent OECD survey who provided 6 or more correct answers to financial knowledge questions and exhibited 6 out of 9 positive financial behaviours (Atkinson and Messy, 2012)[175].

Two points of particular relevance for the present study are to be noted from this survey.

- First, financial literacy does not always translate into good financial behaviour (see figure 7 below); and
- Second, typically, a majority of consumers does not undertake any research before choosing a particular financial product, and only a very small minority of consumers undertakes in-depth research (see figure 8).

Figure 20: Financial literacy and financial behaviour – percentage scoring 6 or more



Note: see footnote 280 for definitions of financial knowledge and financial behaviour.

Source: Atkison and Messy (2012)

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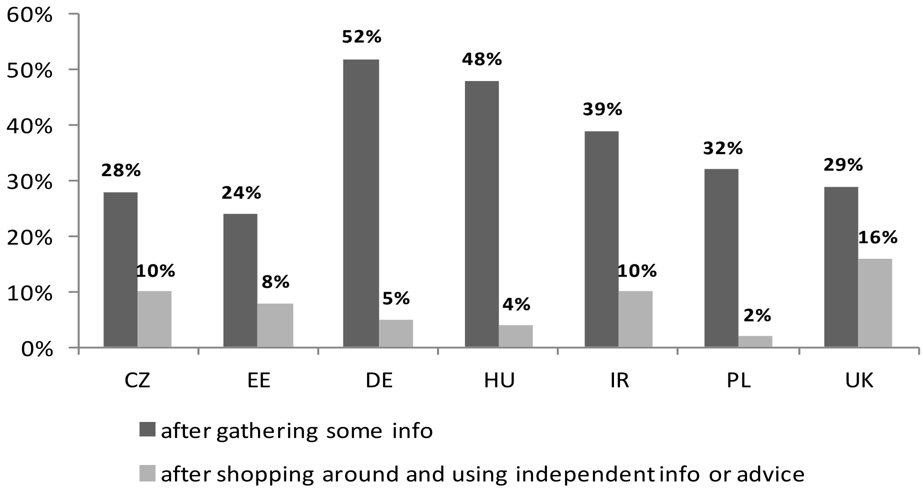
[174] See, for example, Lusardi and Mitchell (2006, 2007 and 2011), Lusardi, Mitchell and Curto (2010) and Lusardi and Tufano (2009). For an overview of the impact of financial literacy and education on outcomes, see, for example, Hastings et al. (2012).

[175] The 8 financial knowledge questions focused on division, time value of money, calculation of interest plus principle, compound interest, risk and return, definition of inflation and diversification. The compound interest rate question was the question which resulted in the lowest percentage of correct response. The 9 positive financial behaviours included carefully considering purchases, paying bills on time, keeping close watch on personal financial affairs, setting long-term goals and striving to achieve them, being responsible and having a household budget, having been actively saving or buying investments in the past year, choosing a financial product after gathering some information, choosing a financial product after shopping around and using independent information or advice, not having borrowed to make ends meet.

Figure 21: Percentage of survey participants choosing a financial product after some light searching or more in-depth searching



Source: Atkison and Messy (2012).

Moreover, the behavioural literature, which has developed over the last 2 decades and which was presented earlier in the report, points out that consumers do not always behave like a rational consumer in standard economic theory. Some consumers may exhibit present-biased behaviour which leads them to value more highly present consumption. Other consumers may lack the cognitive capacity to deal with complex financial products and choose the most appropriate product.

Overall, the consumer experience from 2000 to 2007 can be characterised as a period of financial innovation and liberalisation during which consumers were offered an unrivalled range of financial products, albeit of increasing complexity in some cases.

Yet paradoxically, many consumers were not well-equipped to make proper choices and fell prey to mis-selling or inappropriate selling.

7.3. Consumer protection measures already underway or currently contemplated by the European Parliament

Improved protection on consumers in financial markets is a key preoccupation of the European Parliament. For example, recent European Parliament resolutions[176] call for better financial education and improved financial literacy, improved information provision and stronger consumer protection from misleading and inaccurate information and from financial products which may be highly detrimental to consumers. Similar issues are addressed by the 2014-2020 Consumer Program proposed by the European Commission and currently debated by the European Parliament[177].

Moreover, a number of specific measures which will enhance consumer protection in financial markets have already been adopted or are in the process of being discussed.

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[176] European Parliament resolution of 15 November 2011 on a new strategy for consumer policy (2011/2149(INI)), European Parliament resolution of 22 May 2012 on a strategy for strengthening the rights of vulnerable consumers (2011/2272(ININ)) and European Parliament resolution of 11 June 2013 on a new agenda for European Consumer Policy (2012/2133(INI)).

[177] European Commission (2011), Proposal for a Regulation of the European Parliament and of the Council on a consumer programme 2014-2020, Brussels, 9 November, COM(2011) 707 final.

7.3.1. Mortgage credit

With regards to foreign currency mortgages, the text of the Mortgage Credit Directive which was recently adopted by the European Parliament[178] requires Member States to implement a regulatory framework which, at least, ensures that either foreign currency mortgage holders can convert the mortgage into an alternative currency under specified conditions or that arrangements exist to limit the currency risk to which the mortgage holder is exposed.

As well, Member States will need to ensure that lenders inform foreign currency mortgage holders when the value of the principal or the regular mortgage payments differs by more than 20% from what it would be if the exchange rate prevailing on the date of contract signing was still applicable.

Moreover, whenever such information is provided, foreign currency mortgage holders will also need to be informed of how they can limit their exchange risk.

In addition, before signing the mortgage contract, the consumer will need to be given an illustration of the impact of 20% currency fluctuation when there is no provision in the mortgage product to limit the currency risk.

More generally, mortgage lenders will need to undertake a thorough credit worthiness assessment of any prospective borrower and such creditworthiness assessment should not rely in the main on the value of the property exceeding the mortgage or expectations that the price of the property, for which the mortgage sought, will be increasing.

Finally, the new Directive imposes an obligation on Member States to promote measures supporting education of consumers in relation to responsible borrowing and debt management, in particular in relation to mortgage credit.

7.3.2. Consumer credit

In its report on the implementation of the Consumer Credit Directive[179], the European Parliament points out, inter alia, that improving the cross-border consumer credit market would boost the Single Market.

It notes that, while various provisions of the CCD (related to pre-contractual information, explanations to be provided and credit worthiness assessment) play an important role in making a borrower aware of the risk of foreign currency lending, national regulatory authorities should require lenders to provide consumers with personalised, complete and easily understandable explanations regarding the risks involved in foreign currency lending and regarding the impact of substantial currency fluctuations on the value of the principal and the instalments. Similar information should also be provided about the potential impact of movements in the foreign currency interest rate.

The report further calls on relevant authorities to ensure that advertising and marketing practices of financial institutions be strictly monitored to avoid cases of misleading or false information in the advertising or marketing of credit agreements.

It also notes that comprehensive provisions do not always make for effective consumer protection and that, in the case of less experienced consumers, too much information may be confusing.

[178] Amendments adopted by the European Parliament on 10 September 2013 on the proposal for a directive of the European Parliament and of the Council on credit agreements relating to residential property.

[179] Reference ST-0343/2012.

7.3.3. Consumer rights

The European Parliament Report of 17 May 2013 on a new agenda for the European Consumer Policy[180] calls for consumers to be able to exercise their rights easily and effectively in basic areas including, among others, financial services.

It also stresses that educating consumers reduces their risks *vis-à-vis*, among others, speculative financial products and takes the view that education (including financial education) and empowerment of consumers need to be lifelong and should begin at school.

Importantly, the report emphasises the need to avoid information overload and stresses the need to reduce knowledge deficits and to improve consumer awareness through reliable, clear, comparable and targeted information.

The report also highlights the need for better protection of vulnerable consumer groups with regard to, among others, financial services and calls on the Commission to pay particular attention to consumer protection in the field of short-term loans, as the most vulnerable in times of crisis use such financial products without being fully aware of the obligations and risks they incur as credit takers.

The report also underlines the need, in the area of financial services, for a comprehensive framework ensuring independent advice for consumers, especially in the field of financial services and stresses that market information should be reliable, clear and comparable, and accessible electronically and other forms. It also emphasises the need to take out legal action over unfair commercial practices or contract terms and the need to protect consumers who are trapped by a financial product.

[180] Reference A7-0163/2013.

7.4. Recommendations

The discussion above suggests that a multi-pronged approach is required to prevent consumer detriment in financial markets. Such an approach aims to improve the quality of the demand for financial products through better education and information and the quality of the supply for financial products through strong consumer protection and by ensuring that mis-selling and inappropriate selling becomes a thing of the past.

A number of recommendations[181] are set out below which aim to achieve these twin objectives of improving the quality of the demand for and supply of financial products. These recommendations are addressed to policy-makers at the EU and national level, and EU and national financial sector regulators.

The recommendations set out below aim to address various issues and challenges faced by consumers during the various stages of the four-stage framework used to analyse a consumer's relationship to a financial product or service. Some recommendations apply to more than one stage.

- Recommendations 1, 2, 3, 4, 5 and 6 address issues and challenges faced by consumers during the search stage.
- Recommendations 3, 6, 7 address consumer issues and challenges during the acquisition stage.
- Recommendations 1, 6 and 8 address issues and challenges during the product holding stage; and,
- Recommendations 8 and 9 address issues and challenges in the case of involuntary liquidation through default.

The overarching recommendation is that consumer protection in financial markets should be strengthened and consumers' financial capabilities should be raised. Detailed recommendations to achieve these twin overall objectives are set out below. Considering the significant potential detriment that financial services can cause to individual consumers and to the Single Market, consumer protection policy needs to properly focus on these services. Improved transparency and better informed transactions resulting from such policy will result in better solutions for consumers and greater market efficiency. This is particularly important, since European consumers have very limited access to financial services in other Member States, where these services could be more beneficial and offer more protection (according to recent Eurobarometer survey, 94% of respondents in the EU27 have never purchased a financial product in an EU Member State outside their home country).

Recommendation 1

Consumers should always receive from the seller accurate, simple, comparable information of a financial product or service before and after buying it.

In this regard, it is important to note that simply increasing the quantity of information disclosed to consumers, even if it is simplified, does not resolve the complexity challenge faced by consumers in a number of cases. Due to bounded rationality, a large volume of information results in information overload and is not processed properly by many consumers. The quality, simplicity and completeness of information should allow consumers to 'learn as they buy' and make sure that consumers enter into transactions they fully

[181] These recommendations draw on the findings from the stakeholder survey and the review of the literature from academia, regulators, central banks, etc. Of particular interest in this regard are the articles and studies by Brunnemeier and Oemke (2009), Campbell et al. (2011), Mak (2013), Rutledge (2010).

understand. An obligation to inform a consumer fully and understandably about the transaction and its potential consequences under different scenarios and in practical, outcome-focused terms, should rest with the service provider, with legal consequences in cases where such information is lacking or is not comprehensible.

Standardisation and commoditisation may help. Recommendation 2 builds on this point.

In terms of how to simplify the financial information, it is essential to rely on consumer feedback on what particular pieces of information they would find most useful to assess particular financial products and services. Otherwise there exists a significant risk that any simplification exercise ends up not assisting consumers greatly.

Recommendation 2

The literature on consumer behaviour also suggests that information can be improved by presenting average consumer experience. Indeed, the literature on using "descriptive norms" which describe what most other people are doing has been found to encourage recycling, energy and water efficiency and reducing littering[182]. It would be useful to test whether reliance on "descriptive norms" and the provision of best and worst case scenarios can contribute to improve consumers' financial decision even if their financial literacy and capability is not perfect. In the case of credit agreements, the information provided to consumers should also be very explicit about the consequences of defaulting, the penalty fees and charges that the lender may apply in case of default and any other steps the lenders may take such as repossession, the potential legal costs that a defaulting borrower may have to bear, etc.).

Recommendation 3

In light of the findings from the literature on consumer behaviour in financial markets, consideration should be given to implementing a system whereby consumers would be encouraged by lenders to seek independent financial advice from a third party provider for more complex products which have the potential to result in significant harm to consumers. The set of such products could include, among others, more risky mortgages (for example, variable rate, high loan-to-value, and foreign currency mortgage products). The precise list of products for which prospective borrowers would be encouraged to seek independent advice could be established by the regulator.

Various funding models for the provision of advice could be considered ranging from government funding to industry funding or consumer fees. Each of these approaches has a number of advantages and disadvantages, and these would need to be further assessed in greater detail if the basic idea of an advice scheme is taken forward.

Recommendation 4

Many Member States have implemented financial education and capability programs. However, in light of the poor results of the recent OECD financial literacy and capability survey, considerably more efforts and resources should be devoted by governments, the financial sector and civil society to this activity.

As well, greater efforts should be made to learn from the various programs already implemented in various countries, especially with regards to the effectiveness and efficiency of such programs. For example, all ex-post evaluations and impact assessments of financial literacy and capability programs should be made available on or accessible through the International Gateway for financial education.

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[182] See Cabinet Office (2012) and Schultz et al. (2007).

Recommendation 5

Financial sector regulators and institutions responsible for consumer protection in financial markets adopt a pro-active approach to ensure that financial markets work well for consumers rather than responding to consumer complaints reactively and addressing mis-behaviour or inappropriate behaviour. Such a pro-active approach could contribute considerably to rebuild consumer trust in financial markets and prevent the emergence of problems down the road.

To identify more proactively issues faced by consumers in financial markets, national authorities should make regular use of a) consumer satisfaction survey to identify those products and markets which consumers views as failing them and b) mystery shopper exercises to gather actual information on the behaviour of sellers of financial products.

For example, the Belgian Parliament is currently considering a law[183], which among others, would allow a) mystery shoppers to pretend to be real customers without telling the institution they are visiting that they are working for the Belgian Financial Services and Markets Authority and b) the authority to use the information gathered during the mystery shopping exercise. In the UK, the Financial Conduct Authority uses mystery shopping exercises when it wishes to look at business or selling practices in context. In a recent mystery shopping exercise, focused on advice for a lump sum investment, approximately three-quarters of customers were found to have received good advice. However, the Authority had concerns with the quality of advice for the other quarter of customers. In 11% of mystery shops the Authority felt the advice was unsuitable for the customer and in a further 15% the adviser did not gather enough information to make sure their advice was suitable – so that it was not possible to determine whether the customer received good or poor advice[184].

In addition, regulators should actively aim to prohibit retail financial products which they view as being too complex for consumers to be able to understand or as being too risky for consumers. For example, in 2010 the Swedish FSA (Finansinspektion) introduced guidelines limiting mortgages to a maximum loan-to-value (LTV) ratio of 85% and in 2011, the Dutch Financial Markets Authority (AFM) prohibited interest-only mortgages exceeding 50% of the market value of the mortgaged property. More recently, The UK Financial Conduct Authority banned in June 2013 the promotion of Unregulated Collective Investment Schemes (UCIS) and certain close substitutes (together to be known as Non-Mainstream Pooled Investments (NMPIs)) to the vast majority of retail investors in the UK.

Recommendation 6

As well, in their market monitoring, regulators should identify those financial products which involve high transactions costs (explicit or implicit) in terms of fees, charges, etc and actively use their regulatory power to a) ensure that any transactions cost charged to consumers reflect the actual cost incurred by financial services providers and b) prevent the imposition of high charges arising from steering to more expensive products or from excessive number of transactions related to the product such a churning of investment funds.

Recommendation 7

In addition, the sanctions (financial penalties, probation to undertake certain activities for a certain period, etc.) for mis-behaviour or inappropriate behaviour by sellers of retail

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[183] Press communiqué of Elio di Rupo, Prime Minister of Belgium, 15 February 2013.

[184] FSA (2013c).

financial products should be made more exacting so as to increase the deterrence effect and incentivise financial firms to treat their customers fairly and honestly. Financial institutions should also be systematically liable for adequately compensating consumers who suffered detriment as a result of mis-selling or inappropriately selling of financial products or services. For example, in the case of the mis-selling of payment protection insurance in the UK, financial institutions found to have mis-sold such a product were fined and consumers who bought such a product are eligible to recover all the premiums paid with interest added. Moreover, compensatory collective redress (by a State institution or a private organisation) should be facilitated throughout the EU by the speed implementation of the EC Recommendation of 11 June 2013 on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law.

Moreover, in order to provide the proper incentives at the level of the actual interaction between a customer and an official of a financial institution, the latter should also be subject to stringent penalties for mis-selling or inappropriate selling of particular products.

In light of the fact that, for certain financial products, the risk is long-tailed, the individual liability and the institution's liability should also be of a long duration.

Recommendation 8

In light of the findings of the study identifying a number of unfair practices and the high legal costs of resolving disputes between a consumer and a financial service provider, consumers should have access to an independent, fast, efficient and inexpensive dispute resolution mechanism to address any unresolved disputes with financial institutions. While in a number of EU countries an independent ombudsman for financial matters or a similar institution already exists, this is not yet the case in all Member States.

In this regard, the recently adopted Directive on alternative dispute resolution mechanisms[185] and Regulation on online dispute resolution for consumers[186] will also be of assistance to consumers once implemented.

Recommendation 9

Finally, despite all the measures aiming to ensure that consumers only buy financial products whose risks are commensurate to their capacity to bear such risk, there will be cases where consumers will find themselves in a situation where they are no longer able to meet their financial obligations due to unexpected events such as loss of income due to unemployment or bad health. In such circumstances, consumers should have access throughout the EU to easy, fair and cost-efficient exit mechanisms which allows them to escape from over-indebtedness and be given a second chance. Such mechanisms involve voluntary arrangements and/or personal bankruptcy regimes which are present in many but not all Member States.

In practical terms, serious consideration should be given to the adoption across the EU of the best practice model for dealing with excessive personal debt which has been developed recently for the Financial Services Users Group (set up by EC DG Internal Market and Services):

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185 Directive 2013/11/EU of the European Parliament and of the Council of 21 May 2013 on alternative dispute resolution for consumer disputes and amending Regulation (EC) No. 2006/2004 and Directive 2009/22/EC, Official Journal of the European Union, L165/63, 18 June 2013.

186 Regulation (EU) No. 524/2013 of the European Parliament and of the Council of 21 May 2013 on online dispute resolution for consumer disputes and amending Regulation (EC) No. 2006/.2004 and Directive 2009/22/EC (Regulation on consumer ODR).

- Debt cancellation is not, and should not be, an automatic right, but it should be presumed that someone applying should have access to it unless a lender can demonstrate objective evidence of 'bad faith' by the borrower. The application process should give lenders a time-limited opportunity to raise concerns about an applicant's behaviour, so administrators can reject applicants whose behaviour has been found wanting.
- The creditor must be protected when the debtor has acted in bad faith, but in return for this creditors must accept the responsibility where inappropriate lending has helped cause the problem of over-indebtedness they should bear some of the costs of resolving this problem. Best practice requires a compromise between the debtor and creditor; the debtor must pay what he can and the creditor must accept that as the best resolution they can receive, so it is better for them to cut their losses, stop paying legal fees and allow a rapid discharge of unrecoverable debts.
- The use of stigmatising labels should be ended, and the pejorative term 'bankruptcy' should be replaced with the more neutral 'debt adjustment'.
- Debt cancellation should be delivered by an administrative body without recourse to a judicially-led court-based process except for appeals against the mis-application of the due process, as exists in Sweden and France, transparently applying clear rules quickly and efficiently. Creditors and consumers should have the right to appeal to a court on the grounds of compliance with the process.
- The debt counsellor who leads the administrative process should:
  - determine the solution applicable to the case, rather than the consumer or the debtor;
  - have the power to attach earnings. There should be transparent rules on exempt income based on social benefit levels, taking account of the number of children and/or a partner, and the impact these have on social allowances;
  - only have the right to liquidate assets worth over a substantial threshold;
  - have the right to impose a 'cram-down' on creditors;
  - have the power to impose a 'zero-plan' where there is no chance of the consumer being able to make payments, with immediate discharge if a consumer cannot over three years repay either 10% of their total debt or EUR 10 000, whichever is lower, in line with recent practice in the Netherlands.
- As in Denmark and the UK, discharge should occur one year into a three year payment plan, aligning discharge at the lowest common denominator whilst still ensuring creditors have access to excess earnings for three years.
- There are some debts which consumers should not be able to escape. Child/dependent maintenance payments deserve inclusion in this exemption. Student loans do not merit exemption from debt cancellation. There is a case that society would benefit most if unpaid taxes were given a priority in payment plans over private debts.

Obviously, more in-depth research would be required to ensure that any changes to the bankruptcy regime applying to consumers strikes a proper balance between consumer protection and the rights and obligations of financial service providers.

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ANNEX I: HIGH LEVEL PRINCIPLES ON FINANCIAL CONSUMER PROTECTION[187]

1. Legal, Regulatory and Supervisory Framework

Financial consumer protection should be an integral part of the legal, regulatory and supervisory framework, and should reflect the diversity of national circumstances and global market and regulatory developments within the financial sector.

Regulation should reflect and be proportionate to the characteristics, type, and variety of the financial products and consumers, their rights and responsibilities and be responsive to new products, designs, technologies and delivery mechanisms. Strong and effective legal and judicial or supervisory mechanisms[188] should exist to protect consumers from and sanction against financial frauds, abuses and errors.

Financial services providers and authorised agents[189] should be appropriately regulated and/or supervised, with account taken of relevant service and sector specific approaches.

Relevant non-governmental stakeholders – including industry and consumer organisations, professional bodies and research communities – should be consulted when policies related to financial consumer protection and education are developed. Access of relevant stakeholders and in particular consumer organisations to such processes should be facilitated and enhanced.

2. Role of Oversight Bodies

There should be oversight bodies (dedicated or not) explicitly responsible for financial consumer protection, with the necessary authority to fulfil their mandates. They require clear and objectively defined responsibilities and appropriate governance; operational independence; accountability for their activities; adequate powers; resources and capabilities; defined and transparent enforcement framework and clear and consistent regulatory processes. Oversight bodies should observe high professional standards, including appropriate standards of confidentiality of consumer and proprietary information and the avoidance of conflicts of interest.

Co-operation with other financial services oversight authorities and between authorities or departments in charge of sectoral issues should be promoted. A level-playing field across financial services should be encouraged as appropriate. International co-operation between oversight bodies should also be encouraged, while specific attention should be considered for consumer protection issues arising from international transactions and cross-border marketing and sales.

3. Equitable and Fair Treatment of Consumers

All financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers. Treating consumers fairly should be an integral part of the good governance and corporate culture of all financial services providers and authorised agents. Special attention should be dedicated to the needs of vulnerable groups.

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[187] OECD (2011) G20 High-Level Principles on Financial Consumer Protection, October.

[188] Where relevant, appropriate mechanisms should be developed to address new delivery channels for financial services, including through mobile, electronic and branchless distribution of financial services, while preserving their potential benefits for consumers.

[189] Authorised agents are understood to mean third parties acting for the financial services provider or in an independent capacity. They include any agents (tied and independent agents) brokers, advisors and intermediaries, etc.

4. Disclosure and Transparency

Financial services providers and authorised agents should provide consumers with key information that informs the consumer of the fundamental benefits, risks and terms of the product. They should also provide information on conflicts of interest associated with the authorised agent through which the product is sold.[190]

In particular, information should be provided on material aspects of the financial product. Appropriate information should be provided at all stages of the relationship with the customer. All financial promotional material should be accurate, honest, understandable and not misleading. Standardised pre-contractual disclosure practices (e.g. forms) should be adopted where applicable and possible to allow comparisons between products and services of the same nature. Specific disclosure mechanisms, including possible warnings, should be developed to provide information commensurate with complex and risky products and services. Where possible consumer research should be conducted to help determine and improve the effectiveness of disclosure requirements.

The provision of advice should be as objective as possible and should in general be based on the consumer's profile considering the complexity of the product, the risks associated with it as well as the customer's financial objectives, knowledge, capabilities and experience.

Consumers should be made aware of the importance of providing financial services providers with relevant, accurate and available information.

5. Financial Education and Awareness

Financial education and awareness should be promoted by all relevant stakeholders and clear information on consumer protection, rights and responsibilities should be easily accessible by consumers. Appropriate mechanisms should be developed to help existing and future consumers develop the knowledge, skills and confidence to appropriately understand risks, including financial risks and opportunities, make informed choices, know where to go for assistance, and take effective action to improve their own financial well-being.

The provision of broad based financial education and information to deepen consumer financial knowledge and capability should be promoted, especially for vulnerable groups.

Taking into account national circumstances, financial education and awareness should be encouraged as part of a wider financial consumer protection and education strategy, be delivered through diverse and appropriate channels, and should begin at an early age and be accessible for all life stages. Specific programmes and approaches related to financial education should be targeted for vulnerable groups of financial consumers.

[190] Financial services providers and authorised agents should provide clear, concise, accurate, reliable, comparable, easily accessible, and timely written and oral information on the financial products and services being offered, particularly on key features of the products and (where relevant) on possible alternative services or products, including simpler ones, they provide. In principle, information should include prices, costs, penalties, surrender charges, risks and termination modalities.

All relevant stakeholders should be encouraged to implement the international principles and guidelines on financial education developed by the OECD International Network on Financial Education (INFE). Further national and international comparable information on financial education and awareness should be compiled by national institutions and relevant international organisations in order to assess and enhance the effectiveness of approaches to financial education.

6. Responsible Business Conduct of Financial Services Providers and Authorised Agents

Financial services providers and authorised agents should have as an objective, to work in the best interest of their customers and be responsible for upholding financial consumer protection. Financial services providers should also be responsible and accountable for the actions of their authorised agents.

Depending on the nature of the transaction and based on information primarily provided by customers, financial services providers should assess the related financial capabilities, situation and needs of their customers before agreeing to provide them with a product, advice or service. Staff (especially those who interact directly with customers) should be properly trained and qualified. Where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided, financial services providers and authorised agents should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.

The remuneration structure for staff of both financial services providers and authorised agents should be designed to encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest. The remuneration structure should be disclosed to customers where appropriate, such as when potential conflicts of interest cannot be managed or avoided.

7. Protection of Consumer Assets against Fraud and Misuse

Relevant information, control and protection mechanisms should appropriately and with a high degree of certainty protect consumers' deposits, savings, and other similar financial assets, including against fraud, misappropriation or other misuses.

8. Protection of Consumer Data and Privacy

Consumers' financial and personal information should be protected through appropriate control and protection mechanisms. These mechanisms should define the purposes for which the data may be collected, processed, held, used and disclosed (especially to third parties). The mechanisms should also acknowledge the rights of consumers to be informed about data-sharing, to access data and to obtain the prompt correction and/or deletion of inaccurate, or unlawfully collected or processed data.

9. Complaints Handling and Redress

Jurisdictions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient. Such mechanisms should not impose unreasonable cost, delays or burdens on consumers. In accordance with the above, financial services providers and authorised agents should have in place mechanisms for complaint handling and redress. Recourse to an independent redress process should be available to address complaints that are not efficiently resolved via the financial services providers and authorised agents internal dispute resolution mechanisms. At a minimum, aggregate information with respect to complaints and their resolutions should be made public.

10. Competition

Nationally and internationally competitive markets should be promoted in order to provide consumers with greater choice amongst financial services and create competitive pressure on providers to offer competitive products, enhance innovation and maintain high service quality. Consumers should be able to search, compare and, where appropriate, switch between products and providers easily and at reasonable and disclosed costs.

ANNEX II: THE INFORMATION GATHERING PROCESS

In order to identify products which are detrimental or beneficial to consumers, a large information gathering exercise was undertaken. This exercise involved a literature review and a stakeholder survey. Both activities are described in greater detail below.

Financial products are considered detrimental to consumers if they:

a) involve risks that are not always easily understood by consumers and whose crystallisation may have highly negative financial consequences for consumers. An example of such a product is a foreign currency mortgage;

b) do not meet the needs of consumers because consumers often do not meet the conditions to benefit from such products. An example of such a product is payment protection insurance;

c) do carry excessively high fees and charges which result in low returns to consumers. An example of such product is bank account with high fees or investments in funds (such as UCITs) whose assets are very frequently turned over and/or which attract very high fees which erode the returns achieved on the assets.

In contrast, financial products are considered beneficial to consumers if the risks associated with the product is easily understood by consumers, and consumers can assume such risk without major negative financial consequences, the products meet the needs of consumers and the costs of the products are commensurate with the actual cost of producing the services.

Literature review

The literature review focussed on previous studies relating to consumer detriment. The review examined the concept of consumer detriment and the sources of consumer detriment, both generally and specifically in the context of retail financial markets. The review also considered the most pertinent consumer protection issues in financial services.

The review covered academic literature, studies from organisations such as the OECD and the World Bank, reports from previous studies conducted by and for the European Commission, and grey literature.

Stakeholder survey

Primary evidence was collected through a survey of stakeholders in all 28 EU Member States. Four types of stakeholder were targeted by the survey: financial regulators, financial ombudsmen, consumer organisations, and banking associations. In addition, three commercial banks responded from one Member State[191]. A list of the organisations that have responded to our survey is presented in Table 4.

Each stakeholder was emailed an invitation to participate in the study in their own language, where relevant, plus an English version. Stakeholders who did not respond to the initial invitation were sent a reminder several weeks later, again in their own language and in English. A third and final reminder (also in two languages if relevant) was sent several weeks after the second reminder to stakeholders who had not responded to the first two emails.

[191] These were BCR Banca pentru Locuinte S.A., Garanti Bank S.A. and Volksbank Romania S.A. from Romania. These three banks came to us via the Romanian Banking Association. A number of banking associations (including the Romanian one) said they were unable to participate because the questions weren't appropriate to their role as an association. Instead they sent the questionnaire out to their member banks so we could gather the relevant data directly from them.

Stakeholders were asked to identify financial services and products sold from 2000 to now which:

- proved very beneficial to individual consumers and/or SMEs;
- proved harmful to individual consumers and/or SMEs;
- caused disruptions to the market (national or/and Single Market);
- had substantial beneficial effects for the market (national or/and Single Market);
- do or are perceived to discriminate between either different groups of domestic consumers or SMEs, or between resident and non-resident consumers and SMEs.

For each financial product/service identified, stakeholders were asked to give a description of the product/service and to explain why it is relevant (e.g. why the product/service caused disruptions to the market or why the product/service was particularly beneficial to consumers or SMEs). In addition, respondents were given the opportunity to identify any additional issues that they felt should be considered during the study (in addition to the points above).

Table 4: Survey respondents

Country	Stakeholder type	Stakeholder name
AT	Financial Regulator/ Ombudsman	Consumer Protection Directorate, Federal Ministry for Social Affairs and Consumer protection
BE	Financial Regulator	SPF Economie
BG	Financial Regulator	Bulgarian National Bank
CY	Consumer Organisation	Cyprus Consumers Association
CZ	Banking Association	Czech Banking Association
DE	Banking Association	Bankenverband (Association of German Banks)
DK	Financial Ombudsman	Danish FSA
DK	Consumer Organisation	Danish Consumer Association
DK	Banking Association	Finansradet - The Danish Bankers Association
EE	Consumer Organisation	Estonian Consumer Protection Board (CPB)
EL	Consumer Organisation	KEPKA
ES	Consumer Organisation	ADICAE (Asociación de Usuarios de Bancos, Cajas y Seguros de España)
FI	Financial Ombudsman	Finnish Competition and Consumer Authority
FI	Financial Ombudsman	The Finnish Financial Ombudsman Bureau
FI	Banking Association	Finanssialan Keskusliitto - Federation of Finish Financial Services
FR	Consumer Organisation	Consommation, Logement et Cadre de Vie - CLCV
FR	Banking Association	ASF
HR	Financial Regulator	Croatian National Bank

Country	Stakeholder type	Stakeholder name
HU	Financial Regulator	Hungarian FSA (PSZAF)
HU	Financial Regulator	Ministry for National Economy
HU	Banking Association	Hungarian Banking Association
IE	Financial Regulator	Central Bank of Ireland
IT	Consumer Organisation	Altroconsumo
LT	Consumer Organisation	Alliance of Lithuanian Consumer Organisations
NL	Consumer Organisation	Consumentenbond
PT	Consumer Organisation	Portuguese consumer association (DECO)
PT	Consumer Organisation	Consumer Institute
RO	Financial Regulator	Autoritatea de Supraveghere Financiara (ASF) (Romanian FSA)
RO	Bank	BCR Banca pentru Locuinte S.A.
RO	Bank	Garanti Bank S.A.
RO	Bank	Volksbank Romania S.A.
SI	Consumer Organisation	Slovenian Consumer Association (ZPS)

Review of documents published by official and non-government organisations

The third and final element of the information gathering process was a review of documents published by official and non-government organisations at the EU and national Member State level as well as in the United States. The types of institutions covered include financial regulators, financial ombudsmen, central banks, official consumer protection bodies, consumer organisations and banking associations, as well as court case documentation.

In order to maintain consistency in the approach, relevant material was identified from documents and organised according to the key topics of the study, namely: bad advice and mis-selling; financial services and products with potential serious disruptive impact for consumers and the Single Market; financial services and products with substantive beneficial effects for consumers and the operation of the Single Market; and discriminatory financial services related cases.

ANNEX III: SOURCES OF CONSUMER DETRIMENT

The concept of consumer detriment

Consumer detriment[192] arises when market outcomes fall short of their potential, resulting in welfare losses to consumers, commonly defined as financial and non-financial harm or damage to consumers that occurs in connection with a particular market transaction. Financial detriment would typically include elements such as costs of repair or replacement, loss of earnings and cost of legal advice. Non-financial detriment refers to less easily quantifiable losses such as loss of time, adverse effects on health and psychological detriment arising from, for example, emotions such as anger and frustration, or other impositions imposed on the consumer in the instance where they enter financial distress; for example, historically some countries removed the vote from bankrupt individuals[193].

At its simplest, consumer detriment can be divided into two types: structural and personal detriment[194]:

- Structural detriment is a loss of economic welfare given rise to by market or regulatory failures falling across *multiple consumers or groups of consumers*.
- Personal detriment is the loss of economic welfare for *individual consumers*, relative to some benchmark such as expectations or reasonable expectations.

Sources of consumer detriment in all markets

There are four key sources of consumer detriment:

- Market failures: These fall into four broad categories:
  - Where there is inefficient or lack of competition meaning that suppliers retain market power[195] and are able to price above the competitive level, and consumers will suffer commensurate losses. Lack of competition may also mean suppliers do not feel pressured to provide new or innovative products to meet the needs of consumers better than their existing products.
  - Where informational asymmetries[196] exist, consumers may lose out either through higher search costs leading to suppliers charging higher prices[197], or by being misled in relation to the quality of products as firms have little incentive to supply correct or sufficient information on product quality[198].
  - Externalities (positive and negative) may result in over- or undersupply of a product in turn leading to consumer detriment[199].
  - Sub-optimal product variety may also lead to consumer detriment as consumers are forced to choose a second-best product from their perspective[200].

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192 Monetary valuations for consumer detriment in the EU as a whole do not exist, however, the level estimated for the UK by a 2008 OFT survey may serve as a guide. The estimate for the UK population came to GBP 6.6 billion over the year of the survey. However, this number is calculated for the UK economy as a whole with the share of the financial sector in this sum unknown. A ranking shows that the highest average financial detriment per problem is found in the insurance category, personal banking was ranked third (OFT, 2008).

193 London Economics, (2009) & (2013).

194 See, for example, Europe Economics (2010).

195 Bain, (1951).

196 Stigler, (1961).

197 Hunter et al, (2001).

198 Vickers (2003).

199 Europe Economics (2011).

200 Gaynor (2004).

- Regulatory failures: Structural detriment can arise as a result of regulatory interventions intended to correct for distortions caused by market failures, including restrictions on prices, quantities and product characteristics, regulations with impacts on sellers' costs (acts of commission), or as a result of a failure to take action to address market failures or to create functioning frameworks for markets (acts of omission in regulation). Of particular importance in the case of financial markets is the non-implementation or ineffective implementation of appropriate regulatory regimes for addressing problematic levels of debt which apply to consumers in the different EU countries, either through debt relief or debt cancellation in the most extreme cases[201].
- Behavioural biases: Consumer detriment can arise at the personal level where reasonable expectations were not met, leading to sub-optimal solutions where only structural detriment is addressed by policy. Therefore the individual level of analysis has recently increasingly featured in the literature on consumer detriment, drawing on behavioural economics as a complementary perspective. On the demand-side this means a shift away from the traditional economic theory that views consumers as fully rational in making their consumption choices. A fully-rational consumer knows exactly what the good or service is, how much utility they will receive, how much it costs, what the alternatives are, and where it ranks in against alternatives. However, findings from behavioural economics suggest that, consumers are not fully rational agents but face a multitude of behavioural biases[202]. These behavioural biases may have important impacts on the quality of the decisions consumers make and their ability to make well-informed and welfare- maximising decisions, instead leading them to make choices that are not optimal form a welfare perspective. Specifically consumers:
    - have limited cognitive capacity (cognitive limitations);
    - are influenced by their status quo (status quo bias)[203];
    - place disproportionate levels of emphasis on the present and not enough emphasis on the future (discounting issues and present-bias)[204]; and
    - care more about losses than gains (loss aversion)[205].
- Firm behaviour: This includes businesses' use of unfair commercial practices such as misleading advertising)[206], unfair contract terms and poor service[207], scams and fraud, misleading advertising, sales of unsafe products, and provision of inadequate redress. Such supplier's mis-behaviour may lead to problems for consumers when they interact with companies. According to a 2008 survey by the OFT, the type of detriment experienced in this group most frequently are poor service quality and defective goods[208]. These practices can give rise to personal detriment where these are not kept in check by consumer protection laws and their enforcement. However, it should be noted that not all supplier's mis-behaviour and problems are intentional and companies may spend significant resources trying to ensure good customer service.

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201 London Economics (2013).

202 See, for example, OFT (2011).

203 Tversky (1979); and Tversky & Kahneman, (1991).

204 DellaVigna and Malmendier (2004) & (2006).

205 Heidhues and Koszegi (2010).

206 OECD (2010).

207 Consumer Focus (2009).

208 OFT (2008).

However, these drivers are closely interlinked. For example, legal and regulatory problems may lead to supplier's mis-behaviour and at the same time supplier's mis-behaviour may only be possible if there is a lack of competition in the market.

ANNEX IV: AVERAGE SATISFACTION RATING BY FINANCIAL PRODUCT AND EU MEMBER STATE

Table 5: Average satisfaction rating on a scale of 1 to 10 by financial product and EU27 Member State based on December 2012 Consumer Markets Scoreboard

Vehicle insurance		Home insurance		Bank accounts		Loans, credit and credit cards		Private life insurance		Mortgages		Investment products, private pensions and securities	
FI	8.3	FI	8.3	MT	8.6	FI	8.5	MT	7.8	FI	8.1	MT	7.5
LT	8.3	LU	8.0	EE	8.3	AT	8.2	LU	7.7	LU	7.7	LU	7.4
SI	8.2	AT	7.9	FI	8.2	LU	8.1	LV	7.7	DE	7.6	DE	7.1
LU	8.2	LT	7.9	LT	8.1	MT	7.9	FI	7.6	DK	7.5	EL	6.9
DK	8.1	LV	7.8	LV	8.1	DE	7.8	EE	7.6	BE	7.3	FI	6.8
EE	8.1	DK	7.8	LU	8.0	DK	7.7	LT	7.3	MT	7.1	FR	6.8
LV	8.1	SI	7.8	DE	7.8	EE	7.7	DK	7.3	EE	7.0	CZ	6.7
AT	8.1	BE	7.8	SI	7.6	LT	7.6	HU	7.3	SI	6.9	LV	6.7
DE	8.1	EE	7.7	CY	7.6	SI	7.6	DE	7.3	AT	6.9	DK	6.7
HU	8.0	SK	7.7	NL	7.6	NL	7.5	BE	7.1	FR	6.8	HU	6.6
BE	8.0	DE	7.7	SK	7.5	BE	7.5	FR	7.0	LT	6.8	BE	6.5
IE	7.9	HU	7.6	DK	7.4	LV	7.5	PT	7.0	NL	6.6	PT	6.4
PT	7.8	CY	7.6	AT	7.4	IT	7.3	UK	6.9	SK	6.5	LT	6.4
NL	7.8	UK	7.5	FR	7.3	SK	7.3	PL	6.9	IT	6.5	EE	6.3
SK	7.8	NL	7.4	BG	7.2	UK	7.2	SK	6.9	LV	6.4	UK	6.3
CY	7.6	PL	7.3	BE	7.1	CY	7.2	CY	6.9	UK	6.4	RO	6.2
PL	7.5	IE	7.3	HU	7.1	PL	7.1	IT	6.8	CZ	6.4	PL	6.2
UK	7.5	IT	7.1	PT	7.0	FR	7.1	AT	6.8	CY	6.4	CY	6.2
ES	7.5	FR	7.1	PL	7.0	PT	7.0	RO	6.7	PT	6.2	SK	6.0
EL	7.3	ES	7.1	UK	7.0	IE	7.0	EL	6.6	PL	6.1	IT	5.9
CZ	7.3	PT	7.1	CZ	6.9	HU	6.8	SI	6.6	EL	6.0	BG	5.9
IT	7.2	MT	7.0	RO	6.9	CZ	6.7	ES	6.6	SE	5.8	AT	5.7
FR	7.1	CZ	7.0	EL	6.8	BG	6.5	CZ	6.5	HU	5.4	IE	5.7
MT	6.9	RO	6.8	SE	6.5	SE	6.5	IE	6.5	IE	5.3	ES	5.6
RO	6.9	BG	6.8	IT	6.4	ES	6.4	NL	6.5	RO	5.2	NL	5.5
BG	6.7	EL	6.6	IE	6.3	EL	6.1	BG	6.4	BG	5.2	SE	5.5
SE	6.5	SE	6.2	ES	6.0	RO	6.0	SE	5.9	ES	5.1	SI	5.0
EU	7.7	EU	7.4	EU	7.3	EU	7.2	EU	6.9	EU	6.4	EU	6.3

ANNEX V: MAJOR CASES OF BAD ADVICE AND MIS-SELLING IN MEMBER STATES

KEY FINDINGS

- The survey of stakeholders identified a number of major mis-selling and bad advice in the financial services sector in Member States. The most notable examples are:
  - the sale of foreign currency mortgage and consumer loans and related practices;
  - mis-selling of PPI to consumers who would not be covered in the case of an event that would normally trigger the insurance protection;
  - insufficient information regarding life insurance products;
  - mis-selling of IRHPs to consumers and SMEs;
  - inadequate information provision and lack of suitability of investment products; and
  - compulsory bundling of financial products and services.
  - In aggregate, such mis-selling can reach sizeable levels and be highly detrimental to consumers even if the amount of each transaction is not very high. For example, the latest figures of expected compensation for mis-selling of payment protection insurance in the UK stands now at GBP 18.8 billion or 1.2% GDP, and may rise even more in the future.

This chapter focuses on the behaviours of financial firms which caused consumer detriment since 2000 by identifying and describing major cases of mis-selling and bad advice in the financial services sector in Member States as identified by stakeholders or through the review of the literature.

The cases covered are:

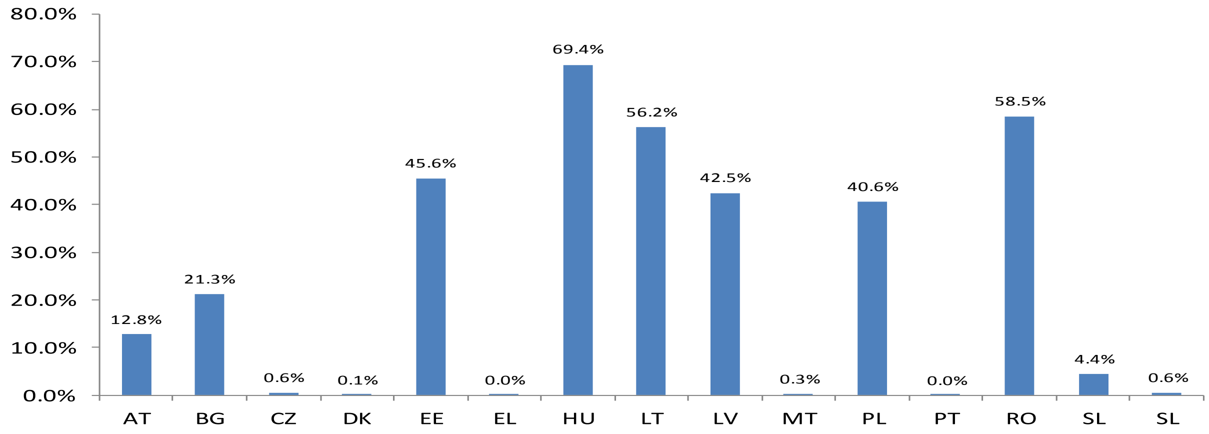
- extension of foreign currency loans and related practices;
- mis-selling of PPI to consumers who would not be covered;
- insufficient information regarding life insurance products;
- mis-selling of IRHPs to consumers and SMEs;
- inadequate information provision and lack of suitability of investment products; and
- compulsory bundling of financial products and services.

Extension of foreign currency loans and related practices

Many consumers who tried to benefit from lower interest rates abroad by taking out mortgages and other loans in foreign currencies experienced financial difficulties when their domestic currency weakened, since the repayments on this type of loan increase (in home currency terms) when the value of the home currency falls relative to the currency in which the loan is held.

Regulators surveyed by the EBA in 2011/12 raised concerns about risks associated with foreign currency loans, including foreign currency mortgages, which in recent years have been attractive to consumers in various Member States, and evidence collected during the present study supports the notion that this is a major issue in several countries[209].

Figure 22: Share of foreign currency loans in total loans to consumers (consumer credit and mortgages) end 2011



Note: Outstanding consumer credit at end of 2011 except Estonia and Slovenia at end of 2010. No data are available for the EU28 countries.

Source: ECRI consumer credit database.

In this case the potential impact on consumers depends on exchange rate movements, which is reflected in the range of countries affected, such as Austria, Croatia, Hungary, Poland and Romania whose currencies depreciated considerably at times between 2007 and now (relative to e.g. the Swiss franc, euro and Japanese yen).

It is important to note that in Bulgaria, Estonia, Latvia, Lithuania and Slovenia most of the foreign currency loans were taken in euro and the currencies of these countries remained stable *vis-à-vis* the Euro. Thus, in these cases, foreign currency loans did not raise the same concerns as in other countries with a high share of foreign currency consumer loans.

Hungary

The situation in Hungary differs markedly from that of the countries mentioned in the previous paragraph.

As of June 2013, 43% of all mortgage contracts were in foreign currency and these contracts accounted for 65% of the total mortgage debt.

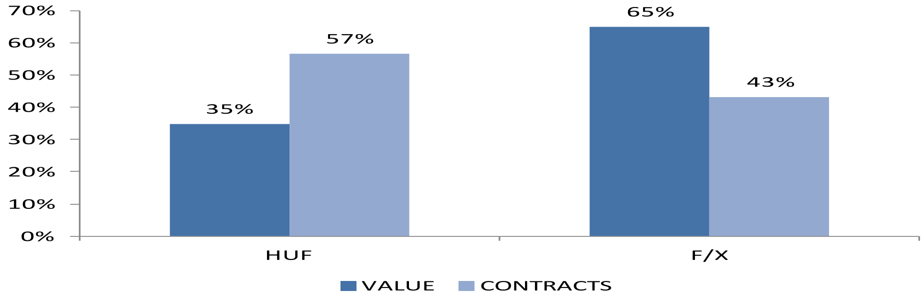
Overall, as of June 2013, there were 865 000 foreign currency loan contracts[210], of which 446 000 where mortgage loans (of which 223 000 were regular housing loans and 222 000 were home equity loans) 368 000 were other loans. In value, these foreign currency loans totalled HUF 3 844 billion or EUR 12.8 billion. 21% of these loans are now classified as non-performing[211].

[209] For a summary of regulators' survey responses from 2011 and 2012 see EBA (2013) *'Report on Consumer Trends: Supervisory Concerns Regarding Protection Issue in 2012/13'*.

[210] The vast majority of these contracts are in Swiss Franc.

[211] See Magyar Nemzeti Bank (2013).

Figure 23: Share of foreign currency mortgages (value and number of contracts) in Hungary in June 2013



Source: Magyar Nemzeti Bank (2013).

The Hungarian Financial Supervisory Authority (HFSA) reported that the number of complaints about foreign currency loans increased significantly in 2008 due to the weakening of the forint, and the Authority's survey response specifically highlighted this issue in the context of mortgages. The Authority noted in their 2008 annual report that 69% of all household debt was held in a foreign currency, mainly the Swiss franc. Furthermore, consumers who wished to transfer their loan from one bank to another under the "loan replacement scheme" saw the value of their liabilities to the original lender grow significantly during the lengthy administration process as exchange rates changed[212].

Following the sharp depreciation of the Hungarian Forint in 2009, many mortgage holders faced financial problems and the Hungarian government took a number of measures such as the introduction of lump-sum repayment and exchange rate limit schemes, the establishment of the National Asset Management Agency and the launching of various bank customer assistance services to limit the financial impact of the depreciation on mortgage holders. According to recent statements by the Hungarian government, the latter has decided to phase out foreign currency mortgages[213].

One important mitigation measure for foreign currency mortgage holders was the Early Repayment Programme, which was announced in September 2011. With this particular scheme the government provided the option of repaying foreign currency mortgage loans at fixed exchange rates. Borrowers with foreign-currency-denominated mortgage loans had the opportunity to repay their total debt at an exchange rate of CHF/HUF 180 for loans denominated in Swiss francs, EUR/HUF 250 for euro-denominated loans and JPY/HUF 2 for loans denominated in Japanese yen. These were far below the prevailing market exchange rates, and thus more favourable to households. As only borrowers who could repay the entirety of their loan were eligible for the program, the program still left by the wayside many less wealthy households who could not afford a full repayment of their loan[214].

Another program allows debtors to make repayments at a fixed forint rate for as long as five years, with the difference between that rate and the market rate accumulating in a separate bank account. According to Hungarian Central Bank, so far the take up is limited with only slightly more than 50% of eligible mortgage holders having entered the scheme. The central bank is of the opinion that "*this much lower-than-expected utilisation is partly attributable to banks' contradictory interests and partly to customers' lack of information and distrust stemming from unfavourable experiences in the past. As the scheme means*

[212] Hungarian Financial Supervisory Authority, Éves Jelentés 2008 (Annual Report 2008).

[213] Statement of Minister for National Economy Mihály Varga on Kossuth Radio's morning programme, 1st August 2013.

[214] See Balogh et al.(2013).

that banks renounce some of their interest income, for them the optimal solution is if only those customers take the opportunity that would more likely become nonperforming without the scheme. On the customers' side, lack of information may be a constraint, while in many cases they do not dare to undertake the new account loan due to the principal not paid within the scheme. Finally, lower level of interest in the scheme is also attributable to debtors' hopes that the government will roll out further, more favourable schemes, prompting them to wait for the best opportunity to enter the exchange rate cap."

At the present time, the Hungarian government is considering further measures to address the issue of foreign currency debt.

Other countries

In **Croatia**, banks offered mortgage loans with a floating rate tied to the value of the Swiss franc. Before 2007/8 these loans were popular since they offered lower interest rates than those expressed in the domestic currency or tied to the euro[215]. However, in 2010/11 the value of the Swiss franc increased, leading to an increase in the interest rate on the loans that were tied to the currency, significantly increasing the debt burden of consumers[216].

- Due to a steady depreciation of the złoty from mid-2007 there was a significant increase in **Polish** household debt, including mortgages, held in foreign currencies, especially the Swiss franc (which rose from PLN 26.7 billion in 2004 to PLN 149.6 billion in 2008). The market share of foreign currency loans had grown to 40.6% of all household debt, according to the Financial Supervision Authority's 2008 Banking Report[217].
- In **Austria**, foreign currency mortgages (especially loans in Swiss francs) became increasingly common from the late 1990s onwards and in 2011 around 30% of household debt was held in a foreign currency[218]. These loans are often 'bullet loans', meaning the borrower saves into a repayment vehicle in order to repay the loan in a single payment. Therefore there is a risk of changes in the value of the repayment vehicle as well as an exchange rate risk. In their survey response the Austrian Ministry of Labour, Social Affairs and Consumer Protection highlighted foreign currency bullet loans as a product that proved harmful for consumers over the period from 2000 to the present, citing high debts, failure of yield forecasts to materialise, and advice errors.
- In response to our survey, the **French** Association of Financial Companies[219] (ASF) identified foreign currency loans as a product that has been particularly harmful to consumers since 2000, citing "badly controlled foreign exchange risk".
- According to the regulator's survey response in **Romania** mortgages in Swiss francs were popular for several years before the financial crisis. Interest rates on these mortgages were lower than those denominated in leu or euro and clients could borrow larger amounts. No indication was given of the exchange rate risk or the possibility of interest rates rising. These loans were "the first credits to go into default". In its survey response a Romanian bank also identified foreign currency loans as a product that has been particularly harmful to consumers since 2000 citing "the volatility of exchange rates".

[215] Croatian National Bank, Tromjesečno Izvješće Bilten, Listopad 2010 (Quarterly Report Bulletin, October 2010).

[216] Croatian National Bank, Godisnje Izvjesce 2012 (Annual report 2012).

[217] Polish Financial Supervision Authority, *'Raport o sytuacji banków w 2008 roku'* (Banking Report 2008).

[218] Albacete et al (2012), *'Risk Buffer Profiles of Foreign Currency Mortgage Holders'*, Austrian Central Bank Financial Stability Report.

[219] i.e. the *Association Française des Sociétés Financières* (ASF).

- Prior to the economic downturn foreign currency mortgages were sold in the **UK** by some private banks (e.g. Barclays Wealth, RBS International and Lloyds International), which harmed consumers when the pound fell against the Swiss franc and Japanese yen, although mainly this affected wealthier individuals (who typically use such banks)[220].

The issue of foreign currency loans is associated with particular sources of individual consumer detriment discussed in chapter 2, namely firm behaviour (i.e. extending such loans and related practices) and behavioural biases that are common among consumers, such as cognitive limitations and over-optimism.

Cognitive limitations are relevant because consumers face particular challenges in understanding the risks associated with foreign currency loans (a point that was raised by regulators surveyed by the EBA), and consumers may be over-optimistic when assessing the negative risks of future exchange rate movements.

In terms of firm behaviour, it is debated whether granting of these loans in itself amounted to mis-selling. According to the Hungarian Prime Minister, courts should examine whether loans denominated in foreign currencies were "faulty products": "everywhere in the world there exists a legal principle which states that one must not sell a faulty product to people even [if] they are warned that the product may easily be faulty". However, a letter from the head of the financial watchdog warned courts of the dangers of ruling against the banks in relation to foreign exchange loans[221].

Reports by regulators and other organisations in several Member States highlight various poor/harmful practices by lenders associated with foreign currency loans. These practices include provision of misleading information, shifting risk to consumers, unclear costs and contracts, impermissible contract clauses, inappropriate marketing, and lenient access to such loans.

- As already noted, new legislation in **Hungary** in 2011 enabled borrowers to repay mortgages at a fixed exchange rate. This repayment option affected many consumers, which was reflected in the large number of claims. However, at one institution the application form said that consumers can only submit an application for repayment at a fixed exchange rate once during the period to 30 December 2011. Another institution required consumers to declare their awareness that the legal provision enabling final repayment may be challenged, and that they therefore commit to repay the amount due from the exchange rate difference if the law is voided. The HFSA found that the institutions in question provided misleading information to consumers and that these practices are particularly harmful, and imposed significant fines. A third institution charged clients a conversion commission, equal to 1% of their monthly payments, plus a handling fee, for repaying their foreign currency mortgage loan in forints. This unlawful charge resulted in more than 26,000 customers paying a combined amount of HUF 289 million. The bank was ordered to reimburse these charges to customers and the regulator imposed a large fine on the institution[222].
- In **Croatia**, according to a verdict from the Commercial Court of Zagreb, consumers were misinformed about the exchange rate risk associated with loans linked to the Swiss franc, and banks could shift the entire burden of the exchange rate and

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[220] Financial Times article, 15th March 2013: http://www.ft.com/cms/s/0/4637a946 87fe 11e2 8e3c 00144feab dc0.html#axzz2dMszUxQR.

[221] http://www.politics.hu/20130705/prime-minister-says-foreign-currency-loans-may-be-faulty-products/.

[222] Hungarian Financial Supervisory Authority, Annual Reports 2011 and 2012.

interest rate risk to the consumer. Furthermore, the formula used to calculate loan costs and the language and terminology used in contracts was unclear, and staff and general marketing encouraged consumers to take these loans, with little regard for whether they were appropriate forparticular consumers[223].

- According to the **Polish** Financial Supervision Authority, access to loans in foreign currencies should have been generally restricted and backed up with a thorough information campaign addressing the risk of long-term fluctuations in exchange rates, both of which are the responsibility of the banking sector[224].
- In response to the financial crisis, using clauses in customers' contracts **Austrian** banks attempted to pass on the increased costs of refinancing foreign currency loans to those who took them out, retrospectively demanded additional collateral from customers with foreign currency loans, and forced a conversion of customers' foreign currency loans into euro [225]. However, following action by consumer protection organisations, the courts ruled that such clauses were ineffective/impermissible[226].

Mis-selling of PPI to consumers who would not be covered

Payment protection insurance (PPI) is supposed to enable repayment of loans if a borrower dies or becomes unable to work for some reason. Consumers do not typically 'shop around' extensively for PPI since it is a secondary purchase and, as noted by the UK Financial Services Authority (UK FSA), it is a fairly complex insurance product that is often sold to 'vulnerable' consumers[227].

Based on the results of surveys of regulators, in 2013 the EBA highlighted concerns about mis-selling of PPI and noted that in some Member States regulatory action on the issue has been taken and is ongoing[228]. Furthermore, documents examined during the present study indentify this issue in several countries, most notably the UK, but also Spain and Ireland.

The main issue, which is relevant in various Member States, is that PPI policyholders are unable to claim in situations where they believe they should be covered, or, in some cases, are ineligible to claim at all (e.g. if the policyholder was unemployed at the time they purchased the policy). A further issue is that consumers were sold policies that are inappropriate for them (e.g. policies with a single premium, rather than regular premiums).

The core issue of non-coverage is closely linked to various poor sales practices, such as poor information provision, insufficient training of staff, staff incentives that promote mis-selling, and unfair/unclear of contract terms. The magnitude of damages caused is significant, especially in the UK where banks have allocated around GBP 14 billion in order to compensate consumers affected by the scandal. In particular, the following details relating to mis-selling of PPI in three Member States are drawn from documents published by national authorities:

- In 2005, the **UK** regulator found that firms selling PPI in sectors such as revolving credit, unsecured lending and subprime mortgages typically had lower standards of

[223] Verdict from the Commercial Court of Zagreb (2013), *'Presuda trgovackog suda u Zagrebu'*.

[224] Polish Financial Supervision Authority, *'Raport o sytuacji banków w 2008 roku'* (Banking Report 2008).

[225] Verein für Konsumenteninformation (2012), *'Bericht zur Lage der Konsumentinnen, 2009-2010'*.

[226] The court cases in question are Oberlandesgericht Graz (2010), Handelsgericht Wien (2010) and Oberster Gerichtshof (2012). Case documentation available at: http://www.verbraucherrecht.at/cms/uploads/media/OLG_Graz_4.2.2010_3_R_183_09w.pdf. http://verbraucherrecht.at/cms/uploads/media/HG_Wien_07.09.2010_22_Cg_11_10a.pdf. http://verbraucherrecht.at/cms/uploads/media/OGH_30.05.2012_8_Ob_49_12g.pdf.

[227] UK Financial Services Authority (2005), *'The sale of payment protection insurance – results of thematic work'*.

[228] EBA (2013), *'Report on Consumer Trends: Supervisory Concerns Regarding Protection Issue in 2012/13'*.

compliance than those selling PPI for prime mortgages. The UK FSA found that firms failed to take reasonable steps to ensure that consumers bought policies that they may be able to claim on, provided improper information, and did not tell consumers that PPI was optional. Furthermore, reward structures for sales staff encouraged mis-selling, training and monitoring was insufficient (in particular, staff were not trained on how to avoid giving advised sales when not supposed to), disclosure of the product and price by firms was poor, and there was little assessment of whether the type of PPI being sold was suitable for particular consumers[229]. In follow-up work in 2006 the UK FSA also highlighted concerns about unfair terms in PPI contracts. In particular, the UK FSA was concerned about terms preventing consumers from receiving refunds if they repay their loan early or wish to cancel their policy and terms relating to the amount that is refunded (which may not be 'fair and proportionate' and which may not have a clear, understandable calculation method).[230] The volume of complaints and consumers seeking redress still remains high, with 74% of new cases brought to the Financial Ombudsman Service relating to PPI in 2012-13[231]. Mis-selling of PPI has been the largest mis-selling scandal in UK financial history, with about GBP 18.8 billion set aside by banks for compensation payouts as of August 2013[232]. This GBP 18.8 billion is equivalent to 1.2% of UK GDP (in current prices) in 2012.

- The **Spanish** General Directorate of Insurance and Pensions (DGSFP) reported that some consumers who purchased PPI incorrectly thought that they were covered in case of either unemployment or temporary incapacity, whereas the coverage actually depended on the specific situation of the person insured. For example, coverage in the event of unemployment was mainly applicable to workers with a permanent contract. According to the DGSFP, consumers were given incorrect information about the coverage of PPI, which misled them to believe they were protected. The DGSFP also noted that the increase in complaints regarding PPI covering unemployment is linked to the country's economic crisis (and consequent high unemployment levels)[233].
- In **Ireland**, firms gathered insufficient information on borrowers in order to ensure the suitability of PPI contracts, with staff trained to consider eligibility rather than suitability. In addition, there were issues related to the timing of information provision, failure to explicitly bring information to customers' attention, and record keeping[234]. In some cases, PPI policies were sold to consumers whose situation meant they were ineligible to make a claim under the policy, without checks being made on these details during the sale process[235]. According to *Money Guide Ireland*,

[229] UK Financial Services Authority (2005), '*The sale of payment protection insurance – results of thematic work*'.

[230] UK Financial Services Authority (2006), '*The sale of payment protection insurance – results of follow-up thematic work*'.

[231] UK Financial Ombudsman Service (2013), '*2012-13 annual review of consumer complaints about: insurance, credit, banking, savings and investments*.

[232] See Which?, press release of 1 August 2013, Cost of PPI scandal now more than double the cost of the Olympics.

[233] Spanish General Directorate of Insurance and Pensions, *'Seguros y fondos de pensiones: Informe anual del servicio de reclamaciones'* (Annual report of the complaints service), 2009.

[234] Central Bank of Ireland Annual Report 2012.

[235] Examples of PPI policies sold to consumers how would be ineligible to make a claim are described in a Central Bank of Ireland information release: http://www.centralbank.ie/regulation/processes/consumer-protection-code/compliance monitoring/Documents/PPI%20 %20Press%20Release%2029%20june%20final%20version.pdf.

refunds announced by two banks (Allied Irish Bank and Bank of Ireland) exceeded EUR 4 million as of May 2012[236].

Insufficient information regarding life insurance products

Concerns about the sales practices of insurance companies and intermediaries that sell life insurance products are highlighted in documents published by national authorities and organisations in a range of Member States, including Austria, Czech Republic, Finland, Germany, Hungary, Italy, Slovenia and Spain.

The main problem in this area is that insufficient or unclear information is provided to consumers about the details of policies and contracts they purchase, including, for example, information on the share of premiums that go towards fees rather than investment, how payouts and redemption values are calculated, and which asset values are used in calculations. Related to this, certain costs and fees are sometimes concealed or non-transparent, such as brokers' negotiation fees or policy cancellation charges. As a result, consumers do not always understand the policies they are sold and may overestimate the net financial benefits of policies (i.e. payouts after fees and charges), especially when contracts are terminated early.

Across the different counties these issues apply to both standard life insurance policies and mixed insurance and investment products (e.g. unit-linked products). According to some regulators, due to the increasing complexity of insurance products consumers may confuse them for savings and investment products. In the case of unit-linked products in particular it is the insured who assumes the investment risk, in which case the policyholder may not be fully aware of this risk and the variability of the assets in which premiums are invested, possibly because insufficient information was given by the provider.

These concerns about product complexity and information provision mirror those expressed by the EBA in a recent report on consumer protection issues, which highlights the issue that consumers may be being offered products they do not understand, especially with respect to the risks involved[237].

Regulators have taken action in the area of information provision for life insurance products in various countries: in Hungary the HFSA fined an insurance company for unclear phrasing of terms and conditions; in Germany contract terms were declared ineffective due to a lack of transparency, and the regulator forced an insurer to explicitly inform consumers of a caveat in its policies; the Spanish regulator concluded that 'Renta Inversion' policies that did not clearly establish how redemption values would be calculated were a case of mis-selling, and that some financial institutions did not comply with regulations by failing to provide compulsory information for unit-liked products; and the Austrian regulator introduced minimum standards for information on profit benefits paid to policyholders.

In addition to consumer information issues, other problems related to life insurance identified by regulators include firms failing to make payments to policyholders, aggressive commercial practices by intermediaries, and contract terms that put consumers at an inappropriate disadvantage.

The following details regarding life insurance sales practices in particular Member States are taken from documents published by national authorities and organisations:

- In the **Czech Republic**, the insurance sector is regularly the subject of the largest share of complaints, with life insurance often being the most significant problem

[236] Figure from Money Guide Ireland: http://www.moneyguideireland.com/ppi-refunds-of-e4-million-paid-out.html.

[237] EBA (2013), *'Report on Consumer Trends: Supervisory Concerns Regarding Protection Issue in 2012/13'*.

area. Issues raised relate to shortcomings in product information, hidden costs, 'surrender values', and consumers confusing insurance products for savings products[238]. According to the Czech National Bank (CNB), consumers do not always understand the life insurance contracts they are sold, which may be due to the way that these contracts are sold and the information that is provided about them. Since it is hard to prove that sellers of insurance are at fault, the CNB believes it is necessary to require records to be kept of clients' needs, detailing why products were recommended and how products were explained[239]. A serious problem detected in 2010 was a tendency for intermediaries to secure commissions by arranging additional "innominate contracts"[240]. The CNB regard this to be an aggressive commercial practice and opened proceedings against some intermediaries[241].

- In **Germany**, it was unclear to consumers that one insurer would only pay out actuarial reserves accrued up to an agreed early termination date on long-term life insurance contracts, and after receiving complaints on the issue the regulator forced the company to explicitly inform customers of this caveat[242]. In another case, a Greek life insurance provider operating mainly in Germany failed to make payouts to policyholders after their contracts expired or were terminated. In response, the company's licence to conduct insurance business was withdrawn and the firm was liquidated. Policyholders were eventually repaid through the Greek *Private Life Insurance Guarantee Fund*, since the company's assets were insufficient to cover the claims made[243]. Finally, in 2012 the Federal High Court of Justice ruled that certain contract clauses used by four insurers since 2001 (relating to surrender values, cancellation fees and loading acquisition costs onto initial premium payments) were ineffective, since these clauses put the consumer at an inappropriate disadvantage or lacked transparency[244].

- In **Hungary**, the majority of consumer complaints in the insurance sector in 2010 concerned unit-linked products. The HFSA found that problems were due to a lack of information provided by insurance companies, as well as the consumers' insufficient knowledge of these products. One company was found guilty of unclear phrasing of terms and conditions, which led to customers paying charges they could not anticipate, and fined by the HFSA[245].

- In **Spain**, many complaints were received about widespread 'Renta Inversion' products, which allowed for redemption by the consumer within a set period but did not clearly establish how redemption values would be calculated and which asset values the calculation would be based on. Often, customers were not aware that the product was actually a life insurance, believing it was a deposit. The DGSFP concluded that this was a case of mis-selling, since consumers were misinformed

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[238] These issues are a summary drawn from the Czech National Bank's Financial Market Supervision Reports 2009, 2010, 2011 and 2012.

[239] Czech National Bank, Financial Market Supervision Report 2009.

[240] Literally meaning 'unnamed contracts'.

[241] Czech National Bank, Financial Market Supervision Report 2010.

[242] German Federal Financial Supervisory Authority (BaFin), Annual Report 2010.

[243] German Federal Financial Supervisory Authority (BaFin), Annual Report 2011.

[244] German Federal High Court of Justice (2012), 'Bundesgerichtshof zur Unwirksamkeit von Klauseln in Lebens- und Rentenversicherungsverträgen'.

[245] Hungarian Financial Supervisory Authority, Consumer Protection Risk Report 2010/II.

leading them to believe they were getting a deposit instead of life insurance[246]. Furthermore, the regulator found that consumers were confused because some financial institutions did not comply with regulations by failing to provide compulsory information about unit-linked products[247]. In 2011, the DGSFP stated that some life insurance products are particularly complex (especially if the insured assumes the investment risk or the value of the policy is referenced to certain linked assets), and therefore clear wording of contract terms are insufficient to ensure that customers are properly informed – in addition proper professional advice from the intermediary selling the product is needed[248].

- In **Finland**, the regulator found deficiencies in how the price and costs of unit-linked insurance products are presented, since the price of the insurance does not always reflect the price of the associated investment basket, and the fee structure can be difficult to comprehend[249].
- After an investigation into the practices of 24 companies in 2009, the **Austrian** regulator criticised the information provided to life insurance customers. After another round of controls in 2010 the regulator concluded that while improvements had been made significant deficiencies still existed, in particular the transparency of costs and impact these have on the amount of premiums that are actually invested. Another problem was information given on 'profit benefits' (i.e. the share of the profit made from a policy that is paid to the policyholder). Companies would provide new policyholders with forecasts of potential profit benefits, which turned out to be over-optimistic. The regulator responded by introducing minimum standards regarding this type of information[250].
- According to the **Slovenian** Consumer Association there were several cases of irregular practices in the life insurance sector, with customers experiencing detriment because they received misleading information. Furthermore, according to the consumer association, the most commonly sold products are those with the highest commission rates for the sellers, regardless of their appropriateness for clients[251].
- In **Italy**, index-linked life insurance packages were sold by a particular bank with no clear statement regarding the level of risk involved. In total, 6,500 customers paid EUR 182 million for these products, which were linked to Lehman Brothers bonds and should have ensured full recovery of customers' initial investments upon maturity. However, after the default of Lehman Brothers the bank informed investors that their capital would not be fully repaid (the bank proposed to repay 50% in cash or to convert the product into another insurance product which itself did not guarantee full repayment at maturity)[252]. A Milan tribunal forced the bank to issue a statement to all customers declaring that their conduct had been lacking

[246] Spanish General Directorate of Insurance and Pensions, *'Seguros y fondos de pensiones: Informe anual del servicio de reclamaciones'* (Annual report of the complaints service), 2008.

[247] Spanish General Directorate of Insurance and Pensions, *'Seguros y fondos de pensiones: Informe anual del servicio de reclamaciones'* (Annual report of the complaints service), 2009.

[248] Spanish General Directorate of Insurance and Pensions, *'Seguros y fondos de pensiones: Informe anual del servicio de reclamaciones'* (Annual report of the complaints service), 2011.

[249] Finnish Financial Supervisory Authority, Annual Report 2010.

[250] Verein für Konsumenteninformation (2012), *'Bericht zur Lage der Konsumentinnen, 2009-2010'*.

[251] Information provided by the Slovenian Consumer Association via email.

[252] Report by Movimento Consumatori: http://www.movimentoconsumatori.it/contents.asp?id=450. Legal document: http://www.movimentoconsumatori.it/public/upload/users//Trib_Milano_21_12_09_reclamo_AMC_CNP.pdf.

good faith and diligence. This statement could then be used by customers to claim full reimbursement of the sums lost in the investment[253]. The first lawsuit concluded by a customer (in March 2010) imposed the reimbursement of EUR 336 000 of invested capital plus interest, as well as damages of EUR 33 000[254].

Mis-selling of interest rate hedging products to consumers and SMEs

Interest rate hedging products (IRHPs) include a variety of products that are sold to retail customers in conjunction with loans in order to protect them against interest rate risk. In principle, IRHPs can be beneficial since they provide customers with more certainty over future loan repayments. However, these products can be very complex, and so may be susceptible to mis-selling.

These products were mis-sold to consumers in Spain and financially unsophisticated small businesses in the UK. In both countries, one of the primary issues was the adequacy of information provided to IRHP customers (the Danish Bankers Association also acknowledged "insufficient counselling" in relation to interest rate swaps). Furthermore, in the UK advice was given in non-advisory sales and SMEs were sold over-hedged products.

As a result, purchasers of IRHPs in both countries were unable to make properly informed decisions and bought unsuitable products. The impact on these customers was significant, since they were required to make much higher payments in relation to their loans.

Further details about mis-selling of IRHPs in each country are provided below:

- In Spain, IRHPs, including products offered alongside mortgage loans, were sold to consumers without accurate and complete information and relevant documentation. For example, consumers were not given proper information about the terms and costs of these products, the possibility and consequences of early cancellation, and how minimum interest rate provisions would be applied.

  As a result, consumers were unable to fully understand how the products work, and to make informed decisions based on an assessment of the risks. Consequently consumers bought products that were unsuitable given their needs. Other poor industry practices included failing to honour verbal agreements, unilaterally terminating or modifying agreements, using sales platforms that did not allow for proof of purchase (e.g. SMS), and providing biased information.

  Overall, complaints about these products accounted for one fifth of those filed with the Banco de España in 2010. According to the Banco de España, the failure of firms to provide sufficient information on these products constituted bad practice, and in a number of cases financial institutions failed to comply with the existing regulations. In particular, the Banco de España stressed that transparency must be ensured because such products concern loans of over EUR 150 000. Consumers suffered monetary damages due to these products since they were required to make mortgage payments at higher interest rates or faced high cancellation charges[255].

- In the **UK**, a review conducted by the financial regulator in 2012 found serious failings in the sale of IRHPs to financially unsophisticated small businesses. Customers were not sufficiently advised on the exit costs of these products, including how to determine the size of such costs, or were misled to believe there

[253] Statement of the association set up specifically to represent consumers in this case: http://www.lericom.it/it/news_completa.php?Nid=16.

[254] Legal document issued by Milan tribunal: http://www.lericom.it/pub/news/NEWS_Recente_sentenza_Milano.pdf.

[255] Annual reports of the Banco de España complaints service 2009 and 2010.

were no such costs. Furthermore, customers were incorrectly informed that they were required to purchase products as add-ons to loans, and banks strayed into providing advice on 'non-advised'[256] sales. In addition, banks sometimes sold 'over-hedged' products, where the duration and/or amount of the hedge did not match the underlying loan. These practices were driven by sales incentives and over 90% of sales examined in the initial 'pilot' review did not comply with regulatory requirements. The regulator believes that if sales had complied with regulatory requirements, businesses would only have bought simple products (e.g. caps or vanilla swaps/collars), rather than the more complex hedges they were sold.

Subsequently, banks involved agreed to review their sales of IRHPs made to certain 'non-sophisticated' customers[257] since 2001, and to engage in a proactive redress process. The full review and redress process began in May 2013 and will examine over 30 000 individual cases using an approach set out by the regulator. At the end of August 2013, mis-selling had been found in 93% of cases where the compliance assessment stage[258] was complete, implying that mis-selling is also likely to be found in around 6,000 other cases that are still at this stage[259]. In addition, more than 6,500 further customers may still opt-in to have their purchases examined[260]. Nearly 2,000 cases were at the redress stage, of which a decision had been reached and communicated in 213 cases, with redress due in 179 cases[261]. Ten offers of redress had been accepted by businesses, totalling GBP 500 000, and the regulator expects this figure to increase quickly in the coming months[262]. Estimates quoted in the press put the total potential cost to banks of providing redress to customers at around GBP 1.5 billion to GBP 2.5 billion[263].

- In **Denmark**, according to the survey response from the Danish Financial Supervisory Authority (DFSA) small agricultural businesses faced major losses if they wished to end interest rate swap agreements, and the Danish Bankers Association (DBA) reported in their survey response that "there has to some extent been insufficient counselling related to currency and interest rate swaps".

Information provision and suitability of investment products

Reports by organisations such as regulators and consumer groups reveal widespread concerns about the practices of companies selling investment products in a number of Member States (including Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Lithuania, Malta, Portugal, Slovakia, Slovenia, Spain, and the UK).

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256 i.e. where no recommendation should be given.

257 Businesses are assessed as being either sophisticated or non-sophisticated based on their turnover, balance sheet size, and number of employees, or, alternatively, whether at the time of sale the business had the necessary experience and knowledge to understand the product being sold.

258 i.e. the stage where it is determined whether an IRHP was mis-sold.

259 Of the 608 cases where compliance has been assessed 564 were found to be non-compliant, and a further 6,550 cases are still at this stage of the process: http://www.fca.org.uk/static/documents/aggregate-progress.pdf.

260 Customers who were sold certain types of products, namely simple swaps or collars, must opt-in to have their purchases included in the review process.

261 http://www.fca.org.uk/static/documents/aggregate-progress.pdf.

262 http://www.fca.org.uk/news/update-on-the-banks-reviews-of-sales-of-interest-rate-hedging-products.

263 http://www.thisismoney.co.uk/money/news/article-2271140/Banks-hit-1-5billion-FSA-finds-mis-sold-90-rate-swaps-SMEs. html; http://realbusiness.co.uk/article/21713-are-interest-rate-swaps-the-next-ppi-scandal-for-smes. http://www.ifaonline.co.uk/ifaonline/news/2292518/fca-banks-pay-out-just-gbp500k-over-interest-rate-swap-misselling.

These concerns typically relate to provision of information, consumer understanding and product complexity. Therefore, sales of complex investment products are often particularly relevant, although similar issues also arise regarding less complex products. In particular, products involved include stocks, bonds, structured products, derivatives, collateralised debt obligations (CDOs), perpetual securities, foreign exchange derivatives, collective investment schemes and convertible and index-linked bonds, sold by both financial institutions and intermediaries.

The main failing of sales practices for these products, which is identified in reports from authorities across Europe, is that companies and intermediaries do not provide sufficient, correct or adequately clear information about products to their customers, coupled with poor or inappropriate advice (or, at least, a lack of monitoring of advice given by staff). For example, according to the documents reviewed, deficiencies exist in the provision of information relating to the risks associated with products, the duration of investments, product specifications, and key terms within agreements.

In addition, in some cases products are sold to consumers to whom they are not suitable because companies fail to take necessary measures to establish that their customers have the required knowledge and experience to understand these products and the associated risks, and to ensure that products are suitable for customers in terms of their investment preferences and objectives and willingness to take risks.

These concerns reiterate those identified and described by the EBA in a recent report, which draws attention to the issue that consumers may be being sold products that they do not understand, especially with respect to the associated risks[264]. The EBA also previously identified low levels of financial literacy among consumers as a key problem, which is evidently closely related to the problems of understanding and product complexity[265].

Furthermore, there are examples of pressure selling, firms promoting products in circumstances where it is not appropriate (e.g. to non-advisory clients, or where products are inappropriate for clients), and misrepresentation and inappropriate promotion and advertising (e.g. advertising potentially unsustainable rates of return, or promoting investment products as bank deposits).

As a result of these practices, consumers may not be aware of the risks that products carry and may purchase products that they would not otherwise have bought. In particular, some regulators highlight the fact that some customers believed their capital investment was guaranteed when it was not. The eventual impact is often that consumers only receive a small proportion of the amount they expected to receive at the end of the investment period, sometimes losing a large share of their initial capital.

Regulators have taken action in this area in a number of countries: in Malta a bank received fines totalling more than EUR 375 000 for mis-selling investments to inexperienced investors and breaches related to disclosure of information and suitability of financial instruments sold to the public (including securities issued by Lehman Brothers); in Finland the Financial Ombudsman found that in one case at least an investor was given false information and the regulator has stated that the term “capital-guarantee” must be used more clearly; in Estonia the regulator fined a company 300 000 kroons for disclosing incorrect and incomplete information about an investment product; in Belgium an investigation was initiated against two banks relating to sales of structured bonds and customers were reimbursed; in Spain the regulator found that agreements related to

[264] EBA (2013), *‘Report on Consumer Trends: Supervisory Concerns Regarding Protection Issue in 2012/13’*.

[265] EBA (2012), *‘Financial Innovation and Consumer Protection: An overview of the objectives and work of the EBA’s Standing Committee on Financial Innovation’*.

structured deposits did not clarify key terms or failed to clearly specify the method for calculating capital to be returned to investors; in the UK a bank was fined nearly GBP 6 million for failures relating to sales of structured products, and a partner at a firm was fined GBP 117,000 and banned from the financial services industry for mis-selling of collective investment schemes; in Italy a class action was taken against a bank that allegedly provided insufficient information to consumers about convertible bonds; in Ireland the regulator upheld cases of mis-selling of bonds by financial advisors; in Lithuania a court found that a bank operated dishonestly and not in the best interest of its clients in relation to sales of a complex investment scheme involving equity-linked bonds; in Portugal the regulator found that two banks provided inadequate information about bonds and suspects serious breaches of banking regulations; in Germany the regulator revoked a firm's authorisation for providing insufficient information about the liquidity of penny stocks; and in Austria the Supreme Court ruled that the brokers had provided misleading advice about the risk of shares they had sold.

Further details of problematic sales practices relating to investment products in particular Member States are set out below. These are mainly drawn from reports published by national authorities and other organisations:

- In **Malta**, reports from the regulator's Consumer Affairs Unit (CAU) describe a number of problematic sales practices relating to investment products between 2008 and 2012. In 2008 and 2009, the CAU expressed concerns that investment products with illiquid underlying assets were sold to retail investors, products were advertised with potentially unsustainable rates of return, and investment products were sold having been packaged and promoted as bank deposits[266]. In 2010, the CAU reported that a number of investors complained that they should not have been labelled as "experienced" and so should not have been sold investments in a property fund[267]. Two years later the regulator fined a bank more than EUR 200 000 in relation to mis-selling of investments in this fund, since the regulator could not find evidence in the bank's possession that the investors were experienced[268]. In 2011, 340 cases relating to investment services alleged mis-selling, provision of bad advice, or improper disclosure of key characteristics of a product[269]. That December the same bank was fined another EUR 175 000 for "breaches related to disclosure of information and suitability of financial instruments sold to the general public" in particular perpetual and other preferred securities issued by banks including Lehman Brothers[270]. In 2012, the CAU reported a "prevalent increase" in products that entice investors with an attractive initial rate and tie them in for several years. These structured products paid high returns for the first years of the product life but zero interest during the rest of the investment period, meaning it would have been better for investors to place their capital in a term deposit account[271]. Finally, in 2013 the regulator suspended the licence of a firm that did not check the suitability of complex investment products before selling them to clients. The company failed to establish customers' investment objectives and risk attitudes or whether they had sufficient knowledge and experience to understand the risks, did not carry out an

[266] Malta Financial Services Authority Consumer Affairs Unit, Annual Reports 2008 and 2009.

[267] Malta Financial Services Authority Consumer Affairs Unit, Annual Report 2010.

[268] Announcement of the Malta Financial Services Authority on 4th June 2012: http://www.mfsa.com.mt/pages/AdministrativeMeasuresPenalties.aspx.

[269] Malta Financial Services Authority Consumer Affairs Unit, Annual Report 2011.

[270] Announcement of the Malta Financial Services Authority on 28th December 2011: http://www.mfsa.com.mt/pages/AdministrativeMeasuresPenalties.aspx.

[271] Malta Financial Services Authority Consumer Affairs Unit, Annual Report 2012.

'Appropriateness Test' to check the knowledge of non-advisory clients, and promoted and sold complex investments to non-advisory clients[272].

- In **Finland**, there have been disputes about the information provided to customers who invested in CDO-securities (the so-called "Mermaid bond") concerning the investment risk of these products[273]. In particular, many customers claimed that the product was marketed as capital-guaranteed, whereas in reality investors lost their capital. The regulator stated that the "characteristics and risks relating to the bonds were brought out" in marketing material[274]. However, the Financial Ombudsman Complaints Board stated that, in one case at least, the investor was given false information regarding the investment risk[275]. In addition, according to the regulator's 2010 annual report, investment funds did not always provide investors with sufficient information on index-linked bonds. The regulator stated that the content and timeliness of prospectuses could be improved, and the term "capital-guarantee" must be used more clearly[276].
- During 2008 the **Estonian** regulator fined a company 300,000 kroons (approximately €19,000) for disclosing incorrect and incomplete information about an investment product ('SEB Likviidsusfond'). According to the regulator the product had been (incorrectly) promoted as a risk-free investment opportunity[277].
- Most complaints to **Slovakia**'s Banking Ombudsman in the area of investment services concern mutual funds and relate to the unsuitability of the investment product or failure to provide correct and comprehensive advice or sufficient product information. According to the ombudsman, poor financial literacy among consumers plays a significant role in this situation[278].
- According to the 2008 annual report of the **Belgian** Financial Ombudsman several complaints concerned perpetual bonds since clients were unaware of the associated risks and duration of these investments. In the view of the Ombudsman in 2008, in most cases banks were not responsible for losses incurred by their clients in relation to these products[279]. However, according to the Ombudsman's 2010 and 2011 reports, consumer detriment did occur in several cases because customers received incomplete or unclear information or inappropriate advice on these products. In addition, in 2009 the Ombudsman highlighted the level of complaints received relating to sales by two banks of structured bonds guaranteed by Lehman Brothers. An investigation was initiated against the banks and both offered to reimburse clients (although only for 65% of their investment in the case of one bank)[280].
- In **Spain**, financial institutions did not properly inform customers about the risks associated with structured deposits or how these products function. These customers received interest payments less frequently than expected and were

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[272] Announcement of the Malta Financial Services Authority on 6th June 2013: http://www.mfsa.com.mt/pages/AdministrativeMeasuresPenalties.aspx.

[273] According to media reports, approximately 1,500 investors lost a total of €140 million from investing in these bonds: http://www.talouselama.fi/sijoittaminen/ei+se+ollut+nordean+vika/a2071444.

[274] Finland Financial Supervisory Authority, Annual Report 2009.

[275] Arvopaperilautakunnan Ratkaisusuositus, 08/12/2009, *'Konsultatiivinen varainhoito. Joukkovelkakirjalaina. Sijoitusneuvonta.'*: http://www.fine.fi/ratkaisut_apl/index.php?todo=4&id=1017.

[276] Finland Financial Supervisory Authority, Annual Report 2010.

[277] Estonian Financial Supervision Authority, Annual Report 2008.

[278] Slovakia Banking Ombudsman, Annual Reports 2008-2012.

[279] Rather the cause was the financial crisis, which could not have been foreseen.

[280] Belgium Financial Ombudsman, Annual Reports 2008-2011.

prevented from recouping their deposits in the short-term, a scenario they could not have foreseen due to the incomplete information provided. Banco de España concluded that the agreements did not clarify key terms or failed to specify clearly and transparently the method for calculating the capital to be returned to customers[281]. In addition, according to the survey response of the ADICAE [282], Royal Bank of Scotland bonds "were sold by a number of separate entities in Spain. The consumers had not been correctly or even minimally informed about the bonds' characteristics and risks associated with them, besides the fact the product was later found unsuitable for small savers. The affected have experienced suspending of repayment, facing a situation where, in medium term, they were unable to recover the invested funds. ADICAE has resorted to a collective and extrajudicial path of settling the dispute in the interest of recuperating the investments made by the affected parties".

- Problems relating to structured funds were reported by the Ombudsman of the **French** Financial Markets Authority[283] in 2008 and 2009. Investors were unaware of the product specifications and the risks involved and complained that they did not receive all the necessary information to take the decision to invest in these funds. Most of these cases concerned funds to which clients had subscribed in 2001 or 2002. At maturity clients only received their guaranteed capital excluding subscription fees, whereas they had been promised twice that amount. In most cases clients accepted the compensation proposed by the finance institution[284]. In addition, the Ombudsman also reported aggressive selling of debt securities in 2009, which lead to complaints about insufficient and misleading information. Most of these cases were resolved with compensation offered by the finance institution[285]. Finally, in 2010 the Ombudsman reported that a number of consumers who typically had no knowledge of stock markets and the risks involved suffered losses after being encouraged to invest in securities without receiving clear and complete information[286].
- The **UK** regulator fined one bank GBP 5.95 million in 2011 for failures relating to sales of structured capital at risk products. These are complex products that provide income but also expose investors to the risk of losing all or part of their capital. The regulator discovered failings relating to assessing clients' risk attitudes, ensuring the suitability of products for customers, and monitoring of advice given by staff, therefore exposing clients to an unacceptable risk of being sold an unsuitable product. The bank consented to a review of its past practices, supervised by an independent third party, and clients who were advised to buy an unsuitable product will be compensated. [287] During 2012-13 a priority of the UK regulator was to investigate mis-selling of investment products such as unregulated collective investment schemes (UCIS) and self-invested pension plans. The regulator found that one firm failed to take sufficient steps to ensure that its recommendations to customers were suitable, to establish adequate compliance arrangements in its

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281 Banco de España Complaints Service, Annual Report 2009.

282 The *Asociación de Consumidores y Usuarios de Banca, Cajas y Seguros* (Banking, Lending Societies and Insurance Consumer Association).

283 i.e. the *Médiateur de l'AMF* (Autorité des marchés financiers).

284 French Financial Markets Authority Ombudsman, Annual Reports (Rapport annuel du Médiateur) 2008 and 2009.

285 French Financial Markets Authority Ombudsman, Annual Report (Rapport annuel du Médiateur) 2009.

286 French Financial Markets Authority Ombudsman, Annual Report (Rapport annuel du Médiateur) 2010.

287 UK Financial Service Authority, Annual Report 2011/12.

business, and to comply with a restriction[288] that prohibits firms from making an invitation or inducement to participate in an UCIS[289]. The impact of these failures was serious, since the firm had advised 94 clients to invest over GBP 12 million in UCIS. As a result, the regulator fined a partner at the firm GBP 117,000 and banned him from the financial services industry[290]. The regulator also took action against another firm for pressure selling of small-cap stocks[291].

- In **Italy**, according to the ADUC consumer association, insufficient information was provided to consumers who invested in a 'mandatory convertible' bond issued by a particular bank. This was a complicated structured product that yielded shares in the issuing bank upon maturity, rather than the face value of the bond in cash. In particular, according to the ADUC, consumers were not adequately informed about the number of shares that investors would receive at maturity. As a result of a significant fall in the share price of the bank investors lost substantial amounts of their initial investments[292]. The securities authority (Consob) fined two executives of the bank EUR 175 000 Euros (in May 2011) stating that their conduct was "non-diligent and non transparent, and not in the interest of customers"[293]. The public prosecutor (Milan Procura) is still investigating and has produced an estimate of the damages, while expecting the bank to produce its own estimate of the losses caused to consumers. In addition, prosecutors are in the process of finding out exactly, for each case, whether the sale of the bond was requested by the customer or suggested by bank employees (current estimates show that around 80% of transactions were initiated by employees and not specifically requested by customers)[294]. Meanwhile the Bank has opened a conciliation board to settle with a large number of customers[295].
- The **Irish** regulator investigated financial advisors who sold bonds with an insurance 'wrap-around' backed by an unregulated financial institution (so-called 'ISTC bonds'). The regulator upheld many cases of mis-selling of this product, for example in one case because the broker had provided assurances that capital would not be lost[296]. Around EUR 40 million of these bonds were sold to retail investors and credit unions, but they became worthless when the financial institution that backed them collapsed[297].
- In **Lithuania**, clients of a particular bank invested in a complex investment scheme involving equity-linked bonds. These customers were sold this high risk investment under the impression that it was low risk. A Lithuanian court concluded that the bank "did not operate honestly and not to the best interest of its clients", and that

[288] The section 238 restriction of the Financial Services and Markets Act 2000.

[289] Final notice of the UK Financial Service Authority to Topps Rogers Financial Management, 13 February 2012: http://www.fsa.gov.uk/static/pubs/final/topps-rogers-financial-management.pdf.

[290] UK Financial Service Authority Annual Report 2012/13.

[291] Final notice of the UK Financial Service Authority to Gracechurch Investments Limited, 20 December 2012: http://www.fsa.gov.uk/static/pubs/final/gracechurch-investments.pdf.

[292] Statement of the ADUCconsumer association: http://investire.aduc.it/articolo/convertendo+bpm+facciamo+po+chiarezza_19830.php, supported by a statement from the securities authority: http://www.consob.it/main/documenti/hide/ingiuntivi/2009/d17077.htm.

[293] Resolution of the securities authority: http://www.consob.it/main/documenti/hide/afflittivi/pec/int/2011/d17776.htm.

[294] Media source: http://www.wallstreetitalia.com/article/1239586/bpm-procura-milano-chiede-nuovi-atti-su-convertendo.aspx.

[295] Statement from Banca Popolare di Milano: http://www.bpm.it/infoclienti/convertendo/convertendo.shtml.

[296] Irish Financial Regulator, Annul Report 2008; Irish Financial Services Ombudsman, Annul Report 2008.

[297] Irish Financial Services Ombudsman (2009), Annual Report 2008.

the bank raised unrealistic expectations among clients by failing to provide adequate information (the investment was presented as profitable in all regards). Over 600 customers incurred significant losses in relation to this scheme, totalling 100 million litas (nearly EUR 30 million)[298].

- According to the **Slovenian** Consumer Association, Slovenian consumers experienced detriment because they received insufficient and unclear information on investment products (e.g. securities), and often products were even structured so that customers would not understand them[299].
- The **Portuguese** regulator found that one bank (Banco Privado Português) mis-managed investment bonds, acted without the consumers' consent, provided false information to consumers, and is suspected of serious breaches of banking regulations. For example, some consumers were issued with inconsistent statements regarding the value and structure of their investments. The regulator also noted that in some cases there were discrepancies between the investment bond contracts signed by customers and those that were effectively enforced by the bank[300]. In addition, prior to its nationalisation the regulator found that some investment bonds sold by another bank (Banco Português de Negócios) were sold without adequate information and with disregard for good practice and, furthermore, were not managed in line with the conditions upon which they were sold. In particular, information provided to customers was not complete and related risks and customers' financial positions were not considered[301].
- In **Germany**, the BaFin received several complaints regarding the low level of liquidity of penny stocks that a particular financial services provider had brokered to them. After examining the case the regulator concluded that the provider had not sufficiently informed its customers about the poor liquidity of the stocks and the associated financial risks. Based on this incident and a number of previous violations by the same provider the regulator revoked the firm's authorisation[302].
- A consumer protection organisation in **Austria** received around 7,000 complaints from customers of a financial intermediary relating to their purchases of shares in a real estate company. Brokers from the intermediary provided verbal advice then asked customers to sign minutes of the conversation, including statements confirming that they had been provided with correct, detailed and competent advice[303]. After a number of proceedings in court, with different outcomes, a verdict from the Austrian Supreme Court of Justice in July 2013 ruled that the brokers had provided advice that was misleading with respect to the risk of the shares. Whereas the shares were sold as absolutely safe, the actual risk involved was considerably higher, leaving investors with an inappropriate investment[304].
- In **Cyprus**, some customers claimed that they were mis-sold securities by two banks since the terms and the risks of these products were not properly explained to

[298] The description of this case is drawn from several press stories: http://www.ve.lt/naujienos/ekonomika/ekonomikos-naujienos/teismas-patvirtino-dnb-banko-rekomendacijomis-investuotojams-padarytos-zalos-pagristuma-987570/; http://vz.lt/article/2013/3/25/dnb-norvegijoje-pralaimejo-byla-del-platintu-obligaciju. http://www.sazininga-bankininkyste.lt/lt-pranesimai-dvi_svarbios_nutartys.html.

[299] Information provided by the Slovenian Consumer Association via email.

[300] Portuguese Securities Market Commission, Securities Market Report 2009.

[301] Portuguese Securities Market Commission, Securities Market Report 2010.

[302] German Federal Financial Supervisory Authority, Annual Report 2008.

[303] Verein für Konsumenteninformation (2012), '*Bericht zur Lage der Konsumentinnen, 2009-2010*'.

[304] Court verdict: http://wirtschaftsblatt.at/images/downloads/8/0/4/urteil_awd20130717194909.pdf.

them. Some also suggest that they were manipulated into changing their deposits into these securities.

- According to the survey response of the **Hungarian** regulator's Consumer Policy Department, online foreign exchange derivatives, mostly provided by non-EU companies with low levels of disclosure, consumer protection, and information, proved harmful to consumers over 2000-present: "These are also classic mis-sellings on the Hungarian market, because only a very few of the customers [are] professional enough to trade in these products. The customers are accumulating large losses on these contracts."

Compulsory bundling of financial products and services

Another example of mis-selling identified by regulators is the practice by some firms of compulsory bundling financial products and services. That is, making access to one product/service conditional on purchasing another product/service.

Whereas bundling of products and services is common in many sectors (e.g. energy and telecommunications) and can have substantial advantages for consumers who benefit from product synergies and lower prices as a result, in some cases the practice is used to restrict the choice of consumers and to force consumers to use certain products/services from particular providers.

Examples identified where this sales practice has had or is having a negative impact on customers in the financial sector include compulsory bundling of mortgage credit with real estate valuation services and compulsory bundling of mortgage credit with current accounts. Problems associated with the tied products include poor service, non-transparent and non-comparable fees.

- According to the **Croatian** National Bank, banks did not allow consumers freedom to choose a real estate valuation service when taking a mortgage. In particular, banks abused their position in the mortgage market by only doing business with their subsidiary companies that undertook real estate valuations. There were inadequate measures of control over the work of real estate evaluators and un-objective and incorrect valuations were frequent. The banks argued that they used in-house real estate evaluators in order to better control their credit risk and other types of risk, and because of bad experiences with other real estate evaluators. The National Bank considered these fears (of the banks) to be justified, but proposed better transparency of conditions and criteria that banks' real estate evaluators must comply with[305]. Another case of compulsory bundling in Croatia was the introduction of current accounts that were tied to other services offered by banks, mostly mortgage loans. In particular, offers of more affordable mortgages were conditional on customers having active current accounts with banks. The fees attached to these tied current accounts were non-transparent and not easily comparable between banks. In addition, some banks had excessive and unnecessary administrative procedures if a customer wanted to close a current account that was tied to another product or service, effectively discouraging consumers from doing so[306].

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[305] Croatian National Bank (2009), *"Antikonkurentski oblici ponašanja banaka u segmentu stambenoga kreditiranja građana"* (Anticompetitive forms of bank behavior in the segment of real estate crediting of consumers).

[306] Croatian National Bank (2011), "*Istrazivanje mobilnosti na trzistu tekucih racuna korisnika bankovnih usluga – potrosaca"* (Research on consumer mobility in the banking market for current accounts).

NOTES

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