

Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance

Responsible finance is much in the news these days,¹ as the fallout from irresponsible financial practices and products in the United States and other developed markets continues to affect global finance. Regulatory failure clearly played a role in the meltdown of the financial system.² One silver lining of the global financial crisis is that more attention is being paid to financial consumer protection. Debates in the legislatures and central banks of countries with sophisticated financial markets are highlighting the link between protecting financial consumers and stable, efficient markets. Restoring consumer confidence in the financial system is a key priority.

Are consumer protection problems and solutions currently under consideration relevant for developing country policy makers, or are the markets, products, providers, and consumers too different? This Focus Note seeks to answer this question, drawing on consumer protection diagnostics of various types carried out by CGAP in more than a dozen countries, widespread consultations with regulators, review of research and experience in developing

and developed countries, and Financial Inclusion 2009 cross-country survey findings.³ It cites significant examples, as well as evidence of their effectiveness (where data are available).

The challenge for policy makers is translating these broad principles into laws, regulations, and enforcement measures that are effective in very different settings. Priorities and practical implementation will vary widely according to the country's stage of financial sector development, financial inclusion goals, regulatory capacity, consumers' experience using formal finance, and consumer culture.⁴ Regardless of timing and phasing, focus on the country's distinct risks and context is key. Wholesale adoption of laws and regulations from elsewhere is rarely appropriate due to differing cultural, legal, and economic contexts. The capacity of the regulator in question to implement and supervise is also critical. Many countries with large underserved markets still struggle with adequate prudential oversight of financial institutions. When regulatory capacity is limited, will a focus on consumer protection divert resources from other essential functions?

No. 60
February 2010

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- 1 This paper defines responsible finance as delivery of retail financial services in a transparent and equitable fashion. The focus is on products, processes, and policies that appropriately balance customers' interests with those of providers' and avoid harmful or unfair treatment. Responsible finance is promoted through measures that may include consumer protection regulation, industry or provider codes and standards, and improvements in consumer financial capability.
 - 2 In 2007, former U.S. Federal Reserve Board Governor Edward Gramlich noted: "In the prime market, where we need supervision less, we have lots of it. In the subprime market, where we badly need supervision, a majority of loans are made with very little supervision. It is like a city with a murder law, but no cops on the beat."
 - 3 Regulators from 129 developing and developed countries responded to this annual survey on their respective financial sector access, provider, and regulatory landscapes. The results of the survey are published in CGAP 2009c.
 - 4 The culture of activism in the United Kingdom, for example, makes some measures work there that are less likely to succeed even in other developed countries, let alone societies where citizens, including particularly the poor, are unlikely to assert their rights and complain.

Box 1. Basic Principles

Three basic principles should guide financial service providers' conduct, whether they serve inexperienced home buyers in the United States or microfinance clients in developing countries. Financial service providers should be required to (i) disclose key information clearly, at appropriate points before, during, and after a transaction is completed; (ii) treat consumers fairly and ethically; and (iii) offer recourse mechanisms for effective resolution of errors, complaints, and disputes.

This Focus Note describes current practices and assesses options for design and implementation of basic consumer protection rules, focusing on low-access environments. It includes the following:

- A package of basic consumer protection rules that address problems faced by poorer consumers with little experience using formal finance and that are appropriate in low-access environments—i.e., those with low levels of access to formal financial services, especially among low-income people, and limited regulatory capacity⁵
- A package of “next generation” measures that could be implemented later, as markets develop, competition increases, products become more numerous and diverse, and regulatory capacity and experience deepens
- Analysis of regulatory options to promote the three core consumer protection principles—transparency, fair treatment, and effective recourse—in low-access environments
- Observations on implementation, monitoring, and enforcement of the basic and next generation packages

- Discussion of how the two other pillars of responsible finance—industry standards and improvement of consumer financial capability—can complement and reinforce regulation

Annex A provides a sample tool to help regulators identify, prioritize, and address consumer protection concerns in their market. Annex B provides information and analysis on the pros and cons of different regulatory set-ups for financial consumer protection.

Financial Consumer Protection in Low-Access Environments

Why should policy makers intervene in financial markets to protect consumers?

Perhaps the most important reason for regulation is to offset the inherent information imbalance between financial service providers and consumers. When providers put out misleading advertisements or provide partial and confusing product disclosures, for example, customers are more likely to make inappropriate choices or even take up products that could harm them (such as unmanageable debt). Providers have an even greater opportunity to exploit their superior information and negotiating power when competition levels are low in local markets.

Financial consumer protection regulation also seeks to address specific biases and weaknesses on the demand side. Consumers have a responsibility to inform themselves, avoid being taken advantage of, and choose wisely. This can be difficult for lower income

⁵ The paper hereafter refers to low-access environments, while acknowledging that the evolution of financial inclusion and regulatory capacity do not always perfectly align.

clients who have less experience with formal finance and fewer options. They may have limited awareness, knowledge, and skills to assess products' appropriateness, costs, and risks. Other factors—such as being female, coming from a caste that faces discrimination, or not speaking the dominant language—may compound consumer protection challenges. Systematic biases in how people perceive their options and make financial decisions can further complicate matters.⁶

Not only may low-income consumers be more vulnerable to misconduct by providers and less able to protect themselves, the consequences of their financial missteps may be more severe, resulting in lost income, assets, and consumption. These factors combined suggest the need for policy makers and regulators to ensure that consumer protection measures adequately meet the needs of poor or inexperienced customers.

Consumer protection regulation can contribute to financial inclusion in several ways. It addresses information asymmetries and other factors that limit consumers' ability to identify the most suitable products and avoid harmful products and practices. Increased transparency and fair treatment can help new consumers gain confidence in formal financial services. It also can promote the efficiency and fairness of markets, by facilitating healthy competition, resulting in improved products and practices. There is growing agreement as well, at least in more developed markets, that effective financial

Box 2. Responsible Finance in Low-Access Environments

Responsible finance is the delivery of retail financial services in a transparent and equitable fashion. Strategies to advance responsible finance include consumer protection regulation; provider and industry standards, such as codes of conduct; and initiatives to improve consumer awareness and financial capability. This Focus Note concentrates on consumer protection regulatory measures that are appropriate for low-access environments, that is, places with low levels of access to formal financial services (especially among low-income people) and limited regulatory capacity.

consumer protection regulation can contribute to overall financial stability.

What can go wrong for consumers in low-access environments?

While problems vary widely, common market conduct issues include pricing transparency, appropriate sales and collections practices, and especially as competition increases, safeguards to prevent over-indebtedness. Some issues and problems arise only for certain products. Others, such as aggressive sales practices, data privacy, and recourse, apply regardless of product type. (See Box 3.)

What types of regulation protect financial consumers?

Several types of law and regulation serve to protect consumers and help them receive fair treatment in the market. The foundation is

⁶ Recent behavioral research shows that consumers consistently underestimate certain risks (e.g., optimistic assumptions about future earnings) and overestimate others (e.g., over-insurance against certain future events). They place more weight on current returns over future ones. Studies also reveal consumers' tendency to overestimate financial acumen and over-trust advice from authority figures (e.g., a loan officer or broker). The temptation to accept an offer that is too good to be true may be universal, judging from periodic pyramid investment schemes. While the research base to date is primarily developed countries, intriguing new findings are emerging on poor consumers in developing countries. See, for example, Collins et al. (2009), Banerjee and Duflo (2006), Tiwari et al. (2008), and Microfinance Opportunities (2008). Further such research would contribute greatly to consumer protection efforts of regulators and policy makers.

Box 3. What Can Go Wrong?

Typical cross-cutting consumer protection concerns

- **Product transparency.** Consumers don't understand the service's total cost; this can be exacerbated by deceptive advertisements, excessive small print, complicated terms, inadequately trained staff, etc.
- **Overcharging.** Consumers are charged extra fees and commissions that are not authorized or proper.
- **Sales practices.** Consumers face aggressive sales techniques as part of door-to-door solicitations or limited-time offers.
- **Inadequate documentation.** Consumers do not receive copies of contracts, receipts, etc.
- **Privacy, security, permission to share with third parties.** Consumers cannot be sure that personal data will be treated appropriately.
- **Recourse.** Consumers don't know that they have the right to complain or get errors resolved; they may know they have this right, but don't know how and where to complain; they know how and where to complain, but fail to receive appropriate redress.

Product-specific concerns

- **Deposit products.** Consumers' savings are eroded by hidden fees or deposits are lost to fraud.
- **Credit products.** Consumers don't understand the terms and conditions of their loan agreement, e.g., what happens in the case of delinquency or default; they pay a high price; they take on too much debt; they are exposed to loan officers that ask for a "gift" to complete the loan process, to recommend a larger loan, or to expedite loan approval; they are subject to intimidation, abuse, or humiliation by collections staff/agents.
- **Payments services.** Consumers transfer money to the wrong person or mobile phone and don't know how to correct the error; they lose their personal identification number or have it intercepted electronically by a fraudster.
- **Insurance.** Consumers don't understand, or they fail to receive, policy benefits (e.g., they don't receive the full benefit when a family member dies); they don't realize that the loan price includes credit life insurance, and so are paying more than expected and failing to benefit from the insurance.

nonprudential consumer protection regulation governing the market conduct⁷ of providers toward users of financial services. Ideally, this should set rules for practices and product features *across provider types*, covering all providers of similar products and services. Consumer protection regulation focuses mainly on products, whereas prudential regulation seeks to maintain the financial health and solvency of *institutions* and the broader financial system. Prudential regulation contributes to consumer protection as well, however, by trying to prevent losses by small, unsophisticated depositors and promote sound providers that can offer reliable access to financial services

over time.^{8,9} Some consumer protection rules serve both prudential and nonprudential objectives (e.g., reckless lending rules aimed at keeping both lenders and borrowers from getting into trouble). Enforcement of other laws and regulations (e.g., those governing fraud, financial crimes, and bank secrecy) through civil and criminal penalties may also have consumer protection dimensions, as when Ponzi schemes are detected and disrupted. Competition-oriented regulation can rein in practices such as unreasonable barriers to switching providers, which can have negative consequences for both consumers and competitors in the market. As a result, in many countries responsibility for

7 Market conduct (or conduct of business) refers here to the interaction between provider and consumer. While regulation also can govern other dimensions of conduct, such as providers' interaction with other providers or investors, this paper focuses on consumer-oriented market conduct.

8 This distinction refers to the nature of consumer protection regulation rather than the locus of enforcement. Most such consumer protection regulation is currently overseen and enforced by prudential regulators.

9 Other measures such as deposit insurance also serve to protect consumers.

financial consumer protection is shared among multiple financial and nonfinancial regulators and enforcement bodies.

Which consumers?

Typically, consumer protection regulation seeks to protect all retail consumers.¹⁰ Special attention may be given to segments that are more vulnerable to abuse or unfair treatment. In many developing countries, where financial inclusion is an ever more prominent policy goal, one priority area might be consumers who are less experienced (e.g., those who are just beginning to use formal finance), which often correlates with lower incomes and education levels. *This is the primary market segment considered in this Focus Note.* A central problem these consumers face is too few options for good quality, formal financial services to help them manage their complicated financial lives.¹¹

Another segment policy makers might prioritize comprises lower level salaried workers—the aspiring middle-class segment that is growing very rapidly in some countries. In contrast to the poor, this group is vulnerable precisely because it has too many options. In countries like Russia, Brazil, South Africa, and India, with skyrocketing consumer credit, salaried workers are bombarded with credit offers and subjected to high-pressure sales tactics that take advantage of their limited experience with formal finance. This market segment tends to be ill-prepared to sort through the options, make good choices, and avoid getting overextended. As policy

makers identify priority market segments, they need to consider how best to tailor consumer protection measures to the segments' specific circumstances so that they are effective.

What is the relationship between financial inclusion and protecting low-income consumers?

Although industry leaders, journalists, and academics debate the available evidence heatedly, most now accept that access to formal financial services of a variety of types can improve the well-being of poor people. In fact, *access to well-designed financial services can yield substantial protective benefits to poor households.* Being able to tap savings or credit from a reliable financial institution, for example, can help the poor manage crises, such as illness, without having to sell assets.¹²

Thus, in low-access environments, regulators should take special care that the cost of complying with new consumer protection rules does not make serving low-income customers unattractive for responsible providers, with the unintended consequence of “protecting the poor out of the market.” At the same time, the goal of financial inclusion need not imply that unbanked customers should receive lower standards of safety and quality.

Regulation engenders direct and opportunity costs for regulators, providers, and consumers. The direct costs of monitoring, compliance, and enforcement may be easier to quantify

¹⁰ Some countries define the scope of retail consumers to include very-small-scale businesses whereas others limit the definition to natural persons.

¹¹ For example, Collins et al (2009) collected financial diaries from hundreds of poor families in Bangladesh, India, and South Africa and found households used an average of 8 to 10 different financial instruments over the year, including savings mechanisms, loans, remittances, and insurance. This work highlights a key consideration for regulation: the poor manage to derive benefit from financial instruments that may appear to be of unacceptably low quality to outsiders, such as regulators. Reducing their options should be done with considerable care.

¹² See, for example, Collins et al. (2009).

than the benefits of responsible financial sector development. This can make it tempting to avoid introducing new regulation in low-access environments, where regulatory capacity or the transaction costs of serving low-income people are major issues. Many valid questions arise: Will new consumer protection rules be enforced adequately to deliver their intended benefits? Will compliance costs be passed on to consumers, hindering access for the poor? Will providers find the cost of complying with basic conduct rules—covering plain-language price disclosures, fair advertising and collections, or recourse—so onerous that they are discouraged from serving the unbanked? There is little evidence to suggest that basic consumer protections will pose a major barrier for responsible providers offering appropriate products and services.

Let's take the hot-button issue of the price of credit for the poor. Policy makers concerned about high-cost providers and deceptive advertising, for example, can (i) impose standard disclosure requirements on all credit providers in the market, (ii) make consumers aware of their right to this information, and (iii) find cost-effective enforcement steps. Responsible players are likely to find the one-time, up-front compliance costs (redesigning forms and signage, training staff on the new rules, etc.) and ongoing expenses feasible. For those players with a business model that relies on opaque pricing and fees for its profitability, however, the new regime could make service to this market untenable.

Is this a loss from a financial inclusion perspective? Typically it is not—if the goal is responsible finance, where market practices and products balance the interests of providers and their clients. Consumer protection rules in low-access environments should safeguard the interests of consumers, promoting quality services and fair competition. The exit of lower quality players that are deceptive and abusive or that seek to maximize profits in the short term at the expense of long-term value for customers and shareholders is in fact usually a major goal of such regulation.

Where to Begin? A Targeted, Incremental Approach

In a small but growing number of developing and emerging market countries, policy makers have developed innovative and effective consumer protection regulation. They have taken an incremental, proportional approach, phasing in new rules that responded to specific consumer risks, the country's financial inclusion priorities, and regulatory capacity. By incremental and proportional, we mean regulatory responses that are crafted in light of (i) the nature and extent of the most critical problems; (ii) the benefits or the consequences of not acting—for consumers, providers, and the market as a whole; (iii) the costs to providers of new rules, and how the rules might affect overall affordability and availability to the covered providers and products; and (iv) the supervisory capacity and political will to implement and enforce regulations.¹³ Policy makers in low-access environments should not

¹³ "Proportionate" or "proportional" is used differently in different contexts, e.g., for the U.K. FSA: "The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions. In making judgments in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements." <http://www.fsa.gov.uk/Pages/about/aims/principles/index.shtml>.

Box 4. Getting Started: Some Key Questions

- Which customer segments are particularly inexperienced or vulnerable to abuse?
- Which significant consumer protection problems are present in our *credit* markets?
- Are there problems emerging around *noncredit* products, such as remittance and payment services, deposit services, and insurance?
- What regulation, if any, is in place? Which types of consumer protection rules—disclosure requirements, fair treatment standards, restrictions on potentially harmful products and practices, mechanisms for recourse, etc.—are best suited to the problems observed?
- What nonregulatory alternatives—such as industry standards or consumer awareness and financial capability measures—might complement or substitute for new regulation?
- Do certain types of providers or products account for a disproportionate share of problems?
- Which entity or entities should oversee market conduct regulation? How can adequate capacity for this expanded role be ensured?

feel that they need to come up with an all or nothing approach or to do too much too fast. If regulatory capacity to monitor and enforce is limited, an overly ambitious new regime could create expectations that are hard to meet.

An example from Cambodia emphasizes how taking fairly simple first steps can lay the groundwork for fair, competitive, and efficient delivery of financial services; extend basic rights to consumers; and reduce instances of deceptive, unfair, or confusing financial products and practices. Cambodian microfinance providers serve far more customers than commercial banks. Little consumer protection regulation was in force, so the central bank began by identifying what it believed to be the greatest problem facing microloan customers—transparent pricing—and implemented simple rules on price calculation and disclosure. The formula required use of the declining balance rather than flat formula (common in many microfinance markets) for interest calculation. The regulation was

widely credited with bringing down the cost of credit at the time for consumers and increasing competition (CGAP 2009a and Clark 2006). This initial step laid a good foundation from which Cambodia can now build with further consumer protection rules as needed.¹⁴

The reality is that overstretched policy makers often wait until a pronounced market failure has occurred to devise a regulatory response. Yet failure to anticipate risks to a financial sector may bring its own inefficiencies and potential damage down the road, to the system as well as to individual consumers. In markets with rapidly expanding access to consumer credit, for example, preventive actions may be the least cost approach in the long run by preventing widespread delinquency and default. And setting clear rules at the beginning can allow responsible providers to achieve efficiencies by putting in place any one-time changes to their systems, forms, and staff training occasioned by the new regulation.

¹⁴ South Africa offers another example of incremental, proportional regulation of credit markets. In 1999, policy makers put in place an Exemption to the Usury Act aimed at reining in problematic practices by credit providers while promoting healthy growth of credit to underserved segments. In 2005 the more comprehensive National Credit Act was enacted, creating a National Credit Regulator and adding provisions to address additional risks and problems arising in the fast-growing market. 1

Box 5 lays out two broad packages of regulation, to provide general guidance for tailoring consumer protection rules to country context and allocating regulatory resources. It is important to emphasize, however, that stylized delineation of this type will not work for all contexts or products. Consumer protection issues and regulatory capacity in a country might be at a very different stage for credit products than insurance products, for example. In many cases, countries will likely apply this framework separately for different types of products and providers. And in all cases, they will be building on their existing legal and regulatory framework. The packages are meant to offer a starting point for assessing rules to protect low-income consumers that are likely to be appropriate at different stages of market development and regulatory capacity.

The first package includes those basic provisions most relevant in low-access settings. These rules are generally less complicated and less costly to implement, both for regulators and industry. They raise fewer risks of unintentional barriers to growth of responsible providers and services.

The second package has measures that could be phased in later, as markets develop, competition heats up, and provider and product diversity increases. As a rule, these measures are more expensive or more challenging to implement and enforce, requiring a greater degree of regulatory capacity. They also demand a deeper understanding of what is happening as the industry develops, to strike the right balance between access and protection in addressing emerging risks.

Three Core Consumer Protection Goals

A policy framework to protect financial consumers in low-access environments should focus first on three general goals:¹⁵

1. **Transparency**—Customers know what they are getting.
2. **Fair Treatment**—Customers are treated fairly and are not sold inappropriate/harmful financial services.
3. **Effective Recourse**—Customer complaints are resolved fairly.

Transparency

Transparency issues in low-access markets. Meaningful transparency rules provide the foundation for the basic package. They figure high among the priorities of financial sector policy makers in many low-access markets. The need for rules is especially important where market monitoring reveals poor customer understanding of product terms and conditions, aggressive competition, or large numbers of clients with loans from multiple lenders or unsustainable household debts.

For credit products, a diverse array of evidence suggests that transparent disclosure of loan terms can contribute to reducing borrowing costs, which is a policy goal in many countries. Disclosure requirements offer a more market-friendly alternative than interest rate ceilings. Microfinance interest rates declined significantly, for example, in a number of more competitive markets, such as Cambodia, Peru, and Ghana,

¹⁵ Country-specific factors will yield important additional consumer protection goals, of course. An example is nondiscrimination in South Africa, India, and other countries.

Box 5. Basic Consumer Protection Package for Low-Access Environments vs. Second-Generation Package

Basic package

- **Basic registration and coverage by regulation of all providers of a particular product or service, to the extent feasible:** Ideally, registration would be triggered by activity rather than institutional type. And consumer protection rules would be extended to as many providers as possible, with loopholes minimized. As a practical matter, exemptions might need to be put in place for tiny transactions and/or providers with a very small number of transactions. However, serious thought should be given before completely exempting the often informal providers low-income consumers might depend on; even these providers could be required to comply with basic conduct rules, while the oversight and enforcement strategy for individual firms might differ proportionate to the risks observed in very small providers versus larger providers that are already regulated and/or supervised.
- **Basic information:** Written, easily understood information provided to consumers before they purchase the financial service; written agreements provided to consumers that clearly show amount borrowed/deposited/paid, obligations of customers and providers, and penalties for nonperformance; written notification to consumers when prices or other conditions of financing change over the course of the agreement. Going one step further by mandating standardized disclosure (e.g., standard wording, formats,^a effective lending rate calculation) enables better comparison shopping.
- **Basic standards of conduct:** Prohibited practices, such as physical violence, fraud, deception, misuse of personal information, discrimination.

- **Basic consequences:** Depending on the severity of the infraction, penalties (fines, withdrawing deceptive advertisements, nonenforceability of noncompliant loans, jail time, or public “naming and shaming,” which has served as a deterrent in some settings).
- **Basic recourse:** Designated contact in each provider that will receive and respond to consumers’ queries and complaints.^b
- **Basic consumer awareness initiatives:** To make consumers aware of the rules and inform them of their rights and redress options.^c
- **Basic market monitoring by regulators:** Complaints data, media.

Expanded “next generation” package

- **Expanded prohibitions on unfair provisions and suitability/appropriateness standards:** Rules that mitigate emerging risks, such as over-indebtedness, aggressive sales, deceptive marketing, or abusive product features.
- **Attention to new technology, distribution, and delivery channels:** For example, agents and outsourcing, third-party advice.
- **Guidance, facilitation, or delivery of more extensive recourse, dispute resolution, and debt management measures:** For example, third-party mediators or ombudsmen, tribunals, counseling and debt management programs.
- **Expanded market monitoring:** Surveys, media monitoring, mystery shopping,^d focus groups.
- **More extensive financial capability initiatives:** Coordinated financial education and literacy initiatives that support consumer protection standards and risks (e.g., using credit wisely, using hot lines, guarding your personal identification number, etc.).^e

Notes:

^a Requiring provision of a simple and plain-language quote sheet, for example, can permit consumers to seek advice from someone else who has greater financial acumen or language skills, before entering into the contract.

^b This could simply be the provider or an independent third-party entity to which the consumer turns when provider recourse is unsuccessful or unsatisfactory. However, the third-party entity need not be the regulator. The regulator’s most essential role is to address overall market behavior rather than resolving individual complaints and problems.

^c While not a regulatory matter per se, this intervention may be necessary to make regulation effective and is often carried out by the regulatory agency.

^d “Mystery shopping” or “incognito shopping” is the practice of using trained shoppers to anonymously evaluate customer service, operations, employee integrity, merchandising, and product quality (www.mspa-ap.org/about).

^e While not a regulatory matter per se, this intervention may be necessary to make regulation effective and is often carried out by the regulatory agency.

and many countries in Eastern Europe and the former Soviet Union, where new price disclosure rules were put in place and enforced (Clark 2006 and Arrunategui 2008).

Transparency challenges also arise with respect to other types of financial services besides credit. For payment services, for example, multiple fees and commissions are common in many countries, especially for international transfers. They are particularly likely to be poorly understood by low-income and inexperienced consumers. Opaque fees and charges for bank accounts can also be a problem (South Africa Competition Commission 2008). Transparency can be a problem with insurance products as well. For example, credit life insurance may substantially increase the cost of a credit purchase—a fact that customers may not realize until after the paperwork has been signed (or sometimes not at all).¹⁶ Funeral insurance policies popular in some countries may be issued by unregulated or loosely regulated providers (such as funeral parlors) without the purchaser knowing the amount of benefit, or whether the value of the in-kind benefit (that is, the funeral) matches or equals that of the stated redemption value of the policy.

Transparency rules—prices, terms and conditions, and key risks. Rules to ensure transparency of basic information are a central element of the basic package for consumer protection in low-access environments. Of 129 countries responding to relevant questions in CGAP’s 2009 annual Access to Finance survey, 47 percent mandated disclosures, 30 percent mandated disclosures and had a usury ceiling, and 23 percent had neither. The most

common disclosure requirement was loan rates (76 percent of reporting countries), followed by account fees (74 percent), changes in loan terms (61 percent), plain-language contracts (47 percent), and reasons for denial of a loan (27 percent). The share of countries mandating loan rate disclosure ranged from 50 percent in South Asia to 91 percent in higher income countries (CGAP 2009c).

For the basic package, transparency rules should first and foremost ensure that consumers have the means to understand what they are getting. This means clear, comprehensible disclosure of relevant terms and conditions. Such disclosures should be required before, during, and after the point of sale, as appropriate to the product. Disclosure rules may specify types of information (such as interest rate or effective lending rate, fees, total of payments, default provisions, other terms and conditions) and how information is to be presented (format, timing, and location of disclosures; language, font, and other attributes; uniformity across providers or products).

Rules also should specify *how* providers are to disclose information to customers, including the following:

- Posted public notices of rates and terms (e.g., posted on premises, in newspapers, or online)
- One-on-one (written and/or verbal) disclosures before, at time of, and post-sale
- Advertisements and marketing materials

Evidence from both developed and developing countries shows diminishing returns when it comes to the number and length of

¹⁶ Research by the South Africa Microfinance Regulatory Council, for example, found that single-premium credit life insurance could increase the cost of a loan by as much as 50 percent.

disclosures (Barr et al. 2008). Regulators can use consumer testing to assess whether typical users understand the information and which formats work best. Less tends to be more, and keeping disclosure requirements simple may reduce the compliance burden in low-access environments for providers targeting hard-to-serve customers.

Standardization and comparability. Requiring standardized, comparable forms and wording increases fairness in contracts and helps consumers compare prices so that they can shop around. Disclosure rules should specify formulas and format by product (requiring all providers of the same or similar product to use the same format). As noted, this type of consumer protection rule also may spur competition and more efficient pricing and terms.

The minimum standard for the basic package is plain-language disclosure of all relevant charges and payments, to ensure consumers understand what they are getting; this standard also facilitates some basic comparison shopping. Requiring a common interest rate calculation (such as a monthly or annual effective interest rate [EIR] or annual percentage rate [APR]) enables further price comparison shopping (though other factors, such as convenience and reliability, may figure just as prominently as cost for low-income consumers).¹⁷ Implementing this type of provision demands some care, so as not to increase the complexity of the disclosure process beyond consumer needs or regulatory capacity to enforce.

Disclosure issues in branchless banking models. The advent of branchless banking—delivery

of financial services through nonbank agents and technology, sometimes at a great distance from any formal financial institution—could cut both ways in terms of transparency. On the one hand, the introduction of nonbank agents raises the possibility of customer confusion or agent trickery in charging unauthorized fees. On the other hand, both the greater accessibility of agents and the potential to program notices and alerts into the technology-assisted process itself could permit consumers to receive real-time disclosures and to understand them better. In general, when providers outsource activities to agents (e.g., whether retailers offering branchless banking services, insurance intermediaries, or collections agents), consumers need to know that they are dealing with an agent and to know who is responsible if something goes wrong. Brazil requires correspondents' signage and documentation to clearly disclose their agent status as well as the bank's ultimate responsibility for accuracy and quality of the service provided by its agents. Regulators can design disclosure requirements, such as mandating that consumers receive the all-in price of the transaction *before* it is consummated. Agents also should be required to inform customers about how to make a complaint and seek redress in the case of problems.¹⁸

Toward effective disclosure in low-access environments. The minimum standard for disclosure rules should be plain-language terminology, simple visual presentation, and straightforward terms and conditions without complex formulas or calculations. Different products will require different approaches to disclosure, and consumer testing will help in all cases to assess whether the requirement is

¹⁷ See, for example, Chapter 5 of Collins et al.

¹⁸ For a fuller treatment of consumer protection regulatory issues in branchless banking, see Lyman et al. (2008) and forthcoming Focus Note on this topic.

likely to be understood by consumers using that product. Taking credit as an example, most customers can understand a simple amortization table that shows all payments and when they are due, or a statement on fees for savings accounts, minimum balances, etc. Evidence from multiple field studies¹⁹ suggests that clients understand information such as loan prices better when it is presented in terms of values (e.g., “Your all-in loan payment will be \$x per month for y months” or “If you keep \$50 in your deposit account, it will earn \$5”) rather than when prices are presented as rates or percentages (e.g., “Your interest rate is 2 percent per month calculated on a flat basis”). Providers serving low-literacy clients could increase client understanding further by reading the preclosing quote or agreement aloud to the client.²⁰

How do policy makers determine what customers will understand and use? Consumer advocates and debt counseling organizations may be able to provide useful insights and help identify common trouble spots. Consumer testing, such as focus groups, also can help regulators identify more effective disclosure approaches for different types of consumers and products.²¹ A study in India found that microfinance borrowers were able to identify the size, duration, and weekly payment of their loans, but did not understand interest rates and total interest expense (Tiwari et al. 2008). Low-literacy clients in this sample based credit

decisions on the amount owed each week, so policies based on the assumption that clients are willing and able to calculate, understand, and compare interest rates may not work. In other settings, clients may want such standardized price data. Consumer testing on how best to calculate and present such data would increase its effectiveness. Research in Bolivia uncovered many practical insights about low-income microfinance clients’ perceptions of consumer protection issues and mechanisms. Broad concepts like transparency did not resonate with respondents, but they did expect product terms to be clear and to be clearly explained.²²

Disclosure requirements could be designed to facilitate comprehension and offer a more relevant comparison for consumers accustomed to informal sector services. For example, describing the prices and terms of new, unfamiliar formal products in comparison to the most common informal products they use could increase inexperienced consumers’ understanding.²³ After all, microloans are often targeting the same types of clients as moneylenders, and moneylenders are probably a more valid point of comparison than the formal bank services typically used only by better off people.²⁴ This disclosure approach also could bring out some relative advantages of formal products and providers. To date, this approach is untested.

19 Tiwari et al. (2008), South Africa fieldwork in Collins et al. (2009), FSD-Kenya (2009).

20 The “transparency” module of the Beyond Codes self-assessment tool [<http://www.centerforfinancialinclusion.org/Page.aspx?pid=1714>], for example, offers practical and creative ways to increase the likelihood that clients understand the prices, terms, and conditions of their financial services. Beyond Codes is a pilot project of ACCION International’s Center for Financial Inclusion to help diverse microfinance providers assess and improve their client protection policies and practices.

21 Indeed, this finding applies to more developed markets as well. The U.S. Federal Reserve, for example, had to carry out extensive focus group testing of specific disclosure language before revising Truth in Lending provisions. See MACRO International Inc. (2008).

22 See Microfinance Opportunities (2008) and Chapter 5 of Collins et al. (2009).

23 Noting that there may be a wide variety of informal products, each with distinct pricing, terms, and conditions.

24 This is a point made by Harvard University Behavioral Economist Sendhil Mullainathan. See, for example, Mullainathan and Krishnan (2008) and Collins et al (2009).

Provider status disclosures. Even in low-access environments, disclosure rules may go beyond product- and service-focused pricing, terms, and conditions. One area is the provider's legal and regulatory status (licensed or registered? as what type of entity?), including its supervision arrangements (supervised? by whom?), and whether deposits are eligible for insurance coverage (including any limitations on such coverage). Ideally, such rules would help consumers distinguish among providers of comparable services, especially as they consider deposit or insurance products where prudential oversight may offer greater assurance of quality and safety. The rules could help prevent consumers from assuming that their deposits are insured or that their provider is supervised when it is not.²⁵ While far from foolproof, disclosure also could help some avoid falling prey to unlicensed providers and even pyramid schemes. Such measures are unlikely to achieve their full potential without complementary consumer awareness-raising activities, however.

Fair Treatment

Consumer protection regulation also should help ensure that consumers receive fair treatment in financial transactions and avoid harmful products and practices. This includes *general rules*, such as those addressing ethical staff behavior, acceptable selling practices, and treatment of client data. The fair treatment principle also can provide a justification for regulating *specific products and practices* and creating frameworks where consumers are more

likely to be offered services that are appropriate for their circumstances.²⁶

Regulating fair treatment of financial consumers is easier said than done. Standards of fair treatment are hard to define—what is considered fair in one country or community may not be considered as such in another. Cultural barriers are significant, too. While low-income customers may hope to be treated fairly and respectfully, their expectations and confidence in formal finance may be low, and their alternatives nonexistent, leading them to accept abusive or coercive treatment.²⁷

Prioritizing and phasing in fair treatment rules is critical. Rules against deceptive advertising might fit well in the basic package, for example. Product regulation that proscribes or requires specific product features, however, is less likely to be appropriate in low-access environments. For one thing, the regulatory capacity needed for effective monitoring and enforcement is usually greater than that required for basic transparency or other fair treatment rules. Furthermore, implementing product regulation prematurely or with unrealistic standards can reduce consumers' options and restrict access. Research has shown that low-income consumers benefit from services that, while far from perfect, help them better manage complicated financial lives. Other approaches, such as improved recourse or cooling-off periods (where a consumer can rescind a contract within a specified time), might be better bets to improve fair treatment in low-access settings.²⁸

25 This is a key reason, for example, that use of the term "bank" is limited to prudentially supervised entities in many countries; if consumers are aware of this, they can then better assess the safety of different providers.

26 Such rules are more common in credit and investments, although some countries also attempt to monitor and control insurance abuses.

27 For example, research in Bolivia and India found that MFI customers consider public humiliation (such as posting a notice of late payment on the borrower's house or banging drums outside her house) an unpleasant but acceptable collection tactic. See Tiwari et al. (2008) and Microfinance Opportunities (2008).

28 Moldova, for example, requires insurance brokers to check the suitability of a product and give customers choices. There is also a 20-day cooling-off period in case a customer later feels she did not make a sound choice (Mundy 2008).

Key issues in fair treatment of lower income and less experienced customers include the following:

Deceptive advertising. Transparency through effective disclosure is the cornerstone of consumer protection regulation. Rules requiring providers' advertisements, marketing materials, and client communications to fairly and accurately portray prices, terms, conditions, and key risks go hand in hand with the basic disclosure requirements described earlier.²⁹

Staff ethics. The basic package calls for rules to ensure that providers' staff, management, and governing bodies maintain high ethical standards in their treatment of customers. Providers might be required, for example, to put in place a clear and specific code of ethics, internal processes to detect and respond to customer mistreatment, and serious consequences for infractions.

Delinquency management and collections. Microfinance providers often talk about a zero-tolerance approach to delinquencies. While prompt and vigorous response to delinquency is essential for providers that want to maintain stable repayment, an overly aggressive policy can lead to abusive collections. And it can have adverse consequences for households, such as taking new loans to make payments on existing debt (perhaps from loan sharks or other high-cost lenders), selling productive assets, or cutting back on food, health care, or schooling expenses. To promote appropriate collection practices, regulators in India, Ghana, the francophone West Africa region, and elsewhere have prohibited intimidation or coercion and

have established fair debt collection rules. Sometimes regulation also establishes explicit lender responsibility for the behavior of outsourced collection agents.

Appropriateness and overselling. Low-income customers can ill afford to buy unnecessary financial services. Well-designed and well-communicated disclosure is the first line of defense and is recommended in the basic package. Sometimes disclosure rules are not enough, however, and further regulation seeks to require providers to take reasonable care that consumers are sold an appropriate product for their circumstances. Stiff competition and providers' desire for quick gains in market share, for example, can trigger overselling (inadequate attention to client ability to repay, sometimes combined with aggressive marketing and sales tactics). This has led to rules prohibiting reckless lending in some countries. Regulators also may put in place rules to address incentives such as loan officer or broker compensation schemes that promote overselling.

Appropriateness is also a challenging concept to define and implement through regulation. In developed countries, "suitability" rules typically address products offered to the upper end of the market, such as investments, pensions, or certain mortgage and insurance products. Many such regulations establish a suitability requirement only when advice or a recommendation is offered (BIS Joint Forum 2008). Developed country regulation also is beginning to address reckless or predatory lending that specifically targets less sophisticated consumers or those with fewer options.

²⁹ Regulation sometimes even prescribes font size for print ads and contracts (to tackle the pervasive "fine print" problem) or prohibits misleading statements in ads ("0% interest").

For poor people, a critical dimension of appropriateness is the ability to meet loan repayment terms. Their income streams are typically variable as well as low, and they face many financial stresses and family emergencies. This affects the size and types of loans they can repay. The South African National Credit Act (NCA) defines “reckless lending” and requires that lenders conduct an affordability assessment. If a court finds that this was not done to the

standard specified in the law, the lender risks not being able to collect on a delinquent loan (see Box 6). Regulations in other countries (e.g., Malaysia and Nicaragua) have set maximum debt-to-income ratios as another approach, particularly for consumer lending (CGAP 2009c). This type of regulation is unlikely to be justified in low-access environments and is not included in the basic package.

Box 6. Dealing with Over-Indebtedness

The rapid rise in household debt levels in some developing and emerging market countries has raised concerns about potential over-indebtedness in both the low- and high-income customer market segments (CGAP 2009c). Policy makers in countries ranging from Bosnia to Peru to India are focusing on this. Given the potential harm to households and financial markets of unsustainable debt levels, policy responses may be needed to both prevent over-indebtedness and deal with it once it occurs. These work best when they take a comprehensive approach and are overseen by a central authority with the power to ensure widespread lender participation and compliance.

Defining over-indebtedness. Clearly defining what constitutes excessive debt is an important first step before creating policies to prevent or cure it. There is no universal definition of “over-indebted,” much less consensus about manageable debt levels for poor customers in developing countries. When laws define over-indebtedness, standards still may be more qualitative than quantitative. This introduces an element of uncertainty for lenders seeking to comply. It might be more practical to define “reckless lending” than “over-indebted,” with reference to local credit market conditions. NCA defines a borrower to be over-indebted when she cannot meet her obligations over a “reasonable period of time.”^a

Regulatory responses. Regulations might specify a broad requirement that the lender conduct an assessment of the borrower’s repayment capacity. In South Africa, for example, a lender must conduct an affordability assessment of the prospective borrower’s debts and income from all sources, which could include checking data available through the credit reference bureau system. If the court system finds

that the lender has failed to assess affordability and reach a positive determination about ability to repay, the claim is unenforceable. Expecting the lender to determine that income is adequate to handle the new loan (in addition to other current loans and obligations) should hardly be controversial. Regulation in other countries sets limits on the amount of allowable debt or a maximum ratio of debt to income (CGAP 2009c). A more detailed requirement such as this permits less flexibility in implementation than a broader standard such as in South Africa. It may reduce uncertainty for lenders, but it risks limiting credit access if the bar is set too low.

The actual delinquency and loss experience of different provider types should inform regulation. For example, microcredit providers typically have high repayment performance despite their nontraditional underwriting and risk management techniques. This track record should be taken into account as new rules are designed to prevent over-indebtedness in the broader market, i.e., regulators should be careful not to set standards based on other lenders, like banks, that unintentionally disfavor microfinance providers.

Role of credit information systems. Credit information systems (e.g., credit bureaus) can play a central role in preventing over-indebtedness by helping providers assess borrowers’ existing debt and repayment capacity.^b They can limit consumers from taking on too much debt while helping them build credit records. They can help policy makers track debt trends, in the overall market and for particular segments. The broader the coverage (i.e., the more categories of providers reporting data, positive as well as negative data), the more useful the credit information system.^c Where credit information sharing

(Box continues on next page)

Box 6 (continued)

does not yet exist or where nonbank providers, such as MFIs are excluded, providers sometimes share information on customer debts informally.

As credit markets become more competitive, policy should promote availability of high-quality credit information to enable responsible lending and a more efficient and transparent marketplace. To avoid unreasonable erosion of client privacy, clear rules are needed on the nature of information to be shared and the process to be followed. For example, clients should be informed if information is collected and shared with third parties, the consequences of default should be clearly disclosed, and clients should have the right to access their data and to have errors corrected. The South African NCA and fair credit reporting laws in countries including Ghana address these issues.

Monitoring and regulating credit practices. Monitoring credit markets helps policy makers better understand risks and regulate destabilizing practices. Over-indebtedness may be an unintended consequence of certain incentives in credit transactions, such as volume-based compensation for loan officers, automatic loan size increases as rewards for good repayment, or stiff prepayment penalties. Rules also may help consumers make more careful use of debt in the first place: for example, South Africa prohibited “negative option marketing” (i.e., where the offer of credit is deemed to be accepted unless the consumer explicitly refuses it) and automatic credit line increases.

Reducing over-indebtedness. Legal avenues for dealing with over-indebtedness—such as bankruptcy and insolvency processes—are only rarely accessible to or workable for low-income clients. Rising debt levels may justify investment in debt counseling and management programs. These give customers an opportunity to negotiate a revised payment schedule and debt rehabilitation over time. They can be cost-effective as a second-generation measure. South Africa and Malaysia have set up debt counseling programs, combining financial education and

manageable repayment schedules for over-indebted borrowers. Borrowers’ participation is logged in the national credit bureau system to prevent any further extension of credit.

Consumer awareness campaigns and financial capability initiatives also may play a role in preventing over-indebtedness. Media campaigns (e.g., television, radio, newspapers) and workplace training are popular ways to reach out to consumers. Where debt is becoming a problem, these programs may point at-risk borrowers to available debt counseling and money management programs.^d

An across-the-board approach. Sometimes the misconduct of lenders is so serious it warrants major policy reform. South Africa took on overly aggressive and predatory lenders through its sweeping NCA. The law responded to widespread abuse in the retail credit market led by nonbank consumer lenders. It imposed stringent requirements on all credit providers regardless of type, from small microlenders^e to large retail store chains to the largest commercial banks. A critical feature of NCA is its attempt to curb over-indebtedness and “reckless” lending, by defining these terms under the law. NCA also sets clear rules regarding disclosures, credit information reporting and data quality, marketing and advertising, and processes for over-indebted consumers.

While full-scale implementation of South Africa’s ambitious consumer protection regime is challenging, the law is widely credited with helping rein in unsustainable lending practices, bring down prices for many products, and create a more level playing field for consumer credit.^f Some providers and journalists have expressed concerns and presented anecdotes that the tighter underwriting standards resulting from the new rules may adversely affect access to credit for certain borrowers—in particular informal (unpaid) workers, vehicle and home financing, and small enterprises. An *ex post* regulatory impact assessment will track the effects of NCA over time.

Notes:

^a National Credit Act: Regulations. Published in Government Gazette of South Africa No. 28864, 31 May 2006. http://www.ncr.org.za/National_Credit_regulations.php

^b Experience in many countries suggests that creating effective credit bureaus can be a long and complicated process.

^c Of course, wider availability of credit information, improperly used by lenders, also can contribute to unsustainable increases in debt levels.

^d Effective initiatives of this type have recently been carried out in countries ranging from Malaysia to Uganda to Peru, for example.

^e In South Africa the term “microlender” describes credit providers that are more like registered moneylenders and consumer finance companies than the MFIs typical in other developing countries; another key distinction is that they serve consumers that are mainly salaried, rather than self-employed workers.

^f See, for example, Hawkins (2009) and RUDO Research and Training (2009).

Noncredit products also may raise appropriateness issues, even in low-access settings. For example, steering a poor consumer toward credit life insurance (or rolling it into a microloan without the client being aware of the coverage—an all too common practice) may not always serve her needs well. Another example is selling a deposit product that has such high transaction fees that typical use is likely to cause the account to lose value over time. Still another example is when a lender denominates loans in foreign currency while customers trade in local currency; this passes the currency risk unfairly to those less able to understand and handle it.³⁰

Pricing. For some, the “fairness” consideration hinges on pricing, a topic that has spurred great debate in the microfinance industry and more broadly.³¹ Some regulators, such as the francophone West Africa Central Bank and those in Brazil, Argentina, South Africa, and Malaysia, have limited interest rates and fees, either by specifying a target level or undertaking ad hoc periodic reviews comparing price levels to costs. As a general rule, interest rate controls may hinder access to formal financial services, especially for lower income and more remote segments, unless rates are set at sustainable, commercial levels that permit providers to cover the typically higher transaction costs of serving poor people (CGAP 2009c).

Switching barriers. Switching barriers can include account closure fees, large prepayment penalties, unnecessary product tying, or loss or delay of getting mandatory savings back. Having

choice among different providers and products is a luxury in most low-access markets, especially rural areas. When choices do exist, however, customers should be able to exercise them with limited hassle or cost. Competition regulation sometimes addresses switching barriers.³²

Data privacy, security, and accuracy. Maintaining data privacy and security can be undermined by clients’ lack of awareness of their rights and responsibilities, growing commercialization of information, and use of agents or technology (e.g., mobile phone, point-of-sale device) that creates a greater data footprint and can obscure the party ultimately responsible for privacy and security of client information (Dias and McKee forthcoming). This is an area for policy makers to monitor as financial markets develop. Some basic protections, such as confidentiality rules, are appropriate even in low-access markets. These can be accommodated while supporting creation of well-managed information-sharing processes through mechanisms like credit reference bureaus.

Recourse—Errors, Complaints, and Abuse

One way for policy makers to help build confidence and trust in low-access settings is to ensure that when things go wrong, financial consumers have avenues for correcting errors and resolving complaints. Ideally, this would include third-party options to lodge a complaint or seek redress, if the provider is unwilling or unable to respond effectively. There are various

³⁰ This is a prudential matter as well. To address both solvency and consumer protection concerns, regulators could require those they supervise to either ensure that customers have cash flows and currencies to match their repayment obligation, or face steep provisioning requirements (Mark Flaming, communication 19 October 2009).

³¹ See, for example, Rosenberg et al. (2009).

³² A South Africa Competition Commission enquiry into excessive bank fees found evidence of negative consumer impacts from a concentrated banking sector with modest market conduct rules that are primarily “self-enforced” by the banking industry (Competition Commission 2008).

Box 7. Who Provides Recourse?

Regulation can mandate or establish workable recourse mechanisms without regulators themselves taking on responsibility for resolving complaints of individual consumers. Sometimes the regulatory agency takes on this role directly. In other places, however, providers, industry associations, independent ombudsmen, or other entities provide recourse to individual consumers. Regulation may specify processes and quality standards.

ways to tackle this, although experience and evidence from developing markets are thin.³³

Recourse in the basic package. When a consumer believes there has been an error or mistreatment, the best starting point is a well-managed recourse process offered by the provider, such as internal complaints departments or consumer advocates. The process should be accessible to and understood by the customer. This is an essential, first-generation measure that regulators should require of regulated entities. Indonesian regulation, for example, covers complaints handling and requires regulated providers to have written procedures and a formal complaints unit. The board of directors is responsible for ensuring effective recourse. Rules stipulate the timeframe for resolution, method of complaints (oral or written), location of complaints resolution providers, and tracking process. They also require that banks regularly report to regulators their complaints and resolution data.

Complaints monitoring belongs in the basic package. Complaints data can be a valuable (and relatively inexpensive) policy tool to inform

regulators' decisions. It can help them discern patterns of abuse, monitor problematic products and practices that are emerging in the market, and spot "rogue" providers that are habitual offenders. Mandatory reporting of standardized complaints and resolution statistics can improve accountability. Sometimes regulators publish this information. Absence of complaints data is not necessarily a good sign. Consumers may lack the awareness or resources to file or be intimidated by the process, provider, or regulator. They may doubt that their concerns will be addressed. If recourse monitoring is designed to distinguish between customer inquiries and genuine complaints, and to screen out nuisance complaints, it will be more efficient.

Next-generation recourse. Recourse mechanisms beyond the provider may be provided directly by regulators, ombudsmen schemes, mediators, courts (small claims and other), tribunals, or civil society organizations. These options may be mandatory or voluntary, such as a facility established by a consumer advocacy entity, a bankers' trade group, or a microfinance association.³⁴ Where resources permit, some countries (e.g., India, Mexico, South Africa, and Peru) establish formal ombudsmen as a source of alternate dispute resolution (ADR) for financial consumers. CONDUSEF handles recourse and financial education in Mexico. In South Africa, there is a separate ombudsman for most provider types, including banks, different types of insurers, financial advisers and intermediaries, credit bureaus, and pensions. Some options are statutory, and others are sponsored by industry associations.

³³ Finmark Trust provides a good overview of both recourse theory and practice, along with various options described using the South African context. The report provides an excellent analysis of challenges confronting low-income and less experienced consumers in access to and effective use of the plethora of ombudsman schemes. See http://www.finmark.org.za/documents/R_consumerrecourse.pdf.

³⁴ While a fuller discussion is beyond the scope of this paper, it is worth noting that the voluntary versus statutory nature of the recourse mechanism can affect how well it works for consumers.

Policy makers in low-access settings should consider the following issues in determining the right recourse strategy for customer recourse beyond the provider:

1. **Financial capability.** Customer awareness and use of recourse mechanisms increases with financial literacy and experience in using financial products, as well as income level (Finmark Trust 2007).
2. **Trust in recourse providers or government.** Consumers must believe that their case will be handled fairly and expeditiously, which is a challenge with socially and economically isolated groups. Customers may fear losing access to services if they complain, or they may be concerned that government officials will use customer data for reasons other than dispute resolution.
3. **Strength or weakness of judicial process** geared to low-income consumers, including mediation, small claims, and insolvency regimes. In many developing countries, small claims courts and other judicial redress do not exist, are too costly (legal fees, cost of travel, time away from work), or do not respond in a timely manner. Enhanced regulatory and ADR mechanisms may be needed to fill the gap.
4. **Regulatory capacity and cost.** For efficiency, one or more entities should be charged with coordinating recourse providers' mandates and responsibilities, to reduce overlaps, gaps, and confusion. One dimension of cost is whether and how mandatory recourse might reduce access.
5. **Interest and capacity of providers to self-regulate.** While not a substitute for official oversight of recourse frameworks, efforts by

Box 8. Effectiveness of Recourse for Low-Income Consumers

What will work for low-income financial consumers? Not surprisingly, they need, at a minimum, simple, plain-language processes, recourse providers they trust, and accessible points of contact, such as free call centers, walk-up complaints desks, or group meetings. When a dispute must be substantiated in writing, assistance should be provided to those who are not able to fill out the forms themselves.

industry to self-discipline and provide redress to customers with complaints can reduce the need for intervention by regulatory bodies.

Implementing, Monitoring, and Enforcing Consumer Protection Regulation

As with any regulatory framework, the ability to implement, monitor, and enforce consumer protection regulations is critical so that rules and principles are not empty promises that undermine trust. Regulators need clear enforcement authority, the power to undertake onsite inspection if necessary, and the ability to act on wrongdoing. Such actions can range from forcing providers to refund excess charges or withdraw misleading advertisements, to more serious sanctions, including fines and penalties, public notice of violations, restraining orders, and even withdrawal of the offending provider's license to operate.

Rules should be put in place to cover as many providers as feasible. Proportionate implementation would mean aligning enforcement, and its intensity, with risks from different types of providers or products. For example, compliance oversight could be

integrated into regular onsite prudential examinations for larger supervised entities while relying on complaints data, mystery shopping, and targeted investigations to deal with smaller licensed providers. Limited regulatory capacity may necessitate phasing in consumer protection coverage of certain providers or practices over time.

Annex B describes different approaches to institutional arrangements for financial consumer protection and explores the pros and cons of responsibility resting with prudential regulators, general consumer protection agencies, or specialized financial consumer protection entities. The annex also analyzes additional challenges of regulatory implementation and coordination, particularly where more than one entity is charged with financial consumer protection oversight.

Not Just Regulation: Industry Standards and More Capable Consumers

When it comes to consumer protection oversight, regulators need not go it alone—regulation is not the only option available for protecting low-income consumers and creating responsible financial markets. Two complementary approaches—industry codes or standards³⁵ and other self-regulatory initiatives³⁶ and consumer awareness and financial capability programs—also can play an important role. Together,

Figure 1: Responsible Finance



these three “legs” of the responsible finance “stool”—regulation, industry standards, and enhanced consumer awareness and capability—can improve the quality of financial inclusion and promote responsible financial providers, products, and practices (see Figure 1).

Industry standards. Sometimes industry bodies commit to helping ensure a responsible financial services environment, by identifying specific challenges—price transparency, over-indebtedness, aggressive collections, absent or impractical recourse arrangements, data confidentiality and protection—and agreeing to specific practices and standards to address them. Self-regulation can be purely voluntary (e.g., initiated and overseen by one or more industry associations), mandated or delegated

³⁵ See, e.g., the SMART Campaign, organized around six core client protection principles (CPPs) for microfinance. Led by ACCION International, CGAP, and a broad coalition of practitioners and funders, the Campaign raises awareness and supports providers to improve client protection policies and practices. Industry leaders assert that the Campaign could result in higher quality access, protect the sector’s image, keep reputation-diminishing “bad apples” to a minimum, and reduce the prospect of heavy-handed regulation. To date, hundreds of providers have endorsed the CPPs. This new initiative merits careful monitoring to assess the potential and limitations of such industry work (<http://www.cgap.org/p/site/c/template.rc/1.26.4943>). Microfinance Transparency is another initiative that seeks to promote pricing transparency, by carrying out country-level price analyses of products offered by diverse microfinance providers (<http://www.mftransparency.org>).

³⁶ Defined as “arrangements imposed by providers of microfinance services upon themselves usually in the form of standards and norms they develop and enforce through a member-controlled council, coalition or federation of service providers” in DOF-NCC (2007). Note that the paper is referring to self-regulation for consumer protection, not prudential purposes.

(e.g., where the financial regulator has set the standards in certain areas and reviewed the adequacy of the sanctions for noncompliance), or motivated (by investors, donors, or regulators, where the threat of formal regulation or loss of financing is sufficient incentive to promote good behavior).³⁷

What is the relationship between consumer protection regulation and industry-led initiatives, especially in low-access settings? *If* coverage is broad enough, *if* policies and practices are well-targeted, and *if* credible sanctions exist for wrongdoing, industry standards might help create an interim framework for some basic protections prior to regulation. These are three big ifs. Typically, self-regulation works better for some issues (such as recourse) than others (such as price transparency). Noncompliant providers operating outside the association and its code pose a big problem, especially where such providers are large. Industry codes might be useful first steps for newer products and channels. Even with consumer protection regulation in place, providers may maintain their own standards to catch emerging problems early and reduce the likelihood of supervisor sanctions.

Consumer awareness and financial capability. Rules and principles alone cannot prevent market misconduct. The planning process for any new rules should pay attention to how to strengthen consumer awareness and financial capability. Practical initiatives to achieve this should precede or accompany new regulation. They may focus on general messages (e.g., “know your rights” or “here are your recourse options”) or provider- or product-specific

knowledge and behavior (e.g., “never share your personal identification number” or “make sure you understand the total cost of your loan—your provider must give you the following information...”). Sometimes counseling can play a role in helping consumers make good choices, although this is less likely to be feasible in low-access environments. Regulators interviewed for this study pointed out that promoting consumer awareness and activism—so all efforts are not top-down—can make reform more robust and help them do their jobs more effectively.

The most important role of government and regulators in this work is not necessarily direct delivery of financial capability programs to consumers (except perhaps broad awareness campaigns). Private players, such as providers, industry associations, or civil society organizations, can help implement the initiatives and even take the lead. Government can then play a complementary role, championing the need for more informed and better prepared consumers, identifying priorities, monitoring quality and effectiveness, and providing overall coordination.

Moving Forward—Regulation to Promote Responsible Financial Inclusion

Creating the base for responsible finance in low-access environments is likely to be a complex undertaking that can be achieved only over time. The potential pay-off makes the investment in getting started worth the effort. This paper has drawn on available experience to begin charting the path toward effective financial consumer protection.

³⁷ In countries where outside investors play an active role in microfinance, they can use this clout to advance client transparency and fair treatment to improve double bottom line or social performance. This leverage should not be underestimated, and may in fact be a greater incentive for improved market conduct than threat of regulatory action.

Achieving basic consumer protections can contribute to more inclusive and stable financial markets over time, particularly if basic protections extend to lower income and less experienced as well as better off consumers. Early evidence suggests that it is possible to craft and enforce basic consumer protection rules such that legitimate providers remain motivated to reach out to underserved low-income markets and are able to serve them profitably. The rules may, in fact, protect these providers against unfair competition from lower quality providers. The transparency and fair treatment measures recommended in this paper also can increase new consumers' overall confidence in the formal financial system. And staving off negative financial access of the sort that a basic consumer protection regime would prohibit is a legitimate policy goal in and of itself.

Three broad principles should govern design and implementation of consumer protection policy and regulation: transparency, fairness, and the right of effective recourse. The specific measures to put these principles into practice need to be tailored to low-access settings. This paper describes creative and cost-effective strategies used by regulators in several countries to manage the capacity and cost requirements of implementing consumer protection rules. Building further knowledge about approaches and what works, especially in contexts of lower regulatory capacity, is a priority for the future.

Regulation should seek to achieve the broadest feasible coverage, creating a level playing field for different provider types offering the same or similar products. Otherwise, there is a tendency for the dualism of markets to be reinforced, with better off people afforded

protection, while poor and less experienced consumers are left to fend for themselves. Thus, even where they may not be subject to prudential oversight, providers of credit and payment services should be subject to basic consumer protection rules.

Countries seeking to improve financial consumer protection can proceed incrementally, starting with proportional regulation to address the most pressing problems first. These countries can then build on a consumer protection framework as markets mature, products get more complex, competition increases, and specific abuses and problems arise.

Effective implementation of consumer protection regulation is not easy, even when regulatory capacity is less constrained. It tends to require less intensive supervision than prudential regulation, because it focuses on specific products and practices rather than the overall financial performance and risk profile of a financial services provider. On the other hand, basic consumer protection regulation may bring many additional providers under oversight, and it focuses on the numerous transactions between providers and consumers. And appropriate standards are still in early stages of development.

Different financial services raise very different consumer protection concerns and require different regulatory approaches. For example, the appropriate disclosure requirements for a short-term microloan will be quite distinct from those of a remittance service or a term deposit with a punitive penalty for early withdrawal. Within the general area of insurance, a crop insurance product raises different transparency issues than a health insurance product.

Developing a detailed framework for consumer protection issues and rules specific to different financial services in low-access environments is important for future attention.

Making key protection measures—disclosures, restrictions on unfair contract terms or deceptive advertising, recourse—work for low-income and low-literacy consumers is challenging but not impossible. Consumer testing is essential to be sure that the measures actually work for them. Further behavioral research and analysis of financial service perceptions and use among these consumers could yield valuable insights for policy makers concerned about financial inclusion and consumer protection in low-access settings.

Regulation is not the only solution to consumer protection problems observed in developing countries and emerging markets. Industry standards, such as codes of conduct and effective financial capability initiatives, also can contribute to increasing consumer protection and fair treatment. Indeed, they can increase the effectiveness of regulation. Regulators can play an important role in supporting and monitoring the effectiveness of these two other pillars of financial consumer protection. The goal of financial inclusion—diverse, good-quality financial services for all—will be well-served by effective initiatives on all three fronts.

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Annex A. Getting Started: Self-Diagnostic Questions, Policy Tools, and Monitoring and Information Sources

The following table can be used as a self-diagnostic tool to spur strategic thinking on individual country needs, priorities, and optimal resource allocation based on the specific

consumer protection risks for lower income or less experienced financial consumers. The table includes **questions**³⁸ for policy makers to assess and prioritize consumer protection needs; **monitoring and information sources** to identify market trends, emerging risks, and policy inputs; and **policy tools** that can be implemented incrementally as risks surface.

QUESTIONS	MONITORING AND INFORMATION SOURCES	POLICY TOOLS
Transparency and disclosure		
Do microfinance customers understand the terms and conditions of financial products? Are they able to compare among different institutions and providers types?	<ul style="list-style-type: none"> Market research (focus groups, surveys, mystery shopping) Press Marketing and advertising materials 	<ul style="list-style-type: none"> Simple, plain language disclosure rules Standardized terms and forms Product-based disclosure rules
How much and what types of information do consumers need to make good decisions? At what point do returns diminish? Can customer capacity to understand be increased?	<ul style="list-style-type: none"> Market research (focus groups, surveys, mystery shopping) 	<ul style="list-style-type: none"> Financial education
Do providers have regulatory or market incentives to be transparent?	<ul style="list-style-type: none"> Provider disclosures and reports Provider and industry codes of conduct 	<ul style="list-style-type: none"> Standards on reporting, codes of conduct (mandated by regulator, industry association, or investors)
Fair treatment		
Are microfinance customers taking on multiple debts? Are there signs of over-indebtedness? Are certain products (e.g., credit card, retail purchases) more troubling?	<ul style="list-style-type: none"> Credit bureau data (delinquency and default, segmented by product, provider, and demography when available) Market research (focus groups, surveys, mystery shopping) Press Marketing and advertising materials 	<ul style="list-style-type: none"> Credit bureau rules (mandatory participation, positive and negative information, etc.) Debt/income ratio, other underwriting standards Predatory lending rules
Are there false or misleading marketing campaigns and advertisements?	<ul style="list-style-type: none"> Press Marketing and advertising materials 	<ul style="list-style-type: none"> Truth in advertising rules and guidelines
Are there signs of aggressive selling of certain products to lower income or inexperienced customers?	<ul style="list-style-type: none"> Press Marketing and advertising materials 	<ul style="list-style-type: none"> Predatory selling rules Suitability requirements Cooling off periods
Are customers being harassed or abused in collections?	<ul style="list-style-type: none"> Complaints data Press 	<ul style="list-style-type: none"> Rules on collections—timing, language, physical contact
Are there prices or fees that result from abuse of a monopoly position by a provider?	<ul style="list-style-type: none"> Public inquiries by competition regulator 	<ul style="list-style-type: none"> Rules on pricing and ability to switch providers with minimal hassle
Are debt-stressed customers and their lenders able to resolve over-indebtedness problems fairly?	<ul style="list-style-type: none"> Complaints data Press 	<ul style="list-style-type: none"> Mandatory or voluntary debt counseling Clear rules on lender priority, collections Judicial reform

(Table continues on next page)

³⁸ These questions cover basic market conduct issues and concerns and will not address all potential risks in individual countries and markets.

QUESTIONS	MONITORING AND INFORMATION SOURCES	POLICY TOOLS
Recourse and complaints		
Are citizens likely to complain when treated unfairly or cheated?	<ul style="list-style-type: none"> Market research (focus groups, surveys, mystery shopping) Complaints data 	<ul style="list-style-type: none"> Financial education programs
Do customers have places to register complaints that are low cost/free, independent, and physically accessible? Do they use them?	<ul style="list-style-type: none"> Complaints data Market research (focus groups, surveys, mystery shopping) 	<ul style="list-style-type: none"> Ombudsman framework (statutory or voluntary) Complaints hotlines (regulator or industry association sponsored) Tribunals Mandated dispute resolution frameworks for providers
What are the main types of complaints made by lower income or inexperienced customers?	<ul style="list-style-type: none"> Complaints data Market research (focus groups, surveys, mystery shopping) 	<ul style="list-style-type: none"> Regular communication between providers and regulators Public disclosure of complaints data and trends
Do low-income customers trust industry and/or regulatory bodies to act on their complaints?	<ul style="list-style-type: none"> Market research (focus groups, surveys, mystery shopping) 	<ul style="list-style-type: none"> Publish industry and regulatory enforcement actions Naming and shaming of wrongdoers Transparent rules regarding dispute resolution processes Financial education on rights and responsibilities
Legal and regulatory frameworks		
What legal or regulatory changes are needed to improve consumer protection oversight? Are these changes feasible in the current political and economic environment?	<ul style="list-style-type: none"> Independent assessment by donor, technical assistance provider, government accountability office, or peer review 	
Are there enough staff with appropriate expertise to oversee consumer protection of providers of microfinance products? Do they have the capacity to enforce new rules?	<ul style="list-style-type: none"> Independent assessment by donor, technical assistance provider, government accountability office, or peer review 	
What coordination issues among regulators of different financial products? Are there gaps or overlaps that lead to regulatory arbitrage or inadequate oversight?	<ul style="list-style-type: none"> Regular meetings of coordinating body of policy makers from different ministries that oversee financial service providers Mandated reviews 	
Are there self-regulatory bodies that provide a functional alternative to formal regulation for low-risk products and providers?		<ul style="list-style-type: none"> Mandated self-regulation Published industry association codes of conduct with sanctions for noncompliance Naming/shaming of wrongdoers
Would there be a negative effect on access to financial services with proposed consumer protection tools?	<ul style="list-style-type: none"> Cost–benefit analysis and other regulatory impact assessment 	

Annex B. Who Should Regulate, Monitor, and Enforce Consumer Protection Standards?

Where should consumer protection regulation fit in the regulation and supervision framework? And how should the responsible authorities monitor developments in the market and the effectiveness of their efforts?

It may help to recall that prudential oversight seeks to maintain the financial health and solvency of financial service *institutions*, whereas consumer protection regulation is designed to protect the *users* of financial services, which may be provided by diverse institutional types offering similar products. Consumer protection regulation may cover products offered by providers that are not subject to prudential oversight, as with the South Africa National Credit Act, which covers banks as well as nonbanks (including even motor vehicle dealerships and furniture stores). Shifting focus from provider-based to product-based rules may benefit poorer and less experienced consumers who are more likely to rely on less-intensively regulated providers.

Ideally, consumer protection regulation should cover as many provider types as feasible, to provide wider protection for consumers and reduce regulatory arbitrage. But what does this mean in practice? Should the prudential regulator also administer consumer protection regulations? Or is it better to have one or more specialized consumer protection regulators with separate mandates and authority for specific products and practices across the entire financial market?

In many countries, the coverage issue is especially thorny since regulatory reach and capacity are limited overall. The semi-formal providers more often used by low-income consumers, such as financial cooperatives or nonbank MFIs, are not supervised by the bank regulator. The presence of a large number of informal, unlicensed providers may further complicate matters. Market structure does affect the ultimate effectiveness of consumer protection rules. Yet early experience suggests that regulators can use creative, low-cost market monitoring techniques, such as mystery shopping,³⁹ and analysis of complaints data to extend effective coverage more widely and bring more of the providers used by the poor into the system of market rules.

Institutional Options

Option 1: Prudential regulators. One possible arrangement is for the entity with prudential oversight responsibilities—e.g., Central Bank or Superintendent—to take the lead on consumer protection as well. This is the case in countries such as Peru, Malaysia, Armenia, and Ghana. While housed in the same body, the consumer protection function should be separated from the prudential one, with its own specialized staffing, resources, etc., so each can perform its distinct responsibilities. The advantage comes from having a prudential regulator already supervising diverse financial service providers so consumer protection rules have relatively broad coverage from the start. However, in countries where the prudential regulator regulates only commercial banks, consumer protection coverage may not reach institutions that target poorer consumers who use more unregulated,

³⁹ "Mystery shopping" or "incognito shopping" is the practice of using trained shoppers to anonymously evaluate customer service, operations, employee integrity, merchandising, and product quality (www.mspa-ap.org/about).

Box B1. Peru

Peru's *Superintendencia* sets and enforces consumer protection rules for a variety of types of financial service providers, including nondepository MFIs. The *Superintendencia* has developed a relatively comprehensive consumer protection framework within its agency, featuring a team of specialized examiners and examination procedures. Central to Peru's offsite supervision process is a Consumer Risk Model, a rating framework using a statistical scoring model that combines quantitative information about complaints, institution size, and regional influence and qualitative information about compliance with transparency and other regulations gathered during supervision activities. This helps the *Superintendencia* allocate resources to those institutions needing greater attention.

Source: Arrunategui (2008).

nonbank providers. In these cases, other financial regulators responsible for prudential oversight (e.g., those responsible for financial cooperatives) might also enforce consumer protection regulation.⁴⁰

Option 2: Specialized consumer protection regulator. To ensure cross-market protection and a level playing field, some countries have established one or more specialized regulators for financial consumer protection, either with broad scope (e.g., Canada, Mexico) or focused on a particular product or activity, (e.g., South Africa National Credit Regulator). Bangladesh offers a variant of this model, where the new Microfinance Regulatory Authority sets rules for MFIs (now that they must obtain licenses). One potential advantage of a specialized consumer protection regulator is that it can create a more level playing field among diverse providers of similar products and services. Another is that it might be less subject to conflict of interest or

regulatory capture than a prudential regulator (and many would argue that this was a key contributor to regulatory failure in the U.S. credit crisis).

Option 3: General consumer protection body.

A third alternative is for a body with a broad consumer protection mandate to attend to financial products and services as well (whether with explicit legislative and regulatory guidance or by default). This is the case in Brazil, where many basic protections are guaranteed in the constitution and the Consumer Protection Code. The Department for Consumer Protection and Defense (housed at the Ministry of Justice) has oversight responsibility, although the Central Bank of Brazil examines some financial services issues not specifically mentioned in the Code. In other countries, including Nigeria, Argentina, Kenya, and Jordan, financial consumer protection has no differentiation from other consumer products, such as toothpaste and electronics.

Evidence from CGAP field work suggests that the first two options are better positioned to handle financial consumer protection, in terms of the (i) specialization and clout of the regulator, (ii) opportunities to identify problem spots in the market, and (iii) ability and political will to enforce sanctions. Countries that rely on a separate, broadly mandated consumer protection body to supervise financial products have found enforcement problematic, or at times nonexistent. Typically, the consumer protection agency is faced with an exceptionally large remit, relative to its financial and human resources, and tends to prioritize higher profile public health, safety, and fraud concerns. Often, this third model results in the consumer protection

40 Draft law in Malawi, for example (William Knight, independent consultant).

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agency shying away from financial services in favor of products and services with more life and death consequences (e.g., baby formula).

Coordination and cooperation. Clarifying jurisdiction for consumer protection matters is also challenging, as is effective coordination. In quite a few countries there are multiple laws with provisions related to consumer protection, complicating jurisdiction and enforcement. Even when one agency takes the lead, other financial regulators and government bodies responsible for trade and commerce, telecommunications, and competition might have relevant consumer protection responsibilities. In South Africa, a policy oversight body was created through a specific statute to facilitate regular communication and coordination among financial sector regulators, industry experts, and stakeholders, including consumer groups.

Even where consumer protection is housed in one agency, intra-agency coordination is necessary to ensure that consumer protection concerns are not overshadowed by other priorities. For example, the Bank Negara Malaysia (BNM), Malaysia's central bank, has responsibility for both prudential and consumer protection oversight of all financial institutions. The two

Box B2. Tanzania

Tanzania offers an example of consumer protection implementation that is sensitive to limitations on staff and resources. The Central Bank's original draft microfinance law contained a provision that would have permitted the regulator to void any microloan in which "abusive" collection practices were present. Recognizing the capacity requirements to respond to complaints about abusive collections from individuals, the policy makers chose instead to authorize the Central Bank of Tanzania to monitor the debt collection practices of institutions engaged in microcredit; the regulator may order the discontinuation of any practice that it deems "abusive." (See Tanzania's Microfinance Companies and Microcredit Activities 2004, Section 27.) This change let the regulator focus its energies on problem areas rather than guaranteeing recourse for individual consumers.

Source: Deborah Burand, independent consultant.

mandates are overseen by different departments but in close coordination. Each financial service provider has a relationship manager that manages both prudential and consumer protection oversight, and BNM follows a risk-based supervision model, using surveillance activities to prioritize examinations and follow up. Consumer protection oversight was originally supported by seconded prudential staff when it was created in 2006; this has facilitated good coordination and communication.⁴¹

41 BNM also maintains a Shariah Advisory Council to interpret and educate regulators and providers on relevant Shariah requirements with respect to Islamic banking product terms, conditions, and pricing.

The authors of this Focus Note are Laura Brix, independent consultant, and Katharine McKee, CGAP senior adviser. The authors thank the following reviewers for their contributions to this Focus Note: Deborah Burand, Heather Clark, Gabriel Davel, Mark Flaming,

Nicola Jentzsch, William Knight, Kate Lauer, Patrick McAllister, Shaun Mundy, David Porteous, Denise Dias, Alexia Latortue, Timothy Lyman, Djibril Mbengue, Richard Rosenberg, Ousa Sananikone, and Jeanette Thomas.

The suggested citation for this Focus Note is as follows:

Brix, Laura, and Katharine McKee. 2010. "Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance." Focus Note 60. Washington, D.C.: CGAP.

