Financial Services User Group's (FSUG)

2012 Risk Outlook –

Impact of the 'new economic paradigm' on EU financial services users

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Introduction and summary

We must hope that one day EU financial markets and economies will emerge from the current financial crisis and return to a more 'normal' state of financial stability. But, in the aftermath of crisis, we are starting to see the emergence of major long-term economic, financial and political events reshaping the European economic and financial environment. This presents serious challenges for the EU financial services industry, policymakers and regulators, consumers and the real economy. It makes the challenge of creating a single market that works for EU citizens even more difficult.

It is the view of the FSUG that policymakers, regulators, civil society representatives and other opinion formers have not yet begun to address these challenges in any meaningful way due to the understandable focus on managing the economic and financial crisis, and rebuilding financial systems and institutions in the EU. But making markets work for EU citizens must now be given the same priority.

As the Commission's own *Consumer Markets Scoreboard*[1] shows, FSUG representatives are right to be very concerned about the failure of financial services to work effectively for financial users. The *Consumer Markets Scoreboard* is a very powerful tool as it evaluates markets from the user perspective – not from the industry perspective. Despite the claims of industry lobbies, the research shows quite clearly that financial services continues to be amongst the very worst-performing markets in the EU.

What concerns FSUG is that the performance of the financial services industry has been very poor even during comparatively 'good times'. Unless policymakers and regulators adopt the right policies, we fear that the level of detriment in the market will be even greater in the post-financial crisis era.

Previous attempts to make EU financial markets work by focusing on demand-side interventions (such as information provision and/or financial capability) have had limited impact on their own. Furthermore, self-regulation has its place and designed properly can work in certain cases but it does not have a very good track record in financial services. For example, in February 2012, Health and Consumers DG published the results of a mystery shopping carried out to assess the implementation of a code of conduct adopted by the banking sector at EU level. It shows that more than two thirds of mystery shoppers were not able to switch their bank account successfully.[2]

Therefore, we hope there is a consensus amongst policymakers and regulators on the need for a different, more robust approach to regulating financial services and making markets work. Tough supply-side interventions are needed to change the behaviours and improve the efficiency of the EU financial markets and promote a real single market that works in the interests of financial users and citizens.

If policymakers and regulators are to protect financial users in this new, more challenging era, first they should become more proactive and responsive to threats to consumer welfare rather than reactive. Early interventions to pre-empt and limit the

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[1] http://ec.europa.eu/consumers/consumer_research/editions/docs/6th_edition_scoreboard_en.pdf

[2] http://ec.europa.eu/consumers/rights/docs/switching_bank_accounts_report_en.pdf

scale of detriment are more effective at protecting consumers (and more cost-effective) than allowing detriment to occur and clearing up after the event.[3]

Therefore, we are taking the initiative and producing this paper which:

- Identifies a 'new economic paradigm' – a series of economic, commercial, and financial trends with a focus on debt – which will impact on the EU financial services industry and financial users.[4] Policymakers and regulators and EU and national level need to understand how these trends will impact on financial users. They also need to understand how financial institutions react to economic and financial cycles. Depending on the phase of the cycle, financial institutions will push savings or credit products which means there is a risk of consumer detriment being displaced from one sector to another. Anticipating these cycles and likely response of financial institutions is comparatively straightforward – this is an approach called 'follow the money' which is based on the knowledge that regulators should look for detriment in sectors which experience a sharp increase in growth and activity, and aggressive distribution tactics.[5]
- Highlights a number of industry-wide risks identified by FSUG experts which will require coordinated actions by EU and national policymakers, regulators and supervisors.
- Highlights examples of consumer detriment and market failure in specific sectors of the financial services industry, including examples provided by FSUG experts from their own Member States.

We hope this risk outlook will help policymakers and regulators identify priorities for action. We also hope to make this a regular publication which we will use to challenge the relevant Commission departments and European Supervisory Authorities (ESAs) to take action to protect the interests of financial users. We would welcome further engagement with the Commission and ESAs to agree priorities for intervention.

We also hope that financial user representatives and civil society groups at EU level and in Member States will find this risk outlook useful for their own activities. Quite often a detrimental practice in one Member State will be copied in other Member States so we hope this risk outlook will be helpful as an 'early warning system' for representatives.

This paper should be read in conjunction with our report, *Principles and practices of financial services regulation*, which provides a template for policymakers and regulators to evaluate how these risks may affect financial users, and how to identify measures to protect financial users.

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3 FSUG has proposed a new approach to regulation which allows regulators to identify detriment and risks and intervene effectively to target root causes of detriment, not the symptoms. Effective interventions include market alerts and product interventions (such as banning toxic financial products), addressing potential conflicts of interest. Interventions should target the root cause of detriment and market failure, not the symptoms.

4 Throughout the report, when we refer to financial users, we include a broad definition which includes consumers, borrowers, investors, pension scheme members and trustees, policyholders, and SMEs.

5 For example, in Romania, consumers have been faced over time with different products, misleading in their structure or advertising/selling strategy. During the credit boom period, misleading techniques were mostly encountered in consumer lending and mortgages. As the marked faced a downturn, the emphasis went from mortgages to savings products. Therefore, so did the misleading techniques.

1. The new economic paradigm

To introduce the risk outlook, we focus on a particular issue. In this case, FSUG expert Nikos Daskalakis writes about the need to confront the EU debt problem which will define much of EU economic and financial services policy over the next decade. We then describe the new economic paradigm which we believe will create major risks for financial users and challenges for policymakers and regulators.

Confronting debt in the EU

There is a general consensus that Western economies are facing a change in the economic paradigm that was prevalent during the last three decades. The global financial crisis of 2008 triggered this discussion which is still ongoing with the current sovereign debt crisis. Both crises have a common ground: the financial sector. It is now obvious that there has been 'something wrong' with the financial sector and the way it developed during the last three decades. Several branches of social science may comment on this: from the concepts of full rationality and symmetric information that lead to the efficiency of self-regulation in economics, to the institutional cover of self-regulation in law, to the sound assessment of risk in finance, to the just allocation of wealth (and losses) to the society in sociology, to the lack of behavioural aspects as these are developed under psychology and to the political decisions and behaviour in the political science; the prevalent economic paradigm seems to self-question its abilities facing a severe systemic crisis.

Restricting our analysis to Europe, there is a growing number of economists who predict recession again for Europe. The main cause for this recession seems to lie again in the debt issue. Focusing on the financial sector as the main core of today's economic turbulences, the data show a gradual raise of government consolidated gross debt as percentage of GDP at market prices during the last twenty years[6] and a simultaneous raise in the gross debt-to-income ratio of households during the last ten years, when data are available[7]. The general conclusion is that, on average terms, the European economy has been leveraged at levels that may have reached its limit and this process threatens the European financial system as a whole.

It seems like the time has come to confront this issue of high debt levels. However, this issue needs to be carefully examined. High levels of sovereign debt call (in the context of the main strategy chosen by euro area countries) for fiscal adjustment which leads to tax increases and public expenditure cuts. This leads to lower disposable income for households, lowering consumption, and thus affecting growth; it leads either to low growth or even to recession. Adding private debt worsens this process, as disposable income becomes even lower, because debt and interest are to be repaid. Lower domestic income does not necessarily lead to low growth, if the production is sold to foreign economies; however, in the current situation, most global economies seem to have chosen the path of surplus trade balances enhancing their exports, and if this persists as a general strategy for economies worldwide, there will be a continuous pressure to lower prices (to enhance exports), which leads to even lower income for households. Thus, a low growth outcome is still highly probable. The main effort to confront low growth is to lower interest rates to enhance

[6] Data can be obtained in: http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm

7 Data can be obtained in: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database?_piref458_1209540_458_211810_211810.node_code=tec00104

investment; however, with the financial system in trouble, cash flows seem to remain within the financial system and are not directed to the real economy, either to meet the higher capital requirements, or because investing in the real economy is now riskier with the fear of recession.

We should also not underestimate the difficulty of gaining citizens' acceptance of proposals to deal with the debt legacy. Ireland, Portugal, Greece and probably other countries are being forced to sell state assets as part of the bailout/financial support provided by EC/ECB/IMF troika. There is little political enthusiasm for this disposal, particularly at a time when they may not realise their proper value. Apart from the prospect of national governments losing control of the use and value of such assets, there is also the distinct possibility of job losses, increased prices for consumers, reduced competition and gains for speculators. All of this again arises from the disastrous consequences of the banking debacle and the pressures for them to deleverage and recapitalise at the citizens' expense. How the proceeds of this privatisation will be applied, is important. Great care should be taken so that financial services users are not further disadvantaged again.

To sum up, high debt seems to be the main source of possible future detriment, affecting main macroeconomic variables, such as growth and employment. This legacy of debt will have a detrimental impact on the economies and household finances of the EU for many years to come.

The new economic paradigm

As well as macro-economic events driven by the legacy of debt, the focus on systemic failures has diverted attention away from long-term structural problems in the EU financial services industry. These structural problems will be exposed as the EU enters a new economic and financial paradigm defined by a range of macro and micro economic events, social changes, and political/regulatory responses.

We have identified a range of events operating at macro and micro economic, political and commercial level which will impact on i) household finances and economic behaviours and ii) the business models in the financial services industry. These include:

- A legacy of high debt (household, bank and public debt) as described above.
- A period of financial repression and retrenchment.
- Severe fiscal adjustments and austerity measures.
- The transition from a previous liberal lending regime to a more restrictive lending regime governed by tougher regulatory requirements and self-imposed restraint by lenders and the market.
- A long period of low economic growth – certainly compared to the pre-crisis period.
- Sustained pressures on household finances and low real household income growth.
- A sustained period of low interest rates and returns on financial assets available to financial institutions.
- Financial institutions face margin and revenue pressures, particularly with regards to core products and business lines.
- Reduced real investment returns, with a paradigm shift in risk/reward ratios impacting on consumer and producer behaviour and attitudes. Sustained low interest rates encourage risky investment behaviour in a 'search for yield' – this leaves investors vulnerable to mis-selling and misleading promotions.

- An uncertain political and regulatory climate, with more intrusive regulation in the pipeline – as financial user representatives we welcome a more sceptical and robust approach to regulation but this will affect business models with consequences for financial users.
- Shareholder attitudes and activism – shareholders in financial institutions are becoming more active and exercising stewardship responsibilities and greater due diligence.
- Changing consumer attitudes, behaviours and levels of confidence.

These individual factors will combine to exacerbate existing detriments and market failure, and create new emerging risks to the welfare of financial users and citizens. These existing and potential detriments and risks are set out below.

2. Industry-wide risks

As experienced financial user advocates, we have considered the impact of the new economic paradigm on the financial services industry and financial users. We have also considered how policymakers and regulators might respond in the face of these pressures. From this assessment, we have identified a range of emerging and potential risks and consumer detriments.

These are detriments that are not restricted to one sector but appear to be evident in the financial services industry across the board. Dealing with these risks at an EU level requires coordination by the Commission and ESAs if consumer detriment and market failure is to be tackled. These risks will also be evident at industry level within Member States.

Transition risks and legacy business models: The new economic paradigm in our view will expose major structural weaknesses in the business models of many EU financial institutions including incumbent banks, life insurance companies and investment/asset managers. At a sectoral level, there are major problems with oversupply of providers and products.[8] These financial institutions were structured to operate in a very different economic paradigm with high returns on equity, high economic growth, easy credit and increasing household incomes. The dislocation effects on financial institutions (and therefore on financial users, shareholders and employees) could be significant and need to be understood and managed by policymakers and regulators. In inefficient markets with high degrees of oversupply, there is a risk that financial institutions will seek to maintain revenues and profit margins through exploitative practices and behaviours. Regulators will need to pay close attention to markets for evidence of detrimental behaviours and practices such as price gouging.

Market inefficiencies: The combination of lower disposable incomes, lower growth and overhang of debt will undermine consumers' ability to afford financial products. Value will be critical. In theory, competition for limited consumer spending should result in firm offering better value to consumers. However, if history is any guidance, it is more likely that firms will respond by introducing complex pricing structures, socially useless 'innovations' and hidden features to protect and grow revenues. This is all the more likely given the legacy business models described above. Ensuring markets are efficient and financial institutions are truly competitive[9] and do not destroy value at a time when household finances are squeezed must be a priority for policymakers and regulators.

Board/senior management responsibilities and priorities: Repairing balance sheets, cost-cutting and efficiency drives, and revenue/profit margin maintenance will be priorities for boards and senior management. There is a serious risk that senior management will ignore behaviours further down the organisational hierarchy – for example, at the point of sale, or in bank branches – resulting in consumer detriment. Senior management will need to be reminded of their responsibilities and better monitoring mechanisms will need to be out in place.

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8 Policymakers should recognise that oversupply (too many providers and products) can be as detrimental to the interests of financial users as too few providers or overconcentration in a market (the classical competition model).

9 This is not the same as the illusion of competition created by the existence of numerous products and providers.

Culture of regulatory circumvention: Legal engineering used by bankers and banking lawyers to systematically circumvent regulations such as tax, capital adequacy, disclosure rules in takeovers and trade embargoes, by get round regulatory control and the rule of law and challenging in a regulatory cat and mouse game.

Basic quality and levels of service: Linked to the above points, basic quality and levels of customer service may deteriorate. For example, basic customer service may suffer – claims handling in the insurance sector, staffing in bank branches, dealing with consumer complaints may be de-prioritised. Regulators will need to monitor customer service standards.

System controls: Pressure on business models and cost cutting means risk of senior management ignoring basic system controls leading to poor service or denial of service, risks to internet banking, risks to client assets.

Unfair contracts: Consumers more likely to fall victim to unfair terms due to pressures on financial services revenues. Financial institutions may be tempted to introduce new unfavourable terms or make greater use of existing unfair terms in contracts.

Conflicts of interest/mis-selling: Margin and revenue pressures will force financial institutions to attempt to reduce high fixed costs and move towards variable costs. For example, we may see an even greater emphasis on reducing fixed salaries and increasing proportion of total remuneration derived from commissions and bonuses that are linked to volume of sales. This will increase the risk of conflicts of interest and risk of mis-selling and inappropriate recommendations by financial intermediaries and sales staff. Impacts on the welfare of employees as well.

Aggressive marketing, selling and promotion of products: Linked to the above, fierce competition to acquire new business and senior management dereliction of duties may encourage aggressive marketing and selling of products and services of questionable social utility (see 'Follow the money' above). Providers and distributors may be tempted to fail to disclose important information to consumers. Regulators should pay special attention to tactics such as 'scamming' which have been targeted at older people.

Adviser/intermediary behaviours and competence: Financial advisers and intermediaries (and directly employed sales staff) may not be sufficiently well trained to understand the consequences of the new economic paradigm on consumer expectations, attitudes to risk, the need for value and so on. As a result, they may end up providing sub-optimal advice to consumers.

Information intermediaries: Intermediaries – especially independent not-for-profit organisations – play an important role in helping financial users make informed choices and effective decisions. However, several FSUG members have expressed concerns about the independence, objectivity and quality of information on commercial websites.

Access to financial advice: Many lower-medium income households will have very complex legacy problems (for example, debt problems), or small investment or pension savings. They will have a greater need for quality advice. However, commercial pressures and squeezed household incomes mean that financial institutions are likely to increasingly concentrate on providing financial advice to higher income households.

Product design/pricing structures: Likely to see greater use of pricing structures biased towards protecting interest of financial institutions which may work against the interest of financial users. Examples might include greater use of front-end loaded charges which ensure that if financial users want to cancel or switch providers they will be penalised, or greater use of penalty charges and hidden costs. Another example is the lack of investment in accessible ATMs and e-banking services which prevent many older people from managing their own accounts or result in high charges.[10]

Anti-competitive practices and behaviours: While we may see fiercer competition to acquire new business, product design and pricing structures may be used to stifle switching away from incumbent provides and therefore undermine effective competition (see above). Particular concerns about anti-competitive practices in banking sector (and to some degree in life insurance sector) due to consolidation in market and consumer confidence.

Financial 'prisoners'/'captive consumers': Linked to the previous point, a strong theme we expect to emerge across a number of sectors is the treatment of consumers who are in effect contract 'prisoners'. They may have limited opportunities to switch to better deals (or lack of awareness of better deals and consumer rights) and as a result, may be exploited and subject to unfair practices such as excessive administrative or penalty charges. Mortgage arrears, life insurance funds, personal pensions, investment funds and bank accounts are obvious areas for concern. There is a particular concern about financially excluded and other vulnerable households who may have been targeted by unscrupulous providers in the first place. Practices which exploit 'captive consumers' violate the principle of freedom of choice for consumers promoted by the Single Market Act.

Complaints and redress: Revenue and profit margin pressures may encourage financial institutions to make it more difficult for financial users to obtain due redress, even more so as financial services users still do not enjoy any collective redress schemes in a majority of EU Member States.

Regulatory pressures: It is not just financial institutions that are under pressure. We are concerned that a regulatory focus on financial stability and prudential regulation and limited resources may divert attention away from consumer protection priorities. As we explain in our paper *Principles and practices of financial services regulation*, civil society groups appreciate that rescuing our economies and financial systems must be a priority. Moreover, civil society groups recognise that prudential regulation is important and that consumer protection can be a rather abstract issue if financial institutions collapse. We do not challenge the need for policymakers to work on these priorities. However, it is critical that policymakers and regulators ensure that there are sufficient resources dedicated to consumer and investor protection priorities. As we explain in this risk outlook, the aftermath of the financial crisis and the response of financial institutions to margin pressures will result in financial users being exposed to detrimental behaviours and practices.

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[10] To process a paper bank transfer in Belgium, a bank typically charges more than EUR 5 to the customer when e-banking payments are free of charge.

Financial supervision: Transparency amongst supervisors is low, effective instruments are missing and in most countries there is no consumer representation in the existing supervisory bodies, no consumer panel with substantial rights (as in the UK) and no 'super complaint' to be worked on in the formalised procedure. For example, BAFin does not disclose how it handles consumer complaints. The whole process is not transparent, both for the consumer(s) affected and for the public.

Regulatory 'capture': The new economic paradigm will put severe strain on business models and financial returns available to financial institutions. We expect industry lobbies to put regulators under severe pressure to ease up on regulatory reform and consumer/investor protection. Regulators will have to steadfast in resisting these lobbies.

Prudential regulation 'overshoot': We recognise the priority given to restoring balance sheets but prudential reforms need to be carefully calibrated to prevent unintended consequences such as restricted access to credit, higher cost of access, higher product prices, reduced investment returns. Similarly, regulators need to be careful to avoid regulatory backlash diluting prudential reforms. This is an important illustration of why regulators have to undertake proper impact assessments when making prudential regulations.

Conflicts of objectives of supervisors: Also, a lot of EU supervisors – including the three new ESAs – have not moved to a 'Twin Peaks' approach, and have still conflicts between the industry solvency objective on the one hand, and the customer protection one on the other hand.[11]

Financial exclusion and access: Margin pressures will lead to banks and other financial institutions increasingly focus on higher margin/lower risk households. This is likely to lead to deteriorating financial exclusion levels and restricted access to services – in particular to customers with special needs (persons with disabilities, senior citizens, etc.[12]). More generally, we are concerned that financially excluded, lower income and other vulnerable households will be disproportionately exposed to emerging and potential risks. Regulators should also ensure there is an equality of interests – that is, they should act in the interest of all consumers, particularly the most financially vulnerable consumers, not just 'middle-classes' or wealthy consumers. It is important that analysis should understand the impact on different groups of consumers. For example, certain pricing structures may work for medium-income consumers but adversely impact consumers on lower incomes or with uncertain patterns of earnings. Assuming they can access markets in the first place, financially vulnerable consumers are more likely to be ripped off and any loss has a greater monetary impact. They are less likely to know and exercise their consumer rights. Following the theory of proportionate regulation, these consumers should attract stronger consumer protection than more economically powerful consumers.

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[11] See for example FIN-USE report on the consumer voice in financial services, May 2009.

[12] One example from Belgium: 18 months ago ING introduced a limit of EUR 1 000 to cash withdrawals from ATM allowed to customers aged 60+. They presented this measure has being necessary to protect them from the increased risk of abuse/theft of their bank card. Consumer representatives suspected that the real reason was that – since the bank has to refund customers who get robbed when using the ATM cash machines – they wanted to limit the risk for the bank. The measure caused such a reaction from senior customers that within half a day the Ministry of Justice intervened and asked the bank to withdraw their measure on the grounds that it was age discrimination.

Technology and risk-based pricing: Technology and risk-based/differential pricing enables more precise segmentation of consumers. This can benefit lower-risk, higher-income consumers but disadvantage vulnerable, lower-income or otherwise disadvantaged consumers.

Consumer confidence and trust: Consumer confidence and trust in financial services has already been seriously damaged. Financial users need to have confidence and trust if they are expected to use financial services to meet their core financial needs, and engage with financial services and make effective choices. This lack of confidence and trust may be exacerbated if we see the emergence of further detrimental practices.

Financial capability: Industry practices and behaviours (complex products, etc.) may further undermine the challenging task of improving financial capability.

3. Sector-specific risks

In addition to industry wide risks, FSUG experts have identified a range of specific risks relating to main financial services sectors – banking, insurance and funded pensions, and securities and asset management. These risks are a combination of existing detriments which still need to be addressed, and potential or emerging risks which – with the proper interventions – can be dealt with.

The classification of risks allows the relevant Commission officials and ESAs (EBA, EIOPA and ESMA) to identify issues that fall within their remit.

To illustrate the impact on financial users, we have included examples provided by FSUG experts from their own countries. Detailed case studies can be found in the annex.

Banking sector

The banking sector faces great challenges; on the one hand, it has to deal with the ongoing sovereign debt crisis, and on the other hand, it is requested to meet the new Basel III capital requirements. In any case, the banking environment is changing and this also affects all users (consumers, micro entrepreneurs and micro investors) of financial services. Specifically, according to the ECB, the net tightening of credit standards by euro area banks surged in the fourth quarter of 2011, and in the short run, a further net tightening of credit is expected. This creates lack of funding problems for all users. The situation is even worse for the Member States that face serious economic problems. Greek, Italian and Spanish banks see billions of deposits withdrawn in fear of their safety.

Another serious problem is the rise of the NPL (non-performing loans) ratio. This ratio has considerably risen during the last two years, mainly for Member States in economic trouble. This deteriorates even more the bad situation of the domestic banking system of these countries and raises the systemic risk for the financial sector as a whole in Europe.

Distribution issues: Banks will look to supplement core banking revenues by playing a greater role in distributing other higher-margin investment/insurance products. While these products are within the remit of ESMA/EIOPA, EBA would need to be aware of the behaviours in bank distribution channels and coordinate interventions with ESMA/EIOPA (see above re: consumer expert group).

Competition: In February 2012, Health and Consumers DG published the results of a mystery shopping they carried out to assess the implementation of a code of conduct adopted by the banking sector at EU level. It shows that more than two thirds of mystery shoppers were not able to switch their bank account successfully.[13] However, competition in the banking sector is likely to be further reduced due to ongoing major consolidation and unintended consequences of prudential regulation reforms.

[13] http://ec.europa.eu/consumers/rights/docs/switching_bank_accounts_report_en.pdf

Mortgages and credit

Mortgage markets

Unsuitable advice: Unsuitable advice when concluding mortgage loans is still evident in Member States including: failing to obtain sufficient information concerning the financial position of consumers, objectives, willingness to accept risk, knowledge and experience of consumers.

Mortgage prisoners: These borrowers will be vulnerable to application of unfair terms, treatment of borrowers in arrears, and restricted access to fair, affordable mortgage credit. In the UK, some mortgage lenders offered tracker mortgages which guaranteed to track at a set percentage below base rate. Such products are now very favourable for consumers and lenders have tried to find ways to move consumers onto other, less favourable products.

Prudential regulation overshoot (banking)/debt financing: Poorly calibrated prudential regulation risks knock-on impacts on financial users through restricted access to credit, higher cost of access, higher prices. In the long run, access to debt financing is expected to be more expensive and more difficult for all users. Banks are expected to become more risk sensitive, ask for more collateral and more information and impose higher interest rates. This is not bad per se, under the assumptions that it could lead to lower risk levels for the system and that a more 'responsible lending' approach will be followed. However, if we assume that the financial sector is the main intermediary in the flow of capital to the real economy, this may lead to severe funding problems for both liquidity and investment. Thus, alternative sources of financing should also be created.

Foreign currency loans (Austria): These loans have caused severe problems for consumers in Austria and provide an ideal example of the type of detrimental pricing practices and promotional strategies that can lead to consumers buying unsuitable products. These risky loans were granted not only to professional clients but even to consumers from approximately year 1995 to 2008. Banks granted those high-risk loans even to consumers who often were not aware of the risks involved. Due to the high number of existing credit agreements with consumers in Austria to the present, it is necessary to adopt individual but not compulsory solutions with borrowers in order to avoid high losses or overindebtedness.

Unfair contracts (Romania): Mortgages have been one of the leading products sold by banks in the boom period of 2005-2008. Therefore – in a rush to gain as many clients as possible – banks have eased the conditions of lending. This was also possible as the regulation was extremely relaxed in the area of financial consumer protection and banks easily found ways to sidestep some important safeguards. Contracts were constructed in a discretionary manner that permitted banks to change unilaterally the costs and other characteristics of mortgages, without the possibility for consumers to refuse (for full details on this issue, see the Case studies in the annex).

Unsecured credit markets

Consumers in the unsecured credit markets are subject to a number of detriments including: application of unfair terms, treatment of borrowers in arrears, access to fair, affordable credit, growth in sub-prime predatory lending, growth in predatory commercial debt management firms.

Overdraft interest rates (Germany): Are much too high though funding has never been that cheap for banks. There is no capping in Germany only a high-court jurisdiction that usury starts with twice the average (which all banks can easily fulfil as the average is already quite high).

Tying practices (Germany): Especially in consumer credit where banks sell binding high-cost payment protection insurance contracts to credit customers without declaring those contracts as binding (in the contract it says 'voluntary') and without calculating their costs into the APRC.

Debt collecting agencies (Germany): Often working for internet or telephone providers that have trapped consumers with costs and with long-term contracts or subscriptions they did not mean to conclude. Often costs after an agency has been mandated are much higher than the real or predicted main claim. It is often not transparent what are the grounds for collecting the debts.

Debt advice: Access to objective debt advice is a priority for households in financial difficulty due to mortgage and unsecured credit commitments. In certain Member States, such as the UK, there has been a significant growth in the number of commercial debt advice companies who charge high fees for providing debt advice[14]. These fees are unnecessary as there are established free debt advice charities.

Flitskrediet (Flash credit): Is a new form of short-term consumer credit[15], similar to SMS loans in Sweden. High costs make Flitskrediet a down-market product for consumers who have already depleted their other liquidity sources or have no other possibilities of credit access. Before they used high administrative or service costs to recover their costs. But apparently since the AFM controls providers they profit by adding in small print standard terms extra costs for those who repay late or those who want very fast access to the money.[16]

Debit Cards – decision taken by employers (Romania): Cards are very popular in Romania. The development of cards market was possible through the practice of paying revenues by employers in a banking account, with debit card attached. More than this, credit cards have gained ground in the last years due to certain optional facilities offered, especially instalments. Still, because of lack of proper regulation and very low level of financial literacy, customers find themselves often in situations of overindebtedness or in situations where they use the product in a detrimental way (details can be found in the annex: Case studies).

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[14] The Financial Inclusion Centre estimates that a borrower with a GBP 15 000 unsecured debt using a commercial debt management company could pay GBP 3 000 in fees over 5 years and take an extra year to repay the debt. The reality is worse as the fees are often structured so that borrowers pay high upfront charges which are lost if the borrower cannot maintain the repayment schedule.

[15] Amounts to about 0.025 % of the Dutch consumer credit market. The average loan size is EUR 230, whereas most contracts have a loan sum of EUR 100. The average maturity of the loan is 24 days.

[16] See IOO, 2009. *Onderbouwing van een maximale vergoeding voor flitskrediet, Eindrapport*, Een onderzoek in opdracht van ministerie van Financiën, Zoetermeer.

Insurance sector

Solvency II: This is an important reform as insurance companies have been mispricing risks. However, the impact on financial users needs to be better understood and assessed – specifically with regards to access, pricing and design of insurance policies. We are concerned that more work needs to be done to ensure that Solvency II is calibrated to maintain and promote diversity, plurality of provision and real competition in the insurance sector. Furthermore, there is an additional challenge to calibrate Solvency II requirements with existing or planned Insurance Guarantee Scheme. It is worth mentioning that there is a lack of coherent Insurance Guarantee Schemes across Europe.

Treatment of policyholders: Policyholders in the life insurance sector are particularly vulnerable to unfair treatment arising from the business risks identified above. Issues that need to be addressed include unfair contract terms, contract prisoners/captive consumers, lower transparency requirements than for MiFID-covered retail investment products. Common usage of abusive clauses: Financial supervision does not include detail analysis of insurance contracts. There are many signs that many policy wording do not meet required standard. There should be possibility to monitor them.

Gender pricing: Regulators will also need to be on their guard to prevent insurance companies and distributors/intermediaries taking advantage of the potential disruption and confusion resulting from the application of gender neutral insurance premiums in December 2012. Specifically, we have concerns about the pricing of insurance products, promotions and advertising of affected insurance products, and quality of advice and information provided to consumers who may be affected by the change.

General insurance: While general insurance tends to perform better than life insurance or investment-based insurance, there are a number of issues to be addressed, including misleading price competition, greater use of excesses on insurance policies, claims handling experiences deteriorating, and greater use of exclusions. The loss adjustment process very often does not provide full compensation which is reduced in an arbitrary way by small amount that does not encourage to take legal steps against insurance company.

Bankassurance: Selling insurance product very often does not provide any add-value for consumers and, what is even worse, it does provide illusion of insurance coverage. High commission received by banks create a huge pressure on sale and lead very often to mis-selling. High commission reduces insurance coverage and increase use of exclusions that often leads to ineffective coverage. Finally, the consumers have countless useless insurance products at the bank account and/or ineffective coverage for mortgage credit.

Life insurance contracts: Insurance with any form of guarantee becomes more and more expensive. Insurance with investment component are sold with no or very limited information about an investment part of the product. For example, in Germany life insurance contracts are often inflexible. Of the contracts, 80 % are not finished and served until the end. Therefore, investors incur high losses if they are not able anymore to make their running payments. This is a prime example of product pricing structures which are designed to protect the interests of providers, not to meet the needs of consumers. Note this was a major detrimental feature of the life insurance

sector in the UK – for example, with-profits funds, mortgage endowment policies. FSUG suspects that this is an issue in many other insurance markets across the EU.

Irregular management of pension insurance brokerage: In 2010, the AFM (Netherlands Authority for the Financial Markets) identified significant shortcomings in chain management of pension insurance brokerage. By 2011, AFM still regularly encounters brokers who do not comply sufficiently with the requirements of the duty of care, integrity and expertise[17].

Savings

Low interest rates: As a response to the financial crisis, benchmark interest rates have been maintained at a low level for a sustained period. Sustained low interest rates encourage risky investment behaviour in a 'search for yield' – this leaves investors vulnerable to mis-selling and misleading promotions.

Confusing/complex savings products[18]: Banks sell through their networks different products offered by other financial institutions, part of the same financial group or not. This includes 'Bauspar' products, mutual funds, insurance (unit-linked, index-linked). In this case, it is not the products or advertising (mostly non-existent) that is misleading, but the selling technique in banking branches. Most of these products are complex, rather difficult to understand by clients, but they are sold as common savings products. After signing contracts, many clients realise that what they contracted is not a standard deposit and that they do not have instant access to the money or they have to pay a lot of fees (see Case studies in the annex). Consumer protection standards on savings is weak compared to loans.

Privately funded pension schemes

Low growth and high unemployment rates continue to put pressure on European pension systems. Pressure is directed either to increasing pension age limits or to pension cuts. The new economic paradigm will have a range of unintended consequences for consumers.

Low financial returns and bond yields: This includes advisers aggressively promoting complex, opaque, expensive investment strategies (dynamic asset allocation, liability driven investments) and financial products (hedge funds, absolute return funds) to pension fund trustees and individuals.

Prudential regulation overshoot (pensions): Possible misapplication of Solvency II style regulation to pension funds. Conversely, industry backlash may cause regulators to dilute scheme member protection by allowing schemes to under-price risk and underprovide for future liabilities (particularly in conjunction with advisers selling opaque, expensive risk management strategies).

Pensions (accumulation): A key priority for regulators is to prevent value destruction in low-return environment due to high and hidden transaction costs. Pension fund trustees and scheme members are vulnerable to mis-selling of socially useless financial innovations and exposure to investment volatility.

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[17] See http://www.afm.nl/en/professionals/afm-actueel/nieuws/2012/jan/ketenbeheersing.aspx.
[18] http://www.conso.ro/depozite/economisire-produse-vandute-gresit-clientilor

Pensions (decumulation): Risks here include annuity portfolios not backed by sufficient assets, low returns on annuities encouraging pensioners to take undue risks with retirement funds, poor advice on income drawdown and equity release schemes. We fear even worse, a negative real return on pensions for pension savers and pension annuities losing real value other time because of below inflation rate increases (see below the section on Investments/asset management). In many countries, annuity market and equity release merely exist. Due to lack of data and experience available products are very expensive. The European Court of Justice (ECJ) ruling on the Test-Achats case on 1 March 2011 could even increase the costs of decumulation.

Transfer of risk and responsibility: It is expected that we will see a major transfer of risk and responsibility for retirement provision away from the state and employers pension schemes to individual citizens. Greater use of individual pensions and defined contribution type schemes is expected. This is a major public policy risk which has not been properly evaluated by policymakers or regulators. There are major concerns about the ability of the industry to provide replacement pensions that are safe, sustainable and efficient, while we challenge the view that citizens generally are capable of managing the risk involved (or even want to take on the risk involved which will impact on willingness to provide for the future).

Insurance and pensions: Sometimes, in Romania, asset management companies sell pension insurance component like an optional fund pension. This confusion is maintained especially by the selling agents, driven by their desire to win a bigger commission. In this manner, these products are described like having the same objective (assuring some additional income at the retirement), but the benefits offered to the clients by these are very different. Proofs for this misleading technique could be found on forums, where consumers state that they have been convinced to buy a product they did not desire. There is also a major lack of transparency and consumer protection. For example:

- In the past, pension funds did not display the structure of their investment portfolio. Therefore, clients had no possibility to compare or asses on their own the risk level of a certain fund. The market changed its behaviour and pension funds started to display details of their portfolios only after a major campaign run by Conso.ro[19] and other financial newspapers (Ziarul Financiar, Bursa).
- There is no minimum yield guarantee for pension funds. The amount invested could have a negative performance, not even covering inflation.
- There are few to none programs for promoting private pensions system and the rights of participants to choose their fund. Only about 20 % of all new entries into the system during a year make a choice. The rest are automatically assigned by ‘automatic distribution’. It is important that these ‘default’ funds are ‘fit-for-purpose’.

[19] http://www.conso.ro/pensii/decizie-istorica-in-pensiile-private-administratorii-vor-dezvalui-in-ce-au-investit-banii-populatiei

Investments/asset management

The investment/asset management sector is vulnerable to similar range of factors as the funded pensions sector.

Low financial returns: Range of potential risks and adverse behaviours including financial users making sub-optimal decisions about risk and reward trade-offs, providers, distributors and advisers aggressively promoting complex, riskier products, such as absolute return funds, exchange traded funds, unregulated collective investment funds to retail financial users, abuse of investment projections. In addition, financial providers and governments are still too much playing on the 'monetary illusion': returns are never communicated in real terms, i.e. net of inflation[20]. Nonetheless, inflation is still quite significant (typically 2-4 % annually throughout the EU Members States), especially for long-term and pension savings, for which its exponential impact can be devastating over time. FSUG suspects a majority of retail long-term and pension investment products are delivering negative returns after inflation and taxes. In other words, they would be destroying the real value of European households' savings. FSUG has already come up with several such cases and is now launching a research study on pension products, with a particular focus on their long-term net performance for the savers.

Destruction of value: In an era of squeezed household incomes and low financial return, a priority for regulators will be to ensure the sector can deliver value for investors. Regulators must guard against hidden and high charges destroying value in a low-return environment. High charges will eat up a much larger proportion of investors and policyholders contributions. For example, if future returns are 6 % per annum instead of 7 %, a 1.5 % annual management charge would eat up a full one quarter of the investment returns. Investors and policyholders would have to significantly increase their contributions to make up the difference. In addition, given that only a small minority of investment managers can consistently outperform benchmarks, the value destruction of investor's portfolios could be even greater. While we have seen a significant growth in the number of investment funds on the market and a degree of cross-border activity, these changes have not resulted in benefits for the ordinary financial user. Indeed, costs to the end-user have risen undermining the supposed advantages of the single market. This is a good example of how market developments can benefit the financial services industry but not the financial user and why it is imperative that policymakers adopt a different approach to regulation.

Socially useless financial innovations: The investment and pensions sector is particularly vulnerable to the development of financial innovations which overall add little real value for ordinary investors (or even destroy value and introduce unforeseen risks) – for example hedge funds. Other innovations may start off offering value for investors but over the time are undermined by conflicts of interest or over-engineering. Prime examples of this trend include exchange traded funds (ETFs). There is little evidence that the increasing complexity of investment markets actually delivers value for ordinary investors – but creates huge value for investment professionals in the form of advisory fees and commissions.

[20] And very rarely net of taxes, although this has been a mandatory disclosure requirement for decades for US domiciled mutual funds.

The role of intermediation: Linked to the above two risks, is the growing number of intermediaries (as well as providers and products) who extract value from investors assets and contributions. This is one of the key challenges facing regulators. There is merit in intermediaries encouraging investors to save for the future or a pension (the well-documented inertia factor is a major barrier to long-term savings). However, there are now many layers of intermediaries between investors and capital markets which not only extract value from investor contributions but reduce the available capital allocated to the real economy.

Technological developments: Platform technology introduces additional layers into investment supply chain and unnecessary charges.

Threats to corporate governance and to economic democracy: The further marginalisation of individual shareholders due to the ever-increasing 're-intermediation' of equity markets by financial institutions. Citizens' or people's capitalism is about to die to the benefit of an all-powerful financial capitalism, which has no interest in the long-term sustainability of the economy and society. The share of individual shareholders in the Western equity markets has already gone from about 50 % in the 1950s to about 10 % in the 2010s to the benefit of financial institutions, through:

- The massive 'packaging' of retail investment products (for example, look at the expansion of investment funds since the 1970s).
- The growth of banks' 'proprietary trading' (especially after the abolition of the US Glass-Steagall Act in 1999).
- The emergence of algorithmic trading and, in particular, of high frequency trading (HFT).

This evolution is a severe threat to the corporate governance of listed businesses as it also impacts very negatively the average holding time of shares. Investment funds for example do not hold their shares on average for much longer than a year, so they have little interest in the mid-term to long-term sustainability of corporations and to getting much involved owners of companies as they know they will likely be gone the following year. Recent capital market reforms have largely ignored the interests of individual investors, accelerating their marginalisation.

It is also a severe threat for the financing of SMEs and of innovation, as financial institutions tend to focus on the most liquid shares to the detriment of small and mid-cap listings. Indeed, the new 'market venues' created by MiFID have only focused on big caps. Also, many big banks are more interested in the profit margins they find in trading and in investment banking rather that in their 'dull' core business of lending to the real economy and especially to the SMEs which are the only generators of jobs in Europe.

High-commission selling (Germany) of especially investment products: The main form of selling financial products hiding high and third-party commissions, making costs incomparable from costs of other products and not disclosing the existing conflicts of interest. Numbers of intermediaries are inevitably high, consumer detriment is definitely higher.

Investments/asset management (Romania): Banks represent a very important selling channel for the mutual funds, but even the employees that sell these products do not fully understand their characteristics. So, the investors are often wrongly informed about the expected yields or the right level of fees they have to bear. Asset management market in Romania is almost entirely based on banking sales force. Even more, banks have put together product that boost sales on investment funds. A very popular product among bank offers is the deposit + investment fund package. Clients receive a higher interest rate for their savings if they also buy fund units, thus encouraging the sale of investment products. But tellers in bank branches are not specialised in selling a wide range of products, especially products for which the bank is only a selling channel. For this reason, cases were customers bought fund units without being properly explained the way this products function, are quite frequent. One important issue is the fiscal obligation of declaring any revenue received during the ownership period of the investment funds units to the fiscal authorities. Most clients are not aware of this obligation and risk fines for not declaring their revenues.

4. Next steps

The FSUG does not have the resources to undertake the necessary research to quantify the potential scale of detriment associated with these emerging and potential risks. Therefore, we urge the Commission and ESAs to proactively evaluate these risks, quantify these risks in terms of potential consumer detriment/welfare loss, and prioritise these risks for interventions.

We would welcome the opportunity to work with the authorities to help prioritise these risks so that financial users are properly protected.

Many of the existing risks could be tackled, and emerging and potential risks pre-empted, using the existing legislative, regulatory and consumer protection framework. However, this requires much tougher, coordinated implementation and enforcement of measures.

This paper should be read in conjunction with our report, *Principles and practices of financial services regulation* which provides a template for evaluating how the new economic paradigm and emerging risks may impact on consumer outcomes.

We hope to make this risk outlook a regular publication which we will use to challenge the relevant Commission departments and European Supervisory Authorities (ESAs) to take action to protect the interests of financial users. We would certainly welcome further engagement with the Commission and ESAs to agree priorities for intervention.

We would also hope that financial user representatives and civil society groups at EU level and in Member States will find this risk outlook useful for their own activities.

Annex: Case studies

Case study: Foreign currency loans in Austria

These loans have caused severe problems for consumers in Austria and provide an ideal example of the type of detrimental pricing practices and promotional strategies that can lead to consumers buying unsuitable products. These risky loans were granted not only to professional clients but even to consumers from approximately year 1995 to 2008. With the breakdown of Lehman Brothers in September 2008, the Austrian banks stopped the provision of foreign currency agreements to consumers immediately. Moreover, the Austrian Financial Market Authority (FMA) banned foreign currency agreements with consumers by setting new minimum standards, *Extension of the FMA Minimum Standards for Granting and Managing Foreign Currency Loans and Loans with Repayment Vehicles* of 16 October 2003, from 22 March 2010. But the detriments for borrowers have existed from 2008 up to now, as the strong Swiss Franc (revaluation against the euro) which is the mostly chosen currency within the agreements caused much higher outstanding debts. In addition to an increase of debts, borrowers have been facing persistent and everlasting devaluations of investment products (funds, shares, endowment life insurance contracts) which are closely linked to the repayment of the entire outstanding credit sum at the end of the term (bullet loans).

Banks granted those high-risk loans even to consumers who often were not aware of the risks involved. Due to the high number of existing credit agreements with consumers in Austria to the present, it is necessary to adopt individual but not compulsory solutions with borrowers in order to avoid high losses or overindebtedness.

Case study: Mortgages – examples of detriments in Romania

Mortgages have been one of the leading products sold by banks in the boom period of 2005-2008. Therefore – in a rush to gain as many clients as possible – banks have eased the conditions of lending. This was also possible as the regulation was extremely relaxed in the area of financial consumer protection, and banks easily found ways to sidestep some important safeguards.

First of all, contracts were constructed in a discretionary manner that permitted banks to change unilaterally the costs and other characteristics of mortgages, without the possibility for consumers to refuse. For example:

- Contracts stipulated that banks can change the interest rate based on changes of the financial market, without providing any formula. There were numerous cases where banks raised costs even when interest rates on financial markets recorded a downward trend.
- Credit contracts permitted banks to rise or even introduce new fees on mortgages in progress.[21]

[21] http://www.conso.ro/citeste-stire/102/cons/UniCredit-Tiriac-Bank-introduce-noi-comisioane-clientilor-vechi.html

- In order to allow consumers to receive as high as possible loan amount, banks have introduced on a large scale mortgages with fixed 3-month/6-month/1-year introductory interest rate, very low, without any indication on how the level of the interest rate will fluctuate afterwards[22 & 23].
- Even more, the total indebtedness was calculated based on this very low promotional interest rate, not taking into account the fact that after the introductory period the instalment would even double.
- Fixed interest rate turned into variable. There were also examples where mortgage contracts that clearly stipulated that the interest rate was fixed, but the bank has raised the cost when the market conditions worsened.
- This type of offer was one of the most advertised and the key point in attracting customers was the **fixed** interest rate. Two years after, the bank decided to change the fixed interest rate into variable and increased the cost of credit[24].
- The practice of expressing annual or monthly management fees as a percentage of the initial amount of the credit, instead of the remaining debt. This results in a fixed annual or monthly fee for the management of the credit, even when the debt decreases. This practice was forbidden by law in 2010, but it did not apply to all ongoing contracts.
- Mortgages in Swiss francs were very popular for several years before the financial crisis. Interest rates were lower than interest rates on EUR or RON and clients could borrow larger amounts. There were no indications on the exchange rate risks or on the possibility of interest rates going up and when markets deteriorated, those were the first credits to go into default.[25]

The situation was partially amended in late 2008 with the issue of a new regulation for credit contracts by the National Authority for Consumer Protection (NACP). It forced banks to have a transparent formula for changing interest rate and no possibility of altering fees during contract. The real breakthrough came in 2010, when Consumer Credit Directive 2008/48/EC (CCD) was transposed into national legislation. Due to the fact that there was merely no regulation for mortgage market, the provisions of the directive were applied to all types of credit, not only to consumer credit. Even if this measure was disputed by banks, it was backed by NACP and Competition Council. It was finally applied to all credit contracts and even some ongoing contracts were updated to meet the new criteria.

Banks have to display all costs of credit to consumers and there is a limited number of costs/fees that can be charged, so that consumers can compare products more easily. Even with this strict regulation, banks found ways to impose a rise of interest rates or to launch products that were detrimental for consumers.

- When real estate market started a sharp decline in 2009, clients of one bank were given the choice of reimbursement of the total debt in advance, providing additional real estate as guarantee or accepting a raise of the interest rate. As reimbursement or refinancing was very difficult and additional guarantees almost non-existent for the most of the clients, they were forced to accept a raise of the credit costs, in order to avoid foreclosure. One client who went to court had his costs returned to the initial level and the bank received

[22] http://www.conso.ro/citeste-comentariu/62/imob/Dobanda-introductorie-lasa-in-urma-supraindatorati.html

[23] National Bank of Romania, *Financial Stability Report 2009*, p. 98 (EN) and National Bank of Romania, *Financial Stability Report 2011*, pp. 103-104 (EN).

[24] http://www.conso.ro/credite-imobiliare/volksbank-repara-greseli-revine-dobanda-fixa-returneaza-parte-bani

[25] National Bank of Romania, *Financial Stability Report 2011*, p. 109 (EN).

a fine. But only few clients went to court, the vast majority remained with the increased interest rate.[26]

- Another important issue concerns the excessive penalties for those not paying instalments in due time. There are cases when penalties exceed the arrear. For example, a client had to support EUR 42 penalty for paying 1 euro cent less on the instalment.[27]

Still, while banks have to display in advertising the Annual Percentage Rate (APR), they do not have to display the APR for a certain period and amount, but they can choose a desired combination. This makes it difficult for consumers to compare and can mislead by offering an example of the best situation rather than the most common one.

Case study: Cards – misleading products and practices in Romania

Cards are very popular in Romania. The development of cards market was possible through the practice of paying revenues by employers in a banking account, with debit card attached. More than this, credit cards have gained ground in the last years due to certain optional facilities offered, especially instalments. Still, because of lack of proper regulation and very low level of financial literacy, customers find themselves often in situations of overindebtedness or in situations where they use the product in a detrimental way (details can be found in this annex, in Case studies).

- Credit cards that offer fixed instalments are the most popular form of credit cards in Romania. This option was the leading characteristic in advertising and helped consumers to buy different home appliances or electronics. Lack of financial education, information and very complicated way of operation, many consumers were overindebted. For example, high interest rates and hidden penalties drove to situations were for a RON 1 500 personal computer, a client, after several years of paying instalments, still had a RON 3 000 debt[28] to the financial institution. Fixed instalments without interest are now a leading product in selling credit cards, but in most cases this option is cancelled when the client makes other purchases and does not pay them in full during the grace period[29]. In fact, a lot of clients are paying high interest rates, without being aware of it.
- Paying the minimum monthly debt is highly recommended by banks for their clients in financial education projects or through bank statements or other means of communication. This practice throws clients into a rolling indebtedness trap. It must be mentioned that in other Member States this practice was forbidden.[30]
- There are just few cases where employees can really choose the bank where they would receive their income. Most companies impose a certain bank where all employees have to open a current account, with debit card attached, some of them having overdraft facility activated. This dramatically lowers the willingness of consumers to switch their main bank account or to opt for a better banking offer. Even more, when changing employer, a customer has to change the bank. This leads to customers having several current accounts

[26] http://www.conso.ro/credite-imobiliare/instanta-anuleaza-actul-aditional-de-majorare-a-dobanzii-la-credit-pentru-un-client-piraeus-bank

[27] http://www.conso.ro/citeste-comentariu/139/cons/BCR-42-euro-penalizare-pentru-o-restanta-de-1-cent.html

[28] http://www.conso.ro/vocea-clientului/banca/efg-retail-services

[29] http://www.conso.ro/carduri/atentie-capcane-rate-fixe-fara-dobanda

[30] http://www.theukcardsassociation.org.uk/media_centre/press_releases_new/-/page/932/

and debit cards. They are seldom aware of the necessity to close an account to avoid paying for it, because even an inactive account still implies fees and bank charges. Another important issue is the overdraft, usually offered for debit cards. When someone changes his employer without paying the debt accumulated on the debit card, he is reported to the Credit Bureau and his credit risk deteriorates considerably. Most times, this implies clients cannot access another credit (including mortgage) for several years.

Case study: Misleading savings products in Romania

Banks sell through their networks different products offered by other financial institutions, part of the same financial group or not. This includes 'Bauspar' products, mutual funds, insurance (unit-linked, index-linked). In this case, it is not the products or advertising (mostly non-existent) that is misleading, but the selling technique in banking branches.

Most of these products are complex, rather difficult to understand by clients, but they are sold as common savings products. After signing contracts, many clients realise that what they contracted is not a standard deposit and that they do not have instant access to the money or they have to pay a lot of fees.

- The interest rate on deposits is not expressed as annual interest rate. Normally, whether the client goes into a 1-month, 3-month or 1-year deposit, the interest rate should be annualised. This permits actual comparison of products. Several banks have launched lately long-term deposits (2 years maturity). Still, those banks do not express the interest rate as annual, but as a total percent obtained at maturity by clients. For example, if the annual interest rate is 7 % and the maturity is 2 years, consumers are told that the interest rate they receive is 14 % (7 % x 2).[31] This deprives consumers from comparing deposits of different maturities and is misleading because banks do not use this way of reporting for other products (i.e. if the maturity is 6 months, than the advertised interest rate should be 3.5 %, following the same judgment).
- Progressive interest rate[32] advertised in a misleading manner. Some banks offer deposits with a progressive interest rate. For example, in the first months the interest rate is very low but increases gradually every month to the point where in the last month the interest rate greatly exceeds the standard interest rate of the market. This way of calculation implies that the average interest rate is not higher than standard levels, but banks communicate in advertisements and press releases only the last and highest interest rate.
- 'Bauspar' products sold as savings[33] through banking branches. 'Bauspar' products are designed especially for customers who want to make housing investments, and imply a first period of savings (with a premium received from the state) and a financing period (when the client receives a loan with a fix interest rate, usually lower than standard interest rate of the market). The product is quite complex and implies at least 5 years savings if the client wants to use the savings and state premium in other purposes. The costs of the products are focused on initial fees, that diminishes the rapidly the amount invested. Most clients acquire this product as an alternative to standard deposits, without fully understanding the risks and the costs.

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31 http://www.conso.ro/depozite/bcr-creeaza-confuzie-prin-dobanzile-afisate-la-depozite

32 http://www.conso.ro/citeste-comentariu/21/depo/Depozitele-progresive-nu-aduc-castiguri-senzationale.html

33 http://www.conso.ro/vocea-clientului/banca/bcr-banca-pentru-locuinte

On the savings area, the regulation is not as strict as for the loan activity. There is almost no regulation that protects consumers that want to invest their money in a product designed or advertised by the banking industry and there are very few limitations on advertising of such products.