Finance Watch response to the European Commission's consultation on the "Green paper on retail financial services: Better products, more choice, and greater opportunities for consumers and businesses"

Brussels, 18 March 2016

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here.

We agree to the publication of this response.

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Finance Watch welcomes the Green paper on retail financial services and insurance, and supports the objective of harmonising consumer protection and lowering prices for consumers.

We regret however the limited scope of this initiative, as it **addresses only cross border issues which are mainly a concern for 3%[1] of EU citizens**.

We agree that facilitating the cross border provision and purchase of financial services could **have a positive effect on prices and comparability**. It would also **reduce administrative burdens** for the 13.6 million citizens targeted.

In the context of the digitalisation of the economy, it is **not clear however in our view that such an initiative would contribute to jobs and growth:** as an example how many jobs did companies like Amazon create for the economy? Some would argue that digital cross border providers of services are often net destroyers of jobs. While we appreciate that there are both risks and opportunities, we find it important to have a more cautious and balanced assessment of the impact.

The oligopolistic market structure of the digital economy and the integration of European financial markets (with the relevant market becoming the European Union rather than a single member state) means that in many cases we might ultimately **end up with LESS competition**. In this respect, for this initiative to truly benefit European citizens and consumers, we must also ensure that it **does not lead to more concentration** in the provision of financial services with new TBTF financial entities.

Past crises have shown that **foreign lenders tend to retreat quickly within their borders in times of stress**, hence not providing the kind of stable financing that is useful for the real economy. To avoid such unintended consequences in retail financial products, we must take parallel measures to **curb the procyclicality of our financial system and to avoid penalising local traditional services providers**, as they have proven to provide more stable services over the cycle and are essential to the resilience of the financial ecosystem.

The claim that **increased cross border supply of financial services will in the long run translate into more choice and better products is also a subject for discussion,** as we explain later (see answer to question 8).

We must also ensure that digitalisation and increased cross border delivery of retail financial services **do not create competitive advantages for firms engaging in tax avoidance[2]** and do not lead to weaker regulatory supervision, but on the contrary that we **establish a regulatory level playing field for new entrants.**

Provided we manage to prevent these risks, this initiative will be a positive and welcome development for the citizens targeted.

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[1] 13.6 million according to the green paper out of 503 million EU citizens.
[2] See airlines and Ireland, financial services and Luxembourg

Question 4: What can be done to ensure that digitalisation of financial services does not result in increased financial exclusion, in particular of those digitally illiterate?

The rise of digitalisation and related increased price competition does not imply the disappearance of all non-digital providers that could serve digitally illiterate consumers. Digital providers might offer the possibility to make transactions over the phone for their potential clients that do not have access to a computer. Whatever means are made available, providers have to guarantee that they can serve any client, including the digitally illiterate.

Digitalisation might also have **other potential impacts on financial exclusion**: on one hand the related increased importance of credit scoring over qualitative elements in the credit decision process might lead to additional exclusion. On the other hand, increased competition and price pressure might incentivise some financial services providers to expand their customer base to unsustainable areas, as happened with subprime mortgage loans. While this would lead to a short-term reduction in financial exclusion, this type of predatory practices should be prevented due to their detrimental long-term impact on the access to financial services of vulnerable citizens.

More generally we must ensure that **new players are subject to a regulatory level playing field** where comparable services and risks are subject to comparable prudential regulation. Failure to do so might lead to increased predatory practices preying on the weakest while claiming to reduce financial exclusion, such as payday loans with extremely high interest rates.

Lastly, the data collected by digital providers and the algorithms used to determine whether to grant access to financial services should be supervised to ensure that the criteria used are relevant and do not lead to discriminatory profiling.

Question 5: What should be our approach if the opportunities presented by the growth and spread of digital technologies give rise to new consumer protection risks?

As mentioned above, we need a regulatory level playing field offering equivalent consumer protection and deterring sanctions no matter the medium or channel used to provide financial services.

Competent authorities should also actively monitor the evolution of products offered in order to identify early on excessive risk transfers to consumers.

It should be emphasised that policy makers should not wait for consumer detriment to occur before they act. On the contrary the growth of digitalisation should follow and not precede the implementation of adequate consumer protection legislation.

Question 6: Do customers have access to safe, simple and understandable financial products throughout the European Union? If not, what could be done to allow this access?

There is compelling evidence that the most vulnerable customers do not always have access to safe, simple and suitable products, typically when they are offered revolving loans with a shorter maturity instead of longer dated consumer loans. Measures ensuring that basic and comparable products are offered to all customers and that maximum interest rates are capped well below usury rates should address this issue.

More generally, we would argue that in many cases an additional issue is not so much whether customers have access to safe, simple and understandable financial products in most cases, but rather how can they identify these safe and simple products within the range of products offered to them, and how can we incentivise them to go for these products instead of better packaged, more attractive to all appearances but more opaque and expensive alternatives.

In this respect, initiatives such as the comprehension alert in PRIIPs that flags clearly less suitable products should be developed further so that mis-selling issues are addressed at all stages of the process, including design and point of sale.

Question 7: Is the quality of enforcement of EU retail financial services legislation across the EU a problem for consumer trust and market integration?

Consumer trust relies strongly on the ability to seek redress in case of a problem with goods or services, something that is by definition difficult in distance selling across different cultures and languages. This even more applies to services where the "service" is only delivered much later, e.g. for travel insurance, where a consumer will often not really know what the claims process and detailed coverage looks like until an insured event has occurred.

In customer goods, experience with the Distance Selling Directive shows that consumers remain reluctant to order from a cross-border provider even when knowing they are entitled to a full refund, including shipping costs in some member states. This is either an issue of redress, or lack of confidence.

Market integration is hampered by national rules that unintentionally block customers residing in other member states from using financial services, such as identify or address verification requirements. In such situations, the issue is national legislation and there is no European "redress" mechanism to seek access to the desired service, not even through the court as the financial institution in question is not discriminating on the basis of nationality (but on member state of residence).

Question 8: Is there other evidence to be considered or are there other developments that need to be taken into account in relation to cross-border competition and choice in retail financial services?

It is far from clear in our view that increasing the cross border provision of financial services **will ultimately lead to more competition, more jobs and growth, more choice and better products.**

The market structure of the digital economy seems to concentrate over time into a "winner takes all" or oligopolistic market. Examples abound such as the dominance of Facebook in social networks, of Amazon in book sales, of Google in search engines, of Apple / iTunes in entertainment content, of Zalando in shoe sales. Consequently the growth of cross border digital providers of financial services could follow a similar path, with big players like Apple Pay, Google Wallet or others taking a dominant market share, and ultimately leading to **LESS competition and new Too-Big-to-Fail entities.**
It might also lead to a lower diversity of business models in the financial ecosystem, as some types of traditional players playing an essential role might not be well placed to compete on this new digital cross border market, such as local banks and cooperative banks.

On a related point, it is also unclear how such an initiative would contribute to jobs and growth: how many net jobs did companies like Amazon create for the economy? Some would argue that digital cross border providers of services are often net destroyers of jobs[3], when taking into consideration their impact on traditional providers.
Some would also argue that based on recent history, the growth of digital providers could lead to **increased tax avoidance**, as these large players tend to optimize taxes (they are more footloose than traditional players, and can shop amongst member states for the most favourable tax treatment), with related detrimental consequences for growth and society as a whole.

It is also **not clear that customers lack choice** in retail financial services in general: retail clients only really need basic products and services, and in addition many providers are already global companies offering more or less the same product range everywhere. Unlike in other industries, innovation is often a very overrated word in financial services. As former chairman of the Federal Reserve Paul Volcker put it a few years ago: "***the only useful thing that banks have invented over the past 20 years is the ATM***".

Linked to the previous point, the idea that **this initiative would automatically lead to better products for consumers is debatable**: retail consumers' low financial literacy combined with the complexity and lack of comparability of the products and well-known behavioural biases means that in practice customers are often unable to tell which product is best for them.

[3] http://www.businessinsider.com/are-apple-and-amazon-destroying-the-jobs-market-2012-4?IR=T
http://www.forbes.com/sites/timworstall/2013/12/01/misundertanding-amazon-the-whole-point-of-technological-advance-is-to-destroy-jobs/#58d444ce463d
http://articles.latimes.com/2014/feb/17/nation/la-na-tt-job-creator-20140216

Studies have shown that they can focus excessively on gimmicky features or features that play on behavioural biases rather than on the core features of the product.
Past examples such as Swiss Franc denominated mortgage loans sold to retail investors in Poland and other Member States also show that high competition does not automatically lead to better products being offered.

In addition increased competition tends to be competition on prices only; **the related compressed profit margins in turn can lead providers to come up with more exotic, complex and profitable products** to compensate and restore their profitability.
While a temporary reduction in profit margins is a good thing from a customer point of view, unsustainable price competition that leads to more complex and less suitable products being offered is not. The issue here is two-fold: simple products are less profitable and more comparable hence more susceptible to price competition; customers' limited financial literacy and behavioural biases mean that they often fall for products that promise higher returns / lower borrowing rates / cheaper services, while failing to integrate the basic concept of risk and reward (there is no free lunch / if it looks too good to be true, it probably is).

This questions the idea that increased competition in retail financial products automatically leads to better products. It also suggests that additional measures are necessary to actively promote simple products, improve disclosure and increase comparability.

More broadly, **exacerbated competition on prices only might have other detrimental effects** on key qualitative elements, such as the soundness of risk assessments, the willingness to support clients in difficult times, the procyclicality of lending and the risk of service disruption to name of few.

To sum up, while increased cross border financial services may present opportunities for customers, we must ensure that this translates into increased comparability and more suitable products being promoted. We must prevent on the other hand that additional competition and price pressure are compensated by a **push towards more complex products, additional risk transfer to consumers, more opacity or a shift towards unsustainable business models and predatory practices, as happened with subprime loans**.

Question 13: In addition to existing disclosure requirements, are there any further actions needed to ensure that consumers know what currency conversion fees they are being charged when they make cross-border transactions?

Disclosure requirements about the cost of currency conversion must crucially not only consider fees but also **the bid-offer spread**, often the biggest cost for the consumer. Failure to include it would render the disclosure partial and meaningless.

Question 17: Is further EU-level action needed to improve the transparency and comparability of financial products (particularly by means of digital solutions) to strengthen consumer trust?

The Key Investor Information Document for UCITS and the Key Information Document for PRIIPs integrated for the first time behavioural economics findings in the design of retail information documents after thorough consumer testing.
We believe that **these formats should be harmonised and their scope expanded** to cover all retail financial products, in order to both foster comparability and understanding.

EU-level action would also be beneficial to **proactively promote and incentivise a range of basic products** for retail investors.

We fear that **digitalisation may lead to a decline in consumer trust as the purchasing experience becomes more impersonal** compared to buying in your local branch from your usual advisor. Maintaining or strengthening consumer trust would thus require in our view **creating a set of incentives to align interests and strengthen accountability** between provider and customer: such incentives could for example reward providers that try and build a long term relationship with their clients, as it would incentivise them to take the client's long term interest at heart.[4]

In addition, if tomorrow retail consumers purchase financial services online through their mobile phone, as is envisioned, this could lead to less attention being given to terms & conditions, as is already the case when users are asked to agree to terms and conditions on various social media and other websites / applications and tend to agree without reading them. This could create a risk of additional mis-selling and should in our view be taken into consideration when assessing transparency and comparability of financial products.

Lastly, on a related point, we must ensure that customers are aware that they buy from a foreign provider that may be subject to different rules when they do. Different Member States can indeed offer different levels of insurance coverage, means of recourse etc.

Question 25: In your opinion, what kind of data is necessary for credit-worthiness assessments?

A number of qualitative and quantitative elements are necessary to make a sound credit lending decision, as is currently done in traditional banking and arguably the same criteria should be used whatever the medium or financial entity providing the service.

An important element is that a credit decision is just that: a decision made based on factual elements (payment and credit history, employment history) and *intuit personae* elements (personality of the borrower). Promoting the expanded use of credit scores based only on

[4] On a related topic, very interesting work is currently being carried out on fiduciary duty by civil society organisations like ShareAction and Franck Bold.

quantitative / factual elements may lead to loss of consumer information, a decline in the quality of the credit assessment and less sound lending decisions.

The **loss of personal customer relationship linked with digitalisation and cross border supply of services** should not lead to an **excessive focus on quantitative metrics such as scoring** and a related decline in the quality of risk assessments. This could also have an adverse impact on the stability of the provision of essential services.

Question 29: Is further action necessary to encourage lenders to provide mortgage or loans cross-border?

There are significant problems for citizens living in one member state and working in another, and for retired citizens wishing to purchase a property using income from a pension in another member state. However, most of these barriers tend to be caused by differences in national tax treatment and insolvency rules. In such specific cases there are examples of financial institutions providing a tailored solution and we do not believe a one-size-fits-all European mechanism can comprehensively address this issue.

As stated earlier, we find it as or more important to **ensure that the provision of cross border loans is incentivised to be more stable across the economic cycle than in the past**: households and companies need stable funding in order to be able to conduct their business and plan for the future.
Past crises have shown that **cross border lending was not as stable as desired across cycles, because foreign lenders and investors tend to retreat within their borders and refocus on their core markets in times of stress**, hence not providing the kind of stable financing that is useful for the real economy.

The promotion of cross border lending therefore needs to be accompanied **by measures to reduce this volatility, such as curbing the procyclicality of leverage** of lenders and of the financial system in general, and incentivising long term relationship lending.

It must also be ensured through complementary measures that **the promotion of cross border financial services does not create distortions and penalise local entities**, since local relationship banking is extremely useful for the financial ecosystem.

Question 32: For which retail financial services products might standardisation or opt-in regimes be most effective in overcoming differences in the legislation of Member States?

We believe that **simplification and standardisation would be beneficial for all retail financial services**. Retail customers most often do not need complex financial products. Low financial literacy and behavioural biases also can lead to unsuitable choices when faced with more complex financial products. For all these reasons we believe that their needs can be served adequately by basic products that can more easily be standardised.