Policy Focus Note 2: Consumer Protection in Credit Markets

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This Focus Note is the first in a series exploring various dilemmas which policy makers face across several topics of great importance to financial inclusion.[1] The focus is on protection of borrowers, specifically low income borrowers who are the current and potential clients of microfinance. While this group is often ostensibly the focus of concern of policy makers, their preferences are often poorly understood.

"The misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all."

JOAN ROBINSON,
ECONOMIC PHILOSOPHY
(1964,2006:45)

Summary

The roots of the global financial crisis, which started in 2008, lie partly in a failure to regulate. Now more than ever, policy makers and regulators face increasing questions over whether and how to regulate consumer credit so as to protect borrowers. Inappropriate forms of protection, however, can restrict access to credit, especially among poorer borrowers. For many policy makers, the question is no longer "to protect or not to protect?" It is "when and how?"

Credit markets are fragile, and not only because of the risk of political meddling: borrowers also tend to exhibit systematic vulnerabilities which compromise their financial decision making capability. In response, policy makers and regulators may use a range of tools to protect borrowers. These include non-regulatory approaches, such as promoting consumer education, and regulatory approaches such as disclosure laws, product-based regulation, which covers the terms of loan contracts and processes, and provider-based laws which require lenders to register and be subject to regulation.

However, the ability of lawmakers to pass rules usually exceeds the ability of regulators to enforce them; so before adopting new regulations, policy makers must carefully consider possible approaches to monitoring and enforcement, ranging from self-regulation to direct state regulation, and hybrids in between. A new campaign for client protection aims to promote basic global standards for microfinance institutions to follow. Educating borrowers may help but is not sufficient.

1. Other Focus Notes in the series will consider policies towards competition, interest rates, and prudential regulation. Clearly, these topics are closely linked, at least in perception if not always in reality. For example, capping interest rates had traditionally been seen as a means of consumer protection; and while competition in credit markets can bring many benefits, it can also result in abuse of borrowers leading to calls for protection.

Policy makers would benefit from identifying and collecting relevant information on the reach and effects of the credit market in their jurisdictions. Proposals for changes in policy or regulation can then be more evidence-based and proportionate to the real risks faced by borrowers or the financial system. In particular, policy makers are well advised to avoid the "rush to regulate" by introducing protection frameworks based on inappropriate norms from developed countries.

Introduction

The calls for consumer protection in credit markets are global and growing. Powerful forces are agitating for new or enhanced forms of consumer protection, although not necessarily from borrowers themselves.

- In many countries, financial markets have been substantially liberalized over the past decade or longer, resulting in increased competition to lend. In the large 'BRIC' countries alone, the value of consumer credit outstanding rose 40% per annum during the period 2001-2005.[2]
- The explosive growth of retail credit raises fears that widespread over-indebtedness may result, especially among first-time or low income borrowers who are the traditional customers of micro-credit institutions.
- Over-indebtedness on a large scale soon becomes a systemic risk in exposed banking systems. Such fears are grounded in recent examples: developing countries such as Bolivia (1999) and South Africa (2002) have already witnessed credit 'busts' with systemic consequences; and the U.S. and other developed financial systems are struggling with similar circumstances arising from the bursting of the sub-prime housing bubble.
- The spread of new communications technology is leading to more rapid diffusion of information, making consumers more aware of their choices and able to report abuses.
- The internet has also linked activist groups opposing exploitative lending across the globe, increasing pressures to adopt common standards which are often based on developed country norms.[3]
- The relaxation of interest rate ceilings has been linked as a quid pro quo with greater consumer protection (Patrick Hohonan, 2004).

The Focus Note considers first the traditional case for protection, in the light of new evidence from behavioral economics about how people reach financial decisions. Weighing this evidence, and understanding which groups bear the burden of proposed measures, is essential to calibrating the policy trade-offs in a way which will lead to better outcomes. Then, the Focus Note explores the various categories of consumer protection measures and discusses how regulation may best be enforced.

2. *Full Steam Ahead for Retail Lending in Emerging Markets* by Scott Bugie, Standard & Poor's Research report.

3. As one example, see the Global Fair Banking Initiative, based in the US and hosted by the National Community Reinvestment Coalition, but with networks in Europe and developing countries such as India, South Africa and Brazil. http://www.ncrc.org/global/aboutGFBI.htm.

As a result of these increasing calls for consumer protection, policy makers and regulators in a number of developing countries such as South Africa or Mexico have introduced new legislation[4] which protects borrowers; or in countries such as India, they have comprehensively reviewed existing lending laws.[5] Meanwhile, in the United States, financial regulators are being forced to consider new approaches to borrower protection in response to the sub-prime lending crisis there.[6]

“The credit market is not a risk-free arena. There is considerable imbalance of power between consumers and credit providers, consumer education levels are frequently low, consumers are mostly badly informed about their rights and unable to enforce such rights through either negotiation or legal action...”

MAKING CREDIT MARKETS WORK, 2005
(Sections 1.9, 1.10)

SELF-REGULATION

One important response on a global basis grew out of a meeting of microfinance leaders, including investors, practitioners, researchers and donors from around the world in April 2008 in Tarrytown, New York. The group resolved that among the most important issues moving forward was to create a set of principles for consumer protection to be adopted by the industry. That initiative has been called the Campaign for Client Protection and is led by CGAP and the Center for Financial Inclusion at Acción. The initiative emphasizes self-regulation through voluntary conformance by microfinance institutions and outlines six concrete actions[7]:

1. Preventing over-indebtedness
2. Transparently pricing and advertising loans
3. Maintaining the privacy of client data
4. Instituting fair loan collection practices
5. Enforcing ethical staff behavior
6. Implementing ways for customers to easily resolve disputes.

THE REGULATOR’S DILEMMA

These steps towards regulation or self-regulation are important and may be necessary, but are not without costs. Confronted by these growing pressures, policy makers and regulators face a classical example of what has been called the “regulator’s dilemma” (Porteous 2006): whether to intervene in credit markets in ways that may slow or hinder the broadening of access to credit in the interest of greater safety for consumers who already have access. The negative consequences may be exacerbated if a political backlash results in hasty or ill conceived measures which destabilize the lending sector as a whole. At the heart of successfully resolving this dilemma, as in all such dilemmas, is the process of carefully evaluating the inherent trade-offs.

4. South Africa’s National Credit Act was passed in 2005; and fully implemented in 2007; Mexico’s Ley de Transparencia, covering various aspects of the financial sector, was passed in 2007.

5. The RBI’s *Technical Working Group to Review Legislation on Money* reported in mid 2007; available via www.rbi.org.in.

6. See for example the *New York Times* article “Fed Shrugged as Subprime CrisisSpread” by Edmund Andrews, 18 December 2007.

7. Full disclosure: I am a member of the Center for Financial Inclusion Advisory Council and have been a consultant to CGAP. For more on the consumer protection initiative see http://www.accion.org/Page.aspx?pid=1392.

The case for consumer protection

"The credit market is not a risk-free arena. There is considerable imbalance of power between consumers and credit providers, consumer education levels are frequently low, consumers are mostly badly informed about their rights and unable to enforce such rights through either negotiation or legal action…Over-indebtedness has a negative impact on families and has in extreme cases even led to family suicides. Over-indebtedness further has an impact upon the workforce, can lead to de-motivation, absenteeism and even a propensity to commit theft."

Making Credit Markets Work, 2005.
Extracted from Sections 1.9 and 1.10

The lack of access to appropriate credit is today often seen as a bigger policy problem than exploitation, which, when it occurs, may affect only a small minority.

This extract from a policy document on consumer credit issued by the South African government expresses the conventional view among many policy makers that credit is to be handled with care: and all the more so among vulnerable groups like first time borrowers or low income people. This view is the basis for most borrower protection laws. At the same time, the so called "microfinance revolution" has provided abundant evidence that the poor may eagerly seek and diligently repay formal microcredit, much of which has been extended in environments with little or no formal consumer protection. In fact, many microfinance proponents have argued vociferously in favor of removing the longest standing borrower protection measure, namely interest rate ceilings, on the basis that these impede the flexibility of new types of lenders to offer appropriate size loans at sustainable rates.[8] The lack of access to appropriate credit is today often seen as a bigger policy problem than exploitation, which, when it occurs, may affect only a small minority. However, the burden of new protection measures may fall on poor people who are denied access as a consequence.

This growing recognition of the trade-offs from consumer protection has given policy makers pause. Nonetheless, many credit markets today exhibit at least some of the factors which are considered indicators of consumer abuse, such as:

- Signs of over-indebtedness among significant groups of the population;
- Widespread usage of unregistered lenders (where there is a requirement for lenders to register);
- Low levels of consumer understanding of implications of credit contracts and legal rights;
- Discrimination among borrowers for reasons unrelated to their credit risk; and
- High levels of complaints about lenders.

8. E.g. Helms & Reille (2004), "Interest Rate Ceilings and MicroFinance—the Story so Far" CGAP *Occasional Paper 9*, 2004.

The evidence of these warning signs is not limited to developing countries; in fact, the list above is mainly drawn from a 2003 official review of the workings of the UK's retail credit market.[9] The problem in most developing countries is that there is no systematic approach to collecting information which would enable the extent or the form of alleged abuses to be understood and monitored beyond the level of anecdotes or rhetoric. For example, while many central banks attempt to measure levels of indebtedness over time, few have defined the concept of "over-indebtedness,"and fewer still have attempted to monitor this over time. It is not easy to do, as Box A below shows. It is easier to measure the numbers of complaints received about lenders, as a number of countries already do (see Box B), but even then, these statistics have to be carefully analyzed, tracked over time and understood in context to be useful for good policy.

9. See DTI (UK) (2003).

10. *Feasibility 2007*, p.

11. *Tackling Overindebtedness Annual Report 2005*, p.7.

BOX A: DEFINING AND MEASURING OVER-INDEBTEDNESS

Several countries have tried in recent years to define and measure levels of over-indebtedness. Here are some examples:

In **South Africa**, a consumer is defined as over-indebted in Section 79(1) of the National Credit Act if "the pre-ponderance of available information at the time a determination is made indicates that the particular consumer is or will be unable to satisfy in a timely manner all the obligations under credit agreements to which that consumer is party..." However, a 2007 report for the new National Credit Regulator, a state agency explicitly charged with monitoring these trends, concluded that it was not possible to determine the extent to which this applies with any accuracy, but recommends a way to proceed: "because of the diversity of data sources, it has not...been possible to assess trends in overall levels of indebtedness. While (central bank) figures reflecting the ratio of household debt to disposable income do reflect a rising trend, the National Credit Regulator should consider instituting a regular monitoring process that incorporates a statistically valid sample reflecting all parts of the household sector and the entire range of incomes...This would provide an early warning system for the Regulator and may also assist the monetary authorities."[10]

In the **UK**, a detailed study for the Department of Trade and Industry in 2005 found that "a small but significant minority of the population continues to be severely affected by problem debt...Over-indebtedness has significant costs for individuals, creditors and societies as a whole." However, the report found mixed signals of the overall level and pattern. On the one hand:
In the UK, a detailed study for the Department of Trade and Industry in 2005 found that "a small but significant minority of the population continues to be severely affected by problem debt...Over-indebtedness has significant costs for individuals, creditors and societies as a whole."[11]
However, the report found mixed signals of the overall level and pattern. On the one hand:

- The number of borrowers who report finding their current repayments very burdensome was low and stable;
- The number of individuals in arrears is low and static;

On the other:

- There were rising calls to debt advice agencies (although it was acknowledged that this could imply that people are being more proactive in accessing advice);
- Personal insolvencies were rising;
- The Bank of England indicated that lenders and individuals may be underestimating their own long term vulnerability.

The report was prepared as part of a review of the progress of the UK government's Action Plan for Tackling Over-indebtedness, announced in 2004.

In **Mexico**, financial services consumer protection agency Condusef estimates in 2007 that 700,000 borrowers (in an adult population of some 65 million) may be over-indebted but there is no official definition.

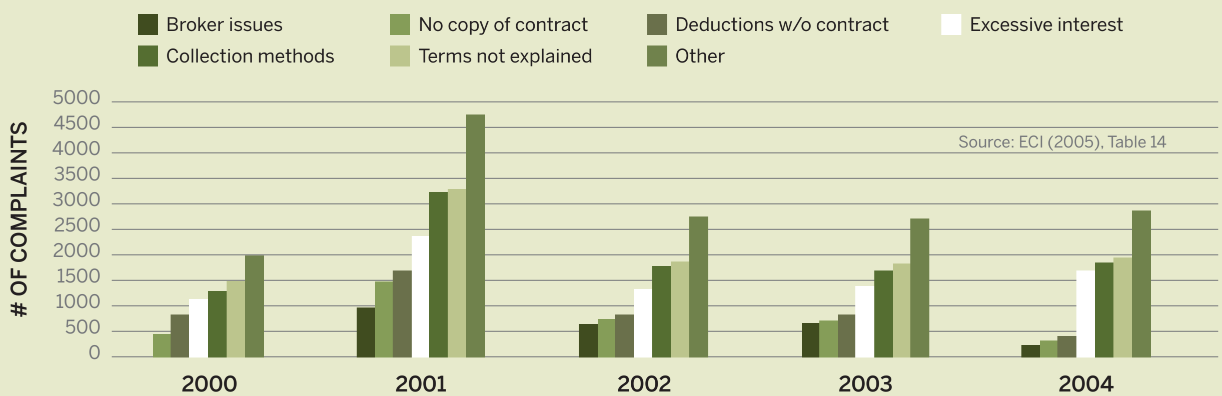
In **India**, although there is also not an official definition of over-indebtedness, the issue often features in politicians' speeches.

BOX B: TRACKING GRIEVANCES

Countries differ widely in the ease with which consumers can register complaints, and also how they track consumer grievances, making comparison difficult. Nevertheless, some indicative information can be gleaned from the reports of various official bodies in a sample.

South Africa's Microfinance Regulatory Council (MFRC) kept detailed statistics on complaint calls by category received from the public (via a toll free number) about small loans of all types which fell under its ambit. These numbers are shown in Figure 1 below for 2000-2004. While the Figure shows that the absolute volume of complaints is stable in nominal terms in recent years, complaints have declined in relative terms because of the soaring number of borrowers and new credit contracts since 2003. The nature of complaints has also changed considerably over the time in response to changes in MFRC rules and crackdowns on different areas of lender abuse.

FIGURE 1: MFRC COMPLAINTS RECEIVED



The Reserve Bank of **India** reported that the number of complaints received about banks had increased 500% to 34,499 in the year to June 2007. Not all are related to credit, and very few to microcredit since banks provide little directly, although credit cards are a significant source of complaint for clients of the private banks. It is not clear, however, whether the increase was the result of worse service or more demanding (or simply more) retail customers.[12]

In **Mexico**, CONDUSEF, the agency charged with protection of clients of financial institutions, also publishes a detailed annual analysis of all consumer grievances against financial institutions by type of institution, by product, by region and by action. The most recent *Annuario Estadistico* (2006) shows a year on year decline in total number of actions; and that of the 329,120 actions involving consumers, the banking sector generated the second highest proportion (pensions were highest); and for banks, credit-related actions constituted around half of the total actions, with issues relating credit cards the largest single sub-category.

New insights from behavioral economics

Experiments in behavioral economics have demonstrated that human attitudes and actions have systematic patterns which deviate from the rational; and that these deviations have important effects on credit markets.[13] Even when human beings are well informed about their choices, they are inherently subject to behavioral biases, including:

12. For the news story on the report, see http://www.livemint.com/2007/12/10010910/500-surge-in-complaints-again.html.

13. For a summary of experiments, see Ariely (2008) or in shorter form, the review by Kolbert (2008). Mullainathan and Krishnan (2007) apply some of these insights specifically to microfinance.

VULNERABILITY TO MARKETING

Lenders can frame offers of credit to exploit the psychological biases of borrowers, reducing the need to discount the interest rate to attract them. For example, people may appear risk averse with respect to losses but risk loving with respect to gains. A random trial of differing loan offers made to a large number of clients of a consumer lender in South Africa found that, in the face of confusion, potential borrowers were more likely to take-up offers framed in the simplest terms (Bertrand et al 2006). In addition, certain features completely unrelated to the loan—such as a picture of a pleasant, smiling person on the offer letter—also made take-up more likely. These framing effects did not reduce with more educated or wealthier borrowers; or even with those who had had more credit activity in the past, suggesting that it may not be first-time borrowers or low income people alone who are vulnerable. While people are often unaware of their personal blindspots, lenders usually are, and may actively seek to exploit these tendencies. This may constitute a case for protection.

As credit exposes certain human vulnerabilities, it may also ameliorate others…

Vulnerability does not automatically lead to abuse, although it may heighten the risk.

THE VALUE OF COMMITMENT

As credit exposes certain human vulnerabilities, it may also ameliorate others: for example, credit can serve as a disciplining mechanism which poorer consumers use to overcome the commitment problem of keeping to a savings routine; and they are willing to pay high interest rates for this discipline (Mullainathan & Krishnan 2007). Alternatively, poorer consumers who have access to formal microcredit may nonetheless continue to draw on more expensive sources of credit like informal money lenders because of their greater flexibility in response to changing and uncertain life circumstances. Reducing the supply of such credit arbitrarily (or increasing the cost) through regulatory action may not in fact improve the welfare of poor people who depend on it to cushion income shocks.

ADDRESSING VULNERABILITY THROUGH PRODUCT INNOVATION

Vulnerability does not automatically lead to abuse, although it may heighten the risk. This risk can be managed in different ways. Product features and contract forms can be designed to 'nudge' clients away from the direction of their bias without forcing them (Thaler and Sunstein 2008). This can be done through a range of mechanisms.

Simplify and standardize disclosure requirements. This may reduce confusion and reduce the risk that framing may lead to poor decisions.

Allow consumers to "opt out." For example, implement credit insurance that is provided with the loan at a fee unless the customer declines it.

Facilitate discipline. Ariely (2008) has proposed—without success so far—that U.S. banks issue a credit card with the ability of the holder to impose ceilings on categories of expenditure via the card, thereby providing an automatic means of budget enforcement. Transactions above the monthly threshold in a category would be declined; and the card holder would have to go through a procedure to override her self-imposed limit. No one would be forced to take the card, but consumers who are concerned about lack of ability to keep to budget could opt for this.

Let customers "cool-off." Another approach to addressing temptation is to provide an easy exit if a borrower decides that a credit purchase was made unwisely: some credit laws provide for a statutory "cooling off" period which allows borrowers to cancel a loan contract without penalty or specific reason within a certain number of days of closing.

Managing the dilemma of access versus protection requires a clear understanding of what the costs and benefits of each measure may be.

The regulators' toolkit: Scope and enforcement methods

Better product design can clearly help to address vulnerabilities; but not everyone responds to nudges.[14] And even nudges, which seek to avoid paternalistic coercion, may require regulation to give effect to them.

The case for introducing or changing any regulatory measures rests not only on the evidence of abuse supposedly being addressed, but also on the assessment that the benefits of intervening exceed the costs.

Additional costs of compliance may be directly levied on lenders; but they can usually pass these on to borrowers, whether through higher charges, less appropriate product designs or even through denying access to small loans for riskier or unknown borrower types. Managing the dilemma of access versus protection requires a clear understanding of what the costs and benefits of each measure may be. UK authorities now undertake regulatory impact assessments of new or changed laws. These assessments attempt to measure the costs and benefits in general, and across certain specified affected groups—for example, differentiating among small, medium and large providers; and even among different groups of con-

14. For further suggestions in this line, see Barr, Shafir & Mullainathan (2007) or Thaler & Sunstein (2008).

sumers.[15] While quantification of some costs and benefits is not easy, the discipline of having to consider these explicitly is often helpful in itself.

Regulatory measures for borrower protection measures fall into three conventional categories: disclosure, product based and provider based regulation.

1. **Disclosure regulation:** These laws standardize the information presented by lenders during the marketing process and/or at time of contracting for credit products in order to inform consumers better of the terms and conditions. In particular, regulation often prescribes the manner in which the interest rate and other charges must be calculated and disclosed. There has been considerable debate about whether the Annual Percentage Rate (APR) approach favored in the U.S. (which expresses finance charges as an annual rate equivalent) or the total cost of credit (TCC) approach (which adds total charges over the life of the contract, usually normalized per $100 of loan) used in countries like South Africa is easier to understand and apply. In addition to disclosure at the level of the individual contract, some laws, such as Home Mortgage Disclosure Act in the US, collect information on lending patterns and practices by lender and by area. This information is then disclosed and can be used as part of evaluating the conduct of lenders and the credit supply in different areas

2. **Product based regulation:** This addresses various aspects of the lending product and process itself, regardless of the creditor, including such common elements as:

   - **Right to cancel:** The ability of the borrower to cancel a contract during an initial cooling off period without penalty, mentioned above, or to repay early with a pre-agreed and often limited penalty;
   - **Prohibited behavior:** Certain types of selling or collection behavior are commonly prohibited or penalized; in particular, some jurisdictions define 'reckless' or 'predatory' lending; however, this can be hard to define, and harder to enforce in practice as discussed in Box C below;
   - **Right of grievance redressal:** Providers may be required to have defined grievance procedures for their customers and to provide more effective channels to arbitrate credit disputes and claims, especially on small amounts, outside of overloaded court systems.

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15. See for example, the RIA on the Consumer Credit Act Disclosure Regulations 2004, available via http://www.berr.gov.uk/files/file23063.pdf.

Product based laws may differentiate their application based on factors relevant to the risk such as:

- Maximum loan size, on the assumption that above a certain size threshold, consumers are wealthy or informed enough to take care of themselves;
- Type of loan contract: certain loan types may be considered especially high risk because of factors such as the term or size relative to the borrower's total assets: on these grounds, the UK's credit regulation regime provides heightened protection for mortgages compared with other forms of credit.

3. **Provider based regulation:** This category provides for the registration and regulation of defined classes of lenders who are in the business of providing credit, whether financial institutions or retail stores. These entities may be required to provide regular information on their activities in order for regulators to monitor at the level of the firm and the aggregated industry; and they may even be subject to other forms of market conduct supervision by the credit regulator, such as mystery shopping or on-site inspections of their lending practices and records.

16. http://www.fdic.gov/news/news/financial/2007/fil07006a.html.

17. See http://www.stopmortgagefraud.com/signs.htm.

BOX C: RECKLESS OR PREDATORY LENDING: WHAT IS IT AND WHAT TO DO ABOUT IT?

Reckless or predatory lending can take many different forms, with the result that law makers and regulators in various countries have struggled to define it adequately in a way that prohibitions or penalties can be enforced

In the **U.S.**, the definition used by the Federal Deposit Insurance Corporation (FDIC), which regulates and supervises member banks, is "the lack of a fair exchange of value or loan pricing that reaches beyond the risk that a borrower represents or other customary standards."[16] This definition is quite general, however. The Stop Mortgage Fraud campaign of the US Mortgage Banker's Association has suggested a checklist of ten warning signs of predatory lending. These include process indicators such as missing or blank signed documents, as well as outcome indicators, such as higher than anticipated payments or costs, or a loan amount larger than the amount of the collateral.[17] In response to rising concerns over predatory lending, the FDIC policy statement of January 2007 states that lenders will be subject to heightened supervision and, in terms of enforcement: "When examiners encounter loans with predatory characteristics, the lending practices will be criticized as unsound. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including applicable state laws or the Federal Trade Commission (FTC) Act prohibition against unfair or deceptive practices, the FDIC will take appropriate action... Actions range from commitments to formal enforcement actions under Section 8 of the FDI Act."

South Africa's National Credit Act of 2005 prohibits credit providers from entering reckless credit agreements. An agreement is defined as reckless if, at the time of entering it, the provider failed to conduct an affordability assessment; or if, having done the assessment, the preponderance of evidence suggested either that the borrower did not understand the agreement or that it would make the borrower over-indebted. (S80(1)). If a court finds an agreement to be reckless, then it may set aside or suspend it. However, if it can be shown that a consumer has failed to fully and truthfully respond to the lender's requests for information during the decision process, this provides a full defense against recklessness by the lender. Courts are therefore left to enforce the definition of reckless lending.

The 2006 Consumer Credit Act in the **UK**, introduces a broad new level of protection against what is called 'an unfair relationship' between a borrower and lender, replacing the term 'extortionate credit bargain' in earlier legislation. The Act does not define this other than by setting out circumstances which a court should consider, such as the terms of the agreement and the way the creditor has acted. Some guidance has been issued by the Office of Fair Trading, which also has expanded powers and a broader range of sanctions which it can take against lenders (see Kempsen 2007).

Table 1: Legislative approaches compared

	INDIA	MEXICO	SOUTH AFRICA	UK
A. CATEGORY OF PROTECTION APPLICABLE				
1. DISCLOSURE	Apparently not	Yes- by provider class	Yes	Yes—under Consumer Credit Act
2. PRODUCT BASED	No	No	Yes—Applies to all credit transactions by individuals or small formal businesses (<$150 000 assets)	Yes—all forms of consumer lending
3. PROVIDER BASED	Yes—money lenders licensed at state level; otherwise, must register as bank or non-bank finance co.	Yes—all complaints about financial institutions are handled by CONDUSEF	Yes—all credit providers must register with regulator	Yes—consumer credit license required
B. SUPERVISION & ENFORCEMENT	RBI for banks and NBFCs; state level authorities for money lenders	Bank regulator CNBV for banks; Condusef for financial institutions	National Credit Regulator, a statutory body	FSA for mortgages; Office of Fair Trading for rest; large measure of self-regulation for non-mortgage through Banking and FLA Code
C. SOURCE	Centre for Micro Finance research 2008	Ley de Proteccion y defensa al usuario de servicios financieros 1999	National Credit Act No.34 of 2005	Consumer Credit Act and FSA Conduct of Business Rules for mortgages

Table 1 on page 12 shows that many regulatory regimes have some or all elements of these measures to some degree. While the scope of borrower protection may appear similar on paper, the biggest differences in the level of effective protection arise from:

Patchy coverage. Certain laws apply only to particular institutional types: often, measures apply in effect only to classes of entities such as banks, because they are subject to other forms of supervision, or members of lender associations with their own market conduct rules. The resulting gaps may give unregulated or unregistered lenders with a higher risk of poor market conduct room to maneuver. The worst (but all too common) outcome of borrower protection is when those entities most inclined and able to serve customers well are penalized through being subject to heavy handed regulation, while higher risk providers escape official scrutiny or sanction altogether.

Consumers' lack of financial literacy. Financial literacy includes knowledge of financial concepts and sound practices such as budgeting, but also the contractual rights and recourse procedures open to consumers. Disclosure requirements work best when consumers are literate and able to use effectively the information provided. But even literate consumers may be confused by complex choices; and increasingly, though it may be necessary, disclosure is seen as a "not sufficient" aspect of a protection regime. In fact, most countries have low levels of literacy according to various measures. For example, FinScope surveys in South Africa and Tanzania in 2006 found that around two thirds of all adults (and slightly more among poorer consumers) did not understand the concept of "interest."[18] Findings like these have led financial regulators to place much more emphasis on developing or supporting consumer financial education programs. The results to date are in general mixed, as shown in Box D below.

Disclosure require-ments work best when consumers are literate and able to use effectively the information provided. But even literate consumers may be confused by complex choices.

18. Data from FinScope South Africa and Tanzania; questionnaires are available via www.finscope.co.za.

19. Hilgert and Hogarth (2003), using data from US Survey of Consumer Finances.

20. Available via http://www.oecd.org/document/28/0,2340,en_2649_201185_35802524_1_1_1_1,00.html.

BOX D: FINANCIAL EDUCATION: HOW EFFECTIVE IS IT?

In general, it is hard to measure the effect of financial education (Lusardi 2007). Empirical research has found strong linkages between better informed consumers and better financial practices, but the causality is often unclear: does higher literacy lead to better practice; or does more practice simply result in higher literacy? Many financial literacy programs rely on providing information or increasing knowledge, but this does not necessarily result in a change in behavior. Research suggests the links to desired practice are strongest when linked to "a teachable moment"—for example, providing home loan education when a consumer is first searching for a house; or retirement financing when entering the workforce. Most people continue to learn from family and friends; but if there were to be a scale rollout, using popular media such as TV or radio would be important.[19] In developing countries, financial education programs are generally new (Sebstad et al 2006) and have not been subject to rigorous evaluation.

Nevertheless, many financial regulators, like the UK's Financial Services Authority (FSA), South Africa's National Credit Regulator or Mexico's Condusef, now include consumer education as an integral part of their mandate. Funding large scale roll out of education programs can be problematical however: for this reason, financial institutions in South Africa voluntarily committed to giving 0.2% of their profits towards increasing financial literacy under the Financial Sector Charter. In 2005, the OECD published a comprehensive analysis of issues and policies for Improving Financial Literacy which serves as a useful guide.[20]

Weak or no enforcement. Whatever the coverage of the law, unless there is the capacity to monitor lender and borrower behavior and enforce penalties and remedies, any protection regime will be ineffective. The scope of the consumer protection agencies differs considerably from country to country: in the UK, general consumer protection regulators such as the Office of Fair Trading are involved alongside the FSA for mortgage credit. In Mexico, a specialized financial agency (Condusef) addresses grievances and consumer financial education. More specialized still, a statutory credit regulator (suitably named the National Credit Regulator) oversees all retail credit markets in South Africa. These agencies differ widely in their internal capacity and funding.

Self-regulation has been recommended in microfinance circles in the absence of, and as a more flexible alternative to, state-based regulation of market conduct.

In some countries, industry bodies play a role in self-regulation: defining standards of lender behavior through codes of practice for their members. Self-regulation has been recommended in microfinance circles in the absence of, and as a more flexible alternative to, state-based regulation of market conduct. For example, the Client Principles, developed by the international SEEP MFI Network, have been applied by a number of microfinance organizations across a range of countries since their adoption in 2005. A 2006 Progress Note provides some examples of how it is being applied.[21] At the national level, MFI associations like SaDahn in India have also defined codes of lending conduct for members.[22] Some of the main elements of these codes are compared in Table 2 on page 15.

The evidence of the effectiveness of self-regulation in financial services is mixed: particularly when members suffer little or no effective loss as the result of breaking a code, self-regulation is unlikely to be effective. However, even if signatories do adhere to their own code, the presence of large numbers of non-members with poor lending practices raises the risk of a general backlash. This would affect compliant and non-compliant firms alike, reducing the incentives for costly participation in the first place. The self-regulation of non-mortgage lenders in the UK offers an interesting exception: Kempsen (2007) reports that it has in general been quite effective. Several reasons stand out, some specific to the UK market situation, but others more general. For one thing, in a sector with a relatively small number of players such as the UK banking sector, the incentive is stronger to avoid the negative publicity arising from self-disciplinary action. More generally, the incentives to comply are also stronger when the members are also subject to prudential oversight by bank regulators who, in their own dealings with a bank, may take into account its poor track record with self-regulatory bodies. Furthermore, enforcement is taken seriously: an independent monitoring body, the Banking Code Standards Board, which has a majority of independent

21. SEEP Network, Progress Note No.14, October 2006.

22. See http://www.sa-dhan.net/corevalues.pdf.

Table 2: Comparing the coverage of self-regulatory codes in microfinance

	SEEP CLIENT PRINCIPLES	SADAHN CODE OF CONDUCT FOR MFIS	MLA CODE OF CONDUCT
APPLICABLE TO	Signatories to the principles—MFI networks	Member MFIs in India	Member institutions (micro-lenders in South Africa)
DATE ADOPTED	2005	2006	
AREAS COVERED BY CODE			
1. QUALITY OF SERVICE	Yes	Yes	Yes
2. DIGNIFIED TREATMENT	Yes	Yes	Yes
3. APPROPRIATE DISCLOSURE OF TERMS AND RATES	Yes	Yes	Yes
4. APPROPRIATE PRICING	Yes (fair prices, reasonable returns and greater outreach)	No	Yes (market related)
5. PROTECTION FROM UNETHICAL AND ILLEGAL PRACTICES	Yes	Yes	Yes (lending rules)
6. PRIVACY OF CLIENT INFO	Yes	No	Yes
CORE VALUES		Yes	
COMPLIANCE MECHANISM	None	Ethics & Grievance Redressal Committee appointed by Board	Following Disciplinary procedure as set out in constitution

directors, applies considerable resources to enforcement, including compliance monitoring, published reports on compliance and a strict disciplinary procedure.

The power of other means of private enforcement is growing as a result of the growth of e-commerce communities such as eBay which rely primarily on feedback mechanisms such as buyer rating; and also have their own low cost dispute resolution mechanisms. While easy access to the internet may be beyond the foreseeable reach of most borrowers in developing countries, mobile phones have become an important communication channel which may be used for information and feedback—consumers may contact an information or complaints hotline at low cost; and can easily communicate negative experiences with a lender to their friends or the media.[23] Publicity around the complaints record of institutions—rewarding the good and shaming the bad—may have some effect on lenders' behavior if communicated widely enough. New technology may enable more effective private enforcement in credit markets, but the development of credible new approaches with sufficient influence and profile is likely to require encouragement and support from policy makers and regulators.

In many developing countries, the rights of lenders have often not been adequately protected in the past, resulting in a limited supply of formal credit to riskier or poorer customers. This is changing as credit markets have been liberalized in many places and new laws have been introduced regarding borrower collateral or access to borrower information.

Navigating the dilemma: conclusions

While the trade-offs underlying this particular dilemma—access and protection—may be very real to policy makers in the short to medium run, the trade-off may be smaller in the long run. After all, developed countries have both high levels of access to formal financial services, and relatively elaborate consumer protection measures after four decades of evolution. However, elaborate does not necessarily mean effective: widespread credit abuse with systemic consequences still occurs. As a result, consumer protection regimes continue to evolve in developed countries. While lessons can be learned from their experience, they must be applied with care to developing countries which have credit markets at very different stages of maturity and growth.

In many developing countries, the rights of lenders have often not been adequately protected in the past, resulting in a limited supply of formal credit to riskier or poorer customers.[24] This is changing as credit markets have been liberalized in many places and new laws have been introduced regarding borrower collateral or access to borrower information. Maintain-

23. To be sure, new technologies in financial services also raise many issues for consumer protection—as an introduction to the issue, see Lyman, Pickens and Porteous (2008).

24. Based on a large sample of indicators collected across countries as part of the World Bank's annual Doing Business survey, Djankov et al (2006) find that better creditors' rights correlate with greater development of private credit markets.

ing a balance between borrower and creditor rights appropriate to the maturity of a particular credit market in the context of national priorities is an ongoing challenge for policymakers who aim to support healthy inclusive credit markets. While it may be a necessary step now, improving creditor rights alone may not be sufficient for the long term growth of healthy credit markets: widespread perceptions of consumer abuse may generate a political backlash against lenders. Even the threat of a backlash may keep reputable lenders out of the riskier niches of the market, leaving them to those with the least interest in developing a sound business for the long run.

Policy makers seeking to balance creditor rights and borrower rights need not feel trapped in a zero sum game. Navigating a course out of the dilemma requires an evidence-based approach so that policy responds both to the goals of public policy and to the real risks faced by consumers and the financial sector. This will require collecting accurate and timely information on macro trends, such as the extent of over-indebtedness, as well as institutional level data, such as complaint trends. In addition, policy makers may consider using randomized trials to test the effectiveness of different policy approaches to enforcement and financial education. Using this information, clear policy statements help to bring greater certainty to all credit market participants, borrowers and lenders alike. Good policy will also take into account the need for careful sequencing when changing legal and regulatory frameworks. Examples of recent policy statements can be found in the UK's 2003 white paper Fair, Clear, Competitive: Consumer Credit Market in 21st Century and South Africa's (2005) Making Credit Markets Work: A Policy Framework for Consumer Credit.

Above all, a proportionate approach to consumer protection avoids a "rush to regulate."[25] Inappropriate regulation, or even appropriate regulation without the necessary enforcement capacity, can hinder and damage nascent credit markets in developing countries by causing further fragmentation. Greater emphasis on consumer protection is necessary; but deciding on when, and in what form, to introduce it is a vital dimension of the regulator's dilemma today.

25. As coined by Bob Christen and Rich Rosenberg in the context of prudential regulation of microfinance, CGAP Occasional Paper No.4, 2000.

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