Financial consumer protection – goals, opportunities and problems

HANS BÄCKSTRÖM
Hans Bäckström works as an analyst at Finansinspektionen (Finandial Supervisory Authority). He has previously worked at the Riksbank, the Ministry of Finance and SEB. He has also worked as secretary in a number of government inquiries, among others the Financial Market Inquiry and the Commission on Business Confidence.

REMIT OF SUPERVISION

The remit of Finansinspektionen the Swedish financial supervisory authority, primarily concerns two things: promoting a stable financial system, and contributing to adequate consumer protection in the financial area.[1]

The motives for specific government interest in conditions in the financial market can be summarised as follows:

- **The financial sector is important for the functioning of the economy.** Financial regulation and supervision is ultimately aimed at ensuring financial systems and markets are economically efficient. It must be possible to make payments, trade in securities and arrange credit in principle in all situations. Otherwise the entire economy will incur major costs and losses.
- **The financial sector is sensitive to disruptions that can easily spread.** This is because primarily banks have a liquid liability side on the balance sheet (in the form of deposits) and an illiquid asset side (in the form of lending), while financial firms are closely intertwined financially. Consequently liquidity disruptions or weakened confidence in a participant often also rapidly affect other participants. The risk of disruptions spreading and destroying the financial sector's ability to function is called systemic risk.
- **The market cannot deal with systemic risks alone.** Disruptions of the order that threaten the system can neither be prevented nor dealt with by the firms alone. Consequently the Government has an important part to play in the financial area, for example through regulation and supervision.

[1] See for example *Government Bill 2010/11:1* (Budget Bill): "The overall objectives of Finansinspektionen are to promote stability and efficiency in the financial system and consumer protection in the financial area […]."

- **Even small participants can have a negative impact on the market.** Normally it is only the major financial firms, in particular the major banks, that have the potential to create direct, acute threats to systemic stability. However, even minor participants can impact the functioning of the market negatively, for example by damaging confidence in the market.[2] In other words, even for minor actors, there are sometimes externalities, and thus also systemic aspects, that should be considered.
- **The consumer is often at a great informational disadvantage in relation to the producer.** Systemic risks are not the only reason for central government interest in the financial area – the need for consumer protection is another. Financial services are in fact often complicated, while often involving large amounts of money for the individual. It is true that the need for consumer protection is not unique to the financial area, but nevertheless there is a considerable difference in degree compared with most other areas, partly because it is often difficult even with hindsight to assess the quality of the services.
- **Consumer protection has two dimensions** *One dimension* concerns protection of consumers' assets and claims, which the financial firms manage in one or another form. For this, it is not sufficient for the "system" as a whole to be stable. Individual financial firms must also be financially and operatively stable, so that they can fulfil their commitments to savers, insurance policy holders and investors. *The second dimension* of consumer protection is about ensuring that consumers receive correct, relevant and understandable information about the services offered and that the service terms are reasonable.

Delving more deeply into what these objectives entail and how they can or should be managed, it quite soon becomes apparent that these are complex objectives that often require weighing up with discernment.[3] Nonetheless the financial stability objective can now be regarded as reasonably well defined from an analytical starting point. The objective is also well accepted among market participants – there is a broad consensus on the necessity of central government involvement, as well as agreement on the overall principles for how the Government and the Riksbank should act and the allocation of roles between them.

---

[2] Carnegie and HQ Bank, which were subject to Finansinspektionen's intervention in 2007 and 2010, can be seen as examples of this. In some situations a minor participant can also have significance for the stability of the system, which was most recently exemplified in autumn 2008.

[3] As an example: that a bank is financially stable is a central consumer interest. But basically stability is a matter of the bank's profitability, and profitability can be based on the consumer paying high interest rates and charges to the bank.

However, it is a different picture as regards the goal of adequate consumer protection. There is an all-pervasive lack of precision and clarity in laws, regulations and authority, both as regards what precisely consumer protection in the financial area should entail and as regards who should be responsible for what. The latter concerns the balance between consumers' own responsibility, firms' responsibility and government responsibility. Central government responsibility must in turn be allocated between different agencies, mainly (but not solely) between Finansinspektionen (FI) and the Swedish Consumer Agency.

At the same time, measures that concern consumer protection are often the part of financial supervision that most closely affect and are monitored by the general public and the media. It is a problem that the goals and division of responsibilities are unclear, and this also makes it difficult to communicate what financial supervision does (or does not do) and why. Therefore, there is reason to discuss and try to develop ideas about and approaches to financial consumer protection. This article aims to discuss some – but not all – aspects of this.

Why consumer protection?

SOME REASONS

Central government involvement in consumer protection in many areas and different forms can be justified on the basis of different premises. One reason, which is often central but will not be discussed more here, is redistribution policy: just as in many other areas, there is reason here to assume that people with less education and lower incomes in general not only have poorer previous knowledge, but also fewer possibilities of seeking and evaluating information, lodging complaints, bringing legal action etc. Consequently they also have a worse bargaining position in relation to companies.[4] Accordingly, action to increase consumer protection can be of benefit in the first place for the weak groups in society. Not least in the United States, the financial sector specifically has been used as a channel for pronounced socio-political and redistribution policy ambitions: the notoriously famous *sub-prime* loans are an (obviously unsuccessful) example.

Another approach to consumer protection is to see government initiatives as a way of creating a better balance between the market participants – producers and consumers – so that the market is ultimately more effective. Focus then falls on representing the general interest of consumers rather than on giving advice and help to individual consumers.

[4] See for example Campbell, Jackson et al., The Regulation of Consumer Financial Products: An introductory Essay with Four Case Studies.

This view proceeds from the premise that the consumer is at a more or less typical structural disadvantage, since

- the consumer finds it difficult to assess the producer's willingness and ability to meet its commitments, particularly in the longer term
- the consumer has less access to relevant information about the goods or service
- the consumer has neither practical nor theoretical qualifications for taking in and acting rationally on the basis of the information available.

FI tries to deal with this by means of three main types of supervision:

- Monitoring firms' financial and operative stability, in other words ensuring that consumers' assets are secure and that the firms can deliver what they have undertaken to deliver.
- Ensuring that firms are owned and run by reputable people, for example by examining the conduct of owners and company management. These can then be expected to have the objective of providing information to their customers as well as treating them correctly and honestly in other respects.[5]
- Ensuring that firms provide correct and relevant information to consumers, manage conflicts of interest efficiently and otherwise deal with their customers in an acceptable way.

Expressed in another way FI's consumer protection policy means that FI is to draw up rules as well as control and monitor firms and markets that consumers are unable (or only with difficulty are able) to monitor themselves.

In addition, in recent years, FI has, on the instructions of the Government, tried to reduce the informational disadvantage by promoting better consumer education. The purpose is to try and achieve a higher level of knowledge of financial matters. Consumers are to receive a kind of assisted self-help, so that they will be better equipped to make their own rational decisions when confronted with financial offers and financial information.

Knowledge disadvantage as a base – but is the financial sector unique?

The basic view is that, on the whole, the consumer is rational and fully capable of making sensible decisions – provided that he or she receives relevant and comprehensible information. But is the information imbalance between seller and buyer in the financial sector so unique as to motivate

[5] "Fit and proper" is of course a basic prerequisite for an efficient financial market, from both the systemic and the consumer perspective.

this special attention from the public authorities? A person buying a car or a house – also costly and complicated products – is normally at a clear knowledge disadvantage too in relation to the seller.

The role and place of consumer protection in the context of supervision and regulation has been more or less prominent over time, to some extent depending on the issues that were in focus in economics and the financial market. The Bill for the new banking legislation that came into force in 2004, which was based on the Banking Law Committee's Report and to a great degree was a response to the stability crisis of the 1990s, states the following:

> **"The objectives of government policy in the financial area are to promote a stable and effective financial system with good consumer protection. Effectiveness and consumer protection are not, however, unique objectives for the financial area but general objectives that can be said to apply to the entire economy."**

The text of the bill can be interpreted to mean that systemic stability is the entirely predominant interest, and that there are really no specific consumer protection problems for the financial sector. This interpretation is strengthened in that the Bill does not raise any arguments or considerations concerning consumer protection in other respects.[6]

But even if one considers consumer protection issues in the financial area to be of a special nature, accordingly justifying special government measures, it must be remembered that far from all financial services are expensive, difficult to assess or have some other quality that justifies government involvement. For example, no sophisticated financial knowledge is needed to select and use basic payment services or a home insurance policy.[7] There are also great differences both in demand for financial services and in the need for protection between different individuals, depending on factors such as income, education, age and attitude. Hence the need for consumer protection varies a great deal for different parts of the financial product range and for different individuals – which in practice means that one cannot pursue a meaningful consumer protection policy either for financial services in general or for consumers in general. Instead the financial supervision related to consumer protection, just as the systemic supervision, must focus on the areas in which there are clear risks and problems.

---

[6] See *Government Bill 2002/03:139*, "Reformerade regler för bank- och finansieringsrörelse (Reformed rules for banking and finance business), p. 156. If the interpretation is correct, the consequences of the argument were not on the other hand fully fulfilled, because if systemic stability were the only material and unique objective of government activity in the financial area then FI's supervisory remit should reasonable have been radically redrafted. Only a fraction, at a high estimate 1 per cent, of the 3,900 or so firms currently subject to FI's supervision, can be regarded as obviously relevant to systemic stability.

[7] What is meant here is that it is fairly simple to understand the principle structure and function of a home insurance policy. But the more specific conditions, as to when and how the insurance policy can be used, may of course be quite complicated.

In the same way there are more circumstances that make the picture more complicated in the financial area than in most others. Apart from the basic fact that financial firms are entrusted in various ways to manage the vast majority of people's financial assets – which already in itself imposes special requirements on how the firms conduct their business – there are also some more specific aspects to take into account; namely that

- some products have a decisive significance for the customer's entire financial situation
- some products have a very long "delivery period", such as pension savings
- it is often difficult for the customer, even with hindsight, to determine whether the product was good or bad, and the extent to which this was due to the merit or fault of the producer.

If we return to the comparison with buying a car or home, in those cases it usually becomes more clearly and rapidly evident whether the products have delivered what they promised, as well as what this is due to. The fact that it is so difficult to evaluate the quality of financial services with reasonable speed and precision also means that it is difficult to manage the problems by means of guarantees, which otherwise constitute a market solution that usually functions well for other complex products, such as cars.

This gives a special dimension to the need for government regulation and supervision. An area that in some respects is very similar to the financial area is health care: here there is often the same combination of complexity, major and long-term significance for the individual's life situation and difficulties in evaluating effects and quality. And for exactly these reasons health care is also an activity that has advanced control procedures and regulations (for example licensing requirements), and is subject to government supervision (in this case through the National Board of Health and Welfare) – just because the consumer interest must be safeguarded.

The importance of confidence

The complexity of the products is, in addition, an important reason for the admittedly woolly and sometimes misused concept *confidence* being of such central importance to the financial sector, just as it is to health care. A basic objective for financial supervision is to reduce the consumers' information disadvantage. But it is unrealistic to believe that

the disadvantage can be completely eliminated – a clear difference will remain, even in the best of worlds. If the customer does not otherwise have the knowledge, time or possibility to match the producer's knowledge advantage, he or she faces two alternatives: either to buy the service and trust that the producer is competent and serious, or to do without the service. The latter may in some cases be impossible in practice, or at least both risky and costly. In other words, confidence must take over where certain knowledge ends – if any exchange is to take place.[8]

Hence the information imbalance is an important reason why confidence is an important factor in the financial market.[9] Another important factor is that there are very clear externalities, so that the problems of confidence in a firm or a sub-market easily spread to others. In some cases, problems of confidence can also directly threaten stability. The classic type of financial crisis – a run on a bank – is the obvious example. The global liquidity problems in the autumn of 2008 may very well also be seen as an outflow of inadequate confidence between the participants.

On a market with the desired level of confidence, market participants can buy and sell while being reasonably certain that they will not be swindled, that agreements will be kept and that counterparties will comply with the rules, both written and unwritten. Insufficient confidence impairs the market's functioning and efficiency, while a failure of confidence forces counterparties to seek protection via more or less expensive insurance arrangements, detailed agreements and so on. Confidence is thus not only a feel-good factor, but is also very much a matter of efficiency.[10]

However, the existence of confidence on a market does not imply that the market may (or even should) be risk-free. Confidence means that the meeting of seller and buyer – the implementation of the transaction and the information surrounding this – works in the expected correct manner, but not that the outcome of the transaction is guaranteed in any sense. For example, the assumption that a fund manager will always provide a yield of x per cent is an expression of wishful thinking, rather than constructive confidence.

---

[8] Conversely, no confidence is needed in the seller if the buyer knows all the relevant facts about the product. It is not necessary to have confidence in a tobacconist to dare to buy an evening paper or a bar of chocolate.

[9] In discussions of the confidence concept it is often maintained that confidence is not a quality in itself but rather an expression of a *relation* between two or more parties. The quality that makes such a relation possible is *credibility,* which in turn may be a function of factors such as competence, transparency and integrity.

[10] There exists a quite comprehensive body of literature that describes and analyses the significance of trust and confidence, sometimes designated *social capital*, in economic development. Chapter 2 of the Commission on Business Confidence's report (SOU 2004:47) presents a relatively detailed discussion of this subject.

Society can contribute towards the strong build-up of confidence in various ways. This is primarily a matter of creating rules, monitoring compliance with these rules and intervening against those who break them. One concrete example is the "fit and proper" assessment carried out by FI, which is aimed at preventing individuals with criminal records or who are otherwise obviously unsuitable from conduct-ing financial operations. However, the government can only provide a wide-meshed net. The necessary, more finely-meshed net is formed by the ethical standards and attitudes existing and being developed on the market and in society in general. This also includes a measure of healthy scepticism and critical thinking, based on the realisation that any market will always include opposing interests.

BUT ARE CONSUMERS REALLY RATIONAL?

The basis of FI's consumer protection policy has, in general, always been formed by the unstated principle that consumers are essentially rational – the problem is a lack of information and a lack of knowledge of how to process information. Being able to remedy this would also mean, in principle, solving the consumer protection problem.

When a consumer receives correct and relevant information about a product and can understand this information, that consumer thereby becomes responsible for taking more or less high-risk financial decisions – and for bearing the consequences of those decisions. According to this approach, the government cannot – and should not – provide safety nets against financial risks, or even prevent individuals from consciously choosing to take financial risks.[11]

However, in recent years, certain events have cast a somewhat new light on the aims and means of consumer protection.

In general, it can be said that the financial crisis has resulted in greater attention being paid to the phenomenon of "insufficient rationality" in market behaviour. The fact is that the crisis brought to light quite a full and varied range of behaviours and phenomena that can hardly be described as rational. This has led to renewed interest in behavioural economics, an area in which research has long focused on developing a more realistic view of people's ability to act rationally, as well as incorporating this into economic theory.

More specifically, attention has been paid to problems of rationality in conjunction with the debate on text loans, as well as the mortgage ceiling decided upon by FI during the autumn. The mortgage ceiling can be seen as a measure intended to do more than merely trying to give

[11] The former is, of course, a precondition for the latter, if a serious moral hazard is not to arise.

consumers more and better information, as it means that FI is specifying a general ceiling for consumers' risk exposure for credit in which housing forms the collateral. Very high mortgage loans may indicate that certain borrowers have failed to understand the risks they are taking, but may also mean that certain borrowers have overexposed themselves to financial risks in an irrational manner, even though they have, in principle, understood the risks. In such cases, the regulations can be interpreted as indicating that FI actually does not accept the ability of certain consumers or borrowers to act in a long-term and rational manner.

It could thus be said that, apart from being ill-informed, consumers are also showing signs of various behavioural disorders. The basis of such behavioural disorders is that consumers are short-sighted or otherwise systemically irrational when it comes to certain financial decisions. In addition, it may be that consumers – or, for that matter, producers – take excessive risks in certain situations, as they expect (with or without justification) that somebody else (the government) will bear the cost of an unfavourable outcome. This is what is known as moral hazard.[12]

The basic issue is thus whether (and under which circumstances) it is reasonable and acceptable for an authority to reject consumers' rationality and directly or indirectly force different behaviour. Does an authority have the right to act as a guardian?

For one thing, it could be said that, for better or worse, there are fairly abundant elements of this within many social areas. Alcohol policy is an obvious example; the law on compulsory seat-belt usage is another. The list of such regulations is very long, and proposals for new initiatives of this kind constantly come and go in the political and media debates. Extra taxation on sweets and unhealthy food, compulsory cycle helmets and quotas for parental allowances are just a few examples that have circulated recently. Indeed, the financial regulations have long included such elements, even if these have not been dominant. For example, the following can be found in FI's general guidelines 2005:3 *(Finansinspektionen's general guidelines regarding consumer credits):*

> **"For mortgages, the lender should make an estimate of housing costs as part of the assessment of the borrower's debt-servicing ability. The borrower should be informed of the content of this estimate, as well as the fact that it may be affected by agreed but as-yet unimplemented amendments to the tax and benefit systems that may be of considerable importance. The borrower should also be informed of the impact of changed interest rate levels on the estimate."**

[12] As regards loans to households, it may be noted that banks and other lenders are not particularly motivated to be restrictive in their lending, as individual persons can never normally have their debts written off, for example via bankruptcy. Whatever happens, the bank will have the entire lifetime of the client in which to get back the money lent. This allows it to feel fairly secure.

Of course, this is partly intended to ensure the lender manages its own risks as regards the borrower, but it also embraces the ambition that the consumer should avoid becoming unsustainably indebted. The text also implies that the client is unable or unwilling to understand the risks this entails. Another example can be found in insurance, in which both deductibility for pension savings and the rule that pension savings may not be withdrawn before the age of 55 basically express the ambition of "helping" savers act in a way that will be beneficial in the long run.

Are consumers under-informed, irrational or both?

THREE MODELS

The principal basic issue is thus one of how the consumer is regarded as a participant. Is the consumer well-informed or uninformed, rational or less rational? Is the consumer informed or rational in certain regards and in certain situations, but not in others? What is the rule and what is the exception? These assessments provide the basis for our view of the need for consumer protection and how this should be formulated.

Neoclassical economists discussed the concept of *the economic man*, a buyer or consumer who, like the producer, was thoroughly well-informed and entirely rational. If we accept that this is a reasonable approximation of reality,[13] there is hardly any need for any consumer policy whatsoever, neither in the financial area nor in any other area.

The next stage of the development of economic theory involved the modification of the hypothesis of perfect information. Within many areas – with the market for used cars forming the classic example[14] – the seller has a near-total informational advantage over the buyer, even if the buyer is completely rational. This conceptual model forms the starting point for the consumer protection philosophy applied by FI. The producers have a knowledge and informational advantage that FI wishes to help reduce, or at least to deal with in a manner that makes the consumer into a more equal partner on the market.

If another step is taken in this review of the neoclassical hypotheses, the assumption that the consumer is always or almost always rational disappears. This is the basis of so-called behavioural economics, which attempts to integrate a psychologically more realistic view of how consume-

[13] However, it should be pointed out that no serious economist has ever believed or claimed that this model depicts empirical reality, particularly not on the individual level. A theoretical model should be seen as a map, making it easier to find a path through the landscape. By consciously simplifying and refining reality – sometimes to a very far-reaching extent – basic driving forces and mechanisms can be exposed. A theory or model should be evaluated on the basis of how helpful this process is. The naïve criticism that economic theory and economic models do not describe "reality" in a detailed and recognisable manner is thus usually entirely meaningless.

[14] George Akerlof (1970), "The market for 'Lemons': Quality Uncertainty and the Market Mechanism" in *Quarterly Journal of Economics* 84(3).

rs actually act.[15] For example, a study by the UK's FSA (Financial Services Authority) claims that psychology governs peoples' actnal behavions on the Financial markets, rather than their knowleadge and insights.[16]

DIFFERENT LEVELS OF IRRATIONALITY

In rather more concrete terms, this means that, among other problems, information overload must be considered. This refers to the time taken and the major practical difficulties than may often be encountered by individual consumers when looking for, receiving and selecting information, and when choosing and implementing the decisions that will maximise their benefit. Certain studies have shown that excessive amounts of information or too many alternatives lead to less advantageous decisions. This overload of information and choices can also lead people to avoid or postpone making decisions.

Consumers thus do not at all need to be "stupid" to act irrationally. This can just as easily be a consequence of the consumer not having the time or interest to absorb, assess, and act on available and correct information. It may also be the result of the consumer lacking the knowledge needed to evaluate this information. However, at this point, it should be said that this is an issue of inadequate capacity as regards receiving and processing information, rather than irrationality in the usual meaning of the word.

It can also be observed that many decisions that could be classed as irrational are due more to great uncertainty or high risk propensity than to normal stupidity – decision-making may entail a clear risk, but also a reasonably decent chance that things will turn out well. For example, a person borrowing extensively against his or her home is certainly taking a major risk, but *may* also be a winner if interest rates, housing prices, income trends and so on go his or her way. No matter how much we may doubt the chances of a positive outcome, it still cannot be ruled out – and there is, of course, reason to point out that nobody, not event government authorities, actually *knows* how the future will turn out. Many apparently irrational financial decisions thus share the characteristics of games of chance – although with considerably greater stakes, it could be added.

---

[15] This is discussed in *Beteendeekonomi och konsumentpolitik* by Robert Östling, published by the Ministry of Integration and Gender Equality, 11 March 2009. See also *Consumer Financial Protection* by Campbell-Jackson et al.

[16] Several investigations have demonstrated that the fairly widespread attitude towards financial issues as being a boring subject is, in practice, a major reason for many decisions being made on the basis of insufficient knowledge.

FAULTY LOGIC MANIFESTED

Alongside this, another well-known characteristic of the human mind is that decision-making is sometimes not just a matter of finding the time to read and obtain information, or of taking high but basically calculated risks – at certain times, we may also prioritise short-term goals at the expense of long-term ones, make obviously incorrect risk assessments, and generally be inconsistent in our decision-taking. It is possible to make an almost endless list of everyday examples of this: we don't do as much exercise as we know we should, we cycle without helmets, we eat too many sweets and too much unhealthy food, we ignore car seatbelts and take out horribly expensive text loans late at night.

In recent years, relatively comprehensive research has been conducted into these issues. A few phenomena that could be cited as examples of irrationality follow:[17]

PROBLEMS OF SELF-RESTRAINT

Problems of self-restraint can play a part in any decision that entails some form of short-term sacrifice in order to achieve an improvement in the longer term. This may be a matter of refraining from consumption here and now in favour of saving for a pension (for example), but could also be a matter of smoking, frequent consumption of alcohol or unhealthy food, avoiding physical exercise or many other behaviour patterns. In all of these cases, there is a risk of failing to meet more long-term interests. An argument could thus be made in favour of public measures to help citizens with these problems of self-restraint – such as government pension and social insurance systems, increased taxation on tobacco and alcohol, and so on.

FRAMING EFFECTS

Framing is an issue of how the alternatives in a decision are presented and linked to other decisions in a more or less relevant manner. One form of framing that is often used in the context of advertising is the claim that a customer would be able to save money by purchasing a product at a reduced price, even though a saving would only be made if the customer bought the product at the normal price level – which is not necessarily a relevant comparison. Another type of framing effect is sometimes called mental accounting: having one "mental account" for small expenses and another for larger expenses. This can take the form of not hesitating to pay SEK 50,000 for extra furnishings for a new house or new car, at

[17] See Kahneman, D.; Tversky, A.: "Prospect Theory: An analysis of Decision under Risk" in *Econometrica* 47(2), 1979. See also Östling: *Beteendeekonomi och konsumentpolitik*, p. 17-27.

the same time as great effort is expended on finding minced meat at a bargain price.

LOSS AVERSION

Psychological experiments have demonstrated that people are often more sensitive to losses than profits – that is, a loss is experienced as being worse than a correspondingly great decrease of profit. Loss aversion means that the reference point that determines what is defined as a loss or profit becomes decisive. For example, the purchase price of a product may form one such – more or less relevant – reference point.

It has also frequently been demonstrated that people are more risk-inclined when it comes to losses than profits, in the sense that, for example, gamblers (and investors!) who have incurred great losses can take very high risks when attempting to "win back" these losses – in other words, throwing good money after bad.

CALCULATIONS OF PROBABILITY

In traditional economic theory, the implicit assumption is that most people have a generally correct view of the probability distribution of the various conceivable outcomes of investment decisions or loan decisions (for example), and will act accordingly. However, many common and systematic deviations from the expectations considered reasonable according to probability theory have been documented. For example, there seems to be a systematic tendency among many people to overestimate risks with low probability or limited potential consequences, and to simultaneously underestimate risks with higher probability or with greater negative consequences, and to act accordingly. This may explain why many people are happy to pay expensive insurance policies for their television sets, but cut corners when it comes to householders' comprehensive insurance or accident insurance, and why many people significantly increase the risk of being affected by serious traffic injuries (and fines) by speeding, even though the amount of time gained is usually marginal.

Is irrationality systematic?

It seems almost trivial to observe that the hypothesis of the inadequately rational consumer would seem to be true in light of how people actually behave in their daily lives. Almost all of us – the author of this article included – will no doubt recognise themselves in several of the examples given above. But, even so, this is *not* sufficient justification to abandon the hypothesis of rationality as a defining feature when describing and analysing consumer behaviour and the need for consumer protection.

The issue is thus whether, and to which extent, there exists a system of *classification and dominance* as regards irrationality. It is entirely possible to maintain the basic assumption of rational behaviour among individual consumers if their behaviour over a longer time span is examined. A person can be considered to be generally (if not perfectly) rational, even if they do occasionally make mistakes. And, as regards consumers as a whole, it could also be imagined that mistakes and bad logic among different individuals largely cancel each other out. Consequently, the facts that a small number of individuals consistently behave in a more or less idiotic manner, and that the overwhelming majority now and again take less sensible decisions, does not mean that irrationality should be seen as characteristic and standard behaviour. Therefore neither should it for the *starting point* for policy and analysis of consumer protection. On the other hand, it is a factor that should be considered.

A few conclusions regarding regulation and supervision

In which respects, then, can we state that there exists a both marked and systematic irrationality in market behaviour that should affect the formulation and application of a financial consumer protection policy? Of course, here there exists a serious problem in that this cannot be supported by quantitative data, not even in indicative form, as far as is known.

However, it would not be going too far to regard the circumstances mentioned as being so common and, in certain contexts, so significant that they should be included and weighted into discussions on the formulation of regulations and supervision.

The next stage is to then figure out how and in which way irrationality should be handled within the framework of FI's consumer protection policy.

An obvious and basic problem for any party wishing to intervene so as to correct this irrationality is that the party performing the correction – usually the state in some form – does not necessarily have the correct information or otherwise know best. This suggests that restraint and caution should form the basic approach in government attempts at correction. It should also be remembered that FI cannot regulate consumers' behaviour, only *companies'* behaviour. The starting point then becomes preventing, through regulation, companies from improperly taking advantage (or attempting to take advantage) of consumers' weak sides in marketing, the presentation of information, the wording of agreements, and so on.

If FI is to intervene in an issue, and the motive for this goes beyond what may be considered traditional requirements for relevant and correct

information, it should firstly be possible to demonstrate clear indications of irrational behaviour to a significant extent in the case in question. These indications must also be well-founded. Secondly, it should be possible to demonstrate that this may lead to significant problems for individual consumers and for society. Thirdly, there should be convincing arguments that the measures to be implemented by FI are relevant and effective.

To sum up, five points for a general consumer protection policy for the financial area could be set down. FI should thus:

1) Ensure that companies have the necessary capital strength and risk management strategy to guarantee delivery capacity.
2) Ensure that consumers receive relevant, correct and comprehensible information on products, terms and conditions.
3) Support confidence in the financial market, its participants and its products, among other means by ensuring that companies are run and conducted by responsible individuals, and that they have functioning governance and control systems.
4) Promote increased knowledge of financial issues and products among consumers. Knowledgeable consumers create demands for increased efficiency and for better and more transparent products, at the same time as they reduce scope for less responsible participants.
5) Be able to intervene if and when there arise clear indications of systematically irrational behaviour among consumers that may have significant negative effects on broad consumer groups, and check these risks through regulations directed towards the financial companies, if this can be done in an effective manner.

In an abbreviated form, the first three points form the basis of the activities that FI has conducted, and continues to conduct, in the area of consumer protection. The fourth point, in which FI has made active efforts in recent years, forms an important complement to these points. The fifth point, finally, is a possibility that can be exploited in certain specific situations.

What is to be responsible and who is do what?

A TARGET-MEANS MATRIX

The discussion above has focused on how a government consumer protection policy in the financial area could be justified and how the content of such a policy could be formulated However, as stated in the introduction, the fairly significant lack of clarity on financial consumer protection does not just affect its targets, means and ambitions, but also how

responsibility should be allocated among different participants. Below, we present a few reflections on this latter area, focusing on the allocation of duties and responsibilities on the government side.

In the introduction, a few of the basic targets for financial supervision were discussed. It could be said that supervision has two main targets, which in turn can be broken down into different sub-targets that can be and ought to be handled with partially differing methods. The figure below is an attempt to structure this.[18] Obviously, such attempts always entail a certain measure of simplification and standardisation of reality – this is no exception. The boundaries between the different boxes are far from being as sharp in reality; to a certain degree, this is a matter of the same things being considered from different angles. The figure still fulfils the function of starting point for determining the type of issues to be covered by supervision and the manner in which supervision may be organised and structured. It should otherwise be noted that the management of individual consumers' business and problems is not charted here, as such management does not come under the normal meaning of supervision. At the same time, it is obviously an important activity – and one which requires great resources – when consumer protection is considered in the whole of its extent in society.

TARGET / SUPER-VISORY FOCUS	PROTECTING THE SYSTEM	PROTECTING THE CONSUMER
STABILITY (*Prudential Supervision*)	Financial and operative stability and adequate risk management among central financial companies.	Strong financial stability and risk control in companies administering client assets. Commitments towards depositors, insurance policyholders, fund-unit holders etc. must be fulfilled.
MARKET CONDUCT and INFRASTRUCTURE "fit and proper"	Transparency and security in trading systems, on marketplaces and in clearing and settlement. Functioning governance/ control, accountancy and auditing of financial companies. Counteracting finance-related crime, among other means through background checks of owners and management.	Correct and relevant information to consumers and investors, reasonable terms and conditions, and correct treatment of clients. Raising consumers' awareness, in certain cases acting directly in consumers' long-term interest.

[18] An earlier variant of the figure can be found in *SOU 2003:22*, "Future financial supervision".

The problems of how supervisory targets are to be formulated, and of how and by whom supervision is to be conducted, have been concentrated, with some simplification, in the box at the bottom right. The two uppermost boxes are quite unambiguous and well-defined, and quite obviously form the core of financial supervision. The bottom left box is also largely a natural task for financial supervision, even though there are grey zones in which other authorities must also act. The optimum allocation of duties and responsibility between authorities is also far from self-evident here.

As regards the lower right square – that is, topics that should generally be associated with the concept of consumer protection – the allocation of duties and responsibility is significantly less clear. To start with, responsibility is divided between FI and the Swedish Consumer Agency, on the basis of different regulatory platforms: FI acts on the basis of commercial legislation (which includes operating regulations and other specific financial legislation), while the Swedish Consumer Agency acts on the basis of the Swedish Marketing Act and the Swedish Consumer Contracts Act, among others. In addition to this, a number of other participants are involved, for example the consumer departments – institutions for advising and assisting individuals, co-financed by government and industry – and the National Board for Consumer Complaints (ARN). Unlike FI and the Swedish Consumer Agency, the consumer departments, ARN and the Consumer Ombudsman (KO) pursue individual consumers' cases.

This fragmented structure is probably dubious from an efficiency viewpoint, and is definitely poor from a consumer viewpoint – it is not easy for a consumer to know to whom to turn in the event of a problem. It is true that FI has long had a both comprehensive and formalised cooperation with the Swedish Consumer Agency, but, from the consumer's perspective, this does not solve the problem to any great extent.

Consequently, this has been discussed repeatedly and in different contexts. Occasionally the solution has been advanced that the Swedish Consumer Agency should take all (or a larger share) of the responsibility (as in the Consumer Policy Commission[19]), occasionally that FI should take a clearer leading role (as in the Commission on Business Confidence[20]). However, at the same time, in both of these cases (as in others), several problems have been noted as regards concentrating activities into one authority. In FI's case, the risk of conflicts of interest and resources that may arise in certain situations has been pointed out. In the Swedish Consumer Agency's case, it has been pointed out, among other misgivings, that the Agency lacks the competence and closeness to the financial

[19] *SOU 2000:29*, "Starka konsumenter i en gränslös värld".
[20] *SOU 2004:47*. See particularly Chapter 10.

market considered to be important for supervision to be effective. Consequently, in both of these cases, the proposals have ended in a shifting of focus rather than in any streamlining.

The development of consumer protection that has certainly taken place in recent years – for example, the increased resources allocated to the consumer departments and FI's active work on consumer education issues – has thus been within a mainly unchanged, and fragmented, responsibility framework.

So are there any new facts on the table that could justify a new approach? Perhaps, perhaps not. The various arguments for and counter-arguments against the solutions put forward over the years are still relevant. But changes in the financial and institutional environments also mean that different arguments and aspects can both increase and decrease in relevance and strength, so that a solution that was appropriate yesterday may be less appropriate today, and entirely inappropriate tomorrow.

Two clear and important factors are at play in this context.

- The importance of strong consumer protection on the financial markets is growing at the same rate as the range of financial products offered to households becomes increasingly comprehensive and, in certain areas, increasingly complex.
- Financial supervision focused on stability is being assigned increasingly comprehensive tasks, among other reasons due to the increased international harmonisation of regulations (both in the EU and globally), which both entails more comprehensive regulations in many areas and also makes tighter international supervisory work necessary. This process has been further hastened by experiences during the financial crisis.

In other words, both of the main areas of financial supervision are facing increased pressure and an increased need for renewed efforts. Viewed from the point of view of a supervisory authority, this may lead to different conclusions. On one hand, it can be seen as an argument for more and stronger efforts – and for increased resources – in both supervisory areas, so that knowledge of the different aspects of the financial sector's conditions can be used in a coordinated manner and synergies between the different areas can be exploited. On the other hand, it can also be seen as a reason for streamlining activities, in which the financial supervisory authority would focus on one or more of the boxes in the figure above, while another body assumes responsibility for the other boxes.

Examples abroad

The United States Congress decided during the year to concentrate and upgrade consumer protection work in the financial area. To do this, the Consumer Financial Protection Bureau was founded within the framework of the Dodd-Frank Act. The intention is for the authority to have a strong and independent position and to be able to work broadly, both with overall issues and with concrete assistance to individual consumers. Financial education is also one of its defined areas of activity. The authority will have its own budget, albeit within the framework of the Federal Reserve, the US central banking system.

In the United Kingdom, the Financial Services Authority (FSA) has, for many years, had a broad supervisory role as regards financial consumer protection. Roughly transposed to Swedish conditions, it could be said that the FSA combines the roles of FI and the Swedish Consumer Agency (in the financial area) under the same roof. This year, with the Bank of England having been given the specifically overriding responsibility for the financial stability system, a shift in focus has taken place regarding the FSA's tasks, which can now be said to be more focused on consumer protection in a broader sense.

Interesting changes in the institutional circumstances of important countries in our geographical area have thus taken place recently. Even though foreign solutions and experiences seldom or never can be copied directly into Swedish circumstances, there is still, obviously, every reason to examine what may be relevant and applicable in this country.[21]

Some alternative models

One solution inspired by the new US model, based on the principle of streamlining, could be to restrict FI's remit to financial *companies* and the relations between these. FI would then no longer be involved with relations between companies and consumers. Instead, this responsibility could be transferred to the Swedish Consumer Agency, possibly in cooperation with the consumer departments, or to a new authority for financial consumer protection with some features in common with the new US authority and/or the FSA, if it is deemed that financial consumer protection needs a well-defined mandate and resources of its own. In

[21] See, for example *A Report on the Mandate, Structure and Resources of the Swedish Financial Supervisory Authority* by Howell E. Jackson, James S. Reid (2010), p. 34: "In recent debates over financial consumer protection in the United States, one of the most contentious issues was the relationship between the newly created Consumer Financial Protection Bureau and traditional supervisory agencies. While the resulting legislation is hardly a model of jurisdictional clarity, the legislation does offer one approach to separating supervision from consumer protection and Swedish officials might wish to consider how the United States has addressed this matter".

such a case, FI's consumer protection responsibility should be delimited as capital value protection (that is, companies' financial and operative stability) – a task closely connected with the system stability target.

This would mean clearer mandates and clearer responsibilities for all authorities involved, which would be positive from all aspects, not least for consumers. In addition, FI would have a clearer focus, as it would be possible to decrease the number of companies under FI's supervision considerably. The fact is that several categories of financial company are without relevance in the aspects of both systems and capital protection (for example, non-life insurance companies and insurance brokers). In this case, FI should not have any supervisory responsibility over these companies.

An alternative model could be for FI to maintain and broaden its role to also include those aspects of financial supervision currently carried out by the Swedish Consumer Agency, but for this to take place in a part of FI that has its own mandate and its own budget – which be necessary to avoid resource conflicts. The connection to FI's other activities would be through the coordination of administration and policy. Such an arrangement would have a certain relationship with the proposals previously put forth by the Commission on Business Confidence. Such a model could possibly also be applied if, and to the extent that, FI is allocated further supervisory tasks outside the core area of financial supervision.

To sum up, no obvious optimal solution exists for presentation at this point. But the growing demands being placed on the different areas of financial supervision are making it necessary to develop both clearer and more expedient organisational solutions than those we have at present.

References:

OFFICIAL SWEDISH PUBLICATIONS::

SOU 2004:47: Confidence in Business (Summary) (Commission on Business Confidence).

SOU 2000:29: Starka konsumenter i en gränslös värld (Consumer Policy Commission).

SOU 2003:22: Future financial supervision (Summary).

Government Bill 2002/03:139: Reformerade regler för bank- och finansierngsrörelse (Reformed rules for the banking and finance business.)

OTHER:

Akerlof, G.: "The market for 'Lemons': Quality Uncertainty and the Market Mechanism" in *Quarterly Journal of Economics* 84(3) (1970).

Campbell, J., Jackson, H. et al.: Consumer Financial Protection (2010).

Campbell, J., Jackson, H. et al.: The Regulation of Consumer Financial Products: An introductory Essay with Four Case Studies (2010).

De Meza, D., et al.: Financial Capability: A Behavioural Economics Perspective, issued by the Financial Services Authority (FSA) (2008).

Jackson, H.; Reid, J.: A Report on the Mandate, Structure and Resources of the Swedish Financial Supervisory Authority (2010).

Kahneman, D.; Tversky, A.: "Prospect Theory: An analysis of Decision under Risk" in *Econometrica* 47(2) (1979).

Östling, R. Beteendeekonomi och konsumentpolitik, Ministry of Integration and Gender Equality (2009).