Review of Consumer Protection Code – Consultation paper CP 47

Submission by:
Andrew Caslin (3rd year Economics student, UCD) and,
Caolán O'Callaghan (3rd year Bachelor of Actuarial & Financial Studies student, UCD)

Introduction

We congratulate the Central Bank of Ireland for conducting a review of the Consumer Protection Code and wish to make a submission. We would like to contribute in relation to two matters: (i) the regulation of investment activities in the section of CP 47 headed '**Information about products**' addressing questions numbered 8 & 9; and (ii) continuing with the theme, 'information about products', information asymmetries between the depositor and the bank in the area of retail deposits. Before we do this, however, we feel it is necessary to make some comments on the the general process of investing.

General Comments on the Investing Process

We are of the view that an investor is interested in putting together a portfolio that maximises the return, subject to such design constraints as risk, liquidity, and taxation. We could not find any reference to the word 'portfolio' anywhere in CP 47 whereas in marked contrast, the word 'product' appears 348 times. We believe that there is perhaps too much regulatory emphasis on products and and not enough emphasis on building investment portfolios that deliver returns for consumers subject to such constraints as risk, liqudity and taxation. Despite its 348 appearances in CP 47, we were unable to find a definition of the term 'product' in the Consumer Protection Code, chapter 13, 'Definitions'. This over emphasis of the term 'product' and absence of any mention of diversification of investment portfolios in the building of portfolios to meet risk, liquidity and taxation constraints is a serious weakness of the Consumer Protection Code especially as diversification is a key tool in risk management. We believe that there ought to be a requirement in the Consumer Protection Code to put together investments with different outcomes in different market environments so that all of the elements of an investor's portfolio are very unlikely to fall in value at the same time.

Further, in relation to the 348 mentions of the word 'product', we humbly suggest that the Central Bank of Ireland give consideration to the idea that consumers don't want products, they want solutions to their investing problems that are in line with the constraints they face in terms of liquidity requirements, taxation and risk.

Comments on the Section of CP 47 Headed 'Information about products' - Question 8

Introductory Remarks

We would firstly like to say that we are delighted with the Central Bank's enthusiasm for wanting the consumer to understand and be presented with as much information about risk as is possible.

We believe that the concept of risk should be attributed the greatest weight of importance when dealing with the disclosure and understanding of investment portfolios and in our limited knowledge it seems important that a portfolio be tailored to the consumer's risk profile.

Question 8

Do you have any ideas about how to disclose risk in the case of investment products in a way that would be consistent enough to be useful for consumers?

We believe that the first thing that all potential investors should be told is that the outcome from making an investment is not certain. Advisers can help investors to reduce the chances of adverse outcomes by chosing a portfolio of investments with a likely return parameter subject to certain liquidity, taxation and risk constraints but they cannot guarantee that advsere outcomes will not occur despite their best efforts. We do not live in a world of certainty and we believe that the Central Bank of Ireland needs to emphasise that for its own protection and for the education of consumers.

We suggest that potential investors be asked: How much can you afford to lose if your investment portfolio had a 'bad year'? For some people, a loss of 5% of the value of their portfolio might be unacceptable; for others the figure might be significantly higher. For example, a person funding for retirement might not be able to afford the extra contributions required to 'restore' his pension to its previous high value if it were to say fall by more than 5% in value because the size of the pension fund close to retirmement might be a large multiple of his income.

We believe that at the very minimum, investors need to be provided with two important items of information about an investment portfolio: (i) the average annual return based on past data using the best available statistical techniques; and (ii) the size of the likely swings around that average. This information could be used to show investors the return in a 'bad' year which might be defined as the return likely to occur once in 20 years.

Example
An investor may choose between two portfolios, A and B, which have very similar tax treatment and liquidity characteristics. The investor would find a loss of more than 5% unacceptable. The figures for both portfolios are based on over fifteen years of past trading data.

Sample Disclosure
Portfolio A has an estimated average return of 6% per year but once in 20 years we would expect that the fund could suffer a loss of more 9%.

Portfolio B has an estimated average return of 4% per year but once in 20 years we would expect that the fund could suffer a loss of more than 3%.

Using this information, investors who accept that the oucome from making an investment is uncertain and who cannot bear a loss of more than 5% would clearly be reluctant to accept Portfolio A to meet their investment objectives.

We propose that a chart showing the distriubtion of a portfolio's returns be provided to investors in addition to the basic information in the box above.

The overriding principles for the production of the data might be as follows: (i) all the past performance of the elements of the portfolo must be used in calculating the figures; (ii) investors should be informed of the length of the past track record so that investors get some idea of the reliability of past performance information based on the size of the sample of return data; and (iii) portfolios that behave in a non-linear fashion like those containing written options would have to refelct the ultimate risk of the strategy should the options be exercised rather than rely solely on past performance where this was unrepresentative of the risk.

Once such a system is established, no regulated entity should be allowed to quote past performance figures without providing certain corresponding risk information.

The statistical models used by regulated entities to produce such distributions of return would be subject to audit by the Central Bank of Ireland in the same way as certain models are audited for use in loan loss reserving under the Capital Requirements Directive.

There is no perfect system for explaining risk to customers. We believe that the Central Bank of Ireland has to start with an approach and refine it as it

learns from its experience in much the same way that regulation develops over time in response to developments in the market regulated.

Question 9

We will now discuss question 9, the 'Traffic Light' proposal for risk disclosure.

"In a system such as a 'traffic light' system, how do you think the different categories of risk, i.e., red, amber, and green should be determined?"

If diversification of a portfolio is carried out successfully, it is possible in many cases for combinations of red (high risk) products to give a green portfolio because of the lack of correlation between the red products. However, after reading the consultation paper, it seems that these red products will be penalised even though the resulting portfolio is green (low risk).

A big question must also be addressed in relation to this traffic light system: Who decides which colour to assign to the different financial products and how are portfolios of products to be rated? This question brings the idea of anti-competitiveness to our attention. Suppose firm A, and firm B are selling the exact same product. Firm A assigns it the colour green, and firm B assigns it the colour red. Firm B is now faced with a competitive disadvatage because it feels it is under pressure to meet regulatory requirements in order to avoid sanctions. This idea is particularly relevant in light of the current economic climate, where competitiveness is key to rediscovering growth. We believe that a traffic light system is too simplistic and may lead to competitive distortions in the market.

The Central Bank of Ireland says it is considering this system of risk disclosure based on a number of factors, one of them being, 'the extent of leverage'. We believe that the focus should be on the risk of the leveraged portfolio and not on the level of gearing. For example, a cash fund leveraged 4 times carries nothing of the risk of an emerging market equity fund leverged 2 times. Yet by focusing on leverage rather than the risk of the leveraged portfolio, investors may be mislead into thinking that the 2x leveraged emerging market fund is some how a lower risk fund than the 4x leveraged cash fund. The risk disclosure we propose in the box above would clearly illustrate the difference in the risk of these two portfolios which is the key issue; the difference in leverage of the two portfolios is not as relevant as the difference in risk.

We believe that a 'traffic light' system provides no risk information and militates against regulated entities that build portfolios by putting together somewhat higher risk assets that are uncorreclated to produce lower risk portfolios which is good for consumers. The 'product' focus of the Consumer Protection Code will require that each element of the portfolio will be disclosed as high risk whereas the overall portfolio may be low risk because of the portfolios higher return and the lack of correlation between the elements of the portfolio. This is would be an absurd result.

Information Asymmetry – Retail Deposits

According to the introduction on page 3 of CP 47,

> *The purpose of the Code is to* ***ensure the same level of protection for consumers regardless of the type of financial services provider*** *they choose. It requires regulated entities to act in consumers' best interests by ensuring that they ...* ***provide them with appropriate information to enable them to make an informed choice****.* [emphaisis added]

At present, we have two major Irish banks which provide or certainly used to provide the bulk of retail deposit taking in Ireland. Credit defaul swap (CDS) spreads on banks provide information to bank counerparties, depositors in this case, on the cost of insuring against a default by the bank. Despite the fact that credit default swaps are not usually available to retail depositors, being confined mainly to instiutional investors, they provide valuable information to the depositing public. CDS spreads have been mentioned on and off in the newspapers since the time that the major Irish regulated banks began to exhibit significant impairments in their assets.

Publicly available information on credit default swap spreads at the time of writing this submission in early December 2010 suggest that the two major Irish banks had 5-year CDS rates of the order of 8% and 10%. By contast, another despit taking institutions in the Irish market had a CDS spread of just 0.7% at that same time.

The Central Bank of Ireland has defined a vulnerable consumer as '*a consumer that is vulnerable because of mental or physical infirmity, age, circumstances or credulity...*' In the presence of significant information assymetries, i.e. management of banks know the CDS spread of their entities whereas the retail depositor does not normally know the entity's CDS spread, almost every retail customer is a *vulnerable customer* and in our view they have been made more vulnerable by the fact that the Knowing the Customer and

Suitability requirements of the Consumer Protection Code don't appear to apply to demand deposit accounts and term deposit accounts.

CDS spreads vary daily and are quick to respond to new information on banks. Ongoing disclosure of CDS spreads by banks to their depositors would remove the information asymmetry and the trend in the CDS spread over time would provide an early warning system for both retail depositors and the Central Bank of Ireland alike.

We believe that the public display of the current CDS spread similar to the display of foreign exchange rates and the trend in the CDS spread within regulated Irish banks would be significantly more useful to retail depositors than 'traffic lights' which we respectfully suggest seem to be based on the notion that consumers are largely innumerate. If people can compare interest rates on demand deposit accounts, we respectully suggest that people would be able to distinguish between a bank paying 2% p.a. interest and a CDS spread of 0.7% and a bank paying 3.0% p.a. with a CDS of 10%.

We note that the Central Bank of Ireland believes (see page 8 of CP 47) '*that product disclosure needs to be improved and we are proposing new provisions setting out the information that must be provided to consumers about products*'. Yet we note the exemption granted by the Central Bank of Ireland to banks in relation to demand and term despoit accounts from the the *Knowing the Customer* requirement and especially the customer's attitutde to risk (Attitude to risk (in particular, the importance of capital securityto the cutomer)) **AND** the Suitability requirement (especially the requirement that *the consumer has the necessary … knowledge in order to understand the risks involved*). Given the signifcant credit risks that Irish retail depositors face in relation to the main Irish banks as measured by CDS spreads, we belive that the Central Bank of Ireland ought to act on its belief that product disclosure needs to be improved and mandate the disclosure of CDS spreads by banks to their deposit customers.

According to CP 47, the Central Bank of Ireland 's purpose of the Code is to ensure the same level of protection for consumers regardless of the type of financial services provider they choose yet investment product providers must disclose capital security whereas banks offering demand deposit accounts don't have to disclose risk statistics. It seems to us that the most vulnearable customers, retail depositors with small sums invested, have been abandoned by the Central Bank of Ireland in the failure of the code to require diclosure of the only key risk in reatil banking, credit risk. The Central Bank of Ireland has specifically exempted the banks it regulates from disclosing the

credit risk of their institutions. In fact, there seems to us to be no risk disclosure in relation to demand and term deposit accounts.

The Central Bank of Ireland might argue that the concept of a CDS spread is too difficult for a simple retail depositor. We would argue that if the disclosure of CDS spreads were mandated by the Central Bank of Ireland our excellent media outlets in this country would quickly find ways of explaining this concpet to potential retail depositors.

Closing Remarks

We thank the Central Bank of Ireland for the opportunity to comment on CP 47.