Central Bank Review of Consumer Protection Code

Consultation Paper CP 47
Submission by the Competition Authority

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The Competition Authority
An tÚdarás Iomaíochta

Introduction

The Competition Authority welcomes the review of the Consumer Protection Code as it serves to illustrate that consumer protection must remain at the centre of financial regulation even in these times of crisis for the banking sector.

The Competition Authority will not be commenting on each of the proposed changes in the Code; instead this submission is intended to provide general comments on the approach that the Central Bank has adopted in the course of this review in so far as it relates to competition in financial services.

The Competition Authority has published two comprehensive studies into the financial services sector; *Competition Issues in the (Non-Life) Insurance Market* in *2004 and Competition in the (Non-investment) Banking Sector in Ireland* in 2005. In these studies, the Competition Authority found that competition was not as vigorous as would be expected in a truly competitive market.

The study into the insurance sector found that persistently high profits among insurance companies, combined with slow rates of entry and low levels of cost reduction meant that consumers were getting poor value for money. The study made 47 recommendations, focusing on three areas: barriers to entry, ease of switching and price transparency. The majority of our recommendations (36) were addressed to the Financial Regulator. By the end of 2010, the Financial Regulator had addressed all the recommendations within its remit; some were addressed by the 2008 Review of the Intermediaries Market.

The study into the banking sector was focused on personal current accounts, working capital lending to small business and the payments clearing system which underpins them. It found that banks were not competing as vigorously for customers as they could. The Competition Authority made 25 recommendations to make personal current accounts and SME lending more competitive. These related to switching, transparency and access to the payments system for new banks. Considerable progress has been made in implementing the recommendations of our banking study with only three recommendations remaining unimplemented by the end of 2010.

A competitive financial services sector is good for consumers and the wider economy. Apart from contributing to economic stability, competition among well-run banks benefits consumers through quality and price. When reforming the financial industry, there should be enough room left for innovation and new entrants should not be faced with unnecessary barriers to entry.

It is therefore a welcome development that the revisions to the Consumer Protection Code in areas relating to intermediaries and consumer information will implement a number of the Competition Authority's outstanding recommendations.

New category of vulnerable consumer

The introduction of what is essentially an additional category of consumer is an acknowledgement that despite the considerable progress made in terms of consumer information, there are segments within the population that are at particularly high risk of exploitation.

There is growing evidence from the increasing number of mortgage arrears cases and the record level of complaints addressed to the Financial Ombudsman that consumers either didn't understand the full implications of the financial contracts they were committing to or they didn't have the correct information at the time they entered into these agreements.

Given the overall anxiety among many consumers about their financial situation and the low level of trust that exists between public and banks it would seem appropriate for the Financial Regulator should take further measures to protect consumers especially those with particular vulnerabilities.

Suitability of mortgages

One of the key proposals for review is that lending institutions should adopt a more rigorous approach towards assessing a customer's ability to repay before issuing a mortgage. In particular, a new stress test is proposed in which a mortgage holders ability to pay will be tested should interest rates rise by 2 per cent.

When carrying out the "Know the Consumer" and suitability assessment for a mortgage, the lending institution must use the Standard Financial Statement required under the *Code of Conduct for Mortgage Arrears* to obtain financial data from a consumer.

Tougher rules on mortgage lending will have no effect on competition so long as they are enforced across all institutions. However a commendable feature of this approach is that it builds on the regulations and codes of conduct which are already in place. Therefore, the additional compliance and enforcement costs of this new approach, both for institutions and the Financial Regulator, should not be significantly greater than their current level.

Product regulation

The new Code contains a number of new rules governing how institutions can market new financial products to the public. Institutions will be subject to enhanced disclosure and transparency requirements and will need to provide consumers with more information about the main features of a product, including the risks attaching to a product and the extent of any guarantee to be provided.

The proposals in the consultation stop short of full *ex-ante* product regulation but seek to allow innovation albeit under controlled conditions. Competition and innovation help the financial system adapt to changing conditions and bring real benefits to well-informed consumers. When coupled with appropriate regulation, this type of controlled innovation allows financial institutions to allocate risk to those who are best placed to bear it and thus re-enforces the protection of more risk-averse consumers.

A financial services sector dominated by institutions that are unwilling or unable to innovate reduces consumer welfare and the stability of the whole financial system. In an uncompetitive environment, financial institutions have little incentive to meet customers' needs or to allocate risk in an efficient manner. Systemic risk is amplified in a banking system closed to competition as banks that face no threat of entry have no incentive to offer better services or to operate more prudently than they would have to under competitive conditions. A banking sector which operates under explicit state protection offers no certainty that the profits of a few uncompetitive banks would be invested any more wisely than they were in the past.

Product innovation should therefore be permitted but the take-up of new products among consumers should be closely monitored in the early stages of a launch to ensure that the product is being used by the intended customer segments and for the intended purpose. The penetration of new financial products should be controlled until the Financial Regulator is satisfied that it fully understands the product well and that any risks can be dealt with.

The role of intermediaries

There is a natural role for intermediaries in financial services as from the consumer's perspective, intermediaries reduce search and switching costs. However it is equally important that the relationship between product producer and intermediary is transparent and that the incentives available to the intermediary do not interfere with its primary role which is seeking the best value for the consumer.

The Competition Authority's study *Competition Issues in the (Non-Life) Insurance Market,* published in 2005, made seven recommendations specifically related to the potential for conflicts of interest for insurance intermediaries. These recommendations related to pricing transparency and the disclosure of information relating to the commissions paid by insurers to intermediaries.

The *Review of the Intermediary Market* of 2008 by the joint Financial Regulator/industry Working Group, discussed the conflict of interest issues identified in the Competition Authority's study in greater detail. Accordingly, the Group made the following recommendations in relation to disclosure of commissions:

1. A non-life insurance intermediary should disclose in general terms that it is paid for the service it provides to the consumer by means of a remuneration arrangement with the product provider.

2. A non-life insurance intermediary should disclose in general terms any remuneration arrangements with product providers that are not directly attributed to the service provided to an individual consumer but are based on levels of business introduced by the intermediary to that product provider or that may be perceived as having the potential to create a conflict of interest.

3. Prior to the sale of a product, a non-life insurance intermediary should either inform the consumer of the amount of remuneration receivable in respect of that sale or that details of remuneration are available on request.

4. The disclosure required at (1), (2) and (3) should be in the terms of business document or through some other suitable mechanism, and with renewal notices.

In the course of the *Review of the Intermediary Market* Review, the recommendations of the review were discussed in detail with the Competition Authority, which indicated its support for the recommendations at that time. The Competition Authority is satisfied that the recommendations of the Working Group as reflected in the revisions to the Code address the issues identified by the Competition in its own study into the non-life insurance market.

Sectoral commitments

The Irish Government has prepared a package of sectoral commitments to the EU Commission regarding the banking sector pursuant to the Commission's approval of the granting of state aid to the Irish banks.

In particular, Ireland committed to carry out specific measures in order to enhance:

- Customer mobility and protection (provision of information; transparency to facilitate consumer decision making; financial inclusion);
- Entry of competitors (electronic banking, SEPA migration, quality and availability of credit history information and reporting by banks);
- Corporate governance.

The Consumer Protection Code currently contains a number of provisions relevant to the area of competition and consumer mobility, however, the specific proposals listed in the sectoral commitments represent refinements which will further improve transparency for consumers. Some of the commitments have already been implemented.

For example, the IBF switching codes for personal and business customers have been placed on a statutory footing. Making it easier for customers to switch banks gives them more choice and incentivises banks to compete more aggressively for business. Empowering customers to switch banks more easily not only encourages competition in the market for basic products like current accounts, it also reduce consumers' dependency on a single provider for all their financial services needs.

The package contains a commitment to implement remaining recommendations of the Competition Authority's study, *Competition in the (Non-investment) Banking Sector in Ireland* of 2005. Specifically, the package commits to the implementation of Recommendations 7 and 12 of the study:-

- Banks will provide personal customers with 12 months of current account statements, without charge.
- Banks will provide SMEs with 3 years of current account history, without charge.

Ease of access to account histories is important to competition in banking as it enhances customer mobility and facilitates new entry as banks that are new to the Irish market can more easily assess the creditworthiness of loan applicants.

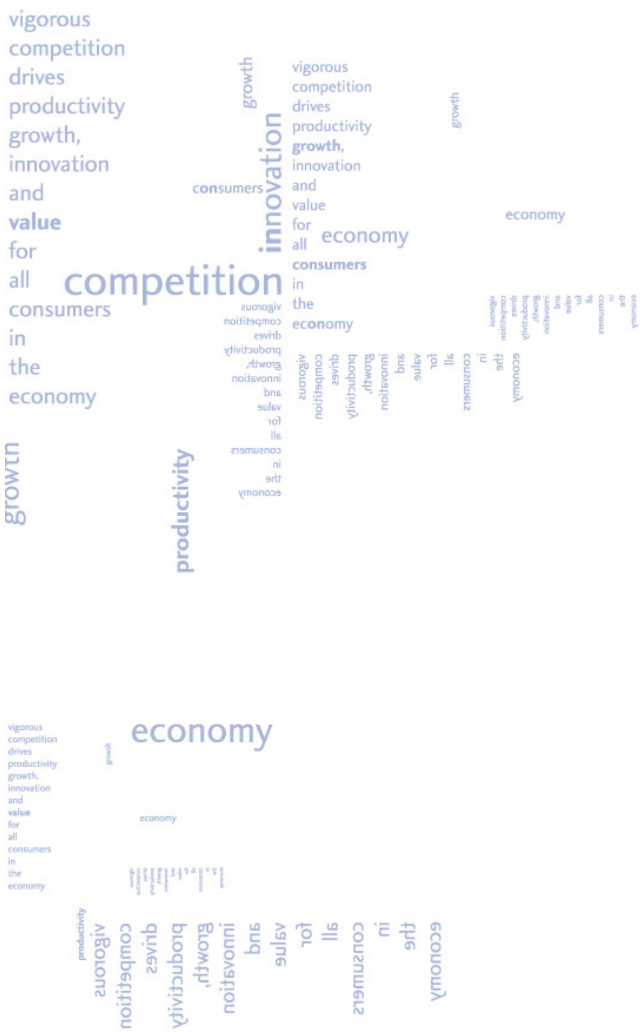
The supply of working capital loans is closely linked to that of business current accounts because banks are able to closely monitor the financial performance of working capital borrowers by referring to their current account histories.

Concluding remarks

The proposed changes to the Consumer Protection Code are an acknowledgement that some of the consumer protection measures contained in the original Code were not sufficiently strong. These weaknesses were exposed during the banking crisis. Nevertheless, the approach adopted by the Central Bank of strengthening the weaker areas of the Code while maintaining the many positive aspects of the original Code is the correct one as this ensures that consumer interests are re-enforced without any loss of regulatory certainty.

The approach taken in the revision of the Consumer Protection Code demonstrates a commitment on the part of the Central Bank to maintain healthy competition while at the same time implementing much needed reforms. Tightening the common rules under which all market participants operate, while maintaining a principles based approach to regulation should ensure that that the creation of unnecessary barriers to entry is avoided. Similarly, greater transparency and oversight should not hinder the expansion of well run institutions.

The banking crisis which has engulfed the Irish economy has necessitated a revision of every aspect of the financial services regulatory framework and a strengthening of the rules relating to consumer protection in these difficult times is especially welcome. The proposed revisions to the Consumer Protection Code strike a balance between the necessity for providing greater protection of those consumers who have found themselves in particularly difficult circumstances and the acknowledgment that the welfare of the vast majority of consumers is met by competition between financial institutions that is fair, open and transparent.



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