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Improving Protection in Financial Services for Russian Consumers

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Key Messages

- **Consumer protection in financial services is critical to ensure confidence in the financial system.**

- **A 2008 World Bank Survey found that Russian consumers had low levels of financial literacy and did not know their rights as financial consumers.**

- **The World Bank has just released its Diagnostic Review of Consumer Protection in Financial Services in the Russian Federation. The review proposes six recommendations:**

  (i) A stronger institutional framework

  (ii) Clearer information disclosure

  (iii) The prohibition of unfair practices

  (iv) Stronger dispute resolution mechanisms

  (v) Financial education programs

  (vi) Regular financial literacy surveys

Over the last decade, consumer credit in the Russian Federation has expanded from almost nothing to 9.2 percent of Gross Domestic Product in 2008. This is an average increase of 84 percent a year for five years.

Across Europe, this was one of the most rapid rises in consumer lending—only Romania was higher at 100 percent annual increases. In just four years (from 2003 to 2007) in Russia, consumer borrowings—excluding mortgages—skyrocketed from a minimal level of US$ 100 per person to over US$ 1,200 per capita.

Yet, the increases have been uneven throughout the Russian population. Even now, more than 40 percent of the population lacks access to any form of financial services. Only 16 percent have bank accounts and less than one percent of the population invests in securities, investment funds or insurance.

Recent developments in financial markets have highlighted the need for consumer protection and financial literacy for the long-term health of the financial sector. The rapid growth of household lending has been accompanied by an increase in the number of households that have difficulty in understanding the risks and obligations that they assume–or the full range of choices available. In the US mortgage markets for instance, complex financial contracts were sold to borrowers, some of whom had weak credit histories. The consequences were disastrous, and highlight the importance of consumer protection and financial education to prevent other similar events.

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Why is Consumer Protection in Financial Services Important?

There are at least three reasons why consumer protection in financial services and financial literacy are paramount.

First, they increase consumer confidence in the financial system, which in turn reduces risks to financial stability. Both consumer protection and financial literacy are needed to build trust in the financial system and, thus, to broaden and diversify the deposit base of banks. This in turn reduces the liquidity risk of the banking sector. Better informed consumers also help foster financial stability by protecting themselves from incurring large exposure to market risks. This increases the transparency of credit risk assumed by the financial system and lowers the monitoring costs for financial supervisors.

Second, they address the imbalance of power, information and resources between consumers and their financial services providers. This is a typical market failure. Financial institutions know their services well but individual consumers may find it difficult or costly to obtain information on the financial products they purchase. In addition, complex financial products may be difficult to assess even when all the information is disclosed.

Third, they promote efficiency and transparency of retail financial markets. Consumers who are empowered with information and basic rights are an important source of market discipline. This encourages financial institutions to compete by offering better products and services, rather than by taking advantage of poorly informed consumers.

A financial consumer protection framework should provide consumers with:

- Transparency--by providing full, plain, adequate, and comparable information about the prices, terms and conditions, and inherent risks of financial products and services;
- Choice--by ensuring fair, non-coercive and reasonable practices in the selling of financial products and collection of payments;
- Redress--by providing inexpensive and speedy mechanisms to resolve complaints and disputes; and
- Privacy--by ensuring control over access to personal information.

Consumer protection and financial literacy are part of the Russian Government's long-term plan for financial sector development adopted in December 2008. The Russian Government also highlighted the importance of financial literacy as a global issue in 2006 within the G8 forum, and allocated US$ 15 million to a trust fund administered by the World Bank to support research and disseminate best practices on this issue.

The Evidence in Russia

In June 2008, the World Bank conducted a financial literacy survey of over 1,600 households in 40 regions of the Russian Federation. The results showed that the Russian population had low level of financial literacy and lacked awareness of their rights as financial consumers. Half the respondents considered their level of financial literacy as unsatisfactory. Over 80 percent were unable to correctly answer five out of six basic financial questions, such as: Does compound interest increase savings more or less rapidly than simple interest? In addition, more than one in ten people believed that the Government should bail them out of bad investment decisions. Over 15 percent thought that the Government should compensate them if they lost money investing, even in residential real estate. Respondents also had little faith that financial institutions would solve any problems that arose with financial transactions. Over three-quarters gave a 50:50 chance (or worse) that disputes with financial institutions would be resolved quickly and fairly.

The survey also showed that Russian consumers are interested in learning how to protect their financial future. Three-quarters of the survey's respondents said they would like to receive financial education in order to protect themselves financially and plan for the future. They wanted to learn how to protect themselves when dealing with financial institutions and how to identify (and avoid) pyramids[2] and other financial frauds. Almost a third wanted to know about the laws that protect them and the procedures that should be followed in case of a dispute with a financial institution. One quarter wanted to understand how the pension schemes work and almost as many wanted information on how to avoid being

[2] A 'pyramid scheme' is a business model that involves the exchange of money for enrolling other people into the scheme, often without delivering any service. New money (brought by new investors into the scheme) is the source of the payoff for existing participants. Pyramid schemes require an exponential increase in the number of participants to sustain them.

overburdened by credits. However, consumers also showed some distrust of private financial sector institutions--not only commercial banks but also insurance companies and other providers of financial services.

Six Recommendations

The World Bank recently released its Diagnostic Review on Consumer Protection in Financial Services in the Russian Federation[3]. The review is the sixth report of a World Bank-sponsored pilot program to assess consumer protection in financial services in emerging markets[4]. The Diagnostic Review was prepared at the request of the Russian authorities and is intended to support the Government's program on financial literacy and consumer protection.

The report finds that the basic legal framework for consumer protection in financial services is largely in place. It recommends that six measures be taken. These measures are based on international experiences, mostly from Europe, United States, Australia, and Canada.

First, the authorities should simplify and strengthen the regulatory and supervisory institutional structure responsible for financial consumer protection. The current framework is complex and not comprehensive. The Russian Consumer Protection Service (*Rospotrebnadzor* or CPS) has responsibility for enforcing the Law on Protection of Consumer Rights. Most banking credit services come under the Law but the latter does not cover securities, investment funds or pension funds. Neither is it clear if the Law covers insurance. The securities and insurance supervisors have an explicit mandate to protect investors and policyholders; however the banking supervisor (the Central Bank) has not. While the financial supervisors have skills in financial issues, the CPS lacks sufficient expertise and institutional capability to adequately monitor consumer protection in financial services. Three options are presented but the review recommends that the best approach would be to strengthen the capability of the CPS as well as its transparency and accountability. At the same time, all financial intermediaries (and particularly debt collection agencies) should be licensed and be subject to business conduct supervision by a financial supervisory agency.

Second, financial institutions should make their consumer disclosure easy to read but still accurate and complete. Basic information regarding financial services should be presented in a simple format, such as a Key Facts Statement like the one used in Australia and elsewhere. Basic provisions of consumer contracts could be standardized. Both the Key Facts Statement and the standard contract provisions could be set by the relevant professional associations, with the suggestion that all member financial institutions follow the formats. In addition, there should be specific disclosure requirements for non-state pension funds, insurance companies, consumer credit providers, credit reporting institutions, and non-credit payment service providers.

Third, unfair business practices should be prohibited. Debt collectors should not be able to call delinquent borrowers at any time of the day or night. Cooling-off periods, when consumers can change their mind for a few days after signing a contract, also make sense for long-term financial contracts (such as residential mortgages or insurance contracts with long-term savings components). Legislation on personal bankruptcy is also needed.

Fourth, the dispute resolution mechanisms should be strengthened. Currently, there is no centralized mechanism that deals with customer complaints on financial services. Financial consumers can complain to six different institutions (the financial institution, the financial supervisor, the professional association, the CPS, the office of the Presidential administration, and the Prosecutor General) but only the CPS can act as an advocate of the consumer in court. Each financial institution should be obliged to designate a department (or an individual) responsible for receiving customer complaints—and that contact point should be identified to the consumer at the time that the financial service is purchased. Consumer complaints about financial services should be collected in one central location, which should publish statistics on the number and status of complaints and analyze the trends in the different types of complaints. Over the long-term, consideration should be given to establishing a form of consumer financial ombudsman—an institution with specialized staff to whom consumers could send their complaints when the financial institutions do not seem to listen.

Fifth, one of the most effective forms of consumer protection in the long run is ensuring high level of financial literacy. Consumers should have easy access to financial education so that they can learn about their

[3] World Bank, *Russian Federation: Diagnostic Review of Consumer Protection in Financial Services*, Revised Draft, July 2009 (available at http://www.worldbank.org/ru and http://www.worldbank.org/eca/consumerprotection)

[4] Other reports were prepared for Azerbaijan, Bulgaria, Croatia, Czech Republic, Latvia, Lithuania, Romania, and Slovakia. The World Bank has also prepared *Good Practices for Consumer Protection and Financial Literacy in Europe and Central Asia: A Diagnostic Tool* (http://www.worldbank.org/eca/consumerprotection)

financial services—not just the terms of service but also the risks and rewards of different personal financial strategies. The number of financial education initiatives from private institutions and NGOs is growing in Russia, but it is mostly focused on investment advice and targets the most affluent segments of the population. The public sector should be involved to ensure that middle- and low-income people are not left behind. Topics such as budget planning, managing personal debt and pension planning and insurance should be covered. It is recommended that financial education be provided to consumers at 'teachable moments', when they are searching for information about financial services and financial planning. For this, a national strategy to develop financial education should be in place.

Sixth, regular surveys of financial consumers should be conducted to evaluate the impact of policy interventions and the financial education programs. The surveys should cover consumer spending habits and financial well-being, as well as levels of financial literacy and understanding.

Where Are We Now?

Several measures have already been taken:

- Five high-level dissemination workshops were held during 'Consumer Protection Week' in late September 2009. Deputy Chairman of the Federal Financial Markets Service of Russia, Sergey Kharlamov, helped kick-off the opening workshop.

- In July 2009, the Law 'About Credit Cooperation' was passed. This Law improves the legal framework for the activities of consumer credit cooperatives acting in the sphere of non-bank financing. Credit cooperatives are non-commercial organizations established for providing financial aid to their members who are individuals and/or legal entities. The new Law regulates their establishment, reorganization, liquidation, membership, and their management and assets.

- Amendments to the bankruptcy legislation have been drafted, introducing provisions on bankruptcy procedures for individual consumer debtors. They would allow individual debtors to file for bankruptcy. Currently, if individuals default on their loans, the banks often restructure the loans but the terms may vary widely. The draft Law would allow debtors--who have accumulated more than Rub 50,000 in debt and have not been able to make payments for the past six months--to ask an arbitration court to declare them bankrupt. Lenders could also initiate the bankruptcy procedure.

- The Association of Regional Banks of Russia has asked for World Bank assistance to lay the ground for a banking sector ombudsman. The approval of the charter establishing the banking ombudsman is expected by mid-2010.

- The Russian Ministry of Finance, along with several Government bodies, is preparing a national strategy on financial education, financial literacy and consumer protection.

- The World Bank is working with the Russian authorities to prepare a Financial Literacy and Financial Education Project to support the Government's program.

There is still some way to go. The six measures mentioned above are not easy to put in place but all are important. Taken together, they will establish the foundations needed to ensure that Russian households can make even difficult financial decisions with confidence—whether it is to buy new homes, pay for car repairs or just find ways to save a little between pay checks. The program requires an active role, not just by the Russian Government authorities but also by the financial institutions, their professional associations and members of civil society. The result will be empowered financial consumers—and a stronger society.

About the Author

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