

Consumer Protection, Market Conduct and Financial Stability

The regulation and supervision of the conduct of financial institutions towards consumers has traditionally served mainly to protect individuals from unfair, abusive and predatory practices by financial institutions. More recently however, regulations that protect financial consumers (or market conduct regulations) have also received greater global attention as having an important complementary role to prudential regulation and supervision in protecting the overall financial system from **systemic risk**. This article elaborates the link between market conduct practices of financial institutions and the build-up of systemic risk drawing on observations from the global financial crisis, and provides an insight to the market conduct regulatory and supervisory regime in Malaysia including the focus of current and future initiatives to mitigate systemic risk.

Observations from the financial crisis

From a market conduct perspective, a confluence of several notable developments contributed to events that culminated in the financial crisis:

- The decade predating the financial crisis saw a dramatic increase in subprime mortgage lending which was partly fuelled by a period of substantive deregulation of the features and terms of consumer loans. In particular, the Depository Institutions Deregulation and Monetary Control Act of 1980 which lifted state-regulated interest-rate caps is widely credited with spurring the growth of subprime lending in the United States (US);
- The rapid pace of financial innovation and growing complexity of financial products also significantly widened the information gaps between financial institutions and consumers, in turn rendering ineffective much of the disclosure-based regulations that had replaced the regulation of the terms of consumer loans. Mortgages and consumer credit products offered by financial institutions in the US have evolved to include complex terms that allowed lenders to reset interest rates or charge heavy fees and penalties that were not apparent or adequately explained to consumers. This in turn led to poor and uninformed financial decisions where borrowers were unrealistically led to believe that they could depend on a perpetual rise in house prices to meet potentially onerous financial obligations;
- In an environment of intense competition, misaligned incentive structures in the credit and sales processes also worked against the interests of consumers. Compensation structures were biased towards encouraging lenders and intermediaries to push products that generated the highest profit or commission, with little or no regard for the suitability of the product to a borrower's particular financial circumstances. Incentive schemes that linked commissions to sales volume or particular credit products expectedly reduced incentives for intermediaries to ascertain the customer's financing needs or capacity to repay the debt over the longer term without substantial hardship; and
- The advent of securitisation enabled lenders to easily offload credit risks and generate cash flows (and lucrative servicing fees) that allowed **and** incentivised them to further increase lending exponentially to the subprime segment. Investors in securities that were backed by subprime credits also suffered major losses which were widely blamed on the misrepresentation of securitisation products as low-risk alternatives to deposits. Subsequent regulatory reviews, including in Asia, of market conduct practices in the offering and sale of securities linked to subprime mortgages revealed mis-selling by sales representatives who were ill-equipped to properly explain the risks associated with the products, and failed to establish the suitability of the products for the investors to whom the products were being sold.

These developments had important and ultimately disastrous consequences for the stability of the overall financial system. They contributed towards significantly increasing leverage in the system as a whole as financial institutions, borrowers and investors collectively miscalculated and failed to properly take account of the risks that they were exposed to. When concessionary interest rates

on adjustable rate mortgages were reset to market rates and house prices eventually corrected, borrowers defaulted in large numbers, triggering a series of events that would threaten the livelihoods of indebted borrowers, the soundness of financial institutions and ultimately, impair the ability of the financial system to perform its intermediation function. Widespread foreclosures further depressed house values, feeding into a vicious cycle that significantly impeded recovery efforts. This was further compounded by regulatory findings of improper foreclosure practices by some financial institutions which further stalled recoveries that were critical to restore the balance sheets of financial institutions and revive lending to the economy. Continuing allegations of pervasive misconduct on the part of lenders, arrangers and brokers both in the mortgage and securitisation markets saw the widespread erosion of confidence in financial institutions and markets which severely affected the functioning of funding markets during the crisis, and continues today to cast a shadow over the firm recovery of financial institutions which remain exposed to financial losses from legal and regulatory sanctions.

In the wake of the financial crisis, financial regulators in a number of countries have since moved to strengthen existing institutional arrangements and regulations in the area of market conduct. Most notably, authorities in many jurisdictions have introduced higher standards on fair and responsible lending practices, particularly in lending to households and small businesses. These standards have substantially raised the bar on practices by financial institutions in ensuring that credit products offered to individuals are both affordable and suitable for their needs. Other significant developments have included extending the existing consumer credit law to regulate the emergence of a wider array of players in the consumer credit market, the establishment of new agencies and enactment of new legislation to support a stronger focus on consumer protection. This requires significantly higher standards of competency of sales intermediaries and a return to stronger regulatory prescriptions on terms and conditions of credit and circumstances under which complex products may be offered to individuals.

Market conduct regulation and supervision in Malaysia

The financial consumer protection framework in Malaysia for which Bank Negara Malaysia is primarily responsible, comprises five main strands which may be described as follows:

- Regulating and supervising the market conduct practices of financial institutions. This focuses on addressing information asymmetries between financial institutions and consumers, and setting clear expectations on fair, responsible and transparent practices by financial institutions in their dealings with consumers;
- Empowering consumers to make sound and well-informed financial decisions through a comprehensive and sustained financial education programme;
- Providing a comprehensive supporting credit infrastructure that promotes a sound credit culture among consumers and robust credit assessments by financial institutions;
- Setting and enforcing qualification and competency standards for sales and marketing personnel/agents and other intermediaries such as insurance brokers and financial advisers; and
- Providing effective and expedient redress and support arrangements for financial consumers, including complaints and mediation channels, financial counselling services and debt management programmes.

In an environment of increasingly intense competition, the search for yield among investors, and the globalisation of financial institutions with operations in multiple jurisdictions, Malaysia benefited in particular from several notable elements of the financial consumer protection framework that has been put in place in averting the widespread market conduct failures which were revealed in some jurisdictions at the height of the financial crisis.

Under the framework applied by the Bank for the regulation of financial products, banking institutions were required until 2007 to obtain the Bank's approval for any new financial product prior to offering the product for sale in the market. This allowed the Bank to review the capacity of the financial institution to effectively manage the risks associated with the product, both to the institution itself and the consumers to whom the products would be sold. As part of this process, the Bank can prohibit a financial institution from offering any product, or require the institution to vary the product (including related disclosures to consumers) to address any regulatory concerns. With strengthened risk management frameworks in place within financial institutions, the product approval regime has since been gradually replaced by a notification requirement which improved the time-to-market of new product offerings, while effectively preserving the ability of the Bank to conduct timely regulatory reviews of significant new products. Supervisory actions by the Bank were also expanded to include requiring financial institutions to recall misleading or high-risk products and provide restitution to affected consumers. Further, the Bank has preserved the requirement for financial institutions to obtain the Bank's prior approval of products that are new to the domestic market. Given the expectations under this framework for a financial institution to be able to demonstrate to the Bank its ability to adequately safeguard the interests of consumers and internally manage the risks associated with any new product, financial institutions in Malaysia largely avoided involving themselves in offering the complex securitisation products that had led to significant losses experienced by financial institutions and investors in several countries during the crisis.

Financial institutions are also required to observe requirements to actively consider and properly advise consumers on the suitability of products for their needs. For the introduction of new financial products, in particular sophisticated investment products, financial institutions are required to establish customer suitability procedures that include processes to clearly describe the types of consumers that a product would generally be suitable for, clear lines of authority for approving transactions with customers that do not meet generic customer suitability profiles and the effective oversight of sales personnel. To establish customer suitability, financial institutions must obtain and document relevant information from a prospective customer to determine the financial circumstances, needs and objectives of the customer as a basis for recommending a particular product.

Financial institutions must further comply with specific disclosure requirements that are designed to ensure that disclosures (including product names and descriptions) are not confusing and presented in plain language, and that the key risks of financial products are highlighted in a prominent manner to consumers. The disclosures must also clearly illustrate in defined terms the financial impact to consumers of changes to key variable features of products. Financial institutions must provide relevant disclosures to consumers before and at the point of entering into a financial contract, as well as during the contract.

Another significant element has been the development of a strong national credit infrastructure in Malaysia that is instrumental in financial institutions' management of credit risk. The comprehensive national Central Credit Reference Information System (CCRIS) which has been acknowledged as among the best by the World Bank for its scope, accessibility and quality of credit information, has now been operational for 10 years. The system captures details of all outstanding credit facilities and the month-by-month repayment track record of any individual or company with a credit facility from banking institutions. The system figures prominently in financial institutions' credit scoring systems and assessments of the creditworthiness of prospective borrowers, and thus plays an important role in mitigating the risk of a system-wide deterioration in underwriting standards among financial institutions such as was observed in some markets in the period dealing up to the crisis.

Moving forward

The main strands that characterise Malaysia's consumer protection framework work together to protect consumers from predatory practices and excessive risk, as well as the financial system from systemic risk. In mitigating systemic risk however, the focus is on addressing **collective action failures**

by financial institutions or borrowers that can lead to systemic risks. In this respect, current and future initiatives to further strengthen the existing consumer protection and market conduct regime to address systemic risk are focused on:

- addressing specific expectations on responsible conduct by financial institutions in the retail financing segment. This aims in particular to promote more rigorous and consistent practices by financial institutions in considering the factors that should be taken into account in conducting assessments of whether a financing product is affordable and suitable given a borrower's financial circumstances;
- further refining disclosure requirements where appropriate to encourage consumers to focus on key risks (e.g. by using more illustrative disclosures, greater standardisation of how key terms are presented to consumers, or through the more effective use of default and opt-in provisions for more complex or higher-risk product features);
- strengthening institutional arrangements for the regulation and supervision of market conduct. This includes enhancing existing inter-agency coordination arrangements to promote consistent approaches to the regulation and supervision of retail financing activities;
- conducting thematic and focused supervisory reviews of market conduct practices of financial institutions in selected areas to identify behavioural biases that can increase systemic risks. This will include industry-wide assessments of retail financing practices, covering incentive systems, the terms of consumer lending and retail investment products, and the manner in which such products are presented and sold to consumers;
- intensifying consumer financial education efforts to promote responsible borrowing decisions on the part of consumers through the nation-wide roll-out of the POWER! Programme and supplementary financial toolkits for consumers; and
- further developing and leveraging on the credit infrastructure to promote a healthy credit culture among borrowers.