

*Given the importance of banks to both the economy and individuals it is important they act fairly. The nature of the bank-customer relationship has been affected by deregulation and technological change. While the HKMA is concerned with macro supervision rather than consumer protection, it wants to foster standards of good banking practice, such as adequate disclosure of information, complaint resolution procedures and customer confidentiality. In some countries this has been assisted by codes of banking practice or the establishment of a banking ombudsman.*

### Introduction

I am pleased to be here this afternoon to speak at this important conference. My objective is to offer a regulator's perspective on the question of fair trading in financial services. I should emphasise that I am speaking as one particular type of regulator - a banking supervisor - and I shall be talking in a banking context. I should also add that in keeping with the international nature of this conference, I shall not be talking specifically about the situation in Hong Kong, although I will be drawing upon experience here.

I think that I can speak for all my fellow regulators in agreeing with the prospectus for this conference that consumers, financial institutions and regulators share the common goal that the financial sector should operate with efficiency, stability and honesty. All these attributes are particularly important in the case of banks because of the key position which they occupy in the financial sector.

At the macro level, banks are the main mechanism by which funds are channelled from borrowers to lenders. They also perform the important function of facilitating payments arising from all forms of transactions and serve as the vehicles through which monetary policy is transmitted to the real economy. This is vital to the effective working of a modern monetary and economic system, but at the individual level also a bank account and access to bank credit (notably for home mortgage finance) are a necessary part of everyday life.

Given the importance of banks, it is perhaps surprising that their reputation among the public is

somewhat mixed. This is less evident in Hong Kong, but in other countries banks tend to be viewed by the public with a mixture of hostility or indifference. Certainly, in the UK at present, the reputation of the banks is at a low ebb if one judges this by press comment; in Japan anti-bank feeling has recently shown itself in opposition to the use of public funds to rescue two small credit unions; and in Australia the banks are the subject of yet another inquiry by the Prices Surveillance Authority.

### The changing relationship between banks and their customers

Part of this no doubt represents a reaction against the lending excesses of the 1980s and early 1990s which led to increased bad debts and banking problems in many countries which in a number of cases still persist. However, the roots of the problem also exist at a more micro level in the changing relationship between banks and consumers. Driving changes in this relationship have been the forces of increased competition reflecting in turn the impact of deregulation.

Few people would argue that the impact of deregulation has been beneficial in terms of increased efficiency, product innovation and consumer choice. However, more competition has exposed banks to greater risk resulting in the losses to which I have already referred. In the case of Australia, this led the Martin Report of 1991 to conclude that:

“With the benefit of hindsight, it can be argued that deregulation took place too quickly. Neither banks nor customers were

\* This is the text of a speech given by David Carse, OBE, Deputy Chief Executive (Banking) to the Consumer Council Conference on Fair Trading on 29 June 1995.

educated for the changes that occurred, particularly for the allocation of, and pricing for, risk.”<sup>1</sup>

The forces of competition and deregulation have not only affected risk, they have also led to a more commercial – some would say “hard-nosed” – attitude on the part of the banks. Banks have become active *sellers* of products rather than passive *providers* of a service. They are looking to target the most profitable customers with their most attractive products and services. The erosion of cross-subsidisation as market rates are increasingly paid on deposits is leading to the introduction of transaction charges and fees for “extra” service: the so-called “user-pays” principle. In some US banks for example, an extra charge is imposed if the customer wishes to talk to a bank teller rather than simply communicate with an ATM.

All this is in the interests of efficiency and from that point of view is to be welcomed. However, there is concern in some countries that the heaviest burden of transaction charges in the wake of deregulation is borne by the lower income groups who get few if any of the benefits. This is a point that is being made by some banks in the context of the interest rate deregulation in Hong Kong and it is one that needs to be taken seriously.

Innovation, particularly in the form of electronic and card products, is another trend which has brought huge benefits in terms of speed and convenience but which also poses new challenges for the bank-customer relationship. Electronic funds transfer, in particular through ATMs, has become an indispensable part of everyday life but it has also de-personalised, and perhaps weakened, the link between bank and customer. It has also provided a fertile source of customer disputes where existing law and practice have not kept pace with technical innovation. How the liability for loss in the case of fraud or technical failure should be allocated between the bank and its customers is an example of this.

The trends I have described – a more competitive and risky environment, a more commercial and less paternalistic attitude on the

part of the banks, new and more complex products – have happened at a time when consumer expectations have increased, partly through the efforts of bodies such as the Consumer Council here in Hong Kong. In theory, this demand for better quality service should match the desire of banks to supply such services for competitive reasons. However, in practice what the banks are willing to supply does not always coincide with consumer expectations, particularly where these take the form of expecting the banks to continue to provide a public service.

The result of these trends has been the need in some countries to clarify and perhaps redefine the bank-customer relationship through new legislation or through non-statutory codes which attempt to define principles and standards of good banking practice.

### **The purpose of banking supervision**

The banking problems of recent years have also led to increased emphasis on developing effective systems of banking supervision. Banking supervision is concerned with the safety and soundness of banks with the aim of protecting the stability of the banking system as a whole. Supervisors attempt to do this by laying down a framework of prudential rules and guidelines relating to such matters as capital adequacy, liquidity, and concentrations of risk. The general purpose is to try to reduce the risk of bank failure by ensuring that banks are prudently managed by fit and proper persons.

It will be evident therefore that banking supervision is concerned with macro issues: the stability of the banking system, the soundness of individual institutions, the protection of depositors as a class. By contrast, it is not generally concerned with regulation of individual transactions, ensuring a given level of consumer satisfaction or dealing with customer disputes. Where, however, a customer dispute calls into question whether a bank as a whole is being prudently managed or raises the possibility that depositors’ interests may be threatened, I can say that in Hong Kong the Monetary Authority will become involved in a

<sup>1</sup> Australian House of Representatives Standing Committee on Finance and Public Administration *A Pocket Full of Change*. December 1991. Australian Government Publishing Service.

supervisory capacity. Allegations of fraud are an obvious example of this. However, as a general rule we do not intervene in bank-customer disputes nor do we regard ourselves as performing the role of consumer “watchdog”.

In fairness, however, I should point out that other banking supervisors may take a different view of involvement in consumer issues. In the US, for example, regulatory agencies such as the Federal Reserve Bank and the Comptroller of the Currency combine supervisory responsibilities with policing of various pieces of consumer legislation. These include the Community Reinvestment Act which imposes an obligation on banks to meet the credit needs of low and moderate income neighborhoods. This is supposed to be done, however, without violating safe and sound banking principles, which does point to a potential conflict between banking prudence and the social objective, worthy though it may be. This may argue for the two roles to be split between different agencies.

However, even when banking supervisors do not have any explicit responsibility for consumer issues, which is the case in Hong Kong and in the UK, this does not mean that they should be indifferent to how banks behave towards their customers. If banks provide a bad or unfair service, this may damage their reputation and destroy customer confidence and loyalty. Taken to extremes, this could pose a threat to the stability of a bank and to its depositors. This is not an academic concern: the unpopularity of banks in Japan is currently hindering measures to resolve the banking problems there.

Thus, banking supervisors have an interest in encouraging and helping to foster standards of good banking practice whereby banks act fairly and reasonably in relation to their customers.

### Elements of fair trading

The elements of fair trading are fairly clear. It seems self-evident for example that customers should be provided with *adequate and readily available information* about the terms and conditions of the various banking products and services and the interest rates and charges which these attract. Variations of course should also be notified in a timely manner. Terms and conditions should be written in plain language, avoiding the example

quoted by the Martin Committee of an Australian bank the first sentence of whose home mortgage document was over 1000 words long - about one-third the length of this speech.

All this is part of a process of trying to improve communication between banks and their customers with the aim of avoiding disputes. It obviously helps in this connection if branch staff know about the products and services they are selling and can explain them to customers. Advertising and promotional literature is another means of getting the message across, but it should be fair and reasonable and not contain misleading information.

However, where disputes do arise it is essential that banks have an *internal complaints procedure* which is readily accessible by the customer and which ensures that disputes are speedily resolved. Complaints can be a warning sign of fraud or of breakdown in internal controls and thus it is important in the interests of the bank as well as the customer, that complaints are recorded and are seen at an appropriate level of management: they should not be lost within the system.

Banks rely on trust and thus it is an essential part of good banking practice that banks maintain *customer confidentiality* and that neither they nor their staff misuse customer information for their own benefit. I should stress incidentally that keeping a customer's affairs confidential is subject to the requirements of the law and the need to ensure that the real identity of all customers is known. It is not an excuse to turn a blind eye to money laundering.

Prudent management of a bank's affairs dictates that management should follow sound lending practices. These include lending at arm's length, taking into account the borrower's ability to pay and the availability of security. The principles of “*truth in lending*” are also an aspect of prudent lending as well as being in the interests of the consumer. The idea behind such principles is that, before choosing credit, borrowers should have sufficient information to enable them to make a reasoned decision on whether the facility is suitable and to be able to compare terms offered by different lenders. The use of a common yardstick for measuring cost such as the annual percentage rate of interest is a necessary means of

making such comparisons and I am glad that banks in Hong Kong are now using this in advertisements on the advice of the Hong Kong Association of Banks.

Of course, a bank's relationship with its customers is taking an increasing variety of forms including the sale of derivative products for investment, speculative or risk management purposes. This creates new complexity in the relationship with the customer arising from the increased complexity of the underlying instruments. As recent events, both in this region and in the US, have shown, it is important that customers are provided with sufficient information, such as sensitivity analysis, to be able to understand the risks in the product at the outset, and sufficient information thereafter to be able to monitor its performance. This can be regarded as an element of fair trading, but it is also an aspect of prudent management of credit risk by the banks. Customers who have bought derivatives on the basis of inadequate information and who have lost money as a result, may refuse to pay the bank which sold them the product.

So far I have been talking about disclosure of information at the product level. However, it is also part of fair trading that banks should disclose sufficient information in the *annual accounts* to enable depositors and other customers to monitor the relative performance and risk exposure of different banks and to make informed choices about those banks with which they want to deal. It is the case, as was pointed out by the Consumer Council in its report on the banking industry last year, that the level of financial disclosure by banks in Hong Kong has been very low by international standards. However, as a result of initiatives by the Consumer Council and the banking and securities regulators in Hong Kong the situation improved significantly in the 1994 accounts and we are looking for further progress in 1995. This is an example of how consumer bodies, the regulators and financial institutions can work together to achieve solutions.

### Code of banking practice

I have already noted that a number of countries such as the UK, Australia, New Zealand and Singapore have embodied some or all of the elements described above into a code of banking

practice. In general, these codes are intended to promote good banking practice and to establish a fair relationship between banks and their customers. That should be beneficial to both parties. However, the process of formulating and drafting a code is not easy. The main practical question is whether the development of appropriate standards should be left to the industry itself or whether the public interest requires that other parties should be involved. An industry-developed code certainly has advantages in terms of flexibility and in encouraging acceptance of the spirit of the code. However, as UK experience has shown, there is a risk that the industry will, initially at least, set its sights too low, and the code will therefore lack the necessary credibility with consumers. Development of a code may therefore require the involvement of government and consumer groups as well as the banks. This will depend in part on what the code is trying to achieve: is it simply intended to pull together existing standards of banking practice - which may be a useful albeit limited exercise - or is it intended to push forward those standards to a higher level?

### Banking Ombudsman

Either way, a code may also provide a useful reference point for an external body charged with dispute resolution, such as an Ombudsman. Of course, as I have mentioned above, banks should make every effort to resolve disputes with customers internally. But if this is not possible, customers may wish to seek a remedy elsewhere. The obvious place is the courts, but it has to be admitted that the cost of legal action rules this out for most people. The Banking Ombudsman scheme in the UK, which is paid for by the banks, tries to redress what would otherwise be an imbalance of power between banks and their customers by providing a mechanism whereby customer complaints can be investigated and arbitrated upon. If the Ombudsman rules in favour of the customer, he can order the bank concerned to apologise, change or reconsider a decision, or to pay compensation. Of course, any scheme of this type can be criticised, as the UK scheme has been in the past, on the detail of its terms of reference, standards of good practice to be applied and degree of independence from the banks which finance it. However, it cannot be denied that such schemes can bring real benefits to customers and

also to the banks in terms of improved public relations and avoidance of statutory schemes which might be even worse from their point of view.

## Conclusions

None of the elements of fair trading which I have described and the mechanisms which help to reinforce them like the code of banking practice or the Banking Ombudsman should be objectionable to the banking supervisor. Indeed, if they help to improve bank-customer relations and confidence in the banking sector, they are positively to be welcomed. If a need were to be demonstrated for such mechanisms in Hong Kong, the Monetary Authority would not object in principle. This reflects our view that consumer protection and banking supervision can, and should, co-exist and complement one another.

I would however qualify this in two respects. First, I do consider that the safety and soundness concern of the banking supervisor should prevail over consumer rights to the extent that they may be in conflict. This is recognised, for example, in the Australian code of banking practice which states that its objectives are to be achieved "having

regard to the paramount requirement of banks to act in accordance with prudential standards necessary to preserve the stability and integrity of the Australian banking system." Stability of the banking system is in fact the ultimate consumer right. The potential for conflict between the two concepts will arise only rarely, but it may exist in such issues as the speed of deregulation of the banking system.

Second, although it is not directly related to the stability issue, I have limited sympathy for the notion which is sometimes advanced that banks have special social responsibilities which go beyond those expected of other commercial organisations: for example, to allow subsidised or free access to the banking system by disadvantaged groups. This is a worthy objective but not one for which the banks should be asked to bear the cost. In general, it would appear that the efficiency of the banking system and the interests of consumers as a whole are best served if the banks are allowed to operate on the basis of commercial principles, provided this is done responsibly and ethically within a prudent supervisory framework and in accordance with fair trading principles and practices. ☉