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The European Commission and Financial Capability: Simplifying Financial Services

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The European Commission is taking initiatives to increase the financial capability of EU consumers: ensuring that they understand the financial products available in the market, are able to manage their personal finances efficiently, and can make informed choices between different bank accounts, insurance policies or credit agreements. The participation of several high-ranking EU officials at a conference on "Increasing Financial Capability", hosted by the Commission in Brussels in March 2007, shows that the European institutions are taking this issue to heart. This ECRI POLICY BRIEF examins why these policies are needed, analyses the EU action in this area and assesses the likely future developments.

WHY FINANCIAL CAPABILITY IS IMPORTANT

At first sight, it may seem that the European Commission would have more pressing issues to give their attention to than whether consumers understand financial services. This could appear as a trivial matter, compared to promoting economic growth or to reducing unemployment across the European Union. However, there are two reasons why financial capability is important from a public policy perspective and deserves the careful attention of policy-makers.

Firstly, from a consumer perspective, if people do not understand financial services they will not be able to choose the products that suit their needs. This is problematic at a time when people depend more and more on financial services to maintain their lifestyle, as the responsibility for financial decisions is shifted away from the government to individuals: many students have to take out personal loans to finance their university education, homeowners rely on mortgages to buy their homes and private pension schemes are becoming increasingly important as a supplemental source of income for retirees in many countries. At the same time, financial products are also becoming far more complex, making it difficult to choose between the different products on offer. For some, this lack of understanding can lead to financial problems and in the worst cases to over-indebtedness.

Secondly, from an economic perspective, if consumers do not know how to make the best choices, the market for financial services will not function well. Markets depend on the ability of consumers to play their role by making informed choices between different products. Therefore, the efforts to create a Single Market for financial services can only bring benefits if consumers understand how to use it. Moreover, companies also want to have financially capable consumers, as it is also in their interest or customers to choose products that suit them since this increases consumer satisfaction. Financial capability therefore has a direct effect on the welfare of consumers and on the functioning of the Single Market. Accordingly, EU action on financial capability is shared between two directorates-general (DGs) of the European Commission: DG Internal Market and DG Health and Consumer Protection, more widely known by its French acronym of DG Sanco (Santé et Consommateurs).[1] Although the relationship between these two DGs is not always ideal (DG Internal Market is traditionally seen as more business friendly, while DG Sanco focuses on protecting consumers), they appear to be presenting a united front in reinforcing financial capability.

REGULATION: WHO READS THE SMALL PRINT?

There are two ways in which government policy can increase financial capability. One is to enact laws that make financial services easier to understand, by imposing obligations for financial services providers to inform and advise consumers, often called 'pre-contractual information' or 'contractual information'. The other way is to promote the financial education of consumers, through websites, media campaigns or seminars.

Several EU directives related to financial services contain clauses on pre-contractual and contractual information. For example, the Consumer Credit Directive (CCD) includes clauses to ensure that the consumer receives correct and complete information about the terms of credit, both in advertisements and in the written agreement. Articles 4-6 of the CCD list several types of information that must be included in a credit agreement, such as the terms of repayment, the costs and the credit limit. [2] In particular, credit providers must indicate the total price of the product calculated in a standardised way, the so-called 'annual percentage rate of charge' or APR. This is intended to avoid a lack of transparency caused by different companies using different methods to calculate their interest rates.

Another example is the Distance Marketing of Financial Services Directive, which establishes rules on the information that must be supplied to consumers when financial services are sold at a distance. Articles 3, 4 and 5 of the Directive specify the information that needs to be provided to the consumer before the a contract can be concluded, including information about the company providing the service, the financial product being sold and the conditions of the contract.

Some of these regulations are controversial. It is widely agreed that it is necessary to ensure that providers give consumers all the relevant information on the product that they are buying, its costs and the risks associated with it. However, the obligations imposed by law should not be too extensive as they may create costs for providers, which in the end make products more expensive for the consumer.

Therefore, a balance must be struck between ensuring that consumers are well informed and avoiding excessive costs for companies. Furthermore, it is also important that the regulations are drafted clearly, so that they do not create uncertainty for the industry and that consumers know their rights. Moreover, it is essential to ensure that the obligations relate to the information that people actually read, and that helps them to understand the services that they are buying.

[1] DG Employment and Social Affairs is also active in this area, but only insofar as it relates to problems of financial exclusion and over-indebtedness.

[2] Council Directive 87/102/EEC. This directive is currently being revised. The relevant articles in the proposal for a new directive, currently in the legislative process, are 4-6 (for pre-contractual information) and 9-11 (for contractual information).

At present, there is no certainty that this is the case, because the existing rules are not based on a rigorous assessment of what consumers read and understand. This is a critical point. The Commission admits that it does not know whether the information that companies are obliged to disclose under the current legislation is actually read by consumers.[3] To tackle this problem, the Commission is funding a study this summer, which will survey representative groups of consumers from each member state to learn which type of information they read when they buy financial services and what information they understand.

This type of study has been already been conducted in the United States. Surveys by the US Federal Reserve Board and academic institutions ask consumers about the type of information they think is necessary when buying financial products, which types of information they find difficult to understand and whether the information has influenced their choices. A 2001 survey showed that 75% of US consumers thought that financial disclosure statements are complicated, and 66% found that the information was not very helpful. Moreover, 46% thought that most people did not read the disclosures carefully.[4]

From the perspective of economic theory, information requirements are desirable only if they are cost-effective. Government intervention is cost-effective if the benefits are higher than the costs, in terms of taxpayers' money and possible distortions caused to the market by more regulations. Information obligations are justified by the need to correct a market failure: asymmetric information. Since consumers are not well informed about financial products, they are often not able to make informed consumption choices in their best interest, and their choices will not be a reflection of their satisfaction with the products. Therefore the optimal outcome for both sides of the market will not be reached, as the information asymmetries are hampering the mechanism of supply and demand.

However, regulations will only be effective if the information provided is actually read by consumers. Here the field of behavioural economics provides useful insights. The theory of *bounded rationality* states that consumers do not act in a perfectly rational way, as is often assumed by economic theory. For instance, consumers might search for prices until they have found a price that provides *some* satisfaction, not until they have found the *best* price. Another example is that consumers may not read all the information that is provided to them before buying a product, even if that information would allow them to make a better decision, because they might find it too technical and thus not appealing. The question is: Who reads the fine print? Including more information could actually lead consumers to read less, as they will be put off by a vast quantity of complex information. Studies show that increasing the quantity of information available increases the quality of decisions up to a certain point, but then starts decreasing it.[5] This phenomenon is known as *information overload*.

TRAINING AND EDUCATION: A ROLE FOR THE EU?

The other way to increase financial capability is through initiatives to train and inform consumers, both about the financial products available in the market, and about how to manage one's own personal finances. Currently there are only two initiatives of this type underway at EU level. The Commission created a website that offers consumer education for adults, called Dolceta (Development of On-Line

[3] In a recent speech at the ECOSOC European Consumer Day, Commissioner Meglena Kuneva said that "we are not sure that the pre-contractual information requirements in current EU directives give consumers the information they really need".

[4] T.A. Durkin (2002), "Consumers and Credit Disclosures: Credit Cards and Credit Insurance", *Federal Reserve Bulletin,* April, pp. 201-213.

[5] See for example M. Handzic (2001), "Does More Information Lead to Better Informing?", in A. Haringer A. (ed.), *Proceedings of the 2001 Informing Science Conference*, 19-22 June, Krakow, Poland, pp. 251-256

Consumer Education Tools for Adults, www.dolceta.eu). Half of the site is dedicated to improving understanding of financial services, while the other half focuses on consumer rights. The Commission, realistically, is not expecting that people will take the initiative to use the website, but is instead relying on consumer organisations to direct their users to it. Another initiative is the 'Europa Diary', a booklet that is distributed to students in secondary school to inform them about their rights as consumers. The diary includes a section on money and debt, which explains how institutions, such as banks, or products, e.g. credit and debit cards, function, and gives school students an early warning about the dangers of excessive borrowing.

Although the activities at EU level are still very limited, several member states are putting more significant initiatives into place at the national level. The UK is leading the way, with a comprehensive strategy to increase financial capability. The Financial Services Authority (FSA), the independent regulator for financial services, has initiated a series of actions to train and inform consumers about financial services. These actions target specific 'stages of life': school children, young people, new parents, work place and planning for retirement. For each of those groups, different information is given, and the information is provided in a way that will be attractive to the relevant age group. In addition, the FSA created a website called 'Money made clear"[6], which gives easy to understand information on running personal finances and financial services, and includes a tool that allows consumers to compare different products in the UK to see which is more suitable for their situation.

Other member states are following the example of the UK, and starting to implement strategies to promote financial education. For example, in the Netherlands, the Ministry of Finance set up a platform for collaboration between the different organisations that are active in the area of financial education, called Centiq.[7] The aim is to allow the different non-governmental organisations, private firms and research centres that were already active in this field to work together, so that, together with the government, they can create a common national strategy.

At the international level, the OECD has also initiated a 'Financial Education Project', under which it undertakes research and issues publications on financial education. The OECD has also issued guidelines on best practice on financial education. These guidelines are based on the experiences of OECD countries and consist of recommendations on how to design financial education policies based on the most effective practices of the most successful countries in this field. For example, one recommendation advises that programmes should be targeted to specific groups and made as personalised as possible and that financial education should start at school.

Is there a role for the EU in financial education? There are arguments in both directions. It can be argued that these policies have their place at the EU level given the Single Market and that fact that the harmonisation of financial services are is mostly an EU responsibility. This would imply that, since financial capacity is an essential element of the policy on financial services, it should also be located at the EU level. On the other hand, financial capability is related to education, which is an area where the member states are not willing to delegate discretionary power to the EU. This would imply that responsibility for ensuring financial capability resides at the national level.

In practice, it appears that it would be most efficient to keep most of these policies at the national level. National governments are better positioned to organise information and training for consumers, as they can tailor policies more appropriately to their citizens. For example, at the national level, it is possible to

[6] www.moneymadeclear.fsa.gov.uk
[7] For more information see: www.centiq.nl

integrate financial education with the existing infrastructure for welfare and education, such as incorporating financial education in the school curriculum.

At the same time, however, there is still an important role for the EU in this area. The Commission is best positioned to help the member states in exchanging best practices, so that they are able to follow the example of the countries whose policies register the best results. Events such as the conference on "Increasing Financial Capability", mentioned in the introduction, are a good way of doing that, as they allow practitioners from different EU countries to exchange their experiences in this field. In addition, in the future there could potentially be a role for the EU in providing 'comparative information': tools that allow consumers to compare different products in the market. These tools already exist for other products, e.g. the websites that allow travellers to compare prices for flights offered by different airlines.

WHAT'S NEXT?

The European Commission is putting financial capability in the limelight and presenting it as one of its main concerns. This could give the impression that it intends to press ahead with substantive initiatives. In reality, however, there is wide disagreement within the Commission as to whether it should take more action in this field. At the moment, the Commission is cautious. The new initiatives officially considered are modest and relate only to its role in promoting best practices and awareness. These consist of the creation of an awards scheme to reward the best schemes to promote financial capability in Europe, the establishment of a consultative group to advise the Commission on these issues, and the creation of EU guidelines for the member states on best practices on financial capability.

EU guidelines would certainly be a welcome measure; at present several member states are starting policies in this area, so it would be useful to be able to benefit from clear guidelines that reflect those policies that have actually worked effectively at the national level. An award scheme would also be beneficial, but it would be advisable to first assess whether it would be a cost-efficient initiative. The coming months will tell whether the Commission decides to step up its action on financial capability. This will never become a major area of EU activity, as education policies are firmly under the control of national governments. However, it appears to be one where the Commission could play a small but useful part.

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