Financial Conduct in the Digital Age

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As an issue financial conduct typically places the consumer (David) against the institution or the financial system (Goliath) - with the consumer facing information asymmetry and an inability to obtain redress cost effectively. An oversimplification but not without merit. It is therefore incumbent on institutions to be responsive to the concerns of customers and for policy makers, regulators, and industry-level actors to have mechanisms to tackle systemic issues.

Financial conduct at an institutional level: An institutional choice

Good financial conduct represents a choice and a commitment from financial service providers. The most basic commitment is restitution, what to do when things go wrong. Often human error underlies performance failings. A personal example illustrates this:

Years ago, I initiated a transfer from Kenya to the UK: Several weeks elapsed before I learned that the transfer had not happened. I received an advice note through the Kenyan postal system (which can take weeks to receive), saying that I needed to provide additional information to support the source of funds due to KYC/AML rules. The failing in this case was not my failure to remit KYC/AML documentation – as I did not appreciate what was required (information asymmetry), but rather at the level of the branch officer initially processing the transfer with me and the choice of communication the authorising officer made. Human responses delayed the transaction for weeks rather than hours (human error).

When there is human error, an institution must ensure, as far as possible, that it implements policy and procedural changes to minimise future occurrences. But to do this it needs mechanisms to collect and quantify examples of service failings as they happen.

Good financial conduct on the other hand can repay the financial institution well. A case in point would be Equity Building Society's (now bank) decision to reprice its products and services in 2002. Research with *MicroSave*[1] showed that although the society's customers appreciated the service they received –Equity's

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[1] Coetzee Gerhard, Kamau Kabbucho & Andrew Mnjama (2002), "Understanding the Rebirth of Equity Building Society", MicroSave, Nairobi accessed on 01/02/2021 https://bit.ly/3aoFF1p

pricing policies were felt to be opaque and penal. To its credit Equity listened to its clients. It introduced more transparent pricing, monthly fees were replaced with transaction charges, and many sundry fees were abolished entirely. The new charges were prominently displayed in every branch. Customers responded with enthusiasm with many new accounts being opened – and Equity marked a major point in its transition to the bank it is today. This example highlights the importance of research, transparency, and fairness in maintaining good financial conduct.

So far so good. But this is where this blog takes a darker turn. Just as good financial conduct is often a choice, human error aside, poor financial conduct can be a choice too, particularly around the issue of informed consent. To illustrate with another personal example:

Years ago, I signed a loan guarantee for a friend to purchase a car on a loan from a financial institution. I was presented by a loan guarantee agreement to sign. The agreement was lengthy and written in legal English in a country where English was not a first language for many. Few would be able to read through a legal English contract and understand it. I persisted, read the contract, and found the bank had the legal authority to freeze all my accounts with the bank as the guarantor, if the borrower failed to repay his loan. Given the assets I had with the bank at the time – this was potentially punitive. Instead, I created a fixed deposit equal to the amount of the loan which was pledged as 100% security for the loan. Lawyers may wish to protect themselves – but 'legal English' is not required in a contract. Customers (and their guarantors by extension) must understand (or be helped to understand) the contracts they are signing. In my view this contract failed the transparency and perhaps the fairness test.

When is consent - informed consent?

The best example of when is consent not informed consent is in computer software or apps we download onto our phones. At the time of installing software - we are asked to tick a box to say that we have read and consent to many pages of terms and conditions. Who reads these? Functionally, this is a legal shield which acts to protect the institution – not the consumer. The same approach is being used in financial technology. When apps are downloaded users often consent to sharing data with the vendor. In the industry this is known as 'screen scraping' – data is often used to improve decision making algorithms. However, data can be systematically misused, for example, in the nano credit industry, some providers access defaulters' phone address books to spam their contacts.

Regulation of financial conduct

These examples begin to illustrate the complex issue of financial conduct at the level of participating institutions. It becomes even more challenging when financial conduct is considered at the level of a system, and as transactions move from human mediated to digitally facilitated. Here regulatory guidelines and oversight are required.

Transparency can be mandated. In many markets there are rules around lending or investing designed to protect the consumer, these include: calculating and displaying annualised percentage rates (APRs) as in the UK; truth in lending provisions, as in the USA; and mandatory statements advising purchasers of investments that the value of investments can go down as well as up. In South Africa, the National Credit Act requires that loans be explained verbally in the language of the customer. However, institutions are adept at exploiting the absence of standards or loopholes in the standards. Chuck Waterfield created Microfinance Transparency to highlight some of these issues and facilitate meaningful comparisons between institutions. Likewise, today in many markets there are price comparison websites – though understanding how these websites work can be challenging too.

So far where does this discussion get us – to principles: We must avoid human error as much as possible, treat the consumer with fairness and transparency, and practice clear communications. We must reduce information asymmetry, ensure where possible that the consumer has the information required to make informed choices. When things do go wrong, and they will, we must build clear mechanisms for redress.

At the level of the financial system as a whole – appropriate regulation and guidelines are required. In some markets such as the UK regulation and guidelines have been enhanced through creating an additional regulatory authority – The Financial Conduct Authority[2], and additional complaint logging and redress mechanisms such as the Financial Service Ombudsman[3]. So far, so good, and so bad.

Financial conduct in the digital finance era is far more complex

In the space of a few years the digital finance revolution has made ensuring good financial conduct much more complex resulting from the following factors:

i. There has been rapid disintermediation of the financial sector as transactional services move from established and regulated institutions to often unregulated financial technology companies.

ii. There is an ongoing transition in channels, from those involving human interaction to automated systems which support access to services through mobile devices and internet-based transactions.

iii. Many, though not all fintech institutions have a small staffing – this can lead to the use of automated, sometimes unethical methods for debt collection[4]. It can also limit the ability of the fintech to respond in person in the case of a service failing.

iv. Typically, codes of conduct, standards, and regulations lag market conduct. This risks reactive responses to market failings.

v. With disintermediation the central bank often has no formal authority over new entrants. Central banks need new tools to control for conduct failings at institutional and market levels.

OK, so we need new tools, regulations, guidelines that can address market conduct failings – and promote fairness and transparency. But there is a further layer of complication. This is because the digital finance revolution has significantly broadened the range of issues related to financial conduct.

The digital age involves:

i. **Data**: The digital age is driven by data, who can access data is a competition issue – but it can become a conduct issue if data is acquired and used without informed consent. Data analytics, and the algorithms that determine how decisions are taken need to be audited. Then there are complex issues relating to data privacy and data ownership which are addressed to a significant extent in a raft of data protection laws, such as GDPR.

ii. **Consent**: This includes the mechanisms of consent, such as digital signature. But consent goes further, into informed consent, transparency, reducing information asymmetry.

[2] https://www.fca.org.uk/
[3] https://www.financial-ombudsman.org.uk/
[4] Accion Blog (2019), "Red Flags in Kenya's Nano Credit Market", Centre for Financial Inclusion, accessed on 01/02/2021, available on https://bit.ly/2MfYzjk

iii. **Partnerships**: With the digital revolution, partnerships are increasingly used, systems interoperate. But who is responsible when things go wrong? How should partnerships be vetted? Outsourcing guidelines can help here.

iv. **Re-regulation**: This covers the ability to regulate both at an institutional level and at a functional level. This would mean banks are regulated, but so are all incorporated lenders. However, there are also issues of regulatory overlap, for example between central banks and telecommunications regulators for mobile money products, and regulatory arbitrage to consider.

v. **Fraud and cybersecurity**: The security of individual institutions and the system becomes increasingly important with the digital revolution.

vi. **Competition**: There are new actors, new third-party relationships, the rise of digital technology as a barrier to entry, and the entry of big-tech into financial systems worldwide – Amazon, Facebook, WhatsApp, Ten Cents, Alibaba.

vii. **Digital identity**: Digital identity is becoming so much more than authentication. Its about the trail that we leave when we transact financially or when we are browsing on the internet.

Responding to financial conduct in a digital age

Responding to financial conduct issues in a digital age will need to be covered in more depth in a future blog. However, what we can surmise is that a response to financial conduct will:

i. **Be multifaceted**: A response will need to tackle issues of transparency, fairness, informed consent, redress, in a digital age.

ii. **Be coordinated**: Responses to financial conduct will need to be coordinated across financial institutions, industry associations, multiple regulators, and ministries.

iii. **Use new regulatory tools and approaches**: We are beginning to see this with test and learn approaches, sandboxes, reg-tech, and supervision technology. However, new laws, regulations and guidelines will be required and realignment within regulatory structures.

iv. **Require appropriate redress mechanisms**: Financial conduct failings need to be redressed at the consumer level. Legal systems are slow, expensive and inefficient – redressal mechanisms within institutions and systemically will need to be reviewed and strengthened.

v. **Will require ongoing consumer education:** Increasing information asymmetry through digitisation must be addressed through appropriate and timely consumer education.

This blog is one of a series of blogs, should you wish to sign up to receive additional blogs, please write to David Cracknell at david@firstprinciples.consulting. David Cracknell is the Director of First Principles Consulting Limited, based in Nairobi, Kenya. He advises financial institutions, governments, policy makers and donors on financial services, including digital finance, policy and regulation, and inclusive finance.

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