Customers' Interest and Information
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I would like to begin with an anecdote that I think sums up some of the issues we discussed yesterday. When I was in Cambridge, I founded and ran the Centre for Financial History, which has now passed to a new director. Most of my PhD students and many of our affiliates were refugees, in their mid-thirties to forties, from financial services. They had made their money and now wanted to do something 'more meaningful' (which is invariably how they put it) with the second half of their lives. One of them, who wrote an excellent PhD on the need for inclusive financial institutions in Zambia, summarised his disillusionment with his old job in sales and trading (where he had risen to the rank of 'trading MD' with a bulge-bracket bank) as follows. "And then there was the question of ethics. Usually it has been treated, by regulators and professional organisations, as something of a joke. It's as if the examination questions read: 'You encounter some colleagues 'rolling a dwarf.' What do you do? A) join the party, B) call compliance, C) execute the dwarf's order first, D) B and C but not A), E) something else entirely.'" Leaving aside the double entendre, and we'll come back to what is meant by 'dwarf' in a moment, there is a poverty of ideas as well as a vacuous morality, embedded in that kind of approach. And it's no surprise that traders fail to take it seriously.

So what are the alternatives? There has been some talk of Sustainable Finance. It means different things to different people, but what it means to me is 1) a movement for socially and environmentally conscious practices in the financial services industry, 2) normally a focus on reducing information asymmetries between institutions and customers, 3) a recognition that 'regulatory arbitrage' has been one of the largest sources of profits to the financial services industry and should be curbed, 4) that there is a need to curb the influence of lobbyists for financial services firms, and 5) a focus on financial inclusion and consumer protection.

Given the recent climate of complexity and opacity, 5) may be the most immediate and toughest challenge. How do we equip the customer? Financial literacy is a serious issue, and there is a lot of evidence that modern consumers do not understand even basic financial products, let alone the terminology. The slide you see in the hand-out with all of these terms comes from the Qatari ministry tasked with educating its consumers. And remember, in Qatar and in the Emirates, debt is a serious business. They still have debtor prisons. But is education enough? Probably not. In most Anglophone countries, consumer financial education is available.

The United Kingdom has the Money Advice Service, the Citizens Advice Bureau (where one of my PhD students, an ex-Inland Revenue official volunteers) and initiatives like Credit Action and the Personal Finance Education Group. The USA has the *Jump$tartCoalition* and the Office of Financial Education of the US Treasury. The U.S. Treasury's Consumer Financial Protection Bureau has made this a priority. In Australia, ASIC has established *MoneySmart* and the OECD's *International Gateway for Financial Education* is a model of its kind, though it still has yet to gain serious traction outside the

Anglophone world. But education is not necessarily the whole key to changing behaviour. Marginal households will still make what we might consider suboptimal choices, and all sorts of cognitive biases prevail even among households that don't have what economists call liquidity constraints. It's not enough simply to 'educate' in the ordinary sense. As others have said, there is also a question of moral formation. The Catholic Church has a role to play and maybe this is the time for a kind of financial catechism directed to young people. Or perhaps something more akin to what the young are told about reproductive choices and sexual behaviour, or about family life in general.

There is also the challenge of making credit reporting more transparent. For consumers, this is key, and there is a very strong argument for nationalizing the process. The oligarchic structure of the credit reporting/credit scoring industry in the Anglophone world hurts the poor, as does the purposes to which this information can be put: in hiring, for instance, or insurance underwriting, to give another example. Many credit reporting agencies use something like the info-graphic in the slide to try to impress upon the customer that he or she is the key to the business, but the reality is much information is erroneous (up to 30-40% of files have material errors including to some estimates), identity theft is increasingly common, and mistakes are difficult to change or challenge. The tyranny of these bodies is a serious problem. Simplifying loan documentation is equally important. While consumers should read the fine print, many don't and financial literacy in itself does not equip them to read 1200-page contracts, which may not be available to them easily anyway. Complexity is a new development. A mortgage document in 1750 looked much like one in 1850 or 1913 or 1960. Even the language was the same. Today all that has changed.

Moving from the micro to the meso level, we also have the perils of regulatory arbitrage. Financial services firms (and not just shadow banks) profit from different regulatory regimes. Globalization has accelerated this process but can also ultimately curb it. Regulatory arbitrage also contributes to the socialisation of risk, which is the antithesis of sustainable finance. The slide on page 11 paints this vividly.

What are my recommendations for curbing reg-arb? It's not an easy task. Here are a few. First, the most important step is to align the legal rules and regulations in a transnational and ultimately global context. This means that supra-national organisations, including the Catholic Church, must bring pressure to bear on nation-states. The 'race to the bottom' in London, Singapore, Hong Kong and (historically) New York is toxic. London in particular is often called 'the wild west' and has little intention of changing. Tax havens, though destructive, pale in comparison to more mundane forms of regulatory arbitrage.

Of course, curbing regulatory arbitrage also depends upon confronting the power of financial services lobbying. The financial services lobby, particularly in the UK and USA, has been very proactive in curbing meaningful reform. The cartoons illustrate part of the problem, but equally important is the sheer scale of funds involved. And this has increased astronomically over the last ten years. If *The Economist* (the source of that graph) is worried about, we should be too.

My final recommendation is a more controversial one, and here I am not going to focus on issues of 'inclusion' for most of the world, but rather on a recurring issue in the developed world that seems to justify all manner of bad behaviour in financial markets. Since the 1930s, following American regulation, most Anglophone regulatory regimes have a bifurcated structure, where qualified, accredited, or registered investors, including qualified institutional investors, are exempt from consumer protection laws that apply to retail investors. The world is divided into 'grown-ups' and 'dwarves'. Yet the barrier to become a 'grown-up' is not that high, as you can see in the slide, and as a consequence, a lot of essentially retail investors (with large stock portfolios or IRAs) could be induced to accredit themselves. In the last crisis, many were sold manifestly unsuitable products, including VVIX products (products that allowed them to gamble on the volatility of the CBoE's volatility index, or forex wrappers that carried undisclosed risks). More importantly, the corporate treasuries of high street firms, university endowments, pension funds, and others, were mis-sold a range of products, including toxic derivatives (mostly interest rate and forex swaps) with tragic consequences for the real economy. As those who attended the event this time last year at the Vatican may remember, Michael Dempster discussed how these products, while theoretically useful to the firms (Thomas Cook Travel, for instance, had a need for foreign exchange swaps), the probability distributions used to structure most of the products sold in 2006-7 were so badly weighted against the customer as to be unconscionable, as the courts have subsequently come to recognise.

In effect, bulge-bracket investment banks tended to think of their institutional clients as 'muppets' (which in some cases seems a fair summary of their market acumen if not the kind of attitude anyone wants to encourage), though it seems no one actually used that word in email that Goldman Sachs could find. In short, some 'grown-ups' are more 'grown-up' than others. Yet it should be obvious that if you wouldn't sell a product to your grandmother, you shouldn't sell it to your grandmother's pension fund managers.There should be no excuse for fleecing institutional investors. But there is another unintended consequence, which is that trading with grown-ups is more lucrative than trading with children and dwarves, which means that firms have been abandoning the retail space as too expensive. Why focus on relationship banking, retail deposits, and catering to the needs of small and medium-sized businesses when there is real money to be made doing something else (even if that means taking on a lot of risk)? Maybe abolishing the distinction would be impracticable and possibly pernicious, but it needs to be rethought.

Finally, though microfinance and peer-to-peer (P2P) lending can be godsends in the developing world, they can also be predatory and need international standards. Inclusive Finance International has made some real progress in that regard, but there is more work to be done.

In closing, I would like to echo what the archbishop repeatedly told us yesterday: inclusivity is the key criteria of the success of any financial system. Inclusive finance helps everyone. Thank you.