SUERF
The European Money and Finance Forum

SUERF Policy Briefs
No 233, November 2021

Caveat Emptor

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JEL codes: G18, G28, G53, K15.

Keywords: Caveat emptor, consumer´s rights, financial markets, litigation.

The principle of Caveat Emptor (buyer´s due diligence) enshrined in Roman Law has been incorporated to many legal systems, including common law ones. Nevertheless, in the first decades of the XXI century, the concept has been eroded in financial markets, where a zero-tolerance consumer rights approach that is prone to litigation and sanctioning has been introduced. This impacts markets: the price (the quantity of payment or compensation given by one party to another in return for one unit of goods or services) is not well defined. The new equilibrium will entail lower volumes of products, less diversity of products being offered, and a higher price and lower volume of financial services being offered to clients with a less sophisticated financial education: rules to protect the weakest segment of the consumer pool may end up damaging them.

1. Introduction

I must confess I have a soft spot for Romans. Yes, as an empire they did terrible things, crushing opposition from Judea to Hispania, from England to Germania. But they did things, from windows with glasses to the Porta Nigra in Trier, that have endured the passage of time, like no other civilisation in Europe has achieved.

One of those everlasting inventions was in the field of law. Roman law, the ancient legal system, is still studied today. Considering it is 2000 years old this is by no means a minor feat. The reason for this is not just the adequate architecture of the rules, that form the base of all civil law legal systems, but also the strong underpinning of the principles underlying it. In fact, even common law countries have adopted many principles derived from Roman law.

2. The principle of personal responsibility and consumer protection

One of the principles that pertain to the Roman legal system is that of caveat emptor, that can be translated as buyer´s beware, or the obligation of the buyer to ensure, up to a reasonable limit, that the good or service that she/he is purchasing does not contain any hidden defects (be it physical or in the form of underlying risks). Unavoidably, the seller of any good or service has more information about its nature than the buyer, and this is precisely the reason why the buyer must be diligent in understanding the characteristics of the purchased good or service. In the presence of asymmetrical information, a buyer´s due diligence is considered essential to ensure a sound daily business life.

That principle was nevertheless abandoned in the late XX century, with the emergence of a consumer rights philosophy. Instead of the application of personal responsibility, it was considered, and rightly so, that for unsophisticated buyers, there was a need for a regulation that would protect them from unfair practices when buying goods or services. The issue of asymmetric information was sorted out by declaring the obligation by the seller to compensate the buyer from hidden defects.

Of course, the principles above must have some limits in order to maintain a smooth functioning of market-based economies. In particular, the protection was extended only to unsophisticated consumers, and even for this group the basic bona fide principles were still being enforced.

In practice a smooth business life was preserved by offering sellers a safe harbour: if some basic principles were respected (right to return the goods shortly after the purchase, guarantee for hidden effects offered, etc.), the seller knew that the transaction would not be subject to controversy and revision by authorities. Or, in other words, by safe harbour we mean a situation whereby the strict compliance with a set of rules put in place by authorities protects financial firms from litigation and supervisory actions. This safe harbour preserved a smooth business life for financial firms: potential compliance costs derived from consumer protection could be identified ex-ante and were kept under control.

Anyway, the actions of courts of justice, as the ultimate gatekeepers of maintaining a fair marketplace for financial products, guaranteed the prevalence of consumer rights, always under the principle of caveat emptor. Particularly, in the US the punitive justice system and class actions (whereby a group of people´s rights are defended in a lawsuit by a subset of them) were the ultimate discipline devices. In Europe, the existence of a very detailed set of obligations, allowed for a tick the box approach by courts on the fulfilment of the conditions attached to the safe harbour.

3. The emergence of a zero-tolerance culture and the unbounding of consumer rights

During the first decades of the XXI century, we are witnessing an additional push on the front of consumer rights and a further weakening of the principle of buyer´s beware. A zero-tolerance philosophy means that any failure of a single transaction in terms of consumer protection, among millions of transactions of the same kind, leads to ever tougher rules that weaken the caveat emptor principle.

This movement is also reversing the burden of proof, to the extent that for financial firms the concept of a safe harbour is increasingly an elusive one. If a single failure among millions of transactions provokes a backlash that creates a wave of judicial rulings and redresses, financial firms are not able to deal in advance with this uncertainty. Transactions that were deemed safe suddenly are seen as unacceptable.

Why this change of social attitudes matters? In the short run, it impacts the profitability of financial operators. In short, shareholders bear the impact. But if we consider ROE an endogenous variable that must be equal or superior to the cost of capital (the remuneration shareholders demand to stay in the capital of a financial institution) for the company to survive in the long run, the medium-term consequences will come as financial firms readjust to the new environment.

The first result is the lowering supply. Firms that do not react will be driven out of business, the ROE not matching the required cost of capital. And firms that react will try to avoid potential weaker clients (weaker in terms of financial literacy, cultural level, age, employment prospects, etc.). The new equilibrium will be accompanied by a lower supply of financial services, especially for those contentious clients. And we should not ignore that the worst problem for any consumer, the greatest attack to his/her rights, is not being able to access financial products.

Another reaction will probably be a simplification of the supply of products. Simpler products, with solid business margins, are a rational response to the ever-increasing consumer rights. A plain vanilla financial product will be less prone to potential changes in society´s mood. Over protection may well lead to lower number of products being offered.

And finally, another obvious reaction will be to become more digital. If the conversation of a customer and an employee of a financial firm is key to determine the chances of a future setback in terms of redress, then a way to reduce risks is to eliminate that human interaction.

4. The failure of the regulatory and supervisory architecture in the area of conduct of business rules

a. The design of conduct of business rules

Felix Hufeld, former head of the German Supervisory Agency (BAFIN), has pointed out a difference between the architecture of conduct of business rules and that of solvency of financial firms. Both regulations are not immune to crisis, and financial crisis and financial scandals do impact regulation. We saw that after the Global Financial Crisis (GFC), with the push to promulgate Basel III just immediately after Basel II was finalised (poor timing: just before the GFC). And we see it in the conduct of business rules, as a result either of financial scandals or of court rulings.

Solvency rules are reformed in a more structured and multiannual way, with clear discussions on the flaws of previous regulations, of the best architecture of the new rules and with well-designed impact assessments and

consultation processes. Conduct of business rules respond also to a well thought design, but the succession of local financial scandals adds a layer of local gold plating that makes them more cumbersome, complex, confusing, expensive for financial firms in terms of compliance costs and obscure for the consumer.

This layer cake structure of conduct of business rules goes against the availability of cheap financial products for all consumers. The objective of conduct of business rules regulation should not be to limit the supply of products to a narrow set of options or to direct them to a narrow group of (wealthy) consumers. Let´s always keep in mind that the worst result for consumers´ rights is not having access to goods or services. The line between effective protection and regulations that do not crush supply is both a fine one and an indispensable one.

b. The digital revolution and the perimeter of consumer protection

The digital revolution will bring, probably, mostly good things on a net basis. Better, cheaper access to financial products, increased competition, better user experience, an increase in overall efficiency for the financial sector, etc. But we cannot be naïve with the challenges associated: any revolution usually leads to someone´s blood being spattered in the asphalt.

Some risks are already obvious: cyber risk and cyber criminals abound in this brave new world. But the challenges go well beyond this. The digital revolution is blurring the boundaries across countries, but across sectors as well. And what is more relevant: it is making regulating the provision of digital services far more complicated. We do not agree even on the architecture of regulation: should we continue to regulate depending on who you are (entity based) or on what you do (activity based)? Should we be implementing the mantra of "same activity and same risks, same regulation and supervision"? Should we go for a new mix of activity based, entity based or a mix of them for bigtechs?

All these questions do matter, because a consumer may well find a very different de facto protection regime depending on which type of firm is providing the services. And the problem is not that of equivalent regulation: Let´s not forget that any regulation is only as good as the supervision ensuring it is being applied and followed.

Or, in other words, what is the purpose of having regulated financial firms being subject to the strictest standards if provision of financial services may come through unregulated financial firms with afar headquarters (or even with no physical headquarters)? The mix of digital revolution, unbundling of financial services, and the disappearance of sectoral and country frontiers do put a major challenge to effective consumer protection.

Finally, the financial sector history reminds us that, hand in hand with welfare-enhancing financial innovation, we have seen also the emergence of harmful financial innovation. This time around it is not going to be different. Technology brings opportunities, but also will bring headaches.

c. The complexity of rules

The basic rationale of conduct of business rules regulation (offering an adequate level of protection to consumers whilst also delivering financial firms a safe harbour) is being challenged by the very complexity of financial regulation.

Two elements are blurring this principle. First, the retrospective bias by which past contractual relationships are judged against the background of current principles. Since economic progress is accompanied (and rightly so) by ever-increasing levels of protection, there is a risk that either supervisors or courts of justice apply new, higher

standards of protection to old contracts. For instance, most of the litigation around mortgages in Spain may correspond to this type of bias. Financial firms that did what seemed to be right (and not just what was acceptable) when the financial contract was signed, but as principles and standards on financial consumer protection evolved, the safe harbour all but evaporated.

The second factor affecting the firms is the intricacy of rules. Whilst in general regulators have tried to deal with the increasing complexity of the financial ecosystem by increasing the density of supervisory rules (something that can be observed, for instance, in Basel III or in the Resolution rules), in the case of financial consumer protection the trend towards more complex financial regulation is a result of two forces acting in the same direction. The first, already mentioned, is the push to codify all potential interactions between consumers and financial firms in an increasingly complex financial sector, where new intermediaries and new financial products abound. The second one, also mentioned, is the impact of concrete financial scandals in shaping new protection rules in a layer cake structure. This mix of forces, normative (rules responding to a well thought design by authorities) and positive (reacting for political reasons very fast to concrete scandals), is unique to the sphere of conduct of business rules.

What does this all mean in practice? Financial firms are faced with a very complex set of financial regulations, with very expensive compliance cost, but that due to its evolution (lack of stability) and increasing complexity ends up not delivering the safe harbour that a supervised entity needs to be able to trade. Selling financial products under these circumstances is like driving in a road where traffic signals and traffic rules change as you drive on the road.

d. The risks of Artificial Intelligence and the outcome-based consumer protection

Can a well-designed financial programme embark in misselling? In principle, financial misselling is the result of interaction of two human beings (one being a financial sector worker and another one being a consumer seeking to buy a financial product), confusion arising from that interaction, and in the end an inadequate product being sold to the consumer. If you take away the human factor at the financial firm side, you also take away the possibility of confusion arising. Or, in other words, a well-constructed IT interface would ensure that the consumer, having gone through all the process, all the check and balances incorporated, would only be buying a product that fits his or her needs.

Do supervisors agree? No, by no means. They recognise the difficulties of proving, for instance, that an AI interface, with a broad use of big data (lake pools) and machine learning techniques, has embarked in misselling. But they also point out the solution: if the outcome is unfair for the consumer, then a sanction to the firm for misselling is possible. We are going from a proof-based enforcement action system to an outcome based one.

What is the problem of such a system? It is an open-ended protection system that offers firms no guarantee. From the safe harbour concept, we went to the unsafe harbour one and, in the future, we run a risk of going to a no-harbour-at-all system.

5. Conclusion

We may wonder why all the above arguments matter. I think they do, and a lot. Any transaction in the marketplace is defined by three elements: supply (someone willing to sell), demand (someone willing to buy) and a price (the quantity of payment or compensation given by one party to another in return for one unit of goods or

services). The problem of an open-ended protection system that is prone to litigation and sanctioning is that the third element, the price, is not well-defined.

What is the rational response to such a situation? That the supply side will try to compensate the pricing uncertainty by shifting the supply curve upward: the new equilibrium will entail lower volumes of products, less diversity of products being offered, and a higher price. But given that the litigation risk is not distributed uniformly among clients, being higher for less sophisticated clients, the new equilibrium will most probably imply that lower volumes of financial services are being offered to weaker clients, or to clients with a less sophisticated financial education. In other words, rules and practices that are being put in place to protect the weakest segment of the consumer pool may well end up damaging the very same group of clients.

Romans knew it well: a good functioning commercial traffic requires a bit of due diligence, of care, by all sides involved in any transaction. Let´s hope that the concept of caveat emptor is back into legislation in the not too distant future. ■

About the author

José María Roldán *is Chairman and CEO of the Spanish Banking Association (AEB) since April 2014, after 13 years as Director-General at the Banking Regulation and Financial Stability department of the Bank of Spain and member of its Executive Board. From May 2015 to June 2019, he was also Vice-President to the European Banking Federation (EBF). During his tenure in office as Director-General he was part of the Basel Committee on Banking Supervision (BCBS), and chaired both the Standards Implementation Group (SIG) of the BCBS and the Joint Forum during the tenure of the BCBS. He founded and was the first Chairman of the Committee of European Banking Supervisors (CEBS); the forerunner of the European Banking Authority (EBA), after being President of the Financial Action Task Force on Money Laundering (FATF) and chaired the extinct Banking Advisory Committee (BAC) of the EU. Mr. Roldán joined the Bank of Spain as Senior Economist of the Research Department in 1989, but in 1994 he took up a post at the European Monetary Institute (the forerunner of the European Central Bank) in Frankfurt.*

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