THE SUPERVISION OF NON-DEPOSIT-TAKING CREDIT PROVIDERS

AN OPERATING FRAMEWORK AND BEST PRACTICES FOR SERBIA

Submitted by:
Business Enabling Project

Submitted to:
Ministry of Finance
National Bank of Serbia

Date:
20 November 2013

Contract No.:
169MAARD-102UP014

THE SUPERVISION OF NON-DEPOSIT-TAKING CREDIT PROVIDERS

An Operating Framework and Best Practice

Introduction

This paper presents a "starter" framework for the supervision and monitoring of non-bank, non-deposit-taking credit providers in Serbia. It reflects wide international practice and aims to promote a common understanding among policymakers about the options for setting up a supervisory administration for these types of lenders. This paper is focused mostly on compliance monitoring. It does not address specific licensing requirements or legal provisions. These issues should be addressed in a separate analysis.

Types of Specialized Non-Bank Credit Providers

The framework applies to most specialized lenders that are not licensed to take public deposits, do not pose systemic risks, and are not part of the financial sector payments and settlement system. These include a range of institutions, such as the following:

- Microcredit companies and NGO's
- Mortgage finance companies
- Consumer finance companies
- Equipment or asset finance companies

These are private companies that use their own capital or the capital of institutional investors to lend. Their goals of operation may be strictly to make a profit on investment by filling an un-served market niche, or they may have additional reasons for being in the business of lending. For example, some equipment finance companies are owned by equipment manufacturers and they offer finance to facilitate the sale of their equipment. In other cases, sometimes in microfinance, they may be nonprofit-making and have affiliation with donors, philanthropic foundations, or faith-based organizations. Many micro credit companies have a dual mandate to achieve both social and financial returns.

Whatever their focus, at the core of operation, these types of credit providers are essentially doing the same thing – making loans to needy businesses or consumers using funds that are outside the scope of concern for the prudential regulator.

Rationale for Regulation

A distinction needs to be made between these credit providers and non-bank institutions that take public deposits, such as cooperatives, savings houses, and deposit-taking MFI's.

Deposit-taking institutions should be subject to prudential laws and regulations that are similar to, or the same as, those for banks[1]. Non-deposit taking credit providers, on the other hand, do not pose prudential risks to consumers or to the financial system in general.
The rationale for regulation is very limited and specific. Regulation should be mostly focused on having a transparent and effective licensing process and light monitoring thereafter.

While there have been a few outstanding cases in the world where some market turmoil resulted from these types of credit providers, these were in markets that saw tremendous growth fueled by domestic bank funding that was politically sanctioned and out of control. In the vast majority of countries where these types of credit providers exist, they have been credited in helping to buffer rather than exacerbate financial crises because they are have less dependence on bank-sourced funding.

There are two primary public policy objectives for monitoring these non-bank providers: borrower protection and mitigating financial crimes.

Objective #1 Borrower protection[2]

The act of getting a loan is relatively straight forward for medium and large companies, but it may not be that way for consumers or small business entrepreneurs. Consumers and small businesses are most vulnerable to deceptive or unfair lending practices. They also have limited capacity to take recourse through the legal system to protect their rights and welfare. Therefore, some oversight is warranted to safeguard against five main types of regulatory risk regarding borrowers.

- **Predatory Lending:** Predatory lending is the unfair and deceptive practices of a credit provider during the loan origination process. This can arise through unclear or inaccurate disclosure of loan terms and conditions, intentionally withholding information, misrepresentation of loan costs, charging hidden or unjustified rates and fees, imposing unfair conditions, false advertising or engaging in aggressive sales practices to get borrowers to take loans, creating loan structures that borrowers are not likely able to pay back, etc.

- **Misuse of information:** Misuse of borrower information or failure to protect the privacy of that information. Such information should only be used for the purposes specified at the time the information is collected or as permitted by law, unless otherwise agreed with the borrower.

- **Misuse of borrower funds:** In some markets, credit providers require depository collateral. While these practices are normal, there is risk of misuse if proper controls are not in place. In Serbia, this should not be a problem since the banking system can be used to hold and protect

[1] An example of how deposit taking MFI's should be regulated (differently from non-deposit-taking MFI's covered in this paper) can be found in the document entitled "Microfinance Activities and the Core Principles for Effective Banking Supervision" published by the Basle Committee on Banking Supervision.

[2] EU Regulations on Borrower Protection include: Directive on Consumer Credit, 1998/7/EC, amending Directive 87/102/EEC, Directive on Consumer Credit, 2008/48/EC, Directive on Credit Agreements for Consumers, 2008/48/EC, repealing Directive 87/102/EEC, Directive on Unfair Terms in Consumer Contracts, 1993/13/EEC, Directive concerning Unfair Business-to-Consumer Commercial Practices in the Internal Market, 2005/29/EC, Directive on the Protection of Individuals with regard to the Processing of Personal Data and on the Free Movement of such data, 1995/46/EC, Directive Concerning Processing Personal Data and Protection of Privacy in the Electronic Communication Sector, 2002/58/EC, Directive on Protection of Consumers in Respect of Distance Contracts, 1997/7/EEC, Directive on the Distance Marketing of Consumer Financial Services, 2002/65/EC, Directive on Markets in Financial Instruments, 2004/39/EC (MiFID), Treaty establishing the European Community (EC Treaty), 1957 as amended.

depository collateral. There is no reason for non-bank providers to directly handle collateral funds from borrowers.

- **Abusive collection practices**: Borrowers are at risk if non-bank credit institutions or their agents engage in abusive debt collection practices, making false statements, or giving false credit information to others.

- **Poor administration leading to high volumes of errors and omissions and unfair practices:** Ineffective operating systems can result in poor loan administration and an unacceptable frequency of errors or system failures that create significant inconvenience for borrowers. A breakdown in operations or systems can lead to customer detriment. Poor management of the credit operation or weak security can cause loss of information or records, which in turn can create problems for borrowers. Borrowers also at risk of being treated unfairly by not getting proper notices of changes in rates and fees, notices of changes in location, or not having timely access to the lender after the loan is made.

- **Discontinuity of operation:** Borrowers are not likely to lose money from a non-bank credit provider going out of business, but there are various ways in which borrowers can face some detriment. For example, if the non-bank goes out of business without warning and cannot fund its loan commitments those borrowers can face problems in quickly arranging new finance to meet their obligations. Non-bank credit providers who are in financial difficulty are prone to take more risk in how they conduct business. These risks are relatively small and are not much different than what would be faced in a commercial transaction, so they do not call for extensive prudential supervision. Rather, this type of risk is covered by having a modest minimum capital requirement that will help support continuity of operation.

The aim of supervising non-banks is not to protect all borrowers from every risk, but to ensure that lenders provide enough information so that borrowers can act to protect themselves. The aim is also to monitor practices from a distance to ensure that there is not widespread abuse or misconduct that could threaten the integrity of the financial system.

Non-bank credit institutions in Europe are not exempt from consumer protection provisions, which exist especially in the EU Directive 2008/48/EC on Credit Agreements for Consumers, repealing Directive 87/102/EEC. However, the enforcement of the law differs from country to country and depends on national institutional arrangements.

Objective #2 Prevention of fraud and financial crimes

Non-bank credit providers, like most lenders, deal with large sums of money and large money transactions. While the opportunity for facilitating money laundering is limited if institutions do not take deposits, some oversight is needed to ensure these institutions are not being complicit in illegal activities or creating structures that enable money laundering. Non-bank providers need to at least identify the main sources of loan repayment and know their clients.

Macro risk monitoring

There may be a third objective if the non-bank industry becomes very large and widespread, though this is not likely to happen in Serbia with the banking system being so large. This objective is related to macro monitoring of credit levels, concentrations, and wholesale funding.

In some markets it may be necessary to monitor the volume of credit issued by non-banks for monetary policy reasons. In addition, in some markets, the funding sources of non-banks are relevant to the regulator if the sources represent significant counter-party risk to other financial institutions. The funding sources are also a concern if the providers are raising significant capital from investors via the capital market under circumstances where there is a risk that those investors may be easily confuse the provider with a bank, or misunderstand the nature of the risks they are taking.

How Should the Government Respond to These Regulatory Risks?

In most developed markets around the world, non-deposit-taking credit providers are monitored lightly, if they are monitored at all. The supervisory process is not very intrusive and regulators tend to rely on borrower complaints, adverse news events, and off-site market monitoring to identify problems. On-site inspections may be done for some types of organizations, but they are infrequent, short, and often focused on borrower protection issues. They are also often done when a problem has been identified as a way of confirming and collecting more information on the nature of the problem and how widespread it is.

Even when supervision is strong the focus is on areas where the most vulnerable, least informed borrowers are at risk. This is often determined based on two pivotal criteria: 1) whether an organization provides services to the general public (as opposed to informed business owners in specific industries) and the nature of financing being provided (e.g. is it long-term finance that commits borrowers for many years or short-term finance); and 2) whether there are specific characteristics of the non-bank business that create vulnerabilities or risks to the financial system (e.g. products and services that are uncommon).

For example, within the above list of specialized credit providers, mortgage lenders likely present the highest risks among all of the providers. The reason for this is that mortgage lenders deal directly with the public, they are likely to have the longest running relationship with borrowers due to the long duration of loans, and they provide relatively large loans for life-time purchases, such as a house. These factors raise the risk profile of lending because the impact on consumers of something going wrong can be very significant. Similar factors may hold true for providers of small business finance, but the impact on the entrepreneur monetarily is probably lower if something goes wrong since the loans tend to be small and short-term. Therefore, while the legal framework for specialized credit may be the same, the practice of supervision may differ as the risks differ –by types of borrowers and types of products.

In Serbia, for the foreseeable future, small business lenders, microfinance and, possibly, equipment finance companies (as well as leasing and factoring companies that are separately regulated) are likely to be the most active in seeking to do business. Given this likelihood, **the infrastructure for supervision does not need to be large or complex. It can be established relatively quickly, at relatively low cost, and flexibly positioned.**

The sections below address where supervision could be located, what resources will be needed, what reporting requirements should be in place, and how supervision can be done effectively.

Who Should Supervise?

The question of who should have responsibility for supervision is common and has been addressed at one time of another by all countries that have specific legislation for these providers. Practice varies considerably. Some countries place responsibility with the bank regulator, but only apply non-prudential standards. This seems to work when the bank regulator is also responsible for fair lending and consumer protection laws.

Some countries use dedicated financial consumer protection agencies. In some countries where the majority of non- bank lenders are micro credit providers special units are set up in the ministries of economy or finance. In countries that have integrated regulatory agencies (i.e. mega regulators), responsibility is usually taken on by those agencies.

There are two types of non-government arrangements - self-regulation and delegated regulation - but these are less common and not likely to be practical in Serbia at this time; though they could be eventually with some collaborative effort by the government and market participants. More on these is provided in the side box.

Self-Regulation and Delegated Supervision

Self-regulation, Supervision by a body that is controlled by the organizations to be supervised, has been tried a lot with mixed results. It works best in an established industry where there are many strong and reputable operators and where the self-regulatory organization is able to work independently and not operate captive to the interests of the industry. Self-regulation may work in a hybrid model where responsibility is shared with a government agency or divided in some way, but in many transitional markets where the culture of self-regulation is weak or under-developed it can be hard to implement.

Delegated Supervision: Under some proposed models, the supervisory agency maintains legal authority over—and responsibility for—the supervised institutions, but delegates regular monitoring and on-site inspection to a third party, such as an industry federation or an independent technical entity, such as an accounting firm or consulting firm. In some countries there are apex organizations that provide funding and assistance to non-bank counterparts. It is sometimes suggested that apex organizations are well placed to carry out supervision because they often have funding at risk.

The role of the supervisor in a delegated arrangement lies in (1) periodically testing the reliability of the agent's monitoring and inspection, and (2) intervening in problem situations. Though the supervisory agency may be able to delegate its monitoring, the law will usually not permit delegation of its authority and responsibility to intervene when institutions run into trouble or collapse.

The decision facing Serbian policymakers about where to do supervision is one whose time may have come, not just for non-deposit taking credit providers, but for the entire financial services sector. The current structure for financial supervision of banks and non-banks is not optimal and Serbia is now with a minority of countries in wider Europe that has not modernized the way it allocates regulatory responsibilities. Over two-thirds of countries have created some form of integrated regulatory agency to take on supervision of non-banks and, in some cases, banks.

Notwithstanding the need to address the larger strategic issue of how regulation should be organized across the financial sector, for now, to quickly establish a supervisory administration for credit providers, the most plausible options are as follows. These can be short or intermediate term while longer-term arrangements are being decided.

Option A- Supervision and licensing by the NBS: Oversight can be done by a small number staff responsible for consumer protection and fair lending.

Option B – Supervision and licensing by a newly created unit in the MoF or MoE: This unit could be trained by the NBS over a period of six months and then operate from within the respective ministry

Option C– Supervision by the Securities Commission: This would open the door for re-scoping the authority of the commission to include all non-bank credit markets.

Option D – Supervision by the consumer protection ombudsman.

Option E – Supervision by the Financial Intelligence Unit.

Option F- Supervision by a newly-established national credit regulator. This regulator will take on all borrower protection regulation relating to credit; including borrower protection matters for banks.

There may also be an option for splitting responsibility for different functions. For example, licensing could be handled by the NBS or MoF and ongoing supervision for financial crime and borrower protection could be handled by other agencies. Or, licensing and supervision could be split between the NBS and the MoF (or MoE), with the ministry doing licensing and the NBS taking on the monitoring. Splitting responsibility is not ideal, but it can work is there is good inter-agency cooperation.

Option C or Option F would also set the stage for eventual establishment of a full-scale, integrated non-bank regulatory commission. This regulator could supervise all types of non-bank institutions, including insurance, pensions, and money exchange operators.

How Much Resources Will Be Needed?

The resources needed to supervise non-banks arise mainly from three obvious areas: 1) licensing; 2) supervision of the licensed organizations; and 3) when needed, management take-over, closing down the lender, and/or liquidation.

At the onset of new legislation, resource needs will be greatest in the areas of licensing and some monitoring (1 and 2). Over time, the resources needed to monitor will grow as the number of licensed providers grow, and eventually resources may be needed to deal with license withdrawals; though for non-deposit taking institutions this process does not require the government to administer or manage a resolution or liquidation, it can just suspend or withdraw the license and force the entity to cease additional lending.

The supervisory administration is scale-able depending on the number of entities being regulated. There is no need for a large staff at the onset of regulating these entities. A very rough estimate of the number of dedicated professional staff needed is broken down by number of licensed entities and value of loan assets in the following table.

Number of Licensed Entities			
Value of Loan Book (Euro)	*3-5 entities*	*6-10 entities*	*10-15 entities*
20m-50m	4-5 staff	4-5 staff	5-6 staff
50m-100m	5-6 staff	5-7 staff	6-8 staff
100m-200m	5-7 staff	7-8 staff	8-9 staff
Estimated Breakdown of Time			
Year 1-2	50% time on licensing 40% Time on monitoring 10% Time on other		
Year 3+ (Normalized)	25% time on licensing 50% Time on monitoring 25% Time on other		

These staff levels are based on a normal operating environment where credit providers are reasonably compliant, there is efficient collection of borrower complaints, access to market information is good and licensing volumes are not excessive. They assume that every licensed entity is inspected no more than once per year and that enforcement matters are relatively straightforward and punitive. In some situations staffing levels could be lower if the volume of licensing applications and compliance records are good, requiring fewer supervisory actions.

If the NBS is not the appointed regulator, it should be willing to provide some training and occasional assistance on complicated issues if needed. In the first one to two years of operation it could help in licensing and then in later years provide 1-2 staff on rotational basis to help coordinate supervision and ensure that borrower protection is harmonized with bank lending. This type of cooperation would also give valuable experience to NBS staff on consumer protection issues associated with different types of loan products.

If the operation is carried out by the NBS, the number of dedicated staff may be lower if licensing and enforcement can be integrated into mainstream operations. In this case, a small unit for off-site monitoring and case management would be needed. The occasional, short, inspection could be carried out by staff that also does bank inspections. Again, the scope of these inspections would not cover prudential issues so they would be short and should not be a big drain on resources.

In order to better manage a small staff, and reduce the need for always having staff available to work on licenses, the regulator could have fixed time-times in which licensing applications can be accepted – for example once a quarter or bi-annually.

How Will Supervisory Operations Be Funded?

Considering the need for very few staff and light supervision, the budget for running a supervisory administration should not be large.

There are various options for paying for the cost of regulation, but there are no standard practices. Because these providers do not require intense prudential supervision, there is not a lot of justification to assess significant fees. However, some supervision is required and these providers will benefit from the stability and credibility realized through a formal regulatory structure. Thus, there is good reason to assess some fees to cover all or part of the cost that the government will incur in running the supervisory administration.

The fee structure is a topic for future discussion once a decision is made on which organization will have responsibility for supervision. As a matter of good principle, the structure may use or all of the following elements:

- Fixed licensing fee
- Minimum ("base") annual license maintenance fee
- A small regulatory transaction fee attached to each new loan origination (e.g. .0010-.0015 of the value of each loan).
- Use of any penalties collected (i.e. retained by the regulator or transferred to the central budget)
- A small fixed budget transfer to cover any budgetary shortfalls[3].

Any accumulated budget surplus (less any penalties collected) could be returned to the industry in the form of lower annual base fees.

What Information Should Be Collected From Licensed Entities

Regulatory financial reports are an important part of the compliance monitoring process, but they do not need to be extensive or so frequent so as to create a burden on lenders. The regulatory reporting regime should cover the following: 1) financial status; 2) significant events; 3) portfolio activities; and 4) self-assessment of compliance with applicable laws and regulations.

The full regime of reports and their frequency of submission could be as follows:

Indicative Report	Reporting Frequency
1. **Performance and Activity Summary:** A two page summary of the organization's financial and lending performance such as: capital and asset values, average rates and fees, value of non-performing loans, and a summary of any new products introduced.	Monthly
2. **Audited Financial Statements:** Financial statements prepared by certified independent auditors.	Annually
3. **"Significant Events" Report:** As part of the ongoing reporting requirements, companies should be required to notify the regulator of any material change in its financial position, risk profile or business activity since the last annual report submission. Any events with a material impact on the provider should be reported – this includes the introduction or withdrawal of a new service or product line.	As needed
4. **Portfolio and Funding Report**: A key statistical report showing, in more detail than the monthly summary, credit activity in the period, outstanding exposures to various client	Bi-Annually/Quarterly

[3] Budget allocations should be evaluated in relation to the expected net benefits that can come from having better access to finance and more financing alternatives. Increase employment and contributions to economic growth are likely to far outweigh any fractional cost of partially funding a small supervisory operation.

segments and sources of funding. The report should provide a flag for any credit or funding arrangements that are with affiliated entities or entities licensed by the NBS.	
5. **Self-Assessment of Compliance (SAC):** A standard questionnaire completed buy organization management affirming that the licensed entity has in place a formal compliance assessment function and that it has verified compliance with certain high-risk areas. This self-assessment should be endorsed by the management and the board of directors, or its parent affiliate. The SAC should mirror the structure of the topic list for in-site inspections.	Annually
6. **Marketing brochures and loan documentation on all products and services.** Non-bank credit institutions should have a Key Facts Statement[4] for each type of account, loan or other products or services. The Key Facts Statement should be written in plain language, summarizing in a page or two the key terms and conditions of the specific financial product or service, and allowing consumers the possibility of easily comparing products offered by different institutions.	Once at licensing and when material additions are made thereafter

How Should Monitoring Be Done?

The supervisory approach should include a minimum amount of on-site evaluation and mostly off-site monitoring.

On-site inspections: Initially, each entity should receive a short on-site inspection at once every 18 months. These inspections should not take longer than a week in most circumstances. For small organizations a visit may take two to three days; in some cases even only a management meeting may be necessary. The scope of review should be limited to borrower protection issues and testing for AML violations. Matters concerning governance, systems and administration can be reviewed even less frequently depending on need.

Management Meetings: While management meetings are not inspections, at least one meeting should be held a year with the entity. The issues covered in these meetings can range from general regulatory issues affecting the industry to specific issues to general conversations about regulatory developments and strategic plans. The overriding purpose of the meetings is to have face-to-face contact with company management and to establish a productive relationship for dispensing regulation.

Off-site Monitoring: Off-site review of information is done between inspections and is the primary activity for supervision. It has two parts.

Part 1 is review of report submissions and any active regulatory issues. The monthly summary report for each entity should be quickly reviewed and, if necessary, discussed with the provider management. Other report submissions should be reviewed in the month they are due. Other information that should be reviewed includes:

---

4 There are several examples of Key Facts Statements worldwide, such as the SECCI form for consumer credits in the European Union, the ESIS format for pre-contractual information on home loans developed by the European Associations of Consumers and the European Credit Sector Associations, the "Schumer Box" for credit cards in the US, the "Hoja Resumen" for consumer credits in Peru

- Results of supervisory follow on corrective or remedial actions being undertaken by the company
- Analysis of company-specific developments
- Review of any relevant advertising or publications distributed by the Company;
- Review of any consumer complaints;
- Review of press coverage or publicity covering the Company;
- Review of other information that have come to the regulators attention

Part 2, which is done on an industry-level, is market monitoring. The regulator should continue to monitor overall market developments that may affect the competitive environment for finance providers or exacerbate risks in companies being monitored. Situations to look for include:

- Aggressive advertising practices or pricing practices
- Material loss of bank share of lending to specialized providers
- Material balance sheet growth over a short time-frame
- Materials changes in industry operating or business patterns or practices
- Industry-wide data on products and services
- Significant inter-firm funding and lending (affiliated lending and funding each other)
- Significant (demand-driven) appreciation in asset prices (houses, cars, equipment, etc.)

The portfolio/funding reports should be used to review growth of credit exposure and inter-company lending, and related payment performance. Collaboration with the central bank is needed to identify any material wholesale funding exposures that banks may have to specialized lenders. (Loan concentration limits may be needed to curb exposure to systemic risk if the balances of wholesale funding are a material portion on bank assets; though there is no indication this will be a concern in Serbia for the immediate future.)

What are Time-Thresholds for Different Activities?

The length of time between inspections and the amount of time spent on off-site monitoring could vary among institutions according to their size, past compliance experience and types of clients they serve. Size and compliance experience are relatively straightforward differentiators for how much effort may be needed. Non-bank credit providers in Serbia are likely to be niche lenders and small in comparison to banks. But differentiating supervision by the types of clients served requires a few considerations – i.e. the level of sophistication of the borrowers, the length and complexity of financing, etc.

For example, credit providers servicing small and medium businesses or industrial equipment finance providers will be working mostly with established businesses. The time spent on these providers can likely be less than the time spent on consumer lenders. In fact, it could be argued that if the providers working with businesses are small and have a reasonably good compliance history, they may rarely need an inspection and may require very little supervision unless a problem is detected from public information.

What Should Supervision Focus On?

The primary areas of focus will be on: disclosure requirements, terms of dealing and contracting, advertising, record retention and account management, consumer complaint handling, and limitations on interest rates and fees (if usury laws are in place).

Examples of areas of supervisory interest and sources of information that are often used are provided in Appendix A. These areas do not need to be reviewed comprehensively in every inspection or in every cycle of off-site analysis. They are types of issues that could be addressed depending on the type and scale of operation of the provider, the sophistication of customers being served, and overall conduct in the market.

What Other Support Is Needed to Make Supervision Efficient?

Non-bank regulation relies substantially on market discipline to regulate errant behavior. This does not mean that consumers have to bear the risk of bad conduct by lenders, but the supervisor should make tactical use of various tools to reduce the need for direct, intrusive regulation.

The supervisor should consider adopting an approach that focuses on the following:

Consumer education: Disclosure regulations work best when consumers are literate and able to use effectively the information provided. A range of initiatives should be undertaken by the relevant authority to improve the financial literacy of the population.

The mass media should be encouraged to provide financial education, information and guidance to the public, including on non-bank credit institutions and the products and services they offer.

Outreach efforts could be extended to some of the following:

Types of information	Means of communication
• General information and advice	• Web site
• Product-specific information	• Print media (brochures, handouts, bulletins)
• Education on financial markets	• Print media (press and journals)
• Statistics	• Public forums
• Consumer complaints	• Public survey
• Watch lists	• Sponsorship
• Enforcement actions	• Helpline/Call Center

Complaint Monitoring and Resolution: Countries differ widely in the ease with which consumers can register complaints, and also how they track consumer grievances, making comparison difficult. Nevertheless, most supervisors have a central place to which borrowers can file complaints and some form of dispute resolution mechanism if they are not satisfied with the resolution offered by their lender.

Publicity around the complaints record of institutions—rewarding the good and shaming the bad—may have some effect on lenders' behavior if communicated widely enough. New technology, such as social media, can also be useful, but the most credible and influential approaches to informing the public are likely to require encouragement and support from policy makers and regulators.

Licensee Register: The supervisory authority for non-bank credit institutions should have a web-based register, which lists the names of non-bank credit institutions. Complaints records and regulatory sanctions could be published on this register.

Promote Development of Industry Associations: Associations have both a vested interest in ensuring that their industry remains in good regulatory standing and in promoting the business interests of their members. In this light, the supervisor should seek to promote and work with industry associations in establishing standards of operation, performance, and conduct[5].

Leverage from External Auditors and Specialists: The conduct of an external audit differs in important ways from a supervisory inspection. They are guided by different standards, methodologies, and assumptions.

Nevertheless, in performing their work external auditors and regulators may review much of the same information. Auditors review financial records in a more detailed fashion; they are often aware of conditions that could be useful to inspections. To the extent that inspectors can avoid duplicating work done by external auditors, inspections could be more efficient and less burdensome for providers. Auditors' work can be highly useful for identifying issues needing management's attention and providing indicators of management ability (or willingness) to address those issues.

The supervisory approach should incorporate the work of auditors in at least the following ways:

- *Review of auditor work papers for high-risk providers (if allowed by law):* Routine review of auditor working papers should become standard operating procedure for reviews of all high-risk providers.

- *Pre-inspection consultation:* As part of a pre-inspection planning, inspectors should be required to contact a provider's auditor to solicit information that the auditor may have gained from work at the provider since the last inspection.

- *Annual meetings:* The supervisor could institute a program whereby annual meetings are held with local accountants to informally discuss accounting, supervisory, and inspection policy issues. Improving cooperation between external auditors and inspectors has the potential to improve inspections, enhance the efficiency of inspections, and reduce regulatory burden on banking providers.

Industry-Wide Initiatives: In the course of its work the supervisor will identify risks that are common among many providers. Generally, these issues will likely include consumer protection issues associated with products, advertising practices, contracting practices, and other issues pertaining to transparency and overall conduct. Some of these issues may lead to 'themes'. Themes are major issues that cut across different industry sectors and have wide-ranging implications for consumers. Others may be sector or product specific.

The approach to responding to these risks may include an industry-wide initiative involving public education, general guidance on acceptable and unacceptable practices, engagement with industry associations, or other measures. The supervisor may consider undertaking these initiatives liberally with a view to turning a risk into an opportunity to better inform consumers and improve conditions in an industry or in the sector overall.

---

5 The European Credit Research Institute is a source for more on the use of codes. Furthermore, the EC has created several consultative bodies, such as the Financial Services Consumer Group, a sub-group of the already existing European Consumer Consultative Group.84 Permanent committees encompass representatives of consumer organizations from each of the EU Member States. They are specifically asked to ensure that consumer interests are properly taken into account in the EU financial services policy. Another group is the European Consumer Debt Network, a network of debt counselors in different countries. Addresses of worldwide consumer associations can be found on the website of Consumers International.

Regulating Inter-group Exposures from Non-Banks

In some cases, like leasing, non-bank credit providers may be affiliated with or obtain funding from other regulated financial institutions where prudential risks are high, such as banks or insurance companies. Where group or consolidated supervision is weak there are opportunities for regulatory arbitrage to circumvent regulatory limitations. Further, while these providers often obtain funding from sophisticated creditors and investors who understand the nature of the risks, these companies may also attempt to raise funds directly from the public outside of the realm of deposit-collection.

In the case of a bank or an insurance company owning a specialized provider of credit, the supervisory activities should be coordinated with the National Bank and prudential rules should be developed within the banking/insurance framework to limit these ownership/funding ties if rules do not already exist.

Appendix A
Examples of Areas of Supervisory Concern
For Non-Deposit Taking Credit Providers

OBJECTIVE	AREAS OF SUPERVISORY INTEREST	
	Areas of Supervisory Attention	**What Do Supervisors Look At?**
Fair treatment of consumers	• Product design and complexity • Fairness and realism of terms and conditions of contracts • Fairness and realism of rates and fees • Sales, advertising, and promotion practices • Reasonable application process • Proper use of information obtained from applicants • Fair and non-discriminatory underwriting practices • Knowledge of customer • Duty of care in treatment of customer • Ongoing customer service • Proper record keeping • Complaints handling	• Small sampling (5% or less) of loan files to check documentation and disclosures • Product publications • Process for handling of customer complaints and information about the complaints • Policies on advising and selling, on assessing customer understanding, on disclosure, on handling customer complaints • Policies, procedures and standards on fair treatment • Level and type of training given to staff
Accurate and adequate disclosure	• Disclosure of terms and conditions and changes thereto • Disclosure of rates and full costs • Disclosure of general loan qualification criteria • Other disclosure practices	• Sampling of APR statements and review of fee schedules – test checking a few calculations on random basis. • Review of disclosures made • Policies on disclosure practices • Internal organization for communicating with customers – clarity of accountability and responsibility for disclosures
Proper Use of Funds	• Use and handling of any client funds	• Policies and procedure on handling of any customer funds. • Internal controls for any funds held or processed • Level and quality of documentation provide to customer to evidence receipt of payments (if applicable).
Qualifications to perform services	• Suitability of skill and qualifications of staff and management	• Verification of qualifications of key staff and managers – i.e. validating licensing criteria • Level of training given to staff in regulatory compliance • Corporate structure, business ethics and overall oversight of operations
Compliance with laws and regulations	• Detection of illegal operating practices • Detection of money laundering, fraud or other financial crimes • Detection of other illegal practices • Detection of non-compliance with regulations	• Quality and extent of independent verification of compliance with all laws and regulations, measures to detect illicit transactions • Policies and procedures on mitigating financial crimes

	• Compliance with any usury laws on rates and fees	• Quality of oversight, corporate structure, and business ethics • Review of rates and fees schedules – random test of rates and fees charges.
Suitable Organization and Administration	• Operational setup (front and back office) • Administrative processes and systems • Accurate and reliable record-keeping • Security of information	• Physical inspection of premises for operation • Policies, procedures and internal controls • Management organization - clear assignment of responsibility, proper administrative organization, and existence of a business continuity plan
Fair competition	• Concentration of market share (by product, market, business) • Business development practices • Commercial linkages and affiliations • Other relationships • Complaints filed by institutions	• Management culture, business strategy, and oversight of client-service personnel • Complaint files
Mechanisms for dispute resolution	• Approach to dispute resolution • Mechanisms for dispute resolution • Use of third party assistance • Dispute resolution history	• Complaint handling process • Training of staff • Review of complaints files • Sample interview of customers with complaints (phone calls) • Evidence of management oversight of complaints handling
Viability of operation	• Financial capacity to meet contractual obligations	• Financial statements and audit reports • Management and reporting structure • Funding pipeline and loan commitment schedule