

Hamburg, March 1999

## Spring Letter 1999

Dear Friends,

Although the year has already started we would like to take this opportunity to wish you a successful and promising eve to the next millennium. Thank you for your support and the confidence you have invested in our endeavours. As a non profit association without equity investment we acknowledge that our partners and employees are the true capital of IFF and responsible for the success enjoyed in the last year. We have created two more jobs and doubled our turnover. Both, the Media and financial services providers have responded to our improved position. We now have further incentives to listen more carefully to our clients and increase our expertise and competence.

1. 1999 starts with a **new philosophy on consumer protection in financial service** at the European level. In fact, what formerly arose in the second banking directive seems to flourish now with the new currency witnessed by merger and acquisition activity and the reorganisation of the banking industry. Understandably the European Commission focuses on the implementation of the EURO and the corresponding bank behaviour, especially as far as charges are concerned. But this is not exactly what we understand as consumer protection and the social responsibility of banks. The Commission's new programme for consumer protection in financial services emphasises education of the consumer, his or her need to undertake more responsibility in the market place and their activity in transborder and electronic business. For consumer organisations the need to improve co-operation with the Commission and to look for solutions in contact with the suppliers is basically favoured over new regulations.

The draft of a mortgage loan Directive has been replaced by an option for future self-regulation, the credit card recommendation, although not due to the banking industry, will not be transformed into a credit card Directive, the banking unit answers questions on consumer protection in the parliament and even the terminology has changed. The new word for consumer "protection" is "consumer advantage". Whereas since the Cecchini report the common market itself is seen as a real consumer advantage consumer protection legislation, especially on the national level, is even presented as a possible threat to the development of market forces and has thus to be restricted in the name of "consumer advantage".

For the first time in the history of European consumer protection legislation the new draft of the Distance Selling Directive in Financial Services indicates in its preamble that the minimum standard in this Directive will in the future also be the maximum standard for national legislation. We seem here to have misunderstood the Amsterdam treaty which expressly declares EU level consumer protection to be minimum standard law.

Have the problems of exclusion, overindebtedness and poverty declined so much that we can now forget about past projects to increase preventive social consumer protection for example, with minimum standards for individual retirement plans, limitation of default interest rates or usury ceilings in credit contracts or concerning consumer liability for the misuse of payment devices and a harmonised law on consumer bankruptcy, never mind forced transparency of bank's relations to their communities as in the US Community Reinvestment Act? Does the EURO, whose direct effects on capital flow and indirect effect on social consumer protection has been described at our Strasbourg conference promise only advantages or does the unrestricted flow of capital also threaten those areas where profit margins are lower due either to poverty or to high consumer protection standards?

"Home country control" and "mutual recognition" are good principles to hide the inability of European States to create a unified body of law governing all member states alike. They are helpful insofar as they create European issues which will force the member states to think again that the future Europe can not be created through the wild west principles of the Chicago School of Economics alone. We must defend a European culture in which social consumer protection is a core principle. And this European culture is not automatically defended by the market as such.

A historic high unemployment level and the new focus towards wealthy clients ("private banking" instead of "retail banking") render rules of social consumer protection more necessary. Empty pockets force us to distribute the social burden more equally among the population and help the unemployed, unsophisticated consumers in difficult personal circumstances and communities in distress not to be exploited or excluded on account of their weak market position. Consumer protection concerns access, the general environment and use of financial services: maximum prices and charges, the disclosure of calculation methods and future costs as well as the responsibilities of banks, financial institutions and insurance companies for mistakes as well as transparency in access and marketing. Instead of using all efforts to cope with the technical challenges of the next two years, we should think about the year 2005: Shall we have poverty riots together with feudal bank systems for the upper classes or a retail banking system which serves all EU citizens and others?

2. The 1998 **Nobel Price winner Armatya Sen** indicates that the newly emerging utilitarian philosophy does not promise "justice" and "human dignity": "The almost single-minded concern of modern welfare economics with Pareto optimality does not make that engaging branch of study particularly suitable for investigating problems of inequality."<sup>1</sup> Even Pareto optimal starvation is imaginable. If we stress for equality and freedom in the common market we have to answer the question of "Equality of What"<sup>2</sup> and distinguish between "achievements" and the "freedom to achieve"<sup>3</sup>. Sen, denouncing the absence of any sophisticated discussion on the just distribution of wealth within the leading economic theories during the last 20 years gives us two alternatives in achieving for social justice: we could either attach equal opportunities to the efforts of people or to their needs. The first **problem is incentives**. Only if your efforts are honoured by the market mechanism you should gain a just part of the wealth. Such an approach would eliminate those who only want to profit from the efforts of others

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<sup>1</sup> Sen, Armatya, *On Economic Inequality*, Clarendon Press Oxford 1973 p. 7

<sup>2</sup> Sen, Armatya, *Inequality Reexamined*, Clarendon Press Oxford 1992 p. 12 ff

<sup>3</sup> op. cit. p. 30 f

rather than using their own opportunities to help themselves. This would force consumers to learn, to know and to act. Any misuse of transfer income and “free riders” can accordingly be minimised.

But the “prisoners’ dilemma” where nobody will contribute to the common good because there is no trust that others will do alike and equally care for collective goals is solved in a purely individualistic system which shows a high esteem for efforts but little concern for needs. Sen rejects this option as inhuman and a-cultural. Handicapped people, residents of poor areas with low education or single mothers bringing up their children cannot offer services or goods that the market will adequately remunerate. But they certainly have enormous needs. Defeating your own illness, coping with one’s handicaps, raising children or supporting people of old age is productive but not profitable. Honour, health and hope are not tradable goods.

But if the market and money is the only way of guaranteeing the Pareto optimum, how can social justice be achieved? Sen argues that the traditional cultures of the Asian and European societies might be able to offer values which together may lead to “trust”. People may act on behalf of others because they trust in members of the same culture. The individual benefit will then satisfy, as Sen puts it, his or her “agency interest” which appreciates Mother Theresa of Calcutta in the same way as Bill Gates of Silicon Valley. Trust in others’ efforts to further the public interest through individual labour may then become an economic factor to stimulate economic growth even beyond individual profit. The reason why, especially in Europe, we may be able to trust each other could lie in centuries of cultural coherence through language, behaviour, ancestors and ties to the region. If this could be mobilised, a specific European answer to the “prisoner’s dilemma” could be found.

3. The vision of an economy based on culturally founded trust brings us back to financial services. Indeed, a lot of transaction costs presently burdening European Banks in particular stem from the mechanisms which are seen as necessary to check the trustworthiness of borrowers and the verification of investment predictions. It seems as if the price of society mistrusting individuals rises ever more.

Rosalind Copisarow, our American-Polish advisor, on our microlending project with the Hamburg based Vereinsbank has summed up her success-story of microlending in Poland with just one word: “credit”. **Credit means “trust”**. This is no philanthropic concept. It is meant as a management concept which addresses the fact that transaction costs linked to increasing mistrust in bigger and more anonymous markets and creditor-borrower relations have become one of the most significant cost elements in modern banking. The Asian crisis, break downs in real estate investments and the rising number of insolvencies testify to this problem. Trust would accordingly be the most cost cutting contribution to the banking community. With an extremely simple credit extension system, Fundusz Micro in Poland is able to supply self-employed and business start-ups with comparatively cheap credit just by strengthening their links to their environment and peer groups. The trustworthiness of the group becomes an asset tradable in the individual credit contract. Similar systems have worked in the Basque area of Mondragon, or in the Wörgl experiment of “town money” in the twentieth century. Its resurrection could guarantee the survival of small banks in rural areas against all predictions.

If strong cultural links could be used in banking as cost cutting and risk efficient devices the European market in financial services could develop a unique and own element for the financial services of the future. We have been continually learning from the **United States** about new financial services, banking, cost efficiency and the use of new technology. We are still learning from the American Community Reinvestment Act, anti-discrimination and equal opportunities legislation to cope with the problems modern banking brings with regard to access and equal distribution. What is our **European contribution**? If we manage to introduce the idea of “**management by trust**” into financial services we too would be able to offer something important to our American friends. Our trust based systems like the public insurance system on health, retirement and care incorporate so many mechanisms of public trust and are accordingly more cost efficient than many private systems. We only would have to extract these experiences and introduce them into the private market

of financial services of the future instead of dividing our society into those who argue for unconditioned privatisation and others who defend the public systems.

4. Especially with its projects on micro-lending, on the use of Community Reinvestment ideas in the European banking market and on the support of business start-ups **IFF** has engaged in very practical research in the last year. Our research has also concerned debt advice and bankruptcy schemes developing model contracts between creditors and debtors for debt repayment in the context of the new German insolvency act. Our debt advice software produces flexible and adequate debt rescheduling plans, information and evaluation tools. In a beta version it is also available in English and French. In the meantime **CAWIN** has become the most widespread German debt advice program used in more than 800 debt advice agencies. Our attempts to export this highly successful German software to other countries have basically failed because the international exchange of data as well as the use of one common approach in debt advice and bankruptcy is not yet on the agenda of national organisations. Perhaps in a few years we will try again, this time on the basis of competing national approaches and techniques.

Meanwhile, our FIS Money Advice Database (<http://iff-hamburg.de/FIS>) which is now available on the Internet free for everybody as well as on a multilingual CD-ROM, will try to keep track with the ongoing process in different European countries and make the information available for everybody. The European Commission has made an additional contribution and will help next year to give IFF's Stefanie Jack the chance to put the FIS Money Advice system onto its own financial feet internationally. The system has to be developed into an international Coop of information providers. This includes not only consumer organisations but also banks, insurance companies and other providers of services in this area - like specialised lawyers and brokers. We want to rent out space in the system and give everybody willing to focus on information the opportunity to be present in nearly all relevant consumer orientated activities in financial services. The contracts with banks and law firms who will use this opportunity have been signed.

The research area on **social investment and small business financing**, led by Jan Evers, has been awarded € 230.000 by the Volkswagen Foundation for a legal and economical project on mediation procedures between creditors and debtors where small businesses default. We hope to find ways to increase the survival rate of business start-ups and thus save more of the personal and financial investment of young entrepreneurs. Besides, our test for the German weekly "Stern" concerning the willingness of banks to extend credit to business start-ups has had wide repercussions. We are part of a team including the savings banks association, the journal and others who want to make business start-ups a national campaign in Germany. In May we are invited to sit on the podium together with the president of the Republic to honour the prize winners of the start-up competition.

Our Hamburg **round table with bankers** organised by the Patriotic Society as well as the EU-consulting project MOTIF which IFF leads together with technical and management advice institutions has concentrated on issues like micro-lending, home ownership for people with average incomes and small business financing. The projects have led to several consulting projects with financial institutions concerning Microlending, local presence of banks through mini bank outlets and new forms of housing finance. The Patriotic Society, an old association of Hamburg businesses and business people is willing to continue sponsorship for the next year.

Together with Leo Haidar, who joined us for some time from Leeds and is now settled in Paris, we have undertaken some research on the effectiveness of the Directive concerning the **Annual Percentage Rate of Charge**. The findings were that essentially all European Lenders (mis)use the loop hole in the legislation by not in-

cluding insurance fees into the APR disclosure. This has the effect that we obtain a structure of extremely expensive insurance fees in linked transactions together with up to 30 % of the real credit costs not being disclosed properly. Germany, the UK and the Netherlands seem to oppose any solutions and we must wait until the effects of political change in these countries may reach the apparently low level of politics where social consumer protection seems to be situated.

The **IFF book series** at Nomos Publisher is now four books, two of them in English language, "The Social Responsibility of Banks in Europe" as well as "Credit and New Entrepreneurs". The latter will also appear in Italian and French language through IRED Nord in Rome. Our 14 paperback-books on financial services, now edited by Marco Habschick, cover nearly all consumer areas. You will find all this information on our new Internet-page which gives a refreshed view of IFF activity as well as a gateway to many more information on the Internet.

Thanks to your co-operation and trust in the IFF's efforts, 1998 was financially a very successful year for the institute. We have nearly doubled our turnover and were able to pay a fair share of our income to our collaborators. Our new manager Martin Jung has joined us from a consulting firm and already introduced a lot of new management procedures. He is also in charge of our debt advice software as well as of our consulting projects with the financial industry. Stefanie Jack is preparing our forthcoming Sweden **conference on "Access to Financial Services"** in June 2000 where we still await the European Commission's decision on participation. The idea and the draft programme have received a warm reception from the University of Goteborg, representatives of the Swedish Ministry of Consumer Affairs, officials of DG VI and XXIII concerned with the financial situation in rural areas or the social economy. The office of Mrs. Bonino, a representative of the European Savings Bank Association not to mention all those consumer and other social organisations that have already supported the conferences on financial services and consumer related issues in Hamburg, Birmingham, Bergamo and Strasbourg during the last 10 years are all looking forward to it. In any event it is still possible that the necessary basic funding which will enable us to start with the advanced phases of its preparation will not be available in time. All support is welcome.

Our TV-journalist Marco Habschick has professionalized our relationship with the media and the appearance of IFF on the Web as well as in news papers and journals. He has published our "Report on Indebtedness in Germany 1999" and presented it to an audience of about 80 journalists in Bonn together with the German Consumer Association AgV.

Ulrich Krüger (who just passed his PHD) was quite amazed to see that his legal department was made up of 8 lawyers when we first held an **IFF lawyers** meeting. These lawyers work part time or on a contractual basis upholding our database, supporting our different periodicals with adequate material, writing books, answering the questions of consumer organisations linked to IFF through service contracts or advising bank customers especially in mortgage loans. We are presently involved in writing several opinions on the Distance Selling Directive for Financial Services, an overview of the coverage of financial services legislation in Germany and legal questions concerning the economic projects on Micro Lending or Small business. From May a third full time lawyer will join IFF.

In spite of the increasing staff, new technology, a week long audit by the internal revenue of Hamburg, the backbone of our internal organisation and communication is still Ilona Kotek. Most of those who were ever in contact with IFF know her and appreciate like us that there is still somebody who overlooks all contacts and 18 or so people who frequent our premises on a more or less regular basis.

5. **Where** do we want **to go** in 1999? Points of gravitudo are already fixed with FIS-Money Advice, Benchmarking in Microlending, Financial Quality in Small Business Financing, our support for consumer organisations and debt advice agencies, where we advocate the idea of a nation-wide service centre using our system of Service letters and Databases developed in consumer protection.

A more significant project for the German ministry of Family Affairs shall concern ways and means to cope with growing "Financial Illiteracy" in a society that relies more and more on private initiatives in financial affairs. How can the process of learning to deal with money issues be developed, strengthened and made more effective where it factually takes place?

We have certainly reached a plateau where old ideas have to be rethought. The banking world is fully under reconstruction, everything seems possible, our own expertise is suddenly acknowledged and traditional opposition is fading. While ideologically everything seems easier, in fact the economic pressure towards a society in which money works even more for those who have it and not for those who should be able to borrow it has increased. What in former times had been ideologically undesirable for our market economies is now just economically impossible. Empty pockets dictate the politics of all parties. But again you can carry any idea with you if you can promise to rationalise and help gain lucrative clients. Things have become less clear and we have to find out what possibilities are actually left to act for traditional values of social justice, peace and well being. If we are able to show how money could flow up the mountain to the deserted peaks of exclusion nobody would oppose this idea. But do we really have an idea how this could be done in the future?

This millennium will end with more questions than answers more than ever before. If we believe Ernst Bloch, the Jewish German Philosopher, this is already a step forward in a world where leaders have given answers to questions nobody had asked them.

I wish you all a pleasant end of millennium and I look forward to mutually beneficial co-operation in 1999.