Financial inclusion from the perspective of basic banking services and consumer credit: A comparative study of law and regulation in the United Kingdom and China

by

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Abstract

The purpose of this thesis is to study the role and effectiveness of law and regulation in relation to the problem of financial exclusion. The research was conducted through a comparative study of the United Kingdom (hereinafter 'UK') and China, and focuses on whether law and regulation could fulfil a role in facilitating vulnerable consumer's access to basic banking services.

The thesis begins with an overview of the theory of financial exclusion and provides definitions of consumer vulnerability. It reviews the exclusion conditions in both countries in respect of basic payment services and consumer credit, and analyses the reasons for, and negative consequences of, being excluded from such services. The thesis then demonstrates the theory of equal opportunity, and the role of law and regulation in the context of facilitating financial inclusion, followed by an overview of credit regulation from a historical perspective.

The main content of this thesis is divided into three major parts. The experiences of the UK, China and the European Union (hereinafter 'EU') are analysed, and it is found that the process of financial inclusion could be facilitated by way of regulation. First, commercial banks are at the centre of the mainstream market. However, their role in financial inclusion largely focuses on payment services. Whether vulnerable customers' access to payment services could be facilitated by regulations is the main content of chapter two. This thesis suggests that without enough incentive, banks can be less motivated in this progress.

To accelerate financial inclusion in respect of consumer credit, alternative credit facilities on the consumer market should be supported by law and regulation, available funding should be made available and regulatory barriers be removed. After a comprehensive review of their legal and regulatory environment, the present research suggests that the UK has generally made good progress in this regard, while China is still in the nascent stage of development. The weakness in a 'one-size-fits-all' model is clarified through the analysis.

Subprime lenders are also essential in the market because they fill a gap. Standards that regulate subprime lenders should be equal for all lenders in the market, but also give consumers in the high-risk subprime lending sector. In the case of detriment, the regulatory regime would be able to provide recovery or simple and easy dispute resolution. This thesis argues for both *ex ante* and *ex post* consumer protection.

Key words: basic banking services, consumer credit, financial exclusion, regulation, subprime lending

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Abbreviations

1979 Act	Credit Union Act, 1979
ABCUL	Association of British Credit Unions Ltd
AFM	Association of Financial Mutuals
AMPFC	Administrative Measures for the Protection of Financial Consumers' Rights and Interests
APR	annual percentage rate of charge
art	article
ATTF	AT&T Family Federal Credit Union
BBA	British Banker's Association
BCOBS	*Banking: Conduct of Business Sourcebook*
BIS	Department for Business, Innovation and Skills
BOC	Bank of China
CAV	Consumer Affairs Victoria
CBRC	China Banking Regulatory Commission
CCA 1974	Consumer Credit Act 1974
CCA 2006	Consumer Credit Act 2006
CCBSA	Co-operative and Community Benefit Societies Act 2014
CCCCI	Consumer Credit (Cost Cap) Instrument 2014
CDCU	Community Development Credit Union
CDFI	community development financial institution
CFB	Chinese-funded bank
CGAP	Consultative Group to Assist the Poor
CMA	Competition and Markets Authority
COBS	*Conduct of Business Sourcebook*
CONC	*Consumer Credit Sourcebook*
COND	Threshold Conditions
CPL 2013	The Law of the People's Republic of China on the Protection of Consumer Rights and Interests (amended in 2013)
CRA2015	Consumer Rights Act 2015
CRA	Community Reinvestment Act
CREDS	*Financial Conduct Authority and Financial Conduct Authority and Prudential Regulation Authority Credit Union Sourcebook*
CSR	corporate social responsibility

CUMAA	Credit Union Membership Access Act
DISP	Dispute Resolution: Complaints
DTI	Department of Trade and Industry
DWP	Department for Work and Pensions
EU	European Union
FATE	Financial Action Task Force
FCA	Financial Conduct Authority
FCUA	Federal Credit Unions Act
FDIC	Federal Deposit Insurance Corporation
FIF	Financial Inclusion Fund
FIT	Financial Inclusion Taskforce
FOS	Financial Ombudsman Service
FSA	Financial Service Authority
FSMA	Financial Services and Markets Act 2000
FSYG	Financial Services User Group
ICBC	Industrial and Commercial Bank of China
ID	identity
IPSA	Industrial and Provident Societies Act 1965
LRO	Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011
MAS	Money Advice Service
MHRSS	Ministry of Human Resources and Social Security
MoF	Ministry of Finance
NCUA	National Credit Union Administration
OFT	Office of Fair Trading
para	paragraph
PBoC	People's Bank of China
plc	public limited company
PPRIN	Principles for Businesses
PRA	Prudential Regulation Authority
RCC	rural credit co-operative
RMB	renminbi (China's legal currency)
RMC	rural mutual co-operative
s	section
Sch	schedule

SET	Shenzhen Special Economic Zone
SLC	small loan company
SUP	Supervision Conditions
SYSC	*Handbook of Senior Management Arrangements, Systems and Controls*
TPCU	The Pentecostal Credit Union Limited
UK	United Kingdom
US	United States
VTB	village and township bank
UTCCR	Unfair Terms in Consumer Contracts Regulations 1999

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Author's declaration

I declare that, except where explicit reference is made to the contribution of others, that this thesis is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

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Chapter 1: Financial inclusion and exclusion in the United Kingdom and China: Manifestations, significance and influences

1.1. Financial exclusion and inclusion

1.1.1. Concepts and scope

The concepts of *financial exclusion* and *financial inclusion* are commonly used in mass media and academic research.[1] The earliest concerns about these issues originated in the United Kingdom (hereinafter 'UK') in the mid-1990s after an earlier debt crisis which led to 'financial infrastructure withdrawal' and the redirecting of credit sources[2] during which many bank branches in less-affluent or remote communities were closed.[3] Earlier definitions of *financial exclusion* focused on geographical factors: Leyshon and Nigel,[4] for example, define it as 'processes that serve to prevent certain social groups and individuals from gaining access to the financial system' due to their lack of geographical access.

Based on this recognition, the concept later developed into a more sophisticated form, with more social and economic factors being taken into consideration. The condition is found to be closely related to the social status of excluded people who usually earn low incomes or have bad credit records and therefore have fewer options of obtaining access to financial services.[5] Kempson and Whyley[6] define several dimensions of financial exclusion apart from the problem of geographical access: people cannot obtain information on an appropriate financial product due to targeted marketing, they do not feel confident enough to apply for a financial

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[1] For example, there is now a database, the Global Findex under the World Bank, that provides data and conditions of global financial inclusion. See, World Bank, 'Financial Inclusion Data' <http://datatopics.worldbank.org/financialinclusion/> accessed 26 March 2015.

[2] Shaun French, Andrew Leyshon and Sam Meek, 'The Changing Geography of British Bank and Building Society Branch Networks, 2003-2012'. More than 7,500 bank and building branches in the UK were closed between 1989 and 2012, and 'two thirds of branch closures have occurred in areas comprised of the least affluent third of the population.'

[3] Ibid.

[4] Andrew Leyshon and Nigel Thrift, 'Geographies of Financial Exclusion: Financial Abandonment in Britain and the United States' (1995) 20 Transactions of the Institute of British Geographers, New Series 312.

[5] Elaine Kempson and others, 'In or Out? Financial Exclusion: A Literature and Research Review' (2000) para 3.120.

[6] Elaine Kempson and Claire Whyley, *Kept Uut or Opted Out ? Understanding and Combating Financial Exclusion* (1st edn, The Policy Press 1999).

product from commercial banks, they cannot pass the risk assessments or because they cannot afford certain products. The standard of 'available' financial services has also been tightened to mainstream services only,[7] with the implication that financial services should be affordable and safe, since the subprime market offers costly alternatives to people who are denied access by banks.[8] People who are unable to obtain services from mainstream financial service providers are thus regarded as the 'financially excluded', not only because there are no bank branches in their community, but also because they are rejected or unable to use banks and building societies' services or products.

This understanding was later widely adopted in political and academic contexts, and introduced to other regions and countries, including the People's Republic of China and Europe. In the context of China, the corresponding concept of *financial inclusion* was recently officially proposed by the government and the governing party, with the intention of promoting more readily available access to affordable and safe financial services for low-income residents and small businesses who are excluded from mainstream banking.[9] This recognition is obviously influenced by international experiences of developed counties.

At the European Union (hereinafter 'EU') level, the concept of *financial exclusion* is also used in similar contexts; for example, in a 2008 report of the Europe Commission,[10] it is defined as follows:

> A process whereby people encounter difficulties accessing and/or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the society in which they belong.

Apparently, although the macroeconomic factor that causes financial exclusion is distinct in each country, the concept of financial exclusion in the UK, China and

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[7] Ibid. See also Collard S and Kempson E, *Affordable Credit: The Way Forward* (1st edn, The Policy Press 2005) 1.
[8] Kempson and others (n 5) para 3.120.
[9] Communist Party of China (hereinafter 'CPC') Central Committee, *中共中央关于全面深化改革若干重大问题的决定* [Decision of the CCCPC on Some Major Issues Concerning Comprehensively Deepening the Reform], 12 November 2013. pt 3, para 12. Authorised English translation available at < http://www.china.org.cn/chinese/2014-01/16/content_31215162.htm> accessed 2 December 2014.
[10] European Commission, 'Financial Services Provision and Prevention of Financial Exclusion' (2008).

EU are, by and large, similar, and focuses on a similar problem in their territories. The meaning of the concept *financial exclusion* used throughout this thesis is therefore the commonly used definition, which refers to the unavailability of essential financial services or products from mainstream providers for people who are vulnerable in their social and economic status.

Related to the concept of financial exclusion, the scope of essential financial services to maintain basic life needs is also generally recognized, which usually involves savings, credit, payments and sometimes also includes insurance and pensions.[11] However, even among the essential financial services there is still a hierarchy, as Kempson and Whyley suggest, the most typically owned financial product among vulnerable people is a current or savings account at a bank or building society,[12] as this does not involve a debt relationship or long-term arrangements.

Furthermore, the unavailability of bank accounts and credit has a more direct negative influence than being without insurance or a pension. For example, in a society where non-cash transmission is increasingly used, having no bank account could cause inconvenience in saving and making payments.[13] Without available sources of affordable credit, low-income people may have to borrow from informal lenders at high costs. While the availability of pensions and insurance is closely related to employment or steady income and the focus on future perspectives, they are, to some extent, more 'advanced' than payment accounts or credit products.[14] This hierarchy among essential financial services is also influenced by the level of macroeconomic development, as in China the scope of essential financial services is generally only limited to banking services and credit, while work, medical or accident insurance and pensions have a more 'social security' context rather than being financial services. Therefore, the scope of essential financial services discussed in this thesis is limited to a 'more basic' definition, namely the use of a payment account and consumer credit.

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[11] Kempson and others (n 5) part 3; European Commission (n 10) pt 2.
[12] Kempson and Whyley (n 6) 40.
[13] Leyshon and Thrift (n 4) 313.
[14] Reasons for people not having insurance in the UK include affordability, improper product and delivery mechanisms, and difficulties in personal conditions, lack of knowledge, having no need to be or choose to remain uninsured. Similarly, reasons for not having a pension include 'lack of opportunity or interest, lack of disposable income and lack of knowledge or mistrust of pension providers'. It is also noticed that young people sometimes think retirement is too far away to secure a pension. See Kempson and others (n 5) paras 3.84-95, 3.105-114.

1.1.2 Consumer vulnerability, disadvantage and financial exclusion

An essential related issue in any discussion about financial exclusion is the 'vulnerability' of consumers in their relationship with commercial banks. It describes certain negative conditions that people may find themselves in, and some people are viewed as 'vulnerable' due to their financial circumstances.[15] Other descriptions such as 'disadvantaged' or 'less privileged' are also used in similar cases.[16] If someone is excluded from access to mainstream credit and has to borrow from a payday lender, it could be assumed that he or she is vulnerable to possible risks such as over-indebtedness. As customer protection is now one of the central values of financial regulation, it is reasonable to anticipate some levels of legal or regulatory protection of those vulnerable customers who are financially excluded.

However, consumer vulnerability cannot simply be viewed as the cause of financial exclusion. The concept of *consumer vulnerability* is defined by many researchers, for example, Baker, Gentry and Rittenburg, as 'a state of powerlessness that arises from an imbalance in marketplace interactions or from the consumption of marketing messages and products'.[17] Similarly, in the Financial Conduct Authority's (hereinafter 'FCA') view, a vulnerable customer is 'someone who, due to their personal circumstances, is especially susceptible to detriment'.[18] What is underlined in the definition is the imbalance in power between two contracting parties and the underlying risks from this imbalance, which most customers actually experience at some point in their life.[19] Vulnerable customers are therefore not necessarily financially excluded and only have a low income, although excluded customers easily suffer from the detriment of the risk of vulnerable circumstances. For example, well-educated people with a normal income could also be vulnerable when they pay their mortgage because of the complex contract terms without actually being excluded by mainstream

[15] FCA, 'Consumer Credit and Consumers in Vulnerable Circumstances' (2014) <https://www.fca.org.uk/your-fca/documents/research-papers/consumer-credit-consumers-vulnerable-circumstances> accessed 30 March 2015.
[16] Peter Cartwright, 'The Vulnerable Consumer of Financial Services: Law , Policy and Regulation', 1.
[17] Stacey Menzel Baker, James W Gentry and Terri L Rittenburg, 'Building Understanding of the Domain of Consumer Vulnerability' (2005) 25 Journal of Macromarketing 128.
[18] FCA (n 15).
[19] Financial Services Consumer Panel, 'Defining Consumer Vulnerability and Disadvantage' 1.

mortgage lenders. Besides, not all vulnerable consumers suffer from detriment.[20] Vulnerability in this sense is less related to customer's economic status or income. As Cartwright[21] suggests, vulnerability is 'relative' rather than an absolute status and is less related to income.

Research also uses the terminology *disadvantaged* to describe this negative status.[22] However, there is a difference between the extent of consumer vulnerability and disadvantage, which is sometimes neglected and mixed up. The degree of customer detriment is not on the same level. The detriment is not necessarily suffered but the risk is high that it will happen in the case of consumer vulnerability.[23] While *consumer disadvantage* is, as defined by Consumer Affairs Victoria (hereinafter 'CAV') of Australia, the status of 'persisting susceptibility to detriment in consumption';[24] in other words, it is the 'real, material' disadvantage that has already occurred.[25] Furthermore, in CAV's definition, 'disadvantaged customers' are those who are 'in persistent circumstances and/or with on-going attributes which adversely affect consumption thereby causing a continuing susceptibility to detriment in consumption.'[26] They are *de facto* negatively influenced by their inappropriate choice of financial products rather than only the risk thereof. CAV clearly states this relation:[27]

> Not all vulnerable consumers are disadvantaged consumers. Some consumers will be vulnerable only because of either temporary personal circumstances that adversely affect them in consumption; or adverse market, product or transaction characteristics specific to a particular purchase, rather than their purchases generally. Consumer vulnerability is the broader concept, but both are relative and dynamic concepts.

In this sense, most financial consumers can be viewed as more or less 'vulnerable', considering the bargaining power and other imbalances between contracting

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[20] Ibid. The Report gives examples of such as pensioners and disabled people who are 'more likely to experience detriments' than ordinarily thought. However, it also points out that 'not everyone who falls into one of these categories faces the same level of risk.' It is imprecise to equate a vulnerable condition with real detriment.
[21] Cartwright, 'The Vulnerable Consumer of Financial Services: Law, Policy and Regulation' (n 16).
[22] Ibid.
[23] Financial Services Consumer Panel (n 19).
[24] Consumer Affairs Victoria (CAV), 'What Do We Mean by "Vulnerable" and "Disadvantaged" Consumers?' (1999).
[25] Financial Services Consumer Panel (n 19).
[26] CAV (n 24).
[27] Ibid.

parties. However, the customer is in a disadvantaged circumstance only if real detriment occurs. If a customer is excluded by mainstream banks and has to use high-cost credit, the risk of long-term detriment would be high, lead to the disadvantaged circumstance and real damages. Income level is also less relevant with vulnerability, as the Office of Fair Trading (hereinafter 'OFT')[28] puts it: 'Vulnerability is not exclusively determined by low income. Consumers can be rendered vulnerable also by higher search costs and particular difficulty in assimilating information.' However, the OFT's report also agrees that low income is 'considerably' associated with both vulnerability and financial exclusion.[29] The general role of financial regulation and customer protection therefore does not distinguish the economic circumstance of the customer; all customers are generally protected equally in aspects of, for example, information disclosure and cooling-off period, although some consumers are indeed additionally protected due to other disadvantaged statuses such as mental disability.

For the purpose of this thesis, both terms *vulnerable* and *disadvantaged* are covered, as the former mainly describes the imbalance between contractual parties, while the latter is about the negative circumstances that lead to real detriment. Both of them are covered by the content of this thesis under the umbrella definition of *financial exclusion*. The use of these two terms in the sections of this thesis that follow is in line with this understanding, as the problem of financial exclusion includes both the condition of being unable to access mainstream financial services and the circumstance of customer detriment caused by their resorting to subprime alternatives.

1.2 Conditions of financial exclusion (1): The scarcity of basic banking services

Basic banking services include measures of payment and receiving payment that fulfil the basic demands of less-privileged customers to maintain their daily lives.[30] This involves the use of a payment account from formal institutions. In

[28] OFT, 'Vulnerable Consumers and Financial Services: The Report of the Director General's Inquiry' (1999).
[29] Ibid.

both the UK and China, promoting the use of a bank account is viewed as the most basic part of financial inclusion, although with a few different features.

1.2.1. The United Kingdom

As a developed country with mature financial infrastructure, the UK has a high penetration of bank or building account holding. According to World Bank data,[31] for example, the percentage of UK adults with an account held at a formal institution reached 97% in 2011, listing among the group with the highest account ownership in the world (81–99%). There is also no significant gender difference in the account-holding percentage.[32] This figure does not, however, distinguish between a traditional current account and a savings account, as the former has more features convenient for daily transaction (eg, setting up an overdraft facility, direct debit and easy bill payment), while the latter is mainly for safely saving money at higher interest rates. Nevertheless, early research also shows a high percentage of current-account holding[33] and, recently, the difference between the two types of account has also been blurring.[34] In any sense, the UK has a solid foundation for account use among its residents.

However, for the remaining people who are still unbanked, convenient payment services are less easy to access. The condition is exacerbated as non-cash transactions have been growing since the 1990s; bank accounts are widely used in, for example, bill payments, online purchases, salary payment or government benefit transmission.[35] Access to basic banking services is therefore regarded as 'a social necessity within a contemporary capitalist economy'.[36] Without account-holding, it is less convenient and more expensive for those people to deal with

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[31] The World Bank, 'Financial Inclusion Data, United Kingdom' <http://datatopics.worldbank.org/financialinclusion/country/united-kingdom> accessed 21 March 2015.
[32] Ibid. In addition, Kempson and others also give earlier research findings on the level of current-account holding. The penetration level of account holding in the UK has been increasing since the late 1990s. See Kempson and others (n 5) paras 3.19-21.
[33] European Commission (n 10) 24.
[34] Many high street banks have started offering 'instant access savings accounts' (eg, Netwest and RBS), combines the saving and easy-transaction features together.
[35] Office of Fair Trading, 'Vulnerable Consumers and Financial Services: The Report of the Director General's Inquiry' paras 303–305.
[36] Leyshon and Thrift (n 4) 313.

daily life; for example, a 1999 Treasury Report mentions the additional costs for unbanked people when they pay for utility bills.[37]

Kempson and others regard low income as the basic factor that negatively influences the account-holding level, which derives from various adverse social statuses such as unemployment, long-term illness or being a single parent.[38] However, it is important to note that not all non-account holders are denied access to formal institutions due to low income. First, people who are denied access actually only make up a very small percentage of non-account holders, and some of them are homeless people due to lack of identity or address.[39] For the extreme cases, a possible appropriate solution would be social assistance rather than financial regulation. The Report of the Policy Action Team 14[40] found that 'past difficulty managing personal finances and other factors, such as poor employment record and low income, lead to an adverse credit score, which is the commonest reason for refusal'. Income is significant in this sense.

Second, among the non-account holders, there are also people who choose to close their accounts due to a drop in income, which helps them to control their expenses.[41] However, at the same time, the need of these people cannot be neglected due to their vulnerable social status. Kempson also points out that people with low income would prefer an account with no access to an overdraft, in case they inadvertently become overdrawn and to better control their personal finances.[42] This is the so called self-exclusion when people feel less confident about applying for or using bank accounts.[43]

Third, products from banks are inappropriate for some potential customers, which leads to non-account holding, as some people prefer a simple account without overdraft facility to better control their money, but do not have available choices, or do not have information at their disposal on the availability of such basic

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[37] HM Treasury, 'Access To Financial Services: The Report of Policy Action Team 14' (1999).
[38] Kempson and others (n 5) paras 3.17–35.
[39] Ibid paras 3.24 to 3.30.
[40] Ibid para 4.16.
[41] Kempson and others (n 5) paras 3.31–323
[42] Elaine Kempson, 'Policy Level Response to Financial Exclusion in Developed Economies: Lessons for Developing Countries', *Access to Finance: Building Inclusive Financial Systems* (2006).
[43] HM Treasury (n 37) para 4.20.

accounts.[44] People do not choose to close their previous account but are unable to use appropriate products. Last but not least, the closure of bank branches is also found to exclude some customer in deprived communities from using banking services.[45]

All these internal and external reasons lead to non-account holding, and the consequences of having no bank account is fully illustrated in the FSA's 'In or Out?' review. Without a bank account, people have to use cash for transactions, cannot use direct debits for bill payment, and have difficulty in using banking facilities that require them to have bank accounts.[46] This raises the cost of living, which leads to 'the poor pays more'. Moreover, bank accounts act as the threshold for entering into the market, since some other financial product suppliers (eg,, insurance companies) require bank accounts for their products. Similarly, without a history of banking transactions, it is also less possible to borrow from banks.[47]

Given the significance of account holding, the UK government has recognised the problem since the 1990s. An early attempt was made by HM Treasury to propose the promotion of a basic bank account, which intended to help those people with a low credit score who would possibly be rejected in their application for traditional current accounts.[48] Such scheme was specifically designed to solve the financial exclusion problem, according to the Treasury,[49] since the original aim of basic bank accounts was to support the move to direct (electronic) payment of welfare benefits.[50] The core features of a basic account can be concluded as convenience, no costs for everyday transactions and no risks of overdrafts.

1.2.2 China

As one of the largest economic entities in the world, China also has a large customer base for its banking sector. Economic growth in the country and the expansion of banking services have promoted the wide use of modern payment

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[44] Ibid para 4.21.
[45] Kempson and others (n 5) para 3.28.
[46] Ibid para 5.2.
[47] R Glenn Hubbard, *Money, the Financial System, and the Economy* (6th edn, Pearson Addison-Wesley 2007) 27.
[48] HM Treasury (n 42) paras 4.34–50.
[49] HM Treasury, 'Promoting Financial Inclusion' (2004) 5.
[50] Citizen Advice Bureau, 'Consultation on Access to a Basic Payment Account: Citizens Advice Response to the European Commission' (2010).

methods; bank accounts and bank cards have increasingly become available to the majority of people in the country in recent years.

There are currently two main kinds of personal renminbi (ie. official Chinese currency, hereinafter 'RMB') bank accounts in China, namely (i) the personal bank settlement account and (ii) the personal savings account.[51] The former is largely equivalent to the current account in the UK banking system, with a full scope of services, including saving, withdrawing money at a branch or through automated teller machines, transferring money, a debit card, e-channel services, wage payroll and bill payment. However, it does not have an overdraft feature, which is the most obvious difference between it and the current account in the UK. On the other end of the spectrum, the personal savings account is limited in its functions, with only saving, withdrawing money through tellers at a branch or using a deposit book and transferring to, or from, an account owner's other bank accounts under his or her name functions available.[52] Customers are free to choose the type of account, depending on their needs. Based on a customer's application, a bank would open an account if eligible criteria are met.

Although official statistics from domestic commercial banks are usually unavailable, increasingly, the use of bank accounts or cards in China could still be verified through various channels. For example, the annual report of the People's Bank of China (2012) (hereinafter 'PBoC') shows that by the end of 2011, commercial banks in the country had issued over 3.53 billion bank cards in total in past years.[53] This is nearly triple that of the total population of the country; on average, the number of bank cards held by customers is around 2.5 per capita. In addition, the total number of bank cards issued in China continued to rise, based on PBoC data in the past three years.[54] However, compared to developed countries such as the UK, the penetration level of bank accounts in China is still

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[51] PBoC, *中国人民银行关于进一步落实个人人民币银行存款账户实名制的通知* [Notice of the People's Bank of China on Further Implementing the Real-name Personal RMB Bank Savings Account System] (2008 No.191).
[52] For a detailed explanation of two sorts of accounts, see, for example, Industrial & Commercial Bank of China, 'Personal Banking' <http://www.icbc.com.cn/ICBC/Personal Banking/Convenient Banking/Personal Settlement Account/> accessed 21 March 2015.
[53] People's Bank of China, '2012 Annual Report'.
[54] According to the annual report of the PBoC (2010), the total number of bank cards in China was over 2.4 billion in that year. The annual report of the PBoC (2012) confirms the uptrend (19.8%) of issued bank cards over the previous year (2011). See PBoC '2010 Annual Report', and '2011 Annual Report'.

moderate: according to data of the World Bank survey conducted in 2011 the percentage of adults with an account at a formal financial institution in China was 63.81%,[55] while in the UK it was 97%.[56]

The ownership of bank accounts among well-off and vulnerable groups is also not balanced. Globally, low income was the most cited reason for not having bank accounts.[57] Gender, education, age and rural or urban residence have strong influences on account ownership.[58] Geographical factors also have influences on customers who live in remote areas with fewer or no bank branches in those areas, where it is less convenient to use bank accounts as a way of saving and payment than cash. Generally, it is less possible for vulnerable groups of people (eg, being female, primary school or less educated, or rural residents) in the developing world to own and use personal bank accounts.[59] These factors also exist in the case of China, yet with some special features; for example, the female:male ratio of personal accounts ownership was not significantly different.[60] The biggest difference was between rural and urban groups, as only 58.02% of rural adults held accounts with formal financial institutions in 2011, while in urban areas it was 82.11%.[61] This indicates that nearly half of rural residents own no bank accounts.

One of the virtual difficulties of research into the situation in China is the opacity of statistics from official channels. Therefore, in this thesis conclusions were deduced from indirect sources.[62] However, these indirect sources show useful information; for example, PBoC's annual report (2012) shows that until the end of 2011, bank cards issued for rural residents was around 1.5 per capita.[63] Of course, this percentage does not mean all rural residents have at least one bank card. Compared with the average number of bank cards held by domestic customers

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[55] The World Bank, 'Financial Inclusion Data, China' <http://datatopics.worldbank.org/financialinclusion/country/china> accessed 30 March 2015.
[56] Asli Demirguc-Kunt and Leora Klapper, 'Measuring Financial Inclusion, The Global Findex Database, New Data on Accounts and Payments' (2012). However, according to PBoC's 2012 annual report, the penetration level of bank cards in the whole country was only 43.5%; much lower than the statistics from the World Bank.
[57] Financial inclusion data of China (n 55).
[58] Ibid.
[59] Ibid.
[60] Ibid.
[61] Ibid.
[62] For example, the China Banking Regulatory Commission (hereinafter 'CBRC') 'temporarily' closed its China Banking Services Distribution Map, without reopening the resource until now.
[63] PBoC, 2012 Annual Report, 'Payment System'.

without differentiated rural and urban residence (2.5 per capita), it is obvious that access to basic banking services in China is seriously imbalanced. People who do not have easy access to basic banking services are largely rural residents.[64] This urban–rural segmentation is actually one of the main features of the Chinese banking service system.[65] However, migrant workers from rural areas who work in towns also experience difficulties in accessing banking services in their workplace.[66] In fact, according to research conducted by the Consultative Group to Assist the Poor (hereinafter 'CGAP'), people in China who have most the difficulty with basic banking services are rural households in remote areas and migrant low-wage workers who have no residence status in their workplace and are therefore unable to open accounts.[67]

Both external and internal reasons would influence the penetration rate of bank accounts in the case of China. The internal reasons include the fact that the income level of rural households and migrant workers is lower than their urban counterparts,[68] which would weaken their consumption capacity and reduce the demand for using a payment system. Considering the income imbalance between China's urban and rural area, it could be assumed that low income is the basic factor that influences the account-holding level. Fees for using banking services is another factor that negatively influences low-income people using bank accounts and other banking services. There is also the issue of information, as many low-income people are less educated and find it difficult to understand conditions of banking products and how to use them.[69] In addition, self-exclusion also exists when low-income people think that bank clerks are discriminating against them.[70]

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[64] Pete Sparreboom and Eric Duflos, 'Financial Inclusion in the People's Republic of China: An Analysis of Existing Research and Public Data' (2012).

[65] Lin Tian, '*城乡统筹视角下的金融排斥*' [Financial Exclusion in Urban-Rural Co-ordination Perspective] (2007) Industrial Technology & Economy 26.

[66] Jeff Jianfeng Wang and Qian Tian, 'Consumer Vulnerability and Marketplace Exclusion: A Case of Rural Migrants and Financial Services in China' (2013) 34 Journal of Macromarketing 34. These people are called 'urban villagers'.

[67] Sparreboom and Duflos (n 64) 10.

[68] National Bureau of Statistics of China, 'Statistical Communiqué of the People's Republic of China on the 2012 National Economic and Social Development' <http://www.stats.gov.cn/tjsj/tjgb/ndtjgb/qgndtjgb/201302/t20130221_30027.html> accessed 30 March 2015.pt XI (Population, Living Conditions and Social Security). In 2012, the annual per capita net income of rural households was 7,917 yuan (about US$1, 300); while in urban areas the number is 24,565 yuan (about US$40, 60).

[69] Wang and Tian (n 66).

[70] Ibid. See also Huixia Cheng and Wentai Wu, 'Governance Research of Chinese Rural Finance Exclusion Based on Peasant Survey' (2014) 4 American Journal of Industrial and Business Management 585.

For external reasons, the economic growth level and infrastructure of the banking industry would accelerate the popularity of basic banking services, and access to banking services would reduce inconvenience for bank branches and outlets. As the CBRC puts it:

> [T]he people living in townships and villages still have rather limited access to banking services. Although there are in average more than 50 banking institutions per county, yet over 30% of them are located in the counties instead of lower level townships and villages. The number of banking institutions per township is less than 3, moreover, a total of 3302 townships are virtually unbanked.[71]

Branch closures during the past decades have exacerbated the access problem, as commercial banks closed many of their unprofitable branches and outlets to reduce high fixed and operational costs during the market-oriented banking system reform.[72] Between 1995 and 2005 the total number of state-owned commercial bank branches (157,704) was halved to 74,712; this was also the case for rural credit co-operatives (hereinafter 'RCC'), which is the main banking service provider in many remote areas.[73] Many of these unprofitable branches that were closed were located in remote rural areas. For rural residents, this imbalance of available branches deprives them of the ability to use a modern method of saving, transferring money and making payments.

Therefore, there are two issues to the problem of access to basic banking services in China, namely (i) the lower income level that prevents people from using banking services and (ii) the scarcity of financial resources in rural areas that would increase the cost of going to a branch. Although one cannot suppose that all citizens would prefer using banking services rather than simply using cash, it is still meaningful to provide equal access to basic banking services. The government and banking regulator of China has already recognized this issue. The CBRC has been promoting 'universal access to basic banking services' since 2005,

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[71] CBRC, 'The CBRC Completed the Compilation of China Banking Services Distribution Map' <http://www.cbrc.gov.cn/EngdocView.do?docID=20070629A79308BC77898AFEFF2499A0B9059F00> accessed 21 March 2015.

[72] Xuejun Zhang and others, 'Rural Finance in Poverty-Stricken Areas in the People's Republic of China: Balancing Government and Market' (2010). During 2000 to 2005, more than 13,000 bank outlets and branches were closed.

[73] Godfrey Yeung, 'Hybrid Property, Path Dependence, Market Segmentation and Financial Exclusion: The Case of the Banking Industry in China' (2008) 34 Transactions of the Institute of British Geographers 177.

by increasing 'the number of branches and exploring innovative alternatives to physical facilities', and handling the social benefits paid through bank cards.[74]

1.2.3 Concluding remarks

This section clarifies the status quo of exclusion in the banking services in the UK and China. Based on the analysis made above, the conclusion could be drawn that non-account holding is clearly influenced by income level in both countries, although the UK has a much higher penetration level of account ownership. Basically, this is due to the different levels of economic development between the two countries, which further impacts on the financial infrastructure. However, for the non-account-holding group in both countries, low income is the common primary reason that limits people's use of accounts at formal institutions. For low-income people, their economic status either leads to denied access to formal institutions, or self-exclusion in which people choose not to use bank accounts. In addition, the problem of lack of information also exists as non-account holders are sometimes not informed about the availability of basic accounts or the banks discriminate against them.

It is inevitable that no matter where, there are always low-income people with a vulnerable status or who live in remote or deprived areas without bank outlets. This is, however, no excuse for not providing enough banking services to them. This means that the account products available should be equipped with basic features such as savings and payment facilities, while lower fees should be charged to lower the threshold for using such accounts. For the basic account, banks' eligibility criteria to opening an account should be appropriate. Information about available accounts should also be provided to avoid unawareness. Fees for using banking services should be affordable. On the other end of the spectrum, setting up new bank branches and new, alternative financial institutions in deprived areas appears to be an expensive, yet effective, by-product of promoting financial inclusion, especially in China where many residents are still physically excluded from using banking services. If there are bank branches in the community, making use of existing banking branches could be achieved

[74] Sparreboom and Duflos (n 64) 23.

more easily. This leads to the question of whether banks should take up this duty and offer basic bank accounts to less-affluent people under regulation.

1.3 Conditions of financial exclusion (2): Scarcity of affordable consumer credit

1.3.1 Role of consumer credit

The role of credit and debt in the modern era should in no way be ignored. This is reflected in many aspects of the market in which all the participants, including the market itself, could benefit from the use of credit, if used properly. Merchants who provide products or services are allowed to sell more if customers choose to use credit rather than merely their own savings. They could also benefit from this kind of credit agreement due to the increased cash flow at the time of the transaction. Furthermore, individuals are allowed to consume more with access to affordable credit, which gives them the chance to purchase products or services they would not otherwise be able to afford at the moment, making it possible for customers to spread their entire purchase price in future but receive the products or services right away.[75] A virtuous circle exists in this circumstance if credit is used properly. Considering the essential role of customer spending in the real economy, it is assumed that a well-functioning market economy largely relies on the availability of affordable credit. As Wallace puts it, 'consumer credit may well promote economic growth by permitting the anticipation of purchases and shifting demand toward durable goods industries which have greater potential for expansion'.[76] In contrast, failing to provide enough access to affordable credit would theoretically reduce customer spending and hinder economic growth. When lending ceases, 'the wheels of commerce grind to a halt'.[77] These are examples of the general benefits of credit for the macro-economy.

Nevertheless, there is little evidence on the precise effect on the macro-economy of credit availability in the high-risk, low-income consumer group. Wallace, in his discussion of the US consumer credit reform in the 1970s, when that country was

[75] Bruce G Carruthers and Laura Ariovich, *Money and Credit: A Sociological Approach* (1st edn, Polity Press 2010) 8.
[76] George J Wallace, 'The Logic of Consumer Credit Reform' (1973) 82 The Yale Law Journal 461.
[77] Ibid.

in recession due to the small volume of debts and relatively low purchasing power, argues that less availability of credit in the lower-end of the market is less significant for the economy.[78] It is possible that the lower spectrum of the personal credit market has fewer stimulating influences on the economy as a whole, but this should not be the pretext for giving up this market.

However, from the perspective of consumer benefits, there are several reasons that justify providing the less affluent group with affordable credit.

First, credit could shift the time of cash flow and allow people to consume that which they would not be able to afford with their present income, as discussed above.[79] A mismatch between income and expenditure exists in many circumstances, even for the middle-income households and individuals: borrowing money in this case allows people to bridge the gap between uneven income and expenses.[80] In general, one solution to solve this problem of a mismatch is to save money and spend less; the proverbial accumulation of a 'financial nest egg'.[81] However, saving is not always possible. People in a better financial position could use savings to deal with daily life, while many lower-income consumers have no chance to save and rely on credit.[82] Hence, the demand for a little credit in the low-income customer group is perhaps more intense than in the case of well-off counterparts due to the extent of the income–expense mismatch.[83] For the vulnerable group of people who have less disposable income and no savings, availability of affordable credit is, to some extent, unavoidable, although it may not be desirable.

Furthermore, the availability of affordable credit can act as a cushion for unplanned events.[84] For people who are struggling to keep the balance between income and expenditure, unexpected changes in life could result in a sharp rise in expense or income reduction, and worsen the situation.[85] These unplanned events

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[78] Ibid.
[79] Carruthers and Ariovich (n 75) 83.
[80] Hubbard (n 47) 32.
[81] Carruthers and Ariovich (n 75) 83.
[82] Ibid.
[83] Ibid.
[84] HM Treasury, 'Financial Inclusion: The Way Forward' (2007) paras 1.19-11.
[85] Hubbard (n 47)31.

could be illness or unemployment or a decrease in income,[86] all of which would cause financial difficulties for the vulnerable group who have no unemployment or health insurance to cover such negative situations.[87] Ideally, people could use savings to get by on rainy days, but even savings could be wiped out during long periods of unemployment or serious medical emergency; for the vulnerable that have less or no savings, this is fatal. Thus, borrowing money is unavoidable.[88] If the current social welfare system cannot cover all emergencies, borrowing money is the last and, perhaps only, solution for the vulnerable group when meeting with financial difficulty. Credit in this sense is an exterior way of support for people who are unable to get through the difficulty by themselves. Therefore, being without access to affordable credit is in this way regarded as one aspect of financial exclusion, in a similar manner to being excluded from basic banking services.

1.3.2 Consumer credit exclusion in the United Kingdom and China

Generally, credit-related activities include both consumer credit lending and hire purchase.[89] The former refers to regulated lending activities, including moneylending such as personal loans, credit card lending, overdrafts, pawnbroking, and activities related to buying goods on, for example, hire purchase and conditional sales.[90]

However, despite the perpetual need for credit that always exists, it is harder for some individuals and households to obtain credit from banks than for the wealthier group. It is ironically said that those who need credit the most are often among the least creditworthy of the would-be borrowers.[91] This is the case in both the UK and China. Both countries share the problem of financial exclusion in the area of consumer credit. In the UK, there are mainly two groups of people who have limited access to mainstream credit, one is affected by low-income and less-stable personal financial status, and the other is influenced by previous poor credit

[86] Carruthers and Ariovich (n 75) 84.
[87] Ibid.
[88] Ibid.
[89] FSA, 'Consultation Paper 13/7, High-Level Proposals for an FCA Regime for Consumer Credit' (2013). Ch 2.
[90] Ibid.
[91] Carruthers and Ariovich (n 75) 85.

records or a history of bad debt.[92] In China, the low-income factor has the highest negative influence on this issue, as the majority of low-income people live in rural areas or are rural migrant workers, who not only have a limited income, but also tend to have no credit histories.[93]

This exclusion is reflected in figures, for instance, 1999 OFT research shows that although the majority of UK households have access to mainstream consumer credit, 33% of the total population in the UK have no access to 'high street' credit from a mainstream provider.[94] It was found that the use of high street credit was strongly related to household income.[95] A survey undertaken for the UK government found that 26% of households had no credit facilities in 2002.[96] The figure in the Eurobarometer data is 30%.[97] This figure is, however, criticized for over-estimating the condition,[98] as credit might not be needed since savings could be used. However, it is admitted that there is currently still a gap between the mainstream credit market and some potential borrowers. Data obtained in 2012 found that 7 million low-income people in the UK were affected by this problem and had to use high-cost credit.[99]

It is unfortunate that data on people excluded from mainstream credit in China are unavailable from the CBRC or the PBoC. Nevertheless, one can still deduce some observations from the continual attempts by the Chinese government to facilitate rural small personal loans, as most of the official attempts are concentred on rural credit markets. In addition, CGAP research in which an indirect calculation of the proportion of rural households that have credit from formal providers was made on the basis of lenders' data and total number of rural residents[100] came to the conclusion that 58% of total rural households have a loan from a commercial bank and RCC.[101] However, the research also admits that the real percentage should be

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[92] Kempson and others (n 5) para 3.120.
[93] Sparreboom and Duflos (n 64) 11.
[94] OFT, 'The Consumer Survey: Appendix 4 of Vulnerable Consumers and Financial Services' (1999).
[95] Ibid.
[96] Elaine Kempson, 'Over-Indebtedness in Britain: A Report to the Department of Trade and Industry' (2002).
[97] Elaine Kempson, Mark Crame and Andrea Finney, 'Financial Services Provision and Prevention of Financial Exclusion: Eurobarometer Report' 14.
[98] Ibid.
[99] Colin Purtill, John Cray and Cath Mitchell, 'DWP Credit Union Expansion Project Project Steering Committee Feasibility Study Report' (2012) para 3.1.
[100] Sparreboom and Duflos (n 64) 23.
[101] Ibid.

significantly lower, considering the number of people who do not want to borrow money from a bank.[102] Although the figure is only meaningful in a limited sense, the remaining group of people who are unable to obtain credit from banks but, in fact, have such a demand are the most vulnerable in this context.

However, it is important to note that only a few people are completely denied any kind of credit available in the market; even those with a lower income and poor credit records are taken into consideration.[103] This is because there are plenty of substitute products available from subprime lenders; people who are ineligible for mainstream credit could still turn to the alternative credit market, although with less favourable conditions and higher interest rates. The adage 'the poor pays more' exists in this circumstance, since lenders have to cover the default risks of high-risk but less creditworthy borrowers.[104] In the UK, *sub-prime lender* includes payday lenders and pawnshops.[105] In China, they include loan companies and pawnshops, who are privately invested and lend at higher interest rates.[106] Beside the 'regulated' moneylender, there are also underground, unlicensed lenders who lend at even higher rates.[107]

However, using alternative ways of lending should not become the ideal solution for financial exclusion, considering the high interest rates and fees of these moneylenders. Economic status is not a fair reason for rationalising the high interests paid by vulnerable customers. Moreover, many have criticized subprime lenders for specially targeting vulnerable people and encouraging them to roll over their loan, which will trap the borrower in debt.[108] This is the problem of credit being too easily accessible, rather than too difficult to access, which often causes indebtedness problems.[109]

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[102] Ibid.
[103] Kempson and others (n 5) para 3.119.
[104] Hubbard (n 47) 291.
[105] Kempson and others (n 5).
[106] Cheng and Wu (n 70).
[107] Department of Trade and Industry, 'Illegal Lending in the UK' (2006).
[108] Marieke Bos, Susan Payne Carter and Paige Marta Skiba, 'The Pawn Industry and Its Customers: The United States and Europe' (2012) Vanderbilt University Law School Working Paper; Christopher L Peterson, 'Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits' (2008) 92 Minnesota Law Review 1116; Todd J Zywicki, 'Consumer Use and Government Regulation of Title Pledge Lending' (2010) 21 Loyola Consumer Law Review 425.
[109] Peter Cartwright, *Banks, Consumers and Regulation* (1st edn, Hart Publishing 2004) 228.

In this sense, being excluded from credit actually refers to 'being excluded from mainstream credit'.[110] Any discussion about 'financial exclusion in respect of consumer credit' must be located in this context. Only affordable credit that is available in a responsible manner to vulnerable customers could relieve people's financial stress, rather than high-interest, subprime loans from payday lenders. The type and amount of consumer credit therefore has two features: (i) the amount of the loan should be small, and (ii) the loan should be affordable.[111] This is not only to ensure banks' profit, but also to ensure repayment can be made and does not 'trap' borrowers in debt.

1.3.3 Reasons for being excluded from mainstream credit: The borrower's perspective

1.3.3.1 Economic circumstance

From the consumer's perspective, there are several factors that influence the problem of access. The first and basic reason for denied access can be attributed to income level, namely people with low or unstable income may find it harder to obtain high street credit from mainstream providers.

Empirical research of both the UK and China confirmed this basic reason; for example, in the UK people who use 'low-income credit'[112] include (i) people with a very low income, (ii) single parents, (iii) people who do not have a current account, (iv) the unemployed, and (v) the sick or disabled.[113] Owing to their economic status, they are unable to obtain high street credit from, for example, banks, building societies or other lenders.[114]

This is also the case in China. Individuals who find it difficult to access mainstream credit from commercial banks and rural credit co-operations include (i) rural households, (ii) low-wage workers and (iii) the unemployed.[115] For all of the listed sub-groups, lower (and/or uncertain) disposable income limits their access

[110] Ibid.
[111] Kempson and Whyley (n 6) 45.
[112] Kempson, 'Over-Indebtedness in Britain: A Report to the Department of Trade and Industry' (n 96).
[113] Ibid.
[114] Ibid.
[115] Sparreboom and Duflos (n 64) 10.

to mainstream credit, because banks are concerned about their repayment ability and potential risk of default, which are closely linked to disposable income.

Certainly, income level cannot be equated with willingness and ability to repay a loan. People with a high income could also default on a loan due to unexpected changes in their life or just ignorance; in this sense, 'low income' is neither a necessary nor a sufficient condition to default. However, compared to 'intention to repay' or willingness, income and many other aspects of economic condition are more measureable standards for banks to make assessments.[116] With profits coming from the interest rates they charge to borrowers and pay to deposits, banks are therefore concerned with the repayment ability of the would-be borrower in order to avoid default risk and profit loss.[117] However, only borrowers themselves know precisely whether they will repay the loan on time and how to afford it. The lender, in turn, may find that it is hard to obtain such 'insider information' from borrowers in order to establish if they can afford the credit.[118]

In this sense, there is a problem with information asymmetry, which forces lenders to examine borrowers' information in a more statistical way, rather than simply literal promises to repayment on time.[119] Hence, banks need to estimate borrowers' credibility and economic condition in a more external way, while disposable income, employment and assets are therefore more easily measurable criteria for lenders to manage possible default risks.[120] To meet banks' eligibility criteria, individual borrowers must usually present information about their employment, income and net worth; banks then use such information to eliminate potential default risk and to obtain creditworthy borrowers. People living on a low income or in less stable economic condition are therefore likely to be classified as less creditworthy, and being denied a loan due to matters related to affordability. Income level in this sense forms the first barrier for vulnerable people attempting to obtain high street credit.

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[116] Hubbard (n 47) 290.
[117] Ibid.
[118] Ibid.
[119] Ibid.
[120] Ibid.

1.3.3.2 Poor or empty credit record

The second and related factor that influences access to high street credit is credit record. Generally, there is a greater likelihood that the lender will deny credit to people with poor credit records. However, it is important to clarify that people with poor credit records do not totally equate to people living on a low income, although these two groups sometimes overlap. Bad credit records could come from many other reasons such as court judgments and unused mobile contracts.[121]

In fact, what is implied in ‘credit record’ is the trustworthiness of the borrower, since all records suggest past experience linked to personal economic condition and, more importantly, the intention to repay debts on time.[122] People with poor credit records are statistically assumed to be more likely to default on a loan than those with higher credit records and a good repayment history.[123] With many aspects of daily life included in a person’s credit file, lenders can conveniently check the credit report and assess the creditworthiness of the would-be borrower.

For example, missed payments on gas or electricity bills in the UK will stay on credit files for six years and would therefore influence credit rating.[124] Moving home frequently has similar negative influence too.[125] People living on a low income who do not own a home and move into, and out of, privately rented homes for cheaper rentals are also negatively scored, as current and previous addresses would also appear on the credit report.[126] Furthermore, if people are tied to someone who has a poor credit history in any joint form of credit, they will also be affected when it comes to the possibility of accessing credit.[127] ‘Traditional’ credit scoring technology easily rejects these people.

Similar problems related to credit records exist in China, with some special features. The national credit rating system in China was only established in the

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[121] See, for example, Citizens Advice Bureau, ‘How County Court Judgments Affect Your Credit Rating’.
[122] Hubbard (n 47) 291.
[123] Ibid.
[124] The Money Advice Service, ‘What Impacts Your Credit Rating?’ <https://www.moneyadviceservice.org.uk/en/articles/how-to-improve-your-credit-rating> accessed 30 March 2015.
[125] Ibid.
[126] Ibid.
[127] Ibid.

1990s, and official statistics show that the credit records of 837 million people were included in the system in November 2013.[128] This means that one third of the total population is still outside the system. Among those people who have credit records, 317 million have a history of taking out a loan.[129] It is unfortunate that official data do not give further details, for example, the regional distribution of people with credit records between rural and urban areas. However, one can still deduce some conclusion from other sources. The individual credit reference system in China was first piloted in Shanghai, the largest city in the country,[130] in 1999, while it was only until recently that rural credit RCCs (which are the most widely spread rural credit institution in the country) were brought into the national credit reference system. Given the rural–urban segmentation in the financial sector of the country and the difficulty of rural residents to obtain mainstream credit, it is assumed that rural residents in China are faced with the problem of lacking an effective credit record. Moreover, the contents of credit records are also limited to information about previous loan records, as well as records of public accumulation funds, unpaid tax, civil judgments and so forth,[131] while other civil contracts (eg, public utility and mobile contracts) are not covered by the current system. For rural residents who have never owned a credit product, the problem they face is largely concentrated on 'blank' credit records, namely there is no useful information on their credit file, which has a further negative influence on their future loan applications, as banks need to consider such data to monitor the credit circumstances of prospective borrowers. The current way in which credit scoring is done is through automatic credit risk analysis, which is perhaps not appropriate in this case.

1.3.4 Reasons for being excluded from mainstream credit: Lender's perspective

1.3.4.1 Unsuitable product design

As discussed above, financially excluded people with respect to mainstream credit usually suffer from low-income or unconvincing credit records. Generally, the

[128] the People's Bank of China Center Reference Center, 'About Us' <http://www.pbccrc.org.cn/zxzx/zxgk/gywm.shtml> accessed 30 March 2015.
[129] Ibid.
[130] Ibid.
[131] Ibid.

credit risk is related to the amount of the loan, that is, the higher the loan amount, the riskier the loss a bank would suffer. Therefore, if a small-amount loan is available from mainstream lenders, the corresponding requirement of credit record and income level could also be reduced.

However, such products are usually unavailable, or at least not targeted to the financially excluded group of people. This is because the fixed costs of lending would not reduce along with a decrease in the loan amount; on the contrary, dispersed small-amounts would raise the costs of banks, as the expected income from such small loans cannot cover the costs. As the DWP Credit Union Expansion Project Report puts it, 'lending small sums to low-income (subprime) consumers is expensive, and carries a higher risk of default and eventual write off'.[132] It is understandable then that suitable small-amount loans are usually unavailable from banks.

To ensure profit, commercial banks nowadays usually target the more well-off classes. From the criteria used to determine consumer credit listed, it is easy to find out which groups of people are targeted customers in the mind of commercial banks. For example, unsecured personal loans for consumption provided by one of China's largest commercial banks, the BoC, are called '*gong xin dai*',[133] which means 'a loan for the salary-earning class', in Chinese. The length of loan repayments is usually set as one year and shall not exceed three years. Borrowers are allowed to use the loan in all legal transactions, including home decoration, car purchase, education and medical treatment. The size of the loan is set as two to three times that of the proposed borrower's annual income. No collateral or pledge is needed for this product. This product is a typical unsecured personal loan available in the Chinese market. Targeted customers of this loan product are quite straightforward: 'This revolving credit loan is provided for staff of enterprises and public institutions who have steady and continued income, including but not limited to civil servants, staff of state-owned enterprise, teachers, doctors, and police and army officers.'

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[132] Purtill, Cray and Mitchell (n 99) para 3.2.

[133] Bank of China, 'Gongxindai' <http://www.boc.cn/pbservice/pb2/201207/t20120716_1899030.html> accessed 30 March 2015.

Other large banks have similar eligible standards for proposed borrowers of their personal loan products. The eligibility criteria for credit card and overdraft facilities have similar standards for targeted customers. The UK's mainstream credit providers require similar conditions.[134]

From the bank's point of view, a steady and decent job means higher and secured income, while unemployment, part-time jobs or being a farmer, among other things, cannot support people's repayment ability, since their income is neither high nor steady in order for them to be able to guarantee repayments. Based on occupation and income level, this would constrain low-income residents' access to credit from commercial banks. Less-valuable customers would naturally be kept out of the mainstream credit sector, while banks design their products 'tailored' for high-value customers.

Furthermore, the amount of available credit tends to be high, which may exceed low-income people's spending ability, as in the example cited above. For people with a low income, what they could obtain based on their economic level and repayment ability would be small-amount credit, which is better since it does not require collateral. As Kempson and Whyley suggest, 'the types of short-term credit facilities needed are ones that offer small, one-off, fixed-term loans rather than revolving credit, fixed and automatic payments, and take advantage of developments in technology to allow much lower annual percentage rates (hereinafter 'APRs') than are currently available from moneylenders'.[135] However, the cost of handling a small loan is not lower than a large one and yields a small profit. Tailored products are therefore specially developed for high-value customers, while the lower end of the market receives less attention. Inappropriate products also exclude low-income borrowers from applying for loans and leads to self-exclusion, as this would result in people turning away from commercial banks, since they believe that they would be rejected. In general, the problem is, as Timothy Edmonds suggests, the 'mismatch between potential customers' needs and the products on offer', while product diversity is 'clearly part of the answer, for all underserved markets'.[136]

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[134] Purtill, Cray and Mitchell (n 99) para 3.2, 'The banks do not . . . tend to serve this sector of the market, seeing reputational risk from the high interest rates required to make adequate returns on capital.'
[135] Kempson and Whyley (n 6) 45.
[136] Timothy Edmonds, 'Financial Inclusion (Exclusion)' (2011).

1.3.4.2 Deregulation of the banking industry

On a macroeconomic level, the change in the regulatory environment could explain many issues: why banks close their branches or why they are targeted at wealth management businesses. This is, however, closely related to the change in the complex macroeconomic environment and cannot be fully discussed here. This section of the thesis only sketches the conditions based on previous research.

In the UK, it is recognized that the deregulation in the banking sector since the 1980s has led to higher competition, which forces banks to focus on high net-worth businesses.[137] Prior to the 1970s, the UK had adopted an 'interventionist approach' in regulating the banking industry by using banks as 'a direct instrument of government macroeconomic policy'.[138] After the change in the regulatory environment, that is, the introduction of new legislation, including the Financial Services Act, in the UK in 1986, the competition in banking industry increased as a result of the new self-regulation regime, which also covers commercial banks' investment business. Financial institutions are therefore encouraged to compete across market sectors.[139] To win competition, the banking market becomes more concentrated and banks have to become more profit-oriented, which inevitably leads to the closure of bank branches to reduce cost.[140] To make higher profits, the main activity of commercial banks also changed, 'from the provision of credit-related services to investment-oriented products and fee-generation activities'.[141] Therefore, targeted customers inevitably turn out to be high net-worth people with higher incomes, while non-profitable basic services are cut, reduced or charged fees.[142]

The banking industry in China has also experienced tremendous reform in its equity structure since the 1990s.[143] There are two dimensions that are relevant to

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[137] Kempson and Whyley (n 6) 1.

[138] Joseph Nellis and Terry Lockhart, 'The Impact of Deregulation on the UK Building Society Branch Network in the 1990s' (1995) 13 International Journal of Bank Marketing 5. Table 1 provides a list of deregulation methods in the UK from 1979 to 1991.

[139] JN Marshall and others, 'Regulatory Change, Corporate Restructuring and the Spatial Development of the British Financial Sector' (1992) 26 Regional Studies 453.

[140] Yeung (n 73).

[141] Ibid.

[142] Ibid.

[143] For detailed discussions of Chinese banking regulatory reform and an introduction to the Chinese banking industry, see, for example, Michael F Martin, 'China's Banking System: Issues for Congress' (2012); Xiaochi Lin and Yi Zhang, 'Bank Ownership Reform and Bank

this issue. First, after the reform, commercial banks have now become a separate legal person responsible for their own profit and loss related to their property, and for taking responsibility for their stockholders.[144] The result of the financial system reform is noteworthy. They are operating in a Western style and using similar international regulatory standards, just like commercial banks operate in Anglo-Saxon countries which actually provided the model for the Chinese banking industry setting up its own business standards.[145] This, however, excludes less-affluent customers outside their 'normal' loan services due to their higher repayment risk and less profitability.[146]

Second, in 1998 the State Council decided on reforming state-owned banks' branch structure.[147] This reform proposal was soon echoed by the PBoC and gives state-owned banks detailed requirements.[148] The number of bank branches in the same region is limited to one, while other branches shall be closed and their licence turned in.[149] Since then, commercial banks have gradually shifted their business to large and medium cities, and closed around 30,000 branches at county level or below.[150] The trend of branch closure in China was initially aimed at cutting costs and improving state-owned banks' performance, and transforming them into more competitive and profitable 'modern' banks. However, the closure of bank branches would inevitability limit rural residents' access to bank services, which is often suggested in the research.

Yeung gives reasons for bank closure in China from another side of the reform, which underlines the stimulating influence of the entrance of foreign banks on Chinese-funded banks.[151] Compared with Chinese-funded banks, foreign banks

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Performance in China' (2009) 33 Journal of Banking & Finance 20; Allen N Berger, Iftekhar Hasan and Mingming Zhou, 'Institutional Development, Ownership Structure, and Business Strategies: A New Era in the Chinese Banking' in James R Barth, John A Tatom and Glenn Yago (eds), *China's emerging financial markets: Challenges and opportunities* (1st edn, Springer 2009).
[144] Lin and Zhang (ibid).
[145] Yeung (n 73).
[146] Ibid.
[147] State Council of China, *国有独资商业银行分支机构改革方案* [Reform Scheme of State-Owned Commercial Bank Branches] (1998).
[148] PBoC, *中国人民银行关于落实国有独资商业银行分支机构改革方案有关问题的通知* [Notice of People's Bank of China on the Implementation of Issues about the Reform Scheme of State-Owned Commercial Bank Branches] (1998).
[149] Ibid.
[150] Sparreboom and Duflos (n 64) para 2.1.3.
[151] Yeung (n 73) 184. It is mentioned that in 2006, before the initial public offerings of the Industrial and Commercial Bank of China (hereinafter 'ICBC'), the largest commercial bank in China, the staff complement was cut by more than 200,000 staff members.

have more mature experience in how to provide high-standard services to the most profitable part of the market but less so to branches, with the result that from the beginning of their market entrance, foreign banks have avoided competing with domestic mega-banks in less-profitable areas. Instead, they are 'strategically' providing personalised higher-end services to rich customers, who want more sophisticated services tailored to their needs.[152] With higher-quality services, foreign banks find it is easier to attract high-value customers. Yeung finds that the pressure of competition from sophisticated foreign banks in the high-end market stimulates Chinese-funded banks to refine their performances, 'through reducing the high fixed and operational costs embedded in the branch networks by closing branches and making staff redundant'.[153] In fact, 16% of the rural unbanked in China attribute the major difficulty of their getting credit to the lack of local financial institutions.[154] The decrease in the number of commercial bank branches also limits access to credit of people who live in remote rural areas, which largely overlaps with the 'low-income' group in the Chinese context. Fewer available branches in service would also affect rural residents' access to basic banking services.

In general, although the Chinese banking market is dominated by mega-banks and followed by joint-stock commercial banks, their efforts are overwhelmingly concentrated in the 'lucrative urban market'.[155] The unprofitability of the lower end of the market, as well as the pressure of cost reduction and competition in the new era, also drives commercial banks to leave the low-profit market. To some extent, this process has been the natural by-product of the reform and deregulation since the 1990s. Reform in the commercial banking sector in China has rapidly increased the availability of consumer credit since then. However, the lower end of the market is largely overlooked by commercial banks. This is similar to the case in the UK after its deregulation in the 1980s, as the increase in competition would inevitably lead to profit-oriented business tactics.

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[152] Ibid.
[153] Ibid.
[154] Zhang and others (n 72). Rural Finance in Poverty-Stricken Areas in the People's Republic of China: Balancing Government and Market' (2010).
[155] Yeung (n 73)

1.4 Influence of financial exclusion

Life is never easy for underprivileged people who are struggling with financial issues. Education, housing, medical and other daily expenses cost more than before, and with limited financial access, people have to borrow money from a bank at some point in their lives. Characterized by lower incomes and lower education levels than the general population, the unbanked tend to be marginalized in socio-economic terms.[156]

Those people who are less able to use banking services, are 'at particular risk of being excluded from transaction banking (in the form of a current or basic bank account),'[157] and they have to use cash instead of payment services, which means more inconvenience and higher costs. For example, in the UK where the use of payment accounts is more common, people without access to bank accounts means they have difficulty receiving their salary, which makes it difficult for them to be employed, which, in turn, leads to further financial hardships.[158] Bill payment is also less convenient and more expensive if banking facilities cannot be used.[159]

Although in China cash is still widely used, carrying cash around is insecure. There are several aspects to this problem. First, since not all rural communities have bank branches, the majority of migrant workers usually use the post office to remit their wages to their rural homes.[160] However, research finds that the transfer fee at around 1 to 1.5% of the whole amount[161] charged by the post office in China is burdensome for rural migrant workers.[162] Since a common migrant worker usually remits roughly 3,000 yuan per year, the fee paid is 30 yuan, which is 'equivalent to their monthly food allowance'.[163] Using a payment system through a commercial bank is cheaper and faster but this choice is less readily

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[156] John P Caskey, Clemente Ruíz Durán and Tova Maria Solo, 'The Urban Unbanked in Mexico and the United States' (2006) 3835.
[157] Sharon Collard and David Hayes, 'Pawnbroking Customers in 2010: A Survey. A Report to the National Pawnbrokers Association' (2010). It shows that the customers of pawnshops in the UK are less likely to have a bank account.
[158] Kempson and others (n 5) para 5.2.
[159] Ibid paras 5.9-15.
[160] Rachel Murphy, 'Domestic Migrant Remittances in China: Distribution, Channels and Livelihoods'(2006) IOM Migration Research Series 4.
[161] Ibid.
[162] Ibid.
[163] Ibid.

available,[164] not only because of possible difficulties of the account-opening criteria, but also due to the relatively low education level of migrant worker who may not able to obtain useful information on banking services.[165] Some of them choose the informal way of remittance by carrying the money home, which makes them vulnerable to theft.[166] Second, without easy access to banking facilities due to branch closure, rural residents may also find it hard to access nearby bank branches and post offices.[167] This is due to the massive closure of bank branches and even post offices in remote areas in the late twentieth century.[168]

Next, people who are excluded from mainstream credit, rely heavily on their informal support network (eg, family and friends), which is probably also quite limited, and on alternative lenders. From the alternative lenders the unbanked could get a loan, which is generally short term, small scale, single payment and more over-priced than a common consumer credit product.[169] These features could be found in the products of payday lending, pawnbroking, auto title lending and other kinds of alternative lending services. Loans are generally used to cover daily expenses, although some of the borrowers are also small business owners.[170]

The high cost of subprime lending and other features makes this market notorious.[171] Taking payday loans as an example, the typical product in the US is a two-week loan for around US$250 to US$300 and the typical fees range from US$15 to US$20 per US$100 borrowed, which is a very high APR.[172] Higher rates can also easily be found in the market. In the UK, payday lending is included in the more general concept of 'high-cost, short-term credit'[173] in the FCA's new regulatory regime. According to several market reviews of payday-lending practices and the Competition Commission and OFT, the typical payday credit

[164] Ibid.
[165] Ibid.
[166] Ibid.
[167] Ibid.
[168] Ibid.
[169] Mark Flannery and Katherine Samolyk, 'Payday Lending: Do the Costs Justify the Price?' (2005) FDIC Center for Financial Research Working Paper No. 2005-09.
[170] Jim Hawkins, 'Credit on Wheels: The Law and Business of Auto Title Lending' (2012) 69 Washington and Lee Law Review 535.
[171] Ibid. Subprime lenders in the US are also blamed for their targeted tactics, as 'the industry has been accused of strategically locating near populations of vulnerable borrowers, such as military bases and low income neighbours.'
[172] Ibid.
[173] FCA, 'Detailed Proposals for the FCA Regime for Consumer Credit (CP 13/10)' para 6.12. The concept is to include other products that share core features but are not confined to next-payday repayment.

that most UK consumers borrow from payday lenders are: (i) amounts less than £1,000,[174] at an average cost of between £265 and £270 if borrowed over 30 days,[175] and the most common amount is £100;[176] and (ii) loan duration of between less than one month and a few months and a maximum of a year; on average 22 days.[177] Research also shows that 90% of payday loan amounts were less than £570 and over 81% loans had a duration of less than 31 days.[178] Other characteristics include repayment either directly from bank account transfers or in cash paid to high street shops,[179] the use of roll-over repayment, and the fast and easy loan approval process.[180]

Except the high cost charged for the service, there is information asymmetry in relation to some citizens. Critics claim that payday borrowers are not well informed about the true cost of their borrowing, and those lenders engaged in deceptive and unfair practices, and made profit from repeated loan rollovers.[181] Lenders are also accused of encouraging customers to borrow frequently.[182] Borrowers then become ‘chronic’ and are trapped in endless debt, which is where the lenders’ profit comes from. Some of them cannot repay the principle of the loan at the due time, but have to roll over their debt by just repaying the current interest. The reputation of these lenders is, at least to some extent, negative when considering their profit sources.

However, the industry claims that it runs its business fairly enough. Since borrowers are generally weak in their financial status and are not required to provide collateral, the high cost of the loan is the price paid for default risks.[183] Lenders have to maintain their business and avoid these risks via higher fees. As the risks of their customers are much higher compared with those who deal with a bank, the high price of alternative financial service should be understandable,

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[174] Competition Commission, ‘Payday Lending Market Investigation: Competition between Payday Lenders and Other Credit Providers’ (2014). 3.
[175] OFT, ‘Payday Lending: Compliance Review Final Report’ (2013) 9.
[176] Competition &Markets Authority (hereinafter CMA), ‘Payday Lending Market Investigation: Provisional Findings Report’ (2014) para 2.10.
[177] Ibid para 2.13.
[178] Ibid paras 2.10-12.
[179] Competition Commission (n 174) 8.
[180] Ibid. See also CMA Investigation (n 176) para 4.190. It mentioned that 74% of interviewed respondents viewed the speed of getting the money as ‘very or extremely important’.
[181] Flannery and Samolyk (n 169).
[182] Ibid.
[183] Ibid.

since their business is not for a charitable purpose, and their services are indeed useful to the unbanked consumers. These lenders supply valued credit services to poor people; the customers also find they are easier to access than mainstream credit, because they are both time-saving and easier to access.[184]

All the reasons cited seem rational and customer-oriented, but do these kinds of transactions agreed to by both parties correspond with business morals? The answer is not as simple as 'yes' or 'no'. Indeed, the subprime market provides complementary services to those who are excluded by mainstream lenders, which are usually referred to as 'gap-filling' when considering their roles or functions. However, this cannot exonerate these lenders from being blamed for charging high interest. There is nothing wrong with credit-lending activities but the unfair business practices are criticized. The high costs of the loans, the inappropriate debt collection and the danger of trapping customers in unaffordable debt by encouraging them to roll over the loan[185] could cause more problems to customers than other existing consumer credit products: according to the Financial Ombudsman Service (hereinafter 'FOS'), the number of customer complaints on payday loan issues reported to FOS reached 794 by March 2014, which is up 46% from the previous year.[186] If borrowing money is inevitable, then the price should also be expected to be reasonable. This is generally the ground for regulating the credit market, whether mainstream or subprime, no matter which country is involved.

1.5 Theories of equal opportunities

Whether regulations could be used in the recognition of financial exclusion, its manifestations and negative consequences will be justified in the following sections before any further analysis is made.

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[184] Rob Aitken, 'Regul(ariz)ation of Fringe Credit: Payday Lending and the Borders of Global Financial Practice' (2010) 14 Competition and Change 80.

[185] See, for example, Nathalie Martin, 'Regulating Payday Loans: Why This Should Make the CFPB's Short List' University of New Mexico School of Law Legal Studies Research Paper Series Paper No. 2011-09. p 46. See also OFT, 'Review of High-Cost Credit: Final Report' (2010) 7.

[186] FOS, 'Annual Review 2013/2014' <http://www.financial-ombudsman.org.uk/publications/ar14/about.html#product> accessed 27 March 2015.

First, the efficiency of regulation may be queried, since it is assumed that the well-functioning free market could deliver resources to those who need them, while regulations may distort this order. Especially in Anglo-Saxon countries such as the UK and the US where the theory of the free market is more cherished, applying regulation to a social issue can raise questions as to its effect and whether there would be intrusion of the free market.[187] In addition, financial exclusion may be viewed as the consequences of lacking state social welfare or market competition, while solving it relies more on the self-adjustment of the market rather than law, financial regulation and regulators.[188]

However, from the recent financial crisis experiences, the free-market theory in the financial sector is more or less indefensible in respect of maintaining market functioning and stabilization. The free-market theory is challenged by the recognition that the market structure is not shaped by itself, but heavily impacted by government regulations and law, as Ramsay argues, for example,

> Both these positions are, I believe, misleading and neglect the important, and often unrecognized, ways in which the ground rules of consumer credit law shape and influence market outcomes. The existing pattern of lending opportunities and forms and outcomes of credit transactions are not a natural consequence of some abstract concept such as a 'credit market' or 'freedom of contract'. They are shaped by the existing ground rules which influence, and are part of, the contractual culture, which structures and influences market outcomes. Contractual culture, in the context of credit markets, includes norms and assumptions about creditors, debtors, and the role of credit, all of which may be shaped by legal norms of permission and prohibition, and differing institutional frameworks for lending. It is misleading therefore to assume that there is some 'natural' level of credit availability or market structure. This is an important point, since it is sometimes argued that state intervention 'distorts' credit markets through regulation, channelling transactions away from their natural course and requiring a 'trade off' between efficiency and equity goals.[189]

Similarly, Sunstein also argues that the functioning of the market inevitably depends on 'intervention':

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[187] Cass R Sunstein, *Free Markets and Social Justice* (1st edn, Oxford University Press 1997) 3.
[188] Iain Ramsay, 'Consumer Credit Law , Distributive and the Welfare State Justice' (1995) 15 Oxford Journal of Legal Studies 177.
[189] Ibid.

> Some people think there is a deep opposition between ‘government intervention’ and ‘free markets.’ But the opposition is too simple. No one is really opposed to ‘government intervention.’ Markets depend for their existence on law, which is necessary to establish property rights and to set out the rules governing contracts and tort.[190]

This is the idea that the market has never been free but always constructed by regulation.[191] In fact, the free market itself is not guaranteed to be able to maintain a well-functioning market; it could ‘produce economic inefficiency and (worse) a great deal of injustice . . . [the] free market depends on a range of coercive legal interventions.’[192] Besides, Sunstein also questions the free-market theory and the irrationality of people, as not everyone is rational or profit-maximization-oriented.[193] The market is not as perfect as assumed; empirical evidence for this can be found in the recent financial crisis.

On this issue, the theory of Karl Polanyi could also be cited here. In Polanyi’s book *The Great Transformation*, the author demonstrates the view that the market is not self-generating and freely operated, but is heavily influenced by state power from a historical perspective. He criticizes the view of leaving everything to the market’s self-regulation, and argues that it would hurt both people and firms.[194] Furthermore, it is the impaired self-regulation that leads to government intervention.[195] Polanyi deems the interventionism as being ‘responsible’ for people’s real interests,[196] in fact, regulation and intervention are not in conflict with market freedom; they are actually for the betterment of terms of freedom, as Polanyi writes, ‘[t]he road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism.’[197] In order to set up and maintain the order of the market, intervention through law and regulation as the tool is essential:

> True, once such a system is approximately achieved, less intervention of one type is needed. However, this is far from saying that market

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[190] Sunstein (n 187) 108.
[191] Therese Ann Wilson, ‘Regulating to Facilitate Access to Safe and Affordable Credit for Low Income Australians’ (DPhil thesis, Griffith University 2010) 31.
[192] Sunstein (n 187) 4.
[193] Ibid.
[194] Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (2nd edn, Beacon Press 2002) 131-132.
[195] Ibid 206.
[196] Ibid 143.
[197] Ibid 140.

> system and intervention are mutually exclusive terms. For as long as that system is not established, economic liberals must and will unhesitatingly call for the intervention of the state in order to establish it, and once established, in order to maintain it.[198]

Using regulation of the market is therefore both essential and inevitable, and is not an enemy to market freedom. Whether this kind of 'intervention' is effective is based on the content of specific regulations, and some regulations or roles may be less effective or even become a 'regulatory burden'. However, regulation itself is a reasonable way, and is not going to reshape or even distort the 'natural' markets.

The next point is the justification for using regulation in the matter of financial exclusion. There are several levels to this question. First, the features and significance of payment services and credit decide that without access to such services, one may be faced with great inconvenience or even disadvantages. These services are, to some extent, essential, as Wilhelmsson argues,

> Many financial services and information society services are now central to the infrastructure of society, and the consumer cannot reasonably be expected to live without them. These aspects of those services can be treated as social rights in the same way that services provided by 'traditional' public utilities are.[199]

This point of view holds that financial services are a new form of 'social rights', which shall be supplied by the state.[200] Nowadays, payment services, for example, are widely used in daily life and thus no access to it means one cannot make use of cash dispensers if there are no bank branches nearby. This is also essential for customers' free mobility such as those people from rural areas who work, study or reside in cities, or from one member state to another.

Furthermore, this understanding of financial services as a social right relates to issues of social justice and equality. Equality as the basic legal principle is not always fulfilled between different classes, which is inevitable. Inequality, however, comes from an existing social structure, as Jacob argues, 'inequalities

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[198] Ibid 149.

[199] Thomas Wilhelmsson, 'Services of General Interest and European Private Law' in Charles EF Rickeet and Thomas GW Telfer (eds), *International perspectives on Consumers' Access to Justice* (1st edn, Cambridge University Press 2003) 194.

[200] Therese Wilson, 'Consumer Credit Regulation and Rights-based Social Justice: Addressing Financial Exclusion and Meeting the Credit Needs of Low-Income Australians' (2012) 35 UNSW Law Journal 501.

have their origins in the design of social circumstances'.[201] This leads to the recognition of the promotion of equality, which does not intend to provide the same and equal resources to everyone but offers equal opportunities.[202] As Fineman argues, this is the role of the state to its residents:

> True equality of opportunity carries with it the obligation on the state to ensure that access to the societal institutions that distribute social goods, such as wealth, health, employment, or security, is generally open to all, and that the opportunities these institutions provide are evenly distributed so that no persons or group of persons are unduly privileged while others are disadvantaged to the extent that they can be said to have few or no opportunities. This is not a call for equality of result or outcome. It does not ignore or deny that there are differences in individual ability or initiative, or that individuals have responsibility for themselves and their circumstances . . . Far from having equal opportunity, many individuals are caught in systems of disadvantage that are almost impossible to transcend.[203]

Fineman's explanation clearly outlines the essence and boundary of promoting equality. It is in this sense that financial exclusion is viewed as 'a social and economic problem that involves a lack of equality of opportunity and which is a form of economic discrimination'.[204] In the field of financial services, this means available access to affordable and convenient financial services for all residents without discrimination based on group characteristics, such as gender, race or residency, while financial institutions' own eligible criteria on each specific customer still acts as the threshold. For example, HM Treasury points out that improving financial inclusion does not mean that the same extent of services should be given to everyone, but the barriers of free choice should be reduced.[205] How to facilitate this equality in access to financial services through the law and regulations will be answered, but this equality for all shall be protected by the state, based on the discussions above in this section of the chapter. This is not going to distort the nature of the market structure.

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[201] Lesley A Jacobs, *Pursuing Equal Opportunities: The Theory and Practice of Egalitarian Justice* (1 ed, Cambridge University Press 2003) 62.
[202] Ibid.
[203] Martha Albertson Fineman, 'The Vulnerable Subject and the Responsive State' (2010) 60 Emory Law Journal.
[204] Wilson, 'Regulating to Facilitate Access to Safe and Affordable Credit for Low Income Australians' (n 191).
[205] HM Treasury, 'Access To Financial Services: The Report of Policy Action Team 14' (n 37).

Last, but not least, Ramsay also highlights the distributive role of law, suggesting the use of consumer credit law in many aspects, such as mandatory information disclosure and cooling-off period, could 'redistribute power and resources generally from creditors to consumers'.[206] Since there is a huge imbalance between borrowers and commercial creditors, borrowers can hardly bargain successfully on contract terms. After listing several changes in the legislation that gave borrowers more legal rights in the UK in the 1970s, represented by the Consumer Credit Act 1974, Ramsay argues that such legislative changes 'could not only alter the distribution of power in credit transactions, but also the culture of the market, from an arm's-length adversarial relationship to a more co-operative relationship between creditor and borrower.'[207] The distributive role of law shall not be neglected and is not the intervention of the private area.[208] For people who are financially excluded from mainstream banks and have to borrow from subprime lenders, consumer credit law acts as the firewall or the minimum protection and rebalances the contractual parties' power.

1.6 Role of legislation or regulations in financial exclusion

In recognizing the problem of financial exclusion and its negative influences, it is not surprising that governments in different countries are seeking solutions to the issue. There are, however, two dimensions to this problem; on the one hand, new access for basic banking services and affordable consumer credit should be provided to low-income people, which requires regulations to facilitate this social right of people, and, on the other hand, subprime lending should also be regulated to protect the vulnerable from being harmed by high interest rates or unfair business practices.

The first dimension of this issue is that the role of law or regulation is essential. This is the 'facilitating' role of regulation with respect to the provision of financial services. To facilitate the provision of such services, regulations shall be fit and proper to remove any regulatory burden and mandatorily lower an inappropriate threshold to make use of banking services. Although the regulatory objectives of the Financial Services and Markets Act 2000 (hereinafter 'FSMA')

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[206] Ramsay (n 188).
[207] Ibid.
[208] Ibid.

do not cover issues related to financial inclusion (which would perhaps be a controversial issue to be fixed as a financial regulatory objective), the significance of providing banking services is not neglected by the regulator and the government. The new conduct regulator, the FCA, for example, continues to use the handbook *Banking: Conduct of Business Sourcebook* (hereinafter 'BCOBS') of the previous FSA, which covers taking deposits, payment services and information disclosure on a detailed basis. It is mandatory for banks and building societies to abide by the FSA sourcebook, which sets up the minimum regulatory standards, thereby protecting customers' interests. For example, when it comes to providing customers with information about basic banking accounts, banks have to abide by clear and understandable standards to communicate with customers who may be unaware of such services.

The role of regulations in facilitating consumer credit provision is more essential. As this is usually related to alternative financial institutions, such as credit unions in the UK and rural mutual co-operatives in China, which are usually small and less sustainable, the role of regulation and legislation is to facilitate the growth of those small firms by giving them additional regulatory exemptions. For example, though years of law revision, the Credit Union Act, 1979 (hereinafter the '1979 Act') in the UK has gradually become more flexible and 'deregulated', and has removed many restrictive roles to support small credit unions' growth. The Act is detailed by the *Financial Conduct Authority and Prudential Regulation Authority Credit Unions Sourcebook* (hereinafter 'CREDS'). Another example of using the law to facilitate credit provision is the Community Reinvestment Act in the US, which obliges federally insured banks to meet the 'credit needs' of low-income communities.[209] Although the Act is criticized, it is indeed an example of how legislation could intervene in financial institutions' commercial activities.

As to the second dimension of the issue, namely conduct regulation of consumer credit providers, the role of regulation appears more traditional or 'direct' compared to the first dimension: it aims to regulate subprime lenders to prevent unfair treatment of customers through measures such as mandatory information disclosure, responsible lending and interest rate caps. This is the case in both the UK and China. Under the inclusive legislation FSMA, the UK has established a

[209] Hubbard (n 47) 334.

complex regulatory regime for the financial industry. The offering of both basic banking services and consumer credit belong to 'regulated activities'. This conception refers to activities related to investments, including assets, rights or interests, that are specified by the Treasury, and carried on in the business way.[210] Only 'authorised' or 'exempt' persons may carry on the regulated activity.[211] To be able to provide regulated activities, an individual or firm has to seek permission from the regulator to do so,[212] and the permission could be varied or cancelled if unsatisfactory conditions are identified.[213] In this sense, the regulator could use the power of variation and cancellation to regulate firms' behaviour. Firms need to comply with the law and regulations included in the new sourcebook, the *Consumer Credit Sourcebook* (hereinafter 'CONC'), which provides the new regulatory regime, as well as the Consumer Credit Act 1974 (hereinafter 'CCA 1974'), which still works in many respects.

Compared with the UK, the law and regulations in China are still sketchy as the consumer credit market is still in its nascent stage. However, customers' interests are increasingly being protected in the consumer credit area through the recognition of the 'financial consumer' under the Consumer Protection Law of 2013. Protecting customers in the financial sector is, in any sense, a basic role of the regulatory system.

The role of regulation in facilitating financial inclusion is therefore mixed and complex. However, the effectiveness of the regulation shall also be considered, which relies on the determination and controlling power of government, and on the preciseness of law, since lenders are known to be good at finding legal loopholes.[214] If not properly set, the effectiveness of regulations would reduce. Interest rate capping, for example, is at first glance very useful in protecting customers in the subprime lending market. It could, however, easily be evaded by lenders. For example, in the US, where every state has its own court system, by operating as an agent for banks in a state with no interest limit on consumer credit, lenders could then open branches in other states without being regulated by local

[210] FSMA 2000, s 22.
[211] Ibid s 19.
[212] Ibid s 40.
[213] Ibid s 45.
[214] Flannery and Samolyk (n 169); Hawkins (n 170). The attitude towards financiers in society is an interesting topic to be researched; yet this thesis is not about social psychology, therefore, that issue was not included.

usury laws.[215] In addition, Zywicki deems the 'unintended effects' of the usury cap, such as price increase and market exit, could deprive consumers of access to title loans, and force them to turn to more expensive lenders and even loan sharks.[216] Furthermore, it should be recognized that the law (and financial regulation) itself cannot solve the financial exclusion problem. More efforts from government departments and society are essential. It could be assumed that if the social welfare system is fully established, then low-income people are less financially stressed as they can benefit from social insurance and other social schemes. However, before alternative lenders such as credit unions take over the market, the gap-filling role of the subprime market is still meaningful in relieving the problem of financial exclusion. Financial regulation in this sense is not a catholicon; it is a way of promoting equal opportunities in financial areas by facilitating more available and affordable choices.

1.7 Regulating credit: A historical perspective

In fact, regulating the credit market has more profound roots in history and is not a purely modern product. Although this thesis is about current regulations, it would still be useful to look back at the evolutionary process of regulation and theory through history which, in turn, has influenced current regulatory methods and attitudes towards questions such as 'what is usury?' and how to define usury, which further leads to the legal or regulatory methods of using interest rate capping on the fee capping in the consumer credit sector.

In general, the regulation of credit in the ancient world focused on the treatment of taking interest from an activity. This is closely related to the society's economic condition and productivity level at that stage. Marx's 'economic base determines the superstructure' theory could probably be used to explain these negative attitudes towards loan interest in the pre-industrial age. The theory is explicitly stated in Marx's book *A Contribution to the Critique of Political Economy*:

> In the social production of their existence, men inevitably enter into definite relations, which are independent of their will, namely [the] relations of production appropriate to a given stage in the development of their material forces of production. The totality of these relations of

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[215] Zywicki (n 108).
[216] Ibid.

> production constitutes the economic structure of society, the real foundation, on which arises a legal and political superstructure, and to which correspond definite forms of social consciousness. The mode of production of material life conditions the general process of social, political, and intellectual life. It is not the consciousness of men that determines their existence, but their social existence that determines their consciousness.[217]

In Marx's theory, the 'economic base' refers to product relations that come from material life, such as relations of employment, labour, property; while the 'superstructure' is the 'superior relations of production',[218] including all other relations such as culture, ideological forms, the state and the family, which represent the interests of the ruler and is decided by the base.[219] For the purpose of this section, the 'base' is the economic condition of a certain society, whether lending–borrowing is common and what is the development level of commerce; while the superstructure generally refers to the ruler's attitude towards loans and loan interest, and the culture and the law; with less-developed commerce and trade, the requirement for business loans is also limited. In these cases, people borrow money mainly to sustain themselves through hard times, and usury prohibition is necessary for social stability. It is therefore common to see the rulers of the ancient agricultural world restrict loan interests for those subjects who were exploited during the written history of humankind. In a more commercialized society, borrowing money for commercial purposes was a normal practice and would not receive wide objections from the public or the ruler.

The earliest known rate regulation was found in ancient Babylonia, and the code of Hammurabi is viewed as the first authentic official record of credit regulation.[220] It set up maximum rates of interest for loans of grain and loans of silver by weight, and if violated, the principal of the debt would be cancelled.[221] Although brief, this represents the attitude of rulers towards lending with interest in ancient agrarian countries. It was argued as being 'one of the very first written laws [that] differentiated between interest as a legal act when charged within the legally accepted rate'.[222]

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[217] Karl Marx, *A Contribution to the Critique of Political Economy* (Progress Publishers 1970) 3.
[218] Ibid.
[219] Ibid.
[220] Sidney Homer, *A History of Interest Rates* (Rutgers University Press 1963) 25.
[221] Ibid.
[222] Abdul Karim Aldohni, 'Loan Sharks v. Short-Term Lenders_How Do the Law and Regulators Draw the Line' (2013) 40 Journal of law and society 420.

A similar negative attitude towards moneylending and usury is also to be found in ancient China's official documents and statutes. Regulating lending with interest rate capping has a profound history which can be traced back to the Western Han Dynasty (206 BCE to 24 CE).[223] Later in the Tang Dynasty (618–907 CE), interest charged by lenders was capped and did not exceed the amount of the loan principle (*息不过本，Xi Bu Guo Ben*), which was aimed at protecting the vulnerable from being harmed by high rates.[224] This principle was generally inherited by later dynasties from the Song, Jin, Yuan, Ming to the Qing.[225] In more than a millennium, rules of ancient China maintained the regulating methodology of credit by setting up interest rate caps. Lending money was in general permitted but the rate was capped; in Xu's view, the rationale for capping interest rates in ancient China comes from the Confucian school, which advocated altruism and humaneness.[226] This, however, also reflected conditions in the typical agrarian society of ancient China.

On the other end of the spectrum, in ancient Greece, credit transactions were not regulated,[227] and there were no interest rate limits.[228] Recorded credit interest was reached up to an appalling 9,000%.[229] This attitude towards moneylending and interest was underpinned by the commercialized social environment, 'the Greeks of the seventh century B.C. developed an economic system that was commercial, urban, and monetary. Credit facilitated trade.'[230]

In fact, the Athens approach is regarded as an ancient version of '*laissez-faire*', that is, a free transaction that does not set any rule or control for moneylending.[231] It is therefore understandable that there is no definition of 'usury' in the Athenians'

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[223] Defeng Xu, '*论利息的法律管制——兼议私法中的社会化考量*' [Regulations of Interest Rates: An Analysis of Socialized Private Law] (2010) 1 Peking University Law Review.
[224] Ibid.
[225] Ibid. For example, Xu notes that in the Qing Dynasty's (1644–1912 CE) primary law, the Great Qing Legal Code, the monthly rate cap was limited to 3% of the principal amount, and moneylenders were prohibited from taking interest higher than the loan principal no matter how long the loan period was. Breaking the law led to physical penalties.
[226] Ibid.
[227] Homer (n 220) 34. It is mentioned that 'the Greeks of the seventh century B.C. developed an economic system that was commercial, urban, and monetary. Credit facilitated trade.'
[228] Brian M McCall, 'Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury' (2008) 30 Cardozo Law Review 549.
[229] Ibid.
[230] Homer (n 220) 34.
[231] McCall (n 228).

approach. However, some negative consequences of unlimited moneylending were also recorded. The personal loan interest was calculated on a monthly basis, and 'small debtors in difficulty dreaded the end of the moon'.[232] Social struggles between classes were fierce and became the most serious problem for Athens. It was against this background that Solon appealed for reform in 594 BCE, when he probably cancelled many debts and freed debt slaves.[233] The reform was highly praised, as Lewis writes,

> Both Aristotle and Plutarch tell us that the amelioration of such debts was one of Solon's most important achievements, although it is highly unlikely that he cancelled them outright. He set clear limits to debt contracts; it is likely that he made it illegal to enforce a default by turning the debtor into a slave (either *de facto* or by ownership). The wealthy could no longer enslave a debtor, and debtors could not pledge their own bodies as security for a loan.[234]

Bankers were, however, also not reputable from Roman times to the medieval age, partly because the society was largely agrarian,[235] so were the conditions in most ancient and medieval societies. 'Among most of the ancient agricultural nations, there was a prejudice against the taking of interest for the loan of money.'[236]

However, based on scholarly research and statutes in the ancient world, from the perspective of law, the Romans had the most sophisticated understanding of moneylending and rate regulation. In Rome, loans for profit were allowed but were also regulated by rate caps.[237] The Twelve Tables had already set up interest rate caps for personal debt.[238] What is more significant in the Roman approach, was the distinction between loan and lease; by making a distinction between *mutuum* (consumable) and *commodatum* (non-consumable), Roman law provided a categorization distinguishing the lending of consumable and durable goods with

[232] Ibid 35.

[233] John David Lewis, 'Solon of Athens and the Ethics of Good Business' (2009) 89 Journal of Business Ethics 123.

[234] Ibid.

[235] James William Gilbart, *The History and Principles of Banking* (Longman, Rees, Orme, Brown, Green, and Longman, Paternoster-Row 1834) 6. The Greeks, obviously, were not a typical agrarian society. In the book *A History of Interest Rates* by Homer (n 220), the author mentions the insufficiency that led to active maritime trade. It is easy to deduce that for the convenience of trade, credit would be used more frequently.

[236] Gilbart (ibid).

[237] Homer (n 220) 44-56.

[238] Ibid.

a solid theoretical basis.[239] The definition of 'loan in the digest' – paraphrased by Paucapalea in the twelfth century[240] – is quoted here: 'A loan [*mutuum*] is so-called from this, that mine [*meum*] becomes yours [*tuum*]. That is a loan, which, consisting in a quality, is offered by me, while from you I shall receive back only as much of the same kind.'[241]

The ownership and right to use a consumable good (eg, wheat and money) cannot be separated; the good was consumed once in use. Similarly, one cannot keep the ownership of money while transferring the right to use; so, in order to use it, one had to own it. This is the case of *mutuum*, where the item is 'lent', both ownership and the right to use were actually transferred.[242] Lenders thus had no right to ask money for what did not belong to them. If they did so, they were selling one thing twice (ie. one for ownership, one for right of use which cannot be separated from the former), namely selling the right that belonged to others. The amount of money hence was to be returned in the exact same amount without any additions. A promise to pay more than received in such moneylending contracts (*mutuum*) was unenforceable.[243] Only by a separate stipulation could the borrower pay the fees, but this was a distinct type of contract compared to the loan contract, and cannot be combined into a single one.[244] However, the actual result of these two contracts means the allowing of loans for profits. It was just the profit of another separate contract.

However, in later medieval times, the attitude of the church towards loan interest was negative. Unlike Romans' permission regulation approach, lending for profit in medieval times was viewed as a 'sin of injustice'[245] and violated the natural law philosophy.[246] In his book, *The Scholastic Analysis of Usury*, John T. Noonan noted the difference between the early middle ages and later Renaissance. Christian tradition itself condemned usury.[247] People in early times accepted the usury theory not because of mundane interests, but because the Church taught

239 McCall (n 228) 560.
240 John T Noonan, *The Scholastic Analysis of Usury* (First Edit, Harvard University Press 1957) 39.
241 Ibid.
242 McCall (n 228) 560.
243 Ibid.
244 Ibid 561.
245 Noonan (n 240) 30.
246 Ibid 21–29. For a detailed discussion on natural law theory and the issue of usury, see McCall (n 228) 561-69.
247 Noonan (n 240) 34.

them to do so. Theological decisions were more important than economic facts, and the chief source on usury analysis was the Church's teaching.[248]

However, throughout history, loans, or usury, did not vanish, not even in European medieval times when it was forbidden by the Church. It survived throughout history until today. In addition, medieval states were not as keen to forbid usury as the Church was. This was partly because the economy in Western Europe was revived and accelerated from the twelfth century, and with increased consumer demands, trade was assisted by the growing supply of money.[249] In the fourteenth century in Florence, only rates of interest exceeding 20% were regarded as usurious, and 15–20% were in a 'grey zone'.[250]

For example, in England loan for profit was first prohibited by Edward the Confessor.[251] Later, in the year 1126, usury was prohibited only to the clergy, who, in case they practised it, were to be degraded. In 1189 the interest rate was fixed at 10% until the time of Henry VIII, in the year 1546, when the taking of interest on money was made legal in England, and the rate was fixed at 10%.[252] In the next few centuries, legal interest rates were adjusted several times, and the word 'usury' was no longer regarded as simply taking interest from loans, but referred to the rate higher than the legal limit allowed.[253] This re-acknowledgement of the interest rate should partly be attributed to the slow but tidy revival of commerce and other kinds of economic activity after the Dark Ages.[254] Loans for profit were finally not being considered as usury after long debates, which established the basis of the contemporary credit system or the base of the economic world today. Many modern countries reaccepted the Roman approach of capping the interest

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[248] Ibid 12–14; 34–36. Things were different in the Renaissance period, when economic factors began to play the main role. According to Noonan, the sixteenth century was a commercial and humanistic age; Jews and Lombards acted as public usurers in Europe during medieval times. They may have disappeared due to prohibition in some periods, but would definitely reappear. The prevalent negative attitudes towards usurers can be found in the literature, the representative of which was the comedy by Shakespeare, 'The Merchant of Venice' in the sixteenth century. In medieval times this would probably have been explained by the lack of enforcement towards usury, since the usury prohibition by the Church was rarely enforced by public authority. It was regarded as a moral sin and would not affect commercial practice as modern credit regulations do, and the usurers, either the Jews or the Lombards, were rarely influenced by the Church's condemnation.
[249] Homer (n 220) 91.
[250] Richard S. Grossman, *Unsettled Account: The Evolution of Banking in the Industrialized World Since 1800* (Princeton University Press 2010) 37.
[251] Gilbart (n 235) 14-19.
[252] Ibid.
[253] Ibid.
[254] Homer (n 220) 87.

rate. 'Usury' no longer refers to any increase in the principle, but a higher rate than allowed by the law. That was, to some extent at least, similar to what is regarded as loan interest today.

Later in the UK, the attitude towards 'usury' was reflected in the theory of Jeremy Bentham,[255] who defended the freedom of moneylending without legal limits and criticized anti-usurious laws, arguing that a usury cap was going to exclude people 'from being precluded altogether from getting the money they have occasion for'.[256] This *laissez-faire* approach in moneylending was financially accepted by Parliament in 1854, when the Usury Act 1660 was repealed as corresponding to the market requirements. During the second reading process in Parliament it was argued that

> [p]eople could not be brought to believe that money was as much a commodity as any ordinary article of produce—that its value must be regulated, such as the value of any other commodity, by the ordinary principles of demand and supply—and that it was as impossible to fix the rate of interest at which it should be lent as to fix the price at which corn and butter should be sold… The usury laws, in fact, did no good whatever, but they produced great inconvenience; they affected to do what all the powers of the Legislature could not do—to apply a different principle to one description of commodity from that which was applied to every other—and they interfered with the principle of supply and demand.[257]

Since then, the UK did not have a legal usury cap for moneylenders for a long time. Regulation of consumer credit focuses on other aspects such as information disclosure. In this sense, the concepts of 'usury' and 'usurers' also did not exist for a long period, as there was no legal limit on how much a lender could take from a customer.[258] However, the concept of 'loan shark' is used instead to describe those unlicensed lenders who charge very high rates.[259] The repealing of the law does not mean the disappearance of such lenders. Those lenders are illegal

[255] Joseph Persky, 'Retrospectives from Usury to Interest' (2007) 21 Journal of Economic Perspectives 227.
[256] Jeremy Bentham, *Defence of Usury: Shewing the Impolicy of the Present Legal Restraints on Pecuniary Bargains in a Series of Letters to a Friend. To Which Is Added a Letter to Adam Smith, Esq.; LL.D. on the Discouragements Opposed by the above Restraints to the Progress O* (London : P, 1818). Letter VI.
[257] 'HL Deb 24 July 1854, Vol 135, cc581–4' <http://hansard.millbanksystems.com/lords/1854/jul/24/usury-laws-repeal-bill> accessed 22 December 2014.
[258] Aldohni (n 222)
[259] Ibid.

due to lack of licences. Licensed lenders were regarded as 'subprime lenders', although they also lent money at high rates without legal limits until most recently. However, the FCA set up a new price cap for the payday lending industry in 2014.[260] To some extent, this is the modern version of the usury cap, as the rule is mandatory for all regulated firms.

Financial regulators in the modern age are accustomed to using legal methods to regulate moneylenders. The outdated idea of 'loan for profit is usury' had become unfashionable and is no longer feasible in modern society. Yet this widely accepted conception has a long history. Behind it was a sophisticated system of theories and ideology, including natural law, divine law, scholastic analysis of usury, and economic and legal theory in early modern periods. All these factors define what one understands about credit and usury today from deep moral, legal and historical perspectives.

1.8 Summary

This chapter discussed the background to the thesis. When the use of basic financial services became increasingly significant in modern days, the inability to access to such services meant great inconvenience and possible detriment to sections of society. This is reflected in the use of payment accounts and consumer credit, where the majority of society does not find such services unfamiliar but some low-income people are still denied access to mainstream service providers. The concept of 'financial exclusion', which became frequently mentioned in recent years is used to describe a condition in which some people are unable to use a basic payment account or borrow money from commercial banks due to their own vulnerable status.

Both internal and external reasons lead to financial exclusion. Although reasons for limited access to basic payment accounts and consumer credit are different, some of the reasons are common to both financial services. First, low-income level is found as strongly related to the condition, no matter whether it is in the UK or China. For the use of a basic payment account, this reason is more invisible and indirect. However, since many low-income people live in remote areas or

[260] FCA, 'Policy Statement 14/16, Detailed Rules for the Price Cap on High-Cost Short-Term Credit Including Feedback on CP14/10 and Final Rules'.

deprived communities, they may find no available bank branches within reachable distances. This factor is more direct in the consumer credit exclusion, as income level is a decisive factor that banks would consider before making any loan. Second, and closely related, since mainstream banks use the credit reference system to screen 'valuable' customers who have the capacity to repay, many potential borrowers are also limited by this procedure, no matter whether or not they have detrimental credit records or do not have any previous credit records. Although banks are doing everything reasonable to control the possibility of bad debt, the lack of appropriate small-amount loan products means there is no capacity to reduce creditworthiness assessment requirements, since the provision of small credit is less profitable for banks. At the macro level, the deregulation of the banking industry leads to competitive pressure, making banks pay more attention to investment products rather than 'traditional' banking services for ordinary people; the closure of bank branches echoes the deregulation, which further exacerbates the conditions of people living in remote or rural areas. Altogether, these completed but interrelated factors lead to financial exclusion. Both the UK and China have similar problems in this regard.

To alleviate the exclusion, it is not surprising that governments try to use financial regulation to facilitate the provision of financial services and regulate improper business practices. This attitude is explicitly clarified in HM Treasury's 2007 report: 'Everyone should be able to plan for the future with a reasonable degree of security. Therefore, affordable credit, saving accounts and simple insurance products should be available to all who need them.'[261] Although regulations (and legislation) are not the catholicon for the issue, further social welfare is also needed to relieve the condition. Regulations could, however, at least not become a burden on banks and other lenders, while subprime markets shall, under proper conduct regulation, protect vulnerable customers' interests. Some of the regulatory methods even have profound roots in history: the usury cap, for example was used in different jurisdictions throughout history. Although social and economic circumstances have changed substantially since ancient times, the historical perspective helps to shape what is thought today.

[261] HM Treasury, 'Financial Inclusion: The Way Forward' (n 84).

Finally, one thing that should be noted is that promoting financial inclusion does not equate to providing financial services to all people, regardless of their circumstances. It is, in fact, an issue of equal opportunities, which means people shall not be discriminated against simply because of their adverse economic conditions, but should be given a chance to choose appropriate products that fit in with their real need. This is the role of regulation that will be discussed later in this thesis, as well as whether current regulations have performed this role.

Chapter 2: Banks, regulation and financial exclusion

Introduction

As discussed in Chapter 1, access to payment services is regarded as a basic financial need that is essential in many aspects of daily life. No access to these services means inconvenience and additional costs. The provision of a payment account to customers is essential, since it is convenient to use.

However, the situation is different in the case of consumer credit, which could also be supplied by the alternative subprime market. Payment services are usually exclusively provided by mainstream financial institutions, and mainly include, for example, commercial banks, building societies in the UK, RCCs in China and post offices. Although both countries have considerable coverage of account holdings, there are still some really practical issues related to vulnerable customers making use of the payment services of commercial bank. These issues include information asymmetry, improper eligibility criteria and service fees, as discussed in section 1.2, making it difficult for some customers to use the payment system.

Whether current rules and regulatory standards in the UK and China could relieve the problem will be discussed in this chapter. First, whether commercial banks have some social duties to provide basic payment services to less-profitable customers is discussed, based on theoretical grounds. Second, regulatory rules in the UK and China are discussed respectively. Third, the content of the new EU Directive is also analysed. The final section is a summary of this chapter.

2.1 Theoretical basis for banks' duty to promote inclusion

Before discussing regulatory standards for commercial banks to observe in the provision of payment services to vulnerable customers, it is essential to clarify first whether banks are obliged to comply with the duty to do so.

From the point of being firms, commercial banks are profit-oriented and shareholder-responsible corporations. There is, in essence, no difference between a bank that provides deposit, loan and investment products in the financial sector and a manufacturing company that sells cars or lawnmowers, as both are selling products to the general public and have to uphold certain quality and safety standards. Whether banks have the responsibility to serve certain banking services for the low-income, unbanked group of people is therefore disputable, so is the role of modern banks in social interests.

However, the provision of payment services has special features that make it a 'social responsibility', rather than a pure business activity. The banks' role in modern society is also extended. There are several aspects at a theoretical level that support this basic recognition.

2.1.1 Banks' special status in the financial system

From the perspective of banks' role in the financial system and to society, there are different views on this basic question. Some argue that 'financial institutions are not used to dealing with poverty', and attribute this duty to state or non-profit institutions.[262] Others have argued for a long time that banks should also bear some responsibility to the general public,[263] which idea was particularly accepted after the recent financial crisis had begun in the US mortgage subprime market.

From this point of view, Cartwright makes an outstanding analysis. In Cartwright's view, owing to banks' central role in the financial system and their significance for financial stability, they receive government protection in case of liquidity.[264] Moreover, empiricism shows that insolvency of major financial institutions was usually the prelude of more serious market collapse and economic crisis, and the closure of one bank may consequently cause risks in the whole system.[265] This is the saying; 'too big to fail'; some of the largest banks are under potential guarantees of the government in case of any liquidity risk and the government has to save banks for the sake of system stability.[266] To enjoy this privileged position, banks have to do something in return. Indeed, governments

[262] Jenny Rossiter, *Financial Exclusion: Can Mutuality Fill the Gap?* (Jenny Rossiter ed, 1st edn, the New Policy Institute 1997) 21.
[263] Peter Cartwright, Banks, Consumers and Regulation (1st edn, Hart Publishing 2004) 212.
[264] Ibid 216.
[265] Ibid.
[266] Ibid.

have a duty to protect the market confidence of the public in the financial system, but this does not mean banks can take this special protection for granted. Cartwright argues that banks have to take social responsibilities, which is the *quid pro quo* (exchange) for this privileged status compared with ordinary companies who do not enjoy as much importance in markets and have to bear their own risk of bankruptcy.[267]

In this sense, anticipating banks to provide basic services to society therefore would not violate the free-market theory; if banks are free from any regulatory duties, and are fully competing and operating on the basis of commercial interest, they should also bear the possible consequence of competition or business failure. With the guarantee and protection from government in case of systematic risk, it is hard to regard the financial market as totally 'free'. In this sense, major banks have more social duties as they receive higher levels of protection during crises compared with smaller firms; this is evident from the recent financial crisis that originated in the United States (hereinafter 'US'), during which many smaller banks were acquired or bankrupted,[268] while what the government seeks to rescue are mainly larger financial institutions. There is an intangible contract between the government and banks from a more macro perspective, making it reasonable for governments to attribute some social duties to large commercial banks.

2.1.2 Banks' social duty as corporations

In addition to banks' special status in the financial system, debates were also concentrated on the scope of duties of banks as corporations.[269] In the traditional free market theory represented by Friedman, what duty a company should bear is to increase its profits.[270] The corporation only needs to be responsible for its shareholders' interests by paying dividends on time. In Friedman's theory, only individuals have responsibility, not the firm; directors of a company are only responsible for their employers and meeting their desire to make profits. They

[267] Ibid.
[268] A failed bank list in the US is available on the Federal Deposit Insurance Corporation (FDIC)'s website. FDIC, 'Failed Bank List' <https://www.fdic.gov/bank/individual/failed/banklist.html> accessed 5 January 2015.
[269] Cartwright (n 263) 213.
[270] Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine* (13 September 1970).

may not use shareholders' money for 'social' purposes,[271] which actually belongs to the agency problem as directors do not work to increase shareholders' benefits, but reduce firm owner's returns for their (the directors') own sake of reputational or for political purposes.[272]

However, criticism of this theory always exists, and especially so after the recent financial crisis when the duty of corporations came under renewed scrutiny. Except for making profits, the firm has other dimensions of duties to society. This is the theory of *corporate social responsibility* (hereinafter 'CSR'), defined as 'actions that appear to further some social good, beyond the interests of the firm and that which is required by law'.[273] The corporate is expected not only to concern itself with shareholders' profits, but also to take care of the stakeholders which include, for example, customers, employees, suppliers, community groups and governments.[274] According to Donaldson and Preston, the stakeholders of a corporation are the following:

> (a) Stakeholders are persons or groups with legitimate interests in procedural and/or substantive aspects of corporate activity. Stakeholders are identified by their interests in the corporation, whether the corporation has any corresponding functional interest in them. (b) The interests of all stakeholders are of intrinsic value. That is, each group of stakeholders merits consideration for its own sake and not merely because of its ability to further the interests of some other group, such as the shareowners.[275]

Based on this understanding, the assumption could be made that the provision of basic payment services to vulnerable customers belongs to the scope of 'social good', because it is concerned with life conveniences. These customers may not be able to bring direct profits to the bank in the future, but their interests should also be of concern because their vulnerable status is, to some extent, influenced by banks' expanding business, since the increasingly wide use of bank accounts means more inconvenience to themselves if they are excluded. This recognition corresponds with the recognition of the UK's major commercial banks and

[271] Ibid.
[272] Ibid.
[273] Abagail Mcwilliams, 'Corporate Social Responsibility: A Theory of the Firm Perspective' (2011) 26
The Academy of Management Review 117.
[274] Thomas Donaldson and Lee E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications' (1995) 20 Academy of Management Review 65.
[275] Ibid.

banking association in their responses to the Department for Business, Innovation and Skills' (hereinafter 'BIS') inquiry into a bank branch in relation to people's basic banking needs. It was acknowledged that banks should 'reflect on their wider social responsibilities and provide vulnerable customers with access to banking services to ensure they are not financially excluded'.[276]

In fact, CSR now, to some extent, goes beyond merely the theory. In the UK's newly revised Companies Act 2006, the director of a company is required by section 172 to act in good faith and to promote the success of the company for the benefit of its members as a whole. The director must take the following factors into consideration:

> (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.[277]

Since the directors are required to consider 'the impact of the company's operations on the community and the environment', a commercial bank in this sense should take care of the community. Such approach was labelled in the *White Paper on Modernising Company Law* as 'Enlightened Shareholder Value', which asks (but does not force) directors to consider the relationship with other stakeholders.[278] This requirement is definitely a sign of progress.

However, as Cartwright points out, when bank directors' judgement is in the banks' interests, 'it is unrealistic to expect it to be challenged'.[279] It is hard to blame banks for not offering some sort of services or products, because this is a commercial judgement. In Keay's view, section 172 only has an educational

[276] 'British Bankers' Association's Response to Banking Needs of Vulnerable Consumers Letter' (2014) <https://www.gov.uk/government/publications/banking-needs-of-vunerable-consumers-letters-to-banks> accessed 21 December 2014.
[277] Companies Act 2006, s 172.
[278] House of Commons Trade and Industry Committee, 'The White Paper on Modernising Company Law' (2003) 7.
[279] Cartwright (n 263) 214.

function and hardly gives any direction or guidance for directors to follow.[280] Keay views the amendment as 'a general statement of principle hopefully encouraging directors to aim for the long-term success of the company and to demonstrate enlightenment' and is sceptical about enforcement.[281] Similarly, in China's Company Law (2005), firms are also required to 'comply with the laws and administrative regulations, social morality, and business morality. It shall act in good faith . . . and bear social responsibilities'.[282] There is also no further statement on how to enforce the CSR in this Chinese primary legislation.

In this sense, although banks are expected to be socially responsible and are, to some extent, under government pressure, provision of basic banking services is still largely a CSR rather than a legal duty under the law. However, this means a 'responsible' bank could be anticipated to bear some social duties.

2.1.3 Essence of basic banking products: Service of general interest

The third point is based on the essence of banking products and whether they belong to the scope of public utilities. In a general sense, *public utilities* refer to those services that provide everyday basic services to the public, and usually include services such as telecommunications, water, gas and electricity. Whether owned through state investment (as in the case in China) or privatisation (as in the UK), public utilities are under government regulations to ensure no one is discriminated against and the public can afford them. The UK's Utilities Act 2000, for example, requires that 'all reasonable demands in Great Britain for gas conveyed through pipes are met'.[283] If some (not all) financial services could be regarded as essential, as are common public utilities such as gas and electricity, then it could be assumed that people should reasonably expect to have access without discrimination due to their low income or rural residency. However, whether the essence of banking services is comparable with that of public utilities needs further demonstration.

[280] Andrew Keay, 'The Duty to Promote the Success of the Company: Is It Fit for Purpose?' in Joan Loughrey (ed), *Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis*, vol 491627 (1st edn, Edward Elgar Publishing Ltd 2012).
[281] Ibid.
[282] Company Law of the People's Republic of China (2005 Revision), art 5.
[283] Utilities Act 2000, s 9.

On this question, more detailed analysis can be found in the work of T. Wilhelmsson, who proves the necessity of banks' duty to provide such services for general interests.[284] In an important essay, he argues that for public services that were traditionally provided by the public, citizens in welfare states have grown to expect that these services would be offered by the public sector and have legitimate expectations of such services being offered, although the industry contracted these services out to private bodies during privatisation or marketization.[285] Owing to this anticipation, the price of services would be relatively fixed, companies must exercise their duties for the well-being of their customers, and it should be less possible for companies to quit the market only because of profit earnings. Those services, in Wilhelmsson's essay, were referred to as 'services of general interest', which are very relevant to consumer's basic life demands, and should therefore be viewed in Europe as social rights.[286]

The basic features of such services, as Wilhelmsson quoted in his essay, are (i) the service fulfils a basic need of its users; (ii) there is often no reasonable alternative to the service; (iii) there are few producers of the service; (iv) the service is based on a long-standing relationship.[287] Since these services are of public interest and expected by the public naturally, every citizen therefore has the right to receive the services on the same terms as others.[288] The author hence argues that, though privatisation took place in the public utility sector, consumers could still expect the same standard of service not only because they grew up with the services in welfare state and have subjective expectations, but they may also objectively be unable to maintain their livelihood without reasonably priced services or products.[289] Because of these reasons, Wilhelmsson concluded that there should be no discrimination towards consumers no matter what their economic status was; to put it simply, 'the weak consumers should receive services equally as easily as those who are better off'.[290]

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[284] Thomas Wilhelmsson, 'Services of General Interest and European Private Law' in Charles EF Rickett and Thomas GW Telfer (eds), International perspectives on Consumers' Access to Justice (1st edn, Cambridge University Press 2003) 149.
[285] Ibid 153.
[286] Ibid.
[287] Ibid.
[288] Ibid 152.
[289] Ibid.
[290] Ibid 161.

However, to what extent should banks also carry out this equality and non-discrimination principle, and provide unprofitable facilities for the poor? Are financial services vital to maintaining life just like electricity, gas and heat? It may be possible that day-to-day banking services before the 1960s when the first credit card was used were not as essential as today and so they are not a 'traditional' need when compared to gas, water and electricity; in other words, they are not as vital as other public utilities at first glance. People could use cash transactions and would not face severe trouble, compared to their supply of electricity being cut off.

Wilhelmsson accepts this difference between traditional public utilities and banking services, but also argues that the scope of 'essential needs' is not a fixed concept; instead, it varies from time to time, and is largely determined by social and technological innovation.[291] Wilhelmsson summarizes two basic purposes of financial services, namely (i) payment and (ii) receipt of payments, and concludes that in the credit card industry the provision of means of payment is also essential for life.[292] The significance of basic banking services arises in modern society since automatic transactions are more widely used. Without bank accounts money management would be 'more complex, time-consuming, more costly and less secure'.[293]

Four features of the social rights mentioned above can hence be applied to the financial sector. First, basic banking services fulfil everyday needs. Without a bank account people cannot use direct debits when paying their bills, but have to choose more expensive and time-consuming ways such as paying cash at a post office or bank branch, using pay-as you-go methods or buying savings stamps.[294] Second, the number of bank branches (suppliers) in an area is low and, third, people intend to have long-term relationships with their banks once they have opened accounts at a certain bank. Though people could use cash instead, this alternative method usually costs more than using payment services. With such features, basic bank services can be regarded as a sort of 'public utility' and are

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[291] Ibid.
[292] Ibid.
[293] Elaine Kempson and others, 'In or Out? Financial Exclusion: A Literature and Research Review' (2000) para 5.2.
[294] Ibid para 5.9.

essential for the citizens of modern society to keep a 'decent life'.[295] It was for these reasons and logic that Wilhelmsson believes financial services should also be treated in the same way as other life essentials; and the right of having basic banking services lies within the scope of social rights.[296]

In addition to its life necessity feature, Wilhelmsson points out that customer's legitimate expectation of a right to public utilities can also be extended to financial services, which were traditional privately run, because they may be unable to tell the difference between public utility companies and banks, and may expect the same standard of services from both kinds of enterprise.[297] He gives several reasons why public utility companies and banks should provide services for the less privileged people from the point of view of CSR:

> [T]he enterprises and bodies that provide the types of services . . . are well suited to bearing certain social responsibilities. Because they are usually (at least partially) former public bodies, they still have a special standing with consumers, and consumers have legitimate expectations that they will carry a public responsibility. They are usually large and powerful corporations which have the ability both to carry the liability and to disperse their risks among a sufficiently broad collective of consumers.[298]

This strong analysis clearly provides the reason why banks should bear this responsibility: not from the standpoint of corporate law, but from the real capability and social duties of banks, as well as from the reasonable expectations of customers.

2.1.4 Difference between transaction banking services and credit

From the above analysis, it could be concluded that payment services belong to a kind of 'general interest', and it is banks' CSR to provide payment services to all possible customers in need without income or price discrimination. However, this recognition of payment service as a public utility cannot simply be extended to the provision of consumer credit. Indeed, in a consumer society in which borrowing is either inevitable or even encouraged, access to affordable credit shall be regarded

[295] Wilhelmsson (n 284) 162.
[296] Ibid 155.
[297] Ibid 157.
[298] Ibid.

as normal, as the Lord Bishop of Durham observes, 'one of the most significant aspects of modern life is that accessible finance and affordable credit have become as much a basic utility as many other areas that we considered to be utilities'.[299] Government may advocate that commercial banks lend small-amount loans to low-income people as a response to financial exclusion, however, there are several central differences between the provision of payment services and consumer credit when examined from the essence of both.

First, there is a difference between the provision of payment services and consumer credit. In general, account holders using payment services through a basic bank account will not expose banks to risks. Although banks may not be able to make profits from basic bank accounts, there is also no underlying risk that would directly reduce these firms' interests. Financial exclusion in this regard has little connection with the potential risk and certain customers' own economic status. The financial regulator could therefore anticipate banks to remove improper eligibility criteria of account-opening, reduce transaction fees for using banking services and properly disclose information to unbanked customers as a whole group, as this would not expose banks to risks. While, in contrast, repayment risk is closely related to the income level and credit records of every borrower. It is both impossible and improper for the regulator to require banks to reduce their assessment standards of consumer credit. Although repayment risk could be reduced by offering small-amount loans, banks usually lack incentives to do so because of high operational costs. The capacity and resources of banks are limited; it is hence 'unrealistic and undesirable' to require banks to offer all kinds of financial services to all customers, regardless of the customers' economic status.[300]

Second, although banks are anticipated to bear CSR to offer basic bank accounts to low-income customers, this duty could not be extended to the area of consumer credit. For commercial banks, CSR in the consumer credit sector means responsible lending, considering customers' needs, and provide the ability to repay, so that customers are not trapped in financial difficulties. This would benefit both the bank from the repayment ability and the customers from unaffordable debts. Banks are required to sell appropriate products to appropriate

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[299] HL Deb 13 Dec 2012, vol 741, col 1172.
[300] Cartwright (n 263) 219.

customers, [301] in other words, comply with responsible lending and selling standards, since some customers are simply ineligible for some high-risk services or products due to their income or financial literacy levels. Providing appropriate products for the poor, in this sense, includes offering basic financial services at reasonable prices and protecting consumers from over indebtedness, rather than offering consumer credit without case-by-case assessment.

In addition, although potential borrowers could be regarded as a kind of stakeholder, there are, however, also different levels of stakeholders. The ‘primary’ stakeholders’ interests should have higher priority; in the context of commercial banks, it is the depositors’ deposit safety that should be considered in the first place. Deposit safety in this sense takes precedence over the aim of financial inclusion, since the latter may expose banks to bad debt risks.

Third, different from payment services, consumer credit does not belong in the scope of public utility and ‘general interests’. The view that everyone should have access to public utility services, including the use of basic banking services, makes it worth noting that banking services are divided into different tiers: the use of bank accounts lies at the base and acts as a threshold for all other subsequent services, while the use of credit is higher up on the ladder and has more complex terms. According to Wilhelmsson’s definition, in order to be identified as ‘public utility’, the service has to satisfy several conditions. Unlike with payment account usage, consumer credit could hardly meet the features of public utilities. First, using credit is not a ‘life necessity’ as in the case of payment accounts, gas or water; many people could rely on their savings and do not need credit. Second, public utility providers are generally referred to as ‘companies that provide essential or important services to the public as monopolistic or near monopolistic providers’. [302] However, there are also plenty of alternatives available in the market; not only subprime lenders, but also affordable choices such as credit unions. Third, there are also no ‘legitimate public expectations’ in this case, as banks are not ‘public companies’ (not understood in a technical-legal sense) as are utility companies, and consumer credit is not offered as a basic life need as in the past. Consumer credit in this sense does not belong to the scope of public utility.

[301] Ibid 218.
[302] Willie A Grieve and Stanford L Levin, ‘Common Carriers, Public Utilities and Competition’ (1996) 5 Industrial and Corporate Change 993.

Although commercial banks are anticipated to offer easy, accessible payment services to release financial exclusion, which is the banks' social responsibility and in the public's general interest, this social duty can hardly be extended to consumer credit.

2.2 Law, regulation and government perspectives of bank's duty to promote financial inclusion

From the analysis and literature review above, one may safely draw the conclusion that banks have a duty to offer basic banking services to less-privileged people no matter whether they are a social responsibility, the corporations' duty or in answer to customers' reasonable expectation. Apart from theoretical reasons, governments would usually advocate or encourage banks to be involved in the financial inclusion progress, although banks may have different reactions towards their government's proposals.

In general, government's willingness could be reflected by the financial regulatory objectives, which are usually set in the basic legislation or rules governing the financial sector. For example, the basic statute of banking supervision in China, the Banking Supervision Law of the People's Republic of China (2006 Amendment), clearly states the statutory objective in its Article 1 as follows:

> The present Law is formulated to strengthen the supervision over the banking industry, regulate the activities of supervision, prevent and eliminate banking risks, protect the legitimate rights and interests of the depositors and other clients and promote the sound development of the banking industry.[303]

The statute also sets the basic working principles of the banking regulator of China, the CBRC, as including the protection of deposits and consumers, maintaining market confidence, enhancing public financial education and reducing financial crimes.[304] Similarly in the UK, the basic legislation, the Financial Services and Markets Act 2000 (hereinafter 'FSMA 2000'), sets its

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[303] *中华人民共和国银行业监督管理法* [Banking Supervision Law of the People's Republic of China] (2006 Amendment), art 1.

[304] CBRC, 'The Supervisory Focuses of the CBRC' <http://www.cbrc.gov.cn/showyjhjjindex.do> accessed 21 March 2014.

regulatory objectives as maintaining market confidence, financial stability, protecting customers and reducing financial crime.[305] Obviously, in China both the statute's and the CBRC's objective are in the same regulatory model as that of developed countries such as the UK.[306] Up to now, none of the statutes has set up mandatory requirements for commercial banks to exercise a duty of financial inclusion. The legislator obviously shows a cautious attitude that is reasonable, because offering basic banking services does not fully fit in with banks' commercial interest; after all, banks are corporations with normal commercial objectives. Theoretically, what is central in the authority's mind is to keep financial stability, maintain market confidence and promote competition; it is not the mainstream approach for banking law to have 'financial inclusion' in its statute or regulatory objective.

In fact, Cartwright poses the question whether it is desirable for banks to be under an obligation to provide appropriate services to all consumers.[307] Although 'the access to financial services' was argued to be inserted into the broad consumer protection objectives of the FSMA 2000 at the time of law making, it was finally decided that such objective would put too much pressure on the financial regulator beyond what the FSMA 2000 already empowered it.[308] Gong and Zhou also mention China's reluctant attitude towards setting up regulatory objectives to reduce the problem of financial exclusion, explaining that 'financial inclusion is regarded as the responsibility of the government rather than that of the banking regulator'.[309]

Indeed, financial exclusion is too complex to be solved in one section, one chapter or one single statute; it involves issues from all aspects of governmental efforts, including social welfare, which goes beyond the scope of financial legislation. However, it is important to note that the gap in legislation does not mean neglect of the issue. As the reaction speed of the law-making progress is usually slower than the implementation of regulatory measures due to more complex legislative processes, it is worth noting this developing process when the regime is in

[305] FSMA 2000, ss 3–6.
[306] FSMA 2000, s 2 (2).
[307] Cartwright (n 263).
[308] Ibid.
[309] Yufeng Gong and Zhongfei Zhou, 'Combating Financial Exclusion in China: A Banking Regulatory Perspective' in James R Barth, John A Tatom and Glen Yago (eds), *China's Emerging Financial Markets: Challenges and Opportunities* (1st edn, Springer 2009) 495.

progress, especially when regulatory change has already taken place at the EU level towards access to banking services, which could possibly have influences in the UK if the direction is implemented domestically.[310] In addition, the prudential attitude of legislation leaves space for the financial regulator to promote financial inclusion through specific regulatory methods.

In the UK, the use of basic bank accounts has been regarded as one of the primary ways to reduce exclusion in the area of banking service since the 1990s. A basic bank account in the UK provides essential features as current accounts do, but does not have an overdraft facility and chequebook in order to minimise unexpected charges for being overdrawn. These basic bank accounts were designed for low-income customers, and the UK government highlighted their importance[311] and the 'shared goal' was set up with the industry in 2004 with the aim of halving the unbanked people in the country.[312] According to the report of the Financial Inclusion Taskforce (hereinafter 'FIT') this goal was met in 2009.[313] All major high street banks are now offering basic bank accounts to people who have financial difficulties.[314] The DWP Credit Union Expansion Project Feasibility Report published in 2012 recognises the achievements banks have made, referring to the nearly 4 million new basic accounts opened by banks and building societies in a decade.[315] However, the DWP report also points out that, without mandatory or compulsory measures, the coverage of account-holding is unlikely to expand continually;[316] for example, since basic bank accounts can hardly bring banks profit, banks are criticized for not recommending this product to customers.

To further promote the progress made, the UK Treasury came to an agreement with several major banks on the issue of basic bank account holding in December 2014.[317] This is, to some extent, in response to the EU Directive on payment

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[310] Directive 2014/92/EU of 23 July 2014 on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features [2014] OJ L257/214.
[311] HM Treasury, 'Access To Financial Services: The Report of Policy Action Team 14' (1999) 42.
[312] HM Treasury, 'Pre-Budget Report' (2004) para 5.47.
[313] Financial Inclusion Taskforce, 'Fourth Annual Report on Progress towards the Shared Goal on Banking' (2009) para 8.
[314] BBA, 'Basic Bank Accounts Give Customers Confidence in Handling Their Finances' (2006).
[315] Colin Purtill, John Cray and Cath Mitchell, 'DWP Credit Union Expansion Project Project Steering Committee Feasibility Study Report' (2012) para 2.4
[316] Ibid paras 2.4; 5.1.
[317] HM Treasury, 'Revised Basic Bank Account Agreement' (2014).

accounts, which was approved in the same year, although the UK Parliament had not approved the implementation of the directive domestically until now. The agreement, however, recognizes future influences of the directive in the UK market. Although the agreement is only between the government and selected banks, and is not a mandatory regulation to the industry, banks signed the agreement taking a majority market share in the UK's basic banking sector.[318] Therefore, the industry is *de facto* coordinating the provision of basic banking services with the government's proposal before it becomes a mandatory duty.

Similar progress can also be found in China, where the central bank, the PBoC, started prompting major commercial banks to provide 'migrant workers' bank card services' to ease their problem of access to money withdrawal services if they had a bank account at or near their workplace but wished to withdraw money in their hometown.[319] Features of this bank card include the maximum withdrawal amount of 5,000 yuan per day, and the fee charged for money withdrawal being reduced from 1% of the withdrawal amount to 0.8%.[320] Furthermore, the PBoC requires that commercial banks provide appropriate customers with migrant worker bank card services and, according to the PBoC's report, all card issuers in China have currently started offering this card product.[321]

In the basic banking services sector, commercial banks usually prefer to do what the authority wishes or requires them to do since there is little risk involved. However, owing to the potential repayment risks, consumer credit usually does not belong in this scope. When the government wishes to reduce low-income people's difficulty in accessing mainstream credit, banks are usually more reluctant to respond to the government in this regard.

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[318] Banks and building societies who signed the agreement with the governments are Barclays, the Co-operative Bank, HSBC, Lloyds Banking Group (Bank of Scotland, Halifax and Lloyds), National Australia Group (Clydesdale Bank and Yorkshire Bank), Nationwide, RBS Group (NatWest, Royal Bank of Scotland and Ulster Bank), Santander and TSB. They cover more than 90% of the UK's current account market. See, HM Treasury, 'New Basic Fee-Free Bank Accounts to Help Millions Manage Their Money' (2014).
[319] Payment and Settlement Department of the People's Bank of China, *中国支付体系发展报告 .2013* [China Payment Development System Development Report. 2013, zhongguozhifutixifazhanbaogao2013] (1st edn, China Financial PUblishing House 2014).
[320] Ibid.
[321] Ibid.

This is more evident in China where major large banks are actually in tight relationships with the government. In order to relieve the poverty distress of low-income people, the Chinese government has taken a series of measures to facilitate access to financial services and tries to include commercial banks into the inclusion attempt. Although commercial banks in China are now joint-stock companies and enjoy their business autonomy in many aspects, it should be emphasized that the controlling shareholders of the 'big four' are still the state, specifically, the Minister of Finance and state-owned investment enterprises. Moreover, the influence of government is also reflected in the nomination of senior officers of mega-banks by the governing party. It is therefore hard to estimate the extent of government influence over commercial banks.[322]

This leads to a special condition, namely when the government wants to 'include' more low-income residents into the mainstream financial system, the banking regulator, the CBRC, would then give details to commercial banks and other financial institutions on how to put the government's intention into practice. Ideally, commercial banks would therefore respond to the CBRC and provide special products and services to certain groups of vulnerable residents. The role of government, the regulator and commercial banks therefore forms a chain, with blurred lines between government's administrative power, the banking regulator's duty and commercial banks' position. The CBRC's measures mainly focus on rewarding commercial banks for providing services to low-income people. However, the CBRC measures are usually voluntary suggestions rather than compulsory requirements for commercial banks to abide by. Although anticipated to be involved, commercial banks are found still lacking enough incentive to provide such products or services to low-income people or in remote areas.

For example, in a 2007 Guiding Opinion,[323] the CBRC provides commercial banks with opinions on how to develop small-loan products for rural residents, in

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[322] Martin, 'China's Banking System: Issues for Congress.' CRS report for the Congress. The author concludes that several factors including the nomination right of senior executive officers of equitized banks belongs to the Organization Department of the CPC Central Committee, the officers often have working experiences with government or other mega-banks, and their promotion is also administered by government and the CPC. These personal factors for senior officers make them tend to comply with the government's intention.

[323] CBRC, *中国银监会关于银行业金融机构大力发展农村小额贷款业务的指导意见* [Guiding Opinions of the China Banking Regulatory Commission on Banking Institutions to Develop Rural Small Loans, guanyuyinhangyejinrongjigoudalifazhannongcunxiaoedaikuanyewudezhidaoyijian], (2007 No. 67)

order to encourage banks to expand such services, and the CBRC promises that it would give priority to commercial banks who wish to open new branches and get licences for new products on the basis of their performance. A 2012 CBRC Notice again encourages commercial banks to open more branches in remote and poor areas, set up village and township banks (hereinafter 'VTBs') with the reward of permission to open new branches in urban areas.[324] Although the CBRC does not have 'financial inclusion' in its regulatory objectives, apparently it has taken some inclusive-oriented measures aimed at facilitating rural residents' access to financial services.[325]

However, as to the real effect, research shows that large banks are less energetic in setting up VTBs. A report of Deloitte China on VTBs notes that medium and small financial institutions are more positive in setting up VTBs, while large banks and joint-stock commercial banks are less involved in this process.[326] Considering the market share of large banks and joint-stock commercial banks in China, it is obvious that they do not have enough incentive to further develop the less profitable rural market than their small-size counterparts.[327]

Another example is more straightforward. Encouraged by CBRC and PBoC, commercial banks are involved in providing services to rural residents and enterprises. Data on 'rural loans' are listed in the annual report of several mega-banks; these loans are inclusive-oriented loans specially offered to the rural market. However, it mainly flows to rural small and medium enterprises, and infrastructure construction rather than direct lending to rural residents.[328]

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324 CBRC, *中国银监会办公厅关于做好老少边穷地区农村金融服务工作有关事项的通知* [Notice of the General Office of the China Banking Regulatory Commission on Relevant Issues Concerning Effectively Conducting Rural Financial Services in Poor and Remote Areas, guanyuzuohaolaoshaobianqiongdiqunongcunjinrongfuwugongzuoyouguanshixiangdetongzhi] (2012 No. 330).

325 Guiding Opinions of CBRC (2007 No. 67) (n 323).

326 Yibing Zhu and others, '*商业银行发展村镇银行业务之路*' [Path for Commercial Banks Develop Village Bank Business' Deloitte (2012). Deloitte's report includes 549 village and township banks (hereinafter 'VTBs'), only 92 of whom are set up by large banks, joint-stock commercial banks and policy banks, which is 17% of the total number of examined village and township banks.

327 Ibid. City commercial banks are more positive about setting up village and township banks, because they wish to grab more of the market share. In contrast, large banks' incentive is to support government's rural policy.

328 Guangwen He and Lili Li, '*大型商业银行的小额信贷之路——兼论与新型农村金融机构间的合作机制*' [Small Credit of Large Commercial Banks: Cooperative Mechanism Between New Rural Financial Institutions, daxingshangyeyinhangdexiaoexindaizhilu] (2011) 5 Rural Finance Research 21.

Although in close relationship with the government, large and medium commercial banks in China may still lack inherent incentives to offer small loans for low-income rural residents, which is both less profitable and highly risky because of their unstable income and lack of collateral. Commercial banks in China are involved in rural loan projects because the government and CBRC expect them to do so, or from the consideration of taking social responsibility to earn a good reputation. Without enough incentive or rewards, it is less possible for commercial banks to provide residents who live in remote or poor areas with unprofitable services in the long run.

The relationship between banks and the financial regulator in the UK is not as tight as in the case of China, since the latter used to have state-owned commercial banks that still hold state investments and have invisible (or visible) administrative relationships in the context of officer nomination. However, commercial banks in the UK are also reluctant to fill the gap between mainstream banking and the low-end market.[329] The small-amount loans, high transaction fees and the relatively higher default risks make small-amount and short-term consumer credit expensive for banks. To serve this market, banks have either to raise interest rates or bear the loss. None of these results is satisfactory, as raising interest rates may cause moral criticism and be labelled 'modern usurer'.[330] In this situation, Cartwright suggests that 'it appears unlikely that pressing mainstream lenders to provider credit to less affluent consumers will be a viable solution without some degree of compulsion.'[331] Without enough incentives set out in the regulatory rules, it is hardly possible that commercial banks would likely participate in this unprofitable market.

On this issue, an example from the US could be cited here as a simple reference. The Community Reinvestment Act (hereinafter 'CRA') passed in 1977 intends to promote depository institutions to 'help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions'.[332] The Act highlights the credit needs of low- and moderate income communities,[333] and a regulatory regime is set up to assess

[329] Purtill, Cray and Mitchell (n 315) para 3.2.
[330] Ibid.
[331] Cartwright (n 263).
[332] Community Reinvestment Act of 1977, 12 U.S.C. §2901.
[333] Ibid 12 U.S.C. § 2903.

institutions' record of meeting such needs, which were 'traditionally underserved by lending institutions'.[334] Four grades – from 'outstanding', 'satisfactory', 'needs to improve' to 'substantial non-compliance' – will be made after each assessment, and if the federal agency regards an institution as not serving the low- and moderate income community, measures can be taken, including delaying or denying an institution's request to merge, open new branches of expand services.[335] Large, medium- and small-sized lending institutions are under different levels of examination, depending on the size of their assets.[336] The often-cited underlying philosophy of the CRA, according to many researchers, is the '*quid pro quo* rationale' (doing something for something);[337] banks need to serve the local community in return for the government's protection, including deposit insurance. As reflected in the CRA, this means that although banks are privately capitalized, they are under the obligation to serve the credit needs of local communities.[338] Furthermore, the Act treats the rigorous levels of tests of large, medium and small banks differently based on their asset size. If the test result is unsatisfactory, the regulatory agency could delay or refuse the merger, branch opening or service expansion requests of that bank. This gives the regulator more regulatory power than simply promising future rewards for banks who participate in the process.

However, despite the good intention of serving low-income communities, the Act has been widely criticised since it was passed. Although it provides a rating system that assesses commercial banks' performance, it is criticized for not providing banks with enough incentives, which is merely the result of an examination, since an unmet rating result could lead to the turning down of a merger request. However, the benefit for banks of being rated as 'satisfactory' is difficult to quantify and therefore the rating system is criticized for lacking effective rewards.[339] For example, Quercia and others point out that 'it is hard to gauge the marginal value of obtaining an Outstanding grade rather than a

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[334] National Community Reinvestment Coalition, 'A Brief Description of CRA.'
[335] Federal Reserve Board of United States, 'About CRA'.
[336] Large institutions are those with assets greater than US$1 billion, 'medium' with US$250 million to US$1 billion and 'small' with assets worth less than US$250 million. Small institutions are under examination. See 12 U.S. Code § 2908.
[337] John Olson and others, 'Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act' (2009) 4 Community Development Investment Review.
[338] Allen J Fishbein, 'The Community Reinvestment Act after Fifteen Years: It Works, but Strengthened Federal Enforcement Is Needed' (1992) 20 Fordham Urban Law Journal 293.
[339] Olson and others (n 337)

Satisfactory',[340] therefore, banks may stop at a 'satisfactory' result and abide by other regulatory standards. Moreover, since the main force of the Act is to control merger requests, as the financial services industry is increasingly being consolidated, the real effect of this enforcement tool is said to be 'dwindling'.[341] Some therefore argue that 'banks that achieve an Outstanding rating could be allowed some sort of financial (perhaps lower deposit insurance premiums) or regulatory relief (eg, more time between examinations, a safe harbour when applying for new powers)' [342] as additional regulatory rewards in order to stimulate further incentives.

From the bank's perspective, offering low-income customers access to credit is not their main task. Not only because they are profit-oriented companies, but also because of the risk management standard with which they must comply, which means banks should not lend to people who are assessed as a high repayment risk in terms of creditworthiness. This is a requirement of responsible lending which protects both the customer and the bank, as responsible lending could prevent customers suffering from over-commitment or unaffordable debts. Banks therefore consider the financial exclusion problem from another perspective, as Barclays's Corporate Responsibility Report 2005 mentions, for example,

> A high street bank like Barclays is not always the most appropriate organisation for some types of loans. For example, high volumes of very low value loans, particularly for those with limited credit histories, do not fit easily into our business.[343]

What Barclays recommends to solve the access problem is to allow banks financing community finance organisations to include credit unions, rather than directly taking the duty of offering small credit upon themselves. In the UK, credit unions are actually viewed as an alternative way of promoting financial inclusion, as Ramsay concludes,

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[340] Roberto Quercia, Janneke Ratcliffe and Michael A Stegman, 'The Community Reinvestment Act: Outstanding, and Needs to Improve' (2009) 4 Community Development Investment Review 47.
[341] Ibid.
[342] Mark Willis, 'It's the Rating, Stupid: A Banker's Perspective on the CRA' (2009) 4 Community Development Investment Review 59.
[343] Barclays, 'Corporate Responsibility Report 2005: Responsible Banking' (2005) 12.

> Banks, notwithstanding their public relations efforts, are not strongly committed to cultivating lower income clients or branches which serve lower income areas which do not generate sufficient profits in this age of shareholder-driven capitalism. The existence of the alternative sector may be partly a consequence of the practices of mainstream financial institutions.[344]

However, whether banks could have enough incentive to finance small community financial institutions is also questionable. In China, for example, major banks show little interest in investing in setting up VTBs.[345]

However, the boundaries of legislation shall not encroach too much on banks' commercial activity. Using the regulatory regime to encourage commercial banks to meet the credit needs of low-income communities shall be cautious. Without existing regulatory instruments, simply introducing foreign statutes into the domestic legal or regulatory system could hardly be effective. Before any legislation such as the CRA is introduced, regulators usually choose to use specific techniques to promote financial inclusion from different angles, for example, by encouraging the setting up of alternative lenders and regulating the subprime lending sector. This will form the main contents of the next chapters of this thesis and will be discussed later.

2.3 Regulatory techniques to promote banking services inclusion

As discussed in section 2.1, commercial banks are usually anticipated by the government to provide easy access to basic transaction services for low-income customers as a duty to society. Although in both the UK and China the coverage of bank accounts and cards involves the majority of residents, whether current regulations would benefit or become barriers to unbanked customers obtaining access shall be overviewed. This section discusses three main aspects that are regarded as essential for low-income customers to get access to banking services.

2.3.1 Information disclosure

In order to facilitate the use of transaction banking services among vulnerable people, the first issue is to increase people's knowledge about them. For

344 Iain Ramsay, 'Access to Credit in the Alternative Consumer Credit Market' (2000).
345 This issue is going to be discussed in detail in Chapter 3.

customers who suffer from financial illiteracy, the lack of information on basic accounts and other transaction banking services or misunderstanding of the eligible criteria of account-opening could leave them remaining unbanked because of self-exclusion.[346] Knowing the available access to bank accounts is also actually the start of using further transaction services. Furthermore, fee charges shall also be disclosed to avoid possible misunderstanding of the cost of using banking services.

2.3.1.1 The United Kingdom

Designed for low-income customers, basic bank accounts in the UK are specifically suited to the targeted customer groups' needs. These bank accounts provide basic features such as that of current accounts but do not have an overdraft facility to avoid possible overdraft charges.

From the supply side, however, banks are sometimes criticized for their reluctance to recommend basic banking services to their customers because of the little added value.[347] There are also *de facto* examples of this criticism. The Financial Services Consumer Panel's basic banking research conducted in 2002 tested the availability of opening basic accounts for low-income people, by choosing several bank branches as samples. They found that only one bank out of ten referred information about basic accounts to customers when customers expressed concern about debt or being overdrawn to the bank.[348] Although the industry questioned the accuracy of this research,[349] this investigation could reflect at least part of the problem. The most extreme case here is the case of a customer who has never been informed of basic bank accounts and remained unbanked; and if customers are unaware of the possible charges of accounts, they may suffer losses due to the lack of information during account-holding.

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[346] Treasury, 'The Report of Policy Action Team 14' (n 311) para 4.21; Jeff Jianfeng Wang and Qian Tian, 'Consumer Vulnerability and Marketplace Exclusion: A Case of Rural Migrants and Financial Services in China' (2013) 34 Journal of Macromarketing 34.

[347] Moneysavingexpert, 'Basic Bank Accounts: Top Accounts for Poor Credit Scores' <http://www.moneysavingexpert.com/banking/basic-bank-accounts> accessed 30 January 2015.

[348] 'Financial Services Consumer Panel Basic Banking Research' (2002).

[349] The British Bankers' Association (hereinafter 'BBA') responded to the FSC Panel's report on the same day, and questioned the accuracy of the report, because the sample used by the report is of just 16 applicants and will not 'present an accurate reflection of the experiences of many of our member's new customers.' See, British Bankers Association, 'Response to Financial Services Consumer Panel Mystery Shopper Survey'. Tuesday, April 23, 2002.

i Duty of recommendation

Indeed, banks would provide the necessary information if customers demanded it. However, this means transferring the responsibility of acquiring information to the customer. This is less effective because customers are less familiar with financial knowledge and possible existing products. Disclosure of information to them is therefore essential to help customers make informed choices. In this case it means banks should recommend basic bank accounts to appropriate customers.

There is currently no mandatory requirement in legislation on this issue. However, with regard to the aspect of general information disclosure, the customer protection objective of the FSMA 2000 requires the authority to consider it, as set out as follows in section 5(2)(C):

> (1) The protection of consumers' objective is: securing the appropriate degree of protection for consumers. (2) In considering what degree of protection may be appropriate, the Authority must have regard to . . . (c) the needs that consumers may have for advice and accurate information.[350]

This is the general requirement for the authority in the statute, which empowers the FCA to decide the appropriate degree of mandatory disclosure. If some consumer protection standards are set down by the regulator, this means the regulator deems it as 'appropriate' at this stage.

Since there is no specifically designed regime for the problem of financial exclusion in the FSMA 2000, it is reasonable to seek further details in regulation and rules.

According to the FSMA 2000, the authority is entitled to issue a code of practice to determine whether an approved person's conduct complied with the statement of principle,[351] in this circumstance, the up-to-date code of practice is the BCOBS.

In section 4.1.4 of the handbook, in order to meet the requirement of information rule, banks are required to provide information on '(9) basic bank account but

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[350] FSMA2000, s 5 (2) (c).
[351] FSMA2000, s 64 (2).

only if the firm offers a basic bank account and the banking customer meets the firm's eligibility criteria for such an account'. This provision underpins the duty banks shall have to provide information on basic accounts. The eligibility criterion here refers to those most basic requirements that opening an account will need.

However, the BCOBS does not provide detailed rules. It does not explain what the 'eligible' criterion is; this is left to the commercial judgement of banks to give them enough space to make decisions. Furthermore, under what conditions will bank staff considering the customer as possibly 'eligible' for the account with a basic feature and provide information to that customer? This is still a problem that some customers may be unable to ask for information that they would actually want. [352] As regards information not being provided, the BCOBS does not answer this question, since this is too detailed to be fixed in a regulatory handbook. How to judge an 'eligible condition' is illustrated in the self-regulatory Industry Guidance which gives examples for member banks on how to put the BCOBS into practice.[353]

The Industry Guidance was issued by the self-regulatory body, the British Banker's Association (hereinafter 'BBA'), together with the other two industry associations, (i) the Building Societies Association and (ii) the Payment Council in 2011. It is non-mandatory and only sets up minimum standards for their members to follow voluntarily. As the guidance points out in its introduction, 'this Guidance only applies where BCOBS applies'.[354] Being issued by the industry association and confirmed by the regulator, the Industry Guidance provides firms with examples on how to comply with the regulatory standard in the handbook.

To help customers make informed choices, the guidance first generally requires banks to behave in a 'fair, clear [manner] and not [be] misleading' when they promote their products or communicate with customers. [355] To achieve this standard, it is suggested that banks present information in an 'understandable'

[352] Cartwright (n 263).
[353] BBA, Building Societies Association and Payment Council, 'Industry Guidance for FSA Banking Conduct of Business Sourcebook' (2011).
[354] Ibid.
[355] Ibid para 2.2.

manner for the average customer; at the same time, the bank shall take special care of vulnerable consumers.[356]

For conditions to be positive to recommend products to customers, section 4 of the Industry Guidance suggests to banks that they can (not 'must', since this would depend on every different case) do the following:

> If a customer wants to know about current account options and the firm assesses that a basic account is likely to be appropriate, then the firm should inform the customer that it offers a basic account and how it can be opened. Customers for whom a basic account might be appropriate include those:
>
> - Who express an interest in opening a money transmission (current) account which does not allow them to go overdrawn;
> - Whose main source of income appears to be state benefit;
> - Who are content to accept the limited money transmission functionality of a basic account (eg, no cheque book).[357]

This provision is a good example of what the appropriate way is to protect the consumer in this case. It could also underpin the BCOBS's information requirement.

It is important to note that the confirmed Industry Guidance is non-mandatory. Its legal status is to illustrate the requirements of the BCOBS and the Principles for Businesses with examples of minimum standards.[358] Based on good faith and the regulatory aims of customer protection, banks can make their own judgements on every different case, with reference to the examples given in the Industry Guidance. When customers are eligible, the BCOBS requires that they be provided with information on basic accounts.

ii Contents of information disclosure

According to the BCOBS, information that shall be disclosed to customers about bank accounts mainly include (i) similar products provided by the firm, (i) terms and conditions of the product, (iii) rates of deposits, (iv) charges for banking

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356 Ibid.
357 Ibid para 4.3.7.
358 Ibid 'Legal status and disclaimer'.

services, (v) right to cancel the contract, and (vi) how to make a complaint.[359] This is aimed at relieving the problem of information asymmetry in the financial market to assist customers with making informed choices or avoiding unnecessary costs; for example, banks need to disclose possible charges for using basic bank accounts, since it is not totally free of charge but customers may have the wrong impression in this regard. A charge would usually be incurred, for example, if the bank has to refuse a direct debit due to insufficient funds in the account.[360]

Since the BCOBS is mandatory for commercial banks, it provides minimum protection of customer's interests. As to the effectiveness of the regime, however, whether customers could be properly protected is still dependent on the level of regulatory power. Theoretically, breach of the handbook will empower customers to sue their banks for unfair treatment, which is, however, hardly practical due to the cost of a lawsuit for ordinary customers.[361] For example, when customers argue they are not informed of the true charge of using bank accounts because the contract does not clearly state it and bank staff did not clearly explain the charges, their first remedy is to solve the issue with the bank, then report it to the Financial Ombudsman Service (hereinafter FOS) or instigate a lawsuit if the result is unsatisfactory. However, considering the vulnerable status of low-income customers, the level of customer protection largely relies on the regulator's effort to set up appropriate conduct of business regulations.

On this issue, the BCOBS refers to the Unfair Terms in Consumer Contracts Regulations 1999 (hereinafter 'UTCCR').[362] According to the UTCCR, the language used in written contracts shall be plain and intelligible to avoid customer misunderstandings.[363] The Director General of the Office of Fair Trading would have the power to assess whether or not the contract terms are unfair. If the terms are regarded as unfair, then they will not be binding on the customer. OFT has been replaced with the FCA and Competition and Markets Authority (hereinafter 'CMA'), and the duty of assessing unfair financial contracts is now that of the FCA.

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359 BCOBS, para 4.1.4.
360 'Financial Services Authority: Basic Bank Accounts, Your Questions Answered' ('The leaflet') <http://webarchive.nationalarchives.gov.uk/20130402220344/http://www.hmrc.gov.uk/leaflets/fsa.pdf > accessed 30 January 2015.
361 FSMA 2000, s 150.
362 BCOBS, para 1.1.7.
363 Unfair Terms in Consumer Contracts Regulations, SI 1999/2083, reg 7 (1).

However, the FCA as the conduct regulator does not intervene in individual conflicts between single customers and firms; it only challenges unfair terms if many customers are affected or the potential risk or harm to customers is considerable. Customers are still anticipated to lodge complaints with FOS on their individual disputes with firms. Furthermore, according to the UTCCR, if the contract language is regarded as 'plain intelligence', then the unfairness test would not be applied to the 'definition of the main subject matter of the contract' or the 'adequacy of the price', which *de facto* assumes that ordinary customers would read and understand the risk of the core content of the contract and the product price, given that the contract terms have listed enough information in plain and intelligible language. However, as Chen-Wishart criticizes, 'consumer protection law should take cognisance of the fact that rational consumers do not read lengthy and complicated standard form contracts for the goods or services they need, whether or not in plain intelligible language.'[364] Even if a contract has made a disclosure, ordinary customers may still be unable to figure out the risk. In a UK supreme court case, the Supreme Court decided that all price terms were covered by the exclusion term of the UTCCR, which therefore means the price term will not be assessed as being 'unfair' under the rule.[365] This approach is criticized for being an 'anti-consumer decision' because it actually means that if the contract term about the price discloses all useful information in understandable language, it will be regarded as fair, whether or not the customer really understands it, therefore high charges are still possible under the UTTTR, unless there is a charge cap in other rules.[366]

iii Appropriate form of information: time, medium and language

In addition to the content of information, there are also requirements on the form of information, which also forms part of the appropriate standard for disclosure. According to BCOBS, banks' duties include the following:

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[364] Mindy Chen-wishart, 'Law Quarterly Review Case Comment Transparency and Fairness in Bank Charges' (2010) 1681 1.

[365] *Office of Fair Trading v Abbey National plc* [2009] UKSC 6, [2009] 3 WLR 1215.

[366] For example, the FCA is now looking at the reasonability of current-account charges, because customers may overlook the charges or fees because of the complexity of the fee terms. See FCA, 'FCA Research Shows Many Consumers Paying Too Much for Overdrafts' (2014) <http://www.fca.org.uk/news/research-shows-many-consumers-paying-too-much-for-overdrafts> accessed 12 February 2015.

> [P]rovide or make available to a banking customer appropriate information about a retail banking service and any deposit made in relation to that retail banking service: (1) in good time; (2) in an appropriate medium; and (3) in easily understandable language and in a clear and comprehensible form; so that the banking customer can make decisions on an informed basis.[367]

Further details are left to the Industry Guidance. For example, the appropriate time includes both an *ex ante* and *ex post* contractual time,[368] which means the bank has a duty to give useful information to customers before they are bound by the terms, as well as after the contract has already been established. In basic bank account cases, this means that banks have to give such information to customers.

For the use of understandable language, in the *High Level Standard Handbook* of FCA and the Prudential Regulation Authority (hereinafter 'PRA'), several principles are set up for all firms under the regulatory system which need to be obeyed. According to Principle 7 (Communications with Clients), banks must communicate information to their clients in a way that is clear, fair and not misleading.[369] To illustrate this requirement from the regulator, the Industry Guidance suggests that 'information should be in plain language and avoid the use of technical or legal terms', which may cause difficulties for common people to understand.[370] The UTCCR also requires that language used in contracts be 'plain and intelligible' to protect customers against unfair treatment by banks. Furthermore, if the meaning of contract terms is in doubt, then they shall be explained in favour of the customer.[371]

For the medium of information, the Industry Guidance lists several channels to make information available, including in branch, and by post, electronic mail, Internet, telephone or text message.[372] It also requires that the medium should be durable. This means customers should be able to look them up multiple times.

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[367] BCOBS, para 4.1.1
[368] Ibid para 4.1.4
[369] FCA Handbook, High Level Standards, Principles for Businesses, para 2.1, The principles.
[370] Industry Guidance (n 353) para 4.31.
[371] Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083, reg 7 (2).
[372] Industry Guidance (n 353) para 4.31.

A leaflet published by the FSA to inform customers about basic bank accounts contains the basic features and application notices of basic bank accounts, gives explanations and provides advice for customers.[373] The FSA distributed copies of the leaflet to a wide range of organisations to promote public understanding of the financial system. In 2006 the Personal Finance Research Centre evaluated the effect of the leaflet,[374] and concluded that the leaflet was successful in providing information for customers to help themselves in making informed decisions and comparisons between appropriate service providers. The table listing basic bank accounts available in major banks is praised in particular[375] and also welcomed by the interviewed customers. This leaflet is a good example of the medium of information, it uses understandable language, which 'alerted people to the existence of the accounts, (and) . . . enabled them to work out which account best suited their requirements.'[376] It contains all the significant information but without information overload, since too much information could also be a problem for people who are financially illiterate.

2.3.1.2 China

Rules about information disclosure of bank accounts and cards in China mainly focus on the content of information that shall be disclosed. Basically, there are two main regulations about bank accounts or bank cards in China. The first is the PBoC's Measures for the Administration of RMB Bank Settlement Accounts (2003) which, however, has no requirements about the conduct of business requirements on information disclosure. The second regulation is the PBoC's Measures for the Administration of Bank Card Business (1999). Since in China a bank card would only be issued to customers after an account has been opened, this regulation could be regarded as the rule of regulating commercial banks' regulated activities in the sector of account and card services.

In chapter 7 of this 1999 measure, commercial banks are obliged to offer information to bank card applicants, include bank card use rules, information on how to use the card and charging policies. Complaint procedures and complaint

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[373] 'The leaflet' (n 360).
[374] Nick Moore, 'An Evaluation of the Fsa Leaflet on Basic Bank Accounts' (2006).
[375] Ibid.
[376] Ibid.

hotlines should also be open to all customers, and customers should be provided with bank statements.[377] Card holders and applicants are entitled to the right to know the function and charge of the card.[378] Although the measures of the PBoC or CBRC are not statutory, in China's legal system these measures are included in 'rules' that are also mandatory and enforceable.[379] Banks must comply with these rules and therefore customer's right to know could be protected at a minimum level, if the rules are carried out properly.

However, there is no requirement about the plain language used in explaining terms and conditions in these regulations. Simply disclosing selected information would not fully fulfil the aim of reducing information asymmetry; it relies on whether customers could understand the contract terms. However, regulation is not a free good and cannot be pursued without limit, and banks are limited in their capacity to communicate with every customer to ensure he or she has understood all the contract terms and risk, even if the contract is in plain language. Nevertheless, since there is no overdraft function attached to the common bank account, risks underlying this kind of financial product is also lower than others.

In addition, it appears that China pays less attention to using regulatory rules to facilitate commercial banks to market their available accounts than the UK does. Not only because of the close relationship between the government and commercial banks, which makes the promotion of bank card usage a kind of official or political task to which commercial banks must usually respond,[380] but also because 'migrant workers' bank card' still belongs to personal current account services, and in China there is no distinction between 'current account' and 'basic bank account' based on the overdraft feature as in the UK, there is also no risks of becoming overdrawn for the account holders. Without the need for a creditworthiness check in an application for an overdraft, commercial banks in China usually need not specially market their bank account to low-income customers because it is natural for customers who wish to open an account for

[377] PBoC, *银行卡业务管理办法* [Measures for the Administration of Bank Card Business, yinhangkayewuguanlibanfa] (1999), art 52.
[378] Ibid art 53.
[379] *中华人民共和国立法法* [Legislation Law of the People's Republic of China](2000), art 71.
[380] For example, in a PBoC 2011 Notice to commercial banks, the central bank planned to carry out the plan of all-coverage of money withdrawal services around the rural country; the plan as reviewed by PBoC in 2013, regard it as 'nearly achieved' by provide the services in more than 80% of previously unbanked villages. See, China Payment Development System Development Report (n 319) 71.

deposit and remittance to be offered the appropriate account, if they meet the bank's requirements for eligibility. Therefore, the issue of customers' risk is less problematic in China than in the UK, which could possibly explain why in China financial regulations about the duty of commercial banks to recommend their account products to potential customers is almost inconsequential.

However, the boundary of information disclosure also exists in China, although there is still no reported dispute between bank account customers and commercial banks on the information issue, judicial cases about investment products hold the view that if the language used in contracts is plain and understandable, and all possible risk is disclosed before customers sign a contract, then local courts would not support the customers' argument that they had not been properly informed about the potential risks of the investment products.[381] It is possible that courts in China would usually hold a prudential attitude on how far banks' duty of information disclosure should go, and ordinary customers are regarded as also having a duty to pay proper attention, and understand the contract terms and risks.

2.3.2 Account-opening eligibility criteria

The second regulatory technique of promoting financial inclusion that could be taken by regulators is to set the primary eligibility criteria of account opening. Nevertheless, whether or not certain customer's account-opening application should be approved remain at the banks' own commercial discretion. Although banks indeed have a social duty to provide basic banking services to the general public, this does not mean it shall be unconditionally provided to all. For commercial banks, using their eligibility criteria is generally to fulfil the identity check needed in order to comply with other legal purposes, such as anti-terrorism activities or money laundering. However, economic conditions shall not become the barrier to customers' access to banking services.

2.3.2.1 The United Kingdom

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[381] Xiuping Pan, '*因银行理财产品纠纷而引发的民事赔偿诉讼若干问题研究*' [Research of Disputes about Bank Investment Products, yinyinhanglicaichanpinjiufeneryinfademinshipeichangsusongruoganwentiyanjiu] in Weiguo Wang (ed), 金融法学家 (1st edn, China University of Political Science Press 2010).

The BCOBS does not set up mandatory requirements for eligibility criteria for banks to abide by. However, as to which kind of criteria is appropriate, the BBA requires banks to comply with the *Handbook of Senior Management Arrangements, Systems and Controls* (hereinafter 'SYSC') for anti-money-laundering purposes. SYSC requires banks to take 'appropriate measures' when taking new customers on board but, at the same time, the handbook also stresses the measures taken by banks shall 'not unreasonably deny access to its services to potential customers who cannot reasonably be expected to produce detailed evidence of identity'.[382] This is the regulatory source of banks' duty to mandatorily check customer's identity (hereinafter 'ID').

As to the question of which sort of ID is acceptable, since ID requirements are designed to identify who the customer is, various kinds of ID shall be accepted other than passports, driver's licences and statement of billing. This is meaningful for some vulnerable residents who may not have valid proof of address who wish to open a basic bank account. Based on this understanding, BBA's Industry Guidance requires that member banks publish a 'non-exhaustive' list of identity documents they would accept. Banks could then use their own eligibility criteria for opening bank accounts and, once the criteria are met, BBA's Industry Guidance requires banks to allow the customer to open an account.[383] It is important to note that for customers who cannot present a common ID such as a passport, driver's licence or statements of billing, there is no legal duty on banks to take on this new customer.[384]

Apart from the ID requirements, the FSA's leaflet also shows that a history of fraud, undischarged bankruptcy or record of bad debts may cause the application to be declined.[385] Banks may check the applicant's credit report to decide whether or not the account should be opened, for example, HSBC has set up its 'eligibility requirements' for basic account applications as follows: the customer has to be 16 years or over, would prefer to undertake a credit scoring search, have

[382] FCA, Senior Management Arrangements, Systems and Controls (SYSC) para 6.3.7G (5).
[383] Industry Guidance (n 353) para 4.3.7.2.
[384] FCA, 'Opening an Account' (2014) <http://www.fca.org.uk/consumers/financial-services-products/banking/your-rights/opening-an-account> accessed 31 January 2015. Several cases are listed in this online instruction when customers cannot prove common ID, which includes benefit claimers, who live in care home or homeless shelters, and prisoners, travellers and international students. For those people, banks could choose to consider other kinds of ID. However, the FCA also stresses that banks do not have a duty to accept alternative types of ID.
[385] 'The leaflet' (n 360).

identification and proof of address, and a UK correspondence address to open an account.[386] For vulnerable customers with a low income, this might become a barrier for them to access banking services, as customers may not want their credit records be further damaged by unsuccessful account applications. Both the FCA and the Industry Guidance currently only require banks to explain the main reason why if asked by the customer to do so, unless there is suspicion of fraud or money laundering.[387]

An important change to be noted, however, is the recent agreement signed between the UK government and several major banks. According to the agreement, customer's economic difficulty will not be used by banks as a reason to reject account-opening applications. Unless there are reasonable reasons, banks that make commitments in the agreement shall provide basic bank accounts to eligible customers.[388] Those reasonable reasons to reject only include the suspicion of unlawful use of the account, customers who display a 'threatening, abusive or violent manner towards bank staff', have no valid ID or do not authorize banks to check their credit record.[389] The last reason is of most significance, because it only sets the criterion as 'do not give banks authorization', rather than 'the result of credit record check meets with bank's anticipation'. Specifically, the agreement stresses that customers, whether banked or unbanked, who need a new account or wish to switch providers but are ineligible for a 'full-service account', shall be offered opening or switching to a basic account.[390] Furthermore, people with undischarged bankruptcy will also be eligible to open accounts.[391] Although the real effect of this agreement is still to be seen, this regulatory technique is real progress in reducing the unbanked problem and promoting financial inclusion.

2.3.2.2 China

Generally, the eligibility criteria for opening accounts with Chinese banks are similar to international common practice.

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[386] HSBC, 'Basic Bank Account' <http://www.hsbc.co.uk/1/2/current-accounts/basic-bank-account> accessed 28 April 2015.
[387] Industry Guidance (n 353) para 4.3.7.4.
[388] HM Treasury 'Revised Basic Bank Account Agreement' (n 317).
[389] Ibid.
[390] Ibid.
[391] Ibid.

First, according to several regulations issued by the PBoC,[392] to be eligible for an account application, customers have to be 16 years or over. This requirement is in accordance with Chinese civil law.[393] Although the age limit for opening an account has been relaxed to 16 years rather than 18, the authority has taken the civil law into consideration, namely a Chinese citizen who has reached 16 years, but is younger than 18, and lives on his or her own income shall be regarded as a person with full capacity for civil conduct.[394] This requirement means customers have to be able to take responsibility at the time when they apply for an account. For customers under the age of 16 years, but who need a bank account, currently there is no special provision for this exceptional case in regulation. However, business practice usually permits guardians to open accounts on their behalf with a valid ID of both the guardian and the person under guardianship.[395] Therefore, age limit does not become a regulatory barrier for customers who need to open an account with formal financial institutions.

Second, there are also legal requirements for identification. Banks are under a legal duty to check the ID of their clients based on the anti-money laundering law of China. According to the law, financial regulations are first required to establish the clients' ID system; they shall also not provide any service with any client who cannot clarify his or her identity.[396] As regards the customer, the anti-money-laundering law also requires that individuals who wish to establish a business relationship with any financial institution shall provide his or her authentic and valid identity certificate or any other identity certification document.[397] Moreover, since China is also a member of the Financial Action Task Force (hereinafter 'FATF'), which is an intergovernmental body set up to combat money laundering, banks' practices are supposed to be in compliance with the good practice

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[392] China State Council, *个人存款账户实名制规定* [The Provisions Concerning the Real-Name Personal Savings Account System, gerencunkuanzhanghushimingzhiguiding] (2000 No. 285).
[393] *中华人民共和国民法通则* [General Principles of the Civil Law of the People's Republic of China] (1987), art 11.
[394] Ibid.
[395] For example, see, Bank of China, 'Eligible Requirements for Current All-in-One Account' <http://www.boc.cn/en/pbservice/pb1/200806/t20080625_1323995.html> accessed 28 April 2015.
[396] *中华人民共和国反洗钱法* [Anti-Money Laundering Law of the People's Republic of China] (2007), art 16.
[397] Ibid.

standards recommended by FATF.[398] All international standards, and domestic law and regulations on 'real name' issued by the State Council and PBC form the legal and regulatory basis for identity check procedures when opening bank accounts.[399]

As to what sort of ID is required, the PBoC lists several documents that could prove applicants' identity in its Measures for the Administration of RMB Bank Settlement Accounts (2003) which shall be mandatorily presented for account opening. Banks are, however, flexible when it comes to choosing a proper ID, including but not limited to national identity card, household register (*户口本*, Hu Kou Ben), passport.[400] Banks will check the ID documents and assess the potential risk of the customer using the information they collected. The authority has labelled this requirement the 'real name' standard under the 'know-your-customer' principle, with the purpose of preventing money laundering and crimes related to terrorism, among other things.

Nevertheless, these legal and regulatory requirements (and banks' eligibility criteria) are not as strict as they appear. The basic proof of ID, ID Card of Residents is legally issued to all citizens who are 16 years or older,[401] hence, customers who wish to open bank accounts are 'naturally' provided with the basic ID document. For vulnerable customers in the country, the ID card is likely the only legal proof of identity they possess.

Since there is no distinction between personal accounts based on overdraft function and, moreover, the personal credit reference system in China is still in its nascent stage, in general, people's negative credit history is less likely to have an obvious influence on bank account applications. However, this does not mean commercial banks in China will not use their own eligibility criteria when

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[398] FATF, 'International Standards on Combating Money Laundering and The Financing of Terrorism & Proliferation , Recommendation 5: Customer Due Diligence and Record-Keeping.'
[399] For details of bank's duty to check client ID, see CBRC, CIRC, CSRC and PBoC, *金融机构客户身份识别和客户身份资料及交易记录保存管理办法* [Measures on the Administration of Client Identity Identification and Materials and Transaction Recording of Financial Institutions, jinrongjigoukehushenfenshibiehekehushenfenziliaojijiaoyijilubaocunguanlibanfa] (2007 No. 2).
[400] This issue can be found in many regulations since 2000, for example, see, State Council (2000 No. 285) (n 392), art 5; PBoC,*人民币银行结算账户管理办法实施细则* [Detailed Rules for the Implementation of the Measures for the Administration of RMB Bank Settlement Accounts, renminbiyinhangjiesuanzhanghuguanlibanfashishixize] (2005, No. 16), art 2.
[401] *中华人民共和国居民身份证法* [Law of the People's Republic of China on the Identity Card of Residents] (2003), art 2.

assessing account-opening applications; for example, there are news reports that commercial banks in Shenzhen Special Economic Zones (hereinafter 'SEZs') are required by local authorities to mandatorily check customers' evidence of local residence before opening an account, which may influence migrant workers' access to banking services, since the authority's Amending-in-Process Regulation of Residence Permits of Shenzhen SEZs is proposed to set '12 months of social insurance payment' as the essential criteria for obtaining the residence permit.[402] Therefore, it is argued that many rural migrant workers will hardly meet the criteria. However, since there is no regulatory objective of banks' duty towards financial inclusion in statutes, vulnerable customers can hardly challenge this.

In general, both the UK and China share similar account-opening eligibility criteria in their regulations and mandatorily require banks to check customers' IDs but also permit banks to choose flexible documents. Commercial banks that do not obey the ID-checking rule would break rules related to anti-money laundering legislation and regulations. This is another kind of social duty that banks have to undertake; in other words, banks shall not make it convenient for possible crimes to be committed.

As long as regulation does not set up barriers for people to access bank accounts, it can be regarded as being appropriate. In general, there are no legal or regulatory barriers to ID requirements for low-income customers to open accounts in both countries. Although in the UK the agreement has not become regulatory rules, it does remove barriers in banks' eligibility criteria for people in financial difficulty in part of the industry and is therefore an early sign of progress made with financial inclusion. While in China, since there are no such rules in regulation, banks' additional eligibility criteria for opening accounts could still become a problem of access for some migrant workers.

2.3.3 Charge limits on banking services

Considering the vulnerable status of low-income customers, the charges for using banking services shall also be monitored. The use of bank accounts must not lead

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[402] Standing Committee of Shenzhen, 'Announcement for Public Opinions About 'Regulation of Residence Permits of Shenzhen SEZ (approach Version of the Amended Draft)' (2014) <http://www.szrd.gov.cn/contenthtml/11/2015010610044.html> accessed 15 February 2015.

to further financial difficulties for low-income customers. This is possibly the most direct way of facilitating low-income customers in using banking services, as they are sensitive to the charges and are usually unable to defend their interests through ombudsman services or lawsuits.

2.3.3.1 The United Kingdom

Since current and basic bank accounts in the UK are distinct based on the overdraft facility, the fees charged for two types of accounts are also different. For customers who use basic bank accounts there is usually no overdraft choice and therefore they are free from overdraft charges.[403] However, using basic banking services is still not totally free of charge; unarranged overdrafts or failed payments may still cause unexpected charges.

On this issue, the recent agreement between the UK government and several major banks is proposed to provide truly cost-free basic bank accounts. First, by confirming that a basic account will not have arranged overdraft facilities, the agreement minimizes customer's chances of suffering from overdraft charges.[404] Customers will not be charged for overdrawn balances in their accounts. Unpaid payment will also be free of charge; failing to pay a direct debit or standing order through a basic account,[405] for example, will no longer penalise customers with high charges. However, apart from the overdraft facility, customers could still make full use of basic bank account with the same standard features (transacted in pounds sterling) of current accounts free of charge. Therefore, banks will not discriminate against customers with basic accounts and limited account functions or will not charge additional fees. The protection of vulnerable customers is clearly the intention as reflected here.

2.3.3.2 China

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[403] Although basic bank accounts do not have an overdraft facility, there is still a chance of customers being overdrawn. For example, customers may be faced with an unarranged overdraft when withdrawing money from an automated teller machine due to note denominations. See HM Treasury 'Revised Basic Bank Account Agreement' (n 317). As a reference, overdraft charges were criticized for being complex and not transparent by OFT in 2008, and regulatory measures have since then been taken by OFT. The FCA is also looking at the problem and proposes to make some change in the current regulatory regime. See FCA, 'Overdrafts' (2014) <http://www.fca.org.uk/firms/firm-types/consumer-credit/consumer-credit-research/overdrafts> accessed 31 January 2015.

[404] HM Treasury 'Revised Basic Bank Account Agreement' (n 317).

[405] Ibid.

Since bank accounts or common debit cards do not have an overdraft feature, the consideration of the regulator is mainly focused on the charges for using banking services.

In 2011, several authorities issued a regulation to waive several types of charges on banking services.[406] Although the starting point of this fee waiver decision is to 'raise the efficiency and quality of bank's service and take social responsibility on the basis of marketisation',[407] it could indeed benefit low-income account holders. Under this regulation, several services of RMB personal accounts are now free of charge; this covers account opening and closing, making deposits, withdrawing and transferring money within the same city, changing a personal identity number or 'PIN', account annual fee, management fee of social security accounts,[408] receiving bank statements and so forth.

Although all clients would benefit from this regulatory change, it improves the availability of banking services among the vulnerable group. This is especially the case in the waiving of 'management fees of social security account[s] with small balance[s]', as the previous industry practice was to charge 3 Chinese yuan (UK$0.5) for accounts with balances less than 300 yuan (US$50) every quarter.[409] The accusation was levelled that profit was being made from those who lived on government transfer payments with little savings in their accounts. Earlier than this regulation, the industry association urged its member banks to waive fees for social security accounts but received little response.[410] Furthermore, for card holders of 'rural migrant bank cards', the PBoC has capped the fee charged for money withdrawal.[411] A mandatory regulation rather than voluntary conduct standard in this case is therefore more effective, it is compulsory for all the banking institutions in the country to abide by the CBRC Notice.

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[406] CBRC, PBoC, National Development and Reform Commission,*关于银行业金融机构免除部分服务收费的通知* [Notice on the Waiver of Some Service Charges of Banking Financial Institutions, guanyuyinhangyejinrongjigoumianchubufenfuwushoufeidetongzhi] (2011 No. 22).
[407] Ibid.
[408] Including bank accounts for receiving pensions, minimum subsistence allowances, medicare, unemployment insurance and so forth.
[409] See a news report for example, 'Bank Urged to Lower Petty Fees' (2010) <http://en.people.cn/90001/90778/90859/7233946.html> accessed 26 April 2015.
[410] China Banking Association, *关于加强银行服务收费自律工作的六点共识* [Six Dimensions to Enhancing Bank's Self-Regulation on Service Charges, guanyujiaqiangyinhangfuwushoufeizilvgongzuodeliudiangongshi]
[411] China Payment Development System Development Report (n 319) 73.

However, this notice also has drawbacks. The management fee it has waived only includes social security accounts rather than general personal accounts. There is therefore still a regulatory vacuum to a large degree. People would still be charged for their RMB savings or settlement account with a small balance. Although the industry association argues that this management fee for personal accounts with small balances is aimed at cutting down on the unused account number and hence save the resources of commercial banks,[412] it would indeed harm vulnerable customers who could not save more money in their accounts.

2.3.4 Geographical access

In general, since the commonly used bank accounts available in China do not have overdraft facilities, the regulatory techniques that the regulator would apply are usually also more simplified than in the case of the UK; for example, commercial bank need not make special efforts to market their accounts to potential customers. Furthermore, because of the features of China's personal bank accounts, there is no risk of being charged for an overdraft, and the eligibility criteria for opening an account used by Chinese banks is usually also less related to customers' financial difficulty or residency. However, this does not mean China could easily expand its residents' use of banking services and reduce the exclusion level. On the contrary, the penetration level of account holding in China is still significantly lower than in the UK.

In fact, problems with accessing the banking services in China do not totally lie in the banks' discrimination against low-income customers or regulatory barriers; rather, it is the lack of rural banking facilities that blocks rural residents from using these services. Setting up more bank branches and bank outlets would be more effective in remote rural areas. The newly issued No. 1 Central Document of the Chinese Central Government requires that '[l]arge and medium-sized commercial banks should ensure presence in counties and extend their networks to townships. Banks should also reinforce their capability of providing services to

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[412] Xueyan Su and Shiping Liu, 'Reply of China Banking Association to Bank Service Charges Issue' (2011) <http://finance.people.com.cn/money/GB/15140940.html> accessed 4 February 2015.

rural areas.'[413] Both credit and basic banking services are covered by this official proposal. By setting up new styles of small banks in rural areas, theoretically, local residents could benefit from the increased availability of banking services by reducing the cost of time and transportation. This is a fundamental way of alleviating the rural–urban imbalance of financial resources. However, as discussed above, although being encouraged by the government, China's major banks are reluctant to open branches in rural areas due to lack of incentives.

Realizing this problem, the Chinese government also chooses to encourage small banks to serve the unbanked in remote areas; for example, according to a CBRC Notice, the regulator encourages rural medium to small financial institutions (including rural business banks and VTBs) to set up new branches, provided that the banks have a good regulatory grade and is prudentially managed.[414] This is a good way of rewarding those small banks for managing their businesses prudentially which, in turn, could benefit more residents if new branches were allowed to open in remote areas. Such rewards are less attractive for major banks, as they have already set up national-scale branches.

In order to fill the gap in rural residents' access to financial services, since 2006, the Chinese government has launched a series of measures aimed at facilitating inclusive-oriented small community financial institutions to be set up at county level or below, where the residents have suffered from branch closure of large commercial banks since the reform of state-owned banks in the 1990s. The intention of this round of reform is clearly stated in a CBRC Opinion.[415] The general goal of the reform is proposed to 'relive the problems that exist in the rural financial market such as the low coverage of bank branches, low supply of financial resources and insufficient competitions by using regulatory measures.[416]

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[413] 'No.1 Central Document Targets Rural Reform' (2014) <http://news.xinhuanet.com/english/china/2014-01/19/c_133057121.htm> accessed 25 January 2014.

[414] CBRC, *中国银监会办公厅关于加强农村中小金融机构服务体系建设的通知* [Notice of the General Office of the China Banking Regulatory Commission on enhancing construction of rural small-medium financial institution system] (2014 No. 151).

[415] CBRC, *关于调整放宽农村地区银行业金融机构准入政策　更好支持社会主义新农村建设的若干意见* [Some Opinions of China's Banking Regulatory Commission on Adjusting and Relaxing the Access Policies for Banking Financial Institutions in Rural Areas and Better Supporting the Construction of New Socialist Countryside, guanyutiaozhengfangkuannongcundiquyinhangyeyinrongjigouzhunruzhengcegenghaozhichishehuizhuyixinnongcunjianshederuoganyijian] (2006 No. 90).

[416] Ibid.

By relaxing the limitation on market entry, brand-new community financial institutions are allowed into the county and rural market.[417] To some extent, the encouraging attitude of the Chinese government and the CBRC of setting up new branches is a response to the reluctance of large and medium commercial banks to serve the lower end of the market. In the design of the CBRC, setting up new financial institutions at local level allows residents in the area easier access to both basic banking services and, more importantly, access to credit. Increased competition in the county and rural banking market would also benefit local residents, if properly regulated.

Similarly in the UK, the alternative type of mainstream service provider, namely credit unions, also have facilities to provide basic banking services to their members. If a credit union is set up in a deprived community where bank branches are closed, then it could also serve local residents by providing deposit and payment services.

Whether the current legal and regulatory environment could support alternative financial institutions to grow forms the main content of Chapter 3. After all, if the legal and regulatory environments could lower the entry and operation barriers to small rural banking institutions, it could also widen access to basic banking services and credit.

2.4 European Directive on Payment Accounts (Directive 2014/92/EU): A reference

After analysing the current legal and regulatory techniques to promote bank account use in both the UK and China, it is also essential to look at the new legislative change at the European Union level, which provides an important reference to the research on financial inclusion regulation.

[417] These institutions include (i) VTBs, (ii) loan Companies, (iii) rural mutual co-operatives and (iv) small loan companies. (i) A VTB is a small-sized local commercial bank, (ii) loan companies and (iii) are non-bank companies that cannot accept deposits, (iv) rural mutual co-operatives are mutual institutions.

2.4.1 Introduction

From the perspective of the EU level, restricted access to basic banking services in its member states could be an obstacle to fulfilling the single market objective, as the use of payment services is essential for customers' free mobility to work, study or reside in other member states.[418] Furthermore, since there are many other services attached to payment accounts, owning a bank account is also of great significance as it fulfils customers' basic demands, especially in countries of higher bank penetration, which could further promote social and economic inclusion.[419]

However, the use of payment services in the EU has not yet reached its potential; for example, a 2011 Eurobarometer survey found that one in ten citizens in the EU did not own a bank account.[420] According to the European Commission, there are about 30 to 68 million EU citizens who have no bank accounts based on two surveys conducted in 2009 and 2011 respectively.[421] The World Bank's 2012 survey deems this number to be 56 million.[422] Although the majority (56%) of people choose not to have an account (eg, less-educated or older people), a significant number of people are refused access to bank accounts by the local banks.[423] As the Single Market Act II (2012) states, '[A]ccess to payment accounts and other banking services have become essential for participation in economic and social life, but discrimination, for instance on grounds of residence, nationality or low level of resources, does still occur.'[424]

Generally, there are two groups of people who have been refused access to bank accounts in the EU. The first group includes people with a vulnerable economic status due to, for example, low income, incorrect documentation or bad credit

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418 Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union [2010] OJ EU 83/01, art 45, 'Freedom of movement for workers shall be secured within the Union.'
419 Commission, 'Single Market Act II: Together for New Growth' COM (2012) 573 final (Single Market Act II), Key action 12.
420 Commission, 'Special Eurobarometer 373, Retail Financial Services' (2012).
421 Commission, 'Impact Assessment, Accompanying the Document, Proposal for a Directive of the European Parliament and of the Council on the Comparability of Fees Related to Payment Accounts, Payment Account Switching and Access to Payment Accounts with Basic Features' SWD (2013) 165 final, Annex II, 1.1.1.
422 Asli Demirguc-Kunt and Leora Klapper, 'Measuring Financial Inclusion, the Global Findex Database, New Data on Accounts and Payments' (2012).
423 Ibid Annex II, para 1.1.5.
424 Single Market Act II, Key Action 12.

history, while the second group are people of non-residence in the current country.[425] Two kinds of consumers are classified here, namely (i) 'vulnerable' consumers and (ii) 'mobile' consumers.[426] The former includes people who are vulnerable because of their mental, physical or psychological infirmity, age or credulity, and low income, while the latter refers to consumers who move across borders for various reasons, including work, study or retirement.[427]

The European Commission concludes that there are several reasons for the problem of why EU customers face difficulties in accessing accounts from a more macro perspective:[428] they can be grouped into three: (i) member countries' regulatory framework, (ii) the banking industry and (iii) the customers themselves.

2.4.1.1 Restrictive regulatory framework in member states

Owing to the significance of payment accounts, several member states are already aware of regulation in this area. However, the levels of regulatory framework in EU member states are different, ranging from mandatory regulation[429] and voluntary industry code[430] to no framework in place. In the UK, for example, there was no mandatory regulation in place prior to 2015. Since there is no unified regulatory framework across different countries, compliance costs of banks with varied regulation are also increased, which are finally transferred to customers.[431] Moreover, some member states also have discriminatory rules on basic bank accounts; for example, in Belgium the right to access basic bank accounts is confined to its residents.[432] Similar rules can be found in the Netherlands, where the conditions of opening basic accounts include a permanent residence or an address with a recognised aid agency in the Netherlands.[433]

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[425] Demirguc-Kunt and Klapper (n 422).
[426] Ibid Annex II, para 1.1.6.
[427] Ibid.
[428] Impact Assessment of the Directive (n 421), Annex II, 1.2.
[429] These countries include Belgium, France, Finland and Denmark. See Impact Assessment (n 421), para 3.2.
[430] Ibid. Member states that only have voluntary industry codes include the UK and Germany.
[431] Ibid Annex II, para 1.2.1.
[432] Commission, 'National Measures and Practices as Regards Access to Basic Payment Accounts Follow-up to the Recommendation of 18 July 2011 on Access to a Basic Payment Account' SWD (2012) 249 final, para 2.1. Belgium.
[433] Ibid para 2.18. Netherlands.

Moreover, without mandatory regulation, it is less easy for customers to obtain basic payment accounts. Data from the European Commission show that member states with a legal framework in place on this issue have lower levels of financial exclusion than those who only have a self-regulatory framework or those who have no frameworks in place.[434] Self-regulation through a voluntary industry code is also criticized as less effective. Without mandatory requirements the industry code may not reach its full effectiveness.[435]

2.4.1.2 Banking industry's reluctance to provide information and service

The summary of responses to the European Commission's consultation on bank accounts published in July 2012 relates to customers' limited access to bank accounts due to insufficient income, poor creditworthiness and unpaid overdrafts, among other reasons for rejected applications for bank accounts.[436] Banks are criticized for 'picking up customers' based on customers' different margins of profitability. Some banking industry associations also admitted that those factors were reasons for financial exclusion, although most respondents in the financial sector maintained that there were no obstacles to consumers' access to bank accounts.[437]

2.4.1.3 Customers' low awareness and confidence levels

From the demand side, customers' low awareness of the availability of basic bank accounts also blocks them from being financially included. This unawareness could be partly attributed to the banks' reluctance to market their basic services because of low profitability, especially in EU member states where banks are obliged to open bank accounts under the regulatory framework. Other reasons include the relatively low financial literacy of the vulnerable group, who may not see the benefits to using banking services. Complex information on banks' products will cause misconceptions in this case. There are also factors of mistrust of banks and the financial system. The Impact Assessment of the

[434] Ibid.
[435] FSUG, 'Financial Services User Group's (FSUG) Response to the Consultation on Bank Accounts' (2012).
[436] Commission, 'Summary of Responses to the Public Consulation on Bank Accounts' (2012), para 2.3.1.1.

Recommendation mentions that due to lack of financial education or bad past experiences, people may feel that they cannot control their personal finance using bank accounts (which have an overdraft facility).[438]

2.4.2 Previous efforts to address the problem of access at the EU level

Given all the considerations above, the European authorities have already adopted several measures to address the issue.

2.4.2.1 The Recommendation on Access to a Basic Payment Account (2011)

As mentioned above, the regulatory frameworks on the problem of access in EU member states are far from unified. The European Commission has realized the fragmentation and its consequences, and after several years of consultation, it published a recommendation on a basic payment account for all citizens in July 2011.[439]

In the recommendation, the commission requires member states to ensure the right of a legal resident in the EU to open and use a basic account, no matter what the customer's financial circumstances are.[440] Member states should also make sure that there are at least one or more providers in charge of offering basic bank accounts.[441] It also defines characteristics of a basic payment account,[442] and requires member states to enhance public awareness on the availability and specific features of basic accounts.[443] With most aspects on basic bank accounts covered, this recommendation sets out general principles for member states on how to establish their own regulatory framework within the jurisdiction, and invites all member states to take measures to apply this document within six months after its publication.[444]

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[438] Commission, 'Impact Assessment Accompanying the Document Commission Recommendation on Access to a Basic Payment Account' SEC(2011) 907, para 4.1.1.
[439] Recommendation of 18 July 2011 on Access to a Basic Payment account [2011] OJ L 190/87.
[440] Ibid section II.
[441] Ibid.
[442] Ibid section III.
[443] Ibid section V, General Information.
[444] Ibid section VIII, Final Provisions.

However, the European Commission regards the real effect of this recommendation as disappointing.[445] In August 2012, the commission published the follow-up report on the recommendation and overviewed the measures the member states had taken. According to the report, only three member states have a legislative framework with binding measures,[446] seven countries have partly set up such legal frameworks that followed the recommendation,[447] five countries only have partly established self-regulation, while the remaining twelve countries have no framework at all. Since EU recommendations have neither binding force nor legal consequences according to the Treaty of Lisbon,[448] Member states are not obliged to follow this kind of non-binding Act. Hence the commission considers that it is necessary to take measures of 'a legislative nature' due to the importance of guaranteeing access to basic bank accounts.[449]

2.4.2.2 The Single Market Act I (2011) and II (2012)

The Single Market Act I adopted in April 2011 has a clear objective, namely to boost growth and reinforce citizens' confidence.[450] In section 2.10 (Social Cohesion) of the Act, with the realisation of the insufficient use of bank accounts which is an essential condition of participating in economic and social life, the Act therefore commits the European Commission to 'present[ing] an initiative concerning access to a basic payment account for all citizens at a reasonable cost, wherever they live in the EU'.[451]

The Single Market Act II adopted on October 2012 further stresses this issue, and states that all EU citizens should be given access to a basic payment account, the assurance should be given that bank account fees are transparent and comparable, and that switching bank accounts should be made easier. It also declares that the

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[445] See, for example, 'European Commission MEMO, Proposal for a Directive on Payment Accounts - Frequently Asked Questions' (2013) <http://europa.eu/rapid/press-release_MEMO-13-413_en.htm> accessed 15 February 2015.
[446] Belgium, France and Italy. See, Impact Assessment of the Directive (n 421), Annex II, para 1.2.1. For details of the national measures after the Recommendation, see, Recommendation on Access to a Basic Payment Account (n 432).
[447] Ibid. Denmark, Estonia, Finland, Lithuania, Luxembourg, Portugal, and Sweden.
[448] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community [2007] OJ C306/01, art 288.
[449] European Commission Memo (n 445).
[450] European Commission, 'Single Market Act - Twelve Levers to Boost Growth and Strengthen Confidence' COM (2011) 206 final.
[451] Ibid pt 2.10.

European Commission will make legislative proposals to address issues, including access to payment accounts, the clarity of banking fee information and the account switching.[452]

However, although both documents stress the importance of access to banking services, they have no legal force and are merely recommendations to member states. The ‘Act’ here is distinct from the ‘Act’ in the UK’s domestic legal system. They are also too sketchy to be implemented in member states.

2.4.3 Directive on the Comparability of Fees Related to Payment Accounts, Payment Account Switching and Access to Payment Accounts with Basic Features (Directive 2014/92/EU)

In May 2013, after years of consultation, the European Commission published its proposal for a directive on payment accounts, which concerns the comparability of payment account fees, switching and equal access to payment accounts. This proposal came into force in 23 July 2014 and was implemented in the UK in June 2015.

The directive, as highlighted in its title, has three main sections: (i) comparability of fees connected with payment accounts, (ii) switching, and (iii) access to payment accounts. It aims to protect customers’ interest from the time (or even earlier) when they became a bank’s client, to setting up minimum standards for member states, and to protect the equal right of EU citizens to access bank accounts. The directive is customer protection-oriented, while it also tries to promote competition in the retail banking market by mandatory information disclosure and free account switching, which could, in turn, benefit the customer with a better regulated, highly competitive market.

Although, in general, EU directives have a binding force on member states,[453] this directive on payment accounts permits member states to decide not to apply all or

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[452] Single Market Act II (n 419), pt 2.4.
[453] According to the Treaty of Lisbon, art 288, directives ‘shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.’

part of it.[454] The current agreement between the government and major commercial banks generally accepts the principles of the directive. However, they are still not mandatory and depends on member state's implementation. Although UK government once shown some prudential attitudes,[455] the directive was implemented in the UK in June of 2015, with some negotiations to protect the customer as well as reduce 'any negative impact' of the directive.[456] The directive will be reviewed below, with comparisons made with the UK's current regulations and approaches on implementing the directive.

2.4.3.1 Raising public awareness

Provision for information on basic bank accounts is made in Article 20 of the directive. In this article, member states are required to raise the public's awareness about the availability of payment accounts, the pricing conditions, procedures to open accounts and access to alternative redress resolutions.[457] Second, the directive also requires that member states shall ensure banks make available to customers information on their basic accounts. Third, member states shall also ensure customers know that they do not need to purchase additional products to access basic bank accounts. Owing to its results-oriented feature, the directive does not provide the means for the application but only sets out the 'result', namely public awareness of basic bank accounts shall be raised through various methods.

In the UK, the BCOBS requires banks to provide information about basic bank accounts to eligible customers. However, the FCA handbook is also sketchy and leaves many gaps in the Industry Guidance, which is non-mandatory and has no binding force on members. Whether the eligibility criteria are met is left to banks'

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[454] Directive 2014/92/EU of the European Parliament and of the Council of 23 July 2014 on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features [2014] OJ L 257/214 (hereinafter 'Directive of Payment Accounts'), art 1.5.

[455] 'UK Government Response to the European Commission Consultation on Bank Accounts' (2012). The UK government is generally supportive of the objective of the directive, but does not support the necessity for the directive at the EU level which needs to be transposed into domestic legislative framework.

[456] HM Treasury, 'Open Consultation: Implementation of the EU Payment Accounts Directive' (2015) <https://www.gov.uk/government/consultations/implementation-of-the-eu-payments-accounts-directive/implementation-of-the-eu-payment-accounts-directive> accessed 15 July 2015~~.~~, s 1.5.

[457] Directive of Payment Accounts, art 20.

commercial judgement on a case-by-case basis and there was no mandatory recommendation duty in this case. Nevertheless, the agreement between the government and industry promises to make basic bank accounts 'visible to potential customers alongside full-service accounts' to fulfil this requirement, which corresponds with the requirement in the directive.

2.4.3.2 Comparison website

Article 7 of the directive also requires member states to set up independent comparison website free of charge for customers to compare fees charged by banks for payment accounts. The language used shall be plain, the website shall be operationally independent of any bank and provide up-to-date information, and provide a sufficiently broad overview of the payment accounts market.[458]

In the UK, the Money Advice Service (hereinafter 'MAS') currently undertakes such duty to provide comparisons of bank accounts.[459] On its website, it gives detailed information on current accounts and basic accounts, and gives advice on how to choose the right bank account, and lists the requirements on proof of the ID of high street banks. The MAS's board is appointed by the FCA, but acts independently of the FCA, nor is the website operationally controlled by any bank. Hence, in this part of the directive, the UK has already set up an eligible website that meets the requirements and needs no change at this stage.

2.4.3.3 Basic bank accounts features

The directive also gives clear characteristics of basic bank accounts in Article 17. The basic features of a 'payment account' include deposit, cash withdrawal, direct debit, the use of payment cards and online payments, and cash transfers.[460] In contrast to the previous Proposal of Directive, which explicitly excludes an overdraft facility, the directive chooses to permit member states to allow banks to provide an overdraft facility with a basic payment account at the request of

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[458] Ibid art 7.
[459] Money Advice Service, 'How to Choose the Right Bank Account' <https://www.moneyadviceservice.org.uk/en/categories/choosing-the-right-account> accessed 11 November 2014.
[460] Directive of Payment Accounts, art 17.1.

customers, giving more flexibility to the customer.[461] These features of basic accounts were reconfirmed in the recent agreement between the UK government and major banks, but do not cover the arranged overdraft feature to avoid the possibility of unexpected charges in the customers' situation.[462] Also, using standard features of the basic bank account, unpaid payment and overdrawn balance would be free of charge according to the agreement.[463]

In addition, the directive allows member states to decide whether permit banks charging 'reasonable fees' on using of basic bank accounts, while the UK government finds this would go against the 'free if in credit' principle within the UK retail banking market. This is regarded as the less advantageous part of the directive to UK customers, therefore the UK government change to choose not to implement this specific point, instead to maintain the 2014 industry agreement.

2.4.3.4 Equal right of access to basic bank accounts

The directive also proposes to protect EU customers' equal right of using payment services in Chapter IV.

First, the directive requires member states to ensure that payment services are provided by all or 'a sufficient number' of credit institutions in their territory.[464] Second, consumers who legally reside in the EU are not to be discriminated against based on nationality or place of residence.[465] Third, banks could refuse an application for payment accounts but only in limited cases such as the consumer already holds a payment account with a credit institution in their territory,[466] or the application goes against the anti-money-laundering or terrorist financing conditions established in Directive 2005/60.[467] Furthermore, banks shall inform the customer whose application is declined immediately in writing and free of charge, unless this declination is related to money-laundering or terrorist

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[461] Ibid art 17.8.
[462] Revised basic bank account agreement (n 317).
[463] Ibid.
[464] Directive of payment accounts, art 16.1. In the proposal the directive, issued in 2013, states that member states are only required to ensure 'at least one' credit institution offers this service. See Commission, 'Proposal for a Directive on the Comparability of Fees Related to Payment Accounts, Payment Account Switching and Access to Payment Accounts with Basic Features' COM (2013)266 final. ch IV, art 15.
[465] Ibid art 15.
[466] Ibid art 16.5.
[467] Ibid art 16.6.

financing.[468] Fourth, the basic bank account shall not be conditional on the purchase of additional services.[469] Under this directive, the conditions of refusal (ie, already has a bank account; anti-money laundering or terrorist financing) together with the non-discrimination requirement (ie, nationality and place of residence) *de facto* setting up EU citizens' legal rights to access to payment accounts. Although the directive does not explicitly highlight the requirement of providing original documents as proof of ID (eg, in the UK it includes passport, UK or foreign driver's licence, EU or EEA national ID card), article 16.4 of the directive has implicit requirements for personal ID under the requirements of Directive 2005/60.

In the UK, although prior to the directive there was no legal duty of offering basic accounts attributed to commercial banks,[470] there are 16 banks (and building societies) already offering the product. The requirement set in Article 16.1 has *de facto* already been met.

As to the non-discrimination rule about eligibility criteria, the agreement between the UK government and major banks promises to provide basic accounts to eligible customers in financial difficulty, which is, however, not a regulatory rule applicable to the whole industry. While in response to the directive, the proposed UK secondary legislation intends to require banks that participated in the agreement to offer basic bank accounts to EU residents who either have no bank account from any UK credit institution, or are ineligible for all bank accounts offered by those banks that are not basic bank accounts.[471] This new standard is de facto a re-confirmation of the customer's equal access to bank accounts and is actually the biggest shift in the UK's current regulatory framework about basic bank accounts. It changes the banks' freedom of commercial judgement when opening payment accounts, and replaces it with the unconditional duty to open basic payment accounts for anyone who holds no account and wants one, even if they are 'ineligible' to bank's ordinary current accounts, the only exceptions are eg the unmet identity criteria and being suspected of money laundering or terrorist financing.[472]

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[468] Ibid art 16.7.
[469] Ibid art 16.9.
[470] UK Government Response (n **Error! Bookmark not defined.**).
[471] HM Treasury, Open Consultation of PAD (n 456), s 4.3.
[472] Ibid s 4.4

For the purpose of anti-money laundering and terrorist financing, banks are prohibited from keeping anonymous accounts. Banks are hence obliged to carry out customer due diligence measures, which include identifying the customer's ID based on documents or data or information obtained from a reliable and independent source.[473] Customers who cannot provide such documents are generally regarded as failing to meet the qualifying criteria, and banks can reasonably refuse to open an account. Considering the necessity for measures against money laundering and terrorist financing, it is reasonable for banks to refuse someone's application who does not produce any valid documentation, but they cannot discriminate against customers due to nationality or for other reasons.

In other words, there are two tiers of the 'qualifying criteria': the first and basic tier is valid proof of ID, and the second tier is the other requirements, namely nationality, place of residence and income level which will no longer be applicable under the new directive. Moreover, as the impact assessment of the directive argues, the EU anti-money laundering directive in itself does not create any barrier to account opening; it does not set up mandatory requirements for customers who want to open an account to present an ID card or passport.[474] No new regulatory barrier will be created after the directive has been implemented in this case.

After the Directive be implemented in the UK, it is most proper to set up a new regulation (and this is the most frequently used way),[475] while adding several details to the FCA handbook, the BCOBS. The Industry Guidance will also need to be revised to comply with the new regulation, introducing the contents of the agreement into it. Based on the analysis of the directive and the UK's current regulations set out in the previous section, the substantive changes mainly include two parts: (i) banks will have a mandatory regulatory duty to inform customers of information about basic payment accounts, and (ii) discriminatory qualifying criteria in account-opening processes would be explicitly prohibited, and customers would not be refused by banks for reasons such as nationality,

[473] Directive 2005/60/EC of the European Parliament and of The Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing [2005] OJ L 309/15, arts 6–8.
[474] Impact Assessment (n 421), para 3.1.
[475] HM Treasury, Open Consultation of PAD (n 456), para 1.7.

residence or economic status. Both changes focus on protecting customers' interests, so it depends on the government's attitude on whether or not to accept this new directive into the UK's legal and regulatory frameworks. Nevertheless, from the agreement between the UK government and major banks, it could be assumed that the UK may choose to approve the directive, as it largely corresponds with what is set up in the directive.

Since the directive will set up a new mandatory duty for commercial banks, the question might well be asked whether this legislative change would conflict or correspond with the basic principles of commercial law. In general, commercial law is about a contractual relationship, it is about 'rights and duties arising from the supply of goods and services in the way of trade';[476] what are central to the commercial law are the two contractual parties, namely the seller and the buyer.[477] In the case of financial services, the banks and the customers are the two parties to the contract. The freedom of contract shall be protected by law as the contract is at the centre of commercial law, which means both parties shall be willing to enter into the contract. The incentive to exchange the equivalents, as Goode writes, with regard to both the seller and the buyer in the deal is worth it; otherwise they would not sell or buy the product.[478] Contract law will not pre-decide whether the deal is worth entering but leaves this to the parties to form their judgement.[479] In this sense, using regulation to mandatorily require commercial banks to sell a certain product (ie, basic bank account) to a certain customer group who are hardly profitable appears, to some extent, unreasonable, as this is an infringement of contractual freedom by administrative measures.

In answer to this problem, it is important to remember the essential feature of the object of the contract. Being essential in modern society means that a basic bank account is indispensable for ordinary customers, just like other public utilities. Therefore, in the general interest, commercial banks shall and could be required to provide this utility-featured product to all eligible customers without discrimination. As to the question of 'freedom of contract' in the market-oriented economy, in Nybergh's view, it is a contractual obligation that public utility

[476] Ewan McKendrick and RM Goode, *Goode on Commercial Law* (4th edn, Penguin 2010) 8.
[477] Ibid 10.
[478] Ibid 64.
[479] Ibid 65.

companies shall bear. In contrast to the traditional view of compulsory contracts as a violation of contractual freedom, Nybergh argues that it is some kind of 'positive contractual freedom' since everyone should have the right to consume.[480] It is a wider concept than the narrowly defined 'contractual freedom' in which companies can choose their customer. Discrimination on the basis of gender, age, race, nationality and religion in contract terms is unacceptable.[481] However, Wilhelmsson does not deny the rationality of different treatments based on risks and costs customers may incur.[482] Indeed, some customers pose higher risks, hence public utility companies are entitled to adjust their prices to within a reasonable range. This is the balance of rights between the supply and demand sides in which the interests of both parties are considered. However, the supply of service shall not be discriminatory and the opportunity of using the service should be equally offered to all residents in need. In this sense, this approach extends rather than violates the traditional commercial law principle which justifies the necessity for the mandatory rule in the directive; it *de facto* provides an external incentive for commercial banks to offer this unprofitable product to customers and protects their 'positive' contractual freedom to be served by banks.

2.5 Summary

This chapter mainly discusses commercial banks' role in facilitating financial inclusion in respect of basic banking services. For vulnerable customers, being able to open bank accounts and use banking services is essential nowadays to reduce living costs and increase life convenience. Since banking services are usually mostly provided by commercial banks, they are, however, sometimes criticized for being reluctant to offer these unprofitable services. Whether the current statutory or regulatory environment would help low-income customers to get access to banking services needs to be reviewed.

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[480] Frey Erik Nybergh, *Avtalsfrihet - Rätt till Avtal: En Nordisk Undersökning Om Kontraheringsplikt till Förmån För Privatpersoner* (*Freedom of Contract Summary: Right to Contract. A Nordic Research Study on Compulsory Contracting for the Benefit of Private Persons)* (1st edn, Nordiska ministerrådet 1997). Summary of the book in English <https://tuhat.halvi.helsinki.fi/portal/en/persons/frey-erik-nybergh(9e9e1c82-2ad8-42fd-910c-76d1faf30aea)/publications.html?rendering=long&page=1> accessed 5 January 2015.

[481] Wilhelmsson (n 284). Wilhelmsson quotes the terms of the Finnish Government Bill, and notes that such discrimination is subject to adjustment by the Nordic court.

[482] Ibid.

Section 2.1 suggests a point of view that commercial banks should be tasked with the duty to serve vulnerable customers. The special status of banks in the financial system, the CSR of banks and the public utility feature of basic banking services prove the theoretical foundation of the view. In reality, although there is usually no explicit statutory objective of financial inclusion, governments would usually choose to encourage commercial banks to serve this market by offering bank accounts. Indeed, there are other institutions that could play a role in financial inclusion, for example, post offices in both the UK and China are viewed as an effective alternative way to serve customers' financial needs in remote areas; in a recent government inquiry in the UK, for example, major commercial banks' responses admit to the need for collaborating with post offices to provide banking services to vulnerable consumers.[483] However, taking commercial banks into this progress is still meaningful as they are the leading players in the financial market.

In general, the common measure of promoting banking service inclusion is to use regulatory rules or standards in different aspects to require banks to conduct their business properly. In order to facilitate the process of low-income customers making use of bank accounts and related services, the eligibility criteria for opening accounts and the fees charged shall be carefully set. These aspects are essential because they matter when it comes to vulnerable customers being able to use banking services as others do. Information disclosure is also central to this discussion. By properly disclosing information about available bank accounts and reducing customers' misunderstandings, the progress of financial inclusion could also be accelerated by introducing more customers to using banking services.

The UK in general has made good progress in these aspects. Being the first country to put forward the concept of financial exclusion, the UK has more concerns about, and regulatory experiences with, the issue. The detailed regulatory sourcebook, the BCOBS, provides the basis for mandatory rules, while the Industry Guidance gives a good example of self-regulation. However, since the issue of promoting financial inclusion is not a statutory objective, but is more likely to be influenced by the relationship between the government and the industry, commercial banks' lack of incentive could hardly be solved if there is no duty to do so.

483 BBA Response Letter (n 276).

In contrast, China does not set up detailed rules on this issue. Current rules about banking service conduct generally do not distinguish between ordinary and vulnerable customers, and give the latter extra protection which, to some extent, stops banks from paying more attention to the issue. Furthermore, although the relationships between government and banks are close in China, banks are still reluctant to open more branches in remote areas because the rewards from the regulator for doing so are not enough.

Moreover, since offering banking services or credit is hardly profitable, commercial banks' lack of incentive in promoting financial inclusion cannot be overlooked. This is more problematic for the issue of credit than banking services as the former has inherent repayment risks, which inevitably holds commercial banks back from offering a little, affordable credit to high-risk customer groups with limited income or living in deprived areas.

As regards the problem of lacking incentive, two examples were used to get the regulatory power to urge commercial banks to provide enough services. The newly approved EU directive on payment accounts is, to some extent, radical; under the directive, banks in member states would not be able to reject account-opening requests because of customers' economic status, which *de facto* sets up a new duty for commercial banks to serve every customer in need, just like common utility companies. The real power of the directive is, however, dependent on whether member states would choose to apply it. Although UK has implemented the directive into its legal system, the effect of the directive is still too early to be seen, though. Another example with a longer history of application is the Community Reinvestment Act of the US, which provides a practical way of assessing banks' performance in serving the deprived community by setting up series of assessment standards, rewards and punishment in the statute; providing incentives for banks to be involved in financial inclusion progress. If the UK and China wish to facilitate financial inclusion through banks' efforts, setting up similar regimes is essential by linking banks' financial inclusion duty to proper regulatory reward and minimum conduct standards.

Chapter 3: Alternative credit facilities: Testing of the role of law and regulations in supporting them to grow

3.1 Introduction: The alternative role of community-based lending institutions in financial inclusion

The second and more complex part of the problem of financial exclusion lies in access to affordable credit. Commercial banks, as discussed in Chapters 1 and 2, are reluctant to provide low-income customers with small-size and affordable credit. Before there is any statutory duty for commercial banks to do so, the alternative way is to set up new, community-based, small lending institutions to serve the local customers' need for credit. This chapter finds that the regulatory environment for credit unions in the UK is generally favourable for the firms to develop, while there are many regulatory barriers in China for rural mutual co-operatives (RMCs), and VTBs. The 'one-size-fits-all' regulation model in China needs to be revisited in future for alternative lenders to grow.

In May 2012, the Department for Work and Pensions (hereinafter 'DWP') published a report on the feasibility of credit union development in the UK. Commissioned by the Secretary of State, the team managed to study the way to 'provide suitable financial services for up to a million more consumers on lower incomes' by modernising and expanding the service of credit unions to achieve financial sustainability within five years.[484] It reveals that 7 million low-income people in the UK were affected by the lack of access to affordable credit – referred to as 'paying a poverty premium' – and were forced to use high-cost credit from 'predatory lenders, such as home credit and payday lenders'.[485] Credit unions' role in facilitating low-income customers' access to affordable credit is therefore highlighted and regarded as a useful way to relieve the problem.

Similarly, in China, in order to fill the gap in rural residents' access to financial services, the Chinese government has launched a series of measures since 2006,

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[484] Colin Purtill, John Cray and Cath Mitchell, 'DWP Credit Union Expansion Project Steering Committee Feasibility Study Report' (2012) para 1.3.
[485] Ibid paras 3.1 and 4.1.

aimed at setting up small community financial institutions at county level or below, where residents are suffering from the branch closure of large commercial banks since the reform of state-owned banks in 1990s. The intention to reform is clearly stated in the opinion pieces by the CBRC, in which it proposed to 'relieve the problems that exist in the rural financial market, such as low numbers of bank branches, low supply of financial resources and insufficient competition' (translated by author) by using regulatory measures.[486] By relaxing limitations on market entry, brand-new kinds of community financial institutions are allowed in the county and rural market. These markets mainly include VTBs, and rural RMCs. Private and foreign investments are also permitted, joining the setting-up procedure of those small financial institutions. As of June 2012, there were already 817 new rural financial institutions serving the financial needs of rural residents and enterprises in rural areas.[487]

No matter whether it is in the UK or in China, the practical significance of setting up such alternative lending facilities is obvious. As discussed in Chapter 2, low-income customers are usually unable to borrow money from mainstream commercial banks. If they are in urgent need of money, the only possible solution is to deal with subprime lenders, or worse, unlicensed underground usurers. Small-size, community-based lenders have the advantage that mainstream banks do not have processing applications for loans, which makes it possible to relieve the credit exclusion that exists among low-income residents and in deprived communities.

First, since the new kinds of lenders are usually community-based, the costs of assessing the creditworthiness of residents living in the community could be reduced. For low-income customers with an impaired or no credit history, this means they would not be directly rejected by the automatic credit assessment system, but could have a chance to be interviewed by bank staff in person. In the case of mutual-style lenders such as credit unions in the UK, customers of the

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[486] CBRC, Some Opinions of CBRC on Adjusting and Relaxing the Access Policies for Banking Financial Institutions in Rural Areas and Better Supporting the Construction of New Socialist Countryside (2006 No. 90).

[487] PeopleNet, 'CBRC Reveals 817 New Rural Financial Institutions Set up in China' (2012) <http://finance.people.com.cn/bank/n/2012/0710/c202331-18484726.html> accessed 21 February 2015.

lender are at the same time owners of the firm, making it more possible for customers to have a chance to prove their creditworthiness to the staff.

Second, since these community-based firms are usually of small asset size, have an inclusion-oriented objective and their oriented customer group tends to be local residents, making small amounts of credit available to personal customers is usually inherent in the firms' business model. Since their business scope is usually limited by statutes or legislation from stepping into, for example, the area of investment, extending credit to local residents is therefore usually the firms' main source of profit source. Large commercial banks, in contrast, make more profit from, for example, wealth management services, and tend to overlook the lower end of the credit market. In this sense, those small community-based financial firms are an alternative to commercial banks.

The third advantage of setting up new lenders in tackling financial exclusion comes from their substance as economic firms. At the government level, there are indeed other official regimes that aim to offer small amounts of affordable credit to vulnerable residents. In China, for example, regional women's federations provide guarantees for local women residents, helping them to apply for credit from local commercial banks.[488] For unemployed urban residents who wish to use a small-amount loan to start their businesses, there are also similar official regimes to provide government guarantees for them.[489] Indeed, these regimes provide other available credit sources for low-income customers from mainstream banks and cannot be overlooked, since the essence of the regime is to supplement borrowers' creditworthiness with governmental credibility. However, these regimes usually need to co-operate with one or more commercial banks that are the appointed credit source.[490] However, since for commercial banks provision of this kind of loan is like undertaking an official task rather than profitable businesses, commercial banks still lack the incentive to do so and rely on the local

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488 Ministry of Finance (hereinafter MoF), Ministry of Human Resources and Social Security(hereinafter MHRSS), PBoC and China Women's Federation, *关于完善小额担保贷款财政贴息政策推动妇女创业就业工作的通知* [Notice of Strengthening the Policy of Treasury Interest Subsidy Funds for Petty Secured Loans to Facilitate Women's Business Start-ups and Employment](2009 No. 72 of Ministry of Finance).

489 See, for example, PBoC, MoF, State Economic and Trade Commission, MHRSS, *下岗失业人员小额担保贷款管理办法*[Measures of Management of Small Secured Loans for Unemployed Residents] (2002 No. 394 of PBoC).

490 Ibid.

Bureau of Finance to provide interest subsidies to avoid losses. Moreover, to be able to receive government guarantees, borrowers are still required to meet complicated application criteria and sometimes the provision of a counter guarantee is also essential. If the policy ends, then the special benefits for certain groups would also stop. Community-based alternative lenders are economic firms and have daily businesses, making them more solid than the government's policy unless the firms close down, which is a central problem for small firms and there is therefore a need for some regulatory exemptions.

In China, for example, the required deposit reserve of VTBs is lower than that of large commercial banks,[491] so that VTBs could have more capital to lend out. A recent Administration Measure of the Ministry of Finance gives well-operated VTBs, RMCs and small-loan companies financial subsidies from the central government.[492] There are also tax cuts for those 'new' small financial institutions.[493] To some extent, the encouraging attitude of the Chinese government and the CBRC is a response to large and medium commercial banks' reluctance to serve the lower end of the credit market. Increased competition in the county and rural banking market would also benefit local residents if the competition is properly regulated. Similarly in the UK, credit unions are also found unsustainable and there is a need for some special regulatory exemptions to be able to compete with subprime lenders.[494]

This chapter hence discusses whether the current legislative and regulatory environment is suitable for those small alternative lenders to survive and develop in both the UK and China, and looks at the regulatory barriers that could be removed in future.

3.2. Possibility of mutuality

[491] PBoC and CBRC, *关于村镇银行、贷款公司、农村资金互助社、小额贷款公司有关政策的通知* [Notice of the PBoC and the CBRC on the Relevant Policies for Village and Township Banks, Loan Companies, Rural Mutual Co-operatives and Small Loan Companies] (2008 No. 137 of PBoC).

[492] MoF, *农村金融机构定向费用补贴管理办法* [Administration Measure of targeted cost subsidies for rural financial institutions] (2014 No. 12).

[493] For the tax-cutting policy, see, for example, MoF, State Administration of Taxation (hereinafter SAT), *关于农村金融有关税收政策的通知* [Notice on the Relevant Tax Policies on Rural Finance] (2010 No. 4 of MoF).

[494] Purtill, Cray and Mitchell (n 484).

Recent years have seen the increasing recognition of the role credit unions play in the UK.[495] As mutual firms, the advantage of credit unions is explicit: low interest rates, easy saving facility, accessible location in local community, self-help and mutual-aid spirits – all features that could distinguish credit unions from 'traditional' financial corporate public limited company (hereinafter 'plc'). This leads to them being praised officially as the main solution to low-income consumers' debt problems and lack of access to mainstream financial institutions.[496]

However, compared with other countries, such as the US and Ireland, the credit union industry in the UK is described as in its early development stage;[497] for example, it has a smaller customer base,[498] lower market penetration[499] and there is an over-reliance on external subsidies from local authorities.[500] The basic statute, the Credit Union Act (1979), is also criticized for being too restrictive and constraining the expansion of the industry.[501] The Act was amended slightly during the following decades; several limitations were removed to support credit union growth. The most recent amendment of the legislation is to raise the interest rate cap on loans that credit unions can charge from 2% monthly to 3%, which is aimed at the sustainability of credit unions.[502]

Similarly, in China there has also been official recognition of mutual-style financial organizations in recent years. Although the word 'co-operative' is contained in the name *rural credit co-operative*s, they have been criticized for losing their co-operative feature over decades. By transforming RCCs into corporations, the government and financial regulator have *de facto* given up on keeping their mutual feature; instead, rural residents are permitted to set up a new

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495 For more details, see ABDUL, 'Credit Unions in Parliament' <http://www.abcul.org/media-and-research/parliament> accessed 3 April 2014.
496 For example, the Prime Minister, David Cameron's answers to a Labour MP that credit unions is 'one of the best ways of addressing the whole problem of payday loans and payday lending' at June, 2013. HC Deb 12 June 2013, col 336.
497 Nicholas Ryder, 'The Credit Crunch - the Right Time for Credit Unions to Strike?' (2009) 29 Legal Studies 75.
498 Purtill, Cray and Mitchell (n 484) 9. As to the February of 2012, total amount of credit unions members in UK is 953,000.
499 Ibid. The percentage of the low-income population served by the credit union industry is 4%.
500 Ibid.
501 See, for example, Olive McCarthy, Robert Briscoe and Michael Ward, 'Mutuality through Credit Unions: Across-National Approach' in Johnston Birchall (ed), *The New Mutualism in Public Policy* (1st edn, Routledge 2001).
502 Credit Unions (Maximum Interest Rate on Loans) Order, SI 2013/2589.

kind of mutual financial organization, RMCs without any state-shareholding or commercial bank promotion. The essence of RMCs represented in the CBRC' regulations indicates that this sort of mutual financial organization shares most of the principles of its foreign counterparts, although with some special features. They are also at a very early stage of development, and only make up a negligible part of the total personal loan amount in the country. Up to now there has also not been a specific statute that has regulated RMCs; only several regulations from the CBRC are in place. Regulatory methods for RMCs are similar to general banking regulation, using methods such as capital adequacy ratios to judge their risk levels, which is criticized for being too simple and not tailored enough for small mutual organizations.[503]

This part of the thesis is therefore divided into three parts. First, why mutual-style credit facilities could play a role in financial inclusion will be discussed on a theoretical basis. Second, the legislative and regulatory reforms for credit unions in the UK are examined, looking at what is the proper way of regulating this sort of financial institution. Third, China's rural RMCs are then analysed.

3.2.1. Mutuality, co-operative and mutual organizations: Why mutual co-operatives could be a solution

Mutuals or co-operatives are not modern products. Co-operatives in the modern sense first emerged in the middle of the nineteenth century in Europe, when the working class in vulnerable conditions joined together to set up co-operatives as a response to the harsh life in the industrial revolution.[504] The earliest mutual group is identified as the Rochdale Society of Equitable Pioneers established at 1844 by a group of impoverished weavers in England,[505] which was a mutually owned shop that provided members with affordable basic necessities. Some of its features are considered the predecessor of later co-operative principles, for example, member ownership of the firm, election of officials and open membership, which were inherited by later co-operative firms.

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[503] Junchang Pan, Xuejiang Zhang and Youli Kong, '*农民资金互助社监管漏洞探析--基于灌南农民资金互助社倒闭案的分析*' [Regulation Loopholes on Rural Mutual Co-operatives: An Analysis on the Collpase of Guannan RMCs] (2013) 41 Jiangsu Rural Science 412.
[504] For a detailed discussion on the history and theory of co-operative, see, Brett Fairbarin, *The Meaning of Rochdale: The Rochdale Pioneers and the Co-Operative Principles* (Centre for the Study of Co-operatives, University of Saskatchewan 1994).
[505] Ibid.

Soon the idea of mutuality spread into other parts of the world, and evolved into more mature organizations in diversified sectors, from agriculture to retailing. Similarly, in the financial sector, mutually owned credit co-operatives provided members with basic but special products, namely credit and saving.[506] The first known credit union in the world saw the light in Germany in 1869.[507] In the next few decades it was transformed into two types in different regions: (i) co-operative banks that now exist in Europe that usually serve the general public, and (ii) the more locally related credit unions that exist in North America. The distinctive name 'credit union' was later adopted by mutual credit firms in many jurisdictions that have common bond requirements.[508] It is well recognized that a credit union under the 1979 Act in the UK is a mutual (or co-operative) financial firm that provides affordable and convenient services to its members.[509] This is also the case with rural RMCs that newly emerged in China, whose name partly reveals their essence, which differentiates them from commercial lenders.

In fact, it should be noted that co-operative firms with a similar mutual nature could have different forms: in the UK, for example, there are several other mutual form firms, including co-operative societies, community benefit societies, friendly societies and building societies,[510] which cover different financial sectors such as saving, insurance and healthcare.[511] All these mutual societies, including credit unions, are registered under the FCA regime. Prior to 2014, the basic legislation for these mutual societies was complex, and mainly included the Industrial and Provident Societies Act 1965 (IPSA), Friendly and Industrial and Provident Societies Act 1968, and the Co-operative and Community Benefit Societies Act 2003. The legislation was criticized for being too complex and has now been consolidated into the Co-operative and Community Benefit Societies Act 2014 (CCBSA). Therefore, the name 'Industrial and Provident Society' was also

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[506] There are also mutual firms in other sectors of the financial services, for example, life insurance and home mortgage, that also share the mutuality feature with credit unions.
[507] Paul A Jones, 'The Growth of Credit Unions and Credit Co-Operatives – Is The Past Still Present?' in Christophe Guene and Ed Mayo (eds), *Banking and Social Cohesion. Alternative Responses to a Global Market* (Jon Carpenter Publishing 2001).
[508] Ibid.
[509] FCA, 'Mutual Societies' < http://www.fca.org.uk/firms/firm-types/mutual-societies > accessed 23 February 2015.
[510] Ibid.
[511] Association of Financial Mutuals (AFM) is the industry association for financial co-operatives in the UK, with 52 members across the country. AFM, 'Welcome to the Association of Financial Mutuals' <http://www.financialmutuals.org/> accessed 23 February 2015.

replaced with ‘Co-operative’ and ‘Community Benefit Society’, with a new legal name of ‘registered societies’.[512] According to the Act, a co-operative is run for the interests of its members, while community benefit societies ‘operate for the benefit of the community in which they work’,[513] with the purpose of serving the local community rather than only for the benefit of members. Although credit unions are also registered under the CCBSA (and previously, the IPSA 1965), it follows with the 1979 Act as the basic statute for other detailed rules.

As long as both kinds of firms exist in the same jurisdiction, a mutually owned credit firm is different from its stockholder-owned counterparts in many aspects.

First, the ownership mechanism of a credit union is special. A credit union is a customer-owned credit firm whose members are its customers and vice versa. By purchasing certain shares of the credit union, one could join in the membership of a credit union and become one of the owners of the firm, entitled to the right to vote and, at the same time, one could also use the credit union’s services and become a customer. In the case of a plc, the identity of shareholder and customer is divided. However, even in customer-owned mutual firms such as credit unions, the firms are also managed by a board of directors and managers, not by the owners’ assembly.

Second, mutuals are often regarded as ‘not-for-profit’’ firms that provide affordable credit services to people outside mainstream commercial lending practices. Mutual-style lenders therefore enjoy a better reputation and are usually linked with social values such as community development and combating financial exclusion. All these features distinguish a mutual from a corporate type of firm (in this case, a credit union and a commercial bank), which leads to the different legal and regulatory treatment of different types of lenders.

However, a mutual is still one type of economic firm that is equivalent to other firms in the market, for example, private company, public limited company (plc)

[512] Co-operative and Community Benefit Societies Act 2014, s 1.
[513] HM Treasury, ‘Consultation Outcome, Industrial and Provident Societies: Growth through Co-Operation’ para 2.1.

or a partnership.[514] This classification is meaningful because the essence of an economic firm is to provide products or services to customers and add value to the firm itself.[515] Added value – value of the firm's output that exceeds its input – could then be distributed to stockholders or members as a dividend, or accumulate to the firm's own reserves. While other elements include scale, asset size and ownership of the firm are secondary. Therefore, a credit union and a commercial bank are equal participants in the personal banking market in this sense. Both of them are credit intermediaries, and provide saving and borrowing products. In the US where credit unions have reached a large scale, the industry as a whole could compete with the commercial banking industry in the personal finance market. Moreover, from an ordinary customer's point of view, there is no essential difference in products between a credit union and a commercial bank. The key to explaining the special legal and regulatory treatment is the mutual feature rooted in the organizational form and ownership structure, which differentiates a mutual from a company.

3.2.1.1. Features and benefits of member ownership

A mutual organisation (or a co-operative) is owned by its members. The owners are at the same time the customers of the co-operative. In its original sense there are no 'internal' shareholders and 'external' customers in a mutual organization; instead, the customers of a mutual are its shareholders who have voting rights at its annual meeting. Ownership of a mutual organization, hence, belongs to all its customers, since to become a customer of a credit union one has to join its membership in the first place. While in the case of a plc, such as a commercial bank, customers are not necessarily its shareholders: stockholders and customers are separate and different groups although there is no barrier to a customer purchasing stock and becoming a stockholder.[516]

This feature of ownership is linked to another feature of a mutual organization. A credit union is often regarded as a 'not-for-profit' firm, which is not very precise, or only meaningful in a limited sense. As economic firms rather than charities, co-

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[514] Leigh Drake and David T Llewllyn, 'The Economics of Mutuality: A Perspective on UK Building Society' in Johnston Birchall (ed), *The New Mutualism in Public Policy* (1st edn, Routledge 2001) 15.
[515] Ibid.
[516] Ibid.

operatives have to make profit from income (eg, loan interests) minus expenses (eg, fees from daily transactions and dividends paid to members) to become sustainable. If a mutual cannot add positive value, it would face failure. More practically, they need to become self-sustainable and not merely rely on government subsidies or public donations. Instead of being 'not for profit', mutual organizations are actually non-profit-maximizing firms. This means that they do not only focus on making profit and distributing it to stockholders, although they also have members based on purchased shares and would receive dividends.

To demonstrate this difference between mutuals and plc's, Kay highlights 'the objective of any business activity' as adding value.[517] However, how these added values are distributed in mutuals or plc's is different. In the case of plc's, stockholders enjoy a primary claim to those profits because they 'own' the firm, although a successful firm would also benefit employees, customers and the community.[518] A plc is profit-maximizing because the interests of stockholders ('owners') are protected. The interests of customers are secondary, as the firm has first to meet stockholders' interests before offering added value to its customers, [519] which, however, is not in conflict with stockholders' interests because in a plc owners and customers are separate groups; the former holding the *ex parte* decision-making power. For example, in a most simplified theoretical case, stockholders of a commercial bank may wish to maximize the profits of the plc by, for example, raising the loan interest rate and lowering the savings rate. Customers of that bank have no choice but to accept the new rate or turn to other suppliers.

However in a mutual, shareholder and customer groups overlap *de facto*. Therefore, the demands of members and customers are also mixed. As members collectively own the mutual, they may wish to earn higher dividends from the firm and that the firm is profit-maximizing. Yet as they are at the same time customers of a mutual firm, they would demand better-value products and to pay less. There are no 'external' customers in a mutual as there are in a plc. A simple subtraction here could explain this role overlap: profits of the firm come from members' own

[517] John Kay, 'The Economics of Mutuality' (1991) 62 Annals of Public and Cooperative Economics.
[518] Ibid.
[519] Ibid.

pockets and a significant part of the added value of the firm goes to the firm's reserves rather than being paid out as dividends to shareholders. Hence, members of a mutual will not benefit from the firm if the mutual becomes profit-maximizing. In fact, Kay notes that the added value of a mutual is usually distributed to consumers;[520] for example, in the form of favourable rates, rather than directly paid to shareholders as in the case of a plc.[521] The customer orientation and special ownership decide that a mutual will not become as profit-maximizing as a plc, although it indeed derives added value through transactions.

3.2.1.2 Relational contract and trust in a mutual

The role overlap of members and customers in a mutual has another impact, namely that its distribution of added value is more blurred than in a plc.

In a profit-maximizing plc, shareholders (or stockholders) naturally enjoy the profits and bear the losses, no matter whether the structure is that of a plc or a mutual, but how these profits or losses are distributed is different in these two types of firms. In a plc, returns are distributed to stockholders based on clear clauses of contracts, therefore, stockholders would have clear knowledge of whether and how much they could earn as dividends annually, or receive no returns because the plc bears financial losses and there is no profit in a year, which is clearly based on the proportion of stocks they hold in hand.[522] In Kay's view, this clarity in stockholders' rights and duties in a plc makes it an efficient way of doing business.[523] In a mutual these factors are not as clear as in a plc, especially when the profit of a mutual is distributed in the form of more favourable terms of the product.[524] Hence, in a credit union, one member cannot guarantee his or her distributed added value if he or she has neither savings nor taken loans in the year, and even if he or she had used such services, the rate of interests is normally not pre-promised.

Why, if a return is not certain, would people still join together to collectively use their money? To explain this special feature of mutuals, Kay (1991) views a

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[520] Ibid.
[521] Ibid.
[522] Ibid.
[523] Ibid.
[524] Ibid.

mutual as the reflection of a relational contract,[525] quoting relational theory contract developed by Ian Roderick MacNeil, whose theory was developed in his representative article 'Contracts: Adjustment of Long-term Economic Relations under Classical, Neoclassical, and Relational Contract Law'.

In MacNeil's theory, a relational contract is in contrast to a discrete transaction, which is defined as a contract made among strangers absolutely separate from present, past and future relationships.[526] To describe the situation, MacNeil uses the phrase of 'near discreteness' rather than pure sense;[527] in other words, it is a present exchange of existing goods without anticipation of a future relationship, but the focus is on the immediate exchange.[528] A relational contract is on the other end of the spectrum as it requires no-present but *future* exchanges based on promise,[529] as MacNeil notes:

> Discreteness is lost even in the simple promise situation, because a basis for trust must exist if the promise is to be of any value. Trust in turn presupposes some kind of a relation between the parties. Whether it is that created by a shared morality, by prior experience, by the availability of legal sanction, or whatever, trust depends upon some kind of mutual relation into which the transaction is integrated.[530]

In short, trust is rooted in the pre-existing relationship (which is not necessarily a relational contract). This gives contractual parties a promise of future benefits at the time of joining the relationship, as they trust each other or one another. It is both impossible and unnecessary to clarify every future promise in a relational contract.

In this theory, a relational contract could exist in many types of relations, for example, mutual, marriage and employment.[531] These relations are rooted in trust, rather than contract clauses. There are several features of such a relational

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[525] Ibid 315.
[526] Ian R MacNeil, 'Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law' (1978) 72 Northwestern University Law Review 854. Although a pure discrete contract is an academic creation, modified cases are quite common in real economies (MacNeil gives the example of a driver who purchases gasoline at a filling station on a road on which he seldom drives).
[527] Ibid 857, footnote 11.
[528] Ibid.
[529] Ibid 858.
[530] ibid.
[531] See, for example, Robert C Bird, 'Employment as a Relational Contract' (2005) 8 University of Pennsylvania Journal of Labor and Employment Law 149.

contract; for example, Bird concludes these aspects in his analysis of employment as a relational contract, which includes (i) the relatively long-term of the contract; (ii) open term that comes from uncertainty of the future; (iii) flexibility of contract implementation upon a possible change in the needs; (iv) sharing, not division of the cake; (v) in order to fulfil the contract people may make further investments; (vi) the contract would promote personal relationships with others, as well as altruism; (vii) inherent dispute resolution, and (viii) more values, including friendship and goodwill would emerge from the contract, which go far beyond merely the exchange of goods.[532]

A mutual generally fits into this type of contract, although compared to a marriage contract, it has more contractual characteristics than merely interpersonal trust. Taking a credit union as an example, when a person joins the membership of a credit union, he or she has chosen a long-term relationship with the firm. Members of a credit union share its profits and losses without dividend-sharing uppermost in their mind. When uncertainty comes about, a credit union usually tends to be more flexible, shows sympathy to the borrower who cannot repay on time and puts forward an alternative repayment arrangement. In this regard, mutuals are based on trust and good will, and when people join them they are seeking a long-term relationship with the firm and future benefits.

It is perhaps in this sense that the mutual could survive in the real economy where other types of firms exist. As to its feasibility, Fama and Jensen argue that mutuality is particularly suited to the financial sector due to its special ownership structure.[533] In their observation, mutuals are suitable for relatively long-term personal financial services such as life insurance and mortgages, while commercial banks are more suitable for business banking.[534] Customer ownership provides mutual financial firms with the possibility of a long-term relationship with customers, which would benefit both the firm and customers in the long term. The governance of a mutual is based on 'one person one vote' rather than

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[532] Ibid 152-153. For more a detailed discussion on this issue, see Richard E Speidel, 'The Characteristics and Challenges of Relational Contracts' (2000) 94 Northwestern University Law Review 823.
[533] Eugene F Fama and Michael C Jensen, 'Agency Problems and Residual Claims' (1983) XXVI Journal of Law & Economics.
[534] Ibid 339.

'one share one vote' as in the case of a plc, which further emphasises the human aspect rather than the capital in the firm.

As regards the relational contract, Kay further argues as follows,

> The special value of mutuality rests in its capacity to establish and sustain relational contract structures. These are exemplified in the most successful mutual organisations, which have built a culture and an ethos among their employees and customers, which even the best of plc structures find difficult to emulate.[535]

In Kay's view, the mutual could promote long-term relationships and trust between contractual parties, which is necessary in the personal finance sector, including life insurance, home mortgage, and saving and loans. When people join the relationship, what they are seeking is the future benefit of staying in the contract. This anticipation of future benefits leads to the relatively stable customer base of a mutual; for example, Amess and Howcroft note the stability of customer loyalty and scarcity of opportunistic customer behaviour in a mutual – not only in the short term, but also in the medium to long run – which means people tend not to quit a credit union and withdraw their deposits to invest in a bank, just because it provides slightly higher saving rates.[536][537]

However, there is a problem in Kay's relational contract theory, which argues that steady customer base provides mutuals with essential stability. In the process of setting up and operating the business of a mutual, there are *de facto* two separate contracts. The first one is made by the members to set up the mutual entity, at the time when people join together and become members of a new firm, while the ensuing contract only happens when members of the mutual start buying products from, or using the services of, the firm and become customers of the mutual. When Kay's intention is to discuss both contracts to demonstrate the superiority of mutuals over plc's, in fact, he only discusses the second contract between the customer and the firm. Is there any essential difference in the relationship between a credit union and its customers, and the relationship between a commercial bank and its customers, if the customers enjoy the same kind of service such as savings

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[535] Kay (n 517) 317.
[536] Kevin Amess and Barry Howcroft, 'Corporate Governance Structures and the Comparative Advantage of Credit Unions' (2001) 9 Corporate Governance 59.
[537] Bird (n 531) 153.

and loans? The answer should be 'no' because whatever form a firm takes, customers choose the better products from better firms, and there should be no baseless loyalty before a customer establishes his or her relationship with a certain mutual or a bank. Although in a mutual members are also the customers and vice versa, the two identities are *de facto* two different ones. Customers of a firm do not necessarily remain constant and loyal to the firm; it is their position as firm members or shareholders that provide the stability. Therefore, the difference and advantage of a mutual over a plc lies in the special ownership structure of a mutual, which actually provides the firm with customers' (in essence, the entire shareholder body) loyalty. There is also no market for mutual members to sell their membership to others such as in the securities market, which further stabilizes a mutual's membership base. The relational contract indeed supports mutuals to grow, but it is the stability of members who stay in the firm that provides this loyalty and trust in future benefits.

3.2.1.3 Agency problems in mutuals

As discussed above, the ownership structure of a mutual gives it a special strongpoint, including the loyalty of long-term customers; but it also has an inherent weakness. Viewing a firm as a nexus of contracts, Fama and Jensen argue that

> [a]gency problems arise because contracts are not costlessly written and enforced. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits.[538]

In short, agency problems stem from the inefficiency of corporate governance that forces one party (the principle) to pay additional resources to control the agents. In principle–agent literature, the agency problem may happen in any organisation that separates decision–making from risk-bearing, and the former (the agent) could make decisions on his or her own interests for the other party (the principle), and deliberately making high-risk decisions without bearing the risk of

[538] Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 Journal of Law and Economics 301.

failure.[539] This separation of decision-making ('control') and risk-bearing ('ownership') in a firm is usually the source of agency problems. The cost occurred in this process is called *agency cost*.

Although collectively owned by its customer group, a mutual still has a group of 'shareholders' and team of managers who act as decision-makers, which is similar to a plc. Customer ownership of the mutual does not mean a member has power in the internal decision-making process. Decision-makers could hence make use of their power. In a Final Notice made by the FSA, the decision-makers of the credit union involved violated regulations on lending practice, that is, they lent to unqualified external borrowers and were faced with the failure of repayment.[540] The agent in this case exercised its power against the customers' interests, and the members suffered from having to bear the costs of that credit union although the regulator had interfered after the failure.

To avoid agency problems, members must protect their own interests as they are the owners of the mutual, as in the case of companies. However, shares of a mutual are usually more dispersed. Some argue that the degree of dispersed ownership has some influence on the agency problem, as in large financial institutions (irrespective of whether they are banks, large building societies or credit unions) the power of one shareholder is too weak to threaten the managers.[541] Amess and Howcroft hence suggest that the dispersed ownership structure and the management control are less severe in small institutions such as community credit unions. However, as pointed out in the example mentioned in the last paragraph, even in a small credit union agency problems could still occur.

In addition, Drake and Llewellyn suggest that members of a mutual are either unable or have no incentive to monitor management performance, as getting involved in monitoring is both time- and money-consuming; if there are not enough rewards for doing so, an ordinary member is less likely to voluntarily get involved in monitoring the decision-making.[542]

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[539] Ibid.
[540] FSA, Final Notice (FSN: 213242, 8 November 2012). The case of The Pentecostal Credit Union Limited (TPCU) will be discussed in detail in later sections (3.2.3.5) of this chapter.
[541] Eric Rasmusen, 'Mutual Banks and Stock Banks' (1988) 31 Journal of Law and Economics 395.
[542] Drake and Llewllyn (n 514) 28.

Amess and Howcroft further note the '1/n' problem among mutuals, namely the one-member-one-vote principle could not provide enough incentive for a member to monitor the mutual decision-making, as he or she has to bear in mind other fellow members sharing the benefits from his or her personal endeavour.[543] The problem of 'free-riding' also exists, which means members would also expect others to take such responsibility but do not take action themselves.[544]

In short, the ownership structure of the mutual cannot avoid agency problems, nor can it effectively control the on-going risk in decision-making processes. It is not the mutual feature but the separation between decision-making and dispersed ownership that causes agency problems in mutuals.

For the problem of the lack of controlling stockholders who have power to influence decision-makers, a possible solution to the agency problem in a mutual rests in the legally redeemable shares. Fama and Jensen suggest a particular feature of the mutual firm, namely that members of a mutual are able to exit the firm when they choose to do so.[545] Unlike common stocks of a plc, which are not redeemable and can only be transferred between stockholders, in a mutual its members are able to redeem their shares and deposits. For example, according to the Credit Union Act 1979, members of a credit union could withdraw their shares and take out deposits if the liabilities are paid up.[546] This feature makes it possible for members to exert some influence on the firm, as Fama and Jensen suggest:

> There is a special form of diffuse control inherent in the redeemable claims of financial organizations. The withdrawal decisions of redeemable claim holders affect the resources under the control of the organization's managers, and they do so in a more direct fashion than customer decisions in nonfinancial organizations. The decision of the claim holder to withdraw resources is a form of partial takeover or liquidation which deprives management of control over assets. This control right can be exercised independently by each claim holder. It

[543] Amess and Howcroft (n 536).
[544] Ibid.
[545] Fama and Jensen, 'Separation of Ownership and Control' (n 538); Fama and Jensen, 'Agency Problems and Residual Claims' (n 533).
[546] Credit Union Act 1979, s 7 (4). S 14 (11) of the Co-operative and Community Benefit Societies Act 2014 empowers registered societies to decide whether members have the right to withdraw; in the societies' rules.

> does not require a proxy fight, a tender offer, or any other concerted takeover bid.[547]

Put another way, in Fama and Jensen's view, the withdrawable shares of a mutual force the managers to be more sensitive to customers' claims, since in a mutual the customers are themselves the owners. If they are dissatisfied with the firm's service, they are able to withdraw their shares and deposits, and turn to other suppliers. With a significant part of shares being withdrawn in a short time, a mutual would be faced with a liquidity problem since its buffering money is depleted. However, in a non-financial corporation, similar action has only an indirect influence on the firm, because neither the departure of customers nor the transfer of common stocks would directly influence the firm.[548] This is perhaps partly a solution to the agency problem in a mutual. Yet it still relies on the involvement of members, and is an *ex post* measure that members could take against manager's decision-making. To become more efficient in avoiding such problems, efficient regulations should be in place to provide some *ex ante* control.

3.2.2 Credit unions in the United Kingdom and China: An introduction

3.2.2.1 Definition and features

A credit union in the UK is a mutual financial organization that can take deposits and make loans to its members.[549] According to the Credit Union Act 1979, a society could be registered as a credit union if its objects are promoting members' thrifts, creating sources of credit, helping members to save and giving them training and education, its membership is restricted with specific qualification, it has proper rules and its registered office is in Great Britain.[550] People with a common bond could join a credit union. After one share of the credit union has been fully paid-up, the person then becomes a member of the union. A credit union could provide services such as basic banking, saving and borrowing to its member free of charge or at affordable rates. Matters of a credit union are decided by its members, on a one-member-one-vote basis.

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[547] Fama and Jensen, 'Agency Problems and Residual Claims' (n 533).
[548] Ibid. See also Credit Union Act 1979, s 7 (4); Co-operative and Community Benefit Societies Act 2014, s 36.
[549] Although the CCA 1979 and some financial regulations also apply to North Ireland, this thesis does not include Northern Ireland's practice and special regulations.
[550] Credit Union Act 1979, s 1.

Similarly, according to the definition given by the CBRC, an RMC in China is a community mutual financial institution that is set up by rural and township residents, and rural small enterprises, and provides deposit, loan and settlement services to its members.[551] The definition underlines its two features, namely the mutual and community feature. The mutuality feature distinguishes an RMC from other financial institutions, namely an RMC is owned and controlled by its members. The community feature indicates its customer group, namely an RMC's role is to serve local residents within a certain small community, and therefore people living outside the locality are not eligible to join the membership. Members of an RMC can join the mutual by purchasing a share and then begin to use the services. The affairs of an RMC are decided by the board of directors, elected by all the members on a generally one-member-one-vote basis. When most credit co-operatives (RCCs) were demutualized and transformed into commercial banks or semi-banks in recent years,[552] RMCs were regarded as the only form of 'pure' authorized mutual financial organization in China.[553] It shares most features with credit unions in the UK, although there is no evidence on whether the regulator would follow experiences from other jurisdictions such as the US, where the credit union industry is already mature.

It is apparent that both credit unions in the UK and RMCs in China share many similarities. They are mutual financial institutions owned by customers, and are equal to other types of firm in the sense of economic organizations. A mutual firm for credit and saving services has its own features distinct from a commercial bank or a subprime lender. In fact, it appears that in both countries a mutual solution is regarded as, at least one of, the main solutions to relieve financial exclusion.[554] As Ryder notes, the self-help echoes the ability to provide affordable access to credit, which is the decisive reason that leads to recognition by the

[551] CBRC, *农村资金互助社管理暂行规定* [Interim Provisions on the Administration of Rural Mutual cooperatives] (2007 No.7), art 2.

[552] There are arguments on whether RCCs should choose 'mutual' or 'corporative' features, but since 2004, a RCC could choose to transform into commercial banks based on the CBRC's regulation and its own business condition. Now it is generally agreed that in the scale of the whole industry, RCCs' mutual feature has been lost.

[553] There are also unauthorized mutual-style credit organizations in the market, which have no financial licence but still take members' deposits and provide loans. These organizations belong to the informal lending sector and will be analysed in a later part.

[554] Purtill, Cray and Mitchell (n 484) para 8.3.1.

government.[555] By permitting a new type of financial institution that has an inherent inclusion purpose, those who were previously excluded from mainstream financial services could have more affordable access to credit, and reduce their chance of becoming trapped in high-cost debt.

3.2.2.2 Development stage and route choice

The first credit union in the UK was only set up in 1964 in Wimbledon by members of ethnic minorities.[556] However, the growth of the credit union industry in the country was slow in the years that followed. Many researchers criticize the progress made with development for being slow. Lack of proper statute was regarded as part of the reason before the 1979 Act came into force. Besides, it is noted that local authorities showed less interest in supporting credit unions until the late 1980s.[557]

This attitude of neglect in political policy has changed since then.[558] Ryder notes the measures taken by the UK Labour government since 1997 were aimed at reducing financial exclusion and increasing access to affordable credit. Since then, the industry has received support from the government and local authorities, 'from political obscurity to the top of the government's financial exclusion policy'.[559] However, after more than a decade's development, the penetration level of credit unions in the UK is still at a low level. Data show that total membership in both Britain and Northern Ireland increased from 232,137 in 1991 to 697,560 in 2001, to 814, 538 in 2004,[560] to 953,000 as at February 2012, which is only 4% of the lower-income population.[561] The size of individual credit unions also increased, but the majority (75%) of credit unions is still small in size with an asset size of fewer than 0.5 million.[562] While in the US, about 30% of the population are

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[555] Ryder (n 497).
[556] Mick Brown, Pat Conaty and Ed Mayo, 'Life Saving Community Development Credit Unions' (2003).
[557] Ian C Thomas and Susan Balloch, 'Local Authorities and the Expansion of Credit Unions, 1991-93' (1994) 9 Local Economy 166.
[558] Paul A Jones, 'From Tackling Poverty to Achieving FInancial Inclusion-The Changing Role of British Credit Unions in Low Income Communitie' (2008) 37 The Journal of Socio-Economics.
[559] Ryder (n 497).
[560] Peter Goth, Donal McKillop and Charles Ferguson, *Building Better Credit Unions* (1st edn, The Policy Press 2006) 1.
[561] Purtill, Cray and Mitchell (n 484) para 6.5.
[562] Goth, McKillop and Ferguson (n 560) 6.

members of credit unions.[563] Many researchers also compare the UK with the Republic of Ireland, where credit unions serve local communities adequately with a high market penetration.[564] Moreover, credit unions in the UK are also found to be non-sustainable and without external support.[565]

RMCs have emerged in the Chinese market more recently[566] and were recognised by the banking regulator only after 2007. Both the industry and the relevant regulations are still in their early development stages. It is unfortunate that there is no national-scale data on the RMC industry in China, there are also no market penetration statistics. However, the industry scale is still small. At the end of June 2012, there were only 49 licensed RMCs in the whole country. Most of them are small in size and have only a few hundred members.[567] Compared with the credit union industry in the UK, the status quo of China's RMC industry is similar to the credit union industry in the UK in the 1970s and 1980s. For example, RMCs are generally small, their locations are mainly in deprived rural communities, the common bond is strictly limited to locality, they rely on members' deposits and external grants, their products are limited to savings and loans, there is no specific statute that governs them, the regulator lacks regulatory resources, and there is no mature licensing and supervisory regime. At present, the industry is still too small to be able to compete with other lenders.

Sibbald, Ferguson and McKillop identified several stages of the credit union industry development, and suggest that there are three stages: (i) nascent, (ii) transition and (iii) mature.[568] The different stages may be divided into many features, including asset size, common bond, the management style, customer target, product variety, sustainability and regulation level.[569] This typology paves

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[563] HL Deb 13 Dec 2012, col 1156.
[564] McCarthy, Briscoe and Ward (n 501) 44.
[565] Purtill, Cray and Mitchell (n 484) para 4.2.
[566] It is generally acknowledged that the first licensed RMC is the '*百信*' [Baixin] Rural Mutual Co-operative in Lishu County, Jilin Province, whose predecessor (as a farming mutual co-operative) was set up in 2004, and received its financial licence from the CBRC in 2007. 'First RMC Set up in Jilin, China' (2007) <http://news.xinhuanet.com/fortune/2007-03/09/content_5824280.htm> accessed 6 May 2014.
[567] Several examples can be found in He Guangwen, '*农民专业合作社金融服务模式探析*' [Analysis of financial services by Farmers' Professional Cooperatives] (2010) 2 The Chinese Co-operative Economic Review.
[568] Alexander Sibbald, Charles Ferguson and Donal McKillop, 'An Examination of Key Factors of Influence in the Development Process of Credit Union Industries' (2002) 73 Annals of Public and Cooperative Economics 399.
[569] Ibid 403.

the way for credit union industry development. Credit unions in their nascent stage are more likely small, mutual help groups in a deprived community, while in the mature stage they are large, experienced financial institutions operating across regions. When this typology is applied, it appears that the industry in China could be placed in its nascent stage, based on the sectors listed above; while the industry in the UK ranks in the transition stage.[570] The credit union industry in the US is perhaps a more vivid example of the mature stage with the size of the total industry exceeding 10,000 credit unions in total, serving more than half the country's population.[571]

As the typology is the path for the development based on real conditions in some typical countries, it is therefore assumed that if well supported, the credit union industry in a country could 'evolve' into a higher stage of development, as Jones argues, 'wherever credit unions have grown significantly, they have all been established as professional financial institutions able to operate effectively within an increasingly competitive market place',[572]

There is, however, concern that the 'modernization' of credit unions may cause the loss of their financial inclusion feature and transform into another sort of mainstream lender. Berthoud and Hinton (1989) suggest two approaches on this issue: the first is the idealist approach, which means credit unions shall keep their original focus of serving only poor people in deprived communities.[573] To avoid losing this feature and becoming yet another commercial financial institution, a credit union shall remain small in size and be managed by voluntary members. The second approach is the instrumentalist approach, namely credit unions are only one type of intermediary of credit and need to be large in size and have more members. The choice of approach would have a direct influence on the industry foreground.

In many respects, the credit union industry in the UK has experienced a deregulation process which gives the industry more flexibility to expand and

[570] McCarthy, Briscoe and Ward (n 501) 41-59.
[571] Ibid 49.
[572] Jones, 'The Growth of Credit Unions and Credit Co-Operatives – Is The Past Still Present?' (n 507).
[573] Richard Berthoud and Teresa Hinton, *Credit Unions in the United Kingdom* (1st edn, Policy Studies Institute 1989).

support its growth. In this sense the UK takes the instrumental approach. The relaxed common bond criteria during the past few years are one of the examples. As regards the size of individual credit unions, Lord Stoneham of Droxford argued for larger credit unions in Parliament in December 2012:

> The small, area-based credit unions need to move to a bigger scale, to the counties or the regions, to be viable and have the capacity to expand. To be sustainable, they must also expand their services; they simply will not be viable if they are concentrating on small loans, although that will be a major part of their work.[574]

In the case of the US, the largest credit unions are found mainly to be serving middle-class employees within one or more occupational common bond who have a stable job and income. However, community development credit unions (hereinafter 'CDCU') in the US are community-based and still focus on low- and medium-income customers. A CDCU enjoys more regulatory advantages and government subsidies due to its community-serving feature, including the use of the Community Development Financial Institutions (hereinafter 'CDFI') Fund. To support the small, community-based credit unions' development, the law has to make some compromises on credit union's 'traditional' feature and remove the legal restrictions, which were originally viewed as representing the mutual and prudent spirit of credit unions.

3.2.3 Deregulation process in credit unions: United Kingdom experiences

Although still small in scale, the credit union industry in the UK has experienced a noticeable increase in institutional numbers, membership size and total loan amount.[575] Apart from natural size increases during the years of accumulation, the development could partly be attributed to the legislative amendments, which give the industry capacity to grow.[576] Legislative amendment, together with gradually relaxed regulatory requirements that take the different sizes of credit unions into consideration, are supposed here as the basic reason for the UK credit unions' growth.

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[574] HL Deb 13 December 2012, col 1171.
[575] Goth, McKillop and Ferguson (n 560).
[576] Ibid.

The basic statute that regulates credit unions in the UK is the 1979 Act, which provides the fundamental legal framework for the industry. Prior to that, the credit union industry in the UK was regulated under the Industrial and Provident Societies Act 1965 and the Companies Act 1948, which were regarded as not appropriate for the industry to develop.[577][578]

Indeed, before the 1979 Act, the credit union industry in the UK was tiny and regarded as a failure. It is well recognized that the lack of an appropriate legislative framework is one of the major reasons why credit unions did not develop.[579]

However, before later amendments, the 1979 Act was also criticized for being too restrictive which constrained industry develop;[580] for example, the maximum number of members was 5,000 people,[581] the limit of loans available to a member was £2,000,[582] the unsecured loan had to be repaid in two years,[583] and the interest rate cap that a credit union could charge was 1% per month.[584] The main content of the 1979 Act focuses on the registration procedure, rather than specific provisions that can facilitate industry growth. As Ryder (2002) notes, the 1979 Act 'was relatively simple in form and content and, despite seeking to encourage the growth of the credit union movement, sought to limit the size of membership, of shareholding and of loans for individual unions to the small amounts consistent with the formative years of credit unions.'[585] Such highly regulated legislation is characteristic of the nascent stage of the credit union industry if using the typology coined by Sibbald, Ferguson and McKillop.[586]

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[577] See, for example, Nicholas Ryder, 'Credit Union Legislative Frameworks in the United States of America and the United Kingdom – A Flexible Friend or a Step towards the Dark Side' (2008) 31 Journal of Consumer Policy 147.
[578] Credit unions are registered under the Cooperative and Community Benefit Societies Act 2014 (and previously, the Industrial and Provident Societies Act 1965), but both the old and the new legislation generally does not cover credit unions as regards the detailed rules.
[579] Gerwyn LL H. Griffiths and Geraint G. Howells, 'Britain's Best Kept Secret? An Analysis of the Credit Union as an Alternative Source of Credit' [1990] Journal of Consumer Policy 447.
[580] See, for example., Nicholas Ryder, 'Credit Unions and Financial Exclusion – the Odd Couple?' (2002) 24 Journal of Social Welfare and Family Law 423; Thomas and Balloch (n 557).
[581] Credit Union Act 1979, s 6 (2). Repealed by FSMA 2000 schedule 22.
[582] Ibid s 11 (2).
[583] Ibid s 11 (4).
[584] Ibid s 11 (5).
[585] Ryder, 'Credit Unions and Financial Exclusion – the Odd Couple?'
[586] Sibbald, Ferguson and McKillop (n 568).

The 1979 Act has since then been amended several times and gives more space for credit unions to develop. It was regarded as a deregulation process.[587]

3.2.3.1 A gradually relaxing process of common bond criteria

To be eligible to join the membership of a credit union, people need to meet some eligibility standards. This is the requirement of common bond between members of a credit union that was first set in s 1(4) of the 1979 Act.

Common bond restrictions on membership originated in the co-operative essence of the credit union, since a co-operative is set up by people 'to meet their common economic, social, and cultural needs'.[588] As discussed previously, a credit union is not only a financial institution, but also a co-operative firm; people who use its saving and borrowing services are also members of it, rather than merely customers. This requires certain boundaries for eligible members, rather than indiscriminately accepting the general public as customers.

Many researchers in economics also explain the purpose of setting up this common bond requirement in legislation. Generally, the common bond is regarded as a way of reducing information asymmetry, because members of a credit union are linked together by something that they have in common and are assumed to be familiar with one another; for example, Black and Dugger are of the view that common bond is 'assumed to reduce the cost of gathering credit information, reducing bad debt and manifests itself in many ways''[589] Griffiths and Howells further explain the essence of common bond as 'the tie that binds the members together', and suggest that it is the knowledge of other members in the credit union that replaces the traditional way of assessing creditworthiness used by commercial banks.[590] This is meaningful as customers of credit unions may experience some difficulty proving their creditworthiness and getting credit from a mainstream lender, while if someone else in the credit union knows about a person's honesty and personal status, then people can assess that person's

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[587] For further details, see Timothy Edmonds, 'Credit Unions' (2013) para 3.2.
[588] International Co-operative Alliance, 'Co-Operative Definition' <http://ica.coop/en/whats-co-op/co-operative-identity-values-principles> accessed 8 April 2014.
[589] Harold Black and Robert H Dugger, 'Credit Union Structure, Growth and Regulatory Problems' (1981) XXXVI The Journal of Finance.
[590] Griffiths and Howells (n 579).

creditworthiness and provide credit. Amess and Howcroft regard the existence of common bond as an informal way of deciding creditworthiness,[591] compared with the formal way of using personal information and credit record databases. As to the effect of this familiarity, Ward and McKillop suggest that members of a credit union are able to get to know one another better and could share the 'sense of loyalty and commitment to a joint enterprise',[592] which is essential for community development. It could also provide some pressure for repayment, since this is related to a person's reputation in the community. All these well-documented suggestions give reasons why legislation on credit unions has the common bond requirement.

However, what must be kept in mind is that the general trend of the credit union industry development is the gradual relaxation of common bonds, or deregulation.[593] Common bond restrictions tend to be the tightest in the nascent stage, and become more flexible after the industry has matured. When the industry develops into the mature stage, large credit unions may have very flexible common bonds.[594] It would not be limited to a certain community or a workplace, but would combine the two or more common bonds together. This gives a small credit union more space for a larger membership, which is essential for the firm to become self-sustainable and rely on fewer external grants.

More flexible common bonds would, however, inevitably influence the familiarity between members. For example, if a credit union serves customers in multiple localities, then members have less opportunity to get to know one another. Therefore, the informal creditworthiness assessment based on members' familiarity of others also loses its effectiveness. On this issue, Black and Dugger argue that, as credit unions grow and become more complex, the personal nature of credit unions is influenced.[595] When multiple common bonds are permitted and

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[591] Amess and Howcroft (n 536).
[592] Ann-Marie Ward and Donal G Mckillop, 'An Investigation Into The Link Between UK Credit Union Characteristics, Location And Their Success' (2005) 76 Annals of Public and Cooperative Economics 461.
[593] Sibbald, Ferguson and McKillop (n 568).
[594] As credit unions in the US are in a mature stage, the common bond of these credit unions is generally highly flexible. For example, State Employees Credit Union (SECU) is one of the largest credit unions in the US, and has about 1.5 million members. The membership eligibility of SECU is very flexible; people who meet with one of the multiple requirements are eligible to join. See, SECU, 'Membership Eligibility' <https://www.ncsecu.org/AboutSECU/MembershipEligibility.html> accessed 8 April 2014.
[595] Black and Dugger (n 589).

different groups of people are allowed into the same credit union, the chance of getting to know one another is decreased. Furthermore, in most mature conditions such as in the US, common bonds in large credit unions are regarded as loose criteria that eligible people could join. The original intention of common bonds has gradually decreased.

Why, if the criteria are relaxed continually, would legislation still have the common bond requirement rather than directly abolishing it? This query could perhaps be partly answered using the 'instrumentalist approach' of the credit union development model. The regulator wishes to keep credit unions mutual, which, as discussed in previous sections, is suggested as suitable to relieve financial exclusion. However, at the same time, the regulator also lists the sustainability of the firm as a priority. Broadening of common bond criteria is hence a legislative compromise between old traditions and firm development. Maintaining the common bond in legislation is still meaningful: for large credit unions, the common bond requirement could distinguish them from commercial banks, which gives legitimacy to, if there is any, regulatory exemptions. While for those small community credit unions, permission for multiple common bonds is essential because it gives them more space to expand.

Griffiths and Howells explain this question in more detail: they divide common bond into two types, namely the (i) 'community' type and (ii) the 'occupational' type.[596] The former is usually chosen by credit unions located in deprived communities and serve low-income members.[597] The problem is that simply to rely on poor customers would limit the growth of the credit union, as the customer it serves cannot collectively save enough funds to be used in the community.[598] Such credit unions are more vulnerable to risks and are forced to determine to whom to lend more carefully, using similar assessment standards to those used by commercial banks.[599] Apparently, this is not desirable for industry development. In contrast, the latter type, namely occupationally based common bond, could provide a more solid base for development, as the members who have a regular income are linked by occupation.[600] Griffiths and Howells' suggestion is that the

[596] Griffiths and Howells (n 579).
[597] Ibid.
[598] Ibid.
[599] Ibid.
[600] Ibid.

combination of the two types of common bond could help to solve the sustainability problem, using an example of a credit union that is able to serve both poor local residents and factory workers. As the factory is located in a poor community, the savings from workers can boost the funds of that credit union, so poor local residents can benefit.[601]

In short, multiple common bonds could strengthen the sustainability of credit unions and facilitate industry development, rather than its original purpose of proven creditworthiness. This is perhaps one of the explanations for the legislative amendments of common bonds in the UK in the past few years, and in the US several decades ago.[602]

Originally, there were five types of common bond in the 1979 Act: (i) following a particular occupation; (ii) residing in a particular locality; (iii) being employed in a particular locality; (iv) being employed by a particular employer; (v) being a member of a bona fide organisation or being otherwise associated with other members of the society for a purpose other than that of forming a society to be registered as a credit union.[603] Ryder (2009) categorises them into four types: (i) industrial, (ii) residential, (iii) association and (iv) live or work association.[604] Credit unions can only choose one of them as their membership eligibility requirement.

Dual common bonds, namely the 'residing in or being employed in a particular locality' common bond, namely the 'live and work' type as mentioned above were only added to the legislation in 1996.[605] Only after that could residents and workers in the same locality join the same credit union.

The next amendment was in 2003. A credit union was permitted to combine the qualification of being a member of a bona fide organisation with any other qualifications in section 1(4)(a)–(d), so credit unions were, for the first time, able

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[601] Ibid.

[602] For a detailed discussion of credit union in the U.S and the legislative change on common bond, see Ryder, 'Credit Union Legislative Frameworks in the United States of America and the United Kingdom: A Flexible Friend or a Step Towards the Dark Side' (n 577).

[603] Credit Union Act, s 1(4)(a)-(d), omitted by the Legislative Reform Order, SI 2011/2687, s 12 (4).

[604] Ryder, 'The Credit Crunch' (n 497).

[605] The Deregulation (Credit Unions) Order, SI 1996/1189, art 3(2).

to use multiple common bonds and combine two groups of people together.[606] The FSA also increased the flexibility on common bonds in its handbook.[607]

However, one of most significant deregulations of common bonds was made in 2011 by the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 (hereinafter 'LRO'), which amended the 1979 Act most profoundly in the following aspects:

First, it allows credit unions to freely combine one or more common bonds in their admission to membership.[608] Separate common bonds that are appropriate for credit unions in the 1979 Act remained in the LRO.[609] After the amendment, credit unions were allowed to serve different groups of customers on the basis of one or more common bonds, which gives credit unions more flexibility to expand their market; for example, a credit union can serve employees' employed by a hospital, and residents and other people employed in the same locality where the hospital is located.

Second, it also regards 'living in the same household or is a relative of a credit union member' as the existence of a common bond,[610] which further widens the potential membership.

Third is the permission of corporate membership.[611] The 1979 Act only permits individuals to be members of a credit union,[612] which is criticized for being too restrictive when compared with the American example.[613] The LRO changed such limitation by permitting three types of corporate members to join the membership of a credit union: (i) a body corporate; (ii) a person acting for a partnership and (iii) an officer or member of the governing body of an unincorporated

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[606] Ibid.
[607] For more details of the FSA's approach to widening common bonds, see Goth, McKillop and Ferguson (n 560) 1; Ryder, 'Credit Union Legislative Frameworks in the United States of America and the United Kingdom' (n 577).
[608] LRO, s 13 1A (1).
[609] Ibid s 13 1A (2)(a)-(e).
[610] Ibid s 13 1A (3).
[611] The definition of 'corporate member' is in LRO, s 15 (2).
[612] Credit Union Act 1979, s 5 (1). Omitted by LRO, s 15 (1).
[613] Federal Credit Union Act 1934, s 109(a). 'Federal credit union membership shall consist of the incorporators and such other persons and incorporated and unincorporated organizations, to the extent permitted by rules and regulations prescribed by the Board'. For criticism of the 1979 Act in the UK on this point, see, for example, Ryder, 'The Credit Crunch' (n 497).

association.[614] Such body corporate, partnership and unincorporated association form the bond between members of a certain credit union, because they employ or engage persons in a particular occupation that are eligible to join a credit union,[615] or employ persons as the particular employer or provide services to that employer, whose employees are eligible for a membership of a credit union,[616] or their workplace is located in 'a particular locality' where other individual members reside or are employed in that locality,[617] or they are a member of a bona fide organisation or are associated with individual members of that organisation.[618] By relaxing the membership, the LRO supports the credit union industry with further flexible common bonds, since local corporates, partnerships and social enterprises could also use the services of a credit union, and give their support to the local community by depositing money into a credit union.[619]

Finally, the scope of 'locality' in a common bond is also virtually expanded.[620] If the total number of potential customers linked by the same locality common bond does not exceed 2 million, and every one of those customers is still able to enjoy full rights as a member, then it is recognized that a meaningful common bond exists.[621] Ryder notes that, previously, the FSA confined the maximum membership of a credit union to 1 million, and if it exceeded this figure, the FSA would assume the common bond was 'so diluted as to be meaningless' unless a credit union could defend itself using sufficient evidence.[622] Combined with other deregulated aspects, the 2 million maximum membership gives plenty of room for UK credit unions to grow in advance, especially since it is now permissible to combine multiple common bonds together.

With all those legislative amendments, credit unions in the UK now, more than ever, have space to grow. The latest amendment is still too new to evaluate its *de facto* effect. However, it is reasonable to assume that they could benefit from such legislation, as the current legislation does not require small credit unions to

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[614] LRO, s 15 (4).
[615] Ibid s 13 1A (4) (a).
[616] Ibid s 13 1A (4) (b).
[617] Ibid s 13 1A (4) (c).
[618] Ibid s 13 1A (4) (d).
[619] ABDUL, 'Legislative Change for Credit Unions' <http://www.abcul.org/media-and-research/briefings/legislativechange> accessed 9 April 2014.
[620] LRO, s 13 1B (3).
[621] Ibid.
[622] CREDS, pt 13, Annex 1A G 11 (3) (C); Ryder, 'Credit union legislative frameworks in the United States of America and the United Kingdom' (n 577).

expand; on the contrary, it gives those small firms the possibility to grow, based on their own willingness. At least, the gradually relaxed process of common bonds removes regulatory barriers for credit unions.
However, the deregulation process does not mean that the common bond would eventually be removed from legislation. The existence of the common bond distinguishes a credit union from commercial banks from a customer group, which gives legitimacy to those regulatory exemptions that apply to credit unions only. In this sense, a credit union could and shall not compete with banks. Hence, if common bond requirements are too flexible, it may cause commercial banks' scepticism on its real effect of distinguishing between banking and credit union industries. Too flexible common bond criteria are criticised as *de facto* expanding a credit union's customers to the general public while still enjoying regulatory exemptions, which is argued by commercial banks as being unfair.

This dispute is represented by the US, where the credit union industry is able to compete with commercial banks due to, at least partly, legislative amendments and deregulation.[623] Although this would only happen when the credit union industry has reached a mature stage, it is still meaningful to look at this case, as it could demonstrate the possible influence of deregulation on this issue.

A US dispute on common bond requirement

Basically, credit unions in the US could be divided into two groups: (i) federal chartered and (ii) state chartered. This division further decides by what regulations they are regulated and who the regulator is. As the dispute mainly occurs between federal chartered unions and the commercial banking industry, the discussion here also focuses on federal chartered credit unions.

For federally chartered credit unions, the basic legislation is the Federal Credit Unions Act (hereinafter 'FCUA'), first enacted in 1934, which also sets out the power of the federal regulator, the National Credit Union Administration (hereinafter 'NCUA').

[623] For a sketch on the legislation amendments before 1980s, see Charles P Edmonds and Robert B Rogow, 'Credit Unions: Competition by Statute' (1980) 97 Banking Law Journal 426.

In the 1930s when the Act was first enacted, the role of the national credit union system in providing affordable credit to the working class had already been recognized by Congress.[624] This led to the enactment of the Act, in which a credit union is regarded as 'co-operative association organized . . . for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes'.[625] It is fair enough to regard this definition as a perfect one, as it defines a credit union with all its features, among which the limitation on eligible membership is essential to distinguish a credit union from a commercial bank.

Besides, common bond is also regarded as useful to promote thrift, as NCUA argues:

> To promote thrift and credit extension, a meaningful affinity and bond among members, manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions.[626]

This argument still focuses on the traditional sense of common bonds, namely members need to share something to fulfil the original purpose of a mutual. However, in a more practical sense, the common bond requirement is more meaningful to distinguish two types of firms. Based on its common bonds, a credit union does not serve the general public and, hence, is not a competitor for commercial banks. This boundary gives credit unions legitimacy to enjoy additional regulatory exemptions.

For example, Black and Dugger mention that, for a long period, federal credit unions were not subject to the branch restrictions of the McFadden Act, which restricted national banks from opening branches across state lines.[627] Credit unions are also not subject to Regulation Q, which limits the interest return on accounts with all other depository institutions, namely a credit union could pay

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[624] Allen G Hicks, 'Common Sense on the Common Bond: Banks, Federal Credit Unions, and Field of Membership Rules' 66 Tennessee Law Review 1201.
[625] Federal Credit Unions Act, s 1752.
[626] NCUA, 'Federal Credit Union Act' <http://www.ncua.gov/legal/pages/fcuact.aspx> accessed 11 June 2014.
[627] Black and Dugger (n589). The McFadden Act was modified in 1994 by the Riegle-Neale Interstate Banking and Branching Efficiency Act.

higher interests on demand deposit than the Regulation Q rate for commercial banks.[628] A credit union is also free from corporate income tax.[629] These exemptions found their legitimacy in the restrictions on membership: as a credit union is not able to grab banks' customers, they shall not be equally regulated at the same level.

Based on this recognition, in the early stages of their development (between 1932 and 1982), federal chartered credit unions in the US could only have a single common bond.[630] NCUA interpreted this restriction in the Federal Credit Union Act (§ 109) in a broader sense in 1982, and expanded single common bonds to combine different occupational groups.[631] This flexibility gives US credit unions enough space to expand their services to different group of customers and reduces credit union failure.[632] It was observed that due to this legislative amendment that reduced membership restrictions, multi-occupational credit unions in the US developed rapidly and dominated the federal credit union industry.[633]

However, the US banking industry regards the redefined common bond requirement as too wide to be meaningful, and large credit unions operate like commercial banks, serve multi-groups of people according to their wishes but enjoy additional tax and regulation exemption.[634] Credit unions also do not comply with the Community Reinvestment Act (hereinafter 'CRA') as commercial banks do. The banking industry therefore argues that *de facto* it serves more vulnerable customers, which adds to the unfairness.[635]

In the 1990s, conflict between the banking and credit union industries entered a white-hot stage, as both were engaged in lawsuit and lobbying activities. NCUA was sued several times by banks and bank associations for breaking the 1934 Act for allowing too many 'unaffiliated groups' into it.[636] Different federal courts

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[628] Ibid. Regulation Q is repealed by Dodd-Frank Act in 2010.
[629] Ibid.
[630] See, for example, Hicks (n 624).
[631] Ryder, 'Credit Union Legislative Frameworks in the United States of America and the United Kingdom' (n 577).
[632] Ibid.
[633] See, for example, Pauline Smale, 'Multiple-Group Federal Credit Unions: An Update' (1998). CRS Report for Congress.
[634] Hicks (n 624).
[635] Ibid.
[636] Ibid.

showed opposing attitudes on the precise meaning of 'common bond'.[637] Without a satisfying result for both sides, finally the dispute was handed over to the US Supreme Court. However, in the most significant lawsuit, *NCUA v First Bank & Trust Co.*, NCUA lost judicial support. The Supreme Court regards NCUA's interpretation of occupation common bond as too wide to be meaningful, believes that it would lead to *de facto* unlimited membership size and points out that NCUA's expanding understanding is 'impermissible'.[638] After this judicial failure, NCUA turned to political support and finally promoted the Credit Union Membership Access Act (hereinafter 'CUMAA'), enacted in 1998,[639] which amends the Federal Credit Unions Act and gives more flexible space for US credit unions to increase their potential members, not only re-confirms the multiple occupational but also allows membership within well-defined local community.[640]

The banking industry is opposed to the legislation, as the Oklahoma Bankers Association argues:

> We believe that it is against the country's best interest, and unfair, to pass a law allowing big credit unions to expand almost without limit while leaving the tax burden on everyone else. The credit unions that have strayed from their original mission and have chosen to become full service financial providers should play by the rules like those governing their tax paying competitors.[641]

The loosely interpreted common bond of credit unions and the loss of the co-operative feature of the organization during the deregulation process in the US have been criticized; for example, Hicks points out that it is the common bond requirements that maintain the mutuality of members together as a co-operative.[642] Citing the example of the AT&T Family Federal Credit Union (hereinafter 'ATTF'), which has 112,000 members working in 191 separate businesses all across the country at that time, Hicks argues that

> the common bond definition is diluted by legislation and agency interpretation, the concept of a credit union as a cooperative becomes

[637] Ibid.
[638] National Credit Union Admin. v. First Nat. Bank & Trust Co. 522 US. 479 (1997).
[639] Credit Union Membership Access Act. Public Law 105–219.
[640] Ibid s 101 (b).
[641] Oklahoma Bankers Association Annual Report (1999). Cited by Sibbald, Ferguson and McKillop (n 568).
[642] Hicks (n 624).

> more tenuous . . . At some point, a collection of unrelated people should not be considered a cooperative because they fail to possess any sort of mutual connection or common relationship.[643]

However, in contrast, this legal dispute between two industries, one of which has only been developed since the gradual deregulation, shows how regulations could facilitate the growth of a type of firm and help it compete with other players in the market.

In the UK, the credit union industry has not developed into the mature stage as its US counterpart has. The deregulation of the common bond could be a problem in the competition sector after the industry has grown to the point where it would be able to compete with commercial banks, as is the case in the US. However, in the current stage it appears that the British government's focus is on increasing the sustainability of credit unions by deregulation, and allows the industry to compete with subprime lenders; home credit, mail order catalogue and payday lender, not the commercial banks.[644] Considering the *de facto* membership size of British credit unions,[645] deregulation of the common bond gives the industry enough space to grow and removes many obstacles before it becomes a meaningful threat to banks. Nevertheless, from the several legislative amendments it is obvious that the UK chooses the sustainability value in the first place; the mutual feature of credit unions has to give way to organisational and industry growth.

Last but not least, when the industry becomes more mature, a large part of credit unions based on occupation would unavoidably serve more middle-class customers. This is distinctive in the US, where the largest credit unions in the country are occupation-based, serving employees; while the CDCUs are community-based and still focus on low- and medium-income customers. A CDCU enjoys more regulatory advantages and government subsidies due to its community-serving feature. For example, a qualified CDCU is able to use the CDFI Fund. The credit union industry in the UK has not reached this stage yet, but the example in the US could partly answer the concern of encouraging credit unions to grow, would push them to become another commercial bank, namely a

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643 Ibid.
644 See Purtill, Cray and Mitchell (n 484).
645 According to Association of British Credit Unions Ltd (ABCUL), there are 362 credit unions who serve about 1.1 million members around the UK, the average membership size is about 3,200 members.

small lender that has a financial inclusion purpose shall enjoy additional regulatory treatment to become sustainable. If regulations cannot give such additional recognition, it could become a barrier for those individual lenders to grow.

3.2.3.2 Legislative amendments of customer borrowing

Deregulation is also reflected in the removal of restrictions on customer borrowing. The original provision is set out in section 11 of the 1979 Act, which is restrictive in many respects. The gradually deregulation process gives more flexibility for customers.

i Expansion of loan purposes

According to the 1979 Act, a loan must have a provident or productive purpose.[646] Although the Act does not explain what a provident or productive loan is, this restriction may exclude consumption loans, irrespective of the borrower's real repayment ability. In fact, whether loan purposes are acceptable, shall be decided only by the credit union itself, as its customers may have different requirements. To facilitate a credit union's development, legislation shall give it enough flexibility in detailed business operations.

This restriction on loan purposes was deleted in the Financial Services and Markets Act 2000 (Consequential Amendments and Transitional Provisions) (Credit Unions) Order 2002. Today in the UK credit unions provide diversified loan products, and there are usually no advance loan purposes for these products; the purpose of a certain loan application is decided by the borrower and the credit union decides whether to accept or reject it.

ii Maximum total amount and length of loans

[646] Credit Union Act 1979, s 11 (1). Substituted by The Financial Services and Markets Act 2000 (Consequential Amendments and Transitional Provisions) (Credit Unions) Order 2002, SI 2002/1501, s 2 (8) (a).

In the 1979 Act, the total amount of a loan to a member shall not exceed £2,000 more than his or her paid-up shareholding.[647] The length of a secured loan could not exceed five years, and an unsecured one could not exceed two years.[648] Under the current FCA and PRA regulations, credit unions are divided into two categories based on their size and capital.[649] This is the distinction between a version one and a version two credit union, the requirements for each are differently based on the difference in their size.[650] Again, taking its size into consideration gives a credit union more flexibility in its daily transactions. Both versions 1 and 2 credit unions are permitted to provide mortgages with the contract period not extending beyond 25 years,[651] which enables credit unions to compete with subprime mortgage providers. The loan amount and length of the loan provide credit unions with more flexibility to serve customers' different needs.

iii Lending to corporate members

As a credit union could have corporate members, it could also lend to corporate members if the rules permit it to do so,[652] with some limitations to protect individual members' interest, for example, the total balance of a credit union's loan to corporate members shall not exceed 10% of its loans to all the members.[653] This protects individual members' interests. It could also prevent a credit union that enjoys tax and other regulatory benefits from not mainly serving individual members, but merely lending to corporate members. However, the permission of corporate members could give a credit union more sustainability. In the US, it is shown that corporate membership in credit unions could support the credit union's growth through an employment relationship, as the joining of a firm as a member facilitates its employees to join the credit union.[654]

iv Interest rate cap

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[647] Ibid s 11 (2). Repealed by FSMA 2000 Sch. 18 pt. V para 22; Sch. 22.
[648] Ibid s 11 (4). Omitted by The Financial Services and Markets Act 2000 (Consequential Amendments and Transitional Provisions) (Credit Unions) Order 2002, SI 2002/1501, arts 1(1), 2(8)(b).
[649] CREDS, para 1.1.3.
[650] Ibid paras 7.3.1; 5.3.10.(1).
[651] Ibid para 7.3.8.
[652] Ibid para 7.1.3. (1)(b)
[653] LRO, s 15(3)(b). CREDS also contains provisions on lending to corporate members. See CREDS, para7.1.3.
[654] Ryder, 'The Credit Crunch' (n 497).

To give credit unions more sustainability, the cap on the interest rate that a credit union can charge was lifted from 1% to 3% per month.

In the 1979 Act, the ceiling is 1% per month, including all administrative and other expenses.[655] Since the 1974 Consumer Credit Act has removed interest rate ceilings, credit unions are the only type of mainstream lender that has a legislative interest rate cap for a long period. Payday lenders are also regulated with interest rate caps.[656] This is criticised for being too restrictive and would influence both borrowers and credit unions. For example, Ryder (2009) mentions that the 1% interest rate ceiling is ‘problematic’ since it forces a credit union to ask its members to save before they can borrow, because credit unions could not accumulate enough funds from interest income to re-lend them.[657] Limited by size, credit unions are, hence, unable to serve more people who need instant loans for emergency purposes, and the gap in the market could be seized by subprime lenders. It could also limit the sustainability of some small credit unions, if interest income cannot cover defaulted loan losses.

Considering this possibility, the Treasury published the ‘Promoting Financial Inclusion’ report in 2004 to consult widely on the cost and benefit of raising interest rate ceilings,[658] and invited responses. The result of the responses shows a generally positive attitude towards raising the cap, although with opposing voices as this would be a ‘threat to the ethos of the credit union movement’.[659] However, the government benefits from the costs. The ceiling was raised to 2% by Credit Unions (Maximum Interest Rate on Loans) Order 2006, yet the 2% ceiling also received some criticism after several years of applying, as not being enough to support small credit unions’ growth. For example, the DWP credit union expansion project has studied the feasibility of the industry, and notes the gap between the high operational cost of small loans and the interest rate that a credit

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[655] Credit Unions Act 1979, s 11(5).
[656] Purtill, Cray and Mitchell (n 484) para 2.14. Credit unions in GB are not regulated by the Consumer Credit Act 1974 due to legal exemptions. For the interest rate cap for payday lenders under the FCA’s regulatory regime, see the detailed analysis in Chapter 4 of this thesis.
[657] Ryder, ‘The Credit Crunch’ (n 497).
[658] HM Treasury, ‘Promoting Financial Inclusion’ (2004) paras 4.36-40.
[659] House of Lords, Merits of Statutory Instruments Thirty Sixth Report, Appendix <http://www.publications.parliament.uk/pa/ld200506/ldselect/ldmerit/198/19805.htm> accessed 23 February 2015.

union could charge.[660] Small, short-term loans usually have more expensive administrative fees, which is partly the reason why commercial banks do not serve the market. A restrictive interest ceiling at 2% makes it unlikely for 'even the most cost-effective (credit unions) to break even on smaller loans at present.'[661]

To increase the sustainability of the industry, the government chose to raise the ceiling for the second time to 3% per month through Credit Unions (Maximum Interest Rate on Loans) Order 2013. The DWP's credit union feasibility report explains the increase to 3% by listing an example of a £400 loan interest rate per month at the rate of 2%, 2.5% and 3%, and shows that the total interest on a £400 loan is £82.19 at a 3% rate over a period of 52 weeks,[662] and regards this example as 'still compar[ing] very favourably to the interest charge of over £300 on a similar loan from a leading credit lender'.[663] Moreover, the interest ceiling is permissive rather than compulsory, and credit unions are free to charge lower rates than the legal maximum.[664] The consultation document of HM Treasury on the credit union's maximum interest rate cap argues that

> a more stable credit union sector will mean that low-income consumers will have greater access to reliable, affordable credit, without having to resort to more expensive means, such as home credit or payday lenders, or worse, illegal lenders.[665]

Increasing the ceiling of the interest rate is regarded as a solution to such a status by giving credit unions more available income to cover the costs.

3.2.3.3 The size matters: Differentiated regulatory standards for credit unions and banks, and for version 1 and 2 credit unions

[660] Purtill, Cray and Mitchell (n 484) para 6.25.
[661] Ibid para 2.14.
[662] Ibid para 7.16. It should be noted that to calculate the right answer for the total loan charges amount, the interest rate used in the formula M = P * (J/(1 - (1 + J)-N)) is 'effective interest rate' ('J' in the formula), not annual percentage rate (APR). In the formula, M = monthly payment amount, P = principal, N = total number of payments. While the formula for the effective interest rate is r = (1 + i/n)^n - 1. R = principal of a loan, I = monthly stated rate, n = months for repaying a loan. Therefore, suppose r = £400, n = 12, I = 3%, then effective interest rate = (1+0.03/12)^12-1 = 0.0304. Substitute it in the formula M = P * (J/(1 - (1 + J)-N)) = 400*(0.0304/(1-(1+0.0304)^-12)) ≈ 40.280846. Total amount charged for the £400 loan for 12 months is (40.280846*12)-400 = 483.37-400 = 83.37. The answer is approximately equal to the amount given by the report.
[663] Ibid para 7.17.
[664] HM Treasury, 'Credit Union Maximum Interest Rate Cap' (2012) para 4.2.
[665] Ibid.

In the regulatory regime in the UK, credit unions are treated in a similar, but simplified, manner when compared with banks and building societies. This means regulating methods are similar, yet the standards are different. Besides, regulatory standards for large and small credit unions are also distinct, considering their size difference. Distinction in regulatory standards is regarded here as another key point in facilitating industry growth, as it is the opposite of a 'one-size-fits-all' approach.

i Regulatory framework for credit unions

Before 1998, the regulatory body of the credit union industry was the Registry of Friendly Societies under the Industrial and Provident Societies Act 1965. Regulation of the Registry was criticized for being too limited to be effective; for example, Sibbald, Ferguson and McKillop mention that in 1980s there were only two people working in the Registry that managed credit union business.[666] Limited regulatory resources does not mean the industry has more room to manoeuvre. On the contrary, it means that the regulator cannot understand new conditions in the industry quickly, which may delay the process of making new rules to adapt the market. Furthermore, if the regulator's resources are limited, then the firm's misconduct cannot be overseen effectively, which, according to the adverse selection theory, would only harm both consumers' interests and the market order.

In order to better regulate the credit union industry, the powers of regulation were transferred from the Registry to the FSA in 2002, as the former was incorporated into the latter.[667] FSA powers include authorisation of the credit unions, supervision and regulation, and investigatory and disciplinary powers. Although there were concerns that the regulator would adopt a 'one-size-fits-all' approach in credit union regulation in the same way as banks and building society regulations, Ryder praises the new regime for being 'proportionate' which could facilitate industry growth.[668] This is reflected in the *FSA Handbook for Credit Unions*. Many aspects of this handbook were superseded by the version of the

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[666] Alexander Sibbald, Charles Ferguson and Donal McKillop, 'A Comparative Analysis of Selected Features Affecting Credit Union Industry Development with Special Reference to the UK and New Zealand', Financial Services Research Forum (1999).
[667] Ibid.
[668] Ryder, 'The Credit Crunch' (n 497).

sourcebook that followed. After the FSA had been split into two regulatory authorities in 2013, namely (i) the PRA and (ii) the FCA, the power of regulating credit unions was also transferred to the PRA and FCA.

The current regulatory framework is the CREDS, which contains both prudential and conduct regulations. However, many other regulatory standards also apply to the industry. CREDS 10.1.3 gives a detailed glossary on the application of other sourcebooks with which a credit union must comply. These include the Threshold Conditions (hereinafter 'COND'), Supervision (hereinafter 'SUP'), *Conduct of Business Sourcebook* (hereinafter 'COBS'), and *Banking: Conduct of Business Sourcebook* (hereinafter 'BCOBS'). Moreover, a credit union that seeks to operate credit-related regulated activities has to comply with the new CONC, which provides detailed conduct standards for consumer credit-related regulated activities.[669]

Generally, these sourcebooks are applied to credit unions only if a credit union operates regulated activities. For example, a credit union that accepts deposits has to comply with several sections in BCOBS and COBS, not the whole sourcebook;[670] if a credit union provides a Child Trust Fund, it shall also comply with COBS, as well as the Child Trust Funds Act 2004. Failure to comply with the rules will result in penalties based on the *Decision Procedure and Penalties Manual* (hereinafter 'DEPP'). Generally, the regulatory regime in these sourcebooks is proportionate to the size of the credit unions, as their size is taken into consideration, as discussed in the next sections.

ii Differentiated regulatory standards between credit unions and other financial firms

Considering the relatively small size of credit unions, it is reasonable to reduce regulatory standards to fit in with their limited size and resources. As discussed in the previous section on common bonds, the separation of customer groups is the legitimacy of any regulatory exemptions, because a credit union cannot directly compete with a commercial bank who serves the general public. Therefore, legal exemptions would not lead to unfair competition. Similarly, reduced regulatory

[669] Since CONC regulates all the credit-related activities, it will not be discussed here.
[670] Ibid para 10.1.3.

standards are not in conflict with fair competition; it comes from the size difference between financial firms.

For example, in section 8.2 of CREDS, all credit unions are required to submit quarterly and annual returns to the PRA, in order to report the 'key financial data' in their operation.[671] Although all the firms that are permitted to take regulated activities have to do this,[672] the format requirements are different. A bank is required by SUP to send its data to the PRA by 'electronic means' provided by the regulator,[673] while a credit union can choose a convenient way to submit the data, including sending a paper report to the Bank of England via post, or to pay the Bank of England a visit and leaving the data report there or sending electronic mail to the regulating team.[674] This gives credit unions more flexibility to abide by regulatory standards. As to the content of data, the requirements for credit unions have also been simplified as opposed to those for banks.[675] Where a UK bank has to submit more than 20 types of data to PRA, a credit union only needs to send five core data: (i) balance sheet, (ii) income statement, (iii) capital adequacy, (iv) large exposures and (v) liquidity.[676] A simplified reporting requirement for credit unions is more appropriate for the industry, as same regulatory standard with banks could be burdensome for small credit unions and add their operational costs. Based on these facts, Ryder (2003) regards the FSA's regime as effectively supported the industry developments.[677]

iii Differentiated regulatory standards between version 1 and 2credit union

Regulators also treat credit unions according to their difference in size and capacity, namely version 1 credit unions and version 2 credit unions.[678] This is further progress made in differentiated regulation to fit in with the industry's status quo, as most credit unions in the UK are version 1 credit unions.

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[671] Ibid paras 8.2.1 – 8.2.5.
[672] Supervision (SUP), para 16.12.3.
[673] Ibid para 16.12.3 (2)
[674] Ibid para 16.12.3 (3) (a)
[675] Ibid para 16.12.5.
[676] Ibid.
[677] Nicholas Ryder, 'The Financial Services Authority and Credit Unions - A New Era in Regulation?' (2003) 11 Journal of Financial Regulation and Compliance.
[678] CREDS, para 1.1.3.

First, in section 2 of CREDS (Senior Management Arrangements, Systems and Controls), credit unions are required to set up robust governance arrangements that fit in with 'the nature, scale, and complexity of the risks inherent in the business model and of the credit union's activities'.[679] These measures include 'establish[ing], maintain[ing] and implement[ing]' a proper business plan,[680] policies and procedures manual,[681] inner control system[682] and accounting system.[683] For a small version 1 credit union, the regulators do not expect it to have the same systems and controls as a large version 2 credit union does,[684] as the former may be smaller in size and the management team, which may not be able to support them, will meet all the regulatory requirements. If all the management and inner control requirements are on the same level, small credit unions could face regulatory burdens that constrain their growth.

Second is the capital requirement for credit unions. According to Principle 4 of the Principles for Businesses (hereinafter 'PRIN') (A Firm Must Maintain Adequate Financial Resources),[685] a credit union is required to have adequate capital in order to absorb unexpected losses coming from daily businesses. This is essential for credit unions' stability, as capital could absorb repayment risks from defaulted loans. Therefore, the capital requirement is related to the level of risk a credit union bears; the higher the risk it has, the more capital it needs. CREDS gives detailed lists of types of capital and special requirements in section 5.[686] A version 1 credit union has the least strict capital requirements (capital: total assets ratio of at least 3%);[687] while a version 2 credit union is at the other end of the spectrum, using the 8% standard.[688] What is more, based on the size of total assets and members, there is a sub-classification in a version 1 credit union, namely the

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[679] Ibid para 2.2.2.
[680] Ibid para 2.2.4.
[681] Ibid para 2.2.6.
[682] Ibid para 2.2.8.
[683] Ibid paras 2.2.24-28.
[684] Ibid para 2.2.3.
[685] FCA, Principles for Businesses (PRIN), para 2.1.4.
[686] Another thing to note is that the Capital Requirements Directive IV (CRD IV), which consists of the Capital Requirements Directive (Directive 2013/36/EU) and the Capital Requirements Regulation (Regulation (EU) No 575/2013), does not apply to credit unions. 'Credit institutions' that shall apply the Directive and the Regulation refers to 'an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credit for its own account' (Article 4.1(1), Regulation (EU) No. 575/2013), while a credit union cannot serve the public. A credit union also does not comply with the General Prudential Sourcebook (GENPRU) of the PRA. See GENPRU, para 1.1.2.
[687] CREDS, para 5.3.1.
[688] Ibid para 5.4.1.

'large version credit union'.[689] The capital requirements for it are also based on its size and risks. This distinction in capital requirement is meaningful, as most UK credit unions are version 1 credit unions,[690] which means they have smaller business scope and asset size, and 'one-size-fits-all' capital regulation would become a barrier to their being able to use their funds. Besides, both version 1 and 2 credit unions are required to have adequate initial capital,[691] in order to set a buffer for credit unions against repayment risks.

Third is the liquidity requirement. If a credit union has fewer liquid assets it cannot give back all the members their savings and non-deferred shares, and it risks defaulting. Therefore, a buffer of liquid assets is essential to avoid liquidity problems. CREDS sets a minimum liquid requirement for all credit unions, namely 5% of its total liabilities that can be withdrawn in a short time. However, as 5% is the minimum standard, the amount of liquid assets shall be 'prudent and appropriate to the scale and nature of its business, having regard to material risks, including the risk of a sudden adverse cash flow, with a view to enabling it to meet its objectives.'[692] Although there is no admission procedure (the level of liquidity is decided by the credit union's management committee) from the regulator,[693] PRA still keeps an eye on version 2 credit unions, which have to satisfy PRA that they have enough and prudent liquid assets.[694]

In general, the regulation set up in CREDS is focused on the safety and soundness of credit unions. It has taken the differentiated risk size of credit unions into consideration, and treats version 1 and 2 credit unions differently based on their risk level. Instead of adopting a 'one-size-fits-all' regime, the FCA's and PRA's regulatory regime is generally reasonable, which could facilitate the stability of credit unions without becoming a 'regulatory burden' for small, community credit unions. This is the recognition of the different sizes of credit unions, which is reflected in the risks taken during taking deposits and giving credit.

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689 Ibid paras 5.3.13-15.
690 There are 421 credit unions as of September 2012 in GB, only 10 of them are version 2 credit unions. See, Edmonds (n 587).
691 CREDS, paras 5.3.6, 5.4.3. For the definition of 'initial capital', see CREDS, para 5.2.1 R (5).
692 Ibid para 6.2.1.
693 Ibid para 6.2.4.
694 Ibid paras 6.2.5-6.

Therefore, the regulation of credit unions is not a 'one-size-fits-all' model; rather, it has taken the relatively small size of a credit union and its limited resources into consideration. This proportionate regulatory regime is appropriate, as it could avoid regulations backfiring on credit unions' development and become a new 'regulatory burden'.

3.2.3.4 Available financial resources

As most credit unions in the UK are version 1 credit unions with smaller memberships and lower customer deposits, it is essential to give them available external fund resources, not only in the start-up stage, but also in the following businesses when a credit union may need to borrow from other financial institutions in its daily transactions. Relying only on members' deposits is not enough, especially for the small credit unions located in deprived communities.

There are two parts to available financial resources, namely (i) the grants from local authorities and society, and (ii) the investments and loans from other firms. At present, there is no legal duty on any firm or organisation to assist a credit union.

i External grants

In the UK, many credit unions still rely on external grants after setting up, due to their high operating costs in daily transactions, and their limited ability to accumulate assets and build capacity.[695] Capped interest rates are also criticized for being a cause of unsustainability.[696] In order to assist small credit unions in playing their role in providing credit, government, local authorities and other entities have to support the industry with financial grants.

To help a credit union start up, local authorities and charities may give financial grants to pull them through their difficulties.[697] Thomas and Balloch note that the grants of local authorities to credit unions are aimed at covering the start-up

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[695] Purtill, Cray and Mitchell (n 484) para 4.2.
[696] Ibid para 2.14.
[697] Thomas and Balloch (n 557).

expenses and the amount of the grants is limited to £500 to £2,000.[698] This is because a well-operated credit union is assumed to be sustainable with its own funds and shall not rely on external grants after the start-up stage. However, some external funds in a credit union's early stage are indeed essential to help it begin with the businesses.

There are also other types of support, including staff training, providing an office in the city council and so forth.[699] In considering the win–win relationship of a local credit union and the local authority, a credit union could usually receive such support at the setting-up stage.

More recent approaches focus on the setting up of a fund that is available to credit unions. In 2004, the Labour government set up the Growth Fund to fund 'third sector lenders', including credit unions and social enterprises such as community development finance institutions (hereinafter 'CDFIs') to promote financial inclusion.[700] The Growth Fund is then administered by the DWP and paid by the Financial Inclusion Fund (hereinafter 'FIF').[701] Grants are gratuitously given to credit unions that are in contract with the DWP and become their capital on the balance sheet. After a credit union has received the full amount of granted funds, the grant turns to its assets and hence strengthens its ability to lend.[702] A credit union could then use the fund to lend to its members who are unable to save before borrowing, which gives it more flexibility to serve the deprived community.[703] Such loans are called 'Growth Fund loans', as the money comes from the Growth Fund grant to the credit union. Since 2010, more than 300,000 Growth Fund loans and £137 million in total has been loaned by credit unions across UK.[704] It is generally agreed that the Growth Fund has played its role during this process.

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698 Ibid.
699 Ibid.
700 See, for example, Edmonds (n 587) 22.
701 Ibid.24. FIF ended in 2011 and the decision was made not to renew it, in consideration of public expenditure.
702 Ibid.
703 Ibid.
704 Sharon Collard, 'Evaluation of the DWP Growth Fund: Revised Final Report' (2010).

Local authorities also help credit unions by giving them financial support, which is based on goodwill rather than legal responsibility. The aim to do so is clearly stated by a credit union in England (SurreySave Credit Union), as an example:

> Local councils may wish to support the credit union as a means to recession proof local economies. Credit unions can stimulate growth by making available lending opportunities for consumers and entrepreneurs. Delivering a credit union service in your neighbourhood can offer a strategic fit with other work the authority may be doing to promote social inclusion and support local communities to access services.[705]

Nevertheless, credit unions' over-reliance on such external funding is criticized. The industry is criticized for not being able to sustain themselves with their own income without making use of external financial support, due to their limited ability to build capacity and improper regulation, for example, capping interest rates.[706]

Ryder disagrees with the criticism, and regards external funding as an essential way to benefit credit unions.[707] External funding is not the cause of unsustainability. On the contrary, it is the by-product of an unsustainable development model of credit unions. Therefore, if a credit union could use external funds as one of the available funding resources rather than totally relying on government grants, the grants could benefit its sustainability, and not harm it. Ryder further quotes four examples from Wales, Scotland, England and the US and supports this view, namely that appropriate grants would benefit small credit unions to grow.[708] Even in the US where the credit union industry has reached such a scale that the banking industry regards it as a competitor, those small-size CDCUs are still supported by external funds. After being certificated as a CDFI, the credit union is able to use the CDFI fund.[709] As the US Treasury mentions, 'the CDFI Fund was created for the purpose of promoting economic revitalization and community development through investment in and assistance to community

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[705] SurreySave Credit Union, 'SurreySave Would Not Exist Without the Support of the Funders Named Below' <http://www.surreysave.co.uk/content.asp?section=202> accessed 29 April 2014.
[706] Purtill, Cray and Mitchell (n 484) para 4.2.
[707] Ryder, 'The Credit Crunch' (n 497).
[708] Ibid.
[709] The National Federation of Community Development Credit Unions (hereinafter 'NFCDCU'), 'Become a CDFI' <http://www.cdcu.coop/expertise/become-a-cdfi/> accessed 16 June 2014.

development financial institutions (CDFIs).'[710] It is recognised as an essential financial resource for a community development credit union to play its role in community developments.[711]

In short, for those small community-based credit unions that bear policy targets for financial inclusion, external funding to support their capacity to provide credit to low-income community appears reasonable. Using external funding does not contradict the target of achieving financial sustainability. In consideration of the policy duty that small credit unions bear, such external resources are both reasonable and important. The US example shows that to provide more steady sources of financial sources, a regime to certify small community credit unions and give them official supports is essential, which provides normal assistance once the criteria are met, rather than occasional donations.

ii External investments

A credit union shall also be allowed to attract external investments, similar to interbank loans but in the longer term.

As a financial institution, although in mutual style, credit unions in the UK are allowed to use their surplus funds[712] to invest or lend to other firms, institutions and credit unions.[713] A credit union is also allowed to borrow money for a certain length of time to cover risks on the balance sheet;[714] the borrower could then use the loan for liquidity purposes.[715] CREDS does not forbid a credit union to use external loans from other credit unions in its daily business, as this is an important way of supplementing its fund, but specifically notes that credit unions shall be cautious about lending to other credit unions, by taking the risks of the borrower's non-repayment risk into consideration.[716]

[710] United States Department of Treasury Community development financial institutions fund, 'About the CDFI Fund' <http://www.cdfifund.gov/who_we_are/about_us.asp> accessed 16 June 2014.
[711] NFCDCU, 'CDFI Fund' <http://www.cdcu.coop/advocacy/cdfi-fund/> accessed 16 June 2014.
[712] CREDS, para 3.1.3. (2). Surplus funds are 'funds not immediately required for a credit union's accepting deposits, lending and ancillary purposes'.
[713] Ibid section 3 (Investment and borrowing).
[714] Ibid para 3.1.2. (2).
[715] Ibid para 3.2.7.
[716] Ibid paras 3.2.6-7.

The sourcebook also differentiates between larger and smaller credit unions. The total amount of this type of debt is different between a version 1 credit union and a version 2 credit union, and shall not exceed a certain percentage of its non-deferred shares.[717] Both could lend to, or invest in, other credit unions, but a version 1 credit union has special time limits.[718] This is because long-term loans as assets would influence a credit union's ability to lend to its individual members; it may also influence a credit union's liquidity, for example, to make payments to its customers as the deposits become due, or to cope with shareholding withdrawals.

In general, the regulator tries to give credit unions more available sources of funds to avoid temporary risks, but also focuses on the safety and soundness of credit unions by setting limits on such transactions. In the short term, external funding could help credit unions to build their capacity and, in the long term, a credit union shall be permitted to attract external investments to further strengthen their sustainability.

However, there is concern about the real ability of these small credit unions to attract external investments, although regulatory sourcebooks have given permission for them to do so.[719]

3.2.3.5 Disciplinary power of the financial regulator

The last point in the regulatory regime is the mandatory power of regulators that could be used over credit unions that break the regulatory rules. Although mutually owned by members, the daily operation of credit unions is still

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[717] Ibid paras 3.3.3-5. 'Total non-deferred shares' means the total of members' share balances in a credit union, excluding deferred shares. See, FSA Credit Unions New Sourcebook (Consequential Amendments) Instrument 2011, FSA 2011/72, Annex A. FSA's definition is continually in use in the new sourcebook of FCA and PRA CREDS. As a 'deferred share' is non-repayable, except in special cases (see LRO 2011, s 17(4)), it is classified into capital of a credit union, namely the 'own' source of funds (CREDS, 5.2.1.) In contrast, when one becomes a member of a credit union, he or she needs to deposit some money into the firm as his or her 'share', which is payable with 'dividends' at year end. This 'share and dividends' in credit unions is actually equivalent to 'deposits and interests' of a conventional commercial bank, therefore, a 'non-deferred share' of a credit union could be freely withdrawn by a member in contrast to the share in a conventional company. Both the share of a credit union and deposit of a commercial bank are shown as liabilities on a firm's balance sheet. It should also be noted that the capital of conventional banks is also shown as a liability on the balance sheet, as it would be owed to shareholders when the firm is in liquidation.

[718] CREDS, para 3.2.2.

[719] Purtill, Cray and Mitchell (n 484) para 2.6.

controlled by the board of directors, which inevitably leads to agency problems as discussed in section 3.2.1.3. To reduce this problem, there are both *ex ante* regulations for firms to follow and *ex post* disciplinary power to punish misconducts.

Before 2013, the regulatory power for credit unions was held by the FSA. After it had split into the FCA and PRA, disciplinary and enforcement power also transferred to both of the regulators. PRA is responsible for authorisation and prudential regulation of credit unions,[720] while the FCA has investigative and enforcement powers to regulate the industry. Credit unions are regulated by both PRA and the FCA. FSMA 2000 empowers the regulators to publish a censure to name and shame the firm or authorised person, or to impose a penalty for more serious condition.[721]

Maintaining the market order by disciplinary action and enforcement would definitely benefit the members of misconducting credit unions, and of well-behaved credit unions. As mentioned in section 3.2.3.3, credit unions have to comply with a series of regulations. Failing to do so may incur public censure or a penalty, depending on which aspect of the rules the credit union breaches. For example, penalties may be imposed on a credit union who fails to submit key financial data to PRA on time.[722] The FCA is responsible for regulating credit unions' misconduct. Both regulators have disciplinary power to impose.

In order to treat authorised persons fairly, FSMA 2000 sets out a series of procedures in its Part XXVI.[723] The Act is further detailed in DEPP.[724] Depending on the stage of the regulator's decision-making, there are five types of notices: (i) warning notice, (ii) decision notice, (iii) notice of discontinuance, (iv) final notice, and (v) supervisory notice. This is generally a step-by-step procedure, as after a warning notice, the recipient has the chance to defend himself or herself within a reasonable period.[725] This is also the case with a decision notice.[726] A warning or

[720] PRA, 'Supervision' <http://www.bankofengland.co.uk/pra/Pages/supervision/default.aspx> accessed 24 February 2015.
[721] FSMA 2000, ss 205-206.
[722] CREDS, para 8.2.8.
[723] FSMA 2000, ss 387-396.
[724] FCA and PRA, DEPP, para 1.2.1.
[725] FSMA 2000, s 387. See also DEPP, para 2.2.
[726] FSMA 2000, s 388 (5).

decision notice can also be changed by a notice of discontinuance.[727] However, a final notice is the final decision without an appeal procedure, since in the previous stage the recipient already had a chance to defend himself or herself. The authority would decide whether to give a public censure or a penalty, or other types of punishment in the final notice, such as cancelation of Permission to Carry on Regulated Activities.[728]

In the period from 2002 (when the FSA assumed the power of regulating credit unions) to 2012, six FSA Final Notices in total have been imposed on credit unions. None of the six final notices includes a decision to give a penalty to a credit union. In three cases, the FSA decided to cancel or refused to vary the permission to carry on regulated activities, generally due to the unmet threshold conditions. In the other three cases, the FSA issued a public censure because the credit union had been involved in misconduct in its business, including lending to its own directors at more favourable interest rates than common members,[729] and loans to non-member exceeded the 25% limit of the credit union's capital.[730]

A most typical case of misconduct, the case of The Pentecostal Credit Union Limited (hereinafter 'TPCU'), is worth quoting here. The case involved a credit union that broke a series of rules, which is a good mirror that reflects the regulatory environment of UK credit unions. It is also important to note that the FSA took a risk-based approach in its regulation until its later reform. This means it would not chase and punish every breach of rules, but selectively focused on the events that have the most serious impact.[731] However, this approach was generally transformed into principle-based regulation.

The case of the TPCU[732] is a vivid example of what the FSA considers to be a serious breach of the restrictions. Many aspects of the rules were involved in the misconduct process, including the TPCU's own responsible lending rules. First of

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[727] FSMA 2000, s 389.
[728] For detailed review on FSA's enforcement process, see, Financial Services Authority Enforcement Process Review: Report and Recommendations. July 2005.
[729] FSA, Final Notice to Shettleston and Tollcross Credit Union Limited ('STCU') (2012 FRN: 213682).
[730] FSA, Final Notice to Pollok Credit Union Limited (hereinafter 'PCU') (2012 FRN: 213798).
[731] Ibid para 1.7.
[732] For details of the case, see FSA, 'FSA Publicly Censured London Credit Union' (2012) <http://www.fsa.gov.uk/library/communication/pr/2012/100.shtml> accessed 2 May 2014. Final Notice of FSA (FSN: 213242, The Pentecostal Credit Union Limited 'TPCU').

all, the conduct of TPCU is opposite to the statutory objectives in the Part I of FSMA 2000, that is, the protection of consumers, and the reduction of financial crime. By indirectly lending to the non-member church organisation under the name of its individual members, the TPCU deliberately exposed those members to the risk of financial loss. This is especially the case for the member who was in a loan contract without being aware of it, as FSMA 2000 requires 'consumers should take responsibility for their decisions.'[733] FSA's Principles for Businesses were also breached, as the principles require a firm to conduct its business with integrity.[734] Under the regulatory objectives and the Principles, both the 1979 Act and CREDS were breached in respect of customer borrowing. For example, the 1979 Act requires that '[a] credit union may make to a member a loan, upon such security (or without security) and terms as the rules of the credit union may provide.'[735] The TPCU has, on the contrary, lent to members in breach of its own terms of responsible lending. This risk was exposed to the FSA before Legislative Reform Order 2011 allowed a credit union to have corporate members or lend to them. While TPCU *de facto* lent to a corporate entity via indirect loan arrangements, which was forbidden by CRED 10.2.11 G (1).

However, although this case was criticized by Tracey McDermott as 'a disgraceful case of a credit union putting the interests of another organisation before those of its members', the then FSA director of enforcement and financial crime[736] issued public censure instead of a penalty to TPCU. The basic reason for the FSA choosing public censure rather than a penalty is the nature of credit unions, as the TPCU was owned by all its members, therefore a penalty would directly influence the innocent members' interest.[737] The small size of credit unions was also taken into consideration. The co-operating attitude of TPCU during the decision-making process also won itself the regulator's forgiveness, as it 'voluntarily replaced its entire management' after FSA required that it do so. Decisions by the FSA were therefore made on a case-by-case basis and it would not rigidly impose punishment without special consideration.

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733 FSMA 2000,s 5 (2)(d).
734 FSA Handbook of the Principles for Businesses. 2.1.1 (replaced with the new FCA and PRA sourcebook).
735 Credit Union Act 1979, s 11 (1).
736 FSA, 'FSA publicly censured London credit union' (n 732).
737 FSA, Final Notice to the Pentecostal Credit Union Limited ('TPCU') (2012 FRN: 213242).

There is still no case of credit unions' misconduct under the new regulator FCA's regulation, due to its youth. However, as the regulator is committed to turn into principle-based regulation, this would influence the credit union industry through enforcement of the principles, rather than merely obeying the detailed rules. MacNeil (2007) suggests that there are two identifying characters for a principle-based regulation regime: the first is whether principles are for the purpose of compliance and enforceable, and the second is whether merely following the detailed rules may still breach the principles.[738] This is explicit in the case of TPCU, as the FSA used the Principles as the basic statutory provision being breached. The outcome required by the FSA was also not achieved. The FSA also criticized TPCU's deliberate circumvention of the rules in 2007, when the credit union put forward several suggestions that were aimed at bypassing the 1979 Act, section 11(1).[739] However, the real effect of transformation to the new approach still remains to be seen.

3.2.4. Regulatory regime of rural mutual co-operatives in China

As discussed in section 3.2.2, the RMC industry in China is still in its nascent stage. Considering the industry's advantages and weakness, it is not surprising that the Chinese government supports the industry through administrative and regulatory measures; for example, in order to facilitate market entrance, threshold conditions for RMCs are significantly lower than with a commercial bank. An RMC could be set up merely by local residents and enterprises based on their credit demands; there is no requirement for state investment. Official support also includes additional tax exemptions for firms.[740]

However, in many respects the current regulatory regime for RMCs is inappropriate and could backfire in regulatory terms when it comes to industry

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[738] Iain G MacNeil, 'The Evolution of Regulatory Enforcement Action in the UK Capital Markets: A Case of "Less Is More"?' (2007) 2 Capital Markets Law Journal 345.

[739] FSA, Final Notice to TPCU (n 737).

[740] For example, in 2010, the State Administration of Taxation (hereinafter 'SAT') of China decided to exempt RMCs from business tax levied on their interest income from rural residents' small-amount loans. The amount of taxable interest income on such loans is calculated on a 90% basis of the original total amount. A small-amount loan for rural residents in this notice refers to a single loan provided to a rural resident (as well as the total amount of loan provided to his household) that does not exceed 50,000 yuan (about £5,000). See, SAT, *关于农村金融有关税收政策的通知* [Notice of the MoF and SAT on the Relevant Tax Policies on Rural Finance] (2010 No. 4), art 5.

development. Regulations for RMCs are mainly aimed at controlling risk and market stability, rather than facilitating development of the industry and RMC's sustainability, although the possible risk originates in an inappropriate register regime. There is also a 'one-size-fit all' approach in the regulatory regime, which sets the same prudential regulatory standards for RMCs as for commercial banks. In addition, available financial resources are also limited; an RMC is *de facto* unable to borrow money from other financial institutions, there is also no official funds that support the growth of the industry. An RMC in this sense has to merely rely on its members' deposits but is subject to the same regulatory standards as commercial banks, which would impair its sustainability and limit its capacity to serve more members. In practice, the CBRC's role of authorisation and registration is also unclear, and leads to a special case that many RMCs in practice are unable to get financial licences from the CBRC local bureau and are forced to register with other authorities without financial licences, bringing their ability to take deposits to the edge of breaking the law. It is therefore assumed that although being officially regarded as one of the new solutions for rural financial exclusion, the industry would not fulfil this role if the regulatory regime is not appropriately amended.

3.2.4.1 Restrictive regulatory rules

As RMCs have only been officially recognized by the CBRC since 2007, there is currently no statute for this new type of firm. However, the Banking Supervision Law of China (2003) will be applied to RMCs in the broader sense if there is no special rule for RMCs in regulations.

At the regulation level, the current basic rule for RMCs is the *Interim Provisions on the Administration of Rural Mutual Co-operatives* (2007) of the CBRC. Its content includes six main parts, namely (i) setting-up procedure, (ii) membership eligible criteria, member's rights and shareholding, (iii) member's decision-making power and management team's duty, (iv) rules about customer borrowing, (v) prudential supervision standards, and (vi) merger, division and liquidation rules. Although it covers the matters of RMCs from their establishment to their liquidation, rules are still quite sketchy in this regulation. It is also a restrictive rule in many respects. In general, the regulatory regime for RMCs is focused on firms' stability from the prudential aspect rather than the sustainability of the firm. This restriction is reflected in several aspects.

First, it relates to the strict eligibility criteria of RMC membership. Although there is no such phrase as 'common bond' in China's regulatory regime, as in the UK and US, an equal concept is accepted in the regulation to define the central mutual feature of the firm. This is the 'eligible membership' requirement in the Interim Provisions (2007), articles 17 to 19.

The advantage of this requirement is suggested by He.[741] Owing to the familiarity and trust between RMC members who live in the same community, information asymmetry between an RMC and its members could be reduced. In He's view, peer pressure within RMCs is another factor that could reduce bad loan rates, as the mutual credit organization is owned by all the members and non-repayment would harm other peer members' interests. Therefore, moral hazard could be reduced, for example, some member may deliberately be taking risks with his or her acquired loan, knowing that the risk would be borne by other RMC members. In practice, some RMCs also choose to raise interest rates for those who do not repay on time. He or she therefore deduces that a well-managed RMC could be sustainable on the basis of the relatively lower level of non-performing assets because of the eligibility membership rule.

The Interim Provisions (2007) recognize only one type of eligibility criteria to join an RMC's membership, namely the locality of the RMC. Individuals must reside in the same area as where the RMC is located, irrespective of whether their households are registered in that town or village, or they have resided in their permanent housing in that locality for more than three years.[742] Although enterprise members are allowed to join the membership, their place of registration or major business site must be located in the same geographical area as the RMC. This rule is really sketchy but still restrictive, as it closes the door to more available fund resources. In practice, as local authorities have the power to issue administrative rules that can further detail the CBRC's rule, stricter restrictions are set in those local rules; for example, RMCs in Guangzhou are forbidden to

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[741] Guangwen He, '农村资金互助合作机制及其绩效阐释' [Regime and Function of Rural Mutual Co-operatives] [2007] Theory and Practice of Finance.
[742] Interim Provisions on the Administration of Rural Mutual Co-operatives (2007 No. 7), art 18.

accept civil servants into membership, while only members of local rural associations are eligible to join in.[743] Although the original intention of this restriction is to avoid civil servants from acquiring higher amounts of loans than other common members, this restriction on eligible membership *de facto* sets up a regulatory barrier for an RMC to grow.

In fact, the existing limitations about eligible members of RMCs reflect what the attitude of the CBRC on the role of RMCs could be. Instead of being an open and inclusive financial institution that could develop to a large scale and across regions, the regulator in China now expects RMCs to be a community mutual credit group with a fixed group of local people and to remain small in size. The only way for an RMC to increase its membership is to merge with other RMCs, as the potential eligible members in a certain locality would not increase quickly enough. It is possible that the regulator intends to control the size of deposit risk within a smaller group or people by using restrictive eligibility criteria, since China currently has no deposit insurance regime as in the UK.[744] This restriction on eligible members – both on residential and working standards – could not support an RMC's capacity in the long run to take enough deposits and increase its business size from broader membership.

The next related problem is RMCs' available fund resources. An RMC is allowed by the CBRC to take members' deposits, accept external grants and use other financial institution's investment.[745] However, for those RMCs located in deprived rural communities where members' capacity to deposit is severely limited and they are not allowed to accept more members based on multiple eligible criteria, it is also not a simple task to attract enough grants or investments.

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[743] See Financial Office of Guangzhou Authority, Guangzhou Rural Bureau, Guangzhou Industry and Commerce Bureau, Guangzhou Civil Affairs Bureau, *广州资金互助合作社工作指引* [Guidelines of rural mutual cooperatives in Guangzhou], art 8.

[744] In fact, China is already in the process of setting up a deposit insurance regime, as the PBoC drafted its Notice of Deposit Insurance at 30 November 2014. The Notice draft had not been officially approved at the time when this thesis was written. See 'Deposit Insurance in China: A Premium for Risk' *The Economist* (London 6 December 2014) <http://www.economist.com/news/finance-and-economics/21635512-scheme-protect-savers-exposes-chinese-banks-useful-uncertainty-premium> accessed 24 February 2015. However, whether the small, nascent RMCs would be capable of joining the regime is questionable. The draft does not mention RMCs in its text but mentions commercial banks, rural co-operative banks and rural credit co-operatives who are 'financial institutions' and have financial licences in the CBRC's regime, although RMCs are also viewed by the CBRC as community mutual financial institutions.

[745] Interim Provisions on the Administration of RMCs, art 41.

There are no national-scale official fund resources for RMCs, and the industry is ineligible to make use of the central bank's policy loan that supports rural financial inclusion.[746] Local authorities and research groups may give financial support to small RMCs in rural areas, which are usually one-off and focus on supporting their start-up phase, for example, purchasing equipment, rather than making funds available to be lent out. Moreover, although RMCs are allowed to accept investments from banks and other financial institutions, their repayment ability *de facto* limits their ability to attract any meaningful external investment or wholesale loans. For most small RMCs, their only fund resource is members' deposits which are not only highly limited by members' low-income level, but also because they are trapped by the restrictive membership eligibility criteria from accepting more members.

Another regulatory failure of RMCs is that the regulator adopts a 'one-size-fit-all' regulatory standard, without any distinction in the difference in size between RMCs. According to the Interim Provisions, all RMCs must obey the same standard of capital adequacy ratio of commercial banks, namely the minimum 8% standard. In some added rules issued by local authorities, the capital adequacy ratio is lifted higher to 10%. The CBRC's rule also sets up disciplinary measures for those RMCs who fail to keep an 8% capital adequacy ratio, in most severe cases (ie, where the capital adequacy ratio is less than 2%), an RMC is required to increase its share capital, recover its non-performing loan and reduce its asset size within a limited period. Those who are unable to satisfy the regulator will be forced to dissolve; the regulator could also cancel their financial licence and business licence. The aim of these prudential rules lies in the stability of the firm which is essential to members' deposit safety. Therefore, a licensed RMC has to comply with the rule on the same level as commercial banks without additional regulatory exemptions when it is less possible for a licensed RMC to cause systemic risk due to its small size, which is, to some extent, unfair on RMCs. However, unless RMCs could be covered by the in-proposal deposit insurance

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[746] It appears that the CBRC also maintains a cautious attitude on the RMCs industry, although they have financial licences from the CBRC. Only those mainstream and commercial lenders would have the central bank's policy loan. See PBoC, '人民银行拓宽支农再贷款适用范围，支持扩大三农信贷投放[PBoC Expands Coverage of Re-Loan to Rural Financial Institutions]' (2013) <http://www.pbc.gov.cn/publish/zhengcehuobisi/3700/2013/20130304182056650382838/20130304182056650382838_.htm> accessed 7 May 2014.

regime of China, it is less likely that the regulator would reduce prudential standards on the core issue.

In general, although the Chinese government regards RMCs as one of the solutions to financial exclusion, the banking regulator does not afford them appropriate regulatory support. In fact, the development of RMCs in China is disproportionately slow as there were only 49 formally licensed RMCs in the country as at the end of 2011,[747] while, according to the CBRC's list of licensed financial firms, there are more than 300 VTBs operating across the country. The restrictive regulatory regime and limited financial resources are here regarded as the main barriers to development in the industry.

3.2.4.2 Improper licence regime and regulation

A special phenomenon in the RMC industry is the coexistence of both licensed and unlicensed RMCs, which derives from the improper regulatory regime and the CBRC's limited regulatory resources.

According to the Interim Provisions (2007) and a new rule that focuses on RMCs' setting-up procedures,[748] an RMC must first send an application to the CBRC's local bureau and get permission to start its setting-up procedure. Only once this has been done can the promoters send an application to the CBRC's local bureau for permission to set up and, if approved, receive a financial licence.[749] To be eligible for the licence, several standards must be met, including the criteria of the appropriate promoter,[750] lowest amount of the registered capital,[751] and several requirements for the management team, business site and appropriate facilities.

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[747] CBRC, 'Annual Report of 2012' (2012). According to the annual report, there are 49 RMCs and 800 VTBs in the country. A list of banking financial institutions in China is available at <http://www.cbrc.gov.cn/chinese/jrjg/index.html>. The list provides the names of licensed financial institutions in China, including commercial banks, rural credit co-operatives, foreign banks, trust companies and many other sorts of firms. The list is, however, incomplete and contains no updates on newly set-up firms.

[748] CBRC, *农村资金互助社组建审批工作指引* [Guidelines for the Examination and Approval of the Establishment of Rural Mutual, Cooperatives] (2007 No. 10).

[749] Ibid.

[750] Interim Provisions on the Administration of RMCs, art 9. see also CBRC, *农村中小金融机构行政许可事项实施办法* [Implementation Measures of the China Banking Regulatory Commission for the Administrative Licensing Items concerning Small and Medium-Sized Rural Financial Institutions] (2014 No. 4), art 36.

[751] Interim Provisions on the Administration of Rural Mutual Co-operatives, art 9. Based on the location, requirement for minimum capital of RMCs are 100,000 yuan (set up in villages) and 300,000 yuan (set up in towns) respectively.

The CBRC would then give a financial licence to the eligible RMC with the local bureau's permission.[752] As in China's banking regulating regime, a financial licence is essential for anyone who wishes to provide financial services to customers.[753] The inability to get a licence would stop a new player from entering the field. Only once a financial licence has been obtained can an RMC register in the local bureau of industry and commerce, and get the business licence and formally start its business.[754]

Ideally, this procedure could screen out an ineligible player by turning down its application. However, in practice, there is evidence that shows that it is *de facto* not a simple task to get a financial licence. Because the approval power is held by the CBRC's local bureau and there are only several rough eligibility criteria in the CBRC's rules, whether local bureaux of the CBRC would accept an application is not guaranteed. Unsuccessful attempts to apply usually occur in this phase; for example, an article notes that a local bureau of the CBRC in Zhejiang Province turned down all applications from locally proposed RMCs because its superior bureau did not list the province as an RMC licence pilot area,[755] even after the local authority had requested the bureau to do so. There is also evidence that shows that local officials' personal supportive attitude is essential for whether RMCs could get licences.[756]

However, those unlicensed RMCs can still trade their business in the market. Because of regulatory loopholes, the CBRC does not explicitly prohibit those unlicensed mutual credit organizations from taking members' deposits and lending to members. In He's observation, there are some unlicensed mutual firms in the market who could not register with the CBRC.[757] Some of them are set up with the support of local authorities; the others are merely set up by local residents. In order to remain in a 'safer' place under some sort of official

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[752] Ibid art 14.
[753] Basic rules for financial licence are set out in CBRC, *金融许可证管理办法* [Measures for the Administration of the Financial Licenses] (2007 No. 8).
[754] Interim Provisions on the Administration of Rural Mutual Co-operatives, art 15.
[755] Xie Yongmo, '*从"被边缘化"到"被山寨化"：农村资金互助社蹉跎三年* [From Marginalization to Fakement: Three Years of Tough Development of RMCs] [2011] Bankers. 71.
[756] Zhou Li, "*资金互助与穷人生计：7 省 11 家农民合作社调查*" [Money mutual and the life of poor people: investment of eleven rural co-operatives in seven provinces] in Zhou Li, *中国农村金融：市场体系与实践调查* [China Rural Finance: Market System and Practices] (1st edn, China Agricultural Science and Technology Press 2010). 199.
[757] He, Analysis of Financial Services by Farmers' Professional Co-operatives (n 567).

regulation, they could still register with local authorities' other departments such as civil affairs bureaux. However, there are concerns that such local authorities are unable to efficiently supervise RMCs as a *de facto* credit intermediary.[758] In practice, many of the local authority departments, for example, the affairs office, industrial and commercial bureau, and the office of agriculture, are assuming the duty of giving mutual credit co-operatives business permission, but are unable to provide further professional supervision after the permission has been issued. Those unlicensed RMCs fall outside prudential regulation and are *de facto* exempted from regulatory requirements, and therefore enjoy more flexibility than licensed ones, irrespective of the fact that their licence applications have been declined or they choose not to be authorized or their registration department is unable to carry out professional supervision.

More severe risks lie in those unlicensed lenders who deliberately use the name 'rural residents mutual credit co-operatives' to confuse depositors, and are accused of being a 'fake bank' (*山寨银行*，Shan Zhai Yin Hang) because they actually do not have a licence or are not efficiently supervised by any authorities but still take deposits from members who mistakenly believe they are joining a formal, licensed financial institution and their deposit is protected. These firms also do not need to comply with membership eligibility criteria, because they are able to attract more deposits from the general public by promising higher deposit interest rates. These firms could then lend the money out at profitable rates. Such unlicensed firms *de facto* turn into profit-making lenders and take semi-public deposits, while still using the similar, yet confusing, name as licensed RMCs, under the guise of being official but, in fact, without offering any protection or insurance. Risks behind this phenomenon may expose members to deposit risks, which has already happened in the Yancheng County of Jiangsu Province in 2012.[759] Without enough supervision, two mutual credit firms in Yancheng County deliberately lent members' deposits out to a non-member corporate, and when the borrower failed to repay the loan, a liquidity problem resulted and the two firms went out of business.

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758 Pan, Zhang and Kong (n 503).

759 See e Yicheng Zhang, '*浅析农民资金互助社异化原因*' [Reasons for Rural Resident Mutual Credit Co-operatives' Inappropriate Practices] <http://www.caein.com/index.asp?xAction=xReadNews&NewsID=85261> accessed 15 April 2015.

It is possible that the CBRC chooses not to prohibit unlicensed RMCs because of the limited regulating resources in its local bureaux. Regulators are more concerned about commercial banks that are more significant in terms of system stability rather than tiny RMCs. However, as the regulator for the banking system, it is irresponsible of the CBRC and its local bureaux to regulate only the 'licensed' RMCs, and leaving the riskier unlicensed ones outside their supervision. Although people who deliberately set up a fake bank and take public deposits would be punished under the criminal law, system stability within the region would still be influenced as *ex ante* prevention is lacking. This is in conflict with the CBRC's implicit regulatory principle, namely the value of system stability and depositor protection. The current licence regime is not only risky, but also unfair in terms of competition, as those licensed RMCs are bearing regulatory burdens because they choose to be regulated, while the unregulated ones have more flexibility in taking deposits. If there are compliance costs for licensed RMCs, while non-compliance would not lead to penalties, then the regime could be regarded as improper and unfair for those who choose to comply with the regulation. The current licence regime, as well as regulation for licensed RMCs, however, cannot support their development but could become a regulatory burden. Instead, it lacks proper monitoring of the 'regulatory perimeter' so as to exclude unlicensed RMCs from the market. The licence regime *de facto* loses its original purpose of controlling the entry of market participants to regulated activities. Failure in unified market entrance thresholds and the licence regime is *de facto* the primary cause that leads to the stagnation of the licensed RMC industry. Improper regulatory standards aggravate this situation.

3.3 Commercial bank in the community level: Regulation of village and township banks in China

The preceding sections discussed the benefits and drawbacks of mutual credit firms, and the regulatory regime in the UK and China respectively. Another form of community financial institution facilitated by the Chinese government that will now be examined is the VTB.

A VTB is a banking financial institution[760] set up in a rural area that provides local residents and enterprises with financial services.[761] In the array of banking institutions with the word 'bank' in their name in China, a VTB is the smallest in respect of the minimum amount of registered capital. Based on a firm's location, the minimum registered capital of a VTB shall exceed at least 1 million yuan (if set up in villages) or 3 million yuan (if set up in towns).[762] The official starting point of setting up VTBs is to provide more accessible banking services to township and rural residents, and to micro- to small enterprises, and to control informal usury practice by offering access to affordable credit in rural areas.

The advantage of VTBs is obvious. Compared with other kinds of 'new' financial institutions, VTBs are the only ones that have full access to basic RMB services for the local general public.[763] In contrast, an RMC can only serve its member, while small loan companies are forbidden from taking public deposits.[764] With access to inter-bank borrowing, VTBs also have more financial resources than RMCs who in reality can only use members' deposits.[765] VTBs therefore have special advantages in competition as they could provide the pubic with full access to banking and credit services. Theoretically, it could therefore fill the gap in deprived areas where large commercial banks lack incentives to re-enter the market or expand their service.

Furthermore, Du suggests several benefits of VTBs compared to 'traditional' or 'old' commercial banks.[766] First, the local feature of VTBs helps to relieve the information asymmetry problem in loan assessments.[767] VTBs are set up at community level and are thus more familiar with local residents' general information and potential repayment risks. Second, VTBs have more simplified

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[760] According to the Banking Supervision Law (2003), art 2, 'banking financial institution' refers to financial institution that can accept public deposit.

[761] CBRC, *村镇银行管理暂行规定* [Interim Provisions on the Administration of Village and Town Banks] (2007 No. 5), art 2.

[762] Ibid art 8(3).

[763] Ibid art 38.

[764] Although in the design of regulators, small loan companies (SLCs) in China are the inclusive-oriented lenders to fill the gap left by commercial banks; in reality, SLCs have largely turned into profit-seeking subprime lenders and lend money at high rates. Regulations for SLCs will be discussed in Chapter 4.

[765] Interim Provisions on the Administration of Village and Town Banks, art 38(5).

[766] Du Xiaoshan, '*村镇银行发展的成绩、问题和可能的前景*' [Progress, Problems and Possible Future: The Develop of Village and Township Banks] <http://wenku.baidu.com/view/00bf3e22a5e9856a56126080.html> accessed 15 April 2015.

[767] Ibid.

and effective loan approval processes than large commercial banks.[768] Their own staff could decide to whom to lend rather than sending the loan applications to higher branches as is the case in the large and medium banks' loan approval model.[769] Third, VTBs have lower operational costs because of their relatively small firm size.[770] Fourth, if a VTB becomes insolvent, considering the small size of its assets, capital and debt, it is less possible to incur systematic risks.[771] Moreover, Du also suggests that, once competition is well established, VTBs are able to attract local borrowers with lower interest rates than informal lenders, which could partly constrain usurious lenders' expansion in rural areas.[772] These benefits of VTBs may explain the positive attitude of the Chinese government and the CBRC of encouraging such institutions to be set up at county and rural level.

Ever since 2006 when the CBRC facilitated the entry and development of small financial institutions in the rural market, the VTB industry has experienced considerable expansion. As of October 2010, there are 1,000 VTBs operating in China.[773] The coverage percentage is also even: all 31 provinces and directly controlled municipalities now have VTBs in operation within the region, among which the central and western parts of China has 62%; 660 in total.[774] These regions are in general less developed than China's coastal region and therefore first require permission from the CBRC to pilot VTBs. However, research shows that there are still statutory and regulatory barriers in the VTB industry. The nationwide market penetration level of the VTB industry is still very low and only takes up a tiny market share in total.[775] There are several well-documented reasons for the constraints in the development of VTBs.

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768 Ibid.

769 In China, the decision-making power of personal loan applications in a commercial bank is usually held by municipal-level branches, rather than county-level branches. See *Long Wu, '国有商业银行县支行职能转变过程中的综合监督'*[Supervision During Role Transformation of Commercial Bank's County Branches] (2005) 351 South China Finance 45.

770 Du (n 766).

771 Ibid.

772 Ibid.

773 Ziman Yang, 'Village and Township Banks Hit 1,000 Landmark' *Chinadaily* (Beijing, 24 October 2013). <http://www.chinadaily.com.cn/business/2013-10/14/content_17031146.htm> accessed 23 March 2014. However, many VTBs are merged during the process. According to the CBRC Annual Report of 2013, there were 987 VTBs in total as at the end of 2013.

774 Wenting Zhang, '1,000 Village and Township Banks in China, Cover All 31 Provinces' (*people.cn*, 2013) <http://finance.people.com.cn/bank/n/2013/1013/c202331-23184349.html> accessed 1 March 2015.

775 There is no official data in the CBRC's annual report. However, a news report reveals that as at the end of March 2013, the total assets of VTBs across the country amounted to 454 billion yuan. See '903 Village and Township Banks Open Across the Country with Total Assets Reach to 454 Billion' (*people.cn*, 2013) <http://finance.people.com.cn/bank/n/2013/0618/c207834-

3.3.1 Strict regulatory standards for eligible setting-up promoters

Under the Company Law (2005), a 'promoter of a company'[776] refers to either an individual or legal entity that prepares and arranges the setting-up procedures of a joint stock limited company, who turns into a shareholder of the company after the company has been established.[777] Promoters must subscribe all or part of the shares that should be issued by the company, depending on whether there are remaining shares to be offered to the general public or specified persons.[778] This concept could also be applied to limited liability companies. For a common joint stock company, the law does not set special conditions for the promoter's eligibility. The rules are set out in two of the CBRC regulations.

In Interim Provision (2007), rules on the qualifications of promoters of VTBs are quite brief. The required promoter or capital investor of VTBs shall contain at least one banking institution, either domestic or foreign.[779] No further restrictions are given in this rule, which means private capital could also join in in the promotion process, together with a commercial bank. However, the main promoter of the setting-up procedure and the then controlling shareholder after the company has been established is restricted to only banking institutions.[780] What is implied in this requirement is that only banking institutions can lead the setting-up procedures of a VTB and be its controlling shareholder, while private investors without a financial licence can only 'follow' the steps of banks and will not have a controlling stake.[781] If several private investors wish to set up a VTB, what they need to do first is to invite a bank as the 'leader'.

21878283.html> accessed 1 March 2015.While the total assets of all banking institutions in China as at the end of 2013 reached 151.4 trillion. CBRC, Annual Report of 2013.

[776] In China's Company Law, a company is an independent legal person that bears liabilities for its debts with all its property. Shareholders of the company are only liable for the number of shares for which they have paid. Differences between a 'limited liability company (hereinafter 'LLC')' and a 'joint stock limited company (hereinafter 'JSLC')' lie in many aspects, for example, (i) shareholder amount. A LLC could have 2-50 shareholders, while a JSLC only has minimum 5 shareholder requirement; (ii) minimum share capital, (iii) whether shares could be freely sold to the public. In general, an LLC in China is similar to a private limited company under UK Companies Act, while a JSLC in China is similar to UK's plc.

[777] China Company Law (2005 amendment), arts 77-80.

[778] Ibid art 78.

[779] Interim Provisions on the Administration of Village and Town Banks, art 8 (2).

[780] Ibid art 25

[781] Ibid.

This restrictive requirement was detailed further in a Notice of the CBRC in 2011,[782] in which the standard for main promoter was raised. Promoters of a VTB shall still contain at least one banking institution. However, the main promoter (and the controlling shareholder, after the firm has been established) must be a banking institution with a last annual supervisory ratings scores of 2, 2+ or 1, using the 'CAMELS+' rating system.[783] The main promoter shall also employ sufficiently qualified staff and meet other prudential regulatory standards required by the CBRC.[784] These rule changes *de facto* raise the threshold for banks as eligible promoters of VTBs. The strict requirement remains in Measures (2014).[785]

The real effect of this restrictive standard on the VTB industry lies in several aspects. It sets up an entrance threshold for banks who wish to set up and control a VTB. Only those banks scoring 2 or 1 are eligible to assume the role of main promoter under the current rule. The purpose of the CBRC is to keep the rural financial market stable by preventing unqualified banks from controlling a VTB. A bank that scores 2 or above in the CAMELS+ system is well operated in respect of supervision, so it can take the responsibility of setting up a VTB and, more importantly, of following up on management of its subsidiary. Although a VTB is an independent legal entity and is legally separate from its controlling shareholder, in the current bank management model, the holding bank usually takes the duty of managing its subsidiary VTBs by setting up a separate management department inside the bank.[786] Banks with a higher score in the rating system are therefore assumed to be more capable of managing a separate VTB in respect of, for example, the qualifications and ability of directors and senior managers sent from the holding company to the subsidiary.

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[782] CBRC, *关于调整村镇银行组建核准有关事项的通知* [Notice of the CBRC on Adjusting Matters Relating to the Approval of the Formation of Village and Township Banks] (2011 No. 81).
[783] China's CAMELS+ system is based on the commonly used international CAMELS rating system with Chinese characteristics, using six components, including capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. There are six levels of scoring in total, 1 is the best and 6 is the worst. More details about China's rating system are set up in CBRC, *商业银行监管评级内部指引* [Internal Guidelines on Supervisory Ratings for Commercial Banks] (2005 No. 88). An English news report available at <http://www.cbrc.gov.cn/EngdocView.do?docID=2210> accessed 1 March 2015.
[784] Notice of the China Banking Regulatory Commission on Adjusting Matters Relating to the Approval of the Formation of Village and Township banks (2011 No. 81).
[785] Measures of CBRC for the Implementation of Administrative Licensing Matters Concerning Rural Medium and Small Financial Institutions (2014 No. 4), art 28.
[786] CBRC, *关于加快发展新型农村金融机构有关事宜的通知* [Notice of Issues about Accelerating Development of New Rural Financial Institutions] (2010 No. 27), s 7.

This standard, however, is also too restrictive, as the majority of city commercial banks cannot score 2 in the rating system. For example, as at the end of 2010, the Bank of Luoyang was the only city commercial bank in Henan Province that reached a score of 2,[787] yet the Henan Province has at least 13 city commercial banks in operation. Besides, none of the city commercial banks in China has ever reached the score of 1. A newspaper article mentions the fact that only large commercial banks (ie, the 'big four') and joint-stock commercial banks (who are, in fact, less interested in getting involved in setting up VTBs, as discussed in Chapter 2), could score 2 or above.[788]

Therefore, the '2 or above' threshold becomes a new restriction for the VTB industry. It is the city commercial banks who show the biggest interest in setting up VTBs.[789] Large and medium banks have less incentive to re-enter the county and rural markets from which they once withdrew, since they could earn huge benefits in their mature urban market throughout the country. A reason for major banks setting up VTBs is suggested as merely 'responding to the CBRC'.[790] In contrast, city and rural commercial banks usually have fewer branches and wish to expand their market access and get more RMB licences by setting up VTBs. It is a new strategy for expanding the market for the small banks, while at the same time, local residents would benefit from available banking facilities and affordable credit. Ideally, here lies a 'win–win' situation. The current threshold on main promoters for setting up a VTB, however, is inviting those uninterested banks into the industry, while keeping those with more incentives outside the realm.

3.3.2 Lack of regulatory incentive for eligible commercial banks

Under the restrictive rule discussed above, VTBs' main promoter and future holding company must be a commercial bank, and since in reality the eligible commercial banks are largely the state-controlled and joint-stock commercial

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[787] Bank of Luoyang, 'About Us' <http://www.bankofluoyang.com.cn/Aboutus.asp?Id=89> accessed 28 March 2014.

[788] 'Supervisory Scoring Must Reach Score 2, Village and Township Banks Met Difficulties in Seeking Main Promoter' (*China Business News*, 2012) <http://www.yicai.com/news/2012/12/2370398.html> accessed 28 March 2014.

[789] Yibing Zhu and others, '*商业银行发展村镇银行业务之路*' [Path for Commercial Banks Develop Village Bank Business' Deloitte (2012) 3.

[790] Ibid.

banks, it is essential for the regulator to offer enough incentive for them to set up VTBs.

In order to facilitate more VTBs to be set up in deprived areas, the CBRC indeed provides some rewards to commercial banks. According to a 2006 Notice of the CBRC,[791] the regulator[792] can examine and approve applications for setting up VTBs prior to other kinds of branch-opening applications, if all other conditions of the two applications are on the same level. This priority reduces the time of waiting for approval, so the main promoter who wishes to grab a rural market share could enter into the market easier. However, this is only a suggestion rather than a rule for the local CBRC bureaux and provides no incentive for banks that do not have such plans.

Another way of stimulating the setting-up of VTBs taken by the CBRC is the 'link-up' policy.[793] This policy links the setting-up of VTBs in rural areas to licences of other RMB market services. Commercial banks who wish to open a new branch or a VTB in a mature market in rich regions, they have to set up a VTB or a branch in a deprived area at the same time; if the 'link-up' objective is unsatisfied, the CBRC shall not approve its application of setting up a VTB in an urban area.[794] The CBRC also proposes to report the real effort of commercial banks in the process of setting up VTBs in deprived areas.[795] The CBRC describes this effort as a 'social responsibility' of large and medium banks.[796]

However, the real effect of this policy is not as satisfying as the CBRC proposed. Deloitte's data show that as at the end of 2011, large and medium commercial banks had promoted 78 VTBs in total, while the number of VTBs promoted by city commercial banks is 273; almost 3.5 times higher than the former. Zhang concludes several aspects from the reluctance of large and medium banks to set up

[791] Some Opinions of CBRC on Adjusting and Relaxing the Access Policies for Banking Financial Institutions in Rural Areas and Better Supporting the Construction of New Socialist Countryside (2006 No. 90), s 2.
[792] Here it means the local bureau of the CBRC at provincial or municipal level.
[793] Notice of the CBRC on Adjusting Matters Relating to the Approval of the Formation of Village and Township Banks.
[794] CBRC, *关于做好《新型农村金融机构 2009 年-2011 年总体工作安排》有关事项的通知* [Notice of CBRC on improving issues about 'Work arrangements of new-type rural financial institutions in 2009-2011'] (2009 No. 72), pt 2.
[795] Ibid pt 4.
[796] Ibid.

VTBs, and notes that the profitability of controlling a VTB is lower than their own branches.[797] Moreover, large and medium banks had already set up sophisticated networks of branches in rich eastern region during the years of expansion. The 'link-up' policy is, hence, less stimulating, since large and medium banks, on the one hand, have less incentive to open new branches in rich regions, and, on the other hand, in those regions commercial banks are also reluctant to set up new VTBs, as this would increase competition for the existing bank branch.[798] What is more, there are also reports that some commercial banks set up VTBs in deprived areas only as an exchange for opening new branches in rich areas.[799] The 'link-up' policy is therefore *de facto* less effective than what it proposes to improve, although with a good starting-point. However, for eligible city commercial banks who have an incentive to operate across the region by opening more branches, this regulatory reward is more meaningful. Nevertheless, since only a city commercial bank scoring 2 or plus in the 'CAMELS+' rating system are eligible to open cross-region branches,[800] the main force of setting up VTBs is therefore still the state-controlled and joint-stock commercial banks. Without more effective incentive in regulations, the current condition could hardly improve.

3.3.3 Restrictive rules of cross-regional business

At present, VTBs are restricted from taking deposits outside the region of their registered location. An Opinion of the CBRC clearly clarifies its attitude of forbidding VTBs' cross-regional business from the aspect of controlling risk and maintaining local system stability, as well as keeping VTBs' inclusive feature of serving the rural household and small enterprise.[801] Under this Opinion, a VTB registered in County A is not allowed to take deposits or give loans to a resident living in nearby County B. It can only provide services to local residents living in County A. One consideration of this prohibition is to avoid VTBs giving up their local feature: if the cross-regional business is allowed, then there will be risks that

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[797] Minggui Zhang, '*发展村镇银行难在何处*' [What are the obstacles to village and township bank development?] [2011] Modern Financiers.
[798] Ibid.
[799] Ibid.
[800] CBRC, *城市商业银行异地分支机构管理办法* [Measures for the Administration of Non Home-City Branches of City Commercial Banks] (2006 No. 12).
[801] CBRC, *关于加强村镇银行监管的意见* [Opinions of China Banking Regulatory Commission on Strengthening the Supervision over Village and Township Banks] (2007 No. 46).

a VTB would use local residents' deposits to serve individuals and enterprises outside its registered place to earn better profits. Local depositors' access to loans, on the contrary, would be harmed. This condition that the regulator proposed to avoid, in fact, actually happened in the 1990s, when local RCCs were described as 'pumping' out local deposits to urban areas. Therefore, VTBs are prohibited from providing cross-regional loans and from taking deposits to avoid similar cases.

However, this prohibition would also constrain VTBs' ability to take deposits and, more importantly, lead to the loss of its inclusive feature. Since a VTB is prohibited from providing loan and deposit services outside its registered region, the only way it could expand its market is to open a new branch. However, according to the CBRC, a VTB is not allowed to open a branch outside its registered region. It can only set up a branch in towns within its registered region, if the VTB is well operated and prudential supervision standards are met; for example, if a VTB is registered in County A, then it could open branches in towns B, C, D. In contrast, if a VTB is set up in town E, then it cannot expand its market since a township is the lowest level of the administrative regions in China. Other towns are parallel with its registered region, so it will not be able to expand the market. Therefore, VTBs would tend to register at county level in order to avoid such restrictions.

Ideally, local residents who live in towns and villages could still have access to the bank if there are branches in their town. However, at present, the majority of VTBs do not qualify to open branches, nor would they have enough capital to do so. The limitation on providing services to residents outside their registered location would cause VTBs to lose their feature of 'village and township', and serve local enterprises rather than low-income rural residents.

For example, the Commissioner of Ministry of Finance Guangdong Office worried about the deviation from VTBs' original purpose in an official news article,[802] which mentions that among the total of 16 VTBs operating in that province, only two had issued more than 40% of rural households with loans of

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[802] Guangdong Commissioner Office Ministry of Finance, 'Stay Alert for Village and Township Bank's Tendency' <http://gd.mof.gov.cn/lanmudaohang/caizhengjiancha/201201/t20120109_621990.html> accessed 2 March 2015.

the total loan amount.[803] The article shows that the main customers of VTBs are actually small enterprises at county level rather than township and village residents.[804] Moreover, those VTBs would usually require guarantees for personal loan products rather than base the loan on personal creditability. [805] The commissioner therefore suggested that VTBs set up at township level and, furthermore, richer regions with mature market competition should not be allowed to set up new VTBs.[806]

However, it should be noted that the restrictive rule of cross-regional businesses could not solve the problem; restricting VTBs from setting up at county level will also lead to an unwanted result, namely of reducing the firm's sustainability, since a VTB set up in a town is not allowed to serve residents in nearby towns and can only serve the limited small market in subsidiary villages. If a VTB cannot grow to be self-sustainable and has to rely on its controlling bank, the percentage of loans to individual low-income customers would be further reduced. This is contrary to the CBRC's purposes.

A recent change in this regulatory barrier is the pilot 'municipal' VTBs set up in selected provinces.[807] According to the CBRC, VTBs are able to register in cities in the western provinces (except for the provincial capital city) and in under-developed cities in the middle part of the country, which has areas that are traditionally regarded as under-served when it comes to financial services. The headquarters of a VTB is allowed to be registered in municipal cities, with its branches located in the counties of the municipal city, so the whole municipal region is blanket-covered. Deposits taken by the headquarters shall be mainly used for the local branches' loans, while deposits taken by branches shall be entirely used for local loans. The headquarters could provide RMB services, except issuing loans. This rule in general provides another way of solving the restrictive rule of prohibiting cross-regional business. However, if not properly regulated, the danger would be that VTBs would become another city commercial bank and not mainly serve local rural residents.

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[803] Ibid.
[804] Ibid.
[805] Ibid.
[806] Ibid.
[807] CBRC, Notice of Issues about Accelerating Development of New Rural Financial Institutions.

3.4. Summary

This chapter discussed the legal and regulatory arrangements of alternative access to credit for low-income customers in both the UK and China. Two kinds of firms are discussed: (i) mutuals, including credit unions in the UK and RMCs in China, and (ii) VTBs in China. Both are regarded as an alternative solution to the credit gap left by commercial banks. Therefore, how the law and regulations facilitate their growth is analysed in this chapter.

For the issue of financial exclusion in the respect of consumer credit, the establishment of mutuals or co-operatives is a useful way of enhancing people's access to affordable credit. The member ownership structure of the firm gives mutuals more special benefits than corporates do, making it possible for low-income members who are usually ineligible to prove their creditability through the traditional manner of assessment in commercial banks. Mutuals are also suitable for maintaining long-term relationships between firms and members, and promote the development of the firms. In both the UK and China, the significance of a mutual-style credit firm is recognised by governments as one way to solve financial exclusion, since commercial banks are usually reluctant to provide services to low-income customers or in deprived remote areas. In fact, it appears that the main solution taken by both countries for financial exclusion is to set up new institutions that focus on the lower end of the market. Credit unions in the UK and RMCs in China are examples of the attempts made in this regard.

As those mutual firms are usually small in asset size, their capacity to serve more members' credit needs is usually limited by firms' available fund resources. For mutuals, available funds mainly include members' deposits and external investments or grants. Therefore, ways to strengthen mutuals' sustainability include two aspects: first, permitting the mutual serves multiple groups of people to enlarge its membership size, thus taking more deposits. This requires regulations to reduce the strict common bond or eligible membership rule. Second, mutuals may also need external investments or grants, especially in the setting-up stage. Whether statute and regulations could support mutuals in these two aspects is therefore essential. Furthermore, in respect of prudential regulation, the small size of a firm decides that they shall be treated differently from large commercial banks; otherwise regulations may become another burden for mutuals.

Generally, the legal and regulatory environment for credit unions in the UK is appropriate for firms' development. Through several legislative amendments, the rules of common bonds have now been relaxed for multiple groups, leaving enough space for UK credit unions' future development. In respect of prudential regulations, small and large credit unions are also distinct in avoiding a rigid application of the rule regardless of the differences in size of the credit unions. In contrast, eligibility for membership rules of RMCs in China still have the most stringent status, which partly reflects the nascent stage of mutuals in the country. The prudential regulation for RMCs adopts the 'one-size-fits-all' approach and treats RMCs on the same level as commercial banks. However, before the licence issue of fake RMCs can be settled appropriately and RMCs be covered by the deposit insurance regime, it is unlikely that the CBRC would reduce current regulation standards to support industry growth. The prudential attitude of the CBRC is, however, a hindrance for any further developments in the industry.

Issues related to VTBs in China were also noted. As China's banking regulator, the CBRC maintains the prudential attitude of setting up depository institutions: only commercial banks are allowed to 'lead' the process of setting up a VTB. However, owing to the regulatory requirement, only larger and medium banks and part of the smaller banks that score 2 or higher are eligible, while the former usually do not have enough incentive to do so, nor do regulations provide appropriate rewards for participating banks. After the VTB has been set up, its operation is further limited by regional restrictions. The effect of the restriction is, however, contrasted with the CBRC's original purpose of maintaining VTBs' inclusive feature. In fact, although being endowed with an inclusive orientation by the CBRC, the essence of a VTB is still that of a commercial bank or, in other words, a profit-maximizing corporate. This is essentially the distinction between VTBs and RMCs, as the latter are non-for-profit-maximizing firms.

In fact, it is inevitable for those alternative lenders who are set up within the mainstream to make a profit. Irrespective of whether it is a mutual or VTB, they all need to grow and expand to increase sustainability. Before the access problem to credit for low-income residents is solved, the law and regulations shall give the sustainability of the firm priority. There are legal and regulatory barriers that could be removed to fulfil this aim. At the same time, it should be recognized that as these alternative community small lenders develop, they are inevitably going to include more affluent customers in their customer base, who are, in fact, the backbone of the firms' sustainability. In order to facilitate firms to serve more low-income customers who are both risky and less profitable, the regulatory system shall not be 'one size fits all' to provide additional space and rewards for small firms operating in deprived communities, and if the regulation standard is distinguished by firm size, mature prudential regulation experiences are also essential to avoid potential liquidity problems. Regulations shall therefore maintain a balance between supporting firms' growth and keeping firms stable.

Chapter 4: Responsible lending: Customer protection through conduct regulation and private law in the subprime credit sector

On 1 April 2014, regulatory power over all consumer credit firms in the UK was taken over by the brand-new regulator, the FCA, from the OFT.[808] This is a remarkable turning point as all firms doing businesses in this sector are now under the supervision of the new authority, and must renew their licences and obey new conduct rules. Firms are proportionately regulated based on different levels of risks posed to customers. Among them, high-risk consumer credit lenders are under enhanced supervision as they may lead to higher risks to consumers in financial difficulty. The FCA has the enforcement power to punish those firms who behave unfairly or dishonestly in dealing with customers. In contrast, local courts provide a redress regime to customers who are unfairly treated, who could also complain to the FOS services under the Consumer Credit Act 2006. Both the *ex ante* conduct of business regulation and *ex post* dispute resolution provides consumers with safety protection in consumer credit markets.

The conditions in China, however, are still similar to that in the UK before the 1970s. Different consumer credit firms are regulated separately, echoing the industry's juvenescence at this stage. Rules of conduct regulation are sketchy, and the law and regulations do not clarify which regulator is responsible. Customers in China rely heavily on judicial solutions when disputes arise, which is neither economical nor practical. Two suggestions for China are made in this chapter: (i) set up more detailed but appropriate conduct rules with regard to responsible lending and information disclosure, and (ii) when possible, provide better and simple dispute solution method for customers.

4.1 Empirical evidence of the subprime lending market's weaknesses

The consumer credit market is usually complex. At the top of it are the mainstream lenders, which mainly include commercial banks, mutual credit

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808 FCA, 'FCA Takes over Regulation of Consumer Credit Firms - Research Shows 9m People Are in Serious Debt and 1.8m in Denial' <http://www.fca.org.uk/news/fca-takes-over-regulation-of-consumer-credit-firms> accessed 20 March 2015.

institutions (eg building societies and credit unions in the UK, rural credit co-operatives in China) and other credit facilities. There are also licensed moneylenders in the subprime market. In the literature on the consumer credit sector, the description of *subprime lending* is basically equivalent to 'fringe banking', and both 'subprime', 'fringe' and sometimes 'alternative' are used in similar context, which describes its non-mainstream and secondary status.[809]

Some lenders in the subprime credit market have a longer history (eg, pawnbrokers[810] and mail order retailers[811]) but their numbers have declined with time, while several new lenders have developed in recent decades and then expanded rapidly;[812] for example, the typical subprime lender in the UK, the payday lender, has continued to grow during recent years under the name 'high-cost, short-term' lender. Another kind of subprime lender is the pawnbroker. Monthly interest rates charged for pawnbroking in the UK range from 5 to 12%, according to an NPA survey[813] The amount of the loan is based on the value of the pledged item evaluated by the pawnshop; generally, it will extend half of the resale value.[814] In traditional points of view, pawnbroking is closely related to usury and thus less appealing to consumers,[815] as it requires borrowers to depart

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[809] Ramsay, 'Access to Credit in the Alternative Consumer Credit Market'(2000). This thesis will also use the conceptions in the same context, as different name will not change the nature.
[810] The history of pawnbroking can be traced back to ancient and medieval ages. For research on pawnbroking in ancient China, see Lien-sheng Yang, 'Buddhist Monasteries and Four Money-Raising Institutions in Chinese History' (1950) 13 Harvard Journal of Asiatic Studies 174. Pawnbroking also exists in medieval Britain, see, for example, William AH Hows, *A History of Pawnbroking, Past and Present* (1847).
[811] In the UK, mail order offers people a way to buy goods by post and pay in weekly instalments, either interest-free or not. See Citizens Advice Bureau, 'Mail Order Catalogues' <http://www.adviceguide.org.uk/wales/debt_w/debt_borrowing_money_e/debt_types_of_borrowing_e/mail_order_catalogues.htm> accessed 20 March 2015.The industry in the Britain started in the late nineteenth century and succeeded in providing credit to the working class in the country in the 1950s to 1970s, see, Richard Coopey, Sean O'Connell and Dilwyn Porter, *Mail Order Retailing in Britain: A Business and Social History* (1st edn, Oxford University Press 2005).
[812] Christopher L Peterson, 'Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits' (2008) 92 Minnesota Law Review 1116. Peterson notes that payday lenders did not exist in the US 30 years ago. However, in 2005, the number of payday lender outlets in the country exceeded McDonald's, Burger King, Sears, J.C. Penney, and Target stores combined, and that within only three decades.
[813] Sharon Collard and David Hayes, 'Pawnbroking Customers in 2010: A Survey. A Report to the National Pawnbrokers Association' (2010).
[814] Elaine Kempson and others, 'In or Out? Financial Exclusion: A Literature and Research Review' (2000).Kempson and others.
[815] Early research on US pawnbroker and regulation pointed out that the reason for interest rates being capped was not only to protect consumers, but also the popular identification of pawnbrokers with usurers. See, PP. III, 'Pawnbroker Regulation and the Pennsylvania Act' (1940) 89 University of Pennsylvania Law Review and American Law Register 104.

with their property to use as collateral.[816] Similar to pawnbroking, is auto-title lending, as borrowers pawn the title of their vehicle for a short-term loan at high interest rates. However in this case, the consumers can keep their vehicle until the loan is repaid or, where they default, the lender gains possession of the vehicle.[817] Proceeds from interest and fees are found to be more profitable than the resale value of the car obtained through repossession, and the repossession cost and legal fees are quite high compared to the value of the car. Lenders would rarely seek defaulting from their customers.[818]

China has also increasingly become accustomed to subprime moneylenders in recent years. The most common one is the small loan company which provides both secured and unsecured loans to individuals and small enterprises. According to the CBRC, there were 8,394 small loan companies in the whole country as of June, 2014. Loan products are diversified, the amount of a personal loan usually varies from a small amount of 3,000 yuan to 100,000 yuan (approx. £300 to £10,000) based on borrower's income level, occupation, or value of their secured property. The minimum loan period is usually three months. Customers can choose to repay their debt automatically directly from their bank account, usually on a monthly instalment basis. Since the 1990s, pawnbrokers have also been revived in China after being prohibited by government for several decades. They provide instant cash for secured property.[819]

Although complex in company types and products, in essence, subprime lenders are similar. No matter what kind of products they provide, they make profit from high interests, fees and penalties from lending. This similarity makes it possible to abstract a definition of *subprime lending*.

Ramsay defines *subprime lending* as 'a variety of financial services and credit selling which target the bottom third of the economic ladder and/or individuals

[816] Todd J Zywicki, 'Consumer Use and Government Regulation of Title Pledge Lending' (2010) 21 Loyola Consumer Law Review 425.
[817] Jim Hawkins, 'Credit on Wheels: The Law and Business of Auto Title Lending' (2012) 69 Washington and Lee Law Review 535.
[818] Ibid. See also Zywicki (n 816). Zywicki mentions that among the 14 to 17% of title loans in default only about half of them resulted in vehicle repossession, because many cars are not worthwhile reselling.
[819] See, for example, *Haihua Yu and Yanping Li, '南昌典当业发展前景及其建议'* [Prospect and advice on the pawnbroking sector in Nanchang city] [1994] 10 金融与经济.

with spotty or blemished credit histories'.[820] Similarly, Caplan describes *fringe banking* as 'the arena of financial services that enables people with bad or no credit and without access to mainstream financial institutions to obtain money'.[821] The intrinsic similarity between different types of credit services provides the ground for consumer credit regulation and customer protection, no matter how the lender deals with its customers.

4.1.1 The three tiers of the subprime credit market

In the 'subprime' context, many would agree that there are two broad tiers of lenders targeting different groups of people, namely those who have blotted credit records, and those who are more vulnerable in economic status.[822] Both are, however, vulnerable to lenders' misconduct.

Specifically, customers in the upper tier in the market tend to be better off and can secure their loans with their property.[823] They are not necessarily living on very low income; for example, Zywicki confirms the relatively better economic status of some title loan customers, some of whom are small business owners.[824] The reason why they are rejected by banks is mainly due to their poor credit records or history of bed debts, or they have already reached the credit limit with mainstream banks.[825] Similarly, the main customer group of small loan companies in China is small business owners, rather than low-income individuals.

The next tier in the subprime credit market, based on the classification of Kempson et al, serves people who are in a more vulnerable economic status than the first group, namely those who have a lower or unstable income. However, these people still have some sort of creditworthiness: this could include a fixed home address, a job and a bank account, if the loan is unsecured; or a valuable property that can be pawned, if the loan is secured. This market in the UK is represented by payday lenders and pawnbrokers, and many other licensed

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[820] Ramsay (n 809).
[821] Mary Caplan, 'Addressing Inequality in the Financial Services Market Place' (2012).
[822] Kempson and others (n 814) para 3.120.
[823] Peter Cartwright, Banks, Consumers and Regulation (1st edn, Hart Publishing 2004) 239.
[824] Zywicki (n 816).
[825] Kempson and others (n 814) para 3.120. Similarly, in the mortgage market, subprime mortgage lenders also target people who usually have work and an income but are not eligible to access mainstream banking.

moneylenders who offer small loans to customers. The customers of payday lenders, for example, usually have a job and repay their loan with their next month's salary directly from their bank account.[826] Furthermore, the consumers of pawnshops often do not own collateral to secure a minimum bank loan, and are judged too risky for unsecured credit.[827] Typically, pawnshop borrowers have been turned down for a payday loan and use pawnshops as their last resort.[828]

In addition to licensed lenders, there is usually an underground credit market filled with unlicensed moneylenders. This market serves the most vulnerable people who cannot even reach the second tier of the credit market. Collard and Kempson suggest that unlicensed lenders are widespread in the UK's low-income neighbourhoods.[829] O'Connell regards this market as a 'sub-sub-prime sector' filled with illegal lenders and more inferior than the subprime sector.[830] Lenders are usually criticized for being usurious or predatory, or being 'loan sharks'. Features of loans sharks defined by the Citizens Advice Bureau are cited here:

> loan sharks often work from home, charge very high rates of interest and don't give you much paperwork to confirm the arrangements they have made with you; loan sharks often take other illegal action to collect the money they have lent you, such as threatening violence or taking away your credit cards or valuables.[831]

On this issue, there is a special concept, 'informal lending and borrowing' (*民间借贷*, *MinJianJieDai*) in China's legal context. When it is mentioned in Chinese legal literature, several different meanings are used in different contexts. In the narrow sense, it refers to the lending activity between individuals, or between individuals and non-financial entities. In contrast to it is the so-called formal lending between customers and any licensed lenders, either mainstream or subprime. People are free to set up loan contracts with other individuals or

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[826] Timothy Edmonds, 'Payday Loans: Regulatory Reform'(2014).
[827] John P Caskey, 'Pawnbroking in America: The Economics of a Forgotten Credit Market' (1991) 23 Journal of Money, Credit and Banking 85.
[828] Zywicki (n 816).
[829] Collard S and Kempson E, Affordable Credit: The Way Forward (1st edn, The Policy Press 2005) 10-13.
[830] Sean O'Connell, *Credit and Community: Working-Class Debt in the UK since 1880* (1st edn, Oxford University Press 2009) 169.
[831] Citizens Advice Bureau, 'Loan Sharks' <http://www.adviceguide.org.uk/england/debt_e/debt_borrowing_money_e/debt_types_of_borrowing_e/debt_loans_e/loan_sharks.htm> accessed 10 March 2015.

enterprises. The activity is *per se* legitimate and is legally protected by China's Contract Law.[832]

However, in recent years, the description 'informal lending and borrowing' has also been understood in a broader sense, namely borrowing money from unlicensed moneylenders or 'underground money shops' (*地下钱庄*, *DiXiaQianZhuang*). Customers are largely small enterprises that need the wherewithal to maintain production, but also include vulnerable individuals who need credit to deal with emergency situations but have no access to licensed lenders. For example, research on usury in China gives nine main reasons why people borrow from underground lenders, among which are (i) dealing with an unexpected emergency, (ii) trying to make ends meet, (iii) paying for medical care, (iv) borrowing to repay old debt, (v) paying for a wedding or funeral.[833] Underground lenders serve this market without a valid banking licence, however conducting similar business to commercial banks and dealing with the public. Some therefore call them 'China's shadow banks'.[834] This is China's underground credit market where usury practices (*高利贷*, *GaoLiDai*) are rampant, especially in the rural areas where residents have a lower income, and where banking outlets are rare.[835]

Irrespective of whether it is in the UK or China, underground lenders are viewed as illegal, not only due to their usurious charges and other possible illegal actions, but also because the financial authority requires all moneylenders to have a licence to operate a lending business. Therefore, it is more common to use financial regulations to regulate licensed lenders who conduct their business improperly, while using criminal law in the case of illegal underground moneylenders who abuse customers.

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[832] Contract Law of the People's Republic of China (1999) Chapter 12, ss 196-211.

[833] Ruiming Liu, '*高利贷借贷的逻辑*' [Logic of high-cost loans] Working Paper of China Northwest University (2004).

[834] See, eg 'Shadow Banking in China: The Wenzhou experiment, China Unveils a Pilot Programme to Legitimise Informal Lending' (*The Economists*) <http://www.economist.com/node/21552228> accessed 10 March 2015.

[835] See, for example, Ethan Wilkes, 'For China's Rural Poor, Life Without Banks' (*The Atlantic*) <http://www.theatlantic.com/china/archive/2013/03/for-chinas-rural-poor-life-without-banks/274435/> accessed 10 March 2015.

In contrast to underground moneylenders, subprime lenders are at least under moderate regulation control, which reduces the risk they could pose to consumers. Moreover, they *de facto* fill the gap left by banks in the consumer credit market, making subprime lenders essential to the market before alternative lenders such as credit unions could take over. Vulnerable people who have to make ends meet or deal with emergencies and need additional money should ideally have their demands met either by the state welfare system or by access to widespread, affordable credit to help them live a decent life and remain free from usurers' exploitation.[836] However, in reality, as discussed in previous chapters, their demands cannot be met by commercial banks, nor would it be realistic for regulators to require banks to do so. The subprime lending sector, in contrast, provides an available choice that could, at least partly, fill the gap left by banks and the welfare system. This gap-filling function is perhaps why subprime lenders are legally licensed to lend at higher interest rates.

The necessity for the subprime lending sector is perhaps more evident in China, where the consumer credit sector is highly monopolized by banks. Privately held lending companies without bank-shareholding were allowed to set up only a few years before. For low-income Chinese citizens, even licensed subprime credit is also scarce. The problem in China is the lack of trustworthy credit resources, rather than too many of them. Too-tight regulations (eg, interest rate cap) will possibly lead to the market exit of licensed moneylenders, leaving customers vulnerable to underground usurers. Similar concerns also exist in the UK, as some argue that regulations could become a burden for subprime lenders.[837] However, this concern cannot exempt subprime lenders from being regulated. Before the available alternative choice developed into a large scale and can be easily accessed, vulnerable customers should be protected from being severely harmed by the moneylenders' misconduct. An appropriate level of regulation should be set to deal with this issue.

4.1.2 Harmful issues related to the subprime lending market

[836] I am grateful to Professor Iain MacNeil for the discussion on this point.
[837] See, for example, James Titcomb, 'Payday Lenders Hit as Watchdog Sets Tough New Rules on Industry' *The daily telegraph* (16 July 2014) B5.

Although being licensed lenders, subprime lenders' practices could damage customers' welfare in many respects.

The first issue is the high costs of borrowing money from lenders. The idea that 'subprime credit is expensive' sounds like a cliché, but it is indeed more costly than loans from banks. It is reasonable for a subprime lenders to set higher APRs due to customers' higher risk level. However, excessively high interest and fees can be usurious and unfair.

For example, on the homepage of one famous payday company in the UK, the lender discloses the costs and fees of its loans, for instance, the APR goes up to 1,509%.[838] Although this is not the actual interest rates borrowers would pay, as the typical length of a loan would not be as long as one fiscal year but only last a short period such as 14 days, it is undeniable that the interest rates charged on payday loans are higher than other consumer credit products supplied by credit unions or commercial banks, or even other alternative lending services.[839] Hence, the payday lending industry is viewed by its opponents as predatory, or usurious; its critics argue that such high interest will be too burdensome for vulnerable borrowers and may trap them in debt cycles.[840] In China, because there is a legal cap on loan interest rates, moneylenders usually choose to charge additional fees to avoid breaking the law on the legal usury cap. A local court in Chongqing, China confirmed the high costs of loans provided by moneylenders, which include 'handling charge, loan management fee, consultancy fee [and] default management fee'.[841]

The next issue is information disclosure. Whereas rich or better-educated customers could use own knowledge or hire experts to make proper

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[838] 'Wanga' (*Wanga.com*) <https://www.wonga.com/> accessed 10 March 2015.
[839] Because a payday loan is 'unsecured' compared pawnbroking or title lending, the APR on title loan is typically 120-300%, depending on the loan amount, which is lower than the unsecured ones. See Zywicki (n 816). A report of the National Pawnbrokers Association shows that the monthly interest rates across the UK ranges from 5% to 12%. See Collard and Hayes (n 813).
[840] Mark Flannery and Katherine Samolyk, 'Payday Lending: Do the Costs Justify the Price?' (2005) No. 2005-09; Paige Marta Skiba and Jeremy Tobacman, 'Do Payday Loans Cause Bankruptcy ?' 6; Richard M Hynes, 'Does Payday Lending Catch Vulverable Communities in a Debt Trap?' (2010) No. 2010-08.
[841] '*规范经营模式 促进健康发展—重庆市江北区人民法院关于非银行金融机构涉诉涉法问题的调研报告*' [Report about Non-Banking Financial Instutotions' Legal and Dispute Issues from People's Court of Chongqing Jiangbei] *Newspaper of People's Court* (30 January 2014).

judgements,[842] customers in the subprime market are usually not very experienced in understanding loan contracts. Mistakenly entering into an improper loan commitment without comparing different products holds the danger of further financial difficulties. For example, customers may not be aware of the real cost of loans and be charged unexpected fees. The CBRC issued a warning for potential customers of moneylenders, reminding them to stay alert when it comes to online loan advertisements that promise 'an unsecured, fast loan at low interest rates', as some of them advise people irresponsibly and others are fraudulent.[843] What is more, subprime lenders are usually criticized for using advertisements targeted at certain consumers, for example, under-18-year-olds or other vulnerable people, or suggest that payday loans could be used to pay for shopping.[844]

The third feature of the subprime lending sector comprises irresponsible lending practices. Generally, lenders' responsible lending means properly assessing customers' creditworthiness and loan affordability; the former means lenders could anticipate that loans would be repaid, while the latter means borrowers can afford the debt. In contrast, irresponsible lending usually means offering unaffordable credit products to customers without checking their repayment ability. Customers may still be able to repay on time, but with financial difficulty. Since people who borrow from subprime lenders usually only have a limited income, any life emergency could lead to the danger of them defaulting. For example, a report on the financial difficulties the customers in the UK experience suggests that people who are in arrears in their household commitments are also largely in debt and have to use their limited income to repay their borrowing.[845] Customers' vulnerable status could be exacerbated by lenders' irresponsibility, dishonest advertisements and hidden high costs, making it more difficult to save up money for future use. For example, a major concern of the opposition to title loans is that default will cause the customers to lose perhaps their most valuable property and the only way of transportation to work.[846] In addition, high costs

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[842] Oren Bar-Gill and Elizabeth Warren, 'Making Credit Safer' (2008) 157 University of Pennsylvania Law Review.

[843] CBRC, '*防范金融风险 警惕非法贷款广告*' [Stay alert of illegal loan adverts] <http://www.cbrc.gov.cn/chinese/home/docView/2008122546942AB8A4AAF942FF678A880BBC6D00.html> accessed 10 March 2015.

[844] Citizens Advice Bureau, 'Payday Loans: Take Action against Irresponsible and Misleading Advertising'.

[845] Elaine Kempson, 'Over-Indebtedness in Britain: A Report to the Department of Trade and Industry' (2002) Part V.

[846] Hawkins (n 817) 568-569.

could lead to higher default rates, especially in the case of payday lending, as it has very short repayment period.[847]

Reasons why lenders ignore creditworthiness checks, as Fairweather explains, is either because the cost of the checks may exceed the benefits of doing so, or because they need to accelerate the speed of the loan approval to win more market share.[848] Lenders could also profit from defaulted loans, for example, payday lenders are criticized for encouraging customers to roll over their loans multiple times.[849] Such debt is only good for the lender, not the borrower. Lenders should know their customer before making any lending decision to make sure the product is appropriate for the customer, and to avoid the possibility of trapping customers in debt.[850] However, affordability is usually not really considered by subprime lenders. Research shows that although 83% of the surveyed UK payday lenders have told the borrower how the loan works and the total cost of the loan,[851] they are less concerned about the customers' ability to afford the loan product. Only 39% of the payday lenders would check whether a customer is suited to a loan, and only 39% of them would carry out a sound, proper and appropriate affordability assessment and credit vetting for each loan application and before the loan is extended.[852]

If borrowers choose to finance the debt with a new loan, the danger of being 'trapped' in debt exists. Because customers are already in a stressed condition, indebtedness over a longer period could make a bad situation worse. Although several researchers do not support the direct correlation between fringe banking

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[847] Therese Ann Wilson, 'Regulating to Facilitate Access to Safe and Affordable Credit for Low Income Australians' (DPhil thesis, Griffith University 2010) 184.
[848] Karen Fairweather, 'The Development of Responsible Lending in the UK Consumer Credit Regime' in James Devenney and Mel Kenny (eds), *Consumer Credit, Debt and Investment in Europe* (1st edn, Cambridge University Press 2012) 89.
[849] See eg Nathalie Martin, 'Regulating Payday Loans: Why This Should Make the CFPB's Short List' 46; OFT, 'Review of High-Cost Credit: Final Report' (2010) 7.
[850] Principles of responsible lending for lenders are given by the Office of Fair Trade (hereinafter 'OFT') in its official guidance. Principles include (i) not use misleading or oppressive behaviour when advertising, selling, or seeking to enforce a credit agreement; (ii) making a reasonable assessment of whether a borrower can afford to meet repayments in a sustainable manner; (iii) explaining the key features of the credit agreement to enable the borrower to make an informed choice; (iv) monitoring the borrower's repayment record during the course of the agreement, offering assistance where borrowers appear to be experiencing difficulty and, (v) treat borrowers fairly and with forbearance if they experience difficulties. Office of Fair Trading, 'Irresponsible Lending-OFT Guidance for Creditors' para 2.2.
[851] Citizens Advice Bureau, 'Have Payday Lenders Kept the Promises They Made in Their Good Practice Customer Charter?' (2013).
[852] Ibid.

and the debt trap (and even personal bankruptcy),[853] irresponsible lending could indeed exacerbate the problem and push customers into a more dangerous status, that is, 'over-indebtedness' or 'debt imprisonment'.[854] There is no generally agreed definition of the term *over-indebtedness* either in the UK[855] or at the EU level,[856] but generally, it can be described as the excess use of credit above an affordable level that causes repayment difficulties and further welfare loss. In Cartwright's view, over-indebtedness is 'the result of credit being too easily accessed, rather than too difficult to access.'[857] Combined with the high-cost feature, easily accessed credit could make customers' vulnerable situation worse.

There are, of course, concerns about debtors' irresponsible borrowing.[858] Not all customers are rational borrowers who will carefully consider their repayment ability before making any decision. Taking out a new loan to repay an old one is a typical example.[859] Entering into a debt agreement knowing the difficulty of repayment is another case.[860] However, customers' weakness does not exonerate lenders, as they are presumed to protect customers' interests, using own business practices and procedures to prevent such cases from happening.[861] The liability is usually attributed to the lender rather than the borrower who may not have enough financial knowledge to make a judgement.

Last but not least, it is important to note that due to the nascent stage of consumer credit development in China, the infancy of the fringe banking sector, and residents' traditional custom of saving money,[862] the problem of irresponsible lending in the country appears not to be as severe as in the UK or US, where the subprime consumer credit sector has existed for decades. In addition, not all subprime lenders in China have access to the central bank's personal credit record

[853] See, for example, Collard and Hayes (n 813).
[854] Thomas Wilhelmsson, 'Social Force Majeure: A New Concept in Nordic Consumer Law' [1990] Journal of Consumer Policy 1.
[855] Kempson (n 845) 39.
[856] Gianni Betti and others, 'Study of the Problem of Consumer Indebtedness: Statistical Aspects' (2001); Luisa Anderloni and Daniela Vandone, 'Households over-Indebtedness in the Economic Literature' (2008); European Commission, 'Towards a Common Operational European Definition of over-Indebtedness' (2008) 5.
[857] Cartwright (n 823) 228.
[858] Kempson and others (n814) para 4.2.
[859] Ibid para 4.2.1.
[860] Ibid.
[861] OFT (n 850) para1.29.
[862] Many researchers confirm Chinese people's negative attitude towards borrowing money from moneylenders. See, for example, Shiqing Xie, '*我国消费金融公司发展的困境与出路*' [Difficuties in Developing Consumer Finance Companies] [2010] Shang Hai Jin Rong.

system, therefore, without this security blanket licensed subprime lenders tend perhaps to be more cautious about creditworthiness assessments of unsecured loans that may result in non-performance. However, this condition is not an advantage and is already in the process of change. Irresponsible lending and borrowing are already reflected in the credit card sector, as relatively better-off people who try to finance one debt using another credit card debt have already burdened themselves with debt problems.[863] As the role of credit records in China have become increasingly more important in recent years as in developed countries, and subprime lenders are gradually joining the national credit record system, this situation is due to change.

4.2 Economic rationale for conduct regulation

Having recognized the fact that customers in the subprime consumer credit market are vulnerable to firm's improper conduct, the necessity of protecting customers' interests can hardly be overlooked. Generally, protecting customers' interests is regarded as the role of conduct regulation, the rationale for conduct regulation is, however, deeper and more complex than the empirical evidence discussed above.

Conduct regulation, as one of two pillars of the modern financial regulation system, focuses on how firms deal with customers while conducting their business. Its aim is to protect customers from being harmed by firms' misconduct, rather than to ensure system safety. By setting up specific and detailed rules for firms to observe, regulators propose to regulate firms' behaviour and to protect customers; and after customers have suffered any detriment, to recover their interests through compensation, penalty and other remedies. In short, business conduct regulation adjusts the relationship between firms and customers.[864]

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[863] The credit card sector in China experienced a 'promotion' period in the early 2000s when bank staff irresponsibly issued credit cards to customers, attracting customers with gifts (even including university students who had no income and relied on family financial assistance) in order to increase the market share, since they could not compete with one another on lower interest rates which were fixed by the country. Many news reports reflect this fast increase of China's credit card sector. See, for example, William Hart and others, 'Consumer Credit in China' (*Knowledge@Wharton*) <http://knowledge.wharton.upenn.edu/article/consumer-credit-in-china/> accessed 10 March 2015. See also 'Credit-Card Companies Battle in China' (*Bloomberg News*) <http://www.businessweek.com/articles/2013-05-02/credit-card-companies-battle-in-china> accessed 10 March 2015.

[864] Charles Goodhart and others, *Financial Regulation: Why, How and Where Now?* (1st edn, Routledge 1998) 6. In addition, there is another perspective of customer protection in the aspect of prudential regulation, namely protecting clients from being harmed by institutional failure and the ensuing systemic risks. For example, depositors shall be protected by deposit insurance scheme or

At first glance, business conduct regulation appears to contradict the 'free-market' assumption represented by Friedman's famous theory, which assumes that the free market can operate well in the long run and needs no more state intervention.[865] This free-market theory has several main assumptions: first, it assumes that individuals are rational and are able to make free choices based on own interests.[866] Second, through rational customers' free choice, only good firms can beat the competition.[867] Since the market can self-adjust through freedom of exchange, that is, rational customers choose good firms and vice versa,[868] excessive government intervention could hence be 'paternalistic' and will increase unnecessary compliance costs for market participants.[869]

Critics objecting to the prefect market assumption usually point out the market imperfection that exists in the real economy.[870] It is recognized that customers and the market are usually neither rational nor perfect and the financial market is not exempt from this imperfection. Owing to information asymmetry, a customer may not be able to make rational choices; firms usually also lack incentives to behave well without minimum standards of regulation. To prevent contracts failing[871] (rather than failure of the whole system) and to protect customers' interests, some sort of government intervention is essential under current circumstances; and, so long as regulation is proportional to the risk posed to firms, the benefits of regulation would exceed its costs and could be undertaken by rational customers.

4.2.1 Market imperfection

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compensation fund of last resort. See David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) FSA Occasional Paper Series. 10.

865 Milton Friedman, *Capitalism and Freedom* (40th anniv, University of Chicago Press 2002).

866 Cartwright (n 823).

867 Ibid.

868 Friedman (n 865) 20.

869 However, this does not mean government and law are unnecessary. Friedman notes that it is essential for a government to set up, interpret and enforce rules of free markets. See Ibid 21.

870 See, for example, Cass R Sunstein, *Free Markets and Social Justice* (1st edn, Oxford University Press 1997) 4.

871 Llewellyn (1999) lists five dimensions of contract failure: (i) the consumer receives bad advice; perhaps because an agency conflict is exploited; (ii) the supplying institution becomes insolvent before the contract matures; (iii) the contract turns out to be different from what the consumer was anticipating; (iv) fraud and misrepresentation; and (v) the financial institution has been incompetent. Llewellyn (n 864).

The first basic understanding of conduct regulation is recognition of the imperfection of the financial market, that is, both firms and customers are less likely to behave like assumed rational market participants. Although market imperfection problem also exists in mainstream financial markets, the subprime consumer credit market is usually less regulated than the mainstream counterparts, while serves the less-privileged customer group who are denied of access to commercial bank credits. This thesis therefore mainly discusses the market imperfection of the subprime credit market and chooses not to expand the discussion to misconduct in mainstream commercial banking activities.

The problem of information asymmetry is a good example in this regard. In the theory of the perfect market, an individual is presumed to be able to make fully informed choices based on suppliers' information. Presumed to be profit-maximizers, customers will only make the choice that best fits in with their needs and choose the firm that provides sufficient information on its products. Suppose all rational customers choose to deal with an information-transparent firm, a firm that cannot collectively satisfy demands for information would face the danger of failing in the competition and exit the market, which provides enough incentives for information disclosure.

However, in reality, customers are not necessarily rational, nor would firms have enough incentive to provide information. From the customers' side, they are not always able to make rational choices as assumed. Their status is vulnerable in dealing with firms due to the asymmetry of information. From the firms' side, Cartwright notes that firms are sometimes reluctant to provide information to low-value individual customers, because this will not increase their profits.[872] If not all firms choose to disclose relevant information on their products – which is foreseeable in an unregulated market – it would be difficult for customers to compare products from different firms and to distinguish which ones are good or not, which further highlights the problem of increased transaction costs and adverse selection.

More specifically, difficulties brought about by market imperfection (in this case, the information asymmetry) in an unregulated market are first met by individual

[872] Cartwright (n 823) 52.

customers. In Llewellyn's view, what distinguishes a financial product from other products is the time and costs involved in figuring out the real quality of the goods.[873] Compared with a physical product whose quality could be evaluated prior to purchase, the real quality of a financial product will only emerge after a period of purchase. Hence, financial products are regarded as 'credence goods' which 'are those where quality can be ascertained only at some cost after purchase, and in its extreme form might never be fully open to objective evaluation'.[874] Furthermore, owing to this feature, many types of transaction costs would emerge prior to, during and after the setting up of financial contracts, as Llewellyn puts it,

> [T]ransaction costs can be divided into search costs (information needed in order to search alternative products and their suitability), bargaining and decision costs (involved in agreeing precise contract terms), monitoring costs (the costs involved in monitoring post-contract behaviour to the extent that it is relevant in determining the ultimate value of a contract), enforcement costs (ensuring that contracting parties deliver on the contract), verification costs (ascertaining the characteristics of the product and whether, for instance, disclosed information is accurate and complete) and finally, where relevant, redress costs (costs involved in securing redress in the event of a contract failure of one sort or another).[875]

Transaction costs of credence goods are apparently higher than common physical goods whose quality could be easily ascertained at lower or no costs.[876] For example, one may not spend several days researching the quality of a new brand of vacuum cleaner as this can easily be figured out by reading commodity comments, while much more time will be spent doing research before entering into a loan contract due to its complexity and potential risks.

In addition, even if consumers are aware of the possible risks of a financial product, they are sometimes unable to make the right decision, which further puts forward the problem of bounded rationality, namely the limitation of individuals'

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[873] Ibid 34. See also David Llewellyn, 'Regulation of Retail Investment Services' (1995) 15 Economic Affairs 13.
[874] Ibid.
[875] Ibid 35.
[876] These products are named 'search' and 'experience' goods, since their quality could be ascertained at a lower price before purchase, or during the experience of the goods after a short period after purchase (eg, have a meal at a restaurant), where the quality will not bring about unforeseeable risks in the long run. Llewellyn, 'The Economic Rationale for Financial Regulation' (n 864) 34.

ability to receive, to process and deal with the information.[877] Not all consumers are irrational, impulsive buyers ignore product quality before purchasing; instead, individuals are sometimes simply unable to receive and judge excessive information due to their ability to understand contact terms. Although most customers may wish to maximize their profits, they may not know how to achieve this. The complexity of financial contracts is an apparent obstacle for ordinary consumers to process all relevant information, which not only exceeds their knowledge level but also costs too much. To put it simply, it is the mismatch between customers' intention and their real choice that leads to the improper choice of financial product, where rationality on profit-maximization fails to take priority.[878] In order to reduce the consequence of bounded rationality in an imperfect market, government regulations on information disclosure may reduce transaction costs.[879]

The problem of market imperfection is also reflected on the suppliers' side which, in turn, influences consumers' welfare. When information disclosure is not compulsory, it could be assumed that only minority firms would voluntarily disclose information to consumers. The firm that discloses sufficient information to customers then bears higher costs than its competitors, which may result in product price increase. What is more, since customers may be unable to distinguish products but choose a cheaper product, this would lead to a dangerous status, namely firms cannot obtain profits from information disclose. This is 'the problem of lemons' when good products or suppliers are adversely selected, because customers know there are both good and bad products on the market but cannot exercise sound judgement and choose the cheaper products.[880] Without proper intervention, it could be assumed that in the long run, information about financial products will become scarcer and individual customers need to pay higher transaction costs during and after purchase. Regulation on information disclosure in this sense is to set up conduct standards and drive those firms who cannot meet the standard out of the market.

[877] Ibid.
[878] Bryan D Jones, 'Bounded Rationality' (1999) 2 Annual Review of Political Science 297. 322.
[879] Llewellyn, 'The Economic Rationale for Financial Regulation' (n 864) 34.
[880] Sunstein (n 870) 327. George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 The Quarterly Journal of Economics 488.

The discussion above shows the difficulties met by both customers and firms in the unregulated market which is far from ‘perfect’. Without government regulation, simply relying on self-regulation and CSR may not make it possible to fulfil the customer protection objective. Conduct regulation, in this sense could provide minimum protection for common customers who are limited in ability, time and effort, and have no enforcement power to protect self-interests.

4.2.2 Cost of regulation

Some may argue that regulation of business conduct will increase direct and indirect costs.[881] These costs are first incurred by firms in the form of compliance costs, but then shift to the customers, who ultimately bear the increased costs, in the form of an increased price. Payday lenders, for example, are concerned about their market exit if regulation becomes more stringent, after which vulnerable customers may be faced with the increased danger of being exploited by loan sharks.

Indeed, conduct regulation on business standards would increase firms’ compliance costs. However, as discussed above, without proper regulation, firms in the financial market usually lack the incentive to conduct their business on a higher level, which would finally hurt their customers’ interests. Suppose there is no guarantee of product quality in an unregulated market, customers now need to bear the burden of exercising proper judgement of the product quality. Yet, owing to the bounded rationality, customers are not always able to bear this self-responsible duty. The cost of monitoring financial firms’ product quality and their level of conduct would be disproportionately high and unbearable for each individual customer during every purchase of financial products.

Moreover, the costs of figuring out product quality would be unnecessarily multiplied for society, since every individual customer needs to do the same research each time. It is difficult for individual customers to share their

[881] Direct costs of regulation include the ‘fees and levies’ paid by firms to the regulator, while indirect costs may include ‘the incremental costs of compliance, including the costs to firms of activities required by regulators which would not have been undertaken in the absence of regulation.’ See 'Financial Regulation: A Preliminary Consideration of the Government’s Proposals' (2011) <http://www.publications.parliament.uk/ pa/cm201011/cmselect/cmtreasy/430/43002.htm> Section 6, Cost of Regulation.

knowledge of a financial product with other customers. The self-monitoring regime of the imperfect market means a waste of time and effort at the social level.

A better and more efficient solution in this case, according to Llewellyn, is to delegate regulator monitoring firms on behalf of individual customers:

> Because most (especially retail) customers are not in practice able to undertake such monitoring, an important role of regulatory agencies is to monitor the behaviour of financial firms on behalf of customers. In effect, consumers delegate the task of monitoring to a regulatory agency, and hence that agency can be viewed as supplying monitoring services to customers of financial firms. This in turn raises the issue of the nature of any perceived implicit contract between the regulator and consumers of financial services. There are strong efficiency reasons for consumers to delegate monitoring and supervision to a specialist agency to act on their behalf as the transaction costs for the consumer are lowered by such delegation. There are potentially substantial economies of scale to be secured through a collective authorisation (via 'fit and proper' criteria), and supervising and monitoring of financial firms.[882]

The cost-saving advantage through conduct regulation is also reflected in its *ex ante* feature in regulating firms' behaviour. By setting up appropriate conduct standards and penalties for misconduct in advance, a rational firm would choose to comply with the law to avoid breaking the rules and being punished. This is more efficient than simply relying on judicial efforts after a dispute has arisen. Although being indispensable, courts could only provide an *ex post* remedy in the case of dispute, which adds additional costs to both the customer and the firm. After all, a fair legal system shall not only punish those who are regarded as behaving 'unfairly', but provides the firm with clear conduct rules.

Furthermore, since the cost brought about by government regulation will reflect on the prices of financial products, it is also assumed that rational customers would prefer to bear these additional regulation costs, as this would be lower than the transaction costs they pay in the case of no regulation. Customers are willing to pay for regulation, which could provide them with more confidence in firms' behaviour and product quality.[883]

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[882] Llewellyn, 'The Economic Rationale for Financial Regulation' (n 864) 24.
[883] Llewellyn, 'Regulation of Retail Investment Services' (n 873).

In addition, regulation is, of course, not a free good. However, as long as regulation is proportionate, its benefits will exceed the costs that provide the economic ground for regulation. The remaining problem is to set up appropriate regulation standards that would fit in with different firms' risk level and do not overburden low-risk firms. According to the Financial Stability Board, reasonable regulation shall be proportionate to, 'characteristics, type, and variety of the financial products and consumers, their rights and responsibilities, and be responsive to new products, designs, technologies and delivery mechanisms.'[884] This is perhaps more evident in the subprime lending sector where the size of firms is usually small, and they may face more difficulties in satisfying stringent regulatory rules than commercial banks.

Last but not least, it is important to note that the regulator cannot pursue the objective of customer protection without limits. As Llewellyn suggests, regulation would always be more effective if customers could pay higher costs.[885] However, the strength of regulation is bounded by the resources a regulator could use. An imaginary supremely powerful regulator has the ability to oversee all possible misconduct of firms in the domestic market which, however, could be to the detriment of consumers, as they have to bear the regulation costs.[886] Regulation is therefore not an ultimate weapon in customer protection, but is *de facto* limited in its effectiveness in respect of costs. Here, there are inevitable trade-offs between pursuing a regulatory objective and bearing its costs. On the one hand, for the majority of customers' sake, regulation is the firewall that provides them with minimum protection. On the other, customers shall be informed of the limits of regulation and be alerted when dealing with financial firms. Their self-cautious attitude cannot be totally replaced with regulation. This also explains why financial customers shall be educated with basic knowledge of protecting themselves to avoid any unwanted transaction costs.

The economic rationale of conduct regulation of the financial market lies in the market imperfection which the market itself has little chance to correct at minor

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[884] Financial Stability Board, 'Consumer Finance Protection with Particular Focus on Credit' (2011). 43.
[885] Llewellyn, 'The Economic Rationale for Financial Regulation' (n 864) 52.
[886] Ibid.

costs. Information asymmetry is the most distinctive example of this imperfection which represents the weaknesses of both consumers and firms. Without proper regulation, customers with limited rationality may be faced with higher transaction costs than the cost of simply delegating a regulator to collectively monitor firms. To recap, regulation is not in conflict with the 'free market' assumption; instead, appropriate regulation provides preconditions for customers' free choice, which cannot be satisfied by a chaotic, non-transparent and unregulated market. Free market in this sense is not simply opposite to but, in fact, relies on financial regulation.

4.3. Setting up an appropriate regulatory regime for subprime lenders

As discussed in section 4.1, there are various kinds of subprime lenders in the market. In order to properly regulate those money lenders, the regulatory regime needs to be appropriately set. The UK has experienced a process of 'unifying' separate regulations in the consumer credit sector, while the regulatory regime in China is still piecemeal at this stage.

4.3.1 The UK's consumer credit regulatory regime development path

4.3.1.1 Consumer Credit Act, 1974 and the original OFT Regime: Pre-1974 to 2006

It is fair enough to regard the issue of the Consumer Credit Act, 1974 (hereinafter 'CCA 1974') as the *de facto* setting-up point of the UK's unified consumer credit regulatory regime. Prior to CCA 1974, firms offering consumer credit were separately regulated by different legislation devised for every credit provider, for example, the Pawnbrokers Acts, Moneylenders Acts and Hire Purchase Acts. The shortcomings of the CCA1974 are criticized by many, but generally, it 'dealt piecemeal with particular legal forms rather than comprehensively with the reality of credit provision common to them all'. [887] Firms are regulated based on transaction form, regardless of the similarities in essence, [888] which leads to

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[887] KE Kindgren, 'The Consumer Credit Act 1974: Its Scope' (1977) 40 The Modern Law Review 159; John Whitmore, 'Consumer Credit Act 1974' (1975) 9 The Law Teacher 1.
[888] RM Goode, 'The Consumer Credit Act 1974' (1975) 34 The Cambridge Law Journal 79.

regulatory loopholes and were out of date when various new types of consumer credit were invented in the new era.

The CCA 1974 repeals those old laws and offers a brand-new, unified regulation regime, [889] with the purpose of setting up a single set of rules that covers the whole industry. The regulatory regime, usually known as the 'OFT-style regime', has three main pillars: (i) the licence regime, (ii) unified business standard and the (iii) enforcement power. All firms are under the regulatory power of the Director-General of OFT, and must obey the same conduct standards in many respects. At the centre of the Act is the licence regime, which empowers the Director-General of OFT to grant, withdraw or limit the licence of a lender. This gives conduct standards real strength, as firms who misbehaved would face the risk of losing their licence and being expelled from the arena. The court also has enforcement power as a judicial control method.

As a product of its era, the CCA 1974 has performed well in more than three decades. It was highly praised at the time it was enacted and is regarded as 'the most comprehensive and sophisticated consumer credit statute ever to have been enacted in any country' [890], since the unified legislation provides an equal environment for all regulated credit activities, promotes competition by applying the same regulatory controls, and prevents legislation overlap or loophole underlying in previous statutes. Furthermore, detailed conduct rules could provide strengthened protection for customers, underpinned by the enforcement power.[891]

4.3.1.2 Consumer Credit 2006, the joint regulation of OFT and FSA: Transitional period 2006-2014

Ever since the CCA 1974 was enacted in the 1970s, the credit market in the UK has become more complex. Unsecured consumer credit expanded rapidly, especially after the 1990s.[892] In consideration of the different conditions, the CCA 1974 was reviewed for its suitability in 2001. The resulting White Paper, *Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century*,

[889] Consumer Credit Act 1974, Introduction.
[890] Goode (n 888) 81.
[891] Ibid 129.
[892] Fairweather (n 848) 85.

released on 2003, decided that the 1974 Act was slightly out of date and must be reformed to accommodate new conditions:

> The laws governing this market were set out a generation ago . . . The regulatory structure that was put in place then is not the same as the regulatory structure required today. As the credit market has developed, reforms have become necessary to modernise the current regime and update it for the 21st century.[893]

For example, many detailed problems such as indebtedness, vulnerable customers being entrapped by loan sharks and information problems are not covered by the original legislation, which was fatal for customer protection.[894] These concerns led to a series of legislative amendments in 2004 that added new standards to the 1974 Act in respect of, for example, advertisements, disclosure and many other details.[895]

However, owing to more fundamental problems, it was decided that 'primary legislation' was essential to amend the original legislation and this finally led to the Consumer Credit Act 2006 (hereinafter 'CCA 2006'),[896] which mainly focuses on the *ex post* consumer protection methods when there misconduct has already occurred:

First, the CCA 2006 empowers OFT with further enforcement power to punish firms who fail to satisfy conduct regulation requirements imposed on them.[897] According to the original CCA 1974, the regulator could only remove, limit or withdraw a licence of a misconducting firm. Now, under CCA 2006, OFT can impose a civil penalty of up to £50,000 for every breach of rules.[898] Second, as regards the power of the court to decide whether an 'unfair relationship' exists between the debtor and creditor, and requiring the creditor to recover the debtor's

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[893] Department of Trade and Industry, 'White Paper, Fair, Clear and Competitive: The Consumer Credit Market in the 21st Century' (Cmd 6040, 2003). Executive Summary.
[894] Ibid.
[895] Legislation includes Consumer Credit (Advertisements) Regulations 2004, the Consumer Credit (Agreements) (Amendment) Regulations 2004, the Consumer Credit (Disclosure of Information) Regulations 2004, the Consumer Credit (Early Settlement) Regulations 2004 in June 2004, the Consumer Credit (Miscellaneous Amendments) Regulations 2004, the Consumer Credit Act 1974 (Electronic Communications) Order 2004.
[896] Explanatory Notes to Consumer Credit 2006, 3.
[897] Ibid s 38.
[898] Ibid s 52 to 54.

loss, the CCA 2006 provides additional protection for customers in a judicial process.[899]

Next is the extension of the Financial Ombudsman Scheme to the consumer credit industry by amending the FSMA 2000.[900] This is meaningful because until later reform, consumer credit regulation under the CCA regime was parallel with the FSMA framework. A consumer credit agreement was not included in the FSMA's 'regulated activities' and therefore the debtor cannot use the original Ombudsman scheme. The new amendment provides individuals with fast and easy dispute resolution with minimum formality, and encourages them to use this alternative way of resolving their complaints.

It is also important to note that during the first decade of the twenty-first century, the consumer credit market in the UK was under dual regulation of both OFT and the FSA as a response to the FSMA 2000. Since the two authorities have 'different but complementary' powers and principles, they have to work together to avoid possible regulation confliction and regulatory burden.[901] Several joint working documents are published by both.[902] However, joint regulation is a product of the transitional period when the CCA regime and FSMA regime were coexisting. The concern about the efficiency of this dual-regulatory regime and unnecessary cost, to some extent, led to the later fundamental reform.[903]

4.3.1.3 FCA regime under FSMA 2000: A risk-based approach from 2014

From April 2014, the regulatory regime of the consumer credit sector shifted to the FSMA regime. This was in response to the new circumstance. On the one hand, the consumer credit market has evolved quickly in recent years, leading to

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[899] Ibid s 19 to 22.

[900] Ibid s 59 to 61.

[901] OFT and FSA, 'Memorandum of Understanding between the Office of Fair Trading and the Financial Services Authority' (2009).

[902] Ibid. Also includes, eg, 'Delivering Better Regulatory Outcomes: A Joint FSA and OFT Action Plan.'

[903] HM Treasury and Department for Business, Innovation & Skills 'A New Approach to Financial Regulation: Consultation on Reforming the Consumer Credit Regime' (2010). This BIS's report lists several weaknesses of the division in regulating responsibility between OFT and FSA, including the split in different regulators' objectives and not a single regulatory body being responsible for it; lack of coherence in consumer protection; confusion for firms and customers, and duplication costs; CCA 1974 is out of date and rigid for the fast-developing credit market; deficiency of licence regime; OFT lacks enforcement power.

higher risks to consumers. With the 'credit crunch' brought about by the recent financial crisis and the rapid increase of the small amount, short-term credit market, enhanced consumer protection standards are essential. On the other hand, the weakness lies in the previous joint-regulation under OFT and the FSA, which required regulatory efficiency improvement. The resulting reform is more profound than any of the previous legislative amendments as it replaced the 40-year-old CCA regime with a unified, single FSMA framework.

The reform, however, does not totally overthrow the previous CCA regime. To reduce firms' burden of acclimatizing themselves to the new regulatory requirements, much of the contents of the CCA remained in the new framework. The new regime is a combination of FSMA (and its secondary legislation), retained provisions of the CCA 1974 (and its retained secondary legislations), and FCA's (and FSA's) rules. A new FCA sourcebook, the *Consumer Credit Sourcebook* (CONC), was also created to provide conduct regulations. It is very flexible to any future new circumstance. The general pillars of the CCA's regulatory regime, namely conduct regulations, enforcement power and dispute solutions by the financial ombudsman and court, still underpin the new regulatory regime. In addition, the new regime would also adopt rules from industry codes if it provides higher levels of customer protection.[904] The regulatory sourcebook, Principles for Businesses, also applies to consumer credit firms and provides the basic behaviour standards in case of any new type of misconduct without specific rules to cater for them.[905]

After the reform, the CCA, 1974, was no longer the basic legal framework, since it had been absorbed into the FSMA regime.[906] The FCA obtains full regulatory power and is responsible for regulating more than 50,000 firms in this market.[907] The FSMA framework is also believed to be more flexible to adapt to the dynamic credit market than the CCA 1974.

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[904] Detailed Proposals for the FCA Regime for Consumer Credit (2013). Para 5.27.
[905] Consumer Credit sourcebook (CONC), para 1.1.4.
[906] The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013. SI 2013/1881.
[907] FCA, 'Consumer Credit' <http://www.fca.org.uk/firms/firm-types/consumer-credit> accessed 10 March 2015.

In the new regime, consumer credit firms are regulated based on different levels of risk posed to customers, known as the 'risk-based approach'.[908] It proposes to provide better consumer protection and set a proportionate regulation burden on firms by distinguishing high- and low-risk firms, and setting up regulatory standards tiers based on the risk level.[909] Low-risk firms are less regulated, while high-risk firms must obey more stringent standards as they pose more risks to customers. This is one of the most significant differences between the old and new regulatory regime, as the CCA 1974 generally provided all firms with the same regulatory standards without considering the risk level of different firms. The most recognized high-risk credit type, namely short-term, high-cost credit, is specifically noted by the new regime.[910] What is more, the sourcebook is applicable to all firms that provide consumer credit; this means it could regulate mainstream firms and banks,[911] building societies, credit unions and subprime lenders. It is based on the essence of regulated activities in different industries. Firms are under the same conduct rule of regulated activities (except for high-cost, short-term credit, which has higher conduct of business rules to obey), since consumers of the same type of regulated activity shall be equally protected regardless of with what kind of lenders they are dealing.

4.3.2 China's unifying-in-process consumer credit regulatory regime

Owing to the nascent development stage of China's consumer credit sector, the regulatory regime for the industry is, overall, less developed. However, the attitude of the regulators is increasingly more positive. Prior to 2010, the regulatory framework for subprime lenders could be regarded as 'piecemeal', different firms were under separate regulations and the regulatory power was exercised by different regulators; China's regulator paid more attention to prudential and administrative aspects rather than customer protection, and focused on commercial banks rather than subprime lenders. Commercial banks have relatively comprehensive business conduct rules, while for the different types of subprime lenders there are only rough separate conduct standards. For example, a consumer finance company is simply required to 'protect its customer, obey open

[908] FCA Proposal (n 904) para 1.14.
[909] BIS (n 903).
[910] FCA Proposal (n 904) Chapter 6.
[911] The sourcebook for commercial banks, BCOBS only regulates depositing activities.

and transparent procedures when dealing with customers, disclose information to customers, including the loan amount, repayment period, price and repayment methods in the loan contract'.[912] It also protects the confidentiality of customers' personal information[913] and shall not collect the debt using threat or harassment without further details.[914] For small lending companies, there is no such conduct requirement; the regulator focuses all its attention on the licence regime and prudential regulation. Although anecdotal evidence since 2008 has repeatedly revealed that China's central bank is drafting a Money-lenders Ordinance, this proposed regulation is still in its drafting process and there is no sign of promulgation.[915]

However after new regulation, the Interim Measures for the Administration of Personal Loans (2010),[916] issued by the CBRC, the fragmented and rough conduct of business regulation for consumer credit activities has largely changed, as the rule is applied not only to commercial banks, but also part of the subprime lenders as long as they offer personal loan products. Table 4.1 gives a primary introduction to, and comparison of, the current regime.

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[912] Pilot Measures for the Administration of Consumer Finance Companies (2013), art 33.

[913] Ibid art 31

[914] Ibid art 32.

[915] See, eg, Youxing Li and Xu Luo, '*论《放贷人条例》制定的难点及其解决*' [Difficulities and solutions of making China's Money-lenders Ordinance] [2011] Zheng zhi yu fa lv.

[916] CBRC, *个人贷款管理暂行办法* [Interim Measures for the Administration of Personal Loans] (2010 No. 2).

Table 4.1 Regulatory regime of firms that provide consumer credit loan in China

	Commercial banks	**Small lending company**	**Consumer finance company**[917]	**Pawnbroker**
Current basic law/ regulation(s) for the industry	(1) Law of the People's Republic of China on Commercial Banks (2003 Amendment) (2) Interim Measures for the Administration of Personal Loans (2010) (3) Several conduct regulations[918]	(1) Guiding Opinions of China Banking Regulatory Commission and the People's Bank of China on the Pilot Operation of Small-Sum Loan Companies (2008)[919]	(1) Pilot Measures for the Administration of Consumer Finance Companies (2013)[920] (2) Interim Measures for the Administration of Personal Loans (2010)	(1) Measures for the Administration of Pawning (2005)[921] (2) Provisions on the Regulation of the Pawn Industry (2012)[922]
Year of issue	(1) 2003; (2) 2010	(1) 2008	(1) 2013; (2) 2010	(1) 2005; (2) 2012
Issuing authority(ies)	(1) Standing Committee of the National People's Congress; (2) CBRC	(1) CBRC, PBoC;	(1) CBRC (2) CBRC	(1) Ministry of Commerce, Ministry of Public Security; (2) Ministry of Commerce
Regulator(s) of the firm	CBRC	CBRC	CBRC	Ministry of Commerce
Is it a financial institution?	Yes	Yes	Yes	No[923]
Does it need a licence?	Yes	Yes, from local Bureau of Industrial and Commerce	Yes, from local bureau of CBRC	Yes, from local Bureau of Industrial and Commerce
Is it allowed to take public deposits?	Yes	No	No[924]	No

[917] Consumer finance company (*消费金融公司*) offers unsecured consumer credit to medium-and-low-income people living in urban area. It is actually another kind of alternative lenders as RMCs and village banks. However, there are only three of these firms in China and they are therefore not discussed in Chapter 3.

[918] Include, e.g., CBRC and National Development and Reform Commission, *商业银行服务价格管理办法* [Measures for the Administration of the Service Prices of Commercial Banks] (2014 No. 1); CBRC, *商业银行信用卡业务监督管理办法* [Measures for the Supervision and Administration of the Credit Card Business of Commercial Banks] (2011 No. 2).

[919] CBRC, PBoC, *关于小额贷款公司试点的指导意见* (2008 CBRC No. 23).

[920] CBRC, *消费金融公司试点管理办法* (2013 No. 2) art 2.

[921] Ministry of Commerce and the Ministry of Public Security, *典当管理办法* [Measures for the Administration of Pawning] (2005 No. 8)

[922] Ministry of Commerce, *典当行业监管规定* (2012 No. 423).

[923] Before 2000, a pawnbroker in China was regarded as a financial institution and was regulated by the PBRC. This regulatory power was then transferred to the state Economic and Trade Commission, and when the commission was merged this regulatory authority was transferred to the Ministry of Commerce.

[924] However, a consumer finance company is allowed to take deposits from domestic shareholders. See Pilot Measures for the Administration of Consumer Finance Companies (2013 No. 2), art 20.

	Commercial banks	**Small lending company**	**Consumer finance company[917]**	**Pawnbroker**
Is it allowed to provide unsecured credit?	Yes	Yes	Yes	No[925]
Main contents of the basic regulation	Both prudential and conduct standards	Licence; setting-up administrative procedures; funding resources; prudential supervisory requirements.	Licence; setting-up criteria; approved business scope; funding resources; prudential supervisory requirements; information disclosure requirements; enforcement power of CBRC. Conduct rule in Interim Measures 2010 applies.	Licence; setting-up criteria; changing licences; close-up procedure; approved business scope and prohibitions; pawn contracts; administrative power of Ministry of Commerce; penalty.

[925] Measures for the Administration of Pawning (2005 No. 8), art 26.

Although the regulatory regime of China's consumer credit sector still appears fragmented, the Interim Measures 2010 provide business conduct regulations to part of the sector, as in its appendix it expanded the application scope from commercial banks ('financial institutions') to other non-banking financial firms that offer personal loan products, including consumer finance comp and auto-finance companies.[926] However, whether small lending companies shall comply with the Interim Measures 2000 is doubtful, since they do not belong to 'financial institutions' in China's legal context. The licence needed to set up a small lending is issued by local industrial and commercial administrative departments (after being approved by the provincial authority's financial office), just like other common companies; while financial institutions should additionally obtain their special licences from the CBRC before applying for the opening-up licence from industrial and commercial bureaux. Since small lending companies are the most popular type of subprime lenders in China, this is an apparent weakness in the Interim Measures 2000.

Nevertheless, the content of the Interim Measures 2000 is still worth discussing. Interim Measures 2010 cover from the pre-contractual to post-contractual stages, and mainly focus on responsible lending and information disclosure, including creditworthiness assessment requirements to lenders (Chapter 2 and 3); contract form and mandatory disclosure in loan contract (Chapter 4); post-contractual loan management rules (Chapter 5); and penalties for misconduct (Chapter 7). In addition, both the PBoC and the CBRC have set up a bureau of consumer protection[927] and issue corresponding administrative rules. Although the rules are mainly focused on mainstream firms and do not clarify whether subprime lenders are also covered, there is no evidence on this issue to suggest otherwise.

For example, the PBoC's rule defines *financial consumer* as a domestic individual customer who buys products or receives services from financial institutions, which also covers subprime lenders.[928] However, the CBRC's conduct rule was

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[926] Interim Measures for the Administration of Personal Loans, Appendix, art 43.
[927] CBRC Bureau of Consumer Protection <http://www.cbrc.gov.cn/chinese/nsbm/FCADE0C47D9E481D9BAC31E06863E7E2.html> accessed 10 September 2014; PBC Bureau of Financial Consumer Protection, <http://www.pbc.gov.cn:8080/publish/jingrxfqy/4047/index.html> accessed 10 September 2014.
[928] PBoC, *中国人民银行金融消费权益保护工作管理办法（试行）* [Administrative Measures of the People's Bank of China for the Protection of Financial Consumers' Rights and Interests (for Trial Implementation)] (2012 No. 107), art 4.

set up for 'banking financial institutions', which literally excludes subprime lenders, who are in essence non-banking financial institution or non-financial institutions in China's banking regulation regime.[929] With general conduct rules and complaint procedures, such rules add more effectiveness to the conduct regulatory regime of the consumer credit sector. Although they are still rough in comparison with the UK's regulatory rules, it is *de facto* China's first step in protecting consumers in the consumer credit sector. However, the regulator has not addressed the question of whether subprime lenders shall also comply with the CBRC's conduct rules. Unless small lending companies and pawnshops are covered by the same conduct standards, consumers in the sector are still under imbalanced protection. The weakness in China's regime is therefore obvious.

4.4 Statutory/Regulatory techniques: Information disclosure

After clarifying the strengths and weaknesses of the consumer credit regulatory regime in both the UK and China, the next step is to look at detailed regulatory techniques and their application.

Among all the regulatory techniques in customer protection, the first and foremost aspect in the consumer credit sector should be information provision. Although the real market is usually not as 'perfect' as presumed, more transparent information could indeed increase customers' welfare. The underlying message is that only with enough effective information can a customer enter into rational, profit-maximizing responsible borrowing from a reputational firm, irrespective of whether the information is offered under the mandatory requirement of the regulator or voluntarily provided by the firm. Given that disclosure of relevant information could be cost-saving for both individual customers and society, the problem is to decide what the proper way of disclosure is, which information is essential and how far regulation should go.

4.4.1 Mandatory versus voluntary disclosure

[929] CBRC, *中国银监会关于完善银行业金融机构客户投诉处理机制切实做好金融消费者保护工作的通知* [Notice of the China Banking Regulatory Commission on Improving the Client Complaint Handling Mechanisms of Banking Financial Institutions to Effectively Protect Financial Consumers] (2012 No.13)

The first question that needs to be answered is whether mandatory disclosure regulation is better than firms' voluntary disclosure and the industry's self-regulation. To some extent, it is similar to the argument about whether regulation is necessary in the financial market, since mandatory disclosure belongs to the scope of government intervention.

There is, however, a conflicting view on this issue; for example, Benston disagrees with the role of mandatory information disclosure in protecting customers' interests.[930] In his book *Regulating Financial Markets: A Critique and Some Proposals*, he argues that due to the complexity of financial products and diversification of customers' real needs, government agencies are less likely than suppliers to be able to set up a disclosure regime that fits in with customers' demands.[931] Benston further argues that mandatory information disclosure tends to be very detailed and since costs of regulation compliance will inevitably reflect in product prices, this could turn out to be a burden rather than a benefit for customers.[932] Benston therefore regards mandatory information disclosure as 'more costly than beneficial' in achieving the customer-protection goal.[933] A better solution suggested is voluntarily information disclosure by financial firms, as firms have stronger incentives to behave well in order to win competition, given that customers could always freely turn to better firms with better reputations and are more transparent on their product information.[934]

As to voluntary disclosure, Ford and Kay suggest that reputation is a powerful incentive for respectable firms, who will 'be careful to ensure that information they do provide is accurate; those that do not will find themselves criticised in the press and facing large numbers of consumer complaints',[935] while a mandatory disclosure regime poses the danger of 'giv[ing] consumers more information than they either want or can understand'[936] and salesmen may use complex rules to

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[930] George J Benston, *Regulating Financial Markets: A Critique and Some Proposals* (1st edn, The Institute of Economic Affairs 1998).
[931] Ibid 61.
[932] Ibid.
[933] Ibid.
[934] Ibid 48; 56.
[935] Chris Ford and John Kay, 'Why Regulate Financial Services?' in Fidelis Oditah (ed), *The Future for the Global Securities Market: Legal and Regulatory Aspects* (1st edn, Clarendon Press 1996) 152.
[936] Ibid.

distract customers' attention from the real meaning of the contract.[937] Benston also regards reputation as an important incentive for firms to provide information and is aware of the adverse effect of excessive regulation. In addition, he notes that detailed mandatory information disclosure regulation could become a burden for new entrants to the financial market and be a detriment for consumers.[938]

Those in favour of mandatory disclosure usually quote the economic rationale of regulation as evidence, that is, to provide minimum protection for customers who usually have limited knowledge of financial markets and products, and whose rationality is sometimes bounded by their limited time and efforts. For example, in Sunstein's view, the benefits of mandatory disclosure have two aspects (i) efficiency and (ii) democracy. Efficiency lies in the economic rationale behind financial regulation (as discussed in section 4.2 of this thesis), while democracy is related to customers' right to know, namely they should be informed about any possible risks in order to make knowledgeable purchases, which is 'a precondition for liberty'.[939] Furthermore, in answer to Benston's criticism, Llewellyn defends his support for mandatory disclosure by arguing that regulatory rules only set up the minimum standards for firms and do not conflict with firms' incentive to provide more information to consumers. Therefore, a firm could still value its reputation and treat its consumers honestly.[940]

In addition, voluntary information disclosure by firms is regarded as less effective than mandatory regulation. Spencer lists three main market-based solutions of information asymmetry: (i) reputation, (ii) signalling equilibrium[941] and (iii) intermediation;[942] the weaknesses of such market-based solutions are, however, evident. For example, reputation that comes from a long-standing relationship is not a very reliable metric of the quality of the product as buyers may not have a past track record in dealing with the firm.[943] Besides, voluntary disclosure needs customers' deeper involvement. However, consumers in the retail market may

[937] Ibid.
[938] Benston (n 930) 85.
[939] Sunstein (n 870) 326-331.
[940] Llewellyn, 'The Economic Rationale for Financial Regulation' (n 864) 33.
[941] Peter D Spencer, *The Structure and Regulation of Financial Markets* (1st edn, Oxford University Press 2000) 32-33. It means suppliers use 'an associated product or service activity high signals, high quality and is uneconomical for low-quality suppliers to provide', an example given by Spencer is the long-term warranty made by car sellers.
[942] Ibid. *Intermediation* here means a third party could use its quality recognition skills to scan out bad items.
[943] Ibid.

find it hard to filter out bad firms.[944] While the 'industrial solutions' in Spencer's analysis is also not enough. Industry associations and professional bodies could set minimum standards for industry membership, provide mutual monitoring or auditing, and establish a mutual industrial insurance or compensation scheme.[945] However, Spencer criticizes this kind of self-regulation for being 'anti-competitive', as the industrial regulator would favour the industry's interests more than the customers'.[946] This is called *regulator capture* as the self-regulatory body could evolve too close to firms.[947]

What is therefore a better way of disclosing information? The possible answer to this disagreement, however, is not simply a 'yes' or 'no'. Whether mandatory disclosure could be depends on many specific conditions, including the development stage of the regulatory regime and the enforcement power of the regulator. However, given the fact that the financial market is far from perfect, as well as empirical evidence existing in the market, it is supposed here that mandatory disclosure in the consumer credit sector is still essential in both the UK and China at this stage. Mandatory information disclosure could also strengthen customers' confidence in the market, since they could assume that they are protected from being unfairly or dishonestly treated by firms.

Moreover, this recognition of mandatory disclosure is not going to abandon firms' role in voluntary disclosure. Since regulation only provides the minimum standard of customer protection, firms that value their reputation could freely disclose more information to customers. It is hard to regard mandatory regulation as being harmful to customers. However, minimum regulatory standards are only the first step towards customer protection; without effective clear enforcement power and penalties, it could hardly fulfil the customer protection goal. The enforcement power of the regulator in business conduct regulation will be discussed in later sections.

In addition, even under the presumed perfect regulation regime, many less-controllable factors, including customers' educational background, knowledge

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[944] Ibid.
[945] Ibid 34.
[946] Ibid 36.
[947] Ibid.

level and their awareness of information would influence the real effect of regulatory rules. Cartwright suggests that customers are sometimes unaware of the potential risks of loan products;[948] for example, they may sign the contract without reading its terms and conditions. This is an aspect of the 'financial illiteracy' which comes from the complexity of financial products and customers' lack of knowledge. One of the possible solutions is to increase customers' awareness of financial risk in every purchase through financial education; while the role of disclosure regulation is to assume customers have no specific knowledge on the financial products and provides them with minimum protection.

4.4.2 Principles and techniques of disclosure, and inclined protection of financial consumers

Having recognized the necessity for mandatory disclosure, it is essential to decide the content of disclosure regulation. This is related to the compliance costs of regulation, since any additional cost of regulation would ultimately be reflected in prices and be borne by customers. To put it simply, excessively stringent rules would become a regulatory burden for firms, while too-relaxed rules would lose their effectiveness. However, if information is essential for customers to make informed choices, it could be assumed that the benefit of regulation exceeds its costs.

4.4.2.1 The UK

The UK has made good progress with this issue. Previously, disclosure requirements in the CCA 1974 covered both financial advertisements and pre-contractual stages; for example, it requires that a financial advertisement shall be 'a fair and reasonably comprehensive indication of the nature of the credit or hire facilities offered by the advertiser and of their true cost to persons using them'.[949] During the purchase, firms are required to provide adequate explanation to the debtor and must give the debtor the chance to understand it.[950] Apparently, the CCA is not confined to disclosing the price of products but proposes to provide more comprehensive information to help consumers make informed choices.

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[948] Cartwright, *Banks, Consumers and Regulation* (n 823) 57.
[949] Consumer Credit Act 1974, ss 43-47.
[950] Ibid s 55A.

This understanding of disclosure was adopted by the later regulation sourcebooks. The Principles (hereinafter 'PRIN') clearly require firms to 'pay due regard to the interests of its customers and treat them fairly' in Principle 6, and to 'pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading' in Principle 7.

CONC generally requires that 'a firm must explain the key features of a regulated credit agreement to enable the customer to make an informed choice'.[951] Chapter 3, 4 and 6 of the CONC set up comprehensive rules for any regulated credit activities regardless of the type of firm, cover advertisements to post-contractual stages. The underlying philosophy of CONC on disclosure is explicitly reflected in its Chapter 3 (Advertisements and promotion) as 'clear, fair and not misleading'.[952] These rules are, however, not only confined to advertisements and the promotion stage, but could be extended to the whole process of consumer lending.

The clear rule means a firm must provide transparent, easily understood information in its advertisements and not deliberately obscure the information; for example, the language used in advertisements must be 'plain and intelligible',[953] with the assumption that consumers may not have specific knowledge of financial terms. Advertisements shall not confuse consumers with dazzling professional vocabulary that distracts customers from the product's real feature. Another related issue of the clear rule in CONC is the requirement of comparison between financial products in advertisements, which shall be 'meaningful and presented in a fair and balanced way' [954] to prevent meaningless comparisons, since a common trick used by credit firms is to simply compare the prices of products, which may give customers an inaccurate impression of their risks.[955] [956] This helps consumers to shop around and make fully informed choices.

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[951] Consumer Credit Sourcebook (CONC), para 2.3.2. R.

[952] CONC, 3.3.1. This 'clear, fair and not misleading' rule is also the basic advertising rule for other regulated financial activities. See, for example, *Conduct of Business Sourcebook* (hereinafter 'COBS') and *Banking: Conduct of Business Sourcebook* (hereinafter 'BCOBS').

[953] Ibid paras 3.3.2. (1); 3.3.5 (2)-(4). This rule is the adoption of the Consumer Credit (Advertisements) Regulations 2010, s 3.

[954] CONC, para 3.3.8.

[955] In a recent review of the FCA on comparative websites in the insurance sector, the FCA showed concern about customers being distracted by 'headline prices and brand' and ignored the

The fair rule is closely related to the misleading rule, although the former has a wider context and is not confined to information disclosure issues, but also covers, for example, responsible lending and charge of credit. Only added to the UK's consumer credit regulatory regime in the last decade and heavily influenced by EU law, the fair rule provides fundamental grounds for further judicial intervention in firms' unfair treatment of customers.

For the meaning of unfair commercial practices, the Consumer Protection from Unfair Trading Regulations 2008 (hereinafter 'CPRs') divides unfair commercial activity into two kinds. It is the implementation of the EU's Unfair Commercial Practices Directive 2005/29/EC into UK law. Under CPRs, there are 31 commercial practices that are unfair in their inherent nature, and would be assessed as unfair without the effect (or likely effect) on average consumers;[957] for example, firms are prohibited from falsely '[c]laiming to be a signatory to a code of conduct when the trader is not.' This is to prevent customers from being deceived by false information, as they mistakenly believe in firms' reputation in the industry and make decisions based on this misunderstanding. Consumer's behaviour is in this sense being distorted. Since such behaviour is by nature deceiving or aggressive, and deliberately conducted by the firm, unfairness assessment does not need to be made on actual effects and whether consumers are 'average'. While other commercial activities would be regarded as unfair only when (i) they contravene the requirements of professional diligence; and (ii) they materially distort or are likely to materially distort the economic behaviour of the average consumer with regard to the product.[958] A firm is not only expected to reasonably exercise its special skill when dealing with consumers,[959] but is also required to treat consumers with special care, as they are regarded as common

crucial product feature and risk. See 'Thematic Review: Price Comparison Websites in the General Insurance Sector' (2014).

[956] For example, FCA criticizes comparative websites in the insurance sector require that the comparison should 'go beyond price to include level of cover, key features, benefits, exclusions, limitations and other relevant information the consumer may require.' FCA, 'Price Comparison Websites Failing to Meet FCA Expectations' <http://www.fca.org.uk/news/price-comparison-websites-failing-to-meet-fca-expectations> accessed 10 March 2015.

[957] CPRs 2008, Sch 1.

[958] The Consumer Protection from Unfair Trading Regulations 2008, SI 2008/1277, reg 3(3).

[959] Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council [2005] OJ L 149/22. art 2 (h) and art 5.

people without any professional financial knowledge. Commercial activity shall not cause average consumers to make distorted decisions. Again, this reconfirms the basic assumption that consumers are likely to be financially illiterate, which, however, shall not exempt firms or provide them with the opportunity to treat consumers unfairly.

COCN recognizes that customers are average people. As regards information disclosure, one of the typical unfair activities is misleading consumers in the pre-contract stage.[960] This means average customers are often deceived by firms' activity into making a transactional decision they would not otherwise have made.[961] Although CONC only gives one example on this issue ('stating or implying that the firm will introduce the customer to a provider of a standard personal loan . . . but instead introducing the customer to a provider of high-cost short-term credit'),[962] there are other forms of misleading activities in CONC and other regulations such as CPRs. For example, firms are prohibited from unfairly 'encourag[ing], incentivis[ing] or induc[ing]' consumer to sign the contract without sufficient consideration, which deprives consumers of their free will in making choices.[963] CONC also prohibits firms from advertising their products by suggesting or implying that no creditworthiness assessment is needed, or promoting unsuitable products to vulnerable consumers regardless of their financial circumstances.[964] Moreover, attracting customers by using tempting expressions is also forbidden.[965] In addition, in order to behave fairly, lenders shall clearly list a representative example in advertisements to provide consumers with direct knowledge of the products, which must include, but not be limited to, for example, the rate of interest, charge of credit and representative APR.[966] Consumers could therefore shop around for the best deal and would be able to foresee costs of the loan and avoid possible indebtedness. In the post-contractual stage, consumers shall be informed of their right to cancel in the cooling-off period.[967] All these rules presume that customers in the consumer credit sector are common people without professional financial knowledge.

[960] CONC, para 3.3.10; CPRs, reg 3(4).
[961] Ibid s 5 (2).
[962] CONC, para 3.3.11.
[963] Ibid para 4.8.2. A.
[964] Ibid paras 3.3.3; 3.8.2.
[965] Ibid para 3.5.12.
[966] Ibid para 3.5.3.
[967] Ibid para 11.1.6.

Specifically, CONC highlights the risk of borrowing money from short-term, high-interest firms by additional risk disclosure requirements to avoid misleading consumers. Except for compliance with all the disclosure rules discussed above, firms in this sector are also under more stringent conduct standards; for example, all their promotions must include a risk warning, given that they are 'especially dangerous' for vulnerable consumers, while other credit firms do not need to obey this additional rule.[968] The new regulatory regime is viewed as following a risk-based approach. Cartwright regards risk-warning as a simple way of raising consumer's awareness of credit products, as this could give them a first impression of the risks involved before entering into a credit contract.[969] Since the final decision-making power to enter into a loan contract is held in consumer's own hand, what the regulator could do at this stage is to allow consumers to be warned about risks, for example, CONC requires lenders in this sector to explain to consumers before they enter into contracts that it is unwise for them to borrow money from them for long periods.[970]

The regulatory regime is therefore not piecemeal but interrelated, as information about products' risks is closely linked to consumers' responsible borrowing behaviour. To help consumers realize the underlying risks of indebtedness, CONC requires firms to disclose 'the principal consequences for the customer arising from a failure to make payments' and other information about repayment,[971] which will enable customers to make a reasonable assessment of whether they could afford the debt and the underlying indebtedness risks.[972]

Next is about the fairness of contract terms, as the Unfair Terms in Consumer Contracts Regulations 1999 (hereinafter 'UTCCR') defines a *contractual term* as follows:

> A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it

[968] Ibid para 3.4.1.
[969] Cartwright, *Banks, Consumers and Regulation* (n 823) 74.
[970] CONC, para 4.2.8.
[971] Ibid para 4.2.5. This requirement was first inserted in CCA 1974 by the Consumer Credit (EU Directive) Regulations 2010, Part 2, Regulation 3. CONC continues carry across this rule without change.
[972] CONC, para 4.2.6.

> causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.[973]

According to the UTCCR, if the annual percentage terms of contracts are 'drafted in advance and the consumer has therefore not been able to influence the substance', then it is not 'individually negotiated', unless the term belongs to mandatory statutory or regulatory provisions.[974] If the contract terms are to the detriment of customers then they are regarded as unfair.[975] Contract terms should be interpreted in the most favourable manner for consumers if there are doubts about their meaning.[976] Customers could lay complaints about the detriment they have suffered to the qualified regulator,[977] and it is the firms' duty to prove that the terms have been negotiated individually.[978] If the terms are assessed by regulators and found to be 'unfair', then they do not bind consumers.[979] Although the UTCCR mainly focuses on the recovery of interest, it could also encourage firms to negotiate with customers who are in the process of setting up a contract to avoid dispute, and therefore reduce customers' unawareness of contract terms.

However, a limitation of UTCCR 1999 is that the assessment of the unfairness of contract term does not cover 'definition of the main subject matter of the contract', and the 'adequacy of the price' of goods or services, as long as the term is in plain and intelligible language.[980] Since the interest rate of loans belongs to the price of services, the fairness of loan interests cannot be challenged as long as the contract has listed it in it, and the language of the contract is plain and intelligible.[981]

Up-to-date legislation on this issue is the Consumer Rights Act 2015 that consolidates the UK's consumer protection regulations. It also applies to the financial service sector. In respect of information disclosure, the Act expands the scope of content of contracts and the application of the fairness test to enhance consumer protection. First, anything said or written to the consumer by the firm is

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[973] The Unfair Terms in Consumer Contracts Regulations 1999, SI 1999/2083, reg 5.
[974] Ibid reg 4(2).
[975] Ibid reg 5. However negotiation is not the element of unfairness test; it is the detrimental result of the contract term that would be regarded as unfair.
[976] Ibid reg 7 (2).
[977] Ibid regs 11-12.
[978] Ibid reg 5 (4).
[979] Ibid reg 8 (1).
[980] Ibid reg 6 (2).
[981] Abdul Karim Aldohni, 'Loan Sharks v. Short-Term Lenders: How Do the Law and Regulators Draw the Line?' (2013) 40 Journal of Law and Society 420.

included in the formal contract terms, if the information is taken into account by the consumer to make a decision during or after entering into the contract.[982] Second, the application of the unfairness assessment of contract terms is also reconfirmed by applying a higher standard, although the UTCCR already covers the exclusion clause. Under the UTCCR, the assessment of fairness does not cover the main contents or price terms if the terms are 'plain and intelligible'. However, as discussed in section 2.3.1.1.ii, consumers would not usually read the contract term even if it is in plain and intelligible language. While the Act still maintains the exclusion clause of the UTCCR, it aims at increasing the level of consumer protection by adding a 'prominent' requirement into the previous exemption application scope, which means contract terms shall not only be plain and intelligible, but also for average consumers to be aware of the term. [983] If this standard is not met, then the main subject or price term would not be exempted from being tested for fairness after a detriment has occurred.

To avoid disputes under the new rule contained in the Act, firms will need to not only talk or write to consumers in transparent language, but also, and more importantly, to inform consumers of the substance and price of the product, rather than simply listing the terms in the contract and leaving it to consumers to read through. It is the firms' duty to ensure that consumers are informed. As the Act covers financial services, lenders in the consumer credit sector shall also comply with it and increase customers' awareness of, for example, loan charges. Failing to do so may lead to negative assessment in judicial processes and statutory remedies.[984]

Together with the transparent standard of contract language, the rule of consumer awareness of the main subject or price terms gives consumers another layer of protection, namely of being informed of the contract contents and product prices, although it still does not cover the substantial fairness of the term, for example, whether or not the high charge of a loan is fair, but focuses on proper disclosure. What is implied in the rule is that as long as the firm has disclosed the charge of the loan to consumers properly and consumers are already fully aware of the

[982] Consumer Rights Act 2015, s 50.
[983] Ibid s 64 (3)-(4).
[984] Ibid s 54.

charge, then it is consumers' own responsibility to decide whether or not to enter into the contract.

4.4.2.2 China

As a comparison, China does not have a single and unified conduct regulation in the area of consumer credit that focuses on protecting financial consumers' right to know; the Interim Measures 2010 also do not have detailed rules of disclosure.[985] Rules of information disclosure are roughly set up in the Law of the People's Republic of China on the Protection of Consumer Rights and Interests (amended in 2013) (hereinafter referred to as 'CPL 2013'), protecting all individual consumers in all consumption sectors.

Prior to the amendment, China's law did not explicitly provide special protection for individuals dealing with financial institutions, although the CBRC has set up some rules and require banks and securities traders to provide adequate information for their consumers, but not in the consumer credit sector.[986] Professional clients and common consumers were not differentiated under the consumer protection law; customers of banks and moneylenders were hence unable to quote the older version of the CPL as the primary legal basis when they were unfairly deprived of their right to know.[987] This part of the basic consumer protection law was criticized by many, who argued that banking customers shall be equally protected as in other consumption areas.[988]

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[985] However, in the life insurance sector, the regulator has issued a specific rule, see China Insurance Regulatory Commission, *人身保险新型产品信息披露管理办法* [the *Administrative Measures for the Information Disclosure of New-type Personal Insurance Products*] (2009 No.3). It provides sophisticated protection for insurance consumers with mandatory disclosure. This is also the case in the security trading sector. Consumer credit area is left behind due to its nascent stage.

[986] See, for example, CBRC, *商业银行个人理财业务管理暂行办法* [Interim Measures for the Administration of Commercial Banks' Personal Financial Management Services] (2005 No. 2)

[987] Another issue in the Consumer Protection Law (2013) is the long-standing argument on the definition of 'consumer', as in its art. 4, the law states that 'the rights and interests of consumers purchasing and using commodities or receiving services for daily consumption shall be protected by this Law,' some therefore argue that financial services do not belong to 'daily consumptions'. However, after the 2013 amendment recognized financial consumer's rights to be equally protected, there is now little argument on this issue. See, for example, Zhenming Peng and Xin Yin, '*论金融消费者知情权的法律保护*'[Legal Protection of Financial Consumer's Right-to-Know] (2011) 145 Fa Shang Yan Jiu 13.

[988] Ibid; Dan Guo, *金融消费者权利法律保护研究 [Legal Protection of Financial Consumer's Rights]* (1st edn, Jilin University Press 2009).

Only in the recent amendment has the basic law recognised the consumer status of individuals who purchase products or services from financial institutions, rather than regarding them as investors with professional knowledge. This is one of the most highlighted changes of the law and reflects the attitude towards change by the lawmaker, which gives financial consumers the same level of protection in respect of disclosure. The discriminatory rule was changed by the recent amendment as follows:

> Firms that offer security, insurance, banking, credit and other types of financial services shall disclose information to consumers, include but not limited to firms' address, firms' contact number, amount and nature of the product/service, price and costs of the product/service, start and end date of the contract, how to fulfil contract obligations, risk warnings, post-contract services, civil liabilities etc.[989]

It is the first time that the status of the 'financial consumer' is officially confirmed by legislation, which underpins the inclination to protect all consumers' right to know in the financial sector. The legislation moves a step away from the *caveat emptor* principle, which requires buyers to beware of their purchase. Consumers in the financial sector are no longer regarded as professional investors who shall take responsibility for their dealings with financial institutions after the amendment, but are equally protected as common customers in other retail areas. This is real progress that China's legislation has made in recent years.

Although article 28 is the only clause in the CPL 2013 that explicitly sets up a mandatory disclosure requirement in the financial sector, other clauses in the law could also apply to financial firms. At the top would be article 4 in the General Provisions which requires firms to 'adhere to the principles of free will, equality, fairness, and good faith',[990] providing the basic legal ground for information disclosure and fair treatment of customers; while the following several articles in the law set up rough protection with respect to information disclosure: article 8 sets up customers' rights to obtain information from the firm; article 9 protects customers' rights of free-choice; article 18 requires firms to provide risk warning for customers; while article 20 requires firms to 'provide consumers with true and

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[989] *中华人民共和国消费者权益保护法(2013 修正)* [Law of the People's Republic of China on the Protection of Consumer Rights and Interests (2013 Amendment], art 28. Translation available at <www.lawinfochina.com> accessed 2 October 2014.
[990] Ibid art 4.

complete information on the quality, performance, use, and useful life, among others, of commodities or services; and shall not conduct any false or misleading promotion'.[991] These clauses set up the conduct standards in disclosure that all firms, including financial firms, must comply with when dealing with consumers. In the later part of the legislation, consumers also have the right to claim for compensation if their interests were unfairly undermined by firms' misleading promotion.[992] Together with article 18, it is fair to regard CPL 2013 as providing the primary ground for the protection of domestic financial customers.

However, the weakness of China's consumer protection regime is also obvious. It is still extremely rough, and lacks any detailed rules and supportive regulations; for example, there is no explanation of what the 'misleading' promotion activity of firms is and what the complaint procedure is. Furthermore, the perspective of current legislation is still firm-oriented and does not cover average consumers' awareness of the price and risks. There is also no requirement on the clarity of language used. Such sketchy disclosure rules in the CPL is a disadvantage for consumers in judicial processes because courts may tend to interpret the law in a narrow sense; for example, if consumers argue that they were unaware of the prices or risks in a contract term, their only chance to be justified by the court is to prove the misleading or missing terms in the contract, which is procedural rather than substantial justice for consumers, since consumers' real awareness of information is not covered by the CPL. In addition, as CPL 2013 is only the second amended version in more than two decades, the flexibility of the statute is limited in the evolving market. Without detailed regulatory rules as support, effectiveness of the statute in reality remains to be seen.

4.5 Statutory/Regulatory techniques: Responsible lending

In order to protect customers' interests, lenders should remain responsible during the whole process of credit relationship, especially in the pre-contractual stage when the lender is going to approve a loan application.[993] In the definition of the

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[991] Ibid arts 8, 9, 19, 20.
[992] Ibid art 45.
[993] For example, the Consumer Credit Directive 2008 requires member states to 'promote responsible practices during all phases of the credit relationship . . . in particularly, it is important that creditors should not engage in irresponsible lending or give out credit without prior assessment of creditworthiness.' See Directive 2008/48/EC of the European Parliament and of the

EU Commission, 'responsible lending means that credit products are appropriate for consumers' needs and are tailored to their ability to repay',[994] it is another way to ensure that the loan product is suitable for customers' needs. Information disclosure also helps customers to decide about the suitability of loan products, since without enough information and comparison, average customers cannot distinguish the better firm or product from the bad one. However, making a judgement is still customers' own duty, while the firms' duty is to provide adequate information to help with a rational judgement. Responsible lending, in turn, is the ender's duty to ensure that only an appropriate loan be approved to suitable borrowers who can repay the debt without financial difficulty, irrespective of whether or not the customers are rational. Responsible lending as the regulatory methods in this sense is the second layer of protection, or a 'firewall' of customers' interests not to be harmed by any negative consequences of their limited rationality when borrowing money from lenders.

4.5.1 Assessment of creditworthiness

In order to ensure that borrowers can repay their debt, lenders should collect relevant information to assess customers' financial situation and repayment ability before approving or significantly increasing the amount of a loan. This is the creditworthiness check procedure, which is the most commonly used method of lending responsibly.

Both the UK and China have a creditworthiness check requirement for consumer credit in their statutes or regulations. In the UK, the role of irresponsible lending was inserted in the UK's regulatory regime by section 25(2B) of CCA 2006, which empowers OFT to consider if business practices in the consumer credit sector may involve 'irresponsible lending' and are 'deceitful or oppressive or otherwise unfair or improper'.[995] It is part of the licence control regime of OFT. If the rule is not satisfied, OFT could use enforcement actions, include requirements, penalties, and vary, refuse or revoke the licence.[996] The extent of enforcement by

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Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC [2008] OJ L 133/66. (26).

[994] European Commission, 'Public Consultation on Responsible Lending and Borrowing in the EU' (2009). para 1.1.

[995] CCA 2006, s 25 (2B).

[996] OFT, 'Irresponsible Lending-OFT Guidance for Creditors' paras 1.11-12.

OFT is 'guided by the level of actual or potential harm to borrowers and by the scale or frequency of identified misconduct.'[997]

Specifically, the creditworthiness assessment requirement (s 55B) was inserted into CCA 1974 by the Consumer Credit (EU Directive) Regulations 2010, which set the requirement for firms as having 'to undertake an assessment of the creditworthiness' before loan approval or significantly increasing the loan amount,[998] based on the information from the debtor and the credit reference agency. However, there is no further explanation on the details. Fairweather therefore views section 55B as merely a statutory provision of 'what is necessary' for lenders to do when conducting their business.[999] There is also no further explanations in OFT's Guidance. CONC further developed the rules about creditworthiness assessment by requiring lenders to consider 'the potential for the commitments under the regulated credit agreement to adversely impact the customers' financial situation',[1000] which, however, still focuses on the borrower's repayment ability.

A similar rule can also be found in China's Interim Measures for the Administration of Personal Loans, which regulates both banks and other subprime credit firms.[1001] For example, lenders are required to assess borrowers' basic condition, income level, loan purpose, repayment source and capacity; lenders shall base their assessment on interviews, and risks of granting loans should be under control. In fact, there is no essential difference between the rules in the two countries' regulations, partly because of lenders' common incentive to check the borrower's financial condition to ensure repayment. Since debtors' repayment ability concerns lenders' own interests to avoid 'damaging and expensive defaults, write-offs and home foreclosure procedures',[1002] it is assumed that lenders have enough incentive to carefully check the potential borrower's financial situation.[1003] In OFT's irresponsible lending guidance, the creditworthiness check is described as a 'credit-focussed test'[1004] or lender-oriented.

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997 Ibid para 1.10.
998 Consumer Credit Act 1974, s 55 B.
999 Fairweather (n 848) 94.
1000 CONC, para 5.2.1.
1001 Interim Measures for the Administration of Personal Loans (2010 No. 2), arts 14 -17.
1002 European Commission (n 994) 1.1.
1003 Ibid.
1004 OFT, 'Irresponsible Lending-OFT Guidance for Creditors' para 4.22.

However, even though it is in firms' own interests to check creditworthiness, there are still concerns about regulation non-compliance. It is observed that moneylenders may choose to ignore borrowers' past credit record or financial situation to reduce the costs of the creditworthiness check, the risk of which is, however, covered by higher charges, which are finally transferred to customers.[1005] For example, in the UK, some payday lenders who promise to provide 'instant loans' would reduce the creditworthiness assessment standards and, instead, charge higher interest and fees as the price.[1006] Nevertheless, this does not mean payday lenders do not care about borrower's creditworthiness; they still tend to use available information (eg, the previous borrowing record with the same lender) to avoid possible loss. Lenders are *de facto* responsible for themselves upon assessments of every single loan application. The prime purpose of the check, however, is to protect lenders' own interests with regard to repayment, rather than customers' interests.

In this sense, mandatory creditworthiness checks in regulation appears to be a minimum requirement for firms. Firms would usually choose to comply in their own interests. This could perhaps explain why non-compliance usually only has 'disciplinary consequences'.[1007] In the prior regulatory regime, non-compliance under CCA 1974 only has a licence issue under OFT's power; section 170 of CCA 1974 clearly states that breach would not lead to civil or criminal sanction.[1008] At present, under the FSMA regime, the FCA could also use its enforcement power in disciplinary cases if firms breach FSMA and its rules,[1009] for example, CONC and CCA; this covers the creditworthiness assessment rule in CONC. FCA can also prosecute firms for serious breaches (eg, insider dealing) through criminal courts and/or bring proceedings (ie, injunctions and restitution proceedings) in civil courts.[1010] However, breach of responsible lending does not reach that extent. Similarly, in the Interim Measures for the Administration of Personal Loans (2010) of China, lenders who fail to make the assessment are in

[1005] FSA, 'Consultation Paper 13/7, High-Level Proposals for an FCA Regime for Consumer Credit' (2013) Annex 2, paras 36-37.
[1006] ibid.
[1007] Fairweather (n 848) 94.
[1008] CCA 1974, s 170 (1).
[1009] FCA, 'Enforcement Information Guide' (2013) <http://www.fca.org.uk/your-fca/documents/enforcement-information-guide?utm_source=CCguide&utm_medium=firm-guide&utm_campaign=CCFG> accessed 22 March 2015.
[1010] Ibid.

breach of article 37 of the Banking Supervising Law of China, local bureau CBRC could order the lender to change its improper conducts.[1011]

4.5.2 Assessment of affordability

In contrast, the updated concept of 'affordability check' in the context of responsible lending has a more customer-oriented factor. In OFT's view, assessment of affordability is the 'borrower-focused test' which requires lenders not only to assess borrower's ability to repay, but also to consider whether they would be faced with any financial difficulty due to loan repayments.[1012] What is implied in it is that a borrower may be able to repay a loan on time but this would entail an additional burden for the borrower, such as in order to pay off the loan a borrower has to pawn her jewellery.[1013]

In the OFT Guidance, the criterion of affordability check is set as 'sustainable': customers could repay the loan in a sustainable manner 'without undue difficulty – in particular without incurring or increasing problem indebtedness', 'over the life of the credit agreement or, in the case of open-end agreements, within a reasonable period of time', and 'out of income and/or available savings, without having to realise security or assets.'[1014] The credit limit and repayment period shall be decided depending on, for example, the type of credit product, loan amount, borrowers' financial situation, credit history (which may indicate any possible financial difficulty), existing and future financial commitments, the impact of a future change in the borrower's personal circumstances, and the vulnerability of the borrower (e.g., limited mental capacity).[1015]

Since failing to make an affordability assessment under the OFT Guidance does not breach section 55B of CCA 2006, which regards creditworthiness assessment as lenders' legal duty, the Guidance manages to classify several cases of failure to assess borrowers' affordability as irresponsible lending,[1016] which further

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[1011] Interim Measures for the Administration of Personal Loans, art 41.
[1012] OFT, 'Irresponsible Lending-OFT Guidance for Creditors' para 4.1.
[1013] Ibid para 4.3.
[1014] Ibid para 4.2.
[1015] Ibid para 4.10.
[1016] ibid paras 4.19-4.31.

breaches section 25 (2B) of the CCA, so that the lender's fitness to hold a consumer credit licence could be questioned by OFT.[1017]

CONC also draws a clear line between assessment of creditworthiness and affordability, and requires firms to consider 'more than customers' ability to repay the credit'.[1018] This means all firms should take reasonable steps to assess customers' repayment ability to make sure the loan is 'sustainable' and would not incur future financial difficulties or significant adverse consequences.[1019] Specifically, lenders are required to 'reasonably expected future income or expenditure (to the extent to which it is proportionate to do so) where it is reasonably foreseeable that it will differ from actual current income or expenditure over the anticipated repayment period of the agreement'.[1020] Only considering current income and expenditure is viewed as not enough, as CONC admits the possible future change of borrowers' personal condition may have an influence on loan repayment. However, to avoid the rule from becoming a regulatory burden, CONC also limits the assessment duty within 'reasonable foreseeable' changes,[1021] Therefore, lenders do not need to undertake excessive duties.[1022] The meaning of 'sustainable' in CONC carries on OFT Guidance's methods as cited in the last paragraph without change.[1023] As CONC is mandatory for all consumer credit firms, affordability assessment is now mandatory for all lenders – including subprime lenders – to comply with under the sourcebook. There is no exception for small-amount, short-term credit under this rule. However, since CONC does not set up a checklist of all possible factors that may influence customers' future income and expenditure, lenders are still left with flexibility during their businesses.

Although China has requirements about creditworthiness assessment in its regulations, rules about affordability are almost all blank. The leading rules for

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[1017] CCA s 25 (2B).
[1018] CONC, para 5.3.1 (1).
[1019] Ibid para 5.3.1 (2).
[1020] Ibid para 5.3.1 (4)
[1021] CONC gives an example of 'reasonable foreseeable income changes', namely a customer is 'known to be, or it is reasonably foreseeable that a customer is, close to retirement and faces a significant fall in disposable income.' CONC, 5.3.1 (10).
[1022] Fairweather notes that in the draft version of the OFT Guidance, lenders foreseeing their duty was once expanded to 'wider economic changes' which is complained by the industry as too difficult to carry out. This rule was deleted in the formal version of the Guidance and is regarded as 'creditor-friendly approach' by Fairweather. See Fairweather (n 848) 96.
[1023] CONC, para 5.3.1 (6).

consumer credit, namely Interim Measures for the Administration of Personal Loans, only sets up creditworthiness assessment requirements. Although in the previous version of the Pilot Measures for the Administration of Consumer Finance Companies (2010), the cap of loan amount was once set as 'five times the borrower's monthly income' to make the loan affordable, this rule was changed by its 2013 amended version, raising the loan amount cap to 200,000 yuan,[1024] yet there are no further rules about loan affordability. One explanation for this regulatory vacuum is the nascent stage of the industry as well as regulations. In addition, since the credit reference system is not as widely used as in the UK, it is assumed that lenders in China would take customers' future possible income loss into account to avoid defaults. This consideration is, however, still 'creditor-focused' rather than out of concern for customers' interests.

Last, but not least, an important issue relating to the strength of responsible lending rule and customer protection needs to be clarified here. In the subprime lending sector, irresponsible lending practices are usually accompanied by unwanted effects after consumers have started repaying the loan, since they have chosen unsuitable loan products, and are usually charged with unfairly high rates and fees. Rules about responsible lending (either creditworthiness or affordability check), however, only provide minimum conduct standard for firms to comply with and disciplinary power for regulators, but do not directly offer remedies or recoveries to the detriment of customers.

The effectiveness of regulations on responsible lending is to regulate lenders' activity from an *ex ante* perspective, although the disciplinary power could only be exercised in the aftermath of irresponsible lending. Similarly, in the case of mandatory disclosure, as customers would only find out the insufficient or deceptive information given to them after entering into the contract and suffering from lenders' unfair charges. Conduct regulations in this sense are proposed to set up standards of behaviour and empowering regulators to take disciplinary measures if the misconduct is at a serious level. However, since there is always misconduct in firms' business, regulators would usually not intervene in every individual case due to limited regulatory resources. What consumers could do is to lodge complaints with the lender and, if unsatisfied, to courts or the appropriate

[1024] CBRC, Pilot Measures for the Administration of Consumer Finance Companies, art 21.

ombudsman. Whether their appeals would be justified is, however, depended on many factors. Another *ex ante* way to protect consumers that regulators could follow is to set a cap on loan charges in advance.

4.6 Statutory/Regulatory techniques: Usury control and remedies

As discussed in the section above, an efficient and direct way to protect customers in the subprime lending sector is to set a certain cap to regulate loan charges. This is similar to 'usury control' in the traditional sense, which has been exercised by states since ancient times; for example, the prohibition of loan charges higher than the allowed interest rates.

However, in the modern legal system, usury has more complex meanings because of the financial licence regime. For example, in Aldohni's view, *usury* can be defined as licensed lender taking charges that exceed the legal cap of interest, if such a cap exists in the regulatory regime, or unlicensed lenders who do so. In contrast, in other jurisdictions, if there is no rate cap in the law, usury only refers to unlicensed lenders' illegal taking of interests from lending activity, while licensed lenders are free to charge in the regulated lending activity on the rates they regard as profitable or proper.[1025] Since in a modern financial system one must obtain a licence before lending money to the public, to do so without licence usually means a criminal offence that is more serious than simply violating financial regulations. In contrast, licensed lenders' lending activities are regulated to prevent unfairly high rates. Traditionally, consumers could protect their interests through the courts. However, whether their appeals could be justified is largely dependent on whether or not there is a rate or cost cap, as well as the courts' judgements on the fairness of the charge. However, this judicial solution criticized for being is less effective for individual consumers. Another remedy taken by the UK is to cover consumer credit in FOS's scheme to provide simple solutions. There is also a usury cap in China and a new ADR for banking consumers has been set up.

4.6.1 The UK

[1025] Aldohni (n 981).

In the UK, lenders can only carry on regulated activities after obtaining a licence from the authority – OFT previously, and FCA since 2014 – otherwise they would be 'loan sharks'.[1026] For licensed lenders, there is no legal cap on interests for a long period of time since the usury law was abolished in 1854.[1027] This status has, however, changed since January 2015, when the interest rate of short-term, high-cost credit was capped. Prior to that, consumers could only seek a remedy from courts after being affected detrimentally. From 2006 consumer credit is covered by the FOS regime. A cap placed on a loan charge, in contrary, is an *ex ante* way of extending protection.

4.6.1.1 Test of fairness in the court

Although there had been no usury cap since the mid-nineteenth century in the UK, the need to protect consumers against being unfairly treated by moneylenders is not overlooked by statutes. In the original CCA 1974, courts were entitled to 'reopen extortionate' credit agreements.[1028] An 'extortionate' credit agreement either requires the borrower to make 'grossly [inflated] repayments', or 'grossly contravenes ordinary principles of fair dealing.' In order to arrive at a judgement, the court needs to consider both creditors' and debtors' conditions and decide whether the cost is extortionate.

However, judicial remedy set up in CCA 1974 has long been criticized for being 'ineffective';[1029] a White Paper made by the Department of Trade and Industry (hereinafter DTI) mentions that during some three decades only 30 cases involving extortionate loan costs reached the courts, and only 10 of them were proven to be extortionate and reopened.[1030] The wording of the statute on what is extortionate is regarded as imprecise,[1031] which leads to the cautious attitude of courts on how to interpret the term. Litigation is regarded as complex, unpredictable and expensive for customer.[1032] Furthermore, the White Paper criticizes the courts' focus on interest rates and overlooks other misconduct,

[1026] 'Loan sharks are illegal moneylenders who often charge very high interest rates.' GOV.UK, 'Report a Loan Shark' <https://www.gov.uk/report-loan-shark> accessed 13 March 2015.
[1027] See above section 1.7 of this thesis.
[1028] Consumer Credit Act 1974, s 137.
[1029] Fairweather (n 848) 100.
[1030] DTI White Paper (n 893), para 3.29.
[1031] Ibid para 3.31.
[1032] Ibid.

including level of security required, default charges and lack of transparent information.[1033] Courts usually also chose not to take post-contract issues into account, which are not guaranteed to be fair.[1034]

The UTCCR provides how terms of contract would be regarded as unfair, that is, it causes 'significant imbalance in the parties' rights and obligations' and leads to consumer detriment. [1035] However, terms about payable price does not belong in the scope of unfair assessment.[1036] Therefore, as long as the lender has disclosed the clear charges of a loan in contract terms, fairness of the term cannot be challenged. Consumers who are charged with high costs by moneylenders are therefore unable to complain to qualifying bodies and have the courts as their only remedy, which were less effective and hard to reach.

All these disadvantages led to the change in legislation. The Consumer Credit Act 2006 replaces the extortionate credit test in the original CCA 1974 with the new 'unfairness test' to provide more profound consumers protection. Instead of merely focusing on the charges of loans, courts are entitled to test the relationship between creditor and borrower, and decide whether it is unfair.[1037] If unfairness is confirmed, then the court has the power to require creditors to recover debtors' interests.[1038] In order to test the fairness of a credit agreement, courts should not only consider all terms of the contract, but also pay attention to how creditors have exercised or enforced their rights, as well as 'anything done' by or on behalf of creditors.[1039]

However, the effectiveness of the new unfairness test is also questioned. Fairweather, for example, points out that English courts are traditionally accustomed to 'unease with the notion of judicial intervention in bargains between private parties' on substantial unfairness, but focus on more procedure issues.[1040] Courts' attitude are also mixed. In several cases the courts found the relationship

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[1033] Ibid.
[1034] Ibid.
[1035] UTCCR 1999, reg 5.
[1036] Ibid reg 6(2)(b).
[1037] CCA 1974, ss 140 A-C.
[1038] Ibid ss 140B(1).
[1039] Ibid ss 140A(1).
[1040] Fairweather (n 848) 102.

as unfair because the interest rate charged by lender was too high;[1041] while in other cases the court justified the high rate because the lender has taken 'considerable' or 'substantial' risks, which entitles lenders to levy high charges.[1042] The result of the court remedy is therefore less predictable for consumers.

Moreover, in Aldohni's analysis of several cases in English courts, instead of being given special care, the vulnerability of consumers is actually a detrimental factor for them during litigation, as courts would regard their risks of repayment as the justification for higher charge levied by lenders.[1043] In Aldohni's observation, courts sometimes choose to justify the high cost of loans taken by lenders, regarding the high costs as reasonable because these are 'common practices of lenders' in the subprime lending market, regardless of consumers' vulnerability, and view the high charges as fair and acceptable.[1044] For example, in a typical case, *Nine Regions. (t/a Log Book Loans) v Sadder*, the defendant who was in serious financial difficulty and had bad credit records borrowed £880 from the claimant and was charged £2,378 in total. The APR at 384.4 % was regarded as reasonable by the court because the loan repayment period was 'over a relatively short period' and was therefore acceptable.[1045] Aldohni regards the unfairness test in judicial use as less effective in substance, as in the existing cases consumers' repayment risk was taken into consideration by the courts as an 'overriding' consideration and therefore justified the high charges of the loan, as long as the rate was in line with common practices of other moneylenders. The vulnerable status of consumers, however, was largely ignored.[1046]

However, simply vulnerability can hardly influence the court's decision because it means, to some extent, 'reverse discrimination' for the better-off borrowers who are also charged with high rates by subprime lenders. Whether consumer's vulnerability shall be part of the unfairness test is not clear. It is simpler to decide if the charge is proportionate to the risk; the courts, however, usually remain cautious by referring to common business practices in relation to high rates.

1041 Ibid 103.
1042 Ibid 104-105.
1043 Aldohni (n 981).
1044 Ibid.
1045 Ibid. *Nine Regions (T/A Logbook Loans) v Sadeer* [2008] Bromley County Court, Case No: 8QT25415.
1046 Ibid.

In addition, the new Consumer Credit Bill, which consolidates previous consumer protection regulations, has actually changed only slightly from the UTCCR, as it still exempts price term from fairness assessment of authorities, unless the term is not plain or intelligible, or consumers were unaware of it. Theoretically, to avoid disputes, firms have to use plain and intelligible language and ensure customers 'awareness of the contract substance and prices of services, which also add the strength of disclosure regulation. However, for vulnerable consumers who have no access to commercial banks and use subprime moneylender as the 'last resort', one possible condition is that they would still choose the expensive credit after information disclosure, because they have no other choices and are less sensitive to the price. The effectiveness of the Bill in this respect is impaired, although it has made good progress with regard to information disclosure.

4.6.1.2 Cap on payday lenders' charges

A more direct way to protect customers in the consumer credit market, as discussed above, is setting up interest rate caps in certain sectors of the market. In the UK, the FCA has taken measures to limit the high charges of high-cost, short-term credit, represented by payday lenders, by setting up an inclusive price cap in its rules.[1047]

The cap has three main parts. First, the initial cost cap is set at 0.8% of the outstanding principal per day, and for all the interest and fees charged during the loan and when refinancing, so firms are prohibited from adding interest to the original principle, regardless of the repaid parts. Second, the cap for default is set at £15 to avoid lenders from charging high fees for failed repayments. Charging interest after default is allowed but must not be higher than the initial cost cap. Third, there is a total cost cap for all interest, fees and charges that shall not exceed 100% of the total amount borrowed to avoid any possible loopholes.[1048] Repeat borrowing is also covered by the rules. All firms that provide high cost, short-term credit are covered by this rule, which came into force by January 2015, as the Consumer Credit (Cost Cap) Instrument 2014 (hereinafter 'CCCCI')

[1047] FCA, *Policy Statement, Detailed Rules for the Price Cap on High-Cost Short-Term Credit Including Feedback on CP14/10 and Final Rules* (2014).
[1048] Ibid table 1.1.

The advantages of this multiple cap are obvious. It is not a simple 'interest rate cap' which only sets up a usury line, but takes all other charges and fees into consideration. The total charges lenders can levy are therefore strictly controlled by the all-covering rule. As a comparable case, the roughly set fourfold interest rate cap could not avoid charges for, for example, 'consultation'. In addition, the CCCCI clarifies the consequence of non-compliance: (i) the agreement is unenforceable or against the borrower, and (ii) if the borrower chooses to not to perform in terms of the agreement, the lender is obliged to repay the excessive charges to the borrower.[1049] The effectiveness of the regulation is enhanced.

However, disputes about the charge cap always exist. A major concern, as the FCA Policy Statement notes, is that the cap will reduce the number of licensed moneylenders in the market, and leave vulnerable consumers to illegal loan sharks.[1050] This concern is, in fact, widespread. Zywicki summarizes the unintended consequences of usury regulations in the US, which include 'term re-pricing' (ie, the lender increases the price of the unregulated terms of a loan or other loan products to cover the loss on regulated terms), 'production substitution' (ie, if the rate cap makes re-pricing impossible, then the lender will change the products; for example, the growth of title lending in the US resulted from regulations that eliminated payday lending) and 'rationing' (ie, market exit of licensed lenders would force vulnerable consumers to turn to the informal sector or go without credit).[1051] A study of France, Germany and the UK indicates that stricter regulation of consumer credit and reduced access to legal credit is correlated with higher rates of illegal lending activity.[1052] Since Japan severely tightened its rate ceiling on consumer loans, there was a two-third decrease in the acceptance of loan applications, accompanied by a dramatic growth in illegal loan sharking.[1053]

The FCA admits this possibility of reduction in credit access but, at the same time, regards those who may be influenced as 'the least creditworthy'.[1054] Customers

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[1049] FCA, The Consumer Credit (Cost Cap) Instrument 2014 (2014/56), 5A(5).
[1050] FCA, Policy Statement (n 1047), para 2.11.
[1051] Zywicki (n 816).
[1052] Ibid.
[1053] Ibid.
[1054] FCA, Policy Statement (n 1047) para 2.5.

who will continue to get loans will benefit from the cap.[1055] In the FCA's view, the majority of consumers in the high cost, short-term credit market will remain in this market.[1056] The FCA therefore regards the cap as proper, since the benefits exceed the disadvantages.[1057] However, it still believes the rule change will 'overall' benefit consumers who access high cost, short-term credit, as those consumers could face a reduced risk of difficulty in paying back high cost, short-term credit loans and would alleviate stress, mental-health and welfare consequences.

The real effects of the cost cap in the high cost, short-term credit sector still remain to be seen due to the very short time for the application. However, this thesis, in general, supports the use of cost caps as one effective way to protect customers more directly than the unfairness test which largely depends on the courts' interpretation of the fairness and is less predictable. For example, if the majority of consumers could benefit from the rule change, then the benefit of the regulation has exceeded the cost of it, which provides legitimacy for the new regulation. Those 'excluded' consumers have the most vulnerable status: their rights and supplements to their income would be better served by state welfare and mature alternative lending facilities, such as credit unions. It is the state's role to establish affordable, alternative credit sources.

4.6.1.3 Dispute resolution through the Financial Ombudsman Service

In addition, since the FCA will not intervene in individual disputes with lenders, and judicial remedy is regarded as expensive and less effective, a simpler and easier way to solve disputes is essential. In the UK, the FOS is entitled by the CCA 2006 to accept complaints in the consumer credit sector.[1058] The FOS scheme is set up in Part XVI and Schedule 17 of FSMA 2000,[1059] while the detailed rules are contained in the FCA's handbook, *Dispute Resolution: Complaints* (hereinafter 'DISP'). In general, FOS provides UK consumers with a simple, informal way of dispute resolution. It has a simple complaint procedure

[1055] Ibid para 2.11. The Reponse.

[1056] Ibid Annex 2, Box 1. Consumers that would remain make the majority of the total consumer numbers who would be served without the cap (about 870,000 individuals, 97% of the total amount), while those no longer served is only 3% of the number.

[1057] Ibid.

[1058] CCA 1974, s 59.

[1059] FSMA 2000, pt XVI.

for average consumers that does not require the help of solicitors; FOS is not only limited to investigating consumers' complaints, but can look at other relevant conditions of the dispute, including consumer's financial difficulties; its services are available free of charge to consumers; its decision is final and binding for the firm to comply with if consumers choose to accept the decision, but not vice versa. For consumers in the subprime credit sector whose disputed loan principle is usually small and demands less time or knowledge in court procedures, FOS is an effective alternative way of solving disputes. Data provided by FOS shows the increasing trend of cases reported to it about payday lending, with 794 cases by 31 March 2014 and 542 by 31 March 2103; and increase of 46%.[1060]

One of the most obvious advantages of the FOS scheme in the subprime lending sector is that it would consider individual's conditions in every case, including the affordability of credit, lenders' assessment of borrowers' financial circumstances and consumers' vulnerability.[1061] In a recent case, for example, when a consumer in financial difficulty could not repay the debt on time and with the agreement of lender, entered into a debt management plan, the lender still tried to withdraw from the borrower's bank account, knowing that the customer was in difficulty. FOS regarded this activity as unfair because it ignored the consumer's financial difficulties and made them worse, and required the firm to refund what it had taken from the consumer's account with interests, plus compensation for the inconvenience it made the consumer suffer. The firm was also required to help the consumer with a repayment plan she could afford.[1062]

4.6.2 China

China has a legal cap on the interest rate for lending activities. In a 1991 judicial explanation of China's Supreme Court, interest rates for 'informal lending' were allowed to be higher than, but shall not exceed fourfold, commercial banks' rates

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1060 FOS, 'Complaints Data: Showing Individual Financial Businesses' <http://www.ombudsman-complaints-data.org.uk/> accessed 14 March 2014.

1061 Fairweather (n 848) 108.

1062 FOS, 'Ombudsman News, Payday Lending' (2013) <http://www.financial-ombudsman.org.uk/publications/ombudsman-news/109/109-payday-lending.html> accessed 15 March 2015. Issue 109 Index of case studies, 109/1.

on the same loan product.[1063] Since there was no subprime lender at all at the time this cap was set up by the Supreme Court, 'informal lending' in its original sense only referred to a money-borrowing activity between individuals or between individuals and legal entities. According to this rule, any claim of a creditor on loan interest that exceeds the fourfold limit will not receive judicial support, if the debtor refuses to pay the additional interests.[1064] Apparently, the fourfold line is what the reasonable interest rate is in the Supreme Court's mind. However, contractual parties could still freely agree on higher rates in contract. The courts will not intervene in contractual freedom unless a dispute is referred to the court.

Originally set up to regulate informal lending activities, this rule now, in fact, applies to all moneylenders. Subprime lenders are allowed to lend money to the public and belong to the 'formal' market; there are also two kinds of 'informal' lending activities: (i) those in the original sense which are by nature legitimate, while (ii) at the other end of the spectrum are the underground illegal moneylenders without licence and who are illegal. In fact, the legal cap is an important aspect for identification of the 'loan sharks; although China's criminal law does not have a 'usury crime', a criminal offence still applies in this case, that is, 'illegally engaging in operate certain business that severely disturbed marketing order', [1065] because they have lent vast amounts of money to the public at usurious interest rates, and use violence to collect loan repayments.[1066] Usury, as defined by Chinese criminal law, therefore has four elements: (i) lenders have no licence, (ii) money is repeatedly lent to the public, (iii) interest rates are charged that exceed the legal cap, and (iv) force is used in debt collection. Apparently, the criminal law aims not to punish whoever crosses the line, instead, only those who repeatedly lend money to multiple debtors and conducting a business without a licence and who charge interest that exceeds the usury cap are regarded as being criminal. Other casual, small-scale and informal lending and borrowing activities with a certain person (ie on a one-to-one basis) are legitimate.[1067] In this sense, although not being explicitly expressed by the

[1063] China Supreme Court, *最高人民法院关于人民法院审理借贷案件的若干意见*[Several Opinions of the Supreme People's Court for the trial of lending and borrowing cases] (1991), para 6.
[1064] Ibid.
[1065] Criminal Law of China (1997), s 225.
[1066] Zhongqiang Li and Yan Chen, '*放高利贷行为的刑法评析*' [Criminal Analysis of Usury](2013) 1 Ren Min Jian Cha.
[1067] Ibid.

authority, the fourfold rate cap is *de facto* the courts' standard of judging the fairness of a lending activity. An interest rate cap in China *de facto* protects all money borrowers, whether they are dealing with subprime lenders or friends and relatives or underground or unlicensed moneylenders. It is a 'blanket' protection in the sector.

However, the effectiveness of the rule is limited. First of all, the fourfold cap is merely an 'interest rate cap' and does not cover any other additional charges, which means lenders could stay under the rate cap and safely charge for other services, such as 'handling charges' or 'consulting fees', without any legal cap or limit.[1068] This is *de facto* a loophole in the regulation and licensed lenders could benefit from customers. However, since the courts would usually also consider whether the total amount of loan interest (including the interest for late repayment and penalties) exceeds the fourfold line, it is a remedy applied by the courts.

A judgment handed down by the Xuzhou Municipal Court reflects this judicial attitude. When the defendant defaulted on the loan, the claimant required repayment of the loan principle, loan interests and compounded interests and attorney fees, as agreed in the loan contract. The court justified the claimant's appeal on the loan principle. However, as regards the agreed default, the rate had exceeded the fourfold rate cap and went against the Supreme Court's judicial interpretation.[1069] Although this dispute arose between a small money lender and several small enterprises, and the loan amount was also high (i.e., 5,000,000 yuan; approximately £540,000), it indeed shows how Chinese local courts would interpret the legal usury cap. Because of the existing rate cap, results of disputes referred to court are largely predictable for both parties.

However, although courts indeed provide a remedy for loan cost disputes, for vulnerable consumers, it is less convenient and economical to seek redress through judicial methods. Available judgements disclosed by Chinese local courts are, in fact, largely between small enterprises and subprime lenders; the former is far from being 'vulnerable'. What is more, judicial control is only meaningful if

[1068] Shenzhen Baoan District Court, '*涉小额贷款公司案件逐年递增亟需引起重视*' [Increased Amount of Cases Related to Small Lending Companies] (2014) <http://www.bafy.gov.cn/NewsInfo.aspx?p1=2&p2=29&infoId=18612> accessed 13 March 2015.

[1069] Xuzhou Municipal Court, 'Judgement of Jiangsu Xuzhou Municipal Court, 2013 No.0022' (2013) <http://xzzy.chinacourt.org/public/paperview.php?id=1236978> accessed 13 March 2015.

borrowers choose to seek judicial remedy, which is difficult not only because of individual consumer's economic or social status, but also due to the nascent stage of conduct regulation. For example, rules about information disclosure are largely sketchy and simply require firms to disclose essential information in contract. There is also no requirement of assessment of affordability or suitability in China's regulatory regime. Therefore, it is difficult for consumers to defend themselves by arguing about being unfairly treated; local courts in China would also usually tend to justify lenders' appeal of the additional charges for delayed repayment of a loan, as long as the two contractual parties had agreed on the charges or compounded interest in the contract.[1070] Lenders' business conduct is outside the judicial view because current regulations of consumer protection in the sector are sketchy, and are more procedural than substantial. Therefore, the only non-compliance risk for subprime lenders is the loss of judicial support for interest that exceeds the fourfold limit; for lenders there is actually nothing of substance to lose. Individual customers are not under special judicial protection but are regarded as an equal contractual party by courts; without the development of conduct of business regulations (eg, affordability assessment), judicial attitudes can hardly change.

A most recent development in China is the setting up of a new dispute resolution mechanism under the authority power of the PBoC, and consumers could seek protection by complaining to PBoC branches. An administrative instrument, Administrative Measures for the Protection of Financial Consumers' Rights and Interests (hereinafter 'AMPFC') was enacted in 2013, which set up rules for PBoC dispute resolution in the banking sector.[1071] Consumers shall first complain to firms, if they are dissatisfied with the result, then they can complain to the PBoC's local branches.[1072] However, if financial institutions' conduct is illegal, then the firm-level complaint procedure can be skipped.[1073] The method of

[1070] See, for example, Yuzhong District Court, 'Judgement of Chongqing Yuzhong District Court, 2012 No. 05009' (2012) <http://www.yzqfy.gov.cn/Item/Show.asp?m=1&d=1451> accessed 13 March 2015.
[1071] PBoC, *中国人民银行金融消费权益保护工作管理办法(试行)* [Administrative Measures of the People's Bank of China for the Protection of Financial Consumers' Rights and Interests (for Trial Implementation)] (2013 No.107 of the General Office of PBoC), art 11.
[1072] Ibid art 12.
[1073] Ibid.

complaining is also flexible and includes a visit to or a telephone call to the PBoC branch, or sending letters or electronic mail.[1074]

However, what the PBoC could do is limited to investigation and mediation between the disputed parties to the agreement between them. The PBoC is not entitled to make judgements. While agreement on individual case is not legally binding on both parties to the dispute, if the firm does not comply with the agreement, the only route consumers could follow is to send the case to court or other arbitration authorities. In this sense, the dispute resolution regime proposed by the PBoC is an 'incomplete' version of the commonly used ombudsman services. Without the binding force, which is central to any dispute solution regime, the effectiveness of the newly established PBoC regime needs to be reviewed after a period, since it is still in its very early stage of application.

4.7 Summary

This chapter discusses another form of access to credit that vulnerable consumers could use, namely credit from subprime lenders. Such lenders are 'subprime' because they are less regulated and tend to misconduct themselves when dealing with consumers. However, since to many consumers, access to mainstream credit is unavailable, the gap-filling role of subprime credit is essential. Regulations of the subprime lending market could be justified in two aspects. First, consumers are not presumed 'rational' participants in the market but may be abused by firms and, second, benefits of regulation exceed the costs. Generally, regulators would set up business conduct rules to provide a minimum level of consumer protection. The main content of this chapter is the discussion on whether the current regulatory regimes in the UK and China are effective.

Both the UK and China have experienced tremendous changes in their regulatory regime. However, it is apparent that UK consumers enjoy more enhanced protection than their Chinese counterparts. The unified regulatory regime in the consumer credit sector in the UK provides equal protection to all consumers, regardless of what kind of firm they are dealing with, while providing an additional safety net for those who access high cost, short-term credit. Detailed

[1074] Ibid art 14.

rules are set up in the FCA's sourcebook on firms' conduct standards. However, in China the regulations are still sketchy and 'piecemeal'. Although the Interim Measures for the Administration of Personal Loans (2013) set up rules for all lenders, the conduct rules in it are still too sketchy, although the consumer credit market is expanding rapidly.

As to the detailed rules about consumer protection in the subprime lending sector, this chapter mainly discussed three major parts: (i) information disclosure, (ii) responsible lending and (iii) cost control.

In general, consumers shall be regarded as 'average' in their knowledge level about financial markets and products. Mandatory disclosure about loans is essential for consumers to make informed choices. However, the effectiveness of disclosure lies in whether consumers are aware of the information; simply listing terms and conditions in contracts does not equal consumer awareness. On this issue, the UK takes the 'clear, fair and not misleading' approach which protects both procedural and substantial interests of consumers. Lenders' business activities and contract terms are all included in the rule; contract terms should be written clearly, in plain and intelligible language, while lenders are prohibited from engaging in misleading activities that would distort consumers' decisions, as this may lead to their detriment. What is more, consumers' awareness of the main content or payable price terms is also enhanced, as the Consumer Rights Act 2015 adds the 'prominent' rule into the exemptions. In China, in contrast, rules about disclosure and consumer protection have only been added to the statute very recently and only require firms to disclose essential information. Neither the plain language standards nor the remedy of possible detriments caused by insufficient disclosure are available in the CPL 2013.

Responsible lending is another way of protecting consumers from detriment by choosing unsuitable credit products. It includes both creditworthiness and affordability assessments. The latter is more essential as it takes consumers' possible financial difficulty into consideration. The UK has already set up rules about affordability checks in CONC, while this issue in China's consumer credit sector has still not been addressed. This is another aspect of substantial consumer protection in the UK's regulatory regime.

However, both information disclosure and responsible lending are *ex ante* rules set up by financial authorities as the minimum standard of business conduct. Firms can always violate rules and once disputes arise, consumers need other remedies to recover their losses. In fact, the common result of lenders' misconduct is default on loans and consumers are charged unfairly high fees and interest. Therefore, central to consumer protection is the cost control, either by setting up a cap on charges, or by referring the dispute to court or FOS for unfairness assessment. The former is a direct way of protection. However, unless the cap is all-charges inclusive, its effectiveness would be limited. As to the latter, since court procedures are both expensive and time-consuming, it is unrealistic for individual consumers to seek judicial assistance. Although the UK has an unfairness test, courts largely ignore consumers' vulnerability. The remaining remedy is through alternative dispute resolution, which is simpler and consumer-friendlier. However to be effective, decisions made by the ADR must be binding on firms.

Chapter 5: Conclusion

This thesis discusses the role of law and financial regulations in financial exclusion in respect of payment services and consumer credit. The term 'financial exclusion' describes the difficulty and negative consequences faced by certain groups of people who have no or limited access to mainstream basic financial services. People are 'excluded' from commercial banks as clients because they yield low profits for banks and are less creditworthy. In the context of this thesis, basic financial services that are essential to vulnerable consumers include (i) payment services and (ii) consumer credit. The former is essential because using cash is both inconvenient and more expensive in many cases; for the latter, making use of consumer credit acts as an income supplement and emergency cushion. Lack of available access means customers have to choose inferior alternatives (eg, subprime credit) or go without access, which would add to their vulnerability. This thesis argues that customers' vulnerability should not rationalize this exclusion; instead, law and regulation should recognize this vulnerability and facilitate possible access for those customers to affordable, easily accessed, basic financial services, and reduce the negative impact brought about by subprime markets.

Several basic understandings are presented in this thesis to justify this viewpoint. First, regulation is not in conflict with the free-market theory. In fact, the market is never totally free from government intervention. Reliance on firms' rationality or the industry's self-regulation does not mean the minimizing of social costs, since consumers are less likely to be able to make rational choices. If they are unable to choose a good firm over a bad one, their remaining option is to rely on business conduct regulation which would, at least, provide minimum protection of their interests. Second, regulation in this area also does not intend to provide everyone in society with account payments or credit; instead, it aims to expand equal opportunities since people should not be discriminated against when it comes to access to basic financial services. Third, as long as regulations are set up properly, their benefits to consumers and to society would exceed the costs.

Based on this understanding of financial regulation, this thesis is divided into three parts. Chapter 2 discusses the role of consumer banks in facilitating financial inclusion. In general, although banks are not in the position of public institutions, they are still anticipated to fulfil the duty of offering easily accessible accounts and payment services to society, including vulnerable consumers. Since commercial banks are at the centre of the regulatory regime and enjoy government protection when it comes to firm stability, they should also show some corporate social responsibility in return. Furthermore, in the modern era, a bank account has become an essential of life and is gradually replacing the use of cash in many social aspects. The position of people who have no access to a bank account is *de facto* exacerbated as a result of the expansion of basic banking services. Although there is usually no explicit statutory objective stating the necessity for promoting financial inclusion, banks are usually encouraged by government to be involved in the process.

In general, commercial banks could be regulated which would require them to conduct their lending business properly. Even if there is no explicitly stated inclusion purpose in the law, access to a basic bank account for the vulnerable could be strengthened by specific rules. In the UK, banks are obliged to disclose information about basic accounts to consumers at an appropriate time, using an appropriate medium, and in plain and intelligible language. While in contrast, in China, as long as the contract terms have listed core information then this could be regarded as proper disclosure. However, this does not touch on the more substantial issue of consumer awareness of the term. Compared with the UK's approach, made by the BCOBS, rules relating to disclosure of bank accounts or cards are still bank-orientated rather than account-holder-oriented; these rules are more disciplinary in nature than standards of business conduct.

In addition, there are issues surrounding banks' reluctant incentives, since offering account and basic payment services is hardly profitable for banks. One way to facilitate banks' participation in the process lies in governments' relationship with the industry. In China, for example, government is the controlling shareholder of the major commercial banks and could take advantage of this status. Another way is to recognize access to banking services as necessary in regulation and to set up a new duty for banks in statutory instruments. This is represented by the EU Directive on payment accounts, which sets out detailed rules on how to facilitate access to payment accounts in Europe. It regards the use of payment accounts as consumers' right, reduces discrimination based on consumers' economic status and intends to increase consumers' awareness through conduct regulation. Since the substantial contents of the directive were *de facto* accepted by an agreement signed between the UK government and the major participants of the industry, it provides a new incentive, namely a relationship with the government, for those banks to be involved in the process. When compared with China, where banks are merely instructed by the PBoC, this thesis regards the UK's approach as more appropriate since there are detailed rules that could support the government–industry relationship on the issue of bank account inclusion.

Comparing payment account services, legal and regulatory issues related to consumer credit are more complex. Again, banks are reluctant to expand access to vulnerable consumers, as lending to them is not profitable; the possible default risks could indeed be covered by increasing interest rates or charges, which is in conflict with banks' strategy of maintaining their moral reputation. However, it is hardly practical to expand the social duty from banking services to consumer credit. Unlike the account issue, which is less relevant to individual's economic status and has fewer risks, consumer credit has the inherent risk of loan default. Regulation could reward banks who offer basic bank accounts to vulnerable people, but is hardly going to compensate the bank if it suffers from default loss. When the responsibility of assessing borrowers' creditworthiness is solely borne by banks themselves, there is no place for regulation to require banks to serve certain groups of the vulnerable. What regulation could do is to provide incentives or rewards for the participation; for example, the Community Reinvestment Act in the US sets up a series of assessment standards, rewards and punishments in the statute to provide incentives for banks. It is a typical example of how law and regulation could play their role in expanding affordable credit to the low-income communities.

However, before any of the roles similar to that in the CRA can be set up, the incentive issue of banks can only be complemented by regulatory rewards. An alternative route followed by China's banking regulator, the CBRC, is to encourage commercial banks to set up VTBs in rural communities, with the reward of promising the participating banks priority in new-branch opening applications. Such rewards, however, were found to be ineffective. Unless the regulator is willing to offer more attractive awards, this thesis adopts the view that it would hardly be possible for Chinese commercial banks to be substantially involved in the credit inclusion efforts.

Therefore, the answer to how vulnerable consumers can access credit is now clear. Apart from mainstream credit from commercial banks, there are also other kinds of firms in the consumer credit market, namely the alternative credit facilities that provide affordable credit to consumers, and the subprime lenders that cover the repayment risk with high charges. Regulations relating to these lenders are discussed in Chapters 3 and 4.

Chapter 3 deals with the regulatory regime of alternative community credit facilities in the UK and China, and tests the effectiveness of the regime in facilitating such lenders to grow. Two kinds of lenders are discussed in the chapter, namely mutuals and the small community-level commercial banks. The latter is exclusive to China.

Mutuals show as special ownership structure. They are owned by customers, who are able to save or borrow money from them. However, before being able to do so, one must first join the membership by depositing a small amount of money in the firm. The long-lasting relationship between members and mutuals provides the essential stability for the firm.

Chapter 3 also reviews the regulatory regime for credit unions in the UK and rural mutual co-operatives in China respectively. The conclusion is reached that credit unions in the UK could benefit from a gradual deregulation process, while the regulatory regime for RMCs in China is 'one size fit all', sketchy and lacks sustainability. In fact, the sustainability of such alternative lenders is at the centre of the effectiveness of the regulatory regime, as it serves some consumers who are unlikely to be approved for accessed to credit by commercial banks, but does not require high rates such as subprime lenders do.

In order to support mutuals to be sustainable, there are several aspects of regulation that are essential. First, the customer base of the mutual shall not be limited to a single community or single group of people, but should cover more diversified customers to increase the members' capacity to deposit money into the mutual. This should particularly be the case if external investment or fund sources are not readily available. Here the diversified membership would be the basis for the mutual's sustainability. Furthermore, to fulfil members' need for credit, there should also be multiple loan products, ranging from small-amount, short-term loans to mortgages, if possible. Since mutuals are allowed to take members' deposits, they are also under prudential regulation. However, small mutuals shall not be equal to huge commercial banks, since their potential level of causing systemic risk is by no means on the same level. In all, this thesis regards the UK's regulatory regime as appropriate, since the basic statute, namely the Credit Union Act, 1979, has been revised several times and gradually deregulated, while prudential regulation distinguishes banks from credit unions, and makes a distinction between large and small credit unions. In contrast, RMCs are still under restrictive rules, which are 'one-size-fits-all' prudential regulation standards. Such a regulatory regime seriously limits RMCs' growth more so than their counterparts, VTBs. This thesis regards the restrictive regulatory regime and limited financial resources as the main burdens on RMC growth.

In addition, an evident weakness in the CBRC's regulatory regime of RMCs is that it strictly controls the licensed ones, but leaves the unlicensed, 'fake' RMCs that also exist in the market. This may distort consumers' decisions and mislead them into believing that the fake ones are licensed and are backed by the government. It is also unfair to the licensed RMCs, since their compliance with the regulations only leads to a burden. In this sense, the CBRC might be regarded as being irresponsible. The licensing regime has *de facto* lost its original sense of controlling market entry. This thesis deems that it is irresponsible for the CBRC to regulate only the licensed RMC but leave unlicensed ones to the market, especially when those unlicensed mutuals are unable to obtain licences.

The second kind of alternative credit facility is the VTB which, by nature, is a commercial bank but set up at community level to maintain its inclusion feature. Although the development process of VTBs is better than the RMCs, they are also seriously restricted by improper regulations. The strict limit on eligible setting-up promoters excludes those banks that have incentives, while the eligible banks are found to be of less interest. Again, incentives here are set up, but are not attractive enough.

In general, for the test of a regulatory regime for alternative credit facilities (ie, mutuals and VTBs), this thesis regards the regime in the UK as more effective in facilitating firms' growth, while in China the regulator *de facto* retains a cautious attitude towards the non-state-holding depositaries. The regulations are mainly intended to discipline rather than facilitate.

Chapter 4 discusses the regulatory regime of the remaining kind of creditors in the consumer credit market, namely subprime lenders. Regulations focus on business conduct regulation as these lenders do not have licences to take deposits. They simply lend money to the public, which is less likely to cause systemic risks. Both the UK and China have multiple subprime lenders. In general, the regulatory regime in the UK is regarded here as better protecting the 'substantial' interests of consumers, while in China regulations still ignore substantive fairness. This is reflected in all four aspects of the chapter: (i) information disclosure, (ii) responsible lending, (iii) usury cap, and (iv) dispute resolution.

For example, the UK has set up the standards of 'clear, fair and not misleading', which require contract terms to be plain and intelligible, not mislead consumers through any business activity, and increase the level of consumers' real awareness of price terms; while China only requires that essential terms be listed in contracts, and there are no requirements related to language used or awareness. This leads to the disadvantaged status of consumers if a dispute breaks out, since lenders are exempted from the duty if they have listed the issue in the contract. Furthermore, there is no affordability check requirement in China's regulatory regime; consumers' potential financial difficulty would not be considered by the court. The usury cap in China also has a loophole and is less effective than the all-covering total cost cap of the UK's regime. In both countries court procedures are regarded as expensive and ineffective for individual borrowers. Decisions made by FOS in the UK are final and legally binding on firms, while in the newly set up dispute resolution regime under the PBoC, agreements made by two parties would not be binding. The most advantageous aspect of the ADR is therefore missing.

In sum, through a detailed analysis and comparison of the UK and China, this thesis arrives at the conclusion that it is possible to use law and regulations to facilitate financial inclusion, as long as regulations are properly set up. However, regulations could also become a serious burden to the growth prospects of community-level lenders. Furthermore, business conduct regulation in the subprime lending sector may lose its effectiveness if it does not consider the real and substantial interests of consumers.

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