

**REGULATING FINANCIAL SECTORS  
FOR DEVELOPMENT AND SOCIAL JUSTICE**  
**Notes for an expert group meeting organized by  
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This note is about retail finance and in particular about financial industry abuses of low and middle-income people in their use of basic financial services (savings, credit, insurance and payments). The topic is a global one, as relevant in developed countries as in developing ones. There are inexorable incentives in the private financial sector that all too often lead finance people to take advantage of other people, whether it is mortgage sellers putting people into houses they could not afford in the US or banks selling high-risk Argentine bonds to unsuspecting households in Italy and Germany before the 2001 default, or Indian microfinance banks in Andhra Pradesh so loading farmers up on loans in 2010 that, it is said, they provoked a string of suicides.

The author is an economist, not a human rights lawyer, and thus not in a position to say whether the financial abuses discussed here qualify as human rights violations, as I do not believe there is an internationally agreed “right” to financial services as such. However, the Human Rights Council has adopted guiding principles regarding how the behaviour of businesses should respect human rights. Most financial providers should be covered by the guiding principles since most are businesses (besides for-profit financial institutions, it would seem that state-owned banks, depositor-owned credit unions and civil society microfinance projects would also qualify as businesses). Moreover, the evident need for effective regulation of the financial services industry would seem to involve States (or non-state industry-level regulators, such as stock market operators) in duties to protect and remedy abuses of human rights that take place in their areas of responsibility. Whether or not falling within an explicit human rights framework, the financial activities to be discussed here are, at least, clear injustices, morally offensive and not often enough

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<sup>1</sup> Contact: [herman@socdevjustice.org](mailto:herman@socdevjustice.org). This presentation draws heavily on two recent pieces, one prepared for the World Council of Churches, called “Financial services, financial needs and global financial architecture: a background paper” (<http://www.oikoumene.org/en/resources/documents/wcc-programmes/public-witness-addressing-power-affirming-peace/poverty-wealth-and-ecology/finance-speculation-debt/background-paper-on-a-new-international-financial-architecture.html>) and a chapter on the “Strike Debt” offshoot of the Occupy Wall Street Movement in New York City, which is contained in a book published in February 2013 by the Friedrich Ebert Stiftung, *The Future We the People Need: Voices from New Social Movements in North Africa, Middle East, Europe and North America*, Werner Puschra and Sara Burke, eds. (<http://library.fes.de/pdf-files/iez/global/09610-20130215.pdf>). Additional material is separately referenced in subsequent footnotes.

illegal. They may or may not impede economic growth, but they certainly aggravate economic inequality.

An important point here is that finance is a special industry. While there are often opportunities for people to exploit other people in daily economic activities, the opportunities are especially prevalent in finance because most financial transactions embody a degree of trust. That is, while a buyer may examine the quality of a shoe before buying it, most financial transactions involve a payment today with a promise for a payment in the other direction later. There are thus good reasons for having strong regulations to protect customers, making certain practices illegal and setting standards for others. This fundamental problem has also been an impetus for creation of alternative non-profit financial providers, some created by States and some by community organizations. All the options can be appropriate and all can be abusive. In truth, this is a case in which “one size does not fit all.”

### **The story in brief**

The focus here is on direct financial system abuse of low and middle-income people. These people may live in developed countries or in developing countries, including in communities at the margin of the market economy. Evidence is that people even in such communities regularly use many financial services, usually from informal providers, including moneylenders.<sup>2</sup> Thus, the question for these people, as for everyone else is the quality, quantity and safety of the financial services they can access.

#### *Abuses*

It has increasingly been appreciated that middle-income as well as poor households need protection from unethical practices by financial service providers. Practices have ranged from banks not informing customers of fees and charges for some of their services (credit cards being a prime example), to aggressive investment advisors working in what are known as “boiler rooms,” in which high-pressure salesmen push high-risk securities onto unsuspecting small investors (drawn from a “sucker list”) and then “churn” the account by encouraging frequent trading to increase fees. The problem extends as well to financial institutions that work with real estate companies to sell houses financed with mortgages that buyers cannot afford. Many of these abuses came into the public eye, in particular, in the United States, in the wake of the financial crisis.

It is indicative of the incentives built into the financial sector and the financial resources that the industry deploys to protect its interests that it can be a formidable foe of the public interest. Indeed, while public outrage about financial abuses in the United States encouraged consumer advocates to push for strengthened consumer protection, the financial industry saw it as a threat to their profits. It has fought back vigorously, weakening the attempted transition to a more transparent, robust, accountable and fair financial system. Thus, a tremendous fight was necessary in the United States to create the Consumer Financial Protection Bureau as a single consumer-oriented focal point in the US

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<sup>2</sup> See, for example, Daryl Collins, Jonathan Morduch, Stuart Rutherford and Orlanda Ruthven, *Portfolios of the Poor* (Princeton University Press, 2009).

Government for restricting unfair, deceptive and abusive financial practices and helping inform consumers (as through clear labelling of financial products and promoting financial literacy, as well as having rule-making powers to prohibit or restrict abusive practices by a range of financial actors). Once created by law in 2010, another fight was needed to start the agency operating. Its director was only appointed in January 2012. Establishing such a regulatory entity should have been as uncontroversial as looking to government to certify food safety or new pharmaceuticals. In some economic sectors, like finance, the cost of *caveat emptor* (buyer beware) is simply too high to let people continually discover the problems on their own.

And yet, the battle continues in the United States, as certain financial practices that had earlier been outlawed were once again made legal under the cynically named 2012 “JOBS” Act (“Jumpstart Our Business Startups”), which reduces the information that small firms seeking investor financing need to make available and weakens other restrictions. Thus, after laws had been earlier adopted to make “boiler rooms” illegal, they have again become a potentially profitable business. The most disappointing fact is that the JOBS Act was adopted by huge majorities in both houses of the US Congress and was strongly supported by the President. Alas, this seems less indicative of any theory of economic regulation being followed in Washington than of the power of financial institution leaders who make large donations to political candidates.

In this regard, the United States is not unique. Problems of consumer abuse by politically protected financial institutions can be found at times anywhere and at any level. There have been several notable instances, for example, in the field of “commercial” micro finance. Initially, microcredit, which offers tiny loans to the poor, ostensibly for business activities, was promoted by non-profit initiatives. Banks had long eschewed serving the poor, assuming them to be unreliable not to mention “unwashed” customers (culture matters in getting a loan, as does caste, class and gender). The advent of commercial microfinance came when it was realized that the poor actually repay their loans at a higher rate than middle-income borrowers. So, in some countries, private investors rushed in to lend to the poor, sometimes with disastrous effect.

For example, in Bolivia in the mid-1990s, consumer credit companies crowded into the retail credit market, offering loans to individuals who were judged creditworthy by virtue of being a customer of a microcredit organization, loading people up on too much debt so that they could not keep up payments when the next economic recession hit. The response was a lot of angry people, including some who occupied the national banking oversight agency with threats to dynamite it.<sup>3</sup> The policy response in Bolivia was to strengthen regulation and most of the consumer credit institutions went bankrupt.

In some cases, government policies enable the exploitation of borrowers. In South Africa, for example, the Government became concerned with the expanding debt levels of middle and low-income salary earners, which had been facilitated by allowing banks to automatically deduct debt servicing payments from wages. In 2000, the Government

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<sup>3</sup> See United Nations, *Building Inclusive Financial Sectors for Development* (New York: United Nations, 2006), pp. 35-36.

revoked that permission and the banks ended with substantial holdings of defaulted debt. That is, the banks lent less without the guaranteed ability to collect payments as they fell due and borrowers then defaulted on their loans. In the end, two major banks that had large volumes of small-scale loans failed, small banks contracted and average banking service charges rose.<sup>4</sup>

A further example reflects what happens when privatisation policies are adopted without adequate regulation. India expanded the private sector role in its banking system in the 1990s, out of which a rapidly growing for-profit microfinance industry emerged. Many of these institutions had converted from social organizations and others were new private start-ups, but they all sought profit from rapid growth in loans, financed by willing wholesale lenders and investors in the firms. By 2010, these micro-loan institutions were expanding their loans at an annual rate of some 80 per cent. Unfortunately, many borrowers, especially in the state of Andhra Pradesh, which had a very dense microfinance sector, became over indebted. The commercial microfinance institutions were seen as aggressively trying to collect what was owed to them. Several of the farmers committed suicide and many of them were found to have been heavily indebted to certain of these lenders. In addition, pressured to pay their private creditors, borrowers tended to not pay their non-profit creditors, endangering their solvency. Local political leaders advocated default, which occurred on a large scale and the state government issued strong restrictions on the private sector lenders, punishing those that attempted “coercive action” in loan collection, prohibiting multiple loans to customers, and restricting the level of interest rates on loans.<sup>5</sup>

#### *Institutional alternatives*

From the above one may conclude that at one time or another, private financial institutions of varying types and sizes have abused their customers, whether low or middle-income. Indeed, the insider-trading and Ponzi schemes of the past few years in the United States underline that the rich can also be targets for abuse. In most such cases, States were inadequately attentive to what was happening. Strong customer protection regulations of the financial sector and State capacity to fully implement the regulations and monitor the financial firms on a timely basis are required to prevent abuse of customers.<sup>6</sup> And yet, adequate consumer protection regulation is a permanent challenge, as the financial enterprises seek ways around regulatory restraints. However, there are alternatives.

Let us first consider the poor. Recalling the point made earlier that the poor use a lot of financial services, the question becomes where do they get those services? One set of answers is the informal financial sector, which includes a wide variety of institutions. In some cases, they operate efficiently and provide an important service. Examples include

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<sup>4</sup> Ibid. p. 34.

<sup>5</sup> Ultimately, the Reserve Bank of India issued national regulations for the sector; see Anuarg Priyadarshie and Asad Ghalib, “The Andhra Pradesh microfinance crisis in India: manifestation, causal analysis and regulatory response,” University of Manchester, Brooks World Poverty Institute Working Paper 157 (October 2011).

<sup>6</sup> This aspect of financial regulation is not often enough stressed in post-2008 international discussions of financial regulation. They have tended to focus on the prudential dimensions of regulation, which, after all, are certainly important as they are meant to prevent banking crises and economic collapse.

the international money transfer business of the *hawala* system in Arab, African and South Asian countries and the *fei ch'ien* system that has operated for centuries in China and with overseas Chinese.<sup>7</sup> Other effective informal institutions include small scale savings and credit systems called ROSCAs (“rotating savings and credit associations”). There are also savings collectors, as in India and parts of Africa, who travel to collect savings from individuals on a fixed periodic basis and whose customers willingly pay a fee for the service (in effect, a negative interest rate on their savings).

Exploitative moneylenders are also a well-known type of informal financial institution (although an interesting conundrum is their continued operation when people have access to and simultaneously use lower-cost alternative microcredit systems—the reason is apparently the attraction of privacy and flexibility in repayment that moneylenders often offer). Moneylenders are not exclusively a developing country phenomenon; for example, “payday lenders” are a type of US moneylender who may operate out of a store front and who gives short-term credit to wage earners (until “payday”) with loans typically renewed at maturity rather than repaid, with interest and charges accumulating quickly to annualised rates of hundreds of per cent.

As the informal financial operations have too often been exploitative rather than communal, governments and social institutions have created formal alternatives, albeit with usually limited scope and coverage. Thus, since the mid-18<sup>th</sup> century at least in Europe the poor have had access to “social finance” institutions created by governments or community authorities, such as churches. These include credit unions at the smaller end of the spectrum and large state-owned institutions, like post office savings banks (from mid-19<sup>th</sup> century), which provide safe savings to small depositors, many of which have since been privatised. A huge example of the latter is the incompletely privatised Japanese postal savings bank and insurance company, which by some indicators has been identified as the largest financial institution in the world.

The independent non-profits themselves range from small to huge institutions. At the smaller end of the retail scale, there are numerous client-owned institutions, such as savings and credit cooperatives and credit unions, and numerous microfinance institutions established by non-governmental organizations (NGOs). But there are also huge NGOs, such as BRAC, an innovative, Bangladesh based, highly diversified and now multi-country institution that is also the world’s largest NGO, with about 120,000 employees.<sup>8</sup>

The economic heart of the financial sector, however, is commercial banking and some countries still reserve at least a partial role for state-owned commercial banks. For

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<sup>7</sup> See Leo Buencamino and Sergei Gorbunov, “Informal money transfer systems: Opportunities and challenges for development finance,” United Nations, Department of Economic and Social Affairs Discussion Paper No. 26 (November 2002).

<sup>8</sup> Originally the Bangladesh Rehabilitation Assistance Committee (1972), BRAC seeks to offer comprehensive assistance to the poor people with whom it works, not only finance and not only credit (giving grants to people deemed too poor to handle a repayment obligation). It offers a comprehensive package, including education and health services, production support (e.g., milk collection centres for dairy farmers) and help in marketing of goods produced by microentrepreneurs. BRAC was rated the world’s top NGO in 2013 by *Global Journal*, 23 January 2013 (see <http://theglobaljournal.net/article/view/986/>).

example, Costa Rica had a fully public banking system until it started to allow limited private banking services in 1987 and full services only from 1995. As of end-2011, it had three large state-owned commercial banks that accounted for over 55 per cent of financial institution assets, while cooperatives accounted for another 9 per cent. Private commercial banks had 30 per cent, the rest mainly in housing and other institutions.<sup>9</sup> A number of other market-based economy countries also have mixed public and private providers of basic banking services.

In general, the public institutions provide services to households and small and medium-sized enterprises that private banks see as less profitable. Some of the public institutions operate at wholesale level, providing loans and other services to other public entities. One example is the German regional banks serving savings banks and non-bank customers (*Landesbanken*). Many countries have government-run provident funds, a famous example being Singapore's Central Provident Fund, which receives mandatory savings from residents to fund insurance programs such as for retirement and health care and invests in housing. It was introduced by the British while Singapore was still a colony in the 1950s, but it seems that private-sector oriented Singaporeans still appreciate how it works. Finally, governments sometimes operate large development banks to provide financial services to enterprises and sometimes to financial institutions that serve individuals. The Brazilian BNDES (*Banco Nacional do Desenvolvimento*) is a huge case in point, lending almost \$70 billion to local firms in 2011, which was nevertheless said to be less than the lending by the national development banks of China and Germany (*Financial Times*, 23 September 2012).

While many of these institutions have done wonderful work, they have also engaged in what with hindsight have been abusive practices. An example of note is the Spanish *cajas de ahorros* (savings banks). They were created in the 19<sup>th</sup> century as private charitable institutions to provide savings services to the working class whose deposits were lent to state-run pawn shops, known as *Montes de Piedad*, which on-lent the funds to the poor. Later the *cajas* directly financed low-income housing and, as they evolved through the Franco and then the democratic regimes, the corporate goal became to generate profits to devote to social programmes. These institutions are supposed to operate with a "double bottom line" of self-sustaining earnings and social mandate. However, they heavily over lent during the housing bubble, when funds to lend were easy to obtain and the market opportunities were apparently irresistible. Many people have lost homes and savings as a result.

While the Spanish *cajas* seem to have mostly been guilty of bad decisions (and the Government of Spain apparently was inadequately attentive to the risks they were accumulating), they have not been alone. Some other institutions have taken on risks that exceeded their mandates, for which they have paid with insolvency. This includes the bankruptcies of "Fannie Mae" (Federal National Mortgage Association) and "Freddie Mac" (Federal Home Loan Mortgage Corporation) in the United States, formerly

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<sup>9</sup> Costa Rica, Superintendencia General de Entidades Financieras, *Memoria Annual 2011*, p. 6 ([http://www.sugef.fi.cr/pagina.asp?lang=0&pagina=servicios/documentos/infgeneral/memoria/indice\\_memoria.htm](http://www.sugef.fi.cr/pagina.asp?lang=0&pagina=servicios/documentos/infgeneral/memoria/indice_memoria.htm)).

independently run semi-official housing finance institutions. In addition, three out of the 11 German *Landesbanken* had to be bailed out after taking substantial losses from investing in risky US mortgage-backed securities, which led to reduced retail lending by the savings banks that were their part-owners.

A further example is provided by the Japanese Postal Savings Bank, highlighting problems that arise from public financial institution involvement in national politics. In this case, the accumulated postal savings deposits provided a large fund for public spending that in time came to mainly satisfy clientalist political needs of important constituencies of the governing party.<sup>10</sup> One must thus be as aware of the potential for what in the economics literature is called “government failure” as well as being aware of “market failure” in the private sector.

### *Principles of regulatory and policy reform*

It seems that policymakers and policy advocates need to be eclectic in their views of steps to take to ensure financial services are provided on an adequate, fair and transparent basis to households and firms. In some cases and for some purposes, public or non-profit providers may effectively and equitably serve an economy’s financial and economic development needs. For other purposes policy makers will deem it best to permit private provision of the service, but they must also create the capacity to properly oversee the activities to prevent abuses. Furthermore, some degree of consumer financial education needs to be provided, as in schools, as well as through public information campaigns for adults.

All in all, one can conceive of policy principles that would be deemed desirable for economic efficiency and equity reasons, as well as serving human rights imperatives:

- Promote financial literacy through full disclosure and education.
- Boost access of the poor to basic financial services on affordable terms, which may be through direct public provision (e.g., postal savings) or socially oriented financial service providers (e.g., credit unions), or appropriately overseen private provision.
- Protect retail customers by disallowing dangerous and unfair financial practices.
- Assess the likely impact of a new financial instrument before it is sold to the public, considering whether the innovation serves a purpose that society supports or not.

### **The advocacy imperative and the case of “Strike Debt”**

Five years after the explosion of the financial crisis, sensible (if hardly radical) proposals for tighter regulation of the financial sector have been fought almost to a standstill by the financial sector. Equity (not to mention prudence) calls for a counter political force. The abuses so highlighted in recent years cry out for independent citizen

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<sup>10</sup> On the politics of the Japanese postal system and its reform, see Kenji Kushida and Kay Shimizu, “Syncretism: the politics of Japan’s financial reforms,” *Socio-Economic Review*, vol. 11, No. 2 (April 2013), pp. 337-369.

agitation to pressure political authorities to be less in thrall to financial interests. This is then a matter for popular mobilisation. It is not simple to say from where it would or should come. In this regard, perhaps some remarks will be useful about “Strike Debt”, a project of the continuing Occupy Wall Street movement in New York that is one example of a people’s project that received a certain amount of positive public attention, if still far from being a full blown movement to fight back against financial abuses.

In the spring of 2012 in New York City, an “affinity group” of the Occupy Wall Street movement formed itself as “Strike Debt”.<sup>11</sup> Through the summer and fall, it marched or joined other marches in public spaces to challenge public apathy about how heavily indebted people struggle to survive. It expressed solidarity with striking students in Quebec by wearing their small red square patches of cloth. It met in the open—mostly sitting on the grass in a big circle outdoors in Washington Square Park—where curious passers-by might listen in on the discussion. It welcomed to its meetings an independent filmmaker and a photographer who wanted to record the beginnings of a new people’s movement. It produced Strike Debt buttons and discussed strategy, tactics and self-education, forming the “Extremely Boring Book Club” for interested volunteers.

Even more uniquely, it created innovative social mobilisation tools that could help at least some individuals reduce their debt burdens. This required intensive study and discussion over the summer within the group and with legal and financial experts who sympathised with the impossible financial situations into which millions of Americans had fallen. Realising the paucity of programs to help people deal with those burdens and the lack of information about the limited options that did exist, Strike Debt wrote a book called *The Debt Resistors’ Operations Manual*.<sup>12</sup> It is full of concrete, useful advice, such as what to do if you cannot meet your student debt repayment obligations but have not yet defaulted (p. 33). It also contains proposals that should be read as playful, as some of them are not legal, for example, how to defraud a payday lender (p. 75), which seems to be offered in the same spirit as many other Occupy actions that use wry humour and irony in the service of delegitimizing the political and economic system.

Strike Debt also conceived a scheme to buy up defaulted medical debt at a deep discount in order to forgive it, and it undertook a fundraising effort to finance debt purchases that mobilised US\$ 500,000 by the end of 2012. This was enough, Strike Debt claimed, to extinguish about US\$ 10 million of personal financial obligations.<sup>13</sup>

The ability of Strike Debt members to find allies to teach them about the system even in the grey areas of the financial sector is itself noteworthy. In this case, the scheme took advantage of a practice available to some types of creditors in the US in which they sell the financial contracts covering household debts they have been unable to collect. The contracts are bundled into packages that debt collection firms buy. The debt collectors then harass the debtors and use legal challenges to try to force them to pay at least some of the principal and interest owed. As the probability of collection is small, since the debtors have

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<sup>11</sup> (<http://strikedebt.org/>).

<sup>12</sup> (<http://strikedebt.org/The-Debt-Resistors-Operations-Manual.pdf>).

<sup>13</sup> (<http://rollingjubilee.org/>).

already defaulted, the creditors are said to sell the loans at about five cents on the dollar. Strike Debt learned it could buy packages of the debt, simply tear up the contracts, and notify the individual debtors that they had been relieved of their repayment obligations. Recalling the biblical reference of the Jubilee Campaign to cancel the sovereign debt of poor countries in the 1990s, the campaign is called “Rolling Jubilee”.<sup>14</sup>

The New York initiative struck a responsive chord around the United States, and affiliates formed in San Francisco, Portland, Philadelphia, Detroit, Chicago, Salt Lake City, and Minneapolis, as well as in London; plus, Strike Debt allied with existing anti-debt groups in France and Spain. Seeing the possibility that the initiative could gain momentum as a national political movement, the New York group drafted an organisers’ manual.<sup>15</sup> It drew lessons for others from how the New York group had evolved and from its experiences in reaching out to other organisations and institutions, such as churches and the public at large.

I doubt that anyone in Strike Debt thinks its initiatives or similar isolated initiatives will themselves solve the over-indebtedness problem of households in the United States. Any independent initiative, however clever and well-intentioned, will at best scratch the surface. Yet without fruitful and persistent social agitation, government will not ameliorate the patently clear abuses of the existing system in the US and elsewhere. Strike Debt found several ways to bring attention to the problem in the US context. Others might find the experience useful in thinking about popular mobilization in other contexts. Perhaps framing these problems in a human rights context would also help advance the campaign for raising people’s need above financial greed.

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<sup>14</sup> The campaign currently focuses on medical debt, which is money owed to doctors and hospitals for services that are not covered by insurance. Almost 50 million Americans do not have insurance and the policies that many people have through their employers or personal purchases generally provide incomplete coverage of medical expenses.

<sup>15</sup> Downloadable at <http://strikedebt.org/Strike-Debt-Organizing-Kit.pdf>.