The International Review of Financial Consumers, Volume.5 Issue.2(Oct., 2020), 19-23 pISSN 2508-3155 eISSN 2508-464X
https://doi.org/10.36544/irfc.2020.5-2.3
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The International Review of Financial Consumers

www.eirfc.com

Policy framework for Financial Consumer Protection: What we know vs. what we do not know - The Indian Experience

Sankarshan Basu†

A B S T R A C T

This article provides economic rationales for the importance of financial consumer protections in a competitive marketplace for financial products, and considers financial consumer protection in India in the context of the various different protection mechanisms that have evolved across the globe. The article identifies initial developments toward greater protections for India’s financial consumers and provides recommendations for how these protections should evolve given the specific needs of India.

Keywords: Financial consumer protection, policy framework, the Indian case

Ⅰ. Introduction

Why do we need a Consumer Protection Framework in a competitive marketplace for financial services? After all, for those who believe in the success of the market and more so about the levelling power of the market, the need for any kind of protection is unclear and mistakenly assumed to be unnecessary. Yet, as is seen, markets are far from being perfect and can be controlled by individuals with vested interests. Therefore, the need to protect the “weak” is of paramount importance. This is all the more true in the financial marketplace as the protection seeker is typically much smaller and significantly less endowed with the resources needed to stand up to the behemoths in the industry. In particular, the need for consumer protection in the highly competitive marketplace for financial services stems from the following:

- Informational Asymmetry: Expertise is required for the development of most financial products and strategies; thus, the seller of a financial product is always at an informational advantage over the buyer. Information asymmetry incentivizes the seller to mis-sell the product by deliberately concealing the not so savoury yet possible outcomes, leading to poor financial outcomes for the buyer. This has been best described by Akerlof (1970).
- Externalities: Failure of one financial institution can be the cause for investors in financial institutions to withdraw their investments prematurely. This can lead to losses for the investors but also potentially cause a solvent institution to become insolvent. Such outcomes have been seen many times in the banking industry, where due to the breakdown of confidence in one institution the depositors have also, as a panic reaction, withdrawn their deposits from other banks causing an otherwise solvent bank to default and become insolvent and causing much larger damage to the system and the investors. This was evident in the financial crisis in Greece a few years back.

† Professor, Finance and Accounting, Indian Institute of Management Bangalore, Bannerghatta Road, Bangaluru, India
sankarshan.basu@iimb.ac.in

In India we saw the same when there was a murmur of a problem in ICICI Bank or even very recently (March 2020) in Yes Bank. And it has not just been the banking industry that has been exposed to this - this has also been seen in the cases of other financial institutions like the drop in investor interest when institutions like ILFS defaulted in 2018. For details, one can refer to Baltensperger and Dermine (1987); Chari and Jagannathan (1988); Diamond and Dybvig (1983); Jacklin and Bhattacharya (1988); and Postlewaite and Vives (1987).

- High Search Costs and Price Dispersion: There often exists no repository of reliable information to enable comparison of the financial products, and different players market their near identical products as seemingly different. This leads to confusion amongst the investors who can be swayed by the marketing gimmicks and make potentially suboptimal decisions.
- Behavioral Characteristics of Consumers: Consumer decisions can be influenced by the way service providers frame the choices, and consumers may mimic behavioral patterns of peer leaders or peer groups, leading them to ignore signs and indicators that would lead a rational consumer to take different decisions. This becomes particularly relevant in the financial market space as the propensity to mimic the perceived successful person is extremely high, often at a huge adverse cost to an individual investor.

Given this background, an obvious question is why consumer protection in finance is different from consumer protection for other retail goods and services. After all, like other products, financial products are offered in a retail marketplace and other markets may also face the problems outlined above. There are some very clear and compelling reasons to differentiate the concept and need for consumer protection in finance from consumer protection in other retail markets.

One such reason is that decisions and outcomes in the context of financial products are fundamentally different from similar decisions and outcomes in the usual retail product space. It is relevant to note that most important financial decisions are undertaken very infrequently in the course of a lifetime. Yet, the outcome of such financial investments and strategies becomes clear only in the long term, and not immediately upon product purchase, and most importantly at a point in time when the ability to reverse the earlier decision is not possible or feasible. On the other hand, for physical products, the outcome of the purchase becomes obvious upon immediate usage and high-quality producers can distinguish themselves through signalling devices such as warranties on their products as well as the fact that reversal of such decisions is generally far easier; for example an authomobile with a longer and more comprehensive warranty would be viewed differently as compared to one without any such warranty. Moreover, market movements can have a substantial impact on the performance of financial products, confounding the ability to ascertain the reasons behind poor poor performance of a financial product. The poor performance can be due to product mis-sale or to the consequence of random shocks in the market, but diagnosis of the exact cause may not be possible. Further, the different causes may also be intertwined and hence segregation may not be possible. Financial consumer protection regulation therefore requires specialized attention considering both the high degree of information asymmetry and the nature of manifestation of outcomes.

Ⅱ. The Experience of India

With the above as a broad background, and something that is applicable universally, let us focus on India and the framework that exists there. The ability of the Indian financial system to respond effectively to the challenges in the financial sector will have a significant impact on the future of India.

A. Challenges in the Financial System

The Indian financial system faces a huge number of challenges, but let us take this opportunity to highlight some of the basic facts about financial consumers in India as that also highlights the sources of the challenges that are likely to come up. Of the close to 1.38 billion population only 34.4 percent of the lowest income quartile have access to savings in financial products and about 70 percent of the lowest income quartile borrows from informal sources at interest rates which are upwards of

24 percent per annum. Only 14 percent of the lowest income quartile have life insurance as a part of their financial portfolio; and, only 1 percent of the entire population has medical insurance (one of the most important costs for the aged). In the context of health, it is also important to note that public spending on health is a measly 1.2 percent of the GDP and is expected to grow to around 3 percent over the next 10 years, which will still be very small compared to the need.

In addition, given the improvements in the living conditions in India and the consequent increases in life expectancy, the proportion of those aged 60-and-above is expected to climb from 4.6 percent in 2000 to 9 percent in 2030. This means that in absolute terms the number of people above the age of 60 will increase from 100.8 million in 2010 to 200 million by 2030. By 2050, it is expected to be over 320 million. It also needs to be noted that only about 10 to 15 percent of the population has access to formal programs designed for providing income security during retirement. Finally, it may also be relevant to note that about 33 percent of the population is below 15 years of age, and they will require huge funding for higher education, given the need for education to move out of the low-income bracket. [1]

So, what will be the future of finance and the financial system in India? More directly, what should be some of the strategies to define the future of finance in India? In the opinion of this author, the future of finance in India hinges on the pillars of innovation, customization and competence.

Regarding innovation, considering the range of unsolved problems and the magnitude of financial inclusion required in India, it is clear that the scale of innovation in the financial sector needs to increase in manifold. There needs to be a clear policy space created for actors in the financial sector to attempt new and better ways of delivering financial services, as long as these do not compromise the stability of the system. Increased innovation will necessarily have to be the engine that drives the future of financial services, and we see this as the only way to achieve meaningful financial inclusion in India. The key directions for increased innovation should be in product development, in channels of service delivery, and in technology.

Further, the nature of financial innovation must be socially relevant in the market where it is implemented. Innovations must address the complexity of consumer needs, and solutions must be customized. This is particularly relevant in a country like India where financial literacy is quite low and there are wide disparities amongst the population on all counts - be they economic, social, educational, or cultural.

B. Financial Consumer Protection Framework

Before addressing the possible measures that India could consider, let us look at the current financial consumer protection framework that exists. In this context, it is important to note that there is no specific regulation covering the interests of financial consumers in India. The only legal recourse that the consumers have in India is through the consumer courts set up under the Consumer Protection Act of 1986. These are courts that address all kinds of consumer disputes, including disputes impacting consumers of financial products. However, financial consumers do have some additional cover through the dispute resolution mechanisms set up by the service-specific regulators: the Reserve Bank of India (RBI) for banking related disputes; the Securities Exchange Board of India (SEBI) for disputes arising out of exchange based trades (primarily equity trades); the Insurance Regulatory Development Authority (IRDA) for insurance related disputes; and the Pension Fund Regulatory Development Authority (PFRDA) for disputes arising out of the new pension scheme[2].

Just as the Consumer Protection Act and the service-specific regulatory dispute resolution mechanisms form the basic tenets of India's current financial consumer

[1] For details, United Nations (2002).

[2] All government employees in India, since independence, were eligible for pension upon superannuation. The pension plan in India was the Defined Benefit scheme. However, by around the end of 1990's the government realised that given the increasing life expectancy of the population and therefore an increased pension bill for the government was becoming unsustainable and some estimates showed that if the Defined Benefit scheme for the government employees continued, by 2035 the pension bill of the Government fo India would be more than the total revenue collections of the government. In the backdrop of this, the government decided to move to a Defined Contribution scheme for pension for all employees joining the service on or after January 1, 2004. This Defined Benefit pension scheme is what is known as the New Pension Scheme. For details see CRIISP (2011).

protection landscape today, they also highlight a number of fundamental gaps. First, there is a lack of mechanisms to deal with the conflicts of interest inherent in regulators responsible for the dual functions of prudential regulation and consumer protection. There are also an increasing number of inter-regulatory conflicts arising out of a rapidly evolving financial sector. Finally, consumer protection regulations have failed to respond to a growing body of evidence on consumer behaviors and preferences.

Ⅲ. The Way Forward for Financial Consumer Protection in India

The future of financial consumer protection in India must be built to not just take care of the India specific-market conditions, but to also ensure that the current gaps are addressed. In this context, the author's idea is that the new framework should be based on the "philosophy of suitability". In particular, the financial consumer protection framework should ensure that the consumer protection equilibrium should shift from being disclosure-driven (in which consumers need to make the right choices), to suitability-driven (in which financial service providers need to provide appropriate advice or products to consumers). Further, in order to prevent malpractice in the financial market, the consumer protection framework could be based on either information disclosure mechanisms (buyers decide based on information provided by the service provider) or suitability requirements (seller assesses the suitability of a product for the consumer and is held legally liable for it).

Increasing complexity of financial products will also lead to a greater asymmetry of information between the buyer and the seller. Not only will the asymmetry be adverse to the buyer as compared to the seller, the gap will continue to widen over time. Given this, it makes sense to suggest that the most appropriate approach in protecting the welfare of the financial consumer would be to put the onus of consumer protection on the financial services provider. This shift in equilibrium, from caveat-emptor to provider-liability, will drive financial service providers to compete on the provision of solutions that are appropriate and not just revenue-maximizing for the provider, thus aligning the incentives of the provider with the consumer.

Taking as given that the protection framework for financial consumers needs to be based on the philosophy of suitability, let us briefly discuss suitability as a process. In that sense, what needs to be recognized is that suitability should be seen as a process with every financial services provider having an approved "Suitability Policy" for the company to follow in all interactions with consumers. The policy should include the process of consumer data collection, the methodology used for the analysis of the data collected, the communication channels used for informing customers of the recommendations of the firm, and the follow-up mechanism used by the service provider. And, the real success of this idea will be when the degree of implementation of the suitability process becomes the basis of evaluating a financial service provider; and, when in the event of a violation, the provider should be subject to legal penalties. This will ensure that the financial services provider is incentivized to follow the suitability philosophy and act in the best interests of the consumer.

Another important aspect of consumer protection is the issue of legal liability. Legal liability ensures that it is in the firms' self-interest to provide suitable recommendations and products to consumers. The combination of ex-ante legal liability and a strong threat of ex-post enforcement provide credible disincentives for financial service providers to act in ways that promote their own self-interest at the cost of consumers. The interpretation of suitable behavior would be best determined by the buildup of case laws over time, thus ensuring that our understanding of suitability comes from the realities of the financial marketplace and its evolution over time. A suitability framework underpinned by legal liability is the most effective way of ensuring that the design and sale of financial services is suitable for the consumer.

The idea of suitability also has to be intertwined with the right of choice for the consumers. The objective of suitability is to ensure that the financial services provider is always incentivized to act in the best interests of the consumer, and not to ensure that the consumer abides by the advice of the provider. The right of choice ensures that the principle of suitability does not in any way impede the right of the consumer to choose. In this context, it is important to note that while it is imperative for the financial service provider to present a clear set of recommendations for the consumer, it is for the consumer to make the final decision on whether to accept or reject

the recommendations given. The process of suitability stops at the point where the financial services provider gives a recommendation based on his/her understanding of the consumer's situation and needs. The liability for the provider only exists when the consumer consents and follows the recommendations made under the suitability framework.

To be able to achieve this environment, appropriate regulations need to be enacted. The regulations should be such that an environment is created where suitability is at the heart of consumer protection. This will require a fundamental change in the current regulatory approaches and instruments. However, it is only through the creation of an enabling legal and regulatory framework that the power of suitability to drive improved consumer protection can be realized.

It is heartening to note that some developments have been happening in this area. In particular, India is undertaking a fundamental review of its financial sector legislation, through the creation of the Financial Sector Legislative Reforms Commission (FSLRC), whose mandate is to rewrite and harmonize all financial sector regulations. In this context, the idea is also to learn from international experiences, in particular the Consumer Financial Protection Bureau (CFPB) in the US and the Twin Peak models of financial regulation as evolving in Australia and South Africa (for more details, one can refer to Schmulow (2020)).

Ⅳ. Conclusions

To conclude, as stated earlier, the future of the financial sector in India will have be based on the development of a system that supports innovation in design of products, in channels of service delivery, and in technology that will enable the provision of customized financial solutions that match the needs of households, enterprises and governments. Also, the equilibrium of consumer protection in finance should shift from buyer-beware (caveat emptor) to a regime where the onus is on the financial services provider to ensure the provision of suitable financial services to consumers. Suitability needs to be made the cornerstone of the legal right of all financial consumers thus ensuring consumer protection is also core to a financial service provider's business. Including a right to choose along with the philosophy of suitability ensures that the service provider acts in the consumer's best interests but does not impinge on the fundamental rights of consumers to choose the products and services they want.

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Received/ 2020. 09. 07
Revised/ 2020. 10. 04
Accepted/ 2020. 10. 21