Consumer protection in finance. Hard steps needed

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Background

Growing up in the 70s and 80s in urban middle India was to know what shortages are. The state strangled enterprise and everything from a scooter to a phone to butter, milk and grain was scarce. The civics and history textbooks stank of double standards as they spoke about an India that was far away from the life of the person for whom that English text-book was written. I call it the Manoj Kumar phase of India – we were losers but were brainwashed into looking back at a glorious past. A past that was distant enough in its historical dividend not to matter to people struggling to find an average 'service class' livelihood. Of course, 'business class' then meant not an airline seat but something totally different.

Socialism and state were dirty words for me back then. The economics classes I took in the Delhi School of Economics were 'market-oriented' in that we learnt that markets were good and that capitalism was the way for a country to grow. But then we began opening up the economy and embraced, though still a bit gingerly, the capitalist way. The first fruits of that breath of air was indeed more goods and services, lower prices, understanding what the phrase 'spoilt for choice' meant and better, much better, service. That was the low hanging fruit of competition that the consumer celebrated, but now 20 years later, I find myself questioning that very system whose coming I celebrated with such gusto. Possibly the problem is in the version of capitalism that walks the street today. I call it predatory capitalism where profits must be made at any cost. At the cost of the people who work to produce the goods and services for the free market. At the cost of the consumers in that free market. Theory said that competition would ensure that prices that did not clear the markets would fall and that shoddy companies would lose to competitors.

Problem

Predatory capitalism is visible in various sectors. It is specially visible in the financial sector and the effect of predatory capitalism has been well documented by Expense Account (http://www.livemint.com/Search/Link/Keyword/expense%20account). Predatory capitalism has far reaching consequences in finance because of the nature of the products. Financial products are invisible and cannot be tasted, sat-in or otherwise experienced at the point of sale. Worse, the moment of truth of a financial product is far into the future, like that of an insurance or pension product. Financial products are sold by sellers such as agents and bankers by describing what they do. If this description is not correct, or is tweaked to suit the seller's interest in pushing it, the principal of buyer beware fails. It fails because once sold on selected description, the product literate describes it in reams of legalese and most often needs an advanced degree in finance and law to decode it. So we have a system that says that the buyer must beware and must read disclosures before buying, but then does nothing to ensure that the product is not described poorly or that the disclosure is understandable by an average human being. This leads to large scale market failures in retail finance. The conflicted distribution channel has been documented by a mystery shopping exercise in 2015 that shows how incentives drive product sales in bank branches. The working paper can be read here: https://www.dropbox.com/s/lrhhplgl0bnicni/Link%20to%20HalanSane2016_audits.pdf?dl=0.

Failure of 'buyer beware' and 'financial literacy'

Our market structure is a 'buyer beware' one, where information empowered consumers will sort through various options that competing firms will offer, and make the best decision that maximises their economic utility. This buyer beware model, where the responsibility sits on us as consumers for choosing the right product, is based on the twin pillars of full disclosure by firms and of literate consumers who are able to decode these disclosures.

Real life is far from this and it has taken western academia decades to accept the fact (some people still live in the Ayn Rand elitist utopia and refuse to believe that reality bites) that markets fail because disclosure is legalese and consumers are not actually capable and don't actually choose rationally. The easiest regulatory cop-out has been to keep pushing responsibility onto consumers. This has been done by pushing for more financial literacy. Financial firms were thrilled because they could now spend money on literacy camps that had little or no effect on the real ability of people to choose financial products. Helaine Olen's book, Pound Foolish: Exposing the Dark Side of the Personal Finance Industry (http://bit.ly/290kVyV), is a must read for knowing how this works.

Financial literacy efforts have failed. There is enough research out there to show that they have negligible impact on financial decisions and behaviour. Worse, with time, the efficacy of what was learnt in the classroom

reduces. The learning from the failure of financial literacy has been the rise of a new buzz word: "financial capability". This too shall fail for the simple reason that it is not possible for an average retail investor to buy financial products without advice. Shifting the burden of decision making and choice to the consumer of financial products hides the mala fide intent of a global financial industry, which is always steps ahead of regulators, never mind consumers. I've been through many financial literacy workshops across the country and the sheer helplessness of the average consumer is palpable. It is manifested as anger, fear and an overall feeling of having been cheated.

The reason for the helplessness is the number of informed decisions an average household is supposed to take is beyond its capacity. The decision-maker needs to have a degree in finance. And then one in law. She also needs to know how to work an Excel sheet. Of course, she should know concepts of present and future value, be conversant with inflation, taxes and costs. And then be able to use all of these to compare thousands of products to choose the set she needs for her financial wellbeing. Indian policymakers are derisive about the Indian household's fixation for gold and real estate. Maybe they should turn the gun towards themselves because they caused the mess in the Indian retail finance market that makes people run to the safety of physical assets rather than risk taking decisions that no average person should be expected to take.

So, what does the landscape look like for a person setting out to buy financial products? There are some 10 basic situations that need the intervention of a financial product to smoothen out the financial journey of a household. These are: to manage cash, for borrowing, for an emergency, for protection of life, health and assets, for short-, medium- and long-term investment goals and then for retirement. To meet these needs, the market has products offered by a variety of market participants—banks, government saving vehicles, insurance (health, car, house, life), investment plans from insurance companies, pension plans from insurance companies, mutual funds, pension plans from mutual funds, gold funds, the National Pension Scheme, Public Provident Fund, small savings products, Employees' Provident Fund—to name a few.

The first level problem is identifying which product you need. Let's look at trying to invest for retirement. I have no issue with plenty of choice in a market place, but should this choice be from a set of options that are governed by different rules? Would we be happy if there were a different set of rules for different brands of car makers? What would we do if the car we bought turned out to be unsafe and we were told that "well, you bought from this company and that is regulated by a standard lower than the other brand which comes from a well regulated regime?" Absurd, right? But this is what happens in the retail financial product market. So, you're in the market for a pension product. You'll have to choose from products that are offered from companies operating under three regulators and two government departments. Your choice of the product implies the choice you make on the regulator. The regulators have different rules for retirement-oriented products. You are expected to know which regulator has what policies. Suppose you are able to make that "informed" choice, and choose an insurance company. Now, you have products from 24 companies—each will have five to 10 products that may offer a solution. You now need to work through all the features, costs and benefits of 240 products to choose your plan. Suppose you chose a mutual fund. There are 45 funds offering 415 equity schemes. You should be able to filter through these to choose the fund you want.

Remember, your analysis will take into account your ability to work through what the product costs—there are costs on entry, an annual cost, and costs on exit. Then there are taxes. And you must remember to reduce inflation from the equation so you can target a real return. Of course, it is too much to ask that costs across products under the same regulator be comparable, much less across regulators. And did you say you don't know how to run an Excel sheet or that you find concepts of present value, future value, internal rate of return and using the XIRR function on the Excel sheet difficult? Shame! See, you deserve the toxic product you bought. So, you forget about buying these products and buy the next flat or more gold. At least you can see what you bought.

What if you are in the market for a medical cover? Well, lucky you. You have a choice of products from 28 companies. And another 15 from life insurance companies that offer health plans. Work through all of them to choose your health plan.

Solution

This is ridiculous. We need to urgently move to a policy regime that puts the onus on the manufacturer and the seller rather than loading the consumer with decisions she is simply not able to make. We must move to a seller-beware model where the onus of selling a suitable product moves to the seller. And we must have one regulator for all retail financial products.

It is not as if the govenrment does not know about the issue on the ground. Several government committees have flagged this problem. In 2009, the Committee on Investor Awareness and Protection (Swarup Committee) submitted the financial well being report: http://finmin.nic.in/reports/D%20Swarup%20Committee%20Report.pdf that recommended a level playing field across regulators and the removal of upfront commissions in financial products that distort agent behaviour. It recommends a common minimum standard across regulators and an outcome based appraoch that will be judged on safety, fairness and trust. The Report of the Committee to Recommend Measures for Curbing Mis-selling and Rationalising Distribution Incentives in Financial Products (Bose Committee): http://finmin.nic.in/reports/Final_Report_Committee_on_ Incentive _Structure.pdf in 2015 took the argument further and recommended a split in rules according to the function of

the financial product and not according to form. The Bose Committee tried to solve the problem of similar financial products that are regulated by different regulators with very different rules. It mandated that the function that was dominat in the product would determine which regulator was the relevant regulator.

In fact, the government set up the Financial Sector Legislative Reforms Commission (FSLRC) to review and recast the legal and institutional structures of the financial sector in 2011. The aim was to make the rules contemporary and construct a set of financial laws to give the Indian financial sector a strong legal foundation over the next 30 years. Headed by Justice Srikrishna, the committee submitted the report to the finance minister on 23 March 2013. The 439 page report (http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf) has recommendations to re-haul the Indian financial system to facilitate the journey of the $2trillion Indian economy to becoming a $15trillion one by 2026. The Justice Srikrishna Commission did not stop at recommendations but went ahead and drafted law that that will make this happen. The draft Indian Financial Code (http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf) has in it the blueprint of a principles based, goals oriented, democratic set of rules that, for the first time, have given consumers their place in the sun. In its essence, the report says that the regulatory structure for the Indian financial system is old, based as it is on laws, some of which are more than 140 years old. Old itself, is not the problem, the issue is a piece-meal approach to financial sector regulation that has resulted in a ground level mess with multiple regulators and large regulatory cracks. On the ground this has resulted in very large scale defrauding of retail investors by financial companies that have used the regulatory mess to appropriate profits from the pockets of people who could hardly afford to lose that money.

Two things that jump out at the first reading are the deep consumer focus of the commission and the plan to move to a seven-agency financial sector regulatory system. First, the paper correctly lists consumer protection as the first objective of any financial regulation and looks at a two-pronged strategy that works on both prevention and cure. Prevention will put the burden of consumer protection on the provider of financial products and services, a definite improvement from the current 'buyer beware' model. Cure will look at setting up a Financial Redressal Agency (FRA) as a single stop for all consumer complaints in the financial sector with a consumer-facing front in every district.

Two, the paper seeks to put in place the afore-mentioned seven agencies in the regulatory architecture — a central bank with a focus on monetary policy and one that enforces consumer protection and micro-prudential law in banking and payments; a unified financial regulatory system that enforces consumer protection law and micro-prudential law in all finance other than banking; a resolution agency; a unified appellate body; a consumer complaints agency; the Financial Redressal Agency; the Financial Stability and Development Council (FSDC); and an independent debt management office.

This would mean that the current multiple non-banking financial sector regulators will collapse into one. The capital market, insurance, pension, and forward markets regulators will all be merged into the unified financial agency, if this approach paper becomes reality.

There is an urgent need for the government to implement the IFC.

This piece is based on columns written by the author in Mint, HT Media

Disclosure: The author was adviser to the Govt of India constituted Swarup committee in 2009, has peer reviewed the consumer protection chapter in the FSLRC Report, was a Member of the Bose Committee and is a Member FRA.

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