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A New Framework for Financial Consumer Protection in India

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Abstract

The financial crisis of 2008 brought to light many consumer abuses prevalent in the financial services industry. As a response to the crisis, countries across the world have been re-designing their legal and regulatory architectures to better protect financial consumers and contain systemic risk. The United States, for instance, has passed the Dodd-Frank bill into law, leading to the creation of the Consumer Financial Protection Bureau (CFPB). The United Kingdom has changed its regulatory architecture, creating separate regulators for prudential regulation and market conduct (or consumer protection). Australia and the Netherlands already have separate market conduct regulators, and South Africa has indicated that it will soon follow suit.

India is also undertaking a fundamental review of its financial sector legislation, with the creation of the Financial Sector Legislative Reforms Commission (FSLRC), whose mandate is to rewrite and harmonise all financial sector laws[2]. In this context, we feel that this is the appropriate time to re-think the framework for consumer protection in finance in India and arrive at an understanding of the fundamental philosophies that should underpin such a framework. In this paper, we propose a fundamentally new basis for financial consumer protection in India.

We begin with an analysis of the theory of consumer protection and follow it up with a discussion on the special case of the financial consumer. We then take a step back and analyse the functions of finance and the role of finance in the life of households. We use real-life case studies to illustrate the capacity of the Indian financial marketplace to fulfil financial needs of households today and also discuss some critical national socio-economic trends in India that the financial system needs to be equipped to respond to effectively. Following from this, we assess the future of finance in India, to come to an understanding of the nature of the financial system that must be created in India to ensure financial inclusion as well as systemic stability. Finally, with the theoretical basis as well as the Indian context firmly in place, we develop the fundamental philosophies around which the framework for consumer protection in finance should be built.

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[2] http://www.fslrc.org.in/

1. Why do we need a Consumer Protection Framework in a Competitive Marketplace for Financial Services?

In order to answer this question, it is useful to delve into the theoretical literature on consumer protection. A survey of the literature throws up a number of insights into the types of market failures that necessitate a formal framework for consumer protection.

(a) Informational Asymmetry and the Problem of Lemons:

A fundamental problem characterising the market for financial products and services is that of information asymmetry. Because of the expertise that is required for the development of most financial products and strategies, the seller of a financial product is always at an informational advantage over the buyer (who generally lacks expertise). This information asymmetry has the potential to adversely incentivise the seller to mis-sell the product, which could lead to poor financial outcomes for the buyer.

Akerlof's seminal study[3][1] on the information asymmetry between sellers and buyers in the market for used-cars in the United States concludes that the uncertainty over product quality will progressively drive away owners of better quality cars from the market. Over time, this leads to a consistent decline in the average quality of used cars in the market (leading ultimately only to lemons coming onto the market) and a corresponding downward adjustment of the price that buyers are willing to pay until a no-trade equilibrium is reached. Such a situation minimises the welfare of buyers and sellers in the market.

In the case of financial markets, such sub-optimal outcomes on account of information failures can be prevented through suitably designed regulations (such as on information disclosure) that enable the creation of a more equitable market for buyers and sellers.

(b) Externalities:

Regulation for systemic reasons is warranted when the social costs of failure of financial institutions exceed private costs and such potential social costs are not incorporated in the decision making calculus of the firm. Banks may, therefore, be induced into more risky behaviour than they would if all risks (including those for the system as a whole) were incorporated in their pricing.

The key systemic point is that banks are potentially subject to runs, which may have contagion effects. The externality is that the failure of an insolvent bank can cause depositors of other banks to withdraw deposits[4] [2][3][4][5][6].This can cause a solvent institution to become insolvent because a large proportion of bank assets are not easily marketable, and because a panic may drive down the current value of those assets which are marketable. In the event of a run, a bank is forced to dispose of assets which, because of asymmetric information problems, cannot be sold at par as potential buyers (if they exist at all) impose a high risk premium on the purchase price[5][7].

(c) High Search Costs and Price Dispersion:

Despite the fact that financial service providers provide almost identical products, there can be substantial price differences between them. These price variations across sellers of similar financial products can be attributable to high search costs that consumers have to

[3] Akerlof, The Market for Lemons: Quality Uncertainty and the Market Mechanism (1970)

[4] See, Diamond and Dybvig, (1983); Baltensperger and Dermine, (1987); Postlewaite and Vives, (1987); Bhattacharya and Jacklin, (1988); Chari and Jagannathan, (1988)

[5] Llewellyn, The Economic Rationale for Financial Regulation (1999)

incur to meaningfully compare products and as a result, lead them to pay higher prices than they should. On the one hand, this is because of the lack of a repository of reliable information to enable price comparison and, on the other, the tendency of product sellers to market their products as being different from others in the market, even in the absence of any substantive differentiating features between them. In such a scenario, the consumer is likely to forgo her own welfare by sticking with her existing financial service provider and paying the price determined by them, thus giving them a modicum of market power, which, in a transparent market they would not be able to enjoy.

While transparent, comparable information on prices is obviously desirable from a consumer welfare point of view, there also needs to be clarity on detailed terms and conditions that can have a material impact on the usage of the financial product. This is especially so in the case of decisions which are infrequent and have long-term implications. Consumers are not in a position to generate information on their own or to get together and jointly generate information with other consumers a classic case of co-ordination failure because of the public-good nature of the endeavour.

(d) Behavioural Characteristics of Consumers:

In the past few years, there have been many new insights from the field of behavioural economics that provide rationale for the need for a regulator for consumer protection: on account of protecting consumers from their own inherent biases and behavioural instincts. Some of the insights that have emerged include the fact that consumer decisions are greatly influenced by the way service providers frame the choices, and that consumers mimic behavioural patterns of peer leaders or peer groups, leading them to ignore signs and indicators that would lead a rational consumer to take different decisions.

While some criticisms of the behavioural economics school remain[6], and even if consumer irrationality is only an exception to the norm of rational behaviour, the insights of behavioural economics alert us to the possible risks of systemic irrational behaviour and the consequence this can have on the financial system. Any regulatory mechanism should therefore be designed to be able to respond to systemic irrationality.

For instance, one of the behavioural insights on information overload caused by disclosures could have systemic repercussions for the way in which we think about regulation of information disclosures. The central insight here is that consumers are unable to assess the quality and amount of information given to them in a meaningful manner, and that in the presence of dense disclosures they can develop a false sense of security about a product. Examples of this phenomenon include consumers casually flicking through tens of pages of terms and conditions when insurance is bought online, without understanding the risks involved.

[6] Criticisms fall in three broad buckets. One, behavioural economics is yet to come up with an all-encompassing theory of the market or consumer choice that can challenge the existing neo-classical theories; it has only pointed out deficiencies of the latter. Two, behavioural economics does not formulate any normative principles, which can be used either for empirical testing as economic models or for normative use as a guideline to an efficient market mechanism. And three, work in experimental economics argues for the emergence of rational behaviour in the context of a repetitive market activity. Consumers display rational behaviour in the long run, through a trial and error adaptation process and repeated market activity and spurts of irrationality are characteristic only of the short run. So, consumer irrationality, it is argued, can only be a factor in the policy of consumer protection, not the starting point.

2. Is Consumer Protection in Finance Different from Consumer Protection for Other Retail Goods and Services?

In thinking about the framework for consumer protection in finance, it is also important to understand how the nature of financial decisions and outcomes fundamentally distinguishes it from consumer protection for retail products and services.

Many important financial decisions such as investing in a mortgage or saving for retirement are undertaken very infrequently in the course of a lifetime. The outcome of such financial investments and strategies becomes clear only in the long term, and not immediately upon product purchase. In stark contrast, 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. In this sense, financial products are more akin to medical services, where the treatment is administered upfront and the consequences become obvious only with the passage of long periods of time.

Financial product outcomes are also complicated by the fact that market movements can have a substantial impact on performance, and it can be difficult to ascertain whether the reasons behind poor outcomes was primarily on account of product mis-sale or the consequence of random shocks.

These factors serve to distinguish consumer protection in finance and provide the rationale for separating it from consumer protection regulation for other products and services. Financial consumer protection regulation therefore requires specialised responses considering both the high degree of information asymmetry and the nature of manifestation of outcomes.

3. What are the Functions of a Well-Functioning Financial System?

The underlying theory helps us establish the need for a formal consumer protection framework and the fact that consumer protection in finance is fundamentally distinct from that for other products and services. However, in order to develop a comprehensive forward-looking framework for consumer protection in India, we also need to develop an understanding of the current state of the Indian financial system and a view of the future of finance in India. In order to be able to do this, we must begin with a discussion on the basic functions of a well-functioning financial system and household interactions with the financial system.

(a) Functions of Finance:

The basic functions of the financial system are essentially the same in all economies and do not change over time. It is these functions that set the benchmarks for innovation in financial systems.

The primary function of any financial system is to facilitate the allocation and deployment of economic resources, both spatially and temporally, in an uncertain environment. Merton (1995) further distinguishes six core functions performed by the financial system: (i) provision of a payments system; (ii) provision of a mechanism for pooling of funds; (iii) provision of means to transfer resources across time and space; (iv) provision of ways to

manage uncertainty and control risk; (v) provision of price information; and (vi) provision of mechanisms to deal with information asymmetry and incentive problems.

A well-functioning financial system should enable individuals, households and enterprises to access financial services that allow them to fulfil their latent potential. This would mean enabling long-term planning and investment; access to high quality financial advice and services at reasonable price to enable growth; risk management tools to protect life, health, assets and business; and options for diversified investments.

(b) Households and the Financial System:

Finance is a critical tool for households to manage risks and smoothen consumption. When used well, finance can help households accomplish a great deal. However, when used poorly it can become an instrument of much hardship excessive borrowing, over-investing in assets whose value is highly correlated with the state of the local economy and under-insuring against risk of accidental death of self or the death of livestock animal are all examples of poor decisions routinely made by households. Financial services must therefore enable a household to manage and increase its consumption smoothly and fully utilize its human capital, financial capital and other resources to improve its well-being. In order to do accomplish this, a well-functioning financial system must enable each and every household to:

- Manage liquidity or smoothen consumption by movement of resources across time
- Manage risk by movement of resources across contingent states of the world
- Facilitate payments by movement of resources through space and
- Diversify asset portfolio across nations, industries and sectors

4. How is the Present Financial System in India Fulfilling its Functions?

A well-functioning financial system is expected to solve the real economy problems of individuals, households, enterprises and governments. In this section, we focus on how well the Indian financial system is currently meeting the needs of households. Finance must ideally give households a smooth and growing net income stream and cancel out noisy shocks in their daily lives.

In order to illustrate the performance of the Indian financial system, it is instructive to delve deeply into case studies of households - and study the mechanisms that are currently available to them to deal with the challenges of managing liquidity, risk, assets and payments.

In each of these cases, we describe real-life situations[7] faced by households and their financial responses in view of the choices available to them thus pointing to the reality of today's financial system. In addition, we also attempt to present the possible responses of the same households in the context of a well-functioning financial system.

(a) The challenge of liquidity management:

[7] All names in case studies have been changes in order to ensure privacy and prevent identification

Thangam (37) and her husband Guna (42) belong to a village of Sanjay Nagar in Thanjavur district, Tamil Nadu. They have two sons Velu (18) and Mani (11), and a daughter Sudha (17), all teenagers. Thangam, Guna and Velu work as manual labourers and contribute to the family income. The two younger children are studying in school.

The three earning members contribute to a total of Rs. 124,000 a year in income, of which a third is used up for regular consumption expenditure - food, clothing and festival expenses.

(I) With two of the children studying and all other members of the family engaged in labour, there are no remaining resources or time for channelling into new forms of productive investment. While avenues for additional income will have to wait till the children become involved in the economic activities of the household, the household faces the immediate problem of meeting current consumption needs food, clothing, education, health and festival expenses. The challenge of liquidity management holds a dominant space in the life of this household.

(i) Thangam accesses credit to meet consumption or liquidity needs. She sources credit from both formal and informal sources. Based on available information, Thangam has availed 27 jewel loans and 3 Joint Liability Group loans[8] from a single formal source in a span of 26 months (September 2008 to December 2010).

Loan Purpose	No. of loans availed	Aggregate Loan Amount (Rs.)	Aggregate Interest Paid (Rs.)
Family related expenses	16	38,300	3,522
Repayment of loan elsewhere	7	65,400	10,777
Medical expenses	3	8,400	964
Festival expenses	2	5,000	163
Purchase of dairy cattle	1	10,000	1,726
Purchase of gold jewellery	1	20,000	3,452
Total		147,100	20,604

(ii) She availed loans in 16 of the 26 months under consideration and in 6 of these months she took 3 loans or more. This is a clear indication not only of the household's uncertainty in predicting the underlying need for liquidity but also of their inability to create a reliable store of funds to meet these needs. Of the approximately Rs. 150,000 that Thangam took up in the form of credit, 64% was used for consumption purposes such as for household expenses, medical expenses, and repayment of existing loans. This amounted to an overwhelming 25 of the 30 loans.

(iii) Thangam's household relies on her ability to unlock value of her assets in the form of gold to access quick liquidity for consumption purposes. She has used this option repeatedly by churning her gold jewellery by taking credit, redeeming the gold when she gets cash in hand, and pledging the gold again in short cycles of credit that she tries to close as soon as possible. The duration for which she kept a jewel loan open ranged from 9 days to one year, with an average duration of 160 days. She pays 24% annualised interest on these loans for the simple convenience of having cash in hand to meet basic consumption expenses. Her inability to access financial services such as bank accounts or capital markets has resulted in her not being able to plan for even regular, predictable liquidity needs and therefore, having to continually substitute for savings with credit - the interest expenses on which amounted to Rs.20,000 over the 26 months.

[8] The Joint Liability Group (JLG) is a group of individuals (usually five) who guarantee each other in the group in order to avail a loan. This is the classic microfinance loan.

(II) None of Thangam's family members have availed any form of insurance. Considering the fact that the husband, wife and son have many years of productive working life left, there is a critical need for them to protect their human capital. It is essential from a risk management point of view for them to have access to appropriate amounts and types of insurance.

(III) Thangam and her husband also need to worry about how they will manage financially once they are past their active working life. In order to ensure that there is stability of income in this stage of their lives, they need to consider how much they would need on a monthly basis to take care of their consumption requirements and other needs, all the while considering long-term inflation and its impact. They will need access to products that will enable them to have steady income flow and help maintain a basic quality of life.

A well-functioning financial system would help Thangam and her family in the following ways:

(I) Enable building a short-term reserve of funds which she can depend on for planned as well as unprecedented consumption expenses. This store of savings should also earn a reasonable rate of interest. She should be easily able to access the savings at any point in time without overt administrative hassles and fees. It is in the absence of such reserves that Thangam's family is forced to rely on repeated cycles of short-term credit to tide over liquidity requirements.

(II) Provide access to right amounts of life insurance and personal accident insurance to protect their human capital. In the event of loss of life or disability, the absence of risk cover could seriously impact the living conditions of the household.

(III) Provide access to inflation-adjusted annuity mechanisms for retirement protection to ensure a steady stream of income in order to maintain a basic living standard.

(b) The importance of risk management:

Shivani Devi (45) and her husband Chaman Singh (47) belong to the village of Sagavan Gaon in Uttarakhand. They have four children Vinod (14), Savita (13) and Rohit (10) are in school, while the youngest Rajesh (7) has not yet started schooling.

The household had an annual income of around Rs. 65,000. Shivani Devi kept 13 goats, which they sold as and when money was needed. This usually amounted to selling 3 goats on average each year, with each goat fetching approximately Rs. 3,000. The availability of NREGA work is erratic and contributed an income of Rs. 4,000 annually. Shivani Devi cultivated a patch of land they owned, and incurred expenses for seeds and fertilizers. The entire produce from the land was used up for household consumption with little remaining for sale in the market. The sale of milk from their buffalo earned them Rs. 16,000 annually. Chaman Singh also undertook some construction work, which earned the household Rs.36,000 annually.

Shivani Devi was involved in an accident and lost her life in December 2011. Shivani was bringing in more than half of the family's income by being involved in multiple activities, besides also taking care of her family's needs. Her death triggered a chain of events in its wake.

(I) To meet the urgent need for money such as for funeral and household expenses, the family resorted to selling off a few goats, as well as selling off their buffalo for a price of Rs.29,000, which was 35% lower than the price at which they had purchased it.

Selling off the buffalo meant the loss of Rs.1,500/month as income from the sale of its milk. The lack of any liquidity in the household upon the unexpected death of Shivani Devi meant that the household had to undertake distress sales of productive assets.

(II) Shivani Devi had taken out some insurance risk cover that enabled her family access to some insurance payouts after her death.

  (i) Shivani Devi had purchased an accident insurance policy for Rs. 100,000, Chaman received the claim amount after 3 months of her death. Chaman plans to save this money for his kids' marriage and education.

  (ii) Shivani Devi had a rural postal life insurance cover in her name where she used to remit Rs. 138 on a monthly basis. She had been saving in this manner for almost 6 years now. This came to around Rs. 9,384 in the account. Chaman hopes to receive a payout of Rs. 25,000 with bonus, from this scheme. Endowment policies, such as this rural postal life insurance product, are 3-4 times costlier than a pure life insurance cover. However, in the absence of adequate access to the latter, Shivani Devi had deployed her funds inefficiently in the postal life insurance product that was available to her. In addition, the formalities in accessing the post office insurance payout have taken a long time and, as a result, Chaman is not sure when and even whether he will get the payout.

  (iii) Shivani Devi's case is an archetypal illustration of the consequences of under-insurance. Life Insurance is inadequate if it is unable to adequately replace the financial contribution of the insured to her family. Shivani Devi contributed 40% of the family's income by utilising her human capital to the extent possible. This income-stream has been lost as a result of her death and the insurance protection she had taken was inadequate to cover the future income lost as a consequence of her death. As a consequence, the household will not be able to sustain the standard of living they enjoyed while Shivani Devi was alive.

(III) Since her death, cultivation has been neglected and the reduced produce from the land meant an increase in their consumption expenditure for food. Chaman now dedicates a lot more of his time to his children, in addition to taking care of the land and their goats. Because of this, he finds it difficult to find enough work since opportunities in the local labour markets are available mostly in the mornings when he is busy taking care of his children. He estimates that he will lose at least Rs. 10,000 in the form labour income which he used to earn previously. A single unexpected event has thus seriously affected the overall income generation capability of the household. Not only has the household lost Shivani Devi's future earnings, but Chaman's earning potential has also been severely diminished as a result of her death.

(IV) The family has not considered the expenses the household will have to incur for higher education of the children beyond school. In considering long-term education expenses, they will also need to think about long-term inflation risk. They will need access to financial mechanisms that will enable them to systematically save over the long-term and at the same time ensure that the value of their savings keeps up with inflation and earns sufficient returns over this period - so that it can be used to meet the education expenses as they come due.

A well-functioning financial system would have helped Shivani Devi's family in the following ways:

(I) Supply Shivani Devi and Chaman Singh with adequate life insurance that allows the family to continue living (upon the event of either's death) without compromising on

their living standards. This would entail access to an insurance policy that would cover them to the extent of their remaining human capital in the event of death. This would amount to human capital of Rs. 150,000 for Shivani Devi, assuming that she sustained her current income-earning capacity till the age of 60. The corresponding cover for Chaman Singh would be Rs. 270,000. They would also have access to purchase accident insurance, which would give them additional disability cover in case of disability due to accidents.

(II) Enable her family to collect insurance payouts in an efficient manner without administrative delays, at a physical location that is easily accessible, and store the payout in a financial instrument which offers growth for the corpus as well as liquidity. Liquidity would enable Chaman to receive periodic payouts or withdraw from the corpus as and when required to meet expenditures.

(III) Provide long-term options to save funds for children's education with inflation protection so as to enable the household to secure the future of their children.

(c) Diversification through asset allocation:

Lalitha (40) and her husband Thyagu (42) are from the village of Andipatti in central Tamil Nadu. They live in a thatched house inherited by Thyagu from his father. The couple have three children: Shanti (16), Bhavani (18) and Kanthan (20). Shanti goes to school and has completed her 10th grade, Bhavani has just started college and the eldest son Kanthan works in Qatar as a driver. The daughters stay at Lalitha's sister's house in another village, a few kilometres away.

Till about 5 years ago, Thyagu worked in Singapore and would remit money back home. When Thyagu returned to his village, he decided to manage the tea shop business that his father used to run. Thyagu spends most of his day attending to customers in his tea shop, while Lalitha manages the shop-kitchen and other household chores. Though there is some seasonality to the business because of the presence of a school nearby, Thyagu is able to make about Rs. 115,000 a year from the shop. Apart from this the family owns about 1.33 acres of agricultural land where they grow paddy for two seasons and black gram for one. Most of the activities on the farm are carried out using hired labourers; Thyagu and Lalitha do not work on the fields themselves and their role is mostly supervisory in nature. The net income from agricultural activity is about Rs. 30,000. Lalitha spends about two hours a day tending to the cows owned by the household. The net income from the cows is about Rs. 30,000 a year. The household also expects some remittance income that Kanthan will send from Qatar; about Rs. 120,000 per annum from next year onwards. The daughters would get married off in the next 6-8 years and the household does not expect to accrue any income from them. Among financial assets, the household owns about 80 grams of gold; has no bank balance or any other financial investments. The family spends about Rs. 45,000 a year on routine household expenses. The family thus has a cash surplus of Rs. 130,000 approximately.

(I) Below is the existing portfolio allocation for the household:

(i) The household's Gross Human Capital is a sum of the Human Capital of Lalitha, Thyagu and Kanthan, net of insurance premiums on personal accident, health and life, amounting to a total of Rs. 1,315,000. Expenses including those on marriage, education of the daughters have been compared to a borrowing which has a repayment in the form of certain cash outflow in the future, amounting to Rs. 2,150,250, thus leading to a Net Negative Human Capital of Rs. 1,195,250. In addition, the household's net position on local real estate is also negative.

Asset / Liability	Investments / Holdings (in Rs.)	Liabilities (Rs.)	Net Positions (Rs.)
Human Capital	1,315,000	2,510,250	-1,195,250
PV of Local Business	787,000		787,000
Local Real Estate	470,000	552,500	-82,500
Cattle	40,000		40,000
Gold	150,000		150,000
Cash / Investible Surplus	130,000		130,000
Loans		105,000	-105,000
Total	2,892,000	3,167,750	-275,750

The household has also loan liabilities that they need to service. Overall, despite the fact that the household has an annual cash-flow surplus of Rs. 130,000, their net asset position is negative.

(ii) The household has sufficient cash surplus at the end of the year and therefore should repay its high-cost debt at the earliest. The household currently has most of its assets and income sources concentrated in the local economy without sufficient diversification. For example, floods (weather risk) may not only affect household income from agriculture but because of its broader impact on the entire local economy, also impact their tea shop income. The household should look to diversify by reallocating some of its local asset portfolio to national assets uncorrelated with local, village-level risks. By sending their son Kanthan abroad, the household has partly diversified its income sources outside the village economy.

(II) Considering the fact that one of the daughters is two years away from finishing school, the household needs to plan for her education expenses. Through access to an appropriate mix of savings and credit products, the household should be able to effectively prepare for this eventuality. All such forward-looking planning must take into account inflation risk.

(III) Lalitha and Thyagu need to carefully plan for their retirement also. Keeping in mind the lifestyle they would like after retirement, they should be able to save, invest and have access to pension products that enable them to have a suitable inflation-adjusted regular income after retirement.

A well-functioning financial system would enable Lalitha and her family in the following ways:

(I) Enable the development of liquid markets for financial products that would help the household create a well-diversified financial portfolio. The household could then diversify its asset portfolio by shedding some of its local real estate risk and reallocate to Index Funds and Money Market Mutual Funds (MMMF) which are national assets, uncorrelated to local village-level risks. The MMMF also enables quick access to liquidity in cases of emergency or unforeseen risks. Also, the household should be able to reduce its exposure to gold and invest in index funds (which have a better risk-return profile), but still keep some exposure to gold for diversification benefits.

(II) Enable the removal of regulatory barriers in creating access to markets by creation of suitable infrastructure.

(III) Provide access to a range of savings and credit options that will enable the household to save for daughters' education and also access appropriately designed inflation protection and education loan products.

(IV) Provide options for long-term savings and access to pension products that will enable the household to plan for their post-retirement life.

(d) Payment mechanisms:

Debashis Behera (30) lives in Sunapur village in Orissa with his wife, Ranjana (29), two sons (5 and 4), a daughter (7) and an aged father (86). Debashis is the sole wage earner for the family and works as a labourer outside of his village in addition to running a dry-fish selling business, both of which are seasonal occupations. The family owns and lives in a brick and mortar house and does not have any other major assets.

Debashis first migrated in 2005 in search for work. Presently, there is no fixed pattern to his migration and he works in Chennai, Surat, Mumbai or other parts of Orissa, depending on availability of work. He earns approximately Rs. 7,000 a month as a labourer but is able to send home only around 60% of the amount due to his own expenses of accommodation, travel and food.

The fish business gives the family an income of Rs. 5,000 but this is limited to a maximum of 6 months in a year. Ranjana helps Debashis by purchasing dry fish in large quantities from a weekly fish market two to three times a week and selling them in nearby villages. Since the children are young, she has to spend most of her time taking care of them and her father-in-law.

(I) Since Debashis works in different places as a labourer, one of the most critical financial services he uses is that of remittance. He uses different mechanisms for remitting funds to his family. Some transactions are done through a tappawala (informal money courier agent) and some through friends or relatives who were travelling home. Occasionally, he also sends money to a savings bank account held in the name of Debashis's neighbour. Once the money is sent, Dandapani Behera, the neighbour helps the family withdraw money from ATMs of Berhampur city or Kanisi. Debashis does not have a savings bank account of his own since he does not have an identity proof document. Below, we see ten payment transactions made by Debashis, the cost he incurred and the use of those funds by his family.

Amount Transacted (Rs.)	Month/ Year	Channel	Total Cost Incurred (Rs.)	Use of Remitted Money
4,500	02/2012	Tappawala[9]	135	Routine expenses and repayment of loans
4,200	01/2012	Tappawala	126	Routine expenses and repayment of loans
4,000	12/2011	Tappawala	120	Routine expenses and repayment of loans
4,500	11/2011	Friend	150	Routine expenses and repayment of loans
5,000	10/2011	Bank	325 (of which 125 is bank charge for sending money and 200 is on account of lost wages)	Routine expenses, repayment of loans and marriage of relative
4,800	09/2011	Bank	325 (of which 125 is bank charge for sending money and 200 is on account of lost wages)	Routine expenses, repayment of loans and religious ceremonies
4,500	08/2011	Tappawala	135	Routine expenses and repayment of loans
4,600	07/2011	Friend	150	Routine expenses and repayment of loans
5,000	06/2011	Tappawala	150	Routine expenses and local festivals
4,500	05/2011	Tappawala	135	Routine expenses

Based on this information, Debashis uses the tappawala mechanism more than the others (6 out of 10). This is because it is the one option that is available at all times, as opposed to friends and family or his neighbour' s bank account. In one instance in August 2011, the tappawala's agent was robbed in transit and hence Debashis's family did not get the remitted money. The total cost to Debashis for these 10 transactions was thus approximately Rs. 6,151 or 13.5% of the total amount remitted.

(II) Debashis and Ranjana's children are all very young and have just begun school and the family has time to plan for their higher education. However, they need to start thinking about how they will finance their children's education.

(III) Debashis and Ranjana are themselves quite young and have a substantial portion of their productive lives ahead of them. Again, this gives the ability to begin early and plan well for retirement.

A well-functioning financial system would enable Debashis and his family in the following ways:

(I) Enable safe, quick and cost-effective channels to transfer funds to his family. Because physical access to banks is a challenge on account of long distances, using this facility currently requires Debashis to forgo a day's wages. Debashis and his family should have physical access to financial institution branches within walking distance and from home offering secure, instant electronic transfer of funds. For instance, the actual cost of money transfer at banks is only Rs 25 per Rs. 1,000 transferred. If Debashis did not have to forgo wages, the total cost for the above set of transactions would then be reduced to Rs.1,140 or 2.5%.

[9] In Orissa, a 'tappawala' is an agent in an informal courier system for money remittances

(II) Enable planning for higher education of their children and for their own post-retirement life. This will involve access to appropriate savings, credit and pension solutions that cater to their specific situation and needs.

The case commentaries amply illustrate the fact that the Indian financial system is currently unable to meet the multi-faceted financial needs of households. This view of the financial system finds further resonance in the national statistics on access to finance in India - only 34.4% of the lowest income quartile have access to savings; only 14% of lowest income quartile have life insurance; only 1% of the population has medical insurance; and 70% of the lowest income quartile borrows from informal sources such as friends, relatives and moneylenders at interest rates upwards of 24% per annum.

National Socio-economic Challenges:

What these case commentaries also reflect is that there are certain critical national challenges - such as planning for retirement, education, health - which are becoming increasingly prominent in India and will only intensify in the future with expected demographic trends.

- The proportion of those aged 60 and above is expected to climb from 4.6% in 2000 to 9% in 2030. In absolute numbers, 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[10] [8]. However, presently in India, only about 10-15% of the working population participates and is eligible to participate - in the mandatory, formal programmes designed for providing income security during retirement[11] [9]. This looming large-scale retirement process will require the financial system to provide immediate solutions that enable appropriate planning for post-retirement, long-term, inflation-adjusted income streams.
- Although India has higher private spending (as a share of GDP) than many other countries, its public spending on health is among the lowest at 1.2% of GDP. This has led to extremely high levels of private expenditure on health, predominantly in the form of out-patient treatment and medicines (as health coverage options such as Rashtriya Swasthya Bima Yojana provide for hospitalisation expenses only). In the next decade, it is proposed[12] [10] that public spending on health be increased to 3% of GDP. India's financial system must therefore ensure adequate financial resources for the provision of universal access to health care, provide financial protection in the form of insurance, establish financing mechanisms that in the long-run ensure improved wellbeing of the population while controlling healthcare cost inflation
- It is estimated that a third of India's population is below 15 years of age. The emergence of a large workforce over the next few decades means that households today need to be able to plan for the higher education of their children, so that they can be competitive in the job markets of the future. Financing the higher education will require the household to have access to adequate funds taking into account risking costs of education and inflationary expectations, as also to avenues to save and invest for the long-term - to take care of all college or polytechnic related expenses.

The ability of the financial system to effectively respond to these challenges will clearly have a significant impact on India's future.

[10] World Population Ageing: 1950-2050, United Nations

[11] Report of the Committee to Review Implementation of Informal Sector Pension (CRIISP)

[12] High Level Expert Group Report on Universal Health Coverage in India

5. The Future of Finance in India

It is obvious that the current financial system is unable to cater the varied needs of households and is also not developed enough to respond appropriately to the larger, national challenges confronting India. This understanding of the shortcomings of the Indian financial system should form the basis for policy direction on the future of finance in India.

(a) The need for innovation:

From the case commentaries above, it becomes abundantly clear that consumer financial needs are varied and have multi-dimensional aspects. Households planning for long-term goals such as retirement require inflation adjusted returns on investment over substantial time-periods. Parents planning for the education of children need to manage inflation risk. Farmers planning for their next crop require credit bundled with rainfall insurance that will pay out in case of flood or drought. Households whose asset profile is concentrated in the local village economy need access to investments that will provide them exposure to the national economy. Each and every household has a combination of such crucial needs that need fulfilment and it is the function of the nation's financial system to provide accessible and economical solutions.

The nature of the challenges facing households today requires a fundamental shift in the way financial services are currently delivered in India. The economic situation and life goals of each household are unique, but the reality of the finance marketplace is that financial service providers offer highly standardised products and services that have traditionally been designed in the context of urban middle and upper-middle class clients. While some amount of standardisation is inevitable, it becomes extremely problematic beyond a point in the context of financial services especially when large swathes of the population need to be financially included. As the case commentaries amply illustrate, household profiles, behaviours and needs differ vastly and the require access to solutions that address their specific concerns. The cases also show that even where households have access to financial services, these products are not tailored to meet their needs. As a consequence, in the present context, household are required to force-fit their unique needs with standard financial solutions. This force-fitting can have adverse consequences for the household in certain situations, because imperfect substitutions can also be inappropriate substitutions. For instance, if a household were to access high-cost credit in the absence of a savings product, its inability in meeting the repayment commitments could push the household over the edge into chronic poverty. Therefore, while millions of households lack basic access to financial products, even those households who have some access to the financial system are confronted by issues of missing products (such as unemployment insurance); missing markets (such as inflation-adjusted retirement planning); and inappropriate substitute products for their needs. Households in India are clearly in dire need of access to appropriately tailored and customised financial solutions - and the financial system must respond to these needs.

In view of the current state of evolution of financial services in India, it is apparent that there is a glaring need for increased innovation from financial service providers. Financial sector policy must create an environment that rewards innovation in the delivery of financial services and thus truly enables meaningful financial inclusion in India. The case commentaries make clear the need for substantial innovation on the product development front, but there is also a great need for innovation on business models that will enable the delivery of high-quality financial services to excluded or under-served populations as well as technological innovations to drive much-needed improvements in efficiencies and effectiveness of the delivery of financial services.

While the policy environment has not explicitly incentivised innovation, especially by private financial firms, there have still been some interesting developments in business models and innovative products in the Indian financial sector. Business models such as the Regional Rural Bank (RRB) model, Self Help Group (SHG) Bank Linkage Program and the Micro Finance model have evolved over time and have had varying levels of success. The development of a rainfall insurance product that would pay out to holders in case of droughts and floods can be seen as a breakthrough in risk management for farmers. However, 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 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 they do not compromise the stability of the system.

Increased innovation will necessarily have to be the engine that drives the future of financial services delivery, and we see this as the only way to achieve meaningful financial inclusion in India.

(b) The Nature of Innovation:

In the aftermath of the financial crisis, the concept of innovation in the financial sector has been viewed with some suspicion. This has largely been due to the role that complex financial engineering played in the development of products that were seen to be at the heart of the crisis. Questions have been raised about the value of these products and the extent of systemic risk they were creating in the financial system. These financial innovations are rightly being evaluated on how they have positively contributed to the real economy and society for ultimately, this is the benchmark that separates good financial innovation from bad. Only when financial innovation is appropriately used to solve real economy problems can it be deemed valuable from a social welfare point of view.

It would, therefore, be a grave mistake if the policy lesson we in India took away from these debates around financial innovation in the developed markets is that innovation itself is bad or dangerous. Financial innovation is valuable, in fact indispensable, when it is used to solve problems that real households and enterprises face, such as enabling easier access to finance and lowering the cost of capital. This is particularly relevant in the Indian context where we have a long road to travel in order to achieve meaningful financial inclusion (unlike US and Western Europe) and must therefore necessarily look to socially relevant financial innovation as the way to achieving this goal.

The future of finance and financial inclusion in India must be in the direction of increased innovation - in product development, in channels of service delivery and in technology.

(c) Complexity of Consumer Needs and Customisation of Solutions:

The complexity of products such as Credit Default Swaps (CDSs) and Collateralised Debt Obligations (CDOs) made it extremely difficult to comprehend the nature of risks they were creating in the financial system. As a result, post the crisis, one of the views that has emerged is that financial products should necessarily be simple so that everyone understands them. However, this is a problematic argument because the simplicity or complexity of products should be determined by the problems they are trying to solve or the needs they are trying to fulfil. The use of mathematically or statistically complex tools should be driven by the nature of problem in question - the tools being necessary aids to finding the most effective and efficient solution possible. The simplicity or complexity of a product should not be of much relevance, all that should matter is that the product solves a real problem this, after all, is the central function of finance.

Consider a financial institution that offers fixed interest rate 30 year home loans, a seemingly simple and easy to comprehend product. Given relatively low levels of home ownership in India and the aspiration around ownership, this is a financial product that is going to be much in demand. However, are we right in acknowledging this to be a good financial product in its current form and can it be considered appropriate for everyone regardless of their individual financial situations? There are a few things to consider:

- First, the fixed rate is a nominally fixed rate and transfers inflation risk to the borrower while her income and value of the home are both inflation linked. A well-functioning financial system must be able to facilitate the provider to offer fixed real rate loans.
- Second, by borrowing and buying a house, the customer takes a leveraged long-term position on real estate. If the customer's cash flows are volatile to begin with, adding leverage to it greatly exacerbates the experienced volatility and might impact the household's consumption in a bad scenario. Also, if asset prices on real estate sharply decline in the future, the borrower must have the ability to lay off this asset price risk.
- Third, the housing loan and the house purchased, need to be viewed in the context of the global portfolio of the customer. If the customer has reasonable financial wealth and negligible real estate exposure, this may be valuable diversification. However if the customer already has high exposure to real estate, this product would appear to be a bad solution. Such products transfer a lot of the risks to the consumer while making the life of the provider simple.

What this illustration highlights is that even a seemingly simple product ends up transferring a lot of risks to the consumer and that simplicity is a poor yardstick to ensure good consumer outcomes. Notions of simplicity and complexity are not particularly helpful in determining the value of a product or service for a household.

Financial products and services, whether deemed simple or complex, are by themselves neither good nor bad. It is in the context of their interaction with an existing portfolio that they can add or destroy value. The outcome of the addition of any financial product to a household's portfolio is dependent on the interaction of that product with the overall portfolio of the household, for it is this interaction that determines whether the product is suitable for the household. For instance, the addition of a loan into the portfolio of a household that is already over-leveraged could send the household into a debt spiral and chronic poverty, but the addition of the same loan into an under-leveraged household portfolio could actually lead to welfare gains for the household. The loan itself is the same product, but the characteristics of the portfolio it enters are very different thus leading to very different outcomes. It is only through the consideration of these interaction effects that a product can be deemed good or bad - or, more appropriately, suitable or unsuitable - in a particular context. The fact that the nature of these interactions will vary from case to case serves to reiterate the need for greater innovation in developing appropriate, customised financial solutions.

The case commentaries in the previous section highlighted the fact that the financial situations and needs of households are unique and complex in their own ways, and meaningful responses to their problems will take the form of customised financial strategies that may not be simple. It is likely that the evolution of financial products to optimally meet the diverse needs of households, enterprises and governments, will cause a move away from simple, easy to understand products to more involved, customised solutions. Accommodating this shift in financial services provision will require a legal and regulatory climate that fosters continuous innovation in the design of financial products. Such a legal climate is particularly relevant for the Indian context where large sections of the population are currently

financially excluded rapid innovation thus becoming all the more essential to bring them within the ambit of the formal financial sector in a timely and sustainable manner.

It is on the pillars of innovation, customisation and competence that the future of finance in India will be built.

6. Suitability and Customer Protection

The failures of the current financial system in providing meaningful solutions to the problems of households points to the need for greater innovation and customisation in financial service delivery. The future of finance, with innovation as its core driver, can only be ensured by the competency and quality of financial service providers. In such an environment, we need to re-assess the framework for financial consumer protection.

While financial access in India remains a primary concern and newer modes of distribution become reality, market participants and regulators are beginning to grapple with issues of consumer protection. This can be seen in recent debates around mis-sale of mutual funds by banks, predatory lending by non-bank financial institutions and the bundling of investment plans with life insurance (ULIPs). This leads to one fundamental question on the future direction of financial consumer protection in India:

> How does India balance the need for financial access and innovation with the requirements of consumer protection?

It seems a particularly appropriate time to address this question, given that India is also undertaking a fundamental review of its financial sector legislation, with the creation of the Financial Sector Legislative Reforms Commission (FSLRC), whose mandate is to rewrite and harmonise all financial sector laws. In parallel, many countries around the world have embarked on reforming their consumer protection frameworks, with the US creating the Consumer Financial Protection Bureau (CFPB) and Australia and South Africa evolving the twin-peak models of financial regulation, providing us a unique opportunity to learn from emerging global experiences.

(a) Current Framework for Financial Consumer Protection

While India does not have legislation governing consumer protection for financial services, consumers have recourse to the consumer courts set up by the Consumer Protection Act, 1986. In addition, consumers of financial products and services may also resort to mechanisms set up by product and services-specific regulators. With the product-based regulatory structure, consumer protection responsibilities for financial services are embedded in multiple regulators.

All regulators have required information disclosure from institutions regulated by them: Reserve Bank of India (RBI) requires banks to clearly disclose material terms on loans, the Insurance Regulatory and Development Authority (IRDA) requires the same of insurance companies for insurance policies. The Securities and Exchange Board of India (SEBI) has extensive disclosure guidelines for securities issuance, both private and public, to provide investors all relevant information before making an investment. The Pension Fund Regulatory

and Development Authority (PFRDA) has however not yet mandated disclosure requirements for pension funds. In addition, regulators have stipulated redressal mechanisms for consumer complaints. For instance, the RBI and IRDA have mandated the creation of banking and insurance ombudsmen respectively and also require that all banks and insurance companies have internal grievance redressal mechanisms. For consumers of securities, SEBI has a complaint redressal mechanism called SEBI Complaints Redress System (SCORES).

Regulators also appear to be promoting financial literacy and education schemes as mechanisms to improve consumer outcomes. For instance, the RBI recently announced the National Strategy for Financial Education aimed at promoting inclusive growth, financial inclusion and financial education.

While these form the basic tenets of India's current financial consumer protection landscape today, there are some fundamental gaps such as:

- lack of mechanisms to deal with conflicts of interest inherent in regulators in their dual functions of prudential regulation and consumer protection
- increasing inter-regulatory conflicts arising out of a rapidly evolving financial sector
- lack of response to a growing body of evidence on consumer behaviour and preferences

(b) The Philosophy of Suitability:

The failings of our current consumer protection framework coupled with the vision of a future for finance based on increased innovation, necessitates a fundamental shift in the approach to financial consumer protection. The consumer protection equilibrium will have to shift from being disclosure-driven where the onus is on the consumer to make the right choice, to one that is based on Suitability - where the onus is on the financial service provider to ensure that the appropriate advice or product has been provided to consumers.

In order to prevent practices of mis-sale and predatory lending that occur in the Indian financial marketplace and to incentivise an innovation-based financial marketplace that is safe for consumers, there exist two possible paths that a consumer protection framework could take:

(i) a regime based on information disclosure mechanisms where the onus is imposed on buyers to decide based on information provided by the service provider; and

(ii) the imposition of Suitability requirements where the onus on assessing the Suitability of a product for the consumer is placed on the seller, who is held legally liable for it.

As we move towards a financial market with increasing product customisation and complexity, the information asymmetry between the buyer and seller will increase over time. In such a scenario, it is not clear that mandating increased information disclosures will lead to improved consumer outcomes. Insights from behavioural economics suggest that one of the problems with increasing levels of disclosures is that of information overload too much information is presented to the consumers who cannot translate this into improved decisions and therefore does not necessarily enhance consumer welfare[13][11][12][13].

If we accept the fact that complexity in financial products could well increase if these products are to solve real household problems, and that, therefore, imbalances in information,

[13]See, for instance, http://www.forbes.com/forbes/2010/0607/opinions-disclosure-legal-contracts-medical-ethics-ideas-opinions.html. This is true, interestingly enough, even in the context of disclosures regarding conflicts of interest: see https://apps.olin.wustl.edu/cres/research/calendar/files/LoewensteinG.pdf and http://jama.ama-assn.org/content/307/7/669.extract.

expertise and power between the buyer and seller will only be exacerbated, then the most appropriate approach in protecting the welfare of the consumer would be to put the onus of consumer protection on the financial services provider. The provider must be held accountable for the service to the buyer, by ascertaining that the products sold or the advice given is suitable for the buyer considering her needs - as determined by the buyer using its expert judgment.

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 for the complex problems of consumer households (and not just revenue-maximising for the provider), thus aligning the incentives of the provider with the consumer.

(c) Suitability as a Process:

Suitability should be seen as a process rather than as an intention of the financial services provider or consumer financial outcomes. Every financial services provider should be required to have a board approved Suitability Policy that the company must follow in all interactions with consumers the policy must lay down the processes for consumer data collection, analysis, communication of recommendations (advice or product sale), and follow-up.

It is the implementation of the Suitability process that should determine if a financial service provider has indeed acted in the best interests of the consumer. If a financial services provider is found to have violated the Suitability process, it must be subject to legal penalties. The power of the Suitability approach is that it will be necessary for the financial services provider to repeat the process on an on-going basis - in every interaction with every consumer. At all points of time, therefore, the financial services provider is incentivised to follow the Suitability process and act in the best interests of the consumer.

(d) Legal Liability:

In order for a framework of Suitability to have teeth, there is a need for the imposition of legal liability on the financial services provider, as this will mean that it is in the firms' self-interest to ensure suitable recommendations and product sales to consumers. The only way to incentivise the financial services provider to act in the best interest of the consumer is to hold them legally responsible for the Suitability process. The power of Suitability can only be harnessed by the imposition of legal liability on financial service providers to act in the consumer's best interests.

The right of financial consumers to get suitable recommendations must be enshrined in law. Every individual must have the right to be provided suitable advice or recommended suitable products. The interpretation of suitable behavior is best determined by the build-up 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.

The combination of ex-ante legal liability and a strong threat of ex-post enforcement provide credible dis-incentives to financial service providers from acting in ways that promote their own self-interest at the cost of consumers. 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.

(e) Suitability and the Right to Choose:

One of the concerns around Suitability is that it is a paternalistic approach that will compromise on the right of the consumer to choose. The objective of Suitability is to ensure that the financial services provider is always incentivised to act in the best interests of the

consumer, and not to ensure that the consumer abides by the advice of the provider. It does not take away the right of the consumer to choose.

Once the financial service provider presents a clear set of recommendations for the consumer, it is for the consumer to make the final decision on whether to offer informed consent or reject the recommendations given. The process of Suitability stops at the point where the financial services provider gives a recommendation based on his understanding of the consumer's situation and needs. For every transaction where the consumer chooses to reject the advice of the financial services provider, she should be required to officially attest to the fact that she has been given expert advice that she has rejected. Beyond this, the financial services provider should be able to sell the products the consumer demands and will not be held liable for Suitability. The provider will be held liable under the Suitability framework only in case the consumer offers informed consent and follows the recommendations made.

(f) Suitability for Advice and Sale:

The discourse on the regulation of consumer protection in financial services draws a clear distinction between the functions of financial advice and product sale or distribution. Financial advice is deemed necessary for a class of financial products that are not simple enough for consumers to understand and therefore place on the financial service provider the onus to ensure that the product be suitable or appropriate for the consumer. All other products, it is argued, do not require an advice component and can be sold by distributors. Financial Advisors are therefore required to be held to high standards of accountability (as desired in the Suitability framework), but product distributors are not.

There are some fundamental problems with this argument. The apparent simplicity of a financial product or service is a poor measure of the impact that it can have on the well-being of a household or an enterprise. As discussed earlier, the simplicity or complexity of the product is not necessarily a good determinant of whether the consumer can make a good decision about it. Assessing the interaction effects of products (simple or complex) with existing portfolios requires expertise that consumers do not have.

It is imperative that the onus for assessing the Suitability of any financial product must rest on the financial service provider, irrespective of the apparent simplicity of the product. The financial service provider has the knowledge and expertise to assess product-portfolio interactions and make suitable recommendations for consumers. By creating an artificial dichotomy between advice and distribution, there is a very real risk that consumers will be making complex financial decisions that they are fundamentally ill-equipped to make - but that financial service providers have the capability to make for them. Therefore, the sale of any financial service must be seen to have the act of advice implicit in it, and must be held to the same Suitability standards.

The other consumer protection concern that arises out of this dichotomy is around the incentive of the financial services provider to act in the best interest of the customer. Especially in the context of heightened information and power asymmetries, consumers must be protected against the possibility of mis-sale by financial service providers.

In an environment where product sale is divorced from advice, there will be a clear incentive for financial service providers to classify their products as simple, so that they will not be held accountable for their implicit advice in selling the product. If they are able to act as pure sellers, without the explicit requirement of Suitability, they will be strongly incentivised to push their products to consumers, even if in their expert judgment the product is unsuited to the customer. The welfare of the customer would be seriously compromised in an environment that enabled such arbitrage. On the other hand, an environment that

explicitly mandates Suitability across the spectrum of financial products and services would ensure the alignment of financial service provider incentives with those of the customer.

In view of the arguments on portfolio interaction effects and information asymmetry, it is apparent that we should eschew the false distinction between advice and product distribution, and move towards a consumer protection framework that requires the financial service provider to assess Suitability, whether in the context of pure advice or product sale, and be held accountable for it.

(g) Regulating Suitability:

An environment where Suitability is at the heart of consumer protection will also require fundamental changes in regulatory approaches and instruments.

Regulators in such an environment should be focused on creating the rules-of-the-game as opposed to constant intervention in the functioning of institutions and markets. This would mean that the regulator sets the ground rules on what it expects in terms of Suitability from financial service providers, coupled with clear and mandatory guidelines on effective grievance redressal mechanisms. The regulator should prescribe requirements of Suitability to ensure that service provider recommendations match the needs of the consumers as expressed and understood at the point of sale in the expert, objective opinion of the provider. Ideally, the regulator would provide guidance, but not legislate tightly, on the assessment of Suitability in different product contexts this would incentivise financial service providers to continually innovate and discover better models for assessing Suitability. The regulator must require all financial service providers (distributors and advisors) to have a board-approved Suitability policy that the company must follow. Directing the creation of these ex-ante Suitability requirements and ex-post redressal mechanisms will be very powerful in dis-incentivising potentially deleterious product designs from being formulated by service providers.

All checks by regulatory authorities for conformity with the Suitability principle should, as much as possible, be ex-post in terms of timing regulatory approvals that inordinately delay go-to-market timelines must be averted, but regulators could have the opportunity to respond to new designs in a timely manner. This is to ensure that regulation does not have a chilling effect upon financial innovation, while at the same time allowing regulators the leeway of preventing poorly designed products from reaching the market. Regulators, therefore, need to be non-interventionist to the extent possible so as to avoid curbing the process of innovation, given its importance to the objective of meaningful financial inclusion in India. Such a non-interventionist approach to the creation of products would mean that regulatory oversight would shift towards detailed monitoring and surveillance of the market place.

The regulator can supervise the compliance of financial service providers in implementing Suitability employing various methods, including:

- On site verification, which can be a very useful approach to assess process compliance with Suitability norms set out by service providers. This includes process employed at point of sale through mystery shopping.
- Continuous, ex-post monitoring through information reporting requirements from service providers such as on incentive and commission structures, financials, customer complaints and grievance records to assess service provider performance.
- Investigations of financial service providers in case of regulator suspicions of malpractice.

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 realised.

7. Conclusion

The future of finance in India is predicated on the development of a financial system that supports innovation in design of products, channels of service delivery and technology that will enable the provision of customised financial solutions that match the needs of households, enterprises and governments. In such an environment, the information and power asymmetries between buyers and sellers will only be exacerbated. This, in addition to a marketplace currently plagued with problems of mis-sale and predatory lending , means that a continued reliance on a consumer protection framework built on information disclosure requirements will be counter-productive. 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 must be enshrined the law as a right of all financial consumers. This will ensure that consumer protection is built into the heart of a financial service provider's business and their internal incentive structures will align themselves with the best interests of consumers. The regime of Suitability will aim to make the provider act in the consumer's best interests but will not impinge on the fundamental right of consumers to choose the products and services they want.

Making Suitability the basis for consumer protection is the only way to enable sustained improvement in financial outcomes for consumers over the long-term.

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