Dvara Research

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Designing Regulations for a Rapidly Evolving Financial System

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Chennai, India.

Dvara Research

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Introduction to the Conference

Financial functions are more stable than financial institutions. In the words of Robert Merton[1], "Functions change less over time and vary less across geopolitical boundaries; and competition will cause the changes in institutional structure to evolve toward greater efficiency in the performance of the financial system". Over the recent past, there have been rapid and unprecedented changes to the form and structure of individual institutions providing specific functions. While the functions themselves have remained relatively unaffected, the format in which these are delivered is going through considerable change. This change is evident in the growing Modularisation of financial services. In the third edition of the Financial Systems Design Conference[2], our objective was to understand the trend of "Modularisation" of financial services and its impact on all stakeholders, namely, customers, market participants and regulators.

The Conference brought together a carefully curated group of regulators, academics and thought leaders in financial services to examine the trend of Modularisation and implications for regulation design for the Indian financial system. After a stage-setting presentation on the nature of Modularisation, the Conference sessions covered topics including: discovery of potential impacts, potential benefits and harms to consumers from Modularisation, as well as implications for prudential and customer protection regulations, led by experts from India, US and Australia. Each session was structured to address the following questions at its core:

- How has Modularisation been shaping, and could potentially shape the financial services industry?

- How should regulation respond to the trend of Modularisation?

The Conference yielded rich discussions and the participants identified several interesting issues and priorities for the Indian financial system. In this document, we provide a comprehensive summary of the discussions.

[1] A Functional Perspective of Financial Intermediation. Robert C Merton. Financial Management, Vol.24, No.2, Silver Anniversary Commemoration (Summer, 1995), pp.23-41

[2] The last edition of the financial systems design conference was held in August, 2012 on the theme of "Envisioning the Future of Financial Customer Protection in India". Proceedings for the first and second Financial Systems Design Conferences can be found http://www.ifmr.co.in/blog/wp-content/uploads/2012/01/Financial-systems-design-conference-2010-2011.pdf and http://www.ifmr.co.in/blog/IFF_Conference_2012.pdf respectively.

Mapping Modularisation in the Financial Services Industry

Modularisation is defined as the unbundling of the financial services value chain into different modules. Traditionally, financial services industry has been populated with institutions that perform all the functions associated with the delivery of a product to a consumer. From the on-boarding of the customer to the delivery and servicing of the product, a majority of, if not all, the functions associated with the sale are performed internally within an institution, like in the case of full-service universal banks.

The recent trend of firms engaged in only a specific part of a financial transaction typifies the growth of Modularisation in the system. In a modular financial system, each module contains a set of functions which may now be performed by different institutions. This allows specialised firms to combine their offerings together and provide a financial product to the end customer. In this context, we identify three specific modules that have emerged as a result of Modularisation in financial services namely:

- Client Relationship Management
- Product Design, including those driven by Big Data
- Financial Resource Management

It is to be noted that Modularisation goes beyond use of specialised intermediaries for some functions such as cash management and loan sourcing, which is common practice in traditional financial services delivery. For instance, the sale of credit product may involve online aggregator platform that create and manage the relationship with the consumer. Borrower verification and risk assessment may involve multiple firms such as credit information companies and data analytics firms. Product design may involve a lending institution with specialised knowledge of the particular customer segment and an eventual financial institution that aggregates the risk and provides the balance sheet resources. This presents new opportunities for consumers and new entrants while providing new challenges for incumbent market players as well as and regulators.

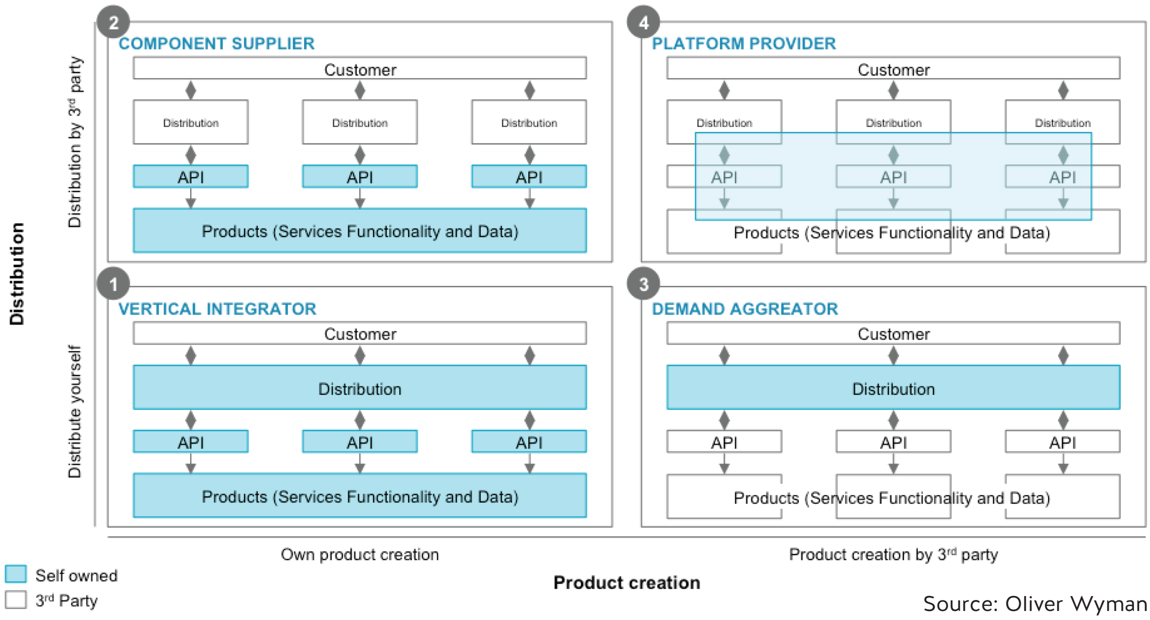
Strategic Evolution of Business Model Archetypes

Modularisation has brought in its wake disruptions to traditional business models in financial services. This is due to

- The decoupling of manufacturing and distribution functions and the creation of marketplaces that move away from one-to-one to many-to-many principal-agent relationships;

- The embedding of financial product delivery into both offline and online real sector businesses, resulting in the blurring of lines between financial and non-financial service delivery, and a resultant opacity that makes it harder to monitor and place accountability for customer outcomes.

One of the ways to understand Modularisation in financial services is by distinguishing the functions of a financial service provider into two broad categories: Product Creation and Product Distribution. In a modular financial system, business models would evolve from being fully integrated models where both functions are performed by the same institution to ones where business models specialise in one of the two functions and multiple partnerships are forged between institutions to supply the end-product to the consumer. We visualise this distinction by classifying the emergent business models into four categories, as described in the Report[3] by Oliver Wyman titled "Modular Financial Services: The New Shape of the Industry":



Source: Oliver Wyman

[3] Modular Financial Services: The New Shape of the Industry, Report by Oliver Wyman, 2016 (http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/jan/OliverWyman_ModularFS_final.pdf)

Strategic Evolution of Business Model Archetypes

1. **Vertical Integrator –** This category represents a fully integrated institution which handles all functions from product creation to the delivery of product and its servicing. Universal banks are an example of a vertical integrator.

2. **Component Supplier –** This category represents institutions that design the financial product but distribute through third party institutions. A typical example is a bank using business correspondents to originate loans.

3. **Demand Aggregator:** A business correspondent is a typical example of a demand aggregator. It distributes products and services which are designed and manufactured by another institution.

4. **Platform Provider:** In a fully modular environment, a platform provider links customers to multiple suppliers. The tasks involved in the manufacturing and distribution of financial products are performed by a variety of specialist firms. The platform provider links firms providing various functions such as product design, risk analytics, back-office operations, payments, balance sheet management and so on to cater to the end customer.

The component supplier and demand supplier models have enabled the embedding of financial products into the retail commerce sector. These modularised models of finance enable the sale of credit and insurance products along with the sale of goods on platforms such as e-commerce websites. A typical example of a platform provider in India would be an e-commerce platform such as Flipkart or Amazon that enables the sale of credit products along with the sale of retail merchandise. For instance, in China, insurance products are available to cover the cost of returning a product on an e-commerce website. This integration allows the consumer to avail extremely customised products with seamless delivery.

Benefits to the Consumer

There are several factors that have motivated the trend of Modularisation in the financial services industry. Most important among these, is that Modularisation will potentially benefit the consumer in multiple ways:

- Providing convenient and efficient services: There is an increasing demand for financial services without the inefficiencies associated with traditional financial institutions. The emergence of the digital medium as a powerful channel for the delivery of financial products has enabled the consumer to access financial products through a multitude of providers. Firms such as e-commerce websites and social networking sites are now leveraging their existing relationship with the consumer to provide financial products. Service providers are now able to access relevant and clean sources of data on consumers through APIs which are enabling the provision of easier and more targeted and customised services. This availability of on-demand and holistic financial services through digital channels is allowing these newer firms and channels to challenge the traditional brick-and-mortar banking model.

- Enabling access to customised products at reduced costs: The unbundling of processes involved in completing the delivery of a financial product has provided financial institutions the choice of employing specialised institutions in a manner that significantly reduces operating expenses. This, coupled with existing cost-effective and scalable technologies in financial services, is bringing down the costs associated with the delivery of products. The prevalence of online marketplaces and platforms selling financial products such as credit and insurance, collate information at one place leading to enhanced transparency for the consumer. In the case of credit, online origination platforms are able to reduce loan processing and underwriting costs. This may enable financial services providers to offer smaller-value loans to households and small businesses in a more cost-effective manner, a business that would have been previously infeasible. The increased access to transactional data and the access to "digital footprints" of consumers may allow lenders to better assess the creditworthiness of potential borrowers, facilitating financial inclusion by providing loans to individuals and firms that otherwise would not have had access to such credit. This may permit better alignment of products to the preferences of these consumers.

Regulatory Concerns in Modular Financial Systems

Concerns for Consumer Protection Regulation

Modularisation of financial services could potentially benefit the consumer in multiple ways, a discussed previously. However, it may amplify existing consumer risks as well as create new risks and harms to the consumer. The understanding of harms is founded on the premise that a consumer has some rights. The infringement of these rights has a negative consequence for the consumer, which we understand as 'harm'. In India the typology of consumer harms in financial sector is informed by the Financial Sector Legislative Reforms Commission (FSLRC, 2013). It identifies the following consumer harms:

- Unfair conduct
- Unfair contracting terms
- Inadequate disclosure
- Inadequate redress
- Unsuitable advice

The challenge facing policy makers today is to anticipate and guard against new kinds of consumer harms that could be caused by Modularisation.

- **The harms from the misuse of big data could materialise at individual as well as societal levels.**

  Societies value financial inclusion because of its ability to improve the well-being of people and afford them greater dignity, freedom and control in their lives. (Unregulated) big data use could diminish or cost these values, thus defeating the rationale of inclusion in the first place. Recent global experiences have been indicating that unregulated data based models could actually counter the values of dignity and freedom that financial inclusion promises. Even more worryingly, some of these models may affect the process of financial inclusion itself. In order to fully understand the implications of data driven models for consumers, it is important to understand the working of these data-based businesses. By harvesting data where traditional data is absent, these new businesses have been able to tap market segments that were previously untapped or underserved. In the particular case of finance, big data based businesses have been able to provide formal credit to thin-filed individual borrowers and small businesses. Two particular cases indicate how data driven models could harm consumers. In 2015, a study pointed out that the price of Princeton Review's Online SAT programs differed according to the ethnicity of the consumer[4]. Asians were being, systematically, charged twice the American consumers, and the customer profiling was based on zip-codes. Other than the consumer harms of misconduct and unfair contract terms already recognised in financial sector, this also presents a new harm of discrimination, raising important public policy concerns. While discrimination is a consequence of the algorithmic ability of businesses to efficiently segment population, the sheer handling of large sizes of personally identifiable information itself, could be a source of harm. In August 2017, CareFirst an American insurance provider suffered a data breach that compromised personal information of 1.1 million consumers. While existing harms to individual are informed and addressed in the FSLRC, the emergent harms could occur at both individual and social levels.

- Harms from Market Exclusion: Though alternative data today is enabling financial inclusion where traditional data does not exist, unanticipated aggregation of person's data from multiple sources to draw adverse conclusions about the individual. For instance the possibility of financial exclusion due to new data practices can lead to market "segmentation" or "customisation". This could systematically prefer one segment and unfairly discriminate against the other.

- Harm to individual liberty: Even when the access to big data is authorised, personal and sensitive information like geolocation or political affiliation could be used to the detriment of individual (liberty and democracy). This is especially plausible in jurisdictions where data processing laws are not transparent enough or the rule of law is not strong enough.

- Harms due to untested design of algorithms: Decisions based on untested algorithms could well be inaccurate or unfair. Algorithms typically work like black boxes and often lead to or unknowable conclusions which may lead to bad outcomes for consumers of businesses using such algorithms.

- Privacy Harms: At the level of the individual, the interconnectedness of data sets increases the risk of unauthorised use of personal information like biometrics.

- Harms due to the ability of differentiate: The extreme efficiency of big data to differentiate among individuals can jeopardise important social benefits. For instance the ability to distinguish between individuals more susceptible to health issues and systematically excluding them from insurance products could attack the foundation of risk-pooling itself. This will leave the most vulnerable individuals out of insurance markets, an outcome that societies do not desire. Moreover pervasive segmentation and differential treatment of communities through the application of data analytics may threaten democratic values.

- Harms due to constant surveillance: Constant surveillance is known to reduce the ability of humans to engage in independent, creative and innovative thoughts.

- Harms due to permeable group privacy: Though some people in a group may seek to maintain their privacy, their privacy could still be breached because individuals similar to them have revealed their preferences. The ability of big data to analyse and infer can lead to weaker privacy for even those individuals who value it more than the rest.

[4] Vafa K, Haigh C, Leung A, Yonack N. Price Discrimination in The Princeton Review's Online SAT Tutoring Service. Technology Science. 2015090102. September 1, 2015. (https://techscience.org/a/2015090102)

Concerns for Consumer Protection Regulation

- **Modularisation poses significant problems for consumer grievance redress**

There is a fragmented complaint system prevalent in India for different kinds of financial providers and their intermediaries. It is understood that only about 0.01% of grievances are redressed per capita India. This is relatively low in comparison to other jurisdictions such as UK where it is 0.52% per capita[5]. There seems to be a high closure rate of complaints but there is a lack of adequate data available to track the quality of redressal of financial institutions or the level of customer satisfaction. There is inadequate data to understand the average duration of complaint redressal. There is also an absence of a standard set of principles for redress across financial institutions. For example, the RBI Citizen Charter of Rights[6] sets out a right to suitability as a basic right of the consumer. However, the complaints on these grounds are inadmissible under the Banking Ombudsman Scheme[7], except in the case of third party products.

A modular financial system with several players working together to provide financial products and services would mean that there exists a variety of different consumer touch points for the delivery of the product. It would also be the case that several institutions would play a role in the design and delivery of the product. This would create an ambiguous environment for the consumer to identify which institution he or she must approach for the redressal. Modularisation further bolsters the argument for the creation of a cross-sectoral Financial Redress Agency as an exponential growth in complaints is likely to be anticipated. This agency should be able to overcome inter-regulatory challenges and regulatory blind-spots in harmonising consumer protection rules and rights along with the legal capabilities to enforce punitive sanctions on market participants.

[5] Compiled from annual reports of respective banking regulators and latest available population estimates
[6] Citizen's Charter of Rights, Reserve Bank of India (https://rbi.org.in/Scripts/CitiChart.aspx)
[7] The Banking Ombudsman Scheme, 2006, Reserve Bank of India (https://rbidocs.rbi.org.in/rdocs/Content/PDFs/BOS2006_2302017.pdf)

Concerns for Prudential Regulation

Any regulatory framework should impose well-defined conditions for entry and propagation of activity in such a way that there is a stable relationship between promoting competition and preserving consumer and systemic welfare. On the other hand, one could argue that a drastic reduction in conditions for entry and propagation of financial activity might lead to a rapid increase of in financial institutions in the market. This may pose concerns for systemic stability and the capacity for supervision. As we see Modularisation unveil, we are witnessing a significant increase in the number of market participants. Currently, it is the case that several of these entities remain unregulated, such as data aggregators and alternative credit scoring companies, personal finance management platforms and so on. Although, several new market players may provide a financial function, it is important for the regulator to identify pre-conditions for regulation of these newer entities. It is also important that regulations are applied in a manner that they are function-specific and institution-neutral in order to make sure competition in the market is sustained. Taking the example of credit intermediaries, there several institution-types that provide the function of credit intermediation, such as banks and NBFCs (and even Telecom companies through Direct Carrier Billing), the manner in which some of the micro-prudential rules have been designed so far are inadvertently skewed against smaller institutions and certain institution types.

- **Existing regulatory frameworks may not completely capture new modular firms**

  Powerful tools such as licensing would need to be carefully applied as it can serve as the most critical barrier to entry. Regulatory framework should avoid taking a central planning approach while designing regulations for these newer entities with non-traditional business models. Regulatory design should consider whether the exact function of the modular firm justifies a need for regulatory oversight and if so, what the optimal channel to apply regulations is. Policy makers should not be considering details of or interfering with the kinds of business models as well as product-designs that should exist for the country. An instance of this is the regulation for Small Finance Banks (SFB) requiring them to originate 75% of their assets as Priority Sector Loans (PSL), a case of regulator deciding the business models of regulated entities. The Revised Regulatory Framework for NBFCs[8] released by the RBI discusses the pre-conditions for the application of Prudential and Conduct Regulations. It is noted that prudential regulation, more specifically capital regulation, would apply to any NBFCs that have access to public funds[9]. Conduct regulations would apply to any NBFC that has a consumer interface. This framework could be used as a base to identify the newer types of firms that would require prudential regulations. In many cases, the modularised entity providing an essential function while working with a bank or NBFC is covered by third party guidelines[10].

[8] Revised Regulatory Framework for NBFCs, 2014, Notification, Reserve Bank of India (https://rbi.org.in/scripts/NotificationUser.aspx?Id=9327)

[9] ibid

[10] Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks (https://rbi.org.in/scripts/NotificationUser.aspx?Id=9597&Mode=0)
RBI releases draft Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs (https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=33673)

Concerns for Prudential Regulation

- **Existing micro-prudential regulation design may provide an uneven playing field between incumbents and newer market players**

  Micro-prudential regulations typically concern with achieving a pre-defined target probability of default of regulated firms. The 'probability of failure' of firms is to be regulated, and the role of regulation is not to bring down the failure probability to zero but to make sure that the market is protected from unstable institutions while at the same time remaining competitive. Given that NBFCs are an early example of dis-intermediated institutions, it is important for us to consider the current regulatory landscape of NBFCs and understand de-merits if any. As mentioned earlier, NBFCs-ND provides credit intermediation functions similar to that of a bank without the acceptance of deposits. However, it has been the case that NBFCs have been prescribed capital requirements higher than those of banks. The design of these high capital requirements for NBFCs has been rationalised, for the most part, by the following:

  1. Protection of the depositors of banks and the creditors of the NBFC
  2. To compensate for the "lower touch"[11] regulations with regard to market conduct and consumer protection

  Both these rationalisations are insufficient to explain the high capital requirements for NBFCs. Regulators should require the strengthening of banks' ability to assess the risk of lending to NBFCs and encourage risk-based pricing of funds as required. Stronger consumer protection and conduct regulations have to be developed and sufficient regulatory capacity should be created to enforce them instead of the ostensible use of micro-prudential regulations to solve a consumer protection problem. These high capital requirements have resulted in negative implications for the sector such as restricting credit growth and higher interest costs for consumers. It has also created an anti-competitive environment for NBFCs. It is possible that the capital regulations applicable to NBFCs may be applied to new market participants such as P2P lenders who may play a role in credit intermediation.

- **Measuring systemic risk becomes harder in the case of Modularisation**

  With the increasing number of participants in the financial services sector, and the increasing ease of manufacturing and delivering customised credit products for customer segments, it is likely that this could lead to rapid expansion of credit in the economy. The increase in the availability of cost-effective delivery channels and better data-driven credit assessments might encourage lenders to concentrate on certain segments. It is likely that there is high concentration risk in particular customer segments such as urban salaried class who are currently experiencing the benefits of increased access to credit.

  It could also be argued that the effects of Modularisation could bring down systemic risk as it would encourage lenders to diversify to segments that were traditionally neglected due to the lack of under-writable information. For example, better data driven credit assessments may be available on SMEs which may encourage banks and NBFCs to lend more to these segments. Hence, Modularisation could have an indirect positive or negative impact on systemic risk. It is important to now place special emphasis on employing tools to measure and understand systemic risks in the modular world.

[11] Review of NBFC Regulatory Framework – Recommendations of the Working Group on Issues and Concerns in the NBFC Sector (https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2619)

Questions and Future Directions for Research and Policy

It was noted that in financial regulation, there are certain non-negotiable principles from a regulator's point of view namely: financial stability, AML requirements, customer fair practices, depositor protection, and institutional neutrality. However, flexibility is afforded for aspects such as micro-prudential regulations, activities undertaken, product types, ownership rules and customer interfaces. These would apply to the modular world just as it did for the non-modular world even while there is acknowledgement that the modular world is exposed to a whole new set of risks as elucidated in the previous sections. Currently, in context of financial products, Indian regulations employ a range of tools designed to protect consumers ex-ante.

- Regulation of Design of Products
- Adequate disclosure in intelligible format
- Fee structure design to ensure the sellers' incentives are aligned with consumers' interests (in certain channel-specific regulations)
- Code of conduct to guide sellers on responsible conduct
- Uniformity across products that ensures that all products are held to similar standards and there is no regulatory arbitrage

However, with respect to consumer data, limited and ineffective regulations exist, driven by the Information Technology Act 2000[12] and with additional data protection regulations prescribed by each financial sector regulator, which are not equipped to handle new harms from Modularisation.

We discuss below the broad themes that emerged from the Conference and which would benefit from further exploration both in terms of research and policy priorities:

1. How do we design strong data protection regulations for financial services?

The protection of individuals' privacy is a policy goal as important as financial inclusion. It was noted that privacy harms tend to be of a permanent nature and cannot be undone, therefore deferring them to later may not be the best policy response

The sessions also discussed regulatory mechanisms to protect consumers from data harm. While India's data protection legislation is still in the making, most of the principles of existing data protection regulation can be traced back to the creation of the Fair Information Practice Principles[13] of the USA. They were created in the 1970s and were founded on "notice" and "choice". They were created for the use case where the data subject was physically handing her data over to the processor, with complete awareness of the content of data and the purpose of its collection. The idea behind the "notice and choice" model was, on the one hand that over time businesses will compete to provide the same service making use of lesser data and on the other hand to keep the data subject in control of her personal information. Through the choice or

[12] For a discussion on the efficacy of the Information Technology Act in the context of financial data, please see Electronic Financial Data and Privacy in India, IFMR Blog, December 23, 2016 (http://www.ifmr.co.in/blog/2016/12/23/electronic-financial-data-and-privacy-in-india/)

[13] Fair Information Practice Principles, Federal Trade Commission. (http://www.ftc.gov/reports/privacy3/fairinfo.shtm)

Questions and Future Directions for Research and Policy

consent framework, the data subject was expected to exercise control over how much or how little of her information she shared with the processor. However, there is growing consensus that consent and notice have become ineffective. Most consumers do not read these notices and the notices are also too vague and complicated for a consumer to get any meaningful information out of them. It is not plausible for a consumer to fully understand the implications of sharing the data that they are consenting to share because the techniques of using and analysing data are changing far too quickly for the consumer to keep pace. Not only does consent put a disproportionate burden on the consumer, the consumers have very little room for bargaining or negotiating on privacy policies. In order to improve the data protection regime, there needs to be more research conducted to understand how individuals' valuation of privacy needs to inform policy discourse. Unfortunately quite often this involves presenting dire trade-offs to consumers.

Therefore, more nuanced ways of framing questions around the value of personal information need to be designed.

- How should the regulator design incentives for markets to adopt privacy enhancing techniques like privacy-by-design or privacy-by-default?
- How does the financial regulator create greater standards for transparency and accountability in a modular financial system?
- What are categories of data that firms engaging in financial services should not be allowed to collect or use for the design and delivery of products?

The Conference also deliberated on the relative relevance of the concept of privacy for emerging markets. It was emphasised that the utility of the concept of privacy is not limited only in the American context which emphasises the freedom of individuals and the right of individuals to trade their personal information or the European context where each individual's right to informational self-determination is recognised. Privacy and protection of personal information is equally valuable in communitarian societies. The Conference discussion predates the Supreme Court of India's judgment[14] recognising a fundamental right to privacy guaranteed to all Indians[15]. More generally design of regulation should be principle based. The regulatory intervention should seek to directly address a well identified market failure while being mindful of the regulator's capacity constraint. The temptations of importing best practices from other institutions as well as prematurely burdening the regulator could both be counter-productive.

[14] Justice Puttaswamy & Anr v. Union of India & Ors, ALL WP(C) No.494 of 2012 (http://supremecourtofindia.nic.in/pdf/LU/ALL%20WP(C)%20No.494%20of%202012%20Right%20to%20Privacy.pdf)

[15] A summary of the judgement and its relevance can be found at The Right to Privacy Judgment: Initial Reflections on Implications for Digital Financial Services, IFMR Blog, August 25, 2017 (http://www.ifmr.co.in/blog/2017/08/25/the-right-to-privacy-judgment-initial-reflections-on-implications-for-digital-financial-services/)

Questions and Future Directions for Research and Policy

2. How do we strengthen market conduct regulations in a modular financial system?

Historically, branches along with individual and institutional agents have been the dominant points of contact of the financial institution with the customer. Conduct regulations have focussed on training and, in recent times, adequate disclosures at the point of sale. There was broad recognition that current mechanisms, even for existing financial services institutions, have minimal efforts directed towards systematic detection of conduct violations in a regular manner. There was also an acknowledgement that the use of disclosure was very important as a regulatory tool to achieve a "Do No Harm" outcome for the customer. However, this is perhaps a mediocre or even too low a bar to set for ourselves in terms of what financial services can achieve for the end customer. It is increasingly becoming ineffective as a tool as it places responsibility on the consumer to understand tedious disclosures. Even if customers may on average 'learn' to choose good products for themselves, those who cannot fend for themselves, ie, the ones at the 'tails' in the distribution are important from the point of requiring regulations to be protected. At the other end is ensuring that customers get provided with products that are 'optimal' for their financial lives. Aiming for a middle ground between these two extremes would be a good target to work towards for the financial sector. With the proliferation of different mediums and channels to engage and provide financial services, and the emergence of multiple players seated within each product delivery channel, there was a strong sense that the relevance of existing conduct regulations needed to be strengthened significantly.

However, market conduct does not have separate treatment by regulators, with the focus being on supervision of micro-prudential requirements, besides the extensive and wrongful prescription of such requirements to fix consumer protection problems. Existing pieces of regulation pertaining to market conduct are most likely observed in institution-specific or product-specific or distribution channel-specific Fair Practice Codes rather than them being function-specific (such as for credit, insurance, savings and deposits, payments, investments, pensions), leading to regulatory arbitrage opportunities for market participants to tend towards setting up businesses under licenses that afford laxer regulatory treatment. This can be both between regulators as well as between different licensing arrangements or product-level regulations put forward by the same regulator. Therefore, the overarching question would be

- What are conduct regulation tools that can be used in addition to the disclosure and consent model to ensure protection against unsuitable sale for the consumer?

Questions and Future Directions for Research and Policy

The emergence of a modular financial system further exacerbates misconduct risk, as described in previous sections, and raises questions on assignment and enforcement of liability in the case of misconduct.

- Are liability regimes feasible regulatory responses to the Modularisation in financial services? If so, how can we change the legal infrastructure to support the creation of a meaningful liability regime?

One of the ideas proposed was to establish a simple registration regime for every product purchase that records details of the consumer, the agent and the product identification. This would enable the regulator to identify and incentivise “good” agents as well as make appropriate sanctions on institutions that use “bad” agents, and to place liability on ‘bad agents’ even if they no longer represent the parent financial institution involved.

3. How do we design necessary and sufficient micro-prudential regulations for new entrants?

The application of the micro-prudential regulations has to be designed in a way that it minimises regulatory arbitrage between institutions providing similar functions such that it promotes competition between institutions. For example, it is worth questioning whether the micro-prudential tool of licensing in itself is required for all the different types of modular institutions described in the previous section.

- What would be the optimal entry-barrier conditions for different types of modular financial institutions?

More efforts need to be directed towards identifying the principles that will further decide the regulatory requirements or interventions that will serve the function of ‘entry barriers’ to ensure viability and orderly development of firms and their ability to keep promises to their customers regarding the levels of business proposed by them when beginning operations.

Most modular entities can be summarised to fall into either of two buckets: Distributors and Manufacturers. Market conduct regulations would have to be applied in the case of any firm in the business of distribution in order to ensure to protect the consumer from the harms defined. Differential application of prudential regulatory tools would have to be applied based on the level and types of risks that are being housed by the firm. Micro-prudential regulations should be designed to maintain a pre-defined target probability of failure of regulated institutions. The smooth functioning of the resolution infrastructure of the country and the success of the IBC and the FRDI Act would be key to achieving this. The introduction of risk-based pricing of deposit insurance, which is yet to become a reality in India, would continue to be a bottleneck to achieving efficient resolution of banking institutions.

4. How do we improve ex-post consumer grievance resolution in a modular financial system?

Current architectures in financial services entail enforcement of customer protection primarily through ex-post grievance redressal mechanisms for each regulator and regulated institution type (case in point being there being no Ombudsman for complaints against NBFCs), and consumer protection forums/ courts. To the extent that systematic mis-selling or unfair contractual treatment of consumers goes undetected by consumers themselves, there are limited[16] supervisory efforts towards information gathering and analysis of conduct of financial services providers that is sufficient to serve as deterrent to institutional conduct malpractices. Depending on whom the duties to take enforcement measures exist, such powers are either not strong enough to have adequate teeth or have not been exercised in a strong manner (as is currently being exercised for prudential regulations).

The unified consumer redress of the Financial Redress Agency (FRA)[17], by design, provides a good solution to these problems above and needs implementation focus. The FRA would provide an efficient redress mechanism as it would be able to work effectively across jurisdictions of different regulators. Taking the redress function out of the regulator's day-to-day focus can help the regulator focus and strengthen core functions using feedback from the FRA. Further,

- How can technology be leveraged effectively to capture, channel and resolve consumer complaints, and be put to use by individual institutions as well as supervisors?

The major challenges in order to collect consumer grievances were identified to be the limited accessibility provided to grievance collection points, the lack of transparency on the actions taken on the grievance and its eventual resolution. Some cases of using technology to resolve these issues were highlighted, and are given below:

- The use of chat-bots by firms such as eBay to improve consumer grievance collection. eBay uses a human-less complaints handling system, where a majority of complaints are handled automatically by a system that leverages a tremendous amount of data collected about customers
- Consumer interactions on social media to submit complaints and to get them resolved
- The creation of a public large scale complaint database by the CFPB[18] to keep track of all complaints and their resolution

[16] A Brief Comparison of Ombudsman Frameworks, IFMR Blog, April 10, 2017 (http://www.ifmr.co.in/blog/2017/04/10/a-brief-comparison-of-ombudsmen-frameworks-part-1/)

[17] Report of the Task Force on Financial Redress Agency, Government of India (http://dea.gov.in/sites/default/files/Report_TaskForce_FRA_26122016.pdf)

[18] Consumer Complaints Database, Consumer Financial Protection Bureau (https://www.consumerfinance.gov/data-research/consumer-complaints/)

Questions and Future Directions for Research and Policy

Some of these technology-driven solutions may be able to achieve much better consumer redressal in a modular environment.

A key discussion which followed outlined the question of which firm should be responsible for the resolution of the complaint. A broad consensus was reached that the firm that interfaces with the consumer would play the most important role in ensuring the resolution of the complaint. Taking an example, an insurance platform such as BankBazaar should be responsible for receiving and tending to complaints even if it is about the failure of a payment transaction or resolution of a claim on an insurance product. It would be the responsibility of the platform to notify the relevant third party firm or manufacturer responsible for the processing of the payment or settlement of the insurance claim. However, it was clearly agreed upon that there needs to be a lucid framework to assign liability across all the entities involved in the transaction.

5. How do we accurately measure systemic risk in a modular world?

The Conference saw a debate around whether or not Modularisation of financial services would indeed contribute to existing levels of systemic risk. There was broad consensus that, many of the functions that the new entrants are fulfilling do not particularly change the location of risks. Modularisation has enabled multiple access points for access to financial products. Given the increase in the number of firms providing more customised products, especially credit, there was a discussion around whether the increased number of originators would increase or decrease the concentration risk to particular customer segments. The larger question is on how the supervisory authority would effectively identify the sources of contagion risk and be able to measure systemic risk in a modular world.

Participants

Ajay Shah
Professor, NIPFP

Anand Sahasranaman
Researcher

Bama Balakrishnan
CFO, IFMR Capital

Bindu Ananth
Chair, Dvara Research

David Medine
Consultant, CGAP

Deepti George,
Head, Policy, Dvara Research

Devesh Sharma
Program Officer,
Bill & Melinda Gates Foundation

Duncan Woods
Partner, Oliver Wyman

Gregory Chen
Policy Head, CGAP

Katherine Kemp,
Research Fellow,
UNSW Digital Financial Services
Regulation Project

Krishna Hegde
Senior VP, Paytm

Kshama Fernandes
CEO, IFMR Capital

Madhu Srinivas
Dvara Research

Malavika Raghavan
Project Head,
Future of Finance Initiative,
Dvara Research

Nachiket Mor
Director of India Office,
Bill & Melinda Gates Foundation

Nishanth K
Dvara Research

NS Vishwanathan
Deputy Governor,
Reserve Bank of India

Parijat Garg
VP, CRIF Highmark

Pawan Bakhshi
India Country Lead,
Financial Services for the Poor,
Bill & Melinda Gates Foundation

Puneet Gupta
Trustee, IFMR Trust

Rajiv Lochan
MD & CEO, Kasthuri and Sons LTD

Ramesh Karunakaran
Director, CRISIL

Renuka Sane
Associate Professor, NIPFP

Sanjay Jain
Chief Innovation Officer, CIIE

Saurabh Jaywant
Chief Legal Counsel, IFMR Capital

Shohini Sengupta
Senior Resident Fellow, Vidhi Legal

Sucharita Mukherjee
Trustee, IFMR Trust

Sugandh Saxena
Head of Advocacy and
Development, MFIN

Sumita Kale
Economist, Indicus Foundation

Suresh Sundaresan
Professor, Columbia University

Susan Thomas
Professor, IGIDR

Vaishnavi Prathap
Head, Household Finance,
Dvara Research

DVARA
Research

10th Floor - Phase 1,
IIT-Madras Research Park,
Kanagam Village, Taramani
Chennai 600 113, India