Proposals for reform but no change

Renuka Sane
Visiting Scientist
Indian Statistical Institute

Background

Improving access to finance has been an important goal of financial policy in India for several decades. Policy tools include measures such as rural mandates for insurance companies, providing tax breaks for investment in equity markets, and most importantly providing incentives to distributors. The success of all of the above measures ultimately rests on financial distributors being able to deliver, and households being able to understand and trust markets. However, participation in retail financial markets continues to be low.

While participation remains low, episodes of mis-selling have been rising. For example, Anagol and Kim (2010) show that in 2006 when closed-end mutual funds were allowed to charge an arguably shrouded amortized fee whereas open-end funds were forced to charge standard entry loads, inflows into the more expensive funds were much higher, and that investors paid approximately 500 million dollars in extra fees in this period. In another study, Halan, Sane and Thomas (2013) study the lapsation in insurance policies after the introduction of unit-linked insurance plans (ULIPs) and find that investors lost more than a trillion rupees from mis-selling over the 2005-2012 period. It is not that these episodes have occured in an environment of unregulated finance. The problem, then, perhaps lies in the manner of regulation. In this article we briefly explain the problem and describe the proposed solutions in the policy landscape.

The problem

Regulation in India is product oriented, focuses on form and not function, and places great emphasis on prudential regulation. Each regulator has its own procedures for licensing, registration of intermediaries, expected code of conduct, caps on commissions, grievance redress procedures. This often lead to instances of regulatory arbitrage, or leaves open the possibility that several entities slip through the cracks and get regulated by no one regulator. For example, one regulator (SEBI) has banned entry-loads for mutual funds, while similar products, such as ULIPs, are permitted to charge commissions under a different regulator (IRDAI). Various distributors such as banks come under far less scrutiny on distribution because they fall under a different banking regulator. SEBI regulations on investment advisors do not apply to agents who provide advice solely on one financial product. More importantly, there is no basic definition of whether a product is suitable for a specific customer and no standard to which distributors can be held responsible for what they sell. Distributors also do not have a fiduciary duty towards their clients. Once investors get duped into signing consent forms, redress seems unlikely.

While regulators have taken individual policy decisions, retail finance continues to be beset with five problems. First, customers are not financially literate to be able to understand complex products. Second, disclosures around products are not clear, and make it more difficult for customers to understand what is being offered to them. Third, differential commissions mean that distributors focus more on those products that earn them the higher commission. Fourth, distributors are not held accountable for what they sell. If a sale goes wrong, they take no responsibility. Fifth, there does not exist a co-ordinated framework for grievance redress.

Proposed transformative solutions

The Swarup Committee Report

One of the first policy reports to propose an over-haul of the system was the High-Level Coordination Committee on Financial Markets (HLCCFM), led by Dhirendra Swarup. This Committee was set up to strengthen the ongoing efforts for imparting financial education and promoting investor protection, and submitted its report in March 2010. The main recommendations of the report related to aligning incentives of the distributor with the customer, improving accountability of the distributor on one hand, and financial literacy of the customer on the other. They are summarised as follows (first described in Sahoo and Sane, 2011):

1. All retail financial products to go no load by April 2011;
2. All financial advisers to undergo a minimum knowledge-linked training program, and selling of more complicated products to require a higher level of education ;
3. All financial advisers to be governed by a code of ethics that is standard across products and organisations;
4. All products to abide by a disclosure template which will display the most important terms and conditions of the products, and the amount an adviser earns from the sale and maintenance of the product;
5. The sales process to be documented, along with customer profiling that took place before a product was sold;
6. A common interface for grievance redress;
7. Financial literacy modules for Advisers, School students, Post Class XII students, and other such

entities to be developed by the Financial Literacy arm. The Financial Literacy arm to be the focal point for all financial literacy initiatives in the country.
8. Setting up of the Financial Well-Being Board of India (FINWEB). The goal of the organisation would be to bring order to the adviser market and building a financially literate community. It will consist of two arms: one SRO arm that will be responsible for bringing advisers under one common standard, and a Financial Literacy arm that will work on promoting financial literacy.

While the Committee submitted the report in 2010, the release took place only in 2014. The report was perhaps controversial for its time, and the suggestion of curtailing commissions was deeply contested.

The Indian Financial Code

The draft Indian Financial Code (IFC) was submitted in 2013 by the Financial Sector Legislative Reforms Commissions (FSLRC) led by Justice Sri Krishna. The IFC contains three key proposals.

1. A single financial agency to regulate securities markets, investments, insurance, pension, and all other financial services except banking.
2. A comprehensive framework of consumer protection which include rights and protections for all consumers, as well as some enhanced protections for individuals and small businesses. This consumer protection framework would seek to ensure adequate initial and continuing disclosures, minimising conflicts of interest, provision of suitable financial services, and protection against unfair conduct.
3. The creation of a single financial redress authority to redress complaints of retail financial consumers in a speedy, inexpensive and predictable manner.

The Bose Committee Report

Even though the Swarup Committee report was finally released in 2014, and the IFC was also accepted by the Ministry in the same year no recommendations seem to have been formally adopted, while at the same time, the problem in retail financial markets continued. This led to the Ministry of Finance to create another Committee led by Sumit Bose, to look into the matter of misaligned incentives and regulatory arbitrage in the sale of financial products. Their recommendations focused on realigning the incentive structure in the sale of the products, and improving disclosures. At the heart of the report, however, was the acceptance that when regulators are based on form and not function, regulatory arbitrage was inevitable, and exacerbated in the case of products that bundled two functions - such as investment and insurance. Increased participation in retail finance will only result when this arbitrage is taken away, and more transparency is brought about. The recommendations of the Bose Committee Report are as follows:

1. Regulation of financial products must be seen in terms of the product function and not form. These functions should be Insurance, Investment and Annuity. The lead regulator, according to function, should fix the rules. In bundled products, the rules of each component should be set by the lead regulator.
2. Returns should be standardised and should be a function of the amount invested. On-going disclosure should show historical returns as an average annual number based on the IRR of the product. The disclosures should be in a manner that an average customer can understand what the product costs, what the benefits are and for how long should the customer hold the product.
3. Investment products and investment components of bundled products should have no upfront commissions. These should move to an AUM based trail model. Upfront commissions on pure insurance products and pure risk portions of bundled products should be allowed, and should be decided by the lead regulator since pure risk is a difficult product to sell.
4. Regulators should create a common distributor (including employees of corporate agents) regulation. Regulators should create a single registry of all distributors. Anybody facing the customer should be registered. The registry should identify each individual distributor with a unique number. The registry should have the past history of regulator actions and awards for each individual distributor. Strict penalties should be defined for distributors who are not registered.

Reason for disappointment

There are overlaps in the proposals of the Swarup Committee and the Bose Committee Report. Both reports emphasise on the alignment of commissions with customer well-being, on improved disclosures of financial products, and increased distributor accountability. The draft IFC goes a step further in solving the regulatory arbitrage problem by creating a unified regulator, as well as enshrining rights of consumers. It has been more than 2 years since the public release of the Swarup Committee Report as well as the draft IFC, and more than six months since the release of the Bose Committee Report. However, there seems to be no move towards adopting any of the proposed recommendations. Perhaps it is time to ask if the Government of India is serious about reform.

References

Anagol, Santosh and Hugh Hoikwang Kim, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market", in: American Economic Review 102.1 (2012), pp. 576–93.

Halan, Monika, Renuka Sane, and Susan Thomas, "The case of the missing billions: estimating losses to customers due to mis-sold life insurance policies", in: Journal of Economic Policy Reform 17.4 (2014).

Sahoo, M. S. and Renuka Sane, A regulatory approach to financial product advice and distribution, Working Paper WP-2011-029, IGIDR, Nov. 2011.