Keynote Address

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1. It gives me great pleasure to welcome you all to this conference, which is the second in the IFMR Financial Systems Design Conference Series. The principal goal of this conference series is to create a platform to discuss issues of significant importance to the future of the Indian financial system that interested researchers in India as well as elsewhere can start to explore and present solutions for. In addition, through this conference and others like it, we hope to build a community of individuals who care about these issues and would be willing to be commentators, researchers and where appropriate, advocates for change. IFMR Business School and IFMR Finance Foundation hope to continue to be closely involved in this research programme and, jointly with a group of like-minded institutions and individuals, expect to build capacity within the country to examine the issues that emerge from the conversations of these conferences.

2. Last year was the inaugural conference in this series and examined a broad range of issues relevant to the future of finance in India. I am pleased to report that the conference sparked several interesting collaborations and initiatives – such as IFMR's collaboration with Dr. Ajay Shah and Dr. Ila Patnaik on financial consumer protection, with Dr. Susan Thomas and Dr. Renuka Sane of IGIDR in household finance, with Dr. Suresh Sundaresan of Columbia University on evolving a research agenda for systemic risk, and with Dr. Sankar De and his team at ISB on financing SMEs.

3. This year's conference theme is "Envisioning the Future of Financial Consumer Protection in India". As financial services gradually expand and acquire depth in India, market participants and regulators are beginning to grapple with issues of consumer protection. It seems a particularly appropriate time to address this issue, 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 both existing and emerging global experiences.

4. The Conference this year aims to stimulate discussion and debate on the possible frameworks for consumer protection in finance for India and arrive at an understanding of the most appropriate framework for India's financial system. And as in the previous conference, at this point, our belief is that it is not a good idea to be pragmatic or to begin by acknowledging the political or regulatory constraints that we see before us. The belief is that if we do this exercise with the starting point of a clean sheet of paper and eventually, through the research, arrive at a design that is dramatically different from what we see around us currently, then we can put on the lens of pragmatism and weigh the costs and benefits and feasibility of bringing about that change.

5. In this conference I am hoping we will think more grandly and set an agenda for the next two decades, and not just the next two years. We are at a time when many of the historic imperatives which led to the current design of financial systems are perhaps no longer valid and that, as a uniquely advanced but also very poor country, urgently in need of sustained and rapid growth and development, we have the opportunity to do things in a way that other countries do not.

6. Everyone here is aware of the need for consumer protection in finance, but I think it is useful to take a moment and dwell upon how consumer protection in finance is distinct from consumer protection for other retail goods and services. Financial services don't have fixed characteristics. They can have almost infinite variations and in a sense, they can be synthesised on the spot by the provider varying one or more features. They are also constantly interacting with the context of the user. Delivered outcomes of financial services usage thus depend entirely on whether this is good interaction or not. Further, many important financial decisions such as investing in a mortgage or saving for retirement are undertaken very infrequently in the course of a lifetime. In addition, the eventual outcomes of financial investments and strategies often become clear only in the long term. In stark contrast, for physical products, the outcome of the purchase becomes obvious upon immediate usage. 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. Financial consumer protection regulation therefore requires specialised responses considering both the high degree of information asymmetry and the nature of manifestation of outcomes.

7. With these distinctions in place, I'd like to explore some socio-economic trends that I believe will shape India's future, and that the financial system of the nation must be well-positioned to meaningfully respond to. This then provides us the context against which the consumer protection framework for India must be designed.

8. Let us talk about some of the significant challenges that citizens are likely to grapple with in the next few decades. I will start with the problem of retirement planning. The number of people above the age of 60 is expected to increase from 100 million in 2010 to 200 million by 2030. Presently in India, only about 10-15% of the working population is eligible to participate in the mandatory, formal programmes designed for providing income security during retirement. These employees are largely part of the formal private sector or the Government and these formal programmes have historically been Defined Benefit programmes where the Government or the employer bears funding and investment risks. In contrast to this, many countries have shifted to Defined Contribution programmes in which the pension is fully funded by the value of the assets accumulated rather than by the Government's annual revenue expenditure account for the year. In 2009, the Government of India launched the New Pension Scheme (NPS) as a social security measure for their own staff and later extended it to people in the unorganised sector as a Defined Contribution scheme, thus shifting the risk to people least equipped to deal with it. The task of retirement planning is extremely complex given the implied need to predict consumption and inflation over long periods of time under Defined Contribution schemes. Consumers may not be well placed to make these decisions and this will need more product innovation on part of financial firms.

9. I'd like to discuss the challenge of financing healthcare next. In the absence of a universal health care system, India has extremely high levels of out-of-pocket point-of-service expenditure on health owing to low levels of insurance coverage and pre-payment. This leaves consumers to manage planning for lifecycle and catastrophic health expenditures and exacerbates the retirement planning problem. In fact, increasing incomes and improving healthcare have led to increasing life expectancy, which makes the planning for retirement and health even more complex.

10. Since 1995, annual inflation based on WPI has ranged from 1.7% to 12.6% with a mean of 5.9% and a standard deviation of 2.7%. The high level of volatility around inflation implies that households face uncertainties around real incomes and real returns. This is compounded by the absence of instruments

such as inflation indexed bonds. For an average household, this means that even routine savings and investment decisions become very risky.

11. Given these trends, we must ask ourselves the following questions: What kind of a financial system does India need to meet these challenges? What are the implications for financial innovation and public policy?

12. Let us imagine a financial institution that offers fixed interest rate 30 year home loans. On the surface, this is a 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. Is this a "good" financial product in its current form and appropriate for everyone? Can the sale process approximate a standardised approach for all customers? I would argue that it is not the case because of some important considerations. One, 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. Can the provider offer fixed real rate loans instead by shorting inflation-indexed bonds at their end? Two, by borrowing and buying a house, the customer takes a leveraged long-term position on real estate. If the customer's cash flows are even somewhat volatile to begin with, adding leverage to it greatly exacerbates the experienced volatility and might impact consumption in a bad scenario. What if asset prices on real estate sharply decline in the future? Does the borrower have any ability to lay off this asset price risk through a Shiller-style macro security? Three, the housing loan and the house needs to be viewed in the context of the global portfolio of the customer. If this is a customer who has reasonable financial wealth and negligible real estate exposure, this may be valuable diversification. For another customer, who already has high exposure to real estate, this exact same product would appear to be a bad solution. Therefore, even an apparently simple fixed rate home loan product hides a lot of important detail that has material consequences for the consumer.

13. Simplicity as an approach to financial services design is problematic. I am often left wondering, simple for whom? A product like the fixed rate home loan transfers a lot of the risks to the consumer while making the life of the provider simple. Surely, that is not the intent. The function of finance is to solve problems. We may want financial providers to incorporate features such as inflation protection and asset price insurance to the basic home loan that makes it more suited to the customer's reality. I like to use the analogy of finance as noise-cancelling headphones. Finance must give households a

smooth and growing net income stream and cancel out noisy shocks in their daily lives. As we think about the framework of consumer protection, it is essential that we keep this theme in mind. What is the value of consumer protection frameworks without a focus on financial outcomes of households? Who are we protecting?

14. What then are the broad directions we can go as a financial system vis-à-vis consumer protection? Recalling the discussion on what makes finance unique, namely infinite variation, ability to be synthesised at point of transaction, information asymmetry and interaction effects, it is evident that a free market with no regulation is not an option. Therefore, what should the relative emphasis of consumer protection regulation be?

15. I believe there are three broad directions that regulation can take:

a. An information disclosure and financial literacy based approach that argues that consumer welfare is best enhanced by providing more information to consumers while working in parallel on improving consumer financial knowledge.
b. An approach that is based on the belief that the core problem in financial services delivery is the conflict of interest between the manufacturer and the distributor or advisor.
c. An approach argues that the onus of consumer protection must shift decisively from the consumer to the financial services provider.

16. Consumers of financial services have less information and sophistication about the financial system and financial services than the financial services providers. This imbalance of information leads to consumers being vulnerable to abusive practices. Disclosure is seen as a way to handle this information gap between the providers and the customers by providing as much information as possible in an understandable way to the customer. Information disclosure pertains to product terms including pricing, risk factors, and provider conflicts of interest. Removing these information gaps is viewed as being critical to promote good consumer choices. This approach believes that well-designed disclosures complemented by effective financial literacy programs enable consumers to make better decisions and improve their financial outcomes.

17. Conflict of interest occurs when remuneration given to a financial service provider might influence the choice of financial product recommended or sold by the provider to retail clients. This approach believes that the root of mis-sale of products and services is the conflict of interest between the

manufacturer and distributor of financial services. It attempts to align incentives within a financial service provider or across providers involved in developing and delivering a service. The solution often proposed to contain this conflict is to separate the roles of advisor and agent, as in the case of Australia, so that the advisor is compensated only by the consumer and the agent is compensated only by the manufacturer. In the context of credit, conflict of interest needs a deeper discussion because a sale and purchase is happening simultaneously.

18. Suitability can be defined as the degree to which the product or service offered by the financial service provider matches the retail client's financial situation, objectives, and risk tolerance. This approach believes that that mandating increases in information disclosures alone will not lead to improved consumer outcomes given the features of finance and that the most appropriate way to protect the welfare of the consumer would be to put the onus of consumer protection on the seller. The seller must be held accountable for the service provided 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 seller using its expert judgment.

19. In reality, any consumer protection framework could have elements of all these three approaches. However, at this conference we have deliberately chosen to debate each of these approaches as distinct choices for India’s financial system. We hope that at the end of two days of discussions, we will have a sharp sense of how each of these approaches will specifically fit into a framework for consumer protection in India.

20. A quick word on the format. We will have two speakers for each approach, who between them highlight both the research as well as market perspectives. We will have a discussion following each set of speakers. Given the small and carefully chosen group, the conference is designed to encourage conceptual conversations and free exchange of views. Views expressed at the conference will be strictly confidential. Audio and video extracts of the presentations and discussions will be used for knowledge purposes and only with prior consent.

21. On behalf of the IFMR Finance Foundation and the IFMR business school, I would like to thank each of you for making time for this important discussion. I hope that through the two days of deliberation we will be able to arrive at some concrete directions for financial consumer protection in India.