

## 4th Dvara Research Conference Regulating Data-Driven Finance April 5-6, 2019

### Primer on Suitability for Consumer Data Use and Product Design

*Beni Chugh, Malavika Raghavan & Anubhuti Singh*

This primer presents an overview of the landscape, emerging concerns and some considerations for regulators in India in relation to suitability for consumer data use and product design. A reference list of background reading materials is available on page 7 & 8.

*This primer has been prepared for participants at the 4th Dvara Research Conference.*

#### Overview

Internationally, **suitability** or **appropriateness** in finance is conceptualised as "*the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience*" (Basel Committee on Banking Supervision, 2008). A suitability-based approach to financial services provision places obligations on providers to make assessments of whether a product is suitable prior to the sale to a consumer. The effort is to move away from the current approach that places the burden solely on consumers to make complex financial choices. In India, financial sector regulators have supported the need to emphasise on suitability to varying extents. The Reserve Bank of India, for instance upholds the consumers' *right to suitability* in its Charter of Customer Rights.

However, practitioners have often asserted that suitability is challenging to implement in practice because of the costs of granular suitability assessments and the absence of the detailed consumer information needed for them. With the growing use of personal information and analytics in provision of financial services, that challenge appears solvable —unlocking the potential for providers to undertake suitability assessments when selling or designing financial products. These new techniques however raise a new set of issues for consideration.

First, inappropriate use of personal information may itself create new harms for consumers. This raises questions of the boundaries of appropriate data use by all stakeholders in this new digital environment. Second, suitability frameworks may need to be updated for a new world where users can interact with integrated platforms as their "front-end" to finance. Such integrated front-ends allow various product features to be brought together by multiple providers. This begs the question of whether suitability frameworks evolved for a more analogue financial landscape need to be updated for digital financial services. These and related concerns re-open many questions on the need for new suitability frameworks for providers and regulators operating in the data-driven environment of modern digital finance.

## 1. Landscape

Suitability or appropriateness in finance encourages providers and distributors to assess if the financial product being offered by them matches the consumers' financial needs and circumstances (International Organization of Securities Commission, 2013). Such assessments are instrumental for effective consumer protection because the complexity of financial products makes it hard for users to understand the welfare-implications of a financial product. These gaps in consumers' understanding are further aggravated by the various behavioural biases that influence their financial decision-making.

Financial consumer protection regulation focuses on equipping consumers to overcome these barriers in choosing appropriate financial products. However, the existing regulatory approach relies predominantly on information disclosures to address these gaps in users' understanding and inform their financial choices. This disclosure-led approach is predicated on the *buyer-beware* principle, which places the onus of choice on the consumer. This is based on the logic that the information asymmetry between the consumer and the seller can be reduced through copious disclosure. However, lengthy, technical and complex disclosure instruments are often incomprehensible to the user and of little value in informing their financial decisions.

Suitability seeks to address these limitations of the *buyer-beware* paradigm for consumer protection. In India, the efforts to embed suitability in the regulatory landscape have conceptualised it as a process-based provider obligation. A process-based approach to suitability has the benefit of being an objective procedural requirement which is not based on the intentions of the provider or consumer outcomes (which are harder to measure). The effort has been for suitability to be seen as a process that covers all aspects of consumer interactions, right from the time of enrolment, data collection and analysis, through to the communication of product recommendation or advice, and follow-ups with consumers on recommendations made (Sahasranaman, 2013). This approach can be supported by a liability framework for providers to incentivise the implementation of the Suitability process in the design and sale of financial services to ensure they meet consumer needs (Sahasranaman, 2013). Support from the idea of suitability has been voiced in various regulatory reports and instruments. The Report of the Financial Sector Legislative Reforms Commission (FSLRC) and the companion draft Indian Financial Code (IFC) conceptualised suitability as a process-based provider obligation. Although the draft IFC is yet to be adopted, there is support from regulators to embed suitability-based provision of financial services in Indian retail finance.

In 2014, the Reserve Bank of India introduced the Charter of Customer Rights which included a *right to suitability* for all consumers. This right requires appropriate products to be provided to customers based on an assessment of their financial circumstances and understanding. The Securities and Exchange Board of India (SEBI) has shown support for suitability, as seen in requirements for certified Investment Advisers to consider factors including the risk profile of the client and the client's objectives before offering them paid investment advice. The SEBI Master Circular for Mutual Funds also contains several references to the suitability and appropriateness of products. The Insurance Regulatory

and Development Authority (IRDAI) mandates that steps should be taken by the insurer while soliciting consumers and during sale of insurance policies to ensure that they are fully informed and made aware of the benefits of the policy. Insurers must also devise board-approved policies to ensure “steps are taken to prevent mis-selling and unfair business practices at point of sale and service” (IRDAI, 2017).

In practice, suitability has proved to be more of an aspiration than a daily reality for those at the frontlines, selling financial services and products. Practitioners have often asserted that suitability is challenging to implement in practice because of the costs of granular suitability assessments and the absence of the detailed consumer information needed for them. With the growing use of personal information and analytics in provision of financial services, that challenge appears solvable—unlocking the potential for providers to undertake suitability assessments when selling or designing financial products.

The potential for data-driven providers to offer personalised financial advice, and even customised products, are recognised as opportunities that arise from new techniques and data sources that have become available (Ananth, 2017). Existing consumer data held by banks and NBFCs who work with lower-income groups could be analysed better to provide more meaningful insights into debt servicing capacities. New types of information about new-to-credit consumers such as utilities payments information or phone usage could also help personalise products to make them more suitable for a particular set of consumers. These new techniques however raise a new set of issues for consideration.

## 2. Emerging Concerns

Individuals are often ill-equipped to judge the welfare implications of financial products: Individuals’ financial choices, viewed in a vacuum, may bely underlying stresses that they experience. This is also a concern for low income households in India. Findings from our research on microfinance borrowers in the southern state of Tamil Nadu suggest that borrowers in financial distress (but who may not have defaulted) are able to access loans which are unsuitable to their financial situation. Our findings suggested that the repayment of these loans resulted in loss of welfare for the borrowers (Prathap & Khaitan, 2016).

Such instances indicate the borrowers’ bounded rationality when considering how financial products interact with their financial circumstances and implications for their welfare. In a data-driven environment where lenders have more access to new forms of data about consumers, the question of whether this data can be used to enhance an understanding of suitable and unsuitable products has renewed significance.

The propensity to engage with unsuitable financial products may be higher on digital platforms: The design of digital interfaces can inadvertently tap into individuals’ behavioural biases, for e.g. pre-checked radio buttons that may unwittingly make consumers opt-in to financial products. Digital finance can therefore conflate two distinct issues worthy of regulatory attention. The first relates to the suitability of a product for a consumer, and the second relates to the manner in which the sale of that product is undertaken.

*There is the potential for data to be used unsuitably in the case of vulnerable consumers:* Evidence from other jurisdictions shows that new conduct risks emerging in the context of data-driven, digitally administered financial services. For instance, the increased availability of personal information is creating more aggressive sales and sourcing practices. Data brokers are known to aggregate and process users' information to create lists that segment people on the basis of their vulnerabilities (such as identifying people with addiction problems, or households who are financially vulnerable at the end of the month) (Federal Trade Commission, 2014). The potential use of these marketing strategies by financial service providers raises fresh concerns around conduct regulation for entities who may connect consumers to financial products without being regulated themselves, especially where they do not act suitably.

*The difference between 'sale' and 'advice' is blurring on the digital platforms:* It is common for platforms which aggregate various financial products to rank or recommend certain services to users. These algorithmically generated recommendations may blur the lines when it comes to existing conceptions of financial advice. Offline, it may be easier to distinguish the intermediaries who are authorised to offer advice from those who are not, but these lines are blurring on the digital platforms. Many digital platforms may be purely marketplaces and not authorised agents of regulated entities. However, these differences may not be evident to a user of the platform, who might view their relationship with the platform (and any perceived "advice" received on the platform) as related to the financial service or product they use the platform to procure.

### 3. Considerations for Regulators

Digital interfaces offer users the rare convenience of buying varied financial products from a single front-end platform. They also offer financial service providers the flexibility to determine the time, method and the manner in which they interact with consumers.

These features raise new considerations for conduct regulation in finance.

*Suitability for consumer data use:* With the increased use of consumers' personal data and advanced analytics in the course of provision of financial services, evidence is growing that inappropriate use of the techniques could expose consumers to new harms, amplify existing harms from misconduct or create unintended consequences. This raises questions of the boundaries of appropriate data use by all stakeholders in this new digital environment.

*Ensuring that algorithmically generated advice and recommendations are fit for purpose:* Algorithmically generated recommendations can often be framed as more objective, rigorous, or conveying higher reliability than traditional non-automated financial advice. There is a need to understand the inputs and methodologies that create algorithmic recommendations (such as the quality of the training data and the parameters used in the algorithm) to assess their suitability. A critical policy challenge in this area is thus creating a common understanding and standards for what definitions of suitability are most appropriate in the context of data-driven finance.

*Applicability of consumer protection regulations for tech-based disintermediating entities:*  
The traditional chain of financial services provision has been disrupted by various disintermediating entities. Several of these entities are technology-led firms that may interact with consumers and mediate their access to financial products or services. However, they may neither be the provider of these services nor a designated agent of regulated providers. The question of whether these entities use consumer data suitably, or market products to consumers appropriately may be outside the realms of financial regulation. An examination of how suitability frameworks can function in this new landscape has impacts not just for new intermediaries but also existing financial firms.

Against this context, the session on *Suitability for Consumer Data Use and Product Design* could examine the following questions:

- What are some ways in which providers are using personal information to provide suitable products? What is the complementing infrastructure that providers need in order to use personal information for designing suitable products?
- What are some risks to be mindful of when considering the use of personal information in product design and deliver?
- Can personal information be used to determine ex-ante indicators of financial distress among users? Currently distress is only measured through default, which does not leave room for any ex ante measures to mitigate distress and avoid default.
- Can we create a common understanding of unsuitable products and adverse consumer outcomes in the context of digital financial services? Should regulation identify certain consumer outcomes that should be discouraged?
- Financial advice can be implicit in the provision of digital finance, since the design of the digital interface and filtering of options frames choices for the consumer. How should the boundary between “sale” and “advice” of a financial product be interpreted?
- Can financial marketplace platforms be vested with the fiduciary responsibility to act in the best, financial interest of the user?

## Resources

1. Basel Committee on Banking Supervision. (2008). Customer Suitability in the Retail Sale of Financial Products. Basel: Bank for International Settlements. Retrieved from <https://www.bis.org/publ/joint20.pdf>
2. Ananth, B. (2017). New Tools. Business Today. Retrieved from: <https://www.businesstoday.in/magazine/special/new-tools/story/251167.html>
3. Calo, R. (2014). Digital Market Manipulation. UN Law Digital Commons. Retrieved from <https://digitalcommons.law.uw.edu/cgi/viewcontent.cgi?article=1024&context=faculty-articles>
4. CGAP. (2018). A digital credit revolution: Insights from Kenya and Tanzania. CGAP. Retrieved from <https://www.cgap.org/research/publication/digital-credit-revolution-insights-borrowers-kenya-and-tanzania>
5. Dvara Research. (2018, December 10). Proceedings of the Participant Sessions at the Workshop on Product Suitability in Microcredit. Retrieved from Dvara Research: <https://www.dvara.com/blog/2018/12/10/proceedings-of-the-participant-sessions-at-the-workshop-on-suitability-in-microcredit/>
6. Financial Conduct Authority. (2017, February 14). What makes good conduct regulation? Retrieved from FCA: <https://www.fca.org.uk/news/speeches/what-makes-good-conduct-regulation>
7. IRDAI. (2017). IRDAI (Protection of Policyholders' Interests) Regulation 2017. Hyderabad: IRDAI. Retrieved from [https://www.irdai.gov.in/ADMINCMS/cms/frmGeneral\\_Layout.aspx?page=PageNo3191&flag=1](https://www.irdai.gov.in/ADMINCMS/cms/frmGeneral_Layout.aspx?page=PageNo3191&flag=1)
8. International Organization of Securities Commission. (2013). Suitability Requirements with respect to the Distribution of Complex Financial Products. IOSCO. Retrieved from <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf>
9. Lumpkin, S. (2010). Consumer Protection and Financial Innovation: A Few Basic Propositions. OECD Journal: Financial Market Trends. Retrieved from <https://www.oecd.org/finance/financial-markets/46010844.pdf>
10. Marda, V. (2018). Artificial Intelligence Policy in India: A Framework for Engaging the Limits of Data-Driven Decision-Making. Philosophical Transactions of the Royal Society. Retrieved from <https://royalsocietypublishing.org/doi/pdf/10.1098/rsta.2018.0087>
11. Prasad, V. (2014, March 25). Towards a Suitability-based Customer Protection regime in India. Retrieved from Dvara Research: <https://www.dvara.com/blog/2014/03/25/towards-a-suitability-based-customer-protection-regime-in-india/>

12. Prathap, V., & Khaitan, R. (2016). When is microcredit unsuitable: Guidelines using primary evidence from low income households in India? Retrieved from Dvara Research: <https://www.dvara.com/research/wp-content/uploads/2017/01/When-is-Microcredit-Unsuitable-Guidelines-for-Lending.pdf>
13. Reserve Bank of India. (2014). Chapter 6.2: Suitability as an Approach. In Committee on Comprehensive Financial Services for Small Businesses and Low Income Households. Mumbai: Reserve Bank of India. Retrieved from <https://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=737>
14. Sahasranaman, A. (2013, April 12). FSLRC moots shift in onus of consumer protection from consumer to provider. Retrieved from: <https://www.dvara.com/blog/2013/04/12/fslrc-moots-shift-in-onus-of-consumer-protection-from-consumer-to-provider/>