India’s path to regulating market conduct

Susan Thomas
IGIDR Finance Research Group

The FSA Annual International Seminar, London

November 2012
Structure of financial sector regulation

Till 1991
- Reserve Bank of India (RBI) and the Ministry of Finance.

In 2012
- Securities and Exchange Board of India (SEBI),
- Insurance Regulatory and Development Authority (IRDA),
- Pension Fund Regulatory and Development Authority (PFRDA).

Regulation is fragmented by financial product / service despite common participants; regulation of credit services are least regulated.
Part I

Products and distribution channels
### Products and Distribution channels

<table>
<thead>
<tr>
<th>Category</th>
<th>Distribution Channels</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>• Banks • Non-banking finance companies (NBFC) • Micro-finance institutions (MFI) • Money-lenders • Chit-funds</td>
</tr>
<tr>
<td>Securities</td>
<td>• Brokers</td>
</tr>
<tr>
<td>Asset management</td>
<td>• Brokers • Agents • Banks • Product providers themselves</td>
</tr>
</tbody>
</table>
### % households with outstanding investment

<table>
<thead>
<tr>
<th>Financial products</th>
<th>March 2010</th>
<th>March 2011</th>
<th>March 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Insurance</td>
<td>27.46</td>
<td>25.15</td>
<td>26.42</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>1.07</td>
<td>0.88</td>
<td>0.89</td>
</tr>
<tr>
<td>Listed shares</td>
<td>0.68</td>
<td>0.68</td>
<td>0.74</td>
</tr>
<tr>
<td>Real estate/housing</td>
<td>65.09</td>
<td>74.82</td>
<td>75.06</td>
</tr>
<tr>
<td>Gold</td>
<td>44.18</td>
<td>63.81</td>
<td>70.73</td>
</tr>
</tbody>
</table>

Source: CMIE Consumer Pyramids
Very low penetration of financial products in India, *but*

The financial distribution industry close to Rs.230 billion around 2011
Problems: lack of focus on customer interest

- Conflict of interest
- Underdeveloped market for advice; No standards for quality of advice.
- Fragmented regulation; Weak implementation.
- A parallel system for low income workers
Part II

Crises of distribution
Distribution crisis #1: Mutual funds pre-2009

- Cap on entry loads of 7%, industry standard 2.5%. But New fund offers (NFOs) allowed to charge the fund 6% of the amount it collected from the market.
- Multiple NFOs launched, high churning. An estimated Rs.500 million (USD 9 million) loss from shrouding by NFOs.
Distribution crisis #2: Unit linked insurance plans pre-2010

- Unit linked insurance plan (ULIP): mutual fund with insurance. Multiple charge heads with no defined cost caps. Staggered annual loads front loaded on year one and two, with a three year lock-in and a high surrender value.
- An estimated Rs.5 trillion (USD 90 billion) loss in lapsed policies, in five years (over 2006-2012).
Part III

Regulatory action
Ban on entry-loads from August 1, 2009.
Since August 2012, structures have been modified to become fungible within the expense ratio.
Outcome-linked hike in expense ratio by 50 basis points.
Regulatory action against firms: Some examples

- 23 September 2010: MCX-SX application to start a new stock exchange rejected; not fit and proper, “dishonest”. (SEBI)
- 2 December 2010: Market manipulation against Ackruti City and Murli Industries. (SEBI)
- 14 January 2011: Order about market activities of Reliance Infrastructure. (SEBI)
- 31 August 2012: Sahara Group asked to refund Rs.174 billion (USD 3 billion) with 15% interest to investors within three months. (Supreme Court of India)
IRDA regulation on ULIP commissions

- New guidelines for ULIPs from June 29, 2010.
- All costs under one head (except mortality).
- Cap on surrender charge of Rs.6000.
- Industry has shifted back to selling traditional plans (which have high costs and are opaque).
IRDA initiative on grievance redressal

- Integrated Grievance Management System.
- Online portal for handing policyholders’ complaints and tracking status.
- Every complaint enters the portal.
- Must be attended by the insurer within 15 days.
Part IV

Looking forward
Global approach

- Ban on commissions.
- Ban on volume based payments.
- Increased standards for establishing “suitability” of products.

Susan Thomas
India’s path to regulating market conduct
India

1. **USAID (2007)**
   - Common regulation of investment advice.
   - Recommended setting up a *Regulatory Organisation*. SEBI as the oversight regulator

2. **Committee on Investor Awareness and Protection (2010)**
   - Emphasis on investor protection and investor education.
   - Recommended setting up the *Financial Well-Being Board of India*. SRO arm to bring advisers under one common standard. Financial literacy arm to promote financial literacy.
   - All retail financial products to go no load by April 2011

3. **SEBI (2011)**
   - August 2011
     - Rules for large distributors separating advice from execution.
   - September 2011
     - Full separation of advice and distribution. SRO under SEBI to regulate advisers.
     - Tied-distribution model
A unified consumer protection law.
- Defines the rights of customers, powers of the regulators, and principles guiding which power is to be used in what situation.
- Regulations created at the level of the individual regulators.

A single agency for redressal across all products, the *Financial Redressal Agency* (FRA).
FRA will have “branches” at the district level.

Feedback loop between FRA and the regulators on what needs improvement in existing regulations.

A single agency to hear cases against all the regulators, the *Financial Sector Appellate Tribunal* (FSAT).
What remains

- Consumer credit: update laws of insolvency and bankruptcy.
- The trade-off between financial inclusion and customer protection (development vs. regulation).
- Political economy – ensuring that regulators are independent.
Thank you
IGIDR Finance Research Group
http://www.igidr.ac.in/FSRR