Rights and responsibilities: building a robust financial advisory business

Renuka Sane

Indian Statistical Institute

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Why are we talking about responsibility?

- Retail financial markets have seen breakdowns in consumer protection the world over
    - Payment protection insurance, UK, 2005-2010
    - Subprime mortgage crisis, US, 2008
    - ULIP mis-selling episode, India, 2005-2010
- Increasing realisation that
    - Individuals are unable to evaluate complex financial products
    - In an environment with high-powered sales incentives, “Caveat emptor” cannot be a guiding principle
    - Competition among financial firms is not enough

How has the world reacted?

- Increased focus on consumer protection.
- Restrictions on commissions paid to distributors of financial products
- Renewed focus on disclosures
- Increased enforcement actions
- Examples include:
  - Retail Distribution Review, UK, 2008
  - Future of Financial Advice, Australia, 2012
  - Consumer Financial Protection Bureau, US, 2010
  - MiFID Guidelines, EU, 2012
  - Draft Indian Financial Code, India, 2013

Issues in bank led distribution models in India

- Banks have become an important distributor of financial products such as mutual funds and insurance
- Products under the regulatory oversight of other financial regulators
- Banks just act as **agents** and not **advisors**
- Mis-selling of third party financial products by banks has been flagged by the media and consumer protection groups for many years
- RBI has asked banks to put in place a board approved policy that guarantees six basic rights of customers. Not much is known about the progress.

Agents vs advisory model

- Commissions led distribution makes the advisory market unviable
- Customers do not want to pay for advice, as they think they get it for free
- This makes it difficult for advisory firms to sustain

RBI circular on commodities

Circular dated 28th May, 2015

Banks should encourage hedging by the agri- borrowers by creating awareness amongst them regarding the utility and benefits of hedging through agri-commodity derivatives. At the same time, banks must keep the sophistication, understanding, scale of operation and requirements of their agri-borrower in mind while advising on the availability and use of these instruments.

RBI circular on commodities

To begin with, bank may encourage large agricultural borrowers such as agricultural commodity processors, traders, millers, aggregators, etc., to hedge their commodity price risk. The hedging can be through agri-commodity derivative products available on recognised exchanges in India. Banks may educate their customers about the suitability and appropriateness of using these products for hedging specific exposures so that these customers can take an informed decision, lessening the scope for mis-selling of these derivatives

What this implies

- **encourage hedging**
  - Become a commodity advisor?
- **educate customers about suitability of the product**
  - Educate but not do the suitability analysis themselves?
- **customers take an informed decision**
  - Ultimately still “caveat emptor”?

Consumer protection framework missing

- Hedging through futures likely to be more complicated than buying insurance.
- Need a framework of what rights the customer has
- Need an outline of the obligations a bank has towards its customers
- Need clarity on whether banks are **agents or advisors?**
  - Is it designing the hedging strategy?
  - Is it just selling strategies designed by a third party provider?
- The hedge working for the firm is in the interest of the banks. To that extent there is incentive alignment.

The CFTC focus on consumer protection

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Draft IFC on consumer protection

- Requirement of professional diligence
- Unfair provision in financial contracts
- Unfair conduct prohibited
- Disclosure requirements
- Suitability of advice requirements
- Redress of complaints