India’s path to regulating market conduct

Susan Thomas
IGIDR Finance Research Group

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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

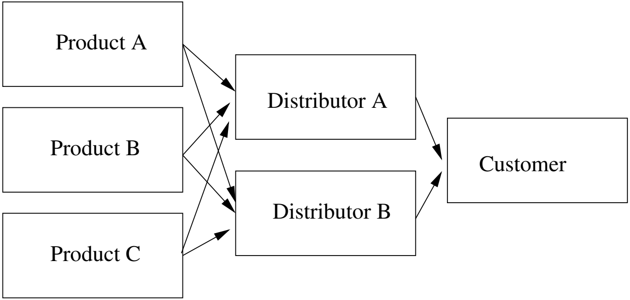
Credit	• Banks • Non-banking finance companies (NBFC) • Micro-finance institutions (MFI) • Money-lenders • Chit-funds
Securities	• Brokers
Asset management	• Brokers • Agents • Banks • Product providers themselves

% households with outstanding investment

	March 2010	March 2011	March 2012
Financial products			
Life Insurance	27.46	25.15	26.42
Mutual funds	1.07	0.88	0.89
Listed shares	0.68	0.68	0.74
Real estate/housing	65.09	74.82	75.06
Gold	44.18	63.81	70.73

Source: CMIE Consumer Pyramids

The structure and state of distribution in India



- 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

SEBI ban on commissions

- 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.

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

Way forward – FSLRC approach, 2012

- 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
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