

*Regulation for Financial Consumer Protection: Present Status and Future Directions**

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Shri A.C. Mahajan, Chairman, Banking Codes and Standards Board of India (BCSBI); Shri C.K Krishnan and Shri M. M. Chitale, Members of BCSBI Governing Council; Shri N. Raja, CEO, BCSBI; Smt. Meena Hemachandra, Principal, College of Agricultural Banking; Principal Code Compliance Officers (PCCOs) from various scheduled commercial banks and urban cooperative banks; officials from BCSBI; colleagues from the Reserve Bank of India; ladies and gentlemen. It is a pleasure for me to be here today at the PCCO Conference 2013, organised by the BCSBI. This annual conference is an important event as it provides a platform for interaction with PCCOs, who are a vital cog in ensuring adherence to BCSBI codes and maintenance of high standards of customer service within banks. I have also viewed this conference as an opportunity to understand the issues faced by banks and the constraints that prevent the roll out of an effective customer service framework. I hope to receive frank feedback from all of you today.

Introduction

2. Globalisation, liberalisation, increased competition and continued deregulation have changed the landscape in which banks and customers operate. While competition was expected to foster the spirit of free enterprise and confer price and efficiency advantages upon the consumer, this does not seem to have been the case. Is it deliberate? And if so, who is responsible for this state of affairs? A part of the blame

has to be placed on the stiff entry barriers that characterise the banking sector and which, in turn, has curtailed true competition and free-play of market forces. This is partly due to the responsibility that regulators have towards the safety of depositors' funds. This should not, however, take away the right of the customers to get a fair deal. The deregulation of interest rates and service charges was brought in with an implicit belief that banks would treat their customers fairly, in a transparent and non-discriminatory manner. However, we still need to go a long way to attain these objectives. While the goal of providing effective customer service has been long recognised, we cannot yet say that the objective has been successfully met. Though the challenge of providing efficient customer service is universal, the challenge is greater in India given that it has to be balanced with the objective of promoting financial inclusion and financial literacy.

3. As a regulator, we have several concerns with regard to customer service practices followed by banks such as the instances of mis-selling of products to vulnerable consumers, sale of unsolicited products—often by bundling them with other products, lack of transparency and disclosure, hidden charges, penalties, *etc.* and improper recovery practices. The widespread proliferation of complex products, often leveraging on technology coupled with the rise in cross-border and electronic transactions, have also added to the challenge of ensuring effective customer service, especially for the most vulnerable groups.

Role of BCSBI and PCCOs

4. It is in this context that the formation of the BCSBI was announced by the then Governor of RBI, Dr. Y. V. Reddy in his Annual Monetary Policy Statement in April 2005. Since then, the BCSBI has done a commendable job as an independent watchdog to monitor the adoption and implementation of its codes and standards by banks. In this mission, the BCSBI has been assisted by PCCOs, who are single point Nodal

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Officers in member banks and are, thus, extended arms of BCSBI for monitoring implementation of codes and standards and for various matters relating to customer service.

5. The BCSBI has evolved two sets of codes, *viz.*, Code of Bank's Commitment to Customers and Code of Bank's Commitment to Micro and Small Enterprises, which have been in existence for seven and five years respectively. However, despite the codes being in existence for a considerable period of time and having been adopted by banks, the quality of service delivered to customers still leaves a lot to be desired. This is reflected in the volume of complaints received by Banking Ombudsmen across the country and from the interaction with customers during Town Hall meetings.

6. I believe that an important cause for deficient customer service is the inability of banks to understand the specific expectations of diverse customer groups and to devise product, pricing and delivery strategies that are best suited to meet these expectations. Many banks would not be aware of the number of customers they have or the number of products they offer. While a plethora of products might be available on paper, many of them might not be actively offered to customers. Hence, understanding their customers and understanding their own product offerings needs to be the starting point of any customer service framework.

7. I have been informed that a recent BCSBI study on the practices followed by banks in respect of charges levied on deposit accounts has brought out several anomalies *viz.*, fixing of charges based on competition instead of on cost plus basis, levying charges without providing any service such as for non-maintenance of minimum balance, levy of intersol charges, *etc.* Visits by BCSBI representatives to bank branches also reveal several deficiencies in implementation of the codes.

8. Clearly, more efforts are needed by PCCOs and banks to ensure that the codes are implemented and in turn, customer expectations are effectively met. I

am told that the BCSBI is considering introducing a rating scheme for the banks based on their performance on code implementation and customer service parameters. Such an exercise should cajole banks for creating an effective internal framework for ensuring that the principle of 'treating customers fairly' gets ingrained into the organisational ethos.

Treating Customers Fairly

9. What do we mean by treating the customers fairly? Can we define the principles of fair treatment and can we measure and compare quality of customer service within the banking industry? Measuring quality of banking services is more difficult than measuring the quality of manufactured goods as services are intangible in nature and there is no 'real' product that the customer takes home. Even within banking, there are a variety of dissimilar services like retail banking, commercial banking, investment banking, *etc.* and, hence, standardised quality measurement becomes difficult. It can only be accomplished by focussing on the outcomes of customer experience. Do we have the systems in place to seek feedback on what the customers feel about the services and quality of customer care? In the absence of an effective feedback mechanism, can we say that banks ensure fair treatment of their customers? Fair treatment of customers is an ideal which we should all strive to achieve. The TCF (treating customers fairly) principles define standards which the institutions must aspire to meet so that the consumers are benefited and have increased confidence in the financial services industry.

Specifically, TCF is aimed at:

- helping customers fully understand the features, benefits, risks and costs of the financial products they buy;
- minimising the sale of unsuitable products by encouraging best practices before, during and after a sale and
- transparent and non-discriminatory pricing.

Financial Innovations – whether fair or unfair to consumers?

10. Every innovation in the financial sector has purportedly the same theme- of the consumer, for the consumer, by the consumer. However, in reality, most financial innovations invariably border on regulatory arbitrage, accounting arbitrage and tax avoidance. An important litmus test for every financial innovation must be the contribution such an innovation makes to the real economy and ultimately, to the society. Though the global financial system has witnessed crises, one after the other in quick succession, our learnings from each crisis have been short-lived. The imperative need for customer centricity and adherence to standards has often been recognised, but has been lost in the rush for short-term business gains. Let me give some common examples of unfair treatment to customers:

11. The product-based incentive for staff in banks selling insurance products or mutual funds creates perverse incentives and, thereby, shifts the focus from the customer's original need. The staff is keen on bundling insurance along with term deposits (and in some cases, in lieu of term deposits) only because of the product-based incentive structures. Sadly, they lose sight of customer convenience, product suitability and blatantly indulge in mis-selling.

12. Pricing of products is an area which gives rise to numerous customer grievances. This is because banks have not adopted a transparent cost-plus approach to pricing. Instead, more often it is dictated by the bargaining power of the customer and the competitor's prices. Specifically, pricing practices followed in case of floating interest rate-based products is replete with instances of lack of transparency and fair play. The base rate may change due to changes in general interest rates in the market, but there is no reason why the spread on base rate charged to a customer should change without any change in the risk profile of the customer. Besides, banks are quick to adjust the

interest rate upwards while they are reluctant to pass on the benefit of interest rate cuts to their customers. Another anomaly in this area is the treatment meted out to old and new customers. It must be logically expected that the floating rate of interest applicable to two customers, with identical risk profiles, will be the same at any point in time irrespective of the fact that a customer is new or old. Regrettably, this is not the case.

13. Another market conduct and integrity related issue is the provision of festive rates. I have no idea how the banks' cost of funds comes down during festivals. You may choose to waive off processing fee, which is transparent, but how can the rates come down? Similarly, there are several instances of levying charges without providing any additional services such as charges for non-maintenance of minimum balances, cancellation of demand drafts, prepayment penalties, intersol charges, *etc.* Also, while penal interest is imposed on smaller customers if they fail to meet their payment obligations, in case of larger borrowers, interest concessions might be offered under restructuring arrangements. There are elements of discrimination in all the above situations, which must be addressed. Let me emphasise that the BCSBI has an important role to play in removing these anomalies as it would not be appropriate to create regulatory prescriptions for all issues. Banks also need to take initiatives on their own.

Implications for Economic and Social Order

14. I would like to point out that there may be situations where the customer demands banks to act in a manner that would suit the customer, but could have adverse social or economic implications. In such cases, banks' internal processes should ensure that their frontline staff chooses the social and economic interests over customer demands. Adherence to high standards of conduct by banks has important implications for ensuring maintenance of economic and social order. Let me cite a recent instance, the

expose by a media outfit on unethical practices at banks. Our enquiries have revealed that there were transactional and market conduct issues which need immediate redressal. At the transactional level, instances of bank staff facilitating splitting of deposit transactions by customers for avoiding their reporting as CTRs/STRs to the investigative agencies were also noticed. If these are not unfair and unethical practices then what is? These transactions may be beneficial to individuals but, eventually, they manifest in the form of societal cost.

15. Let me highlight that unfair market conduct does not only mean being on the wrong side of the law or the regulations. What banks must consider is whether the transactions that they undertake or approve of are beneficial for the society as a whole. The layering of transactions on behalf of customers so as to facilitate tax management (or avoidance) is an example where societal interests are subverted to suit customer requirements. Likewise, how ethical is it to facilitate customers' transactions by allowing them to have several relationship/customer IDs within the same branch/bank?

16. There may also be instances where banks' conduct could even have important implications for the economic health of the country. Take for instance the lack of follow up on the part of the authorised dealers in respect of export bills sent for collection. As the bills are not funded by banks, they feel that their obligation is limited merely to regulatory reporting of such cases, although some banks have been found to not be diligent even in reporting. For a forex starved and current account deficit country like ours, it amounts to colossal profligacy, which is unacceptable. Similarly, I do not know how the society benefits from the large scale off-balance sheet transactions entered into by the banks. I know these actions/transactions may not be illegal nor contravening any regulatory guidelines, but they certainly are a social drag and are, therefore, best avoided.

17. Take another issue of 'Unhedged Foreign Currency Exposures of Corporates'. It was through our circular of October 2001 that we had advised the banks to monitor and review the unhedged portion of the foreign currency exposures of those corporates whose total foreign currency exposure was relatively large. These instructions have been reiterated over and over again subsequently. Despite all these instructions/reiterations, it is observed that unhedged forex exposure risks are not being evaluated rigorously and built into pricing of credit by banks. As you would appreciate, the unhedged forex exposure of corporates is a source of risk not only for the corporates' balance sheet, but also for the financing bank and, ultimately, for the financial system.

18. There is an underlying motivation for the corporate to keep their exposures unhedged as hedging has a cost. But banks cannot afford to be complacent against such risky practices. They ought to have a risk limit for each of their exposure. We have already witnessed instances of accounts of corporates which carried large unhedged forex exposures on their books, turning non-performing. Theoretically, the foreign exchange rate can move to any level and, therefore, expose the corporate and consequently, the bank, to infinite risk. Therefore, for good order, it is necessary that the banks, on the basis of an internal Board-approved policy, stipulate limits on the unhedged position of corporates. For larger corporates which enjoy facilities from consortium of banks or under multiple banking arrangements, the onus would have to be on the consortium leader or the bank having the largest exposure to monitor the unhedged foreign currency exposure of the corporate.

Shift to Twin Peaks Regulatory Architecture

19. With the objective of focusing specifically on the market conduct and customer protection issues, several jurisdictions across the globe are moving towards a 'twin peaks' regulatory architecture. Conceptually, twin peaks regulation separates the

Market Conduct Regulation and Consumer Protection (*i.e.*, how firms conduct their business, design and price their products and treat their customers); from Prudential Regulation, which is regulation of financial institutions through stipulation of liquidity and solvency parameters and regulation of the Payment system, with an underlying objective of ensuring financial stability. To tackle the challenges around customer protection and market conduct, we need to think rationally about what needs to change, what needs to be strengthened and what needs to be re-engineered. Increasingly, countries are moving towards twin peaks regulation wherein the prudential regulation and the market conduct regulation authority is vested in different institutions. Regulation and supervision on functional basis is being dispensed with.

Twin Peaks Separation of Remit and Jurisdiction

20. How does this specialisation and separation of functions between two independent supervisors work in praxis? Either there are two self-sufficient apex bodies which address issues of Prudential Regulation and consumer protection or varied regulatory agencies which address these separate functions and report to or fall within the ambit of two distinct regulators. Different objectives are set to be subserved by macro prudential regulation and micro prudential consumer protection. As I mentioned above, the goal of prudential regulation is to secure financial stability and contain systemic risk through swift resolution of issues in systemically important financial institutions.

21. The regulation of market conduct is, essentially, to secure consumer protection, for example, in the sale of third party products, remittances, foreign exchange derivative transactions, *etc.* The objective is to build and beef up market confidence, to protect customers, make available financial services and promote access, while buffering the financial system against financial crimes. The tools available include setting the bar high

and specifying service standards, which we trust BCSBI to do. Vetting of financial products against these codes is also important.

Global Developments

22. The twin peaks approach has been adopted by several jurisdictions over the years. Australia adopted this approach in 1997 with the Australian Prudential Regulatory Authority (APRA) regulating deposit taking institutions with a mandate of ensuring financial stability and the Australian Securities & Investment Commission (ASIC) being the business conduct regulator, responsible for market integrity and consumer protection. Likewise, in the Netherlands, the central bank (DNB) is the prudential and systemic supervisor of financial services, while the Netherlands Authority for Financial Markets (AFM) promotes consumer protection through conduct of business oversight.

23. In the UK, the Prudential Regulatory Authority came into existence on 1st April 2013, with a mandate for prudential regulation of financial institutions including banks, investment banks, building societies and insurance companies. The integrated regulatory structure brought in by the UK after the Barings debacle did not quite measure up to expectations and has prompted a move to a twin peaks structure. Several other European nations including Belgium, France, Portugal, Italy *etc.* have also recognised the need for a twin peak regulatory architecture. In fact, both Australia and Netherlands were perceived to be relatively less affected by the Financial Crisis.

24. But, what are the immediate provocations for various jurisdictions to consider this change? I see two – one, the boundary between sectors has become blurred. The liberalisation and globalisation ushered in over the past two decades has made distinction between sectors absolutely meaningless. Today, a bank branch has virtually turned into a financial supermarket selling all types of financial products – loans, insurance

policies, mutual funds, gold, securities, *etc.* The interdependence between the mutual funds and the banking sector is a well acknowledged fact. This development has also found resonance in the way in which the financial market players have reorganised themselves. Almost all major banking groups have insurance and securities subsidiaries/JVs. The other non-bank led groups have set their sights on getting a banking license. Thus, the integration of the financial market place is a reality that hits us in the face.

25. The other reason that has exacerbated the clamour for a change in the regulatory architecture, especially in the wake of the financial crisis, is a lack of concern for the man on the street. Prior to the crisis, consumer protection was viewed through a narrow prism of safety and soundness of the financial entities. If the financial institutions could remain solvent, consumer protection could be ensured. This only reflected a very constricted view of what constitutes consumer protection and how the financial market players should conduct themselves.

26. The inability of the financial market players to behave in a responsible manner in the lead up to the crisis was highlighted in the acerbic 'Occupy Protests' which united the common man across continents. The protests gave vent to the seething anger that the people had against the unethical practices followed by the financial institutions, including an utter disregard for the silent majority. Not only have the financial market players become an object of despise; the regulators, Governments and the central banks have also lost their credibility in the eyes of the public.

Desirability in Indian context

27. Having seen the twin peaks structure and a heightened global preference for this form, let us focus on its desirability in the Indian context. Is there a case for a separate agency for consumer protection? Since so many agencies BCSBI, BO, Consumer courts, Courts of law, SEBI, IRDA, PFRDA, RBI, MCA already exist, will a separate regulator dilute, duplicate or damage

existing mechanism? Or will the creation of a separate market conduct regulator facilitate greater customer protection? In the West, the financial crisis has demonstrably proved that shadow banks, with their large customer base, pose a huge systemic risk which only twin peaks regulation can effectively stem. We too have a plethora of financial products which fall between two stools.

28. In India, in order to ensure financial stability and closer monitoring of financial conglomerates, recently, RBI, SEBI, IRDA and PFRDA have entered into an MOU enabling consolidated supervision and effective monitoring of financial conglomerates which presently exist. But, this MoU broadly has a financial stability objective.

29. We need to have an open mind on the subject and look at it as an opportunity to bring customer-centricity to our regulation. The role regulators presently have in product design and pricing is minimal. The advent of market conduct regulation would mean greater role and responsibility of the regulator in design and pricing issues. This sort of an intervention may force the banks to focus more on appropriateness of selling strategies and product development. The pricing freedom conferred on banks will continue to be in place but would be ring-fenced with a lot of responsibility towards the consumers.

30. In the Indian context, we additionally have the twin challenges of financial inclusion and financial education. The need of the hour is to ensure that our unbanked population gains access to formal sources of finance, their reliance on informal channels and on the shadow banking system subsides, and, in the process, consumer exploitation is curbed. A glaring example is the recent case of a chit fund defrauding poor people of their hard earned savings. The fact that people have to rely on such entities for their saving needs indicates a failure on the part of the formal financial system to reach out to such groups and earn their trust and confidence through a transparent and

responsive customer service regime. Hence, the financial sector architecture that we aspire for should be one that is most conducive to meeting the objectives of financial inclusion and financial literacy, besides meeting the goals of customer service.

31. The adoption of a twin peaks approach would imply that the larger financial institutions would have to comply with the requirements set by two regulatory entities. This would result in rise in compliance costs for such institutions as they would have a broader framework of rules and regulations to comply with. The rise in business costs could increase the cost of providing financial intermediation, which could, potentially, have an adverse impact on the financial inclusion objective.

Conclusion

32. I can go on with examples that highlight the need for consumer protection and adherence to codes and standards in the banking industry. The principle of fair treatment of customers is yet to be ingrained into the ethics and culture of financial institutions in India. Hence, our endeavour should be to try and develop a culture that enshrines these values, and to ensure that we conduct our operations in a transparent and non-discriminatory manner. This change, in order to be successful, needs to be driven by the Board/Top management and should percolate down to the field level. Good and quality customer care is not a charity; it is a sound, long term investment in your brand. Let me add that the brand of a bank signifies the highest level of trust and would have the most instantaneous recall in the minds of its customers. I have always believed that banks, by and large, sell the same products and services. So what would distinguish them from each other in the coming days is the quality of customer care and service.

33. The global focus on regulation of the financial services industry, with particular emphasis on consumer protection, continues to dominate the

proceedings at various international fora such as the IMF, World Bank, OECD, G-20, Financial Stability Board, *etc.* It needs to be recognised that efficient market conduct and fair treatment to customers are not only in the best interests of the consumers and financial service providers, but are also an essential pre-requisite for financial stability.

34. During my address at the last year's conference, I had raised certain issues such as the need for a change in attitude towards customers right from the top management down, need for effectively communicating with the consumers, need for being proactive while compensating for lapses, lending responsibly, transparency in disclosure of incentives received while selling insurance/mutual fund products, protection of customers in case of electronic banking transactions, *etc.* I notice that a lot more still needs to be done in these areas as the position is far from satisfactory. I hope banks and the PCCOs refocus their efforts on meeting regulatory and customer expectations in these areas.

35. The BCSBI and all of you as PCCOs have a vital role to play in ensuring that banks rise to meet the above challenges. Pro-active and dynamic PCCOs can make a real difference to the quality of customer service rendered by banks. You are the eyes and ears of BCSBI within the bank and, hence, can positively influence your respective organisation's approach towards adherence to codes and standards. We count on all of you assembled here today to act as change agents within your respective organisations and ensure that the principle of treating customer fairly becomes part of your organisation's DNA.

36. Let me remind that in the wake of the global financial crisis, the public gaze is firmly fixed on the conduct of financial institutions. In case banks do not demonstrate customer centricity in their operations, it would be fair to expect that the society would not only demand but force a change in the financial sector architecture involving a move towards a twin peaks

approach with a dedicated market conduct regulator. For regulated entities, such a move would mean a huge spiral in regulatory obligations and resultantly, compliance costs. It is, therefore, in banks' own interest to convincingly demonstrate, through effective customer service and consumer protection initiatives, that the existing framework is adequate to meet the market conduct objectives envisaged under the twin peaks model.

37. With the above aspirations in focus, I hope that today's deliberations would be able to generate practical ideas on how the institution of BCSBI and PCCOs can be best leveraged to ensure that the customer service and conduct standards of banks soar high and meet the expectations of customers and the society at large.

Ladies and gentlemen, I sincerely thank you for your patience.