Section 6
Customer Protection

Chapter 6.1
Introduction and Current Approaches

The vision statement that is relevant to customer protection is as follows:

> Each low-income household and small-business would have a legally protected right to be offered only "suitable" financial services. While the customer will be required to give "informed consent" she will have the right to seek legal redress if she feels that due process to establish Suitability was not followed or that there was gross negligence.

Consumer protection could embody a wide range of measures including disclosure requirements, conduct of business rules, codes of conduct, product design related regulations, Suitability and assessment related requirements and would require the establishment of an appropriate institutional mechanism for implementing such measures and for redressing consumer complaints that arise from the use of financial services and in their interactions with financial services providers.

The role of financial services is to help customers maximise the benefit from the human and other resources that they possess while minimising the impact of adverse shocks on their lives. Financial products do this by interacting with the "natural" financial flows of households. This interaction is crucial. The same product that enhances well-being for one type of customer could do harm in the case of another. An apparently "simple" and "transparent" product such as a loan with fixed monthly payments, while entirely suitable and value enhancing for an urban salaried household with fixed monthly incomes, can exacerbate the consumption volatility of a rural household with highly uncertain farm incomes in a manner identical to a highly leveraged position in equity, and is an entirely unsuitable product for that household. In fact, on their own both savings and loans could be unsuitable strategies for such a household that may need an additional capability to manage income variability. From this example it is clear that the best way for financial providers to innovate while ensuring that the financial well-being of the customer is not negatively impacted is by granting the customer the Right to Suitability, which requires the provider to:

1. Fully understand the products that they offer to their customers.

2. Have a clearly laid out process including a customer due-diligence process which is Board-approved and demonstrably ensures that if it is followed it does result in the sale of financial products that are designed to enhance the financial well-being of the customer. This would go beyond standardised literacy and disclosure methods.

3. Have a process of customer audit that regularly reviews the actual adherence to this process by the staff of the financial services provider.

4. Accept legally enforceable liability for non-adherence to the process and for gross negligence in the manner in which it offers products to its customers. There would be no liability for specific customer outcomes per se.

Global customer protection regulation (such as in Australia and the USA) is steadily gravitating towards a Suitability based regime and in keeping with this directional shift in the nature of consumer protection, India should also move towards establishing a Right to Suitability for customers of financial products and services. Australia, for instance, has passed the Future of Financial Advice Act 2012, which introduced a duty for financial advisors to act in the best interests of their clients, subject to a 'reasonable steps' qualification, and to place the best interests of their clients ahead of their own when providing personal advice to retail clients. In the USA, the CFPB has amended Regulation Z, which implements the Truth in Lending Act (TILA). Under regulation Z, a creditor is

prohibited from making a higher-priced mortgage loan without regard to the consumer's ability to repay the loan. This rule implements sections of the Dodd–Frank Wall Street Reform and Consumer Protection Act which require creditors to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling.

Suitability also encompasses the ex-post grievance redressal mechanism available to aggrieved customers and it would be advisable for the institutional mechanism offering grievance redressal to be common across financial regulators to concentrate expertise and improve efficiencies. Although there are product or sector specific concerns which would require specialisation, a common agency that identifies, implements, and tackles customer protection related concerns in the financial services sector working closely with sector-specific prudential regulators would be an essential step in ensuring for customers, ease of access to a one-stop point for all financial services related issues.

While the focus of this discussion is on low income households and small businesses, the same issues are true even for middle and high-income households and large companies.

Failures of Customer Protection

Even as India has continued to rely on mandated information disclosure and financial literacy to ensure the best outcomes for customers, the experienced reality for a significant section of customers indicates that their financial well-being continues to be compromised on account of the rampant mis-sale of products and services. India has witnessed significant customer protection failures in the recent past. For instance, it has been estimated that there has been a loss of about Rs.1.5 lakh crore to investors owing to mis-selling of insurance over the 2004-05 to 2011-12 period[249]. Entry loads in mutual funds is another example that led to mis-sale, where agents got unsuspecting customers to churn their portfolios in order to cash in on the entry-loads each time the customer bought into a new mutual fund. A recent example of a large scale customer protection failure is the case of the Saradha Group. The now defunct Saradha Group is estimated to have received deposits from about 17 lakh people and about 10 lakh people have so far filed for compensation[250].

The customer protection failures specific to different banking designs are examined in the following paragraphs:

1. National bank with branches: The RBI has noted on multiple occasions the customer protection challenges associated with this institutional design. The Damodaran Committee (2011) notes that banks are "focusing excessively on achievement of quantitative targets rather than rendering quality service to select customers after having carried out the process of due diligence." This highlights the potential for mis-sale or unsuitable sale of products due to conflicted remuneration structures that place excessive importance on the achievement of sales targets. In a speech[251] dated 30 April 2013, Deputy Governor Dr. K.C Chakrabarty noted that "the product–based incentives 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." Providing such incentives to bank employees leads them to not act in the best interest of the customer.

   The RBI has also previously observed that some banks follow the practice of sanctioning housing loans to customers at teaser rates i.e., at comparatively lower

rates of interest in the first few years, after which rates are reset at higher rates. This practice raised a concern as some borrowers found it difficult to service these loans once the normal interest rate (which is higher than the rate applicable in the initial years) became effective. The regulator took into consideration the fact that many banks were not taking the repayment capacity of the customer at higher interest rates into account at the time of their loan appraisal. Considering the higher risk that these loans carry as a consequence, the RBI directed banks to increase standard asset provisioning on the amount outstanding from 0.40 per cent to 2 per cent[252].

Many studies have pointed that over-indebtedness of farmers in the Vidarbha region of Maharashtra have led to detrimental outcomes for farmers[253]. The financial situation, existing debts, and cash flows of these farmers were not taken into account by banks in these cases leading to the unsuitable sale of loans. The Central Government later announced a debt waiver for farmers in six districts of this region[254].

2. National Bank with Agents: Banks in India outsource financial services including applications processing (loan origination, credit card), document processing, and loan recovery through Direct Sales Agents and Recovery Agents. As observed by the RBI, "some banks set very stiff recovery targets or offer high incentives to recovery agents. These have, in turn, induced the recovery agents to use intimidating and questionable methods for recovery of dues.[255]" There were also widespread reports regarding "misrepresentation and misleading information provided by direct selling agents and marketing agents as also non-fulfilment of such promises made by agents or bank officials while marketing the products[256]". This led the RBI to remind banks that they as principals are responsible for the actions of their agents and that "…their agents engaged for recovery of their dues should strictly adhere to the above guidelines and instructions, including the BCSBI Code, while engaged in the process of recovery of dues."

   The mis-sale of Unit-Linked Insurance Policies (ULIP) also presents the possibilities of mis-sale in an institutional design that relies on agents. Certain product features and misaligned incentive structures encouraged the mis-sale of ULIPs to customers[257]:

   a. ULIPs typically had a lock-in period of three years. If a policy was discontinued during the lock-in period, companies were allowed to deduct up to 100 per cent of the value of the policy post costs.

   b. Although the ULIP was a long-term (15 year) product, up to 40 per cent of the commissions from the product could be collected in the first year. This 'front-loading' of commissions offered considerable scope for mis-sale of the product.

   The case of mis-sale of ULIP to customers highlights the conflict of interest that arises as a result of skewed incentive structures to agents. In such cases, agents do not act in the best interest of their clients and even in the presence of disclosure mechanisms, the possibility of an unsuitable sale is high.

3. NBFCs: This institutional design has been successfully leveraged in reaching out to customers in underserved locations and income segments.

   There are two main customer protection challenges relating to access to grievance redressal mechanisms specific to this institutional design. First, since most NBFCs operate in traditionally underserved areas, customers have limited access to ex-post grievance redressal mechanisms. Many customers that this institutional design serves are first-time customers of formal financial services. Their unfamiliarity with formal services could prevent them from accessing grievance redressal mechanisms. Secondly,

the first port of call for these customers is the internal redressal mechanism of the NBFC while the second port of call is the RBI's regional office[258]. Accessing the second port of call, in this case, involves substantial costs for these customers and could deter them from reporting complaints. As mentioned in the vision for customer protection, such customers must have ease of recourse to ex-post grievance redressal mechanisms.

Analysis of Dominant Approaches to Customer Protection

While India does not have legislation governing customer protection for financial services, customers have recourse to the consumer courts set up by the Consumer Protection Act, 1986. In addition, consumers of financial products and services may also resort to mechanisms set up by product and services-specific regulators. With the product-based regulatory structure, customer protection responsibilities for financial services are embedded in multiple regulators. India has six primary regulators- RBI, SEBI, IRDA, PFRDA, EPFO, and FMC. In addition NABARD, SIDBI, NHB are also involved in regulation and supervision, as subsidiaries of the RBI. As many as six Ministries of the Government of India and State Governments have an implicit or direct (as in the case of Ministry of Corporate Affairs) role.

The current regulatory approach to customer protection in India can be divided into two complementary ex-ante approaches, namely, mandated information disclosure, and financial literacy and education. These approaches are predicated on the principle of caveat emptor or 'buyer beware'. In addition, there are ex-post mechanisms for grievance redressal to enable wronged customers to be compensated by financial services providers. The ex-ante approaches are discussed below, while ex-post mechanisms are discussed in Chapter 6.3.

Mandated Information Disclosure

Information disclosure is the most popular ex-ante approach to implementing customer protection because there is a belief that more information enables the customer to reach a more reasoned decision on buying that product. Dependence of a regime based primarily on disclosure, such as is the case in India, has been fraught with many limitations. These can be broadly grouped into the following aspects – the nature of financial products, the nature of the transaction, the 'expertise' of the buyer to ascertain what she requires, and whether she is indeed getting what she needs.

In India, all regulators have required information disclosure from institutions regulated by them. For example, the RBI requires banks and other financial institutions to clearly disclose material terms on loans. The RBI Guidelines on Fair Practices Code for Lenders[259] advises banks to transparently disclose to the borrower:

1. all information about fees and charges payable for processing the loan application;
2. the amount of fees refundable if loan amount is not sanctioned or disbursed;
3. pre-payment options and charges, if any;
4. penalty for delayed repayments if any;
5. conversion charges for switching loan from fixed to floating rates or vice versa;
6. existence of any interest reset clause; and
7. any other matter which affects the interest of the borrower.

Further, the Fair Practices Code for NBFCs[260] mandates the following disclosures in the loan agreement:

1. all the terms and conditions of the loan;

2. that the pricing of the loan involves only three components: the interest charge, the processing charge, and the insurance premium (which includes the administrative charges);

3. that there will be no penalty charged on delayed payment;

4. that no Security Deposit / Margin is being collected from the borrower;

5. that the borrower cannot be a member of more than one SHG / JLG;

6. the moratorium between the grant of the loan and the due date of the repayment of the first instalment; and

7. an assurance that the privacy of borrower data will be respected.

Other regulators like the IRDA also mandate extensive disclosure requirements of insurance companies for insurance policies.

Disclosure based regimes hinge on eliminating the information asymmetry between the customer and the provider. However, studies have shown that disclosure can have the opposite effect of what is intended. For example, customers are often 'over-loaded' with information and this leads them to take sub-optimal decisions[261]. Moreover, mandated disclosure can crowd out useful information. Since disclosers can proffer, and disclosees can receive, only a limited amount of information, mandated disclosures effectively keep disclosees from acquiring other (potentially more useful) information[262]. Disclosure may therefore have evolved as a means for providers of financial services to 'absolve' themselves of their fiduciary responsibilities towards their customers, especially in standard form contracts that exist between providers and retail customers. These responsibilities are those placed on providers to act in the best interests of their clients, failing which the transaction would tantamount to a mis-sale. Mandated disclosure can also cause inequity in customer protection outcomes. For instance, "mandated disclosure helps most those who need help least and helps least those who need help most. Information is most useful to well-educated and well-off people who have the resources and sophistication to locate, interpret and use the revealed information.[263]" Several studies[264] have found that customer knowledge of credit markets is closely related to family income and education. In the Indian mutual fund context, studies[265] have shown that "firms respond to disclosure policy (relating to 'unshrouding' of fees) by altering products to essentially maintain lack of clarity in pricing." It is estimated that investors in India lost and mutual fund firms gained approximately Rs. 3,000 crore due to the shrouding of fees by closed-end mutual funds.

Disclosures have been shown to have limited value in improving customer well-being over time and across countries, and cannot be the basis for a customer protection framework. While there are specific benefits to having disclosures for financial services, the fundamental framework that underpins customer protection cannot be predicated on putting the onus on the customer. In fact, there needs to be a move in the opposite direction, requiring more from the financial services provider in ensuring protection of customers.

Financial Literacy and Education

The expectation with this approach has been that over time creating a more financially literate citizenry will contribute to enhanced decision making as well as improved financial wellbeing. Regulators in India have promoted financial literacy and education schemes as mechanisms to improve customer outcomes. For instance, the RBI recently announced the National Strategy for Financial Education aimed at promoting inclusive growth, financial inclusion, and financial education. SEBI implements financial literacy campaigns through the Resource Person (RP) model. Under this model, SEBI trains RPs who in turn conduct workshops for target groups like school children, young investors, home makers, SHGs etc. In 2009, RBI initiated the Financial Literacy and Credit Counselling (FLCC) model with the objective of providing free financial literacy/education and credit counselling. The specific objectives of the FLCC were the following[266]:

1. To educate the people in rural and urban areas with regard to various financial products and services available from the formal financial sector.

2. To make the people aware of the advantages of being connected with the formal financial sector.

3. To formulate debt restructuring plans for borrowers in distress and recommend the same to formal financial institutions, including cooperatives, for consideration.

4. To provide financial counselling services including education on responsible borrowing, proactive and early savings, and offering debt counselling to individuals who are indebted to formal and/or informal financial sectors.

The RBI encouraged banks to set up trusts or societies for running FLCCs and to induct respected local citizens on the Board of such a trust or society. The Eastern Area of the RBI (a region comprised of 12 states and 1 union territory) has 186 FLCCs[267].

In June 2012, the RBI modified the FLCC scheme and lead banks were advised to set up Financial Literacy Centres (FLCs) in each of the Lead District Manager (LDM) Offices[268]. The FLCs are expected to impart financial literacy through monthly outdoor camps and collaboration with local NGOs. As of September 2013, there are 822 FLCs in the country[269].

While financial literacy is seen as a way to create ‘empowered’ customers who would be sufficiently competent to take the right decisions, many studies have pointed to the weak relationship between financial literacy and financial behaviour, especially among low-income households[270]. For example, a recent meta-analysis of the relationship between financial literacy and financial behaviour in 168 research papers finds that interventions to improve financial literacy explain only 0.1 per cent of the variance in financial behaviours studied, with weaker effects in low-income samples. Like other education, financial education decays over time. Evaluation studies of financial literacy and education programs conducted in India provide further evidence of their lack of impact on the customer. These studies find that even after intensive training sessions (some lasting two days), there is insignificant or no impact on the customer’s financial behaviour[271].

While building financial capabilities of customers is obviously desirable, it is clear from the evidence that a strategy for customer protection cannot be built around this approach. The level of expertise required to understand financial products and services will always mean that the provider will know more than the customer.

Chapter 6.2
Suitability as an Approach

When the fact is considered that imbalances in information, expertise, and power between the buyer and seller of financial products will only be exacerbated in the future, then it becomes clear that existing approaches to customer protection have severe limitations. As argued earlier, the "caveat emptor" principle has led to fundamental flaws in India's customer protection architecture and has created large welfare losses for customers. As the recent examples of customer protection failure in India highlight, there is a pressing need to shift away from this approach to financial customer protection. There is a need to move to a customer protection regime where the provider is held accountable for the service to the buyer, by ascertaining that the products sold or the advice given is suitable for the buyer considering her needs and current financial situation, i.e. the customer must have a Right to Suitability.
The RBI has already signalled its intent to proceed along these lines in the Report on Trend and Progress of Banking in India 2012-13[272] where it notes the importance of the Treating Customers Fairly (TCF) model. The TCF framework however has a number of differences from the Suitability regime. First, the TCF framework does not impose a legal liability on the financial services provider to ensure Suitability. Second, the TCF approach talks about the need to ensure that products and services sold meet the needs of identified customer groups. The Suitability framework goes a step further and mandates that the provider ensure that the products meet each customer's needs and objectives; not just customer groups. Third, TCF mandates that Suitability needs to be considered only in the case of advice given to customers while the Suitability regime requires that both sale and advice be tied to Suitability requirements. While the adoption of the TCF model by the RBI would be an important step in shifting away from the caveat emptor approach, progress towards a Suitability centric regime of customer protection in India would be much more appropriate.

In this context, it must also be noted that the FSLRC's recommendation on customer protection "marks a break with the tradition of caveat emptor, and moves towards a position where a significant burden of customer protection is placed upon financial firms[273]." The Draft Code establishes basic rights for financial customers. These include the right to professional diligence, protection against unfair contract terms, protection against unfair conduct, protection of personal information, requirement of fair disclosure, right to redress of complaints, right to suitable advice and protection from conflict of interest of advisors. It is especially significant that the FSLRC has recommended that retail customers have the right to receive suitable advice in relation to the purchase of a financial product or service, and that the provider must collect all relevant information on the needs and financial situation of the customer in making its recommendation. This shift in equilibrium, from caveat-emptor to provider-liability, will ensure that financial services providers compete on the provision of solutions that are appropriate for customer households (and not just revenue-maximising for the provider), thus aligning the incentives of the provider with the customer.

Suitability as a Process

Suitability should be viewed as a process of the provider rather than as an outcome for a customer. Outcomes can be driven by many factors and in most cases it will be near impossible to specifically assess the extent to which unsuitable provider actions were responsible for it. Suitability as a process would require every financial services provider to have a Board approved Suitability Policy that the company must follow in all interactions with customers – the policy must lay down the processes for customer data collection, analysis, communication of recommendations (both advice and product sale),

and follow-up. It is the implementation of the Suitability process that should determine if a financial services provider has indeed acted in the best interests of the customer.

The power of the Suitability approach is that it will be necessary for the financial services provider to repeat the process on an on-going basis - in every interaction with every customer. At all points of time, therefore, the financial services provider is incentivised to follow the Suitability process and act in the best interests of the customer.

As mentioned earlier, financial customer protection regimes in Australia, UK, and USA have shifted to a provider-liability regime and mandated a process for ensuring Suitability. For example, in the case of a standard home loan product, regulators in these countries require that Suitability assessment take into account two parameters- one, the customer's requirements and objectives and two, the customer's financial situation. Both parameters are examined in some detail below.

1. Customer's requirements and objectives: The Australian Suitability assessment (under the Responsible Lending Conduct[274]) mandates that the financial services provider look into the following aspects of the customer's requirements and objectives:

    a. the purpose for which the credit or customer lease is sought and the benefit to the customer;

    b. whether the customer seeks particular product features or flexibility, the relative importance of different features to the customer, and whether the customer is prepared to accept any additional costs or risks associated with these features;

    c. the nature of the credit requested by the customer;

    d. if the customer has more than one requirement or objective, the relative importance of each to the customer (e.g. whether the cost of the credit or flexibility to make later changes is more important to the customer);

    e. the customer's understanding of the proposed contract; and

    f. if the credit is to purchase a specific item, the term of the credit relative to the likely useful life of the asset

2. Financial Situation of the customer: The Consumer Financial Protection Bureau (CFPB) regulations mandate that eight underwriting factors should be looked into while determining the financial situation or 'ability to repay' of the customer. They are:

    a. Current income or assets;

    b. Current employment status;

    c. Credit history;

    d. Monthly payment for the mortgage;

    e. Monthly payments on other mortgage loans got at the same time;

    f. Monthly payments for other mortgage-related expenses (such as property taxes);

    g. Other debts; and

h. Monthly debt payments, including the mortgage, compared to your monthly income (“debt-to-income ratio”). The lender may also look at how much money you have left over each month after paying your debts.

The regulations require that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the customer have a total debt-to-income (pre-tax monthly income) ratio that is less than or equal to 43 per cent.

The UK Mortgage Conduct of Business Rules require that the firm assume (in the absence of evidence to the contrary) that any regular payments under a regulated mortgage contract will be met from the customer's income. A firm should therefore take account of the customer's actual or reasonably anticipated income, or both and determine whether the customer intends to, repay, either wholly or partly, from resources other than income. The Australian regulations deem credit contracts to be unsuitable if the customer will be unable to meet their payment obligations, either at all or only with substantial hardship[275].

3. Other parameters: Apart from the two parameters described above, certain regulations like the CFPB guidelines deem certain characteristics of a home loan product to be ‘globally unsuitable’ for all categories of customers. For instance, loans with negative amortisation, interest-only payments, balloon payments, terms exceeding 30 years and the so-called “no-doc” loans where the creditor does not verify income or assets are deemed unsuitable for all customers. Products with these features do not enjoy a ‘safe harbour’, i.e., the customer can challenge the sale of the product in court if the customer’s income and debt obligations left insufficient residual income or assets to meet living expenses.

   In the Indian context, examples of such globally unsuitable products would include teaser-rate home loans, and ‘no-doc’ loans, where creditor does not verify income or assets before lending to the customer.

   Further, under ASIC’s guidelines, Suitability requirements are ‘scalable’ or more stringent under certain circumstances. For example, if the potential impact on the customer of entering into an unsuitable contract is high, i.e., if the size of the loan is large in comparison to the customer’s capacity to repay, financial services providers are expected to conduct extensive inquiries about the customer’s objectives and requirements. Similarly, in the case of reverse mortgages, where customers are often senior citizens, the service provider is expected to make inquiries about the customer’s requirements and objectives in relation to certain future needs, including the possible need for aged care accommodation and whether the customer prefers to leave equity in their dwelling or land to the customer’s estate.

Legal Liability

In order for a framework of Suitability to have teeth, there is a need for the imposition of legal liability on the financial services provider, as this will mean that it is in the firms’ self-interest to ensure suitable recommendations and product sales to customers.

Every individual and small enterprise must have the right to be provided suitable advice or recommended suitable products. The interpretation of suitable behaviour is best determined by the build-up of case laws over time, thus ensuring that the understanding of Suitability comes from the realities of the financial marketplace and its evolution over time. The combination of ex-ante legal liability and a strong threat of ex-post

enforcement provide credible dis-incentives to financial services providers from acting in ways that promote their own self-interest at the cost of customers. A Suitability framework underpinned by legal liability is the most effective way of ensuring that the design and sale of financial services is suitable for the customer.

Australia's market conduct regulator, the Australian Securities and Investments Commission (ASIC) administers the Financial Services Reform Act 2001 (FSR Act), which requires persons who provide financial product advice to retail customers to comply with certain conduct and disclosure obligations. The obligations vary depending on whether the advice given is personal advice or general advice. According to the FSR Act, personal advice is financial product advice that is directed to a person (including by electronic means) in circumstances where the provider of the advice has considered (and is reasonably expected to have considered) one or more of the person's objectives, financial situation and need (all other financial product advice is general advice). All personal advice must meet the Suitability rule while all general advice must be accompanied by a "general advice warning"[276].

ASIC also places legal obligations on financial services firms to meet specific conduct, disclosure, skills as well as professional indemnity insurance requirements, amongst others, to implement the Suitability requirement. In the case of a breach of law, ASIC is empowered to take a variety of actions such as:

1. Punitive action such as court order, prison terms, criminal and civil financial penalties;

2. Administrative action (without going to court) such as ban on providing financial services, revocation, suspension or variation of conditions of licences, public warning notices;

3. Preservative actions such as injunctions; and

4. Negotiated resolutions such as through enforceable undertakings, and others

ASIC can decide on which remedy to take depending on various factors such as the severity of the suspected misconduct, the extent of losses, the compliance history of the individual or firm in question, and so on. The Australian Government has further passed the Future of Financial Advice Act 2012, which introduced a duty for financial advisors to act in the best interests of their clients, subject to a 'reasonable steps' qualification, and to place the best interests of their clients ahead of their own when providing personal advice to retail clients. To complement this, the Act also introduced a prospective ban on conflicted remuneration structures including commissions and volume-based payments, in relation to the distribution of and advice about a range of retail investment products (not applicable to some products and advice services including general insurance, basic banking products and for financial product advice given to wholesale clients).

Interpreting Suitability

In Australia, the interpretation of principles of Suitability is dependent on case law. For example, consider the following case regarding maladministration in the case of a 'low-doc' loan[277]. Mr. and Mrs. Z applied for a 'low-doc' loan from a Financial Services Provider (FSP) for two stated objectives- to refinance an existing loan and to obtain additional finance of AUD 200,000 to assist them in purchasing property. The FSP approved the loan based on the income disclosed in the application and a declaration stating that the loan was within their ability and capacity to service. Mr. and Mrs. Z declared a partnership income of AUD 400,000, rental income of AUD 40,000, and a parenting allowance of AUD 20,000. The FSP did not make any independent enquiries to verify this information.

Mr. and Mrs. Z subsequently claimed that the FSP's decision to lend amounted to maladministration as they did not have the capacity to service the additional loan of AUD 200,000. The case manager of the Financial Ombudsman Service (FOS), Australia's external redressal ombudsman, found that the level of income was, at first glance, inconsistent with an entitlement to a parenting allowance of AUD 20,000. Further, the case manager obtained from Mr. and Mrs. Z a copy of their partnership tax return prepared one month prior to their loan application. The tax return revealed a net partnership income of AUD 45,000. The case manager also found that Mr. and Mrs. Z had made two previous loan applications in which they had made similar income declarations (although these loans had not proceeded), and two opportunities to correct their misquoted income, and failed to do so. As the FSP had failed to make enquiries, the case manager concluded that the FSP's approval of the loan was maladministration in lending. However, the case manager also took into account the principle of fairness in the circumstances of the case and the principle of proportionate liability in claims of misleading conduct, and concluded that Mr. and Mrs. Z should bear two thirds of their loss and the FSP was responsible for one third of the loss. The FSP disagreed with the case manager's evaluation and appealed against it.

The final decision of the Ombudsman agreed with the case manager's assessment. In the decision, the Ombudsman noted that the common law and the Code of Banking Practices require an FSP to exercise the care and skill of a diligent and prudent lender in the case of 'low-doc' lending, and arguably a diligent and prudent lender would not rely solely on information provided by the customer to get a loan. The Ombudsman noted that a customer's self-declaration of financial details does not protect the FSP from having the loan considered maladministration or unjust if the circumstances were such that the FSP ought to have made enquiries but chose not to do so. This decision relied on extant case law and the comments of the trial judge in Permanent Mortgages Pty Ltd v Cook (2006)[278], where it was ruled that a customer's false declaration, whether knowingly or inadvertently, is a relative factor to be taken into account, but is not decisive, such that the FSP should avoid liability for maladministration in lending.

The interpretation of Suitability by case law around the world has also reinforced the notion of Suitability as a process-oriented, not outcome-based approach. For instance, consider the FOS's final decision in a case involving an elderly couple in the UK. Mr. and Mrs. W, an elderly couple who were both 73 years of age, had built up a corpus of savings over the years[279]. They decided to invest some of their money and approached their bank for some advice. The couple spoke to an investment adviser at the bank. The adviser enquired about the type of investment the couple sought to make (needs and objectives) and asked for information regarding their personal circumstances. As part of this process, the adviser asked them some questions about their health taking their age into account. The adviser recommended that Mr. and Mrs. W invest GBP 40,000 in a 'capital guaranteed multi-index equity bond deposit plan' and the couple followed the recommendation. Under the terms of the investment, the couple were obliged to keep the corpus for six years to retain the capital guarantee. Unfortunately, Mr. W died just 15 months after the couple had made the investment. Mrs. W asked the bank to cancel the plan since she felt that the bank had recommended an unsuitable investment plan for the couple. The bank disagreed with Mrs. W's view that the couple had been given inappropriate or unsuitable advice and it refused to cancel the plan. It pointed out to Mrs W that the adviser had recorded their health as 'good' during the fact-finding process that he had gone through with them. Subsequently, Mrs. W approached the FOS and in her complaint, she pointed out that her husband had clearly been in poor health when they had taken out the investment plan – and that such a long-term investment could not have been right for them and therefore, should not have been recommended.

On examination of the bank's records, the FOS found that Mr. and Mrs. W were not experienced investors. The FOS took the view that the couple's age should also have prompted the bank to make sure the couple had understood they would not necessarily receive their investment back in full – if they did not keep the bond for six years. Further, Mr. W's medical records showed that he was using a wheelchair at the time of the sale – and that given his particular medical history, he had already exceeded his life expectancy by four years. Using this, the FOS argued that it was unlikely that the couple would have confirmed that they were both in 'good health' when the adviser had asked them. The FOS was of the opinion that the bank needed to make further enquires about the couple's health in order to arrive at an accurate picture of their circumstances.

In its final decision, the FOS concluded that the bank had not given the couple appropriate advice. The bank was required to put Mrs. W in the financial position she would now be in if she and her husband had left the money where it was in the first place.

These cases highlight the importance of creating timeless principles for the Suitability process that can be interpreted in specific contexts and reinforces the notion of Suitability as a process-oriented approach. The first case also serves to underpin the responsibilities of the customer in a Suitability based regime - for instance, in honestly and accurately disclosing information about her extant financial situation, and her needs and objectives to the financial services provider.

Suitability in India

Regulators in India have also established Suitability guidelines for several financial products and services. For example, the RBI has issued Suitability and Appropriateness guidelines[280] for derivative products. These guidelines mandate that "market-makers should undertake derivative transactions, particularly with users with a sense of responsibility and circumspection that would avoid, among other things, mis-selling. It is imperative that market-makers offer derivative products in general, and structured products, in particular, only to those users who understand the nature of the risks inherent in these transactions and further that the products being offered are consistent with users' business, financial operations, skill & sophistication, internal policies as well as risk appetite." Further, market-makers are advised to adopt a Board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business. It is pertinent to note that small business have been provided protection under these guidelines.

Several counterparties to derivative transactions have alleged that such transactions were wagers and have also sought to argue that the transactions did not follow RBI guidelines requiring that such transactions be undertaken only for risk mitigation. The aforesaid argument has generally not been entertained by courts. For example, in the case of Rajshree Sugars and Chemicals Limited v. Axis Bank Limited (AIR 2011 Mad 144), the company contended that Axis Bank entered into structured products in violation of the aforementioned guidelines and the Master Circular On Risk Management as the company did not have a risk management policy in place. The Court held that the contention of the company could not be maintained since their authorised signatory had signed a Risk Disclosure Statement that showed that the company was aware of a variety of risks associated with the deal, such as market risk, basis risk, operational risk and legal, regulatory and tax risks. The Risk Disclosure Statement also contained an undertaking by the Company that they will get only into those derivatives transactions as are permitted by the laws of the country including RBI guidelines. Hence, in conclusion, the bank was found to have not violated the guidelines.

Apart from the RBI, other regulators in India have also issued Suitability guidelines. For example, SEBI's Investment Advisers Regulations, 2013 mandates the following Suitability requirements of investment advisers:

1. "All investments on which investment advice is provided is appropriate to the risk profile of the client;

2. It has a documented process for selecting investments based on client's investment objectives and financial situation;

3. It understands the nature and risks of products or assets selected for clients;

4. It has a reasonable basis for believing that a recommendation or transaction entered into:
   a. meets the client's investment objectives;
   b. is such that the client is able to bear any related investment risks consistent with its investment objectives and risk tolerance;
   c. is such that the client has the necessary experience and knowledge to understand the risks involved in the transaction.

5. Whenever a recommendation is given to a client to purchase a particular complex financial product, such recommendation or advice is based upon a reasonable assessment that the structure and risk reward profile of financial product is consistent with clients experience, knowledge, investment objectives, risk appetite and capacity for absorbing loss."

IRDA has introduced guidelines for the development and implementation of a Suitability Index – Prospect Product Matrix by insurance companies. These guidelines are intended to help direct sales personnel, brokers and agents to recommend products based on the need and Suitability of customers. These guidelines are currently applicable to all life insurance policies (Traditional, ULIPs, Pension and Health) sold as individual policies. The Prospect Product Matrix will indicate the suitable products for a customer on the basis of Life stage (Single, Married, Married with children, Married with grown-up children or Retirement) Generic need (Protection (Life), Protection (Health), Goal based savings for wealth creation, Investment, Income) and Income segment of the customer (Mass, Mass affluent or HNI).For example, a married person with grown up children will need goal based savings products, investments and health cover more than life protection products. So the matrix will indicate 100 per cent Suitability of products intended for goal based savings, investments and health cover. The insurer will then recommend appropriate products from its portfolio for this purpose.

Regulating Suitability

An environment where Suitability is at the heart of customer protection will also require fundamental changes in regulatory approaches and instruments. Regulators in such an environment should be focussed on creating the rules-of-the-game as opposed to constant intervention in the functioning of institutions and markets. This would mean that the regulator sets the ground rules on what it expects in terms of Suitability from financial services providers, coupled with clear and mandatory guidelines on effective grievance redressal mechanisms. The regulator should prescribe requirements of Suitability to ensure that service provider recommendations match the needs of the customers as expressed and understood at the point of sale in the expert, objective opinion of the provider. Ideally, the regulator would provide guidance, but not legislate tightly, on the assessment of Suitability in different product contexts. This would ensure that financial

services providers are incentivised to continually innovate on products and discover better models for assessing Suitability.

Beyond the regulatory guidance, there should be no requirement for regulatory approvals that inordinately delay go-to-market timelines, but regulators could have the opportunity to respond to new designs in a timely manner. This is to ensure that regulation does not have a chilling effect upon financial innovation, while at the same time allowing regulators the leeway of preventing poorly designed products from reaching the market. Regulators, therefore, need to be non-interventionist to the extent possible so as to avoid curbing the process of innovation, given its importance to the objective of meaningful financial inclusion in India. Such a non-interventionist approach to the creation of products would mean that regulatory oversight would shift towards detailed monitoring and surveillance of the market place.

For instance, in Australia potential breaches of the law are brought to ASIC’s notice through reports of misconduct from the public, through referrals from other regulators, statutory reports from auditors and the licencees themselves, and through ASIC’s own monitoring and surveillance work using regular surveillance visits and mystery shopping studies, the results of which are shared in the public domain.

It is apparent that only through the creation of an enabling legal and regulatory framework can the power of Suitability to drive improved customer protection be realised. However, until a dedicated legislation for customer protection in financial services is passed, there will be a need to rely on strengthening regulatory action and wherever relevant, the existing provisions of the Customer Protection Act, 1986.

The RBI should however issue regulations on Suitability, applicable specifically for individuals and small businesses, to all regulated entities within its purview, i.e., banks, NBFCs and payment institutions (under Sections 35 A of the BR Act, Section 45 JA of the RBI Act and Section 38 (2) of the Payments and Settlement System Act, 2007); so that the violation of such regulations would result in penal action for the institution as contemplated under the aforesaid statutes through a variety of measures, including fines, cease-and-desist orders, and modification and cancellation of licences.

These regulations should be applicable specifically for individuals and small businesses defined under the term “retail customer” by FSLRC. FSLRC defines a retail customer as “an individual or an eligible enterprise, if the value of the financial product or service does not exceed the limit specified by the regulator in relation to that product or service.” Further, an eligible enterprise is defined as “an enterprise that has less than a specified level of net asset value or has less than a specified level of turnover.”

All financial firms regulated by the RBI would be required to have an internal process to assess Suitability of products prior to advising clients with regard to them. It is recommended that all financial services providers be obligated to have in place adequate procedures that are approved and monitored by the board of directors. Compliance with the firm’s internal process should be embedded in the compensation package of the sales staff. In the event of a customer complaint, the redress authority would consider whether the process was adhered to and if so, the same would be a defence or a mitigating factor for the conduct of the firm[281]. The RBI would provide the following guidance with regard to the internal compliance requirements for firms regarding Suitability:

1. The Board should approve and oversee the procedures put in place for Suitability on an annual basis and attempt to detect and correct any deviations from procedure.

2. The firm would have to carry out a limited due diligence of the customer and put in place a process to assess the appropriateness of any product offered to a customer

based on the results of the diligence. With respect to credit, for instance, the firm could be obliged to check the borrower's information from credit bureaus to determine the current level of indebtedness, make reasonable attempts to determine the current and projected income of the borrower, financial capacity, objectives and risk tolerance of the borrower, to determine the repayment capacity of the borrower. The lender should seek appropriate documentation to evaluate income and the ability of the borrower to repay given the increasing interest rates of the loan.

3. The requirement to conduct a due diligence should include the requirement to obtain relevant information about the customer's personal circumstances and give advice or recommendations based on due consideration of the relevant personal circumstances. If the financial firm finds that the information is inaccurate or incomplete, the customer must be warned.

4. Any product may be offered to customers upon establishing its Suitability, except "globally unsuitable" products discussed in (13).

5. In the event a consumer chooses to purchase a product considered unsuitable to the customer, the financial services provider should consider providing written advice to the customer and seeking acknowledgement from the customer. This should however, not be misused by the financial services provider.

6. The firm's internal rules relating to compensation packages of staff should not create incentives or otherwise promote inappropriate behaviour. In addition, requirements relating to Suitability and appropriateness should be embedded into compensation packages. Accordingly, the compensation packages and incentive structures should not be based solely on numerical targets but should include qualitative aspects such as offering appropriate products and services to customers and complying with requirements of the internal policy relating to Suitability etc.

7. The firms should have internal processes to track compliance with Suitability and an internal process to detect and correct any deviations from the policy, including potential disciplinary action and sanctions for the staff for any deviations. This could include a customer audit committee which reports to the board that is responsible for determining compliance with the Suitability process and other customer protection initiatives of the financial services provider.

8. The firm must have internal grievance redressal mechanisms for non-compliance with process and this should be required to be communicated to customers as well. The customers, should however be made aware that it is the process that is guaranteed and not the outcome. An internal grievance redressal process would not, however, preclude a customer from proceeding against the firm in any other forum.

9. The internal policy and procedure of the board should be communicated across the organisation and appropriate training programs should be put in place for the staff- both the client facing and the control staff. Such communication should articulate inter alia (a) the business benefits of having Suitability requirements, (b) the firm's commitment to a zero-tolerance approach to follow the process and (c) the consequences for the breach.

10. The firms should have a paper trail and record keeping procedures to demonstrate compliance with its internal procedures which should be available for inspection by the RBI.

11. Additionally, if gross negligence, fraud or wilful misconduct can be established on the part of the financial services provider, the adherence to the process will not be sufficient and the firm would be liable to be penalised regardless of the process.

12. The regulations should additionally protect the firm from penal action in a situation where the customer may have deliberately misled or misrepresented to the firm, or if despite reasonable attempts the firm was unable to assess Suitability.

13. In addition, specific products may be deemed as "globally unsuitable" and would not be eligible to be offered to households or businesses below a certain income threshold or net worth or individuals above a certain age. Such products should be prescribed by the RBI and could be amended from time to time based on feedback from customers and financial services providers.

14. There is a specific set of de minimis products, the offer of which is to be subjected to a limited application of the Suitability requirements - basic bank accounts, the universal electronic bank account recommended in the Report and credit below Rs. 5000 subject to ascertaining the income and repayment capacity of the borrower. However, the Suitability process should definitely apply if an insurance, investment or derivative product is being offered to a customer, whether on a standalone basis or bundled along with credit.

In view of the Regulations outlined, a Board approved Suitability Policy of a financial services firm serving low income households such as IFMR Trust's KGFS may look like this:

1. Reasonable steps must be taken to collect detailed information about the current financial status of its customers. This should include information on assets, liabilities, income and expenses, in additions to objectives and needs of the customer. The collection of this information must involve a physical visit to the customer's residence. This information should be updated on an annual basis, or at the time of product recommendation or sale, whichever is earlier.

2. This information must be input into the customer management system and used to generate a financial 'well-being' report for each customer which recommends appropriate products for the customer. The customer must be informed of her household's financial well-being and how specific financial products or services that she seeks could potentially improve or weaken her financial well-being.

3. It must be ensured that the product or service that is recommended or sold completely matches the stated requirement of the household.

4. It must be ensured that the customer completely understands the key features of the specific product that is recommended, and how the product interacts with the existing financial portfolio of the household. Upon ensuring this, the 'informed consent' of the customer to enter into the specific financial transaction must be sought in a written form.

5. It must be ensured that a product that does not match with the stated requirements or could deteriorate the financial situation of the household, even if demanded by the customer, is not recommended to the customer. It must be clearly communicated to the customer that buying an unsuitable financial product could place her household in financial distress. In the event that the customer wants to disregard this and purchase the product or service, a signed document stating that the customer understands the consequences of purchasing the unsuitable product must be obtained.

6. The customer must have ease of recourse to the internal grievance redressal mechanism of the provider with a toll-free number prominently displayed in all branches of the provider. In addition, the existence of this mechanism and the modalities to access it (phone, SMS, e-mail, written complaints) should be clearly articulated to the customer in the first meeting as well as any subsequent meeting when there is a product recommendation or sale. The customer must also be informed of the exact timeline within which she should be able to expect an outcome for grievances registered. The internal redressal mechanism should look to resolve the complaint of the customer in an unbiased and speedy manner.

7. The customer should be informed of her right to approach the external redressal mechanism with details of how to access such mechanism, in the event that she is unsatisfied with the response of the internal mechanism or if the issue remains unsolved within a reasonable span of time.

8. A Customer Audit committee will conduct an annual audit to assess compliance with Suitability provisions, and efficiency of internal grievance redressal mechanism. This committee will report directly to the Board.

9. Employees will not be incentivised based on quantitative targets or other such targets that could potentially lead them to adopt practices that are in conflict with the provisions mentioned above. Instead, the employees will be incentivised to adhere to provision of suitable products or advice to customers. Employee adherence to the process of ensuring Suitability will be established through the annual customer audit.

Chapter 6.3
Enforcement

In addition to the ex-ante approaches to customer protection, regulators have stipulated ex-post redressal mechanisms for customer complaints. India follows a sectoral approach to grievance redressal and each regulator has set up its own grievance redressal architecture. For example, the RBI has set up the following hierarchy of ex-post redress for aggrieved customers of credit:

1. In-house grievance redressal mechanisms set up by banks
2. Office of the Ombudsman, created by RBI under the Banking Ombudsman Scheme[282]
3. Consumer Courts under the Consumer Protection Act, 1986
4. Courts of law

For customers of securities, SEBI has an online complaint redressal mechanism called SEBI Complaints Redress System (SCORES). If the issue remains unresolved or resolved unsatisfactorily in the customer's view, she can approach the SEBI Tribunal, which has exclusive jurisdiction in matters falling under the scope of the SEBI Act to the exclusion of courts of law and by extension, consumer courts. The Securities Appellate Tribunal (SAT) forms the forum for first appeal from decisions of the SEBI Tribunal and the second appeal lies directly to the Supreme Court but only on 'questions of law'.

For customers of insurance, IRDA has mandated the setting up of grievance redressal cells within each of the life and non-life companies under the IRDA (Protection of Policyholders' Regulations), 2002. The IRDA Grievance Cell or Director of Public Grievances (in the case of public sector insurance companies) remains the second port of call, coming into play in practice only after the customer has sought redress through the in-house grievance cells. The latter, the Director of Public Grievances entertains complaints against the public sector insurance companies (including LIC, GIC, United India, National, New India, Oriental) and is based within the Cabinet Secretariat of the Government of India. The Insurance Ombudsman, first created by Government of India notification in 1998 can be approached in case the customer remains unsatisfied. Customers of insurance products can also appeal to the consumer courts and the civil courts if the complaint persists.

In the case of NPS, the Central Grievance Management System (CGMS) run by NSDL is the first port of call for customers. Customers can register complaints with the CGMS through a toll-free number, on the internet and through physical forms available at the PoP. If the CGMS does not respond to the complaint in 30 days or if the customer is dissatisfied with the resolution, she can apply to the Grievance Redressal Cell (GRC) of PFRDA.

Table 6.3.1 below summarises the grievance redressal mechanism across financial sector regulators in India. In general, across the financial sector, all financial institutions are expected to have an internal grievance redressal mechanism that is the first port of call for aggrieved customers. Then there are the external redressal mechanisms such as the ombudsmen in the case of banking and insurance, and the Securities Appellate Tribunal (SAT) in the case of capital markets. If the customer remains unhappy with the verdict reached through the external redressal process, she is free to take the case to the Consumer Courts set up under the Consumer Protection Act of 1986.

Table 6.3.1 Grievance Redressal Mechanisms			
RBI	SEBI	IRDA	PFRDA
In-house grievance redress	SEBI Complaints Redress System (SCORES)	In-house grievance redress	Central Grievance Management System, NSDL
RBI Banking Ombudsman	SEBI Tribunal Securities Appellate Tribunal (SAT)	IRDA Grievance Cell Director of Public Grievances (for public sector insurance companies) The Insurance Ombudsman	Grievance Redressal Cell (GRC) of PFRDA.
Consumer Courts	Supreme Court	Consumer Courts	Consumer Courts
Court of Law		Court of Law	Court of Law

The Consumer Court has a three-tier structure- District Forums, the State Consumer Disputes Redressal Commissions and the National Consumer Disputes Redressal Commission have been set up at the district, state and national level respectively. A written complaint, can be filed before the District Consumer Forum for pecuniary value of up to Rupees twenty lakh, State Commission for value up to Rupees one crore and the National Commission for value above Rupees one crore, in respect of defects in goods and or deficiency in service. The Consumer Courts are an alternative to that already available to the aggrieved customers by way of civil suit. In the case of a complaint/appeal/petition submitted under the Act, a customer is not required to pay any court fees but only a nominal fee.

Consumers have also often tried to invoke other regulators to get relief, such as the Competition Commission of India (CCI). For instance, in a home-loan case, it was alleged that banks were imposing restrictions on pre-payment of home loan by imposing penalty on prepayment, which amounted to cartelisation and abuse of dominant position. While in this case, the CCI held that the levy of prepayment charges was not a uniform practice, that there was no evidence of action in concert or agreement between banks and that no effect could be seen on competition as a result of this practice, it is important to note that the CCI actually heard the case.

<u>Strategies for Monitoring Suitability</u>:

Drawing on international best practices, it is recommended that regulators monitor the compliance of financial services providers in implementing Suitability employing various methods, including:

1. On site verification, which can be a very useful approach to assess process compliance with Suitability norms set out by service providers. This includes process employed at point of sale through “mystery shopping”[283].

2. Continuous, ex-post monitoring through information reporting requirements from service providers such as on incentive and commission structures, financials, customer complaints and grievance records to assess service provider performance.

3. Proactively try to detect violations in the prescribed code of conduct and conduct of business standards established for such entities through tools such as mystery shopping, surprise audits, review of compensation packages, staff interviews and interviews with consumers etc. The Malaysian and Irish Central Banks regularly monitor compliance with consumer protection regulation through the conduct of mystery shopping. Existing outreach programs could be used to conduct staff interviews and interviews with consumers.

4. Investigations of financial services providers in case of regulator suspicions of malpractice.

Financial Redress Agency

Previous committees such as the Damodaran Committee (2011) have argued for strengthening of the Banking Ombudsman Scheme through measures like creating internal ombudsmen in banks, creating public awareness of the scheme, and increasing the number of offices in the country. However, it could be argued that sector specific redressal platforms like the BOS are not sustainable alternatives since they suffer from the pitfalls of a sectoral approach to grievance redressal discussed in the preceding section. As customers face an integrated portfolio of services especially from financial services firms that operate in the shadow of regulatory oversight, a sector-specific ombudsman like the BOS will be unable to act as an effective grievance redressal mechanism.

Keeping with the non-sectoral approach to customer protection, it is recommended that a unified Financial Redress Agency (FRA) be created as a unified agency for customer grievance redress across all financial products and services by the Ministry of Finance. This Agency will be consumer facing and will in turn coordinate with the respective regulator for customer redress. The Rajan Committee (2009) recognised the need for creating a one-stop source of redress for customers in the form of an Office of the Financial Ombudsman (OFO)[284]. The Report envisages that the OFO will perform the following functions:

1. Monitor the selling of different products, the degree of transparency about their pricing, and their Suitability for targeted customers.

2. Act as a neutral forum (and possibly act as an arbitrator) for out-of-court negotiated settlement of debt.

3. Enhance financial literacy and financial counselling, issues that span regulators

The FSLRC Report also recommends the creation of a new statutory body to redress complaints of retail customers through a process of mediation and adjudication. The report envisages that this agency (the FRA) will function as a unified grievance redress system for the entire financial system and will be independent of all regulators. This mandates a shift away from the present sector-specific redressal agencies in the form of the Banking Ombudsman and the Insurance Ombudsman, although customers will retain the right to approach the consumer court for redress. The report opines that the powers of the consumer court should be ultimately transferred to the FRA for financial customers once it acquires the requisite scale and expertise. The report suggests that the FRA be managed by a board of directors.

Further, as mentioned in Chapter 4.6, a State Finance Regulatory Commission (SFRC) could be created into which all the existing State Government-level regulators could be merged and functions like the regulation of NGO-MFIs and local Money Services Business could be added on. In some states, the SFRC could be created by upgrading existing Institutional Finance Cells. There is also value in bringing regulatory function close to the enforcement

function under the Economic Offences Wing (EOW), so as to ensure that they are working closely together. The RBI must be closely involved over a longer time frame in training the commissioners and licensing and accrediting the Commission itself. The local regional directors of the RBI could, for example, be ex-officio Chairs of the Commission's Board of Governors while the Commissioner could be a senior State level appointee drawn from the local Banking community. The District Magistrates would also play an important role in their respective districts.

Until such time as the FRA is created, existing efforts to strengthen inter-regulatory coordination must continue as well as between financial sector regulators and CCI.

Continuous Surveillance and Monitoring – Citizen-led Surveillance

Given the size of the unregulated financial services industry in the country and the limited capacity of regulators, it is inevitable that certain fraudulent financial firms will dupe customers of their savings or mis-sell products. In most such instances, the regulator becomes cognizant of the crime much after the damage has been done. In order to prevent such instances of fraud, a citizen-led approach to surveillance and monitoring would be useful to consider.

There are several examples of the enforcement and surveillance machinery collaborating with citizens to prevent crime. For instance, the Economic Offenses Wing of the Tamil Nadu Police Department with the support of Friends of Police (FoP) and members of the public has formed a "FoP Scambusters" unit to monitor the hundreds of non-banking financial institutions in the state. Members of the unit will monitor the activities of NBFCs and the methods adopted by such operators and report suspicious activity via email, phone and social media[285]. The Friends of Police (FoP), modelled on the Los Angeles Community Policing (LACP) forum, is a Tamil Nadu based grassroots initiative that encourages members of the public to communally participate in the detection and reporting of crime. Any member of the public may voluntarily become a "friend" of police on the condition that she is a citizen and a resident in the same district, is not involved in any civil or criminal court case, be literate enough to write, and be between the ages of 18 and 70[286]. Members of the FoP Scambusters inform the EOW of unregistered, suspicious or fraudulent institutions that seek to defraud potential customers. Taking a lead from this, the RBI should create a system by which any customer can effortlessly check whether a financial firm is registered with or regulated by RBI. Customers should be able to access this service by phone, through text-messages or on the internet. Once the FRA comes into being, this system should be subsumed under the FRA and be available for firms registered under all regulators.

Chapter 6.4
Recommendations Regarding Customer Protection

6.1 The RBI should issue regulations on Suitability, applicable specifically for individuals and small businesses, to all regulated entities within its purview, i.e., banks, NBFCs and payment institutions (under Sections 35 A of the BR Act, Section 45 JA of the RBI Act and Section 38 (2) of the Payments and Settlement System Act, 2007); so that the violation of such regulations would result in penal action for the institution as contemplated under the aforesaid statutes through a variety of measures, including fines, cease-and-desist orders, and modification and cancellation of licences. These regulations should be applicable specifically for individuals and small businesses defined under the term "retail customer" by FSLRC. FSLRC defines a retail customer as "an individual or an eligible enterprise, if the value of the financial product or service does not exceed the limit specified by the regulator in relation to that product or service." Further, an eligible enterprise is defined as "an enterprise that has less than a specified level of net asset value or has less than a specified level of turnover." All financial firms regulated by the RBI would be required to have an internal process to assess Suitability of products prior to advising clients with regard to them. The RBI would provide the following guidance with regard to the internal compliance requirements for firms regarding Suitability:

a. The Board should approve and oversee the procedures put in place for Suitability on an annual basis and attempt to detect and correct any deviations from procedure.

b. The firm would have to carry out a limited due diligence of the customer and put in place a process to assess the appropriateness of any product offered to a customer based on the results of the diligence. With respect to credit, for instance, the firm could be obliged to check the borrower's information from credit bureaus to determine the current level of indebtedness, make reasonable attempts to determine the current and projected income of the borrower, financial capacity, objectives and risk tolerance of the borrower, to determine the repayment capacity of the borrower. The lender should seek appropriate documentation to evaluate income and the ability of the borrower to repay given the increasing interest rates of the loan.

c. The requirement to conduct a due diligence should include the requirement to obtain relevant information about the customer's personal circumstances and give advice or recommendations based on due consideration of the relevant personal circumstances. If the financial firm finds that the information is inaccurate or incomplete, the customer must be warned.

d. Any product may be offered to customers upon establishing its Suitability, except "globally unsuitable" products discussed in (m).

e. In the event a customer chooses to purchase a product considered unsuitable to the customer, the financial services provider should consider providing written advice to the customer and seeking acknowledgement from the customer. This should however, not be misused by the financial services provider.

f. The firm's internal rules relating to compensation packages of staff should not create incentives or otherwise promote inappropriate behaviour. In addition, requirements relating to Suitability and appropriateness should be embedded

into compensation packages. Accordingly, the compensation packages and incentive structures should not be based solely on numerical targets but should include qualitative aspects such as offering appropriate products and services to customers and complying with requirements of the internal policy relating to Suitability etc.

g. The firms should have internal processes to track compliance with Suitability and an internal process to detect and correct any deviations from the policy, including potential disciplinary action and sanctions for the staff for any deviations. This could include a customer audit committee which reports to the board that is responsible for determining compliance with the Suitability process and other customer protection initiatives of the financial services provider.

h. The firm must have internal grievance redressal mechanisms for non-compliance with process and this should be required to be communicated to customers as well. The customers, should however be made aware that it is the process that is guaranteed and not the outcome. An internal grievance redressal process would not, however, preclude a customer from proceeding against the firm in any other forum.

i. The internal policy and procedure of the board should be communicated across the organisation and appropriate training programs should be put in place for the staff- both the client facing and the control staff. Such communication should articulate inter alia (a) the business benefits of having Suitability requirements, (b) the firm's commitment to a zero-tolerance approach to follow the process, and (c) the consequences for the breach.

j. The firms should have a paper trail and record keeping procedures to demonstrate compliance with its internal procedures which should be available for inspection by the RBI.

k. Additionally, if gross negligence, fraud or wilful misconduct can be established on the part of the financial services provider, the adherence to the process will not be sufficient and the firm would be liable to be penalised regardless of the process.

l. The regulations should additionally protect the firm from penal action in a situation where the customer may have deliberately misled or misrepresented to the firm, or if despite reasonable attempts the firm was unable to assess Suitability.

m. In addition, specific products may be deemed as "globally unsuitable" and would not be eligible to be offered to households or businesses below a certain income threshold or net worth or individuals above a certain age. Such products should be prescribed by the RBI and could be amended from time to time based on feedback from customers and financial services providers.

n. There is a specific set of de minimis products, the offer of which is to be subjected to a limited application of the Suitability requirements - basic bank accounts, the universal electronic bank account recommended in the Report and credit below Rs. 5000 subject to ascertaining the income and repayment capacity of the borrower. However, the Suitability process should definitely apply if an insurance, investment or derivative product is being offered to a customer, whether on a standalone basis or bundled along with credit.

6.2 The Committee recommends that a unified Financial Redress Agency (FRA) be created by the Ministry of Finance as a unified agency for customer grievance redress across all financial products and services which will in turn coordinate with the respective regulator. The FRA should have a presence in every district in the country and customers should be able to register complaints over the phone, using text messages, internet, and with the financial services provider directly, who should then be required to forward the complaint to the redressal agency. The customers should have their complaints resolved within 30 days of registration of the complaint with the FRA.

6.3 The RBI should create a system using which any customer can effortlessly check whether a financial firm is registered with or regulated by RBI. Customers should be able to access this service by phone, through text-messages or on the internet. Once the FRA comes into being, this system should be subsumed under the FRA and be available for firms registered under all regulators.