K C Chakrabarty: Impact of global financial crisis on financial consumers – global and Indian perspective on need for consumer protection – role of ombudsmen

Address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the Annual Conference of the International Network of Financial Services Ombudsman Schemes – INFO 2011, Vancouver, 21 September 2011.

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Introduction

Mr. Douglas Melville, Chairman INFO 2011, all the delegates attending the annual conference of INFO, Ladies and Gentlemen, It gives me immense pleasure to be here in British Columbia and particularly, Vancouver, the beautiful city and share my thoughts on a subject that has occupied centre stage ever since the global financial system has been hit by crisis leading to concerns being raised about the efficacy of laws, regulations and their implementation with the stated objective of protecting the consumer. All the Ombudsmen who are present here may definitely be exercised over the limited role they may be able to play in such situations. Nonetheless, it would be worthwhile looking at certain fundamental issues which are at the root of the need for financial consumer protection.

The focus of current international discourse is on financial sector stability. It may not be out of place to recall what the great American President Abraham Lincoln had to say "*If we could first know where we are, and whither we are tending, we could better judge what to do and how to do it*". Financial Sector stability, as we all know, in simple terms, is the absence of instability in the financial system. As a policy objective, it refers to the avoidance of financial crisis as also to the ability of the financial system to limit, contain and deal with the emergence of imbalances before they constitute a threat to the economic processes. Financial sector stability also has deep linkages to the principle of financial consumer protection.

Securing the customer

As I come from India, I would like to convey the message of Mahatma Gandhi who said "*A customer is the most important visitor on our premises. He is not dependent on us. We are dependent on him. He is not an interruption in our work – he is the purpose of it. We are not doing him a favour by serving him. He is doing us a favour by giving us the opportunity to serve him*". Thus, irrespective of whether the business has good or bad times, the consumer and his protection are central to the existence of business. Consumer protection is achievable by having appropriate commercial laws and open competition. But our experience in dealing with provision of financial products and services indicates that the law is heavily loaded in favour of the financial services industry. As far as competition is concerned, it has no implications for the most vulnerable sections of the society. Further, the legal processes tend to be expensive and unaffordable in terms of both time and money. The good times for the financial services industry have meant expensive services and products for the common person while bad times have meant inadequate or no supply of even basic financial services.

Can the above contradictions be balanced without having consumer protection at its core? What did the consumer gain when the times were good for the financial services industry and why is he made to suffer today, for no fault of his, just because the industry has fallen into bad times? The disconnect between business strategy and consumer protection can only be a recipe for disaster. When Mr. Bill Gates made the famous statement “world needs banking but it does not need banks” everyone perhaps was euphoric that we would soon breach the final frontier of banking. But it is going to be quite some time before we say good bye to banks. The recent past has seen product innovation and product penetration through use of technology. The challenge posed by the rapid changes in products and service delivery models is our ability to scale up our efforts regarding financial education and customer awareness. A financially literate and enlightened customer would be able to better judge the suitability of a product to meet his requirements.

The question I am often asked is: “Why as a regulator, are you concerned about customer care and protection? Why is it not left to the market forces and competition to take care of?” The answer to this lies in the fact that in a service industry where market forces and competition play out freely, this may well be the case. However, banking / financial services industry being a highly regulated service industry with very stiff entry norms, consumer protection cannot entirely be left to the market forces. Hence, the regulator has a role. Availability of financial services / products at affordable prices on an uninterrupted basis is the purpose and result of financial sector stability. Responsible marketing, responsible lending, responsible grievance redress mechanism and responsible consumer protection are not mutually exclusive but are inter-dependent. The public deposits and the funds available to the financial services industry represent a nation’s wealth. As such, the least we can think of is protecting the owners of this wealth, not merely in terms of deposit insurance but also in terms of day to day transactions and contractual relationships a consumer has with the banking and financial services industry.

Consumer trust and protection has always been an issue of interest and concern for policy makers and the entire financial industry. The debate has become particularly acute over the last few years in view of the recent market developments. In times of globalization, new opportunities in terms of new financial products, new instruments and technologies became available posing new challenges for the consumers such as understanding the risks associated with complex products. The current levels of transparency and the consequent difficulty of consumers in identifying and understanding the fine print from a large volume of information leads to an information asymmetry between the financial intermediary and the consumer. From the perspective of policy makers, including the Reserve Bank of India and other financial sector regulators, financial literacy is a must to gauge the needs of the population and financial institutions, so that financial resources can be translated into higher economic growth while minimizing the financial stability risks.

It is widely believed that the complex financial instruments that contributed to the financial crisis essentially had their basis in the boom period home loans, the credit quality of which was poorly assessed. Apart from the credit quality issues which went against the interest of the lenders, the interest of the borrowers were also severely compromised as they were lured into the complex yet alluring deals without being assessed for their repaying capacity based on their prospective income and net worth. Costs of such irresponsible lending and borrowing were borne by tens of millions of tax payers in the form of bailout of beleaguered institutions.

The financial services industry players need to evolve efficient consumer policies that must be based on two main pillars: financial education and transparent information on one side and competition on the other. These aspects are central to foster the confidence of consumers and help them make informed financial decisions and select the products best suited for their needs. Competition is an important dimension of consumer policy which has a positive impact on prices, quality of service and choice of products. Was this evident when we were going through turmoil in the global financial services industry? Perhaps not. We, therefore, have to harmonize the role of regulation, competition and financial education to achieve the twin objectives of consumer protection and financial sector stability.

Financial consumers need protection because they are at a structural disadvantage inasmuch as they have difficulty in exercising their market power since their heterogeneity and mass make it difficult for them to organize themselves into pressure groups. Additionally, the fixed costs of procuring information can be high. A greater degree of protection may therefore make sense. Information asymmetry between financial service providers and customers, especially in emerging economies, works to the advantage of the former. Therefore, transparency rules or disclosure regulations should, at the minimum, seek to create standardized and comparable information about pricing, suitability of the product to different population groups, terms and conditions and risks to customers and supervisory authorities. Full disclosure of quality information should be combined with mechanisms to ensure that clients properly understand the information provided and their impact on their personal financial decisions.

For countries where banking with formal institutions is still emerging, consumer protection measures must be a top priority. In all such cases the targeted client groups come from the most vulnerable and low income segments. This is a major challenge for the credibility and sustainability of the whole financial sector. If not properly addressed, some of the problems faced by these consumers could lead to a long-term mistrust in formal financial institutions and loss of confidence in the banking system. It is, therefore, imperative that all consumers should benefit from the same level of security and protection, whatever be the institution they operate with. Unchecked market forces and lax policies, combined with relaxed regulatory oversight, can result in customers being exploited while efforts to open financial markets to serve the bottom of the pyramid are made through financial inclusion measures. While financial inclusion is a necessary pre-condition for financial stability and inclusive economic development, the negativities that may affect a poor ill-informed new customer can be enormous – from high level of indebtedness due to excessively high prices and predatory lending, to complete loss of savings and assets created out of loans and those collaterally charged to the banks. Hence, the financial services industry cannot blindly follow a strategy of customer acquisition without providing new accesses to new customers by using the ICT led financial inclusion models or brick and mortar structures or the business correspondent model. These initiatives must not be seen as costs but need to be reckoned as investment necessary for business stability.

It is important to highlight that customers have rights but responsibilities also. While financial service providers have to ask the relevant questions to their prospective customers and ensure that the proposed products and services are the most appropriate according to their needs and means, it is the customers' responsibility also to provide relevant, complete and accurate information on their financial situation and taking their personal as well as financial circumstances into account when making their decisions. The responsibility of the financial service provider may, therefore, be read and assessed in the light of the customer's responsibilities. Financial Service providers need to understand that for their businesses to survive, their customers' must survive and for that, they need to understand the appropriateness of the products themselves to be able to explain it to their customers.

The financial entities must not use the vulnerable sections to cross-subsidize the clientele with power to bargain and command a price of their choice. The reasonableness of service charges / interest rates must be ensured by way of commitment to the cause of financial inclusion. Further, the service charges / penalties must not be disproportionate to the level of default. The bundling of products by banks with a view to generate more non-interest income would fall in the category of exploitative pricing. Every bank / financial service provider, in order to expand its customer base, needs to understand the requirements of their customers, the risks involved and return to be achieved.

The USA, which was affected the most by the crisis, had, in the aftermath of the crisis, initiated exemplary policy and other structural reforms to guard against financial instability (*Dodd–Frank Wall Street Reform and Customer Protection Act*). Among the measures initiated, the customer protection aspect had received prime attention resulting in enactment of Customer Protection Act and creation of Customer Financial Protection Bureau (CFPB) to assure that markets for financial products and services worked in a fair, transparent, and competitive manner and were subject to meaningful and consistent oversight. In India, setting up of Financial Stability and Development Council has also been with a similar view to strengthen and institutionalize the mechanism for maintaining Financial Stability by way of macro-prudential supervision together with focus on developmental aspects of customer protection, viz. financial literacy and financial inclusion.

Where the banking ombudsman comes in

The role of the Ombudsmen adjudicating financial consumer disputes is onerous and the recent upheavals in the market place have only heightened the consumers' expectations. The existence of a legal framework is a must for consumer protection. The Ombudsmen, by definition, deal with individual grievances about which the common person is agitated. They cannot substitute effective legal and regulatory systems. Expecting them to bring about systemic improvements of a sustainable nature by resorting to class action may be to expect too much from the schemes. The Ombudsman Schemes achieve two important objectives viz., timely disposal of grievances and continuing the relationship between the financial service provider and the consumer. While the courts of law decide cases in finality, many a times bringing contractual relations to an end, the decisions or awards passed by Ombudsmen generally do not have such implications.

What needs to be done is to have a constant interaction between law makers, regulators, standards & codes setting bodies and the Ombudsmen to sort out systemic issues that may be leading to individual grievances. The regulators also need to be aware of their responsibility of protecting the vulnerable sections of the poor in matters of pricing, fair treatment, non-discriminatory approach to consumer care and transparency in dealings with customers. Very often, the Ombudsmen are bogged down with issues of jurisdiction, either pecuniary or physical. This should not hinder them from encouraging a conciliatory approach to redress the grievances. We just cannot leave it to the care of the market forces and competition and expect them to serve the cause of the consumers. The standards and codes setting bodies must evaluate the quality and effectiveness of consumer care measures including the financial education initiatives taken by the service providers. The Ombudsmen need to move out of their Offices to spread awareness about existing redress systems available within the framework of the financial services industry. All the initiatives must be aimed at empowering the customer to be able to make a studied and reasonable choice of a financial product or service. The effectiveness of the Ombudsmen is not to be judged by the number of complaints handled every year but by the cases that resulted in bringing about sustainable continuous systemic improvement.

In this age of networking, fora like the INFO play an important role in broadening our outlook and understanding of issues from a local as well as global perspective. While globalization has had its share of success in improving markets and competition, it has also exposed the limitations of national regulators in protecting their consumers from actions arising out of trans-border transactions. Hence, the Ombudsmen who are part of INFO and the regulators must adopt the high level principles on financial consumer protection that have been put in public domain by G-20 OCED.

What are we doing in India

In India, for the banking industry, we have the following broad structure for consumer protection that is underpinned by Deposit insurance. India has the statutory framework for consumer protection by way of a Consumer Protection Act. We also have the Banking Codes and Standards Board of India and a Banking Ombudsman Scheme. The Banking Ombudsman Scheme has been in existence for over fifteen years and is cost free for access by the common person. The Banking Ombudsman Scheme (BOS) is fully funded and managed by India's central bank i.e. the Reserve Bank of India. As of now, bank customers can lodge a complaint with any of the fifteen Offices of the Banking Ombudsman situated across the country, on twenty seven different grounds of deficiency in banking services. These grounds of complaint cover all the delivery channels as also customer touch points. The number of complaints handled under the BO Scheme during the year 2010–11 was 71274 as against 79266 during 2009–10. Though these numbers may not reflect the true picture about the quality of consumer care or the hardships faced by the common persons, given the vastness of our country and the large customer base numbering over 800 million, we are seized of the need for bringing about greater awareness about the Ombudsman Scheme, especially in small towns and villages. The bigger challenge facing us is that of financial inclusion and financial education. To address these issues, we have embarked on an ambitious plan of financial inclusion and are committed to providing access to financial services to every village with a population of 2000 or above by March 2012. The challenge of financial education, in a multi lingual and multi ethnic country like India, poses many operational difficulties, given the low levels of financial literacy and a population of 30% which is uneducated. We are trying to tide over this situation by adopting multi-disciplinary and multi-channel strategies.

Despite having undertaken a number of initiatives for ensuring fair treatment to customers, it was realized that the efficacy of the tiered mechanism for customer grievance redress in banks was far from satisfactory. It was necessary to further develop a credible and effective functional system of attending to customer complaints by strengthening banks' internal structures to attend not only to the basic customer needs but the special needs of disadvantaged groups such as pensioners and small borrowers, including farmers. Taking into account these considerations, a Committee was constituted by the Reserve Bank. The committee was to look into the banking services rendered to retail and small customers and pensioners, structure and efficacy of the existing grievance redress mechanism, the functioning of Banking Ombudsman Scheme, possibility of leveraging technology for better customer service in the light of increasing use of Internet and IT for bank products and services, etc. and to recommend steps for improvements.

Conclusion

The lessons that the global financial crisis had to teach us have been expensive and painful. Let us not blindly believe in the ability of the markets and competition to take care of all segments of the population. There are sections of financial consumers who always have the highest sense of protection and there are the vulnerable sections of the society who feel left out. We, therefore, have to move to an order where the market forces, competition, effective regulation and a vibrant Ombudsman scheme all co-exist and handle matters concerning financial consumers' protection in a harmonized way.

As I conclude, I would like to thank the organizers of INFO 2011 and in particular, the host country Canada. It is a matter of pride that Canada has decided to host this event a second time around in the last five years. It speaks volumes for their concern for the cause of the financial sector consumer.

Thank you, Ladies and Gentlemen.

Annex

The major highlights of the recommendations made by the Committee on Customer Service in Banks constituted by the Reserve Bank of India are as follows:

- Creation of a toll free Common Bank Call Number
- Providing plain vanilla savings account without prescription of minimum balance

- Prescription of service charges for basic services
- Providing small remittances at reasonable price
- Providing floating rate housing loans on non-discriminatory basis
- Compensation for delayed return / loss of title deeds in the custody of banks
- Zero Liability against loss in ATM and Online Transactions
- Enhancement of DICGC cover up to Rs 5,00,000/-
- Transition to Chip based card (EMV) with Photograph
- Every bank to have a Chief Customer Service Officer (CCSO) for grievance redress