R Gandhi: Regulating financial innovation - P2P lending platforms design challenges

Valedictory address by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the Mint Marketplace Lending Summit, Mumbai, 17 May 2016.

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1. I am very happy to be addressing this Conclave to debate the Discussion Paper that the Reserve Bank has recently presented for public discourse on regulating the Peer to Peer Lending Platforms. Let me first explain the rationale for financial regulation in general and regulation on financial innovations in particular. Let me also discuss the different approaches that the Reserve Bank had employed in the past in dealing with financial innovations and finally the challenges that we have on hand in designing an appropriate regulatory approach to the Peer to Peer Lending Platforms.

Financial Regulation

2. The traditional neo-classical economic theory argues that unrestricted or laissez-faire competitive equilibrium is the most efficient economic arrangement. This is built on Pareto equilibrium and on the assumptions of perfect competition, with no externalities and no destructive competition.

3. Many academic liberals are doubtful of the benefits of regulation of financial services. Their case, as effectively summarised by David Llewellyn in his paper "The Economic Rationale for Financial Regulation", goes like this: there are no market failures or imperfections; if they do exist they are not sufficiently serious to warrant regulation; regulation may not in practice solve these failures; or if it does, it can do so only by imposing costs that exceed the costs of the original problem; serious moral hazards may arise when regulation is imposed; and regulation imposes a wide range of costs which are paid ultimately by consumers.

4. Another set of argument against regulations is that financial regulations actually serves the interests of the financial service providers and mostly detrimental to consumers, particularly because regulation results in reduced competition. As G.J. Benston points out, this happens because financial regulations typically include restrictions on entry, controls over products, restrictions on allowable business, restraints on prices, portfolio restrictions, restrictions on geographical diversifications, etc.

5. However, several other academics find that the validity of the neo-classical assumptions, when applied to the financial sector, do not hold good as there are in reality imperfections, information asymmetry, incompleteness, and failures in perfectly competitive or laissez-faire financial markets.

6. They argue that financial systems, markets and participants need regulation. Arguments range from the need for regulation per se to the need to avoid consequences of absence of regulations.

7. Prof Charles Goodhart, in his book "Financial Regulation: Why, How and Where Now?" argues that the private sector, left to itself, produces market failure, or at least sub-optimal results. In his view, there are three main reasons for financial regulation. They are:

i. To protect the customer against monopolistic exploitation

ii. To provide smaller, retail (less informed) clients with protection, and

iii. To ensure systemic stability

8. According to David Llewellyn, financial regulations have three objectives viz., to sustain systemic stability, to maintain the safety and soundness of financial institutions and to protect the customers. He argues that the case for regulation depends on various market imperfections and failures which, in the absence of regulation, produce sub-optimal results and reduce consumer welfare. In other words, the purpose of regulation should be limited to correcting identified market imperfections and failures.

9. One critical argument in favour of financial regulation relates to what happens in the absence of regulation. As Prof Charles Goodhart, says "Whatever the social costs and benefits of an externally imposed system of regulation may be, public revulsion at the effects and outcome of failures of unregulated financial systems can force the establishment of …. external regulation". Similarly, Randall Dodd argues "No matter how much responsibility is granted to individuals or no matter how much self-reliance is promised by private enterprises, when troubles become big and bad enough, they all turn to the government and demand that prompt action be taken to rectify problem".

10. Prof Goodhart also cautions "Interposing regulation and supervision into an otherwise free-market context weakens the incentives for the owners and managers to monitor and control themselves, and for their clients to exercise due diligence".

Financial Innovation

11. The Journal of Financial Innovation defines financial innovation as "the action of creating and popularizing new financial instruments as well as new financial technologies, markets and institutions. This includes innovation in the level of product, process and / or the institution". We also know that innovations occur in businesses, when ideas are applied to meet the needs and expectations of the customers. It may be new needs, or hitherto unarticulated needs, or existing needs met in unique ways. Innovations are also driven sometimes by stringent rules & regulations.

12. There is a debate whether financial innovations should be regulated. Whether the innovators and entrepreneurs should be largely left alone, or whether public policy authorities should be actively involved in regulating those.

13. Innovations bring in positive changes in efficiency, productivity, quality, competitiveness, and market share, among other factors. However, as innovations usually result in paradigm shifts, they are typically disruptive. It takes effort and time to understand them. The associated dangers include untested effects, lack of clarity on long term effects, and can lead to misunderstanding and misusing the innovation. Innovations can sometimes be bad per se; sometimes even good innovations can be misused.

14. The World Economic Forum opines that financial innovation has been more positive than negative and hence it will be better not to regulate them away by imposing excessively harsh standards or outright bans on new products. The Forum suggests that let innovation occur; but react appropriately and quicker to any flaws that become apparent and therefore the tendency should naturally be to err on the side of caution.

15. An OECD Report argues that we should preserve the benefits of innovative activities, while ensuring that new products and services that prove harmful are appropriately contained.

Indian Experience

16. How have we been regulating financial innovations in India? The Reserve Bank has employed several approaches while examining whether a financial innovation should be regulated. They include:

i. To ignore

ii. To watch out

iii. To regulate passively

iv. To regulate actively, and

v. To ban

17. What determines the approach? I can answer this in a simple, rule of thumb manner as follows:

i. Can the innovation cause large scale damage; then ban it.

ii. Is the size or magnitude very small; then ignore it.

iii. Can informed decision be taken by the consumers; then caution them.

iv. Can it be beneficial to many consumers; passively regulate it with light touch regulation.

v. Can it be beneficial to many consumers, but consumer protection issues loom over; then actively regulate it.

18. For example, the Prize chits and Money Circulation schemes have been banned, whereas with regard to the virtual currencies like Bitcoins, we cautioned the public about the risks involved in dealing with them. We had a studied stance and we preferred to err on caution based on the simplicity or complexity of the product or service. While we said “Yes” to micro finance, we said “No” to complex derivatives. In some other cases, we looked for risk mitigants and permitted them only after they are available. For example, we did not permit banks to engage agents to collect or pay moneys, until technology enabled Banking Correspondents were available. We permitted Mobile Banking initially only for very small amounts and as security and confidence were built only then, higher amounts were permitted.

19. As regards Micro Finance, let me explain a little more, as it offers a good case study. When Micro Finance came on the scene in early 1990s, we recognized it as a new paradigm, with immense implications and were very supportive. When the demands for regulating the Micro Finance Institutions were made, Shri Jagdish Capoor, the then Deputy Governor, stated in 2001 “As MFIs are significantly different from commercial banks both in terms of institutional structure and product portfolio, application of the same set of regulatory and prudential guidelines to MFIs, in our view, not only runs the risk of distorting the emerging market but it may also reduce the efficiency of these institutions”. When the demands gained momentum by 2005, the then Governor, Dr YV Reddy stated in August 2005, “Microfinance movement across the country involving common people has benefited immensely by its informality and flexibility. Hence, their organisation, structure and methods of working should be simple and any regulation will be inconsistent with the core-spirit of the movement”. Thus we were extending every possible support for a financial innovation which was assessed by us as very important for furthering financial inclusion in the country. We were very convinced that light touch regulation was sufficient in those formative years. However, as the sector grew, certain inadequacies and failures became apparent. As Shri Anand Sinha, my predecessor mentioned in April 2012, “In their eagerness to grow business, the institutions had given a go by to the conventional wisdom and good practices such as due diligence in lending and ethical recovery practices. Over-indebtedness of the borrowers led to difficulties in repayments and the forced recoveries by some MFIs led to public uproar and the subsequent intervention by the state government”. Consequently, we also had to tighten our regulations on micro-finance, based on the Malegam Committee recommendations.

Regulating P2P Lending Platforms

20. The first set of questions that we need to answer in dealing with the issue of regulating the P2P Lending Platforms are:

i. To regulate them or not?

ii. If to regulate, should it be ex-ante or ex-post?

iii. Is it now the right time? and

iv. If it is now the right time, should it be light touch or intensive regulation?

21. In the Discussion Paper, we have noted that internationally there are every type of approach to dealing with the P2P Platforms, ranging from outright ban to total indifference. Our tentative assessment is that P2P Lending Platforms need to be regulated, it may be the right time now and it can be light touch. Let me re-emphasize that these are tentative. We do want the stakeholders to express their views – either affirming our assessment or reasoning out alternate assessment.

22. Given the MFI episode and the prescient words of wisdom by Prof Goodhart and Prof Dodd about public reaction to failures of unregulated entities, that I referred to earlier, we feel P2P Lending Platforms need to be regulated, even though they have not yet really taken serious magnitude.

23. Regulations are of two types – prudential regulation and conduct of business regulation. While the prudential regulation focusses on solvency, safety and soundness of financial entities and financial system, the conduct of business regulation focusses on how the financial entities deal with their customers and includes information disclosure by the entities, their competence, their continuity and fair business practices.

24. It is clear that prudential regulation may have to be light for these Platforms, as they will not be handling the moneys of the lenders. Actually, we need to be prohibiting them from dealing in such moneys. Obviously, the conduct of business regulation will be appropriate. As the lenders "trust" the Platforms for getting to know the borrowers, and avail additional services like KYC authentication, credit scoring, legal formalities, recovery assistance, etc. code of conduct and fair practices norms will need to be applied.

25. Next set of questions relate to the Platform's structure – should it be a corporate entity or other types as well, what should be its capital, how should its governance structure be, etc. We have given certain proposals in the Discussion Paper regarding these questions. These were primarily guided by the need for serious, fit and proper and long term players to maintain the Platforms.

26. Finally, the risk management structure focussing on operational risk and business continuity, and the technology and customer grievance redressal mechanisms will need attention. As lending and borrowing is a maturity transformation matter, continuity and availability will be the essence for the services rendered by the Platform. Accordingly, the expectations in this regard have been spelt out.

Conclusion

27. In the end, let me reiterate that the Reserve Bank considers that the innovation of P2P Lending through Platforms facilitates direct interaction between small lenders and small borrowers, and hence further financial inclusion; as consumer protection issues can get amplified, the role of the Platforms come into focus; with appropriate regulatory arrangement, we hope that the Platforms will be worthy of the trust that the lenders and the borrowers repose on them.