Consultation Paper

Minimum Common Standards for Financial Advisers and Financial Education

Committee on Investor Awareness and Protection

Financialwellbeingboardofindiafinweb

The need for common minimum standards for financial advisers and financial education: a consultation paper.

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Scope of this document

This consultation paper has a twin objective:

One, establish a framework for setting up a regulatory system with minimum common standards for financial advisers who engage with retail investors.

Two, suggest an integrated approach to financial education that aims at increasing the financial literacy quotient of the Indian consumer of financial products and services.

The following document is Chapter 1 of the Consultation Paper on Minimum Common Standards for Financial Advisers and Financial Education.

Parts A, B and C of the Paper, along with the annexure, will comprise the full document and be submitted later.

Note: The Committee on Investor Awareness and Protection has been constituted by Government of India and is chaired by Shri D Swarup, Chairman, Pension Fund Regulatory and Development Authority. The six-member committee comprises members from the Ministry of Finance, the Ministry of Corporate Affairs, the Reserve Bank of India, the Insurance Regulatory and Development Authority and the Securities and Exchange Board of India.

Chapter 1: Introduction, Executive Summary and List of Main Recommendations

Delhi in the 1970s had few private cars. The stretch from Old Delhi Railway Station to Qutab Minar had a total of one traffic signal, and opinion is yet divided on whether it was a signal at AIIMS or a policeman. Still, the journey was smooth and uninterrupted. The same journey in Delhi 2009 looks very different. One malfunctioning signal on the stretch causes traffic jams and commuter distress. The signals by themselves are not enough. Drivers need to know the rules. When a new rule is introduced, like the one that made seat belts mandatory in the front seats of a car, users of the grid need to be educated about it. Even if they know the rules, it needs sightings of traffic policemen to deter those wanting to break the rules.

Financial markets are similar. When the number of investors and products are few, there is little use of a regulatory structure aimed at users and sellers of mass products. There was a time when people could only buy government-guaranteed, zero-risk investment and insurance products. Even the small number who chose to participate in the stock market knew what they were doing. It was a time when specific rules for sellers of financial products were not needed.

Today, there's an army of nearly 3 million financial advisers[1] plus banking staff selling non-banking financial products. They serve about 188 million investors[2] holding financial assets. Of these, 8 million investors participate in debt and equity markets, either directly or indirectly through complex and risk-bearing products like mutual funds and market-linked insurance plans. It drives home the need for order.

These numbers will only grow. The next 200 million Indian consumers of financial products are waiting to join the traffic. They are at the gate, wanting to see some signs of traffic signals to feel safe enough to navigate the roads. If rules are important, so are efforts to upgrade the skill set of those intersecting with new financial products—from the investor buying a mutual fund or pension product to the village woman taking a lump-sum from a micro-lending organisation. Both sets of people, and all others in the spectrum between, need help in understanding the new financial system so that they can maximise the efficacy of their financial decisions.

When the Committee decided to focus on the twin areas of investor protection and literacy, the idea was to work on two separate reports: one, on the need for a national strategy on financial education; two, on the need for a minimum common set of rules for the financial adviser population. The work began in two different silos.

But while working on the report, the research team came to the conclusion that one could not be extricated from the other. **Regulation and education are two sides of the same coin. In isolation, neither will have the desired impact.** A simultaneous and coordinated effort in both education and regulation will have a pincer effect on the problems of poor financial choices due

[1] 2.7 million insurance agents, Life Insurance Council, and 55,000 mutual fund agents, Amfi

[2] Indian Retail Finance Markets, 2007, IIMS Dataworks

to lack of knowledge and mis-selling due to lack of adequate order in the retail interface of the financial sector.

Order In The Marketplace

There is a perceived need for more order in the army of financial advisers, which reaches out to the financially included in India. Since over 70 per cent of investors buying mutual funds relied on the agent at the time of their most recent investment[3] and almost 90 per cent[4] are buying insurance policies from agents, it is clear that the final retail interface is of critical importance in ensuring a good financial outcome from the transaction.

Ensuring that the retail sales interface does not mislead becomes imperative. To believe that agents will look after the interest of their consumer, rather than their own income, is naive. In the words of a US regulator[5]: “The agent will go where the money is.”

Historical events in India and aboard show that advisers or product manufacturers will need not just a nudge, but effective rules that will induce them to do the right thing. This Committee believes that the Micro Financial Sector (Development and Regulation) Bill, to be tabled in Parliament soon, will take care of the sales side issues of credit relating to micro-finance institutions.

This leaves the 3 million-plus army of insurance, mutual fund agents and bank officers (selling non-banking investment and credit products), who are reaching 188 million customers, to be regulated today. This 3 million will increase as the sales network for emerging products like the New Pension System (NPS) begin to fall into place and the next 200 million consumers become active in the financial markets.

Financial products are invisible—they cannot be tasted, smelled, sat in, worn or perceived by the senses in any other way. A car can be driven before it is bought. A music system can be physically examined to see what it does. A garment can be tried on to see if it fits. But because a financial product is invisible, it needs to be described by the person selling it. And because the moment of truth of a financial product is 1-20 years away from the point of sale, its actual face will only be seen sometime in the future

These two attributes (invisibility and distant moment of truth) of a financial product make the point of sale an extremely important link to the entire product chain. Unless the sales person is able to correctly describe the product and its role in the portfolio of an investor, the product is likely to ‘explode’[6].

[3] Influential factors at the time of most recent investment in mutual funds: 72.2 per cent agent, 51.6 per cent TV/radio promotion, 31.4 per cent banks. IIMS Dataworks, 2007

[4] 89.9 per cent buy insurance from agents, 6.1 per cent from independent adviser and 1.8 per cent from banks, IIMS Dataworks, 2007

[5] Non-formal interviews with US regulatory staff

[6] The US saw ‘exploding’ financial products during the sub-prime crisis, when mortgage products were sold that were inherently unsafe. For example, a product that allows a partial interest repayment in the first few years and capitalises the unpaid interest into the principal will explode in any average portfolio. It is a term made famous by academician Elizabeth Warren http://www.democracyjournal.org/article2.php?ID=6528&limit=0&limit2=1500&page=1

This importance can prove to be potentially harmful for customers, who rely on the verbal communication of the sales person to describe the product, its costs, its risk, return and flexibility to them. The written communication, as it exists today, is lengthy and leans towards 'checklist' compliance. The offer documents and communication with customers lie within the letter of the law, but leaves them with very little idea of what it is that they have bought. There are notable exceptions in the industry that do try to bridge the gap, but this is not the industry standard.

Consumers lose faith if they have a bad financial outcome due to an ill-fitting financial product. This can happen in two ways. One, a badly constructed product being sold in the market. Two, a product that does not fit the risk-return profile of the consumer, and has the potential to 'explode'.

India has good product manufacturer regulations in place and the instances of products that are designed to mislead are few. However, the manner of their sales leaves much to be desired. Consider a zero-risk individual, who wants a tiny part of her portfolio invested in equity. She is sold an equity unit-linked insurance plan that soaks up all her investible surplus or a sector mutual fund that sits at the high end of the risk-return curve. Who has misled the consumer in this case: the insurance company or mutual fund, or the seller who sold it[7]?

This Committee recommends tighter norms for financial advisers in India. There are two arguments that previous committees[8] have flagged to prefer status quo instead of more order in the marketplace. One, the insurance and mutual fund agent is already a regulated entity and the Reserve Bank of India (RBI) regulates the bank officers who sell financial products. Two, while the agent is regulated, it is the adviser who is not under regulation, and may hence need action at a future date.

But examining the IOSCO (the International Organization of Securities Commissions, which is the global meeting place for securities markets regulators[9]) guidelines, and the code of

conduct of insurance associations and regulators[10], shows a regulated entity is one that faces:

- A set of compliance exams
- A system of continuing education
- A process of registration
- A process of regulatory filings

[7] Of exploding toasters and sugared 'sandesh', 1 July 2009, Mint. http://www.livemint.com/articles/2009/07/01003757/Of-exploding-toasters-and-suga.html

[8] Report of the Committee on Regulation of Investment Advisers in Non-Securities Markets, 2008

[9] Objectives and Principles of Securities Regulation, IOSCO, 2003

[10] 1. Advocis, the Financial Advisors Association of Canada, http://www.advocis.ca/index.html
2. The Singapore Insurance Act 2002, http://tinyurl.com/lgppdp
3. The Financial Services Authority, UK. http://tinyurl.com/ngwgoe

- An ongoing system of monitoring
- A system of compliance that the adviser will follow
- Well-defined enforcement procedures
- Punitive action

Clearly, the current sellers of financial products cannot be called 'regulated' by any global standard. Agents are, at best, passing a threshold exam. Two, the distinction between adviser and agent is fictitious when the agent is selling a load-bearing product. **A load-bearing product has advice embedded in it[11].**

The US is grappling with the creeping transformation of broker-dealers to advisers, as they sell load-bearing products. The UK will do away with this conflict of interest by making all products go no-load from 2012. Australia favours the fee-for model over the commission-based model. **The key question here is: whose agent are they—the consumer's, the producer's or their own?** And if they are the agent of the consumer, surely the consumer should directly compensate them to ensure service.

The Insurance Experience

It is apparent from the ground reality in India that the lack of fear of punitive action or responsibility nudges the bulk of the sales force to use incentives on financial products as the driving force to sell products. If this were not so, the lapsation rates of insurance policies would not be so high. Data for 2007-08 shows that lapsation rates range between 4 per cent and a shocking 80 per cent. The lapsation rate for half of the 16 companies was more than 20 per cent. Only three insurers had a rate of less than 10 per cent[12].

While no single factor can be isolated for such a situation, the distributor has a huge role to play in this regard[13]. There is agreement in the insurance regulatory system that high lapsations that occur during the first few years of the policy are caused **"by mis-selling—intentional or otherwise, and selling under duress. For instance, in consideration of a loan sanctioned by a bank or any other nature of 'favour' done by the insurance salesman to the policyholder, or under 'obligation' to a relative or a friend[14]."**

The chief cause of mis-selling is the incentive structure that induces agents to look after their own interest rather than that of the customer. If that were not true, the average sum assured of the insured Indian would be higher than the current Rs 90,000[15]. With an industry commission expense ratio (commission expenses as a percentage of total premium) of 16.25 per cent and

[11] The Role of Brokers and Financial Advisors Behind Investments Into Load Funds, Xinge Zhao, China Europe International Business School (CEIBS)

[12] Statement 53, Irda Annual Report 2007-08

[13] J Hari Narayan, Chairman, Irda, Irda Journal, Lapsation in Life Insurance, August 2008

[14] Lapsation of life insurance policies, Irda Annual Report 2007-08

[15] http://economictimes.indiatimes.com/Features/Investors-Guide/Why-is-India-so-grossly-under-insured/articleshow/4900520.cms

total commissions paid at Rs 14,704 crore in 2007-08[16], the reason for sharp selling practices is obvious.

The life insurance incentive structure is currently under change, with a 300 basis cost cap between gross and net yield. Still, the underlying issue of front-loading (pushing the cost applicable over the life of a product into the entry point of the product—or to recover upfront, the cost across many years) the product with commissions that are due over the lifetime of a product makes harmful sales a foregone conclusion.

The high front-loading of commissions is allowed by The Insurance Act, 1938. The commission for the first can be a maximum of 40 per cent of the premium[17]. In years two and three, the caps are 7.5 per cent, and 5 per cent thereafter. These are the maximum caps and serve as a ceiling rather than a floor.

Any Act or regulation needs to keep pace with changing markets, as its aim is to ensure a fair deal for all parts of the market, not just one. When the high front-load was envisaged in the Insurance Act originally, the premise was that the agent would service the policy owner over the policy life of 10, 15 or more years. The customer then would be indifferent towards paying the cost upfront or distributed evenly over the life of the product.

It must be remembered that the logic of such an incentive structure worked in 1938, when a single-player industry was envisaged and consumers had few other options for long-term investments. The year 2009 is a different time and place in terms of number of players, products, consumers and their needs. Arguably, the Insurance Act needs to keep pace and take notice of a changed world.

Now, with multiple players, each time an agent switches companies, or a new agent approaches a policyholder of some other company, they can potentially get those customers to churn—sell their old policy and buy a new one. Churning a product that has a cost structure where the customer has paid in advance the service fee for the next 10 to 50 years in the first three years is a harmful trade practice. With no system in place to refund the commission paid for the years foregone, the consumer ends up losing not just money, but also faith in the financial system.

[16] Annual report 2007-08, Irda

[17] This is 35 per cent of the first year's premium for an insurer who has completed 10 years of his business

The Mutual Fund Experience

The mutual fund experience shows that it is indeed the incentive structure that tilts sales towards particular funds. The change in incentives from 2006 till 2009 is a story of the regulator gradually tightening the regulation to contain motivated product manufacture and sale.

In 2004 and 2005[18], as the stock market was rising, it came to the notice of the regulator that some banks and large distributors were churning mutual fund investors from one new fund offer (NFO) to another. At stake was the 6 per cent cost that each NFO was allowed to charge investors, plus the upfront load of 2.25 per cent.

Under Sebi (Mutual Fund) Regulations 1996, initial issue expenses up to 6 per cent of the amount raised by the scheme was permitted to be amortised over a period of five years. This meant that 6 per cent of whatever an NFO collected during the NFO period could be charged to the scheme, apportioned over five years. So, an NFO gathering Rs 1,000 crore could charge the scheme's investors Rs 60 crore from their assets or Rs 12 crore a year.

Meant to take care of the advertising and marketing costs, most of this money was routed to distributors as their commission, in the form of cash and as a percentage of the amount raised. The use of the initial issue expenses to compensate distributors become so widespread that no new fund could enter the market without promising the large distribution chains 7-8 per cent commissions.

The practice became so widespread that it came into the regulatory radar. In April 2006, amortisation charges were banned in open-ended funds. Fund houses, right away, began launching closed-end schemes that were exactly like an open-ended scheme, with a regular redemption window. In 2007, 42 closed-end schemes were launched, compared to nil in the few years preceding that. In January 2008, this window was shut down as well, with closed-end funds not being allowed to charge the 6 per cent amortisation cost.

However, questions over the 2.25 per cent front load being used to push new funds continued. To do away with this problem, **Sebi has recently taken a significant step forward by making advisers the agents of customers, rather than that of the company whose products they sell. Mutual funds have gone no-load from 1 August 2009.**

This follows the New Pension System (NPS) example, where there are no entry or exit loads from inception. It is up to customers to compensate the agent and adviser according to the service they receive. It is early days yet after the change over to a no-load world in mutual

[18] http://www.indianexpress.com/storyOld.php?storyId=87085
http://www.indianexpress.com/oldStory/74320/
http://www.indianexpress.com/oldStory/73834/
http://www.indianexpress.com/oldStory/67507/
http://money.outlookindia.com/article.aspx?90185

funds. While no system can deal with an errant jaywalker dashing across a busy road or a speeding driver jumping a red light and hurting someone, on the whole, there is a greater obvious display of order. The inherent contradiction in the system has been addressed.

The New Pension System Experience

With mutual funds going no-load, one piece of the market is largely in place. The emerging pensions piece is already structured right to give the consumer a fair deal. The New Pension System (NPS) has been conceived as a no-load product. It also has other investor-friendly features like full portability at no cost, which allows investors to switch fund managers.

With no inducement to push one fund over another, the point of sale will either allow the customer to make the product choice, or the customer will be put in a default option. (Default options are used to make the decision for the customer who would rather not choose. The NPS uses a well-regarded, lifecycle-based investing formula that reduces the equity allocation of a person as they age.) The NPS could have taken the route of higher sales commissions than insurance to get market share, but it has chosen an ethically mature path, risking a slow start to the product offtake in the market.

Globally, there is a rethink on loads in products, and the blurring of lines between a broker-dealer and an adviser. **It is an opportune time for India to set global standards by following a no-load plus fee model for the entire financial sector, and then using outcome-based regulation to ensure a fair deal for all market participants, the producer, the adviser and the consumer.** Given the size of a market like India and the ability of the seller to move with the money, a low-cost, high-impact method to taking away the incentive to mis-sell is proposed.

The Way Forward

The Committee proposes the use of financial incentives in a manner that nudge participants into doing the right thing. The commission and reward system today makes advisers the agents of the financial products manufacturer, but their compensation comes from the customer. This gives rise to the inherent conflict in this relationship.

A (agent) is the agent of B (manufacturer), but is paid by C (customer). So, A will sell to C a product that B manufactures that gives A the greatest remuneration. There is no other way for A to behave in a market economy—A is programmed to maximise its own utility rather than that of either B or C. **Now, if instead of B, C, the customer, was to compensate A, the whole equation changes. It is now in A's interest to keep C happy.** Not just this one time, but over a lifetime of financial product buying, maintaining and selling.

Educating Consumers

There is a global buzz around an emerging area that goes by many names: financial literacy, financial competence, financial education or financial ability. The names are many, but the goal is the same: a population that has the knowledge, understanding, skills and competence to deal

with everyday financial matters and make informed choices in selecting products that meet their needs.

There is a proliferation in the number and complexity of financial products. Risk is being transferred to the household. A large population bulge in newly developed or developing countries is being exposed to formal banking and financial products, as well as smart sales practices, for the first time. All these make a base level of understanding of money, its management and use a basic life skill.

The lack of this skill has the potential to fritter away economic gains made at an aggregate level by nations, resulting in wealth transfer from the financially illiterate to a small sliver of the financially literate. OECD research[19] shows that a financially literate population promotes economic growth and well-being by expanding the quality of available financial services, and by enhancing the ability of individuals to more effectively use the services in their best interests.

Work on the topic by financial literacy scholar Annamaria Lusardi[20], Professor of Economics at Dartmouth College and a Research Associate at the National Bureau of Economic Research (NBER), shows that individuals with low levels of financial literacy tend not to plan for retirement and borrow at high rates of interest. No wonder, there is a rush to get citizens financially literate, sparking off an article in *The Economist*[21] calling it the "global crusade".

With a household saving rate of over 30 per cent[22], India understands the merits of saving over current consumption. Unlike much of the west, where getting people to save is an issue, the bottleneck for India is the efficient conversion of this saving into investment. A large part of this money is in low-yielding assets like bank deposits and traditional insurance[23], but there is a clear trend[24] of individuals preferring security-based investments as they go up the income ladder.

One part of the population, due to advantages of birth, location and education, has benefited from the growth spurt in the Indian economy. It has moved into the population bracket with cash incomes that are large enough to allow a surplus after taking care of all expenses. Estimated at 321 million[25], this population segment is usually the first to begin buying financial products other than bank deposits and real assets like gold and property.

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[19] Improving Financial Literacy: Analysis of Issues and Policies. OECD 2005

[20] Lusardi, Annamaria and Olivia S. Mitchell (2007b): Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education. Business Economics, January 2007

[21] Getting it Right on the Money, 3 April, 2008, The Economist

[22] Handbook of Statistics October 2008, RBI

[23] Of the 105 million insurance customers, 90.9 million have a traditional endowment plan, IIMS Dataworks

[24] Indian Retail Finance Markets, 2007, IIMS Dataworks

[25] Indian Retail Finance Markets, 2007, IIMS Dataworks

The share of mutual funds in household saving wallet more than doubling from 3.7 per cent in 2005-06 to 7.80 per cent in 2007-08[26] points to the emerging better-off population looking for avenues, other than those traditionally available, to target a better return. The growth in the number of market-linked insurance plans and home loans, too, point in the direction of the newly emerged middle-class experimenting with financial products and credit.

While heavy advertising and a powerful sales push has generated an awareness of a new set of products in the market, few are able to understand what these products will help them achieve in their financial journey. As many as 98.3 per cent of traditional insurance policyholders did not buy unit-linked insurance plans (Ulips)—the market-linked, investment-bearing life insurance plan—since they did not understand it. A large 90.2 per cent of working Indians with cash incomes were unaware of a mutual fund as a vehicle of investment and less than 5 per cent could give an accurate description of the mutual fund concept[27].

Clearly, advertising and the agent network have worked positively to create awareness, but not knowledge. A coordinated approach is now needed to convert this awareness into knowledge. Interviews with the industry confirm the need for such an effort that is beyond what an individual company, association, regulator or non-profit can do. While spontaneous efforts have been initiated by government departments, regulators and associations, each looks at the world with a limited view of the part of the market they serve. For instance, the Reserve Bank of India (RBI) has taken a lead in the financial literacy space, and its efforts are mainly in the banking space. The Ministry of Corporate Affairs too has programmes on the ground, including the setting up of the Investor Education and Protection Fund (IEPF), and this is mainly in the securities market space.

However, for the consumer, the piecemeal approach does not work. Individuals are not looking to learn markets, banking and insurance as separate modules that they will later put together and connect the dots. Rather, while buying a product, they feel the need to get a quick shot of information that will help they choose. They want a big-picture view of their money life and then specific information for the part of the market they choose to go to for product transactions.

If this is the story of the largely urban investor, the rural consumer possibly needs the literacy effort even more urgently, though at a different scale and content level. While more than 80 per cent of the agricultural wage labour is still unbanked[28], due to reasons of location, society, caste, religion and poverty, micro-finance institutions have been able to reach 86 million[29] of the poorest Indians (80 per cent being women) with tiny loans.

Handling a lump sum for the first time, this population needs a basic course in money management, cash-flow rhythms and budgeting, agree the micro-finance companies. In

[26] Handbook of Statistics, 2008, RBI

[27] IIMS Dataworks, 2007

[28] A 100 Small Steps, 2008, Planning Commission, Government of India

[29] Sa-Dhan, the Bharat Microfinance Report-Quick Data 2008

addition, this will be the first generation of financial savers from the ranks of the poor who will save in terms of money, instead of land, livestock or gold. A base level of understanding of risk, return, financial products and their use is mandatory so that the millions of choices become informed ones.

A global review of efforts in financial literacy initiatives shows that state-led, national-level financial education programmes are already in place in many parts of the world, especially the mature markets and the emerging ones. The US, UK, Australia, New Zealand and OECD countries have well-defined financial education programmes led by the state. Some are funded by the government (like the US) and some by the financial sector (UK).

When asked if India needs a national-level effort to build financial literacy, respondents from the financial sector, regulators, NGOs, micro-finance professionals, consumers and global regulators were unanimous in their verdict: yes. The need for common definitions, benchmarks, a core content set, a depository of knowledge, clearing house of already created content, non-duplication of effort were reasons given for the need for such a national-level agency. The need for a strategy-based, cohesive approach that uses innovative means to deal with one of the most difficult lessons to impart—how to manage money—is strongly felt.

As India embarks on the road to financial literacy, we must not ignore the red flags raised by the experiences of countries already on this path. Apart from the fear of financial literacy becoming the reason for looser financial regulation at the product manufacturing and adviser level, the big global concern is around measuring efficacy of financial education. Unless outcomes are built into the system, there is a real fear of this effort of time and money going waste.

Order + Education = Well-Being
Educating individuals in money matters is one of the toughest challenges faced by the national efforts in financial education across the world. To get an adult in a class, and that too in a money class, is not the easiest thing to do. Even if one gets them in a class, retention and efficacy are issues to worry about.

One of the best ‘teachable moments’ identified is when the person has a need, and is looking for information and knowledge before making a financial decision. The seller of the financial product becomes the default source of this information—in the hope of making a sale, the adviser will spend time and effort to communicate with the consumer. If this communication is motivated, and hung on the weight of commissions and other benefits the adviser earns from the sale of the product from the manufacturer, the consumer will not get the right advice.

One way to take care of this problem is to take the load, or the motivation to mis-sell, away from the adviser. The second way is to back this step up with a system that fixes responsibility of the product sold on the adviser to stop them from harmful sales practices.

Education of the consumer and more order in the market emerge as two sides of the same coin. The UK regulator, Financial Services Authority (FSA), has financial capability as part of its mandate. The Australian regulator, Australian Securities and Investments Commission (ASIC), too is responsible for educating the end-user of financial products. **This Committee comes to the conclusion that instead of setting up two institutions with overlapping mandates, it would be efficient to club the education and order pieces into one organisation, which will be responsible for the financial well-being of the Indian consumer of financial products.**

The final report will be divided into three parts. Part A builds a case for a common minimum standard of regulation for retail financial advisers that cuts across regulators, products and markets. Part B builds a case for a state-led, national-level effort in financial education. Part C connects the dots and sees education and order as two sides of a coin.

It suggests the setting up of **Financial Well-Being Board of India (FINWEB),** which will have order and literacy as its twin mandates. It is an outcome-based organisation, as is apparent from its name itself. It must be remembered that development of the profession of investment advice and financial education are social infrastructure. India needs to develop common standards within this framework.

Recommendations

India needs a coordinated approach to address the twin issues of investor protection and financial education. The research undertaken by this report shows that education and order in the adviser marketplace are two sides of the same coin. Additionally, there are global best practices that collapse these two goals into one executive organisation. Based on research, interviews with key market participants—including regulators, heads of financial institutions, mutual funds, insurance companies, banks, distribution houses, financial planning institution, and others—a survey of the financial sector[30] and a review of global best practices, this Committee proposes the following:

Recommendation 1. The objectives of greater financial literacy for Indians and establishing a system of common minimum standards for financial advisers should be met by a single organisation. **Financial Well-Being Board of India (FINWEB)**, the proposed organisation, will have the twin objectives of building a financially literate population and bringing order to the adviser market to facilitate good financial outcomes from financial decisions. With an outcome written into its very name, FINWEB is envisaged to be truly working in the interests of consumers of financial products and services.

Recommendation 2. FINWEB should consist of two operational arms. The **Self Regulatory Organisation (SRO)** will work on bringing financial advisers under one common standard. The **Financial Literacy Cell** will work on making Indians financially literate.

Recommendation 3. The organisational structure of FINWEB should keep in mind the PFRDA model in terms of staffing, outsourcing of functions and an outcome-oriented philosophy.

Recommendation 4. FINWEB should be a participative organisation, with representatives from government ministries and departments, regulators, industry associations, financial organisations active in the field of financial literacy and investor protection.

Recommendation 5. FINWEB should have a board of directors drawn from the existing regulators, ministry of finance, financial sector, industry associations, independent entities and academics.

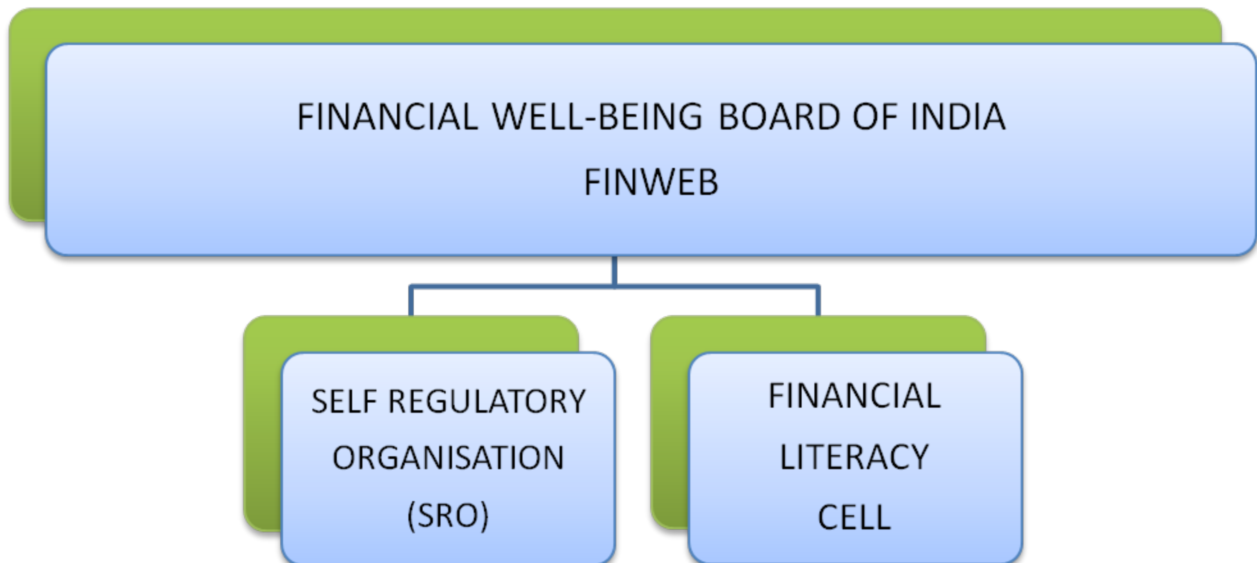
Funding. FINWEB should have independent funding. There are two options for this: it could be funded by the government or by regulators.

[30] The Committee mailed over 100 companies a common questionnaire, asking for opinions, views and suggestions in the twin areas of financial literacy and adviser regulation. It got 24 responses

In either case, either a capital grant is made to FINWEB or the annual budget deficit gets covered each year.

> *Recommendation 6.* FINWEB should be funded by the government through a capital grant, drawing upon the funds in frozen accounts and the investor protection fund.

The Organisational Structure of FINWEB



Part A
FINWEB: SRO Cell

Regulators can be seen in the same way as parents who negotiate teenagers at home. There are those that over-prescribe, who get into every little market crevice and in every transaction of market participants. There are those that lay out the broad desirable outcomes and then step aside to let market forces take over—but are always present in the background with their policing and supervisory staff patrolling the markets. This translates into two broad thoughts behind regulation.

Rule-Based Regulation
Rule-based regulation is where the regulator tries to be present in each and every transaction that takes place, through an extensive rulebook, tight policing and penal system. The regulator tries to anticipate every possibility, every change, every innovation in the market, and then writes rules around it.

Principle-Based Regulation
Principle-based regulation is where the regulator is more focused on the outcome of the regulation. The regulator will articulate broad principles and allow market players to innovate around them, keeping the outcome (as defined in the principles) sacrosanct.

This approach does not totally do away with the need for rules. There will still be rules to follow in any regulatory system, but it does eliminate the practice of compliance officers using the 'checklist' approach to staying within the letter of the law. Checklist compliance harms customers, as there may be no case of regulatory violation, yet there may be mis-selling and malpractice. **In such an environment, compliance officers are not working towards a desired outcome for the customer, but to outwit regulators.** Once a regulatory loophole is discovered, it becomes a race to the bottom, with the rest of the industry following.

Using Financial Incentives As A Regulator
There is a third way to look at regulation. **Where the market incentive structure is used to take most of the reasons behind misconduct out of the market and then use a principle-based approach to target an outcome.** The challenge is to find the holy grail of regulation that allows for market innovation, while taking away the incentive and power that the adviser has over the customer due to a skewed incentive structure and knowledge. One of the tools for such regulation is to use financial incentives in a manner that nudge participants into doing the right thing. **The commission and reward system today makes the adviser the agent of the financial products manufacturer, but his compensation comes from the customer.** This must change for the adviser to look after the consumer of financial products. The consumer, too, will have to learn to pay directly.
Market review, opinions, views, the survey and global best practices all point to the fact that India is ready for a statutory body to bring all financial advisers under a common minimum standard of regulation. The rule-based entry thresholds and documentation already

in the market, and the industry practices around them, point to 'checklist' compliance by product manufacturers and distributors; only in some cases is there evidence of a real effort to reach out to the customer with material facts. **This report leans towards a principle-based approach, while flagging the issue that to translate principles into rules that work would be a huge challenge in a market as vast and diverse as India.**

> *Recommendation 7.* This report proposes the use of market incentives as the base on which principle-based regulations will be used to ensure a common minimum standard of rules and regulations for the financial adviser.

Who Will Be Regulated?

The Indian investor is served by agents, banks, post offices, financial planners and, now, through the employer and retail chains as well. The common minimum standard should apply to any person who sells financial products, provides advice, or directly or indirectly profits from recommending and selling retail financial products. This will include individual agents selling mutual funds and insurance, financial advisers, financial planners, bank employees, direct selling agents from banks who sell banking and credit products like fixed deposits, credit cards, home loans and car loans. Most of these currently do not display signs of 'mis-selling'. But they do come under the scope of over-the-counter retail finance products and are included for work, if needed, at a future date. **Today, the pressing need in the market is a regulatory structure for mutual fund, insurance and pension sellers and advisers. The report will focus on advisers in these three product categories.**

> *Recommendation 8.* The report proposes a common minimum standard for all sellers of mutual funds, insurance products (life and general) and pensions products.

The Roadmap

> *Recommendation 9.* The Committee suggests **adopting an SRO-driven regulatory system for financial advisers. The SRO will be a statutory body with punitive powers over its members[31].**
>
> *Recommendation 10.* All retail financial products should go no-load by April 2011. The pension product in the NPS is already no-load. Mutual funds have become no-load with effect from 1 August 2009. Insurance policies need to remove the bias towards selling the policy with the highest commission. Because there are almost three million small agents who will have to adjust to a new way of earning money, **it is suggested that immediately the upfront commissions embedded in the premium paid be cut to no more than 15 per cent of the premium. This should fall to 7 per cent in 2010 and become nil by April 2011.** The interim period should be used by insurance companies to help their agents make the transition to a more mature way of selling and advising.

[31] FPSB India has presented a workable SRO model to the Committee. The FPSB concept note will be appended to the final report

The Outcomes

> *Recommendation 11.* The overarching **outcome of the SRO arm of FINWEB should be financial health**. The outcome of financial health can be broken down into the **outcomes of safety, fairness and trust**, which will have **goals around education, conduct, disclosure, reporting, punitive action and dispute redress.**

Safety. Consumers should feel safe while dealing with, transacting and doing business in the retail financial products and services market.

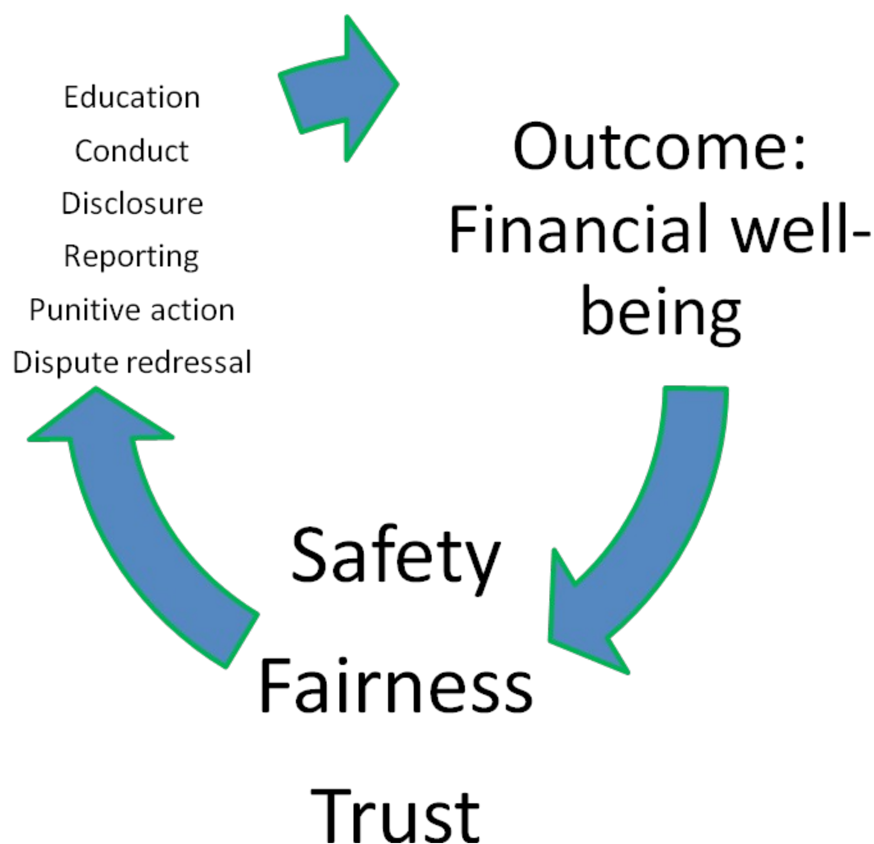
Fairness. Consumers should not feel cheated, but should get a sense of fair treatment in their interactions and transactions.

Trust. Consumers should feel confident, rather than cynical, about the redress mechanism.

The outcomes above will be achieved by setting outcome goals in the following six areas:

Education
Conduct
Disclosure
Reporting
Punitive action
Dispute redress

Each of these is linked to one of the three outcomes of safety, fairness and trust. It is beyond the scope of this Consultation Paper to flesh out each of these, but a broad framework could look like this:



1. Education. Outcome: Safety

Recommendation 12. There should be a common minimum entry barrier for all financial advisers. The entry barrier should comprise a minimum knowledge-linked training programme, which specifies a set of knowledge outcomes rather than number of hours of study.

Recommendation 13. A person must clear a common examination pattern, with several modules, before beginning selling financial products to retail consumers. The existing examinations in mutual funds, insurance and others will continue as different modules within the outcome-specific goals of FINWEB.

Recommendation 14. A new benchmark qualification should be introduced that will license an adviser to operate in the market.

Recommendation 15. There should be a graded qualification matrix that will link more complicated products to a higher level of education and testing. The nature of the license will determine what products or what level of service an adviser can provide.

Recommendation 16. FINWEB should undertake a mass media campaign to ensure that consumers are able to link the license with the service offered.

Recommendation 17. There should be a system of continuing education. The license should be renewed every three years by clearing the refresher exam. This will be available for each level of the qualification matrix.

Recommendation 18. There should be a system of educating not just individual advisers, but also employees working for a firm or bank that intermediates. Anybody facing the customer must be a licensed entity. A corporate license is not enough—the entire sales team will need to acquire the qualification.

2. Professional Conduct. Outcome: Safety

A trade becomes a profession when there is a development of formal qualifications based on education and examination, and an emergence of a regulatory body with the power to admit, discipline and demit members. Intermediation currently is a low-value trade with little respect in society. The conversion into a profession will need, apart from the education and examination thresholds mentioned above, a code of conduct that ensures a minimum common threshold of service expectation.

Recommendation 19. All advisers should be registered with FINWEB.

Recommendation 20. All members of FINWEB should be governed by a code of ethics that is standard across products and organisations. Note will be taken of the structure put in place by the RBI for its banking correspondents standards while formulating the code of ethics.

Recommendation 21. The code of conduct should have principles of integrity, privacy and honesty as key goals.

3. Disclosures. Outcome: Fairness

To remove the last shred of doubt about the intent of the adviser, which currently is suspect, India needs a minimum common standard of disclosures. This must address costs, risks, product features and realistic potential outcomes.

Recommendation 22. There should be a disclosure template developed by FINWEB that has consumer understanding as an outcome.

Recommendation 22.1. The disclosure should reveal the income—direct or indirect—that an adviser earns from the sale and maintenance of a product, both from consumers and from product manufacturers.

Recommendation 22.2. The disclosure should reveal the total cost, current and ongoing, that will be borne by the consumer of the product.

Recommendation 22.3. The disclosure should give a realistic picture of the risk the product carries.

Recommendation 22.4. The disclosure should have third-party benchmarks in them to compare past performance.

Recommendation 22.5. The disclosure should ensure that consumers understand the role of the product in their financial life.

Recommendation 22.6. The disclosure should ensure the product outcome is understood by consumers.

Recommendation 22.7. A one-page note, with the most important terms and conditions, should be part of the disclosure to ensure the customer understands the product and its impact fully.

Recommendation 23. Product labelling[32] should be used innovatively to inform consumers about what they are buying.

4. Reporting. Outcome: Fairness

There is a mismatch today between what the adviser verbally tells the customer and what the final product has the ability to achieve. Unless there is a paper trail that affixes a name to advice and a product that has been sold, the practice of hit-and-run financial products (where an adviser will hit a customer with a product and disappear) will continue, eroding confidence in financial markets. The reporting process must be such that:

Recommendation 24. The sales process should be documented.

Recommendation 24.1. A customer profiling should be put in place, as should a documentation of the process that led to product selection.

Recommendation 24.2. The declaration should be counter-signed by the customer, acknowledging the disclosures made by the adviser.

Recommendation 24.3. There should be a system of a paper or electronic trail to document the adviser's professional life and the business he writes.

5.Punitive Action. Outcome: Trust

A key requirement of a trade transforming into a profession is the ability of a consumer to get redress from the professional body that regulates the profession. A well-defined system of affixing penalties in cases of mis-conduct, mis-selling or otherwise causing a bad financial outcome must be put in place.

[32] http://www.nytimes.com/2009/05/24/opinion/24gibson.html?_r=1

Recommendation 25. There should be a well-defined process to affix responsibility for a bad outcome.

Recommendation 25.1. Punitive action will include fines that are related to the financial loss the consumer has had to suffer.

Recommendation 25.2. For a serious breach of trust, the adviser or adviser firm will face loss of license to do business.

Recommendation 25.3. For repeated and serious breaches of trust, criminal proceedings to be initiated.

6. Dispute Redress. Outcome: Trust

An accessible system of dispute redress must be in place. Today, when customers have a complaint, they go back to their agents, who are not accountable in any manner. Most complaint systems today cost a person a lot of time in repeating the complaint to six different call centre employees each time the phone is passed on to the next person or when the consumer calls again. There must be a robust system that makes it easy for consumers with a genuine complaint to file it, track it and be able to explain why and how they feel cheated.

Recommendation 26. Consumers should have a common interface to complain about financial products, service and outcomes.

Recommendation 26.1. A time-bound redress system should be put in place.

Part B
FINWEB: The Financial Literacy Cell

Transforming India's financially challenged millions into an informed consumer base is no easy task. There is no immediate solution. Further, any solution will not be easy to conceptualise or implement. The newness of the subject and the lack of empirical evidence on what will work make the task that much more challenging. The good part is that there is a broad agreement on the need for a nodal national agency to be at the heart of the Indian national financial literacy initiative. What it should be like, what work it should do and not do, how it will reach the millions across the length and breadth of the country is the subject matter of the following recommendations.

> *Recommendation 27.* **FINWEB should be the heart of all financial literacy initiatives in the country.** It is from the knowledge and expertise of FINWEB that willing agencies active in the field of financial literacy should draw material, conceptual knowledge, expert trainer and testing.
>
> *Recommendation 28.* FINWEB will engage key professionals in various steering groups to drive specific financial education programmes in identified areas of intervention.
>
> *Recommendation 29.* **FINWEB will not prevent any financial literacy initiative from carrying on its work in its chosen area of interest and work.** Its aim is to be a knowledge and resource partner; not a regulator of financial literacy, but a standards setting body.
>
> *Recommendation 30.* The aim of FINWEB is not to educate people to choose between mutual fund A and mutual fund B. That is the work of the financial adviser. The aim is not to substitute financial education for effective adviser and product regulation. The goal of FINWEB would be to enable individuals, at their level of need, to understand the role of money in their life, the need and use of savings, the various options available in the market they can access to convert their savings into investments, and a realistic recognition of the attributes of these options. **FINWEB would consider its work well done if the financially literate person knows enough to be able to ask the right questions of the person selling financial products.**

Content
An alternate school called Mirambika, based in New Delhi, does not introduce written language to children till age six. Sometime between the age of six and seven, they are introduced to the shapes of letters and the sounds that go with them in a random manner. There is no chronological recitation of the alphabet. Once they know most of the sounds and can connect it the shape, they are encouraged to join them to write down the names of their friends. Then, one or two lines on what they enjoy most about their classmates. Children learn reading and writing

in two weeks with this method. Linear and structured learning takes much longer to achieve this.

A review of most current financial education initiatives show that they are largely in the linear, structured space, where teaching is around defining a stock market, a mutual fund, a bank and so on. Could non-linear, concept- and utility-based learning work better in financial education? Recent academic work in financial education from the US[33] shows that utility-based learning is more useful in changing behaviour. Unless the recipients of financial education are clear about how this material and training will help them, and they are able to connect it to what they are doing in their lives, the retention is usually very low. Merely learning the structure of a market or how a mutual fund works is alienating. It is quickly forgotten once the class is over. The other reason for taking a concept-centric route is that constant innovation in the financial sector means that by the time the knowledge and understanding of a new type of a product trickles down, it is already outdated.

> *Recommendation 31.* This report recommends an alternate approach to financial education in India. **The content plan should focus on utility and concept-based learning.** The key question to be asked before developing any material or conducting any training will be: how will this connect with the desired audience and of what use is it in a person's financial life in a practical way? While definitions and descriptions are important, they come as an aside.

Utility-based learning. A group of health workers were trying to get women of a remote village in India to understand age-weight benchmarks for children. The idea was to encourage them to feed kids who were below the benchmarks better. The NGO workers plotted the ideal age-weight line in the mud in the village square. For age three, the ideal weight is this; at age four, it should be this much; and so on. Next, they plotted the names of the kids by age and weight, above or below the line. Everyone could see whose kids were under-nourished and whose kids were nourished fine. The mothers of the under-nourished kids asked mothers of the kids who were fine what they were feeding their kids, and begin doing the same. No structured class could have achieved such an outcome, in such little time.

FINWEB should use a utility-based approach to develop content and training programmes. These should explain the lifecycle of money in a person's life, with earning, spending, budgeting, insurance, saving, investing and credit as key areas of work. Asset classes, markets, products will fit into the utility-based paradigm, rather than being taught separately.

Concept-based learning. Finance rests on concepts. These concepts can be seen as alphabets. Once understood, they can be strung together to simply sign a name or write books. Every part of the market—banking, insurance, capital market, loans—uses certain finance concepts in product construction. A regular investment-saving product will use the

[33] The Impact of Financial Literacy Education on Subsequent Financial Behaviour, Lewis Mandell and Linda Schmid Klein. Journal of Financial Counselling and Planning Volume 20, Issue 1 2009

concepts of present value, future value and rate of return. A life insurance product will use concepts of mortality—probability of people dying at a certain age. A mutual fund will use the concept of risk and reward. While these sound complex, their usage is not. **It will be a challenge that FINWEB will have to take up to convert these concepts into mind maps, pictures, stories and examples that will explain without alienating the learner.**

> *Recommendation 32.* **FINWEB will identify, after consultation with various parts of the market, a set of concepts that are basic to financial products. These will then be innovatively worked on by a small group of finance experts drawn from the corporate sector and educationists.** The concepts will include (the list below is not exhaustive):

Present value
Future value
Simple interest
Compounding
Real rate of return
Inflation
Post-cost return
Post-tax return
Benchmarks
Floating vs fixed loan rates
Insurable interest
Human life value
Risk mitigation
Moral hazard

The challenge for FINWEB is core content development that is applicable at various gradations. These are concepts that can be scaled up and down the understanding ladder, with no change in the basic message. But its communication will have to be made specific to the group the particular literacy effort is trying to reach. For instance, a person making a savings deposit and one investing in an exchange-traded fund (ETF) are both using the concepts of present and future value and risk. Only the gradations are different. The material and the training would have to scale the concept up or down to be in tune with the needs of the particular group being targeted. The concept-led approach will allow a certain amount of cohesion in the financial education efforts of various partners of FINWEB.

> *Recommendation 33.* **The content will be at three levels: Level 0 for the financially excluded; Level 1 for the financially included, basic; Level 2 for the financial included, advanced.**

Reaching It
Distribution is the game-changer for a corporation. A company can have the best product, but unless it populates the market, it will remain in the warehouse. But distribution chains are expensive to create, especially in a country as vast as India. Rather than create a network of arteries that will carry the oxygen of financial empowerment across the length and breadth of India, it will be cheaper and more effective to embed the existing networks with customised content and training.

FINWEB will not create an army of financial literacy staff. Rather, it will work with a small core team of content developers and trainers, who will then partner willing institutions, groups, organisations, NGOs and micro-finance companies. The idea is to first empower the nodal agency's staff with financial education. Once the recipients understand and use the concepts in their own financial life, they can pass on the training much better than some theoretical recitation of facts. Disparities along regional, cultural, religious, gender, social, economic and political lines would have already been resolved by the existing pipelines. FINWEB will need to be nimble to be able to customise training and content to suit specific pipeline needs.

Recommendation 34. Financial literacy modules and training should be embedded in existing pipelines (the pipelines are described below).

Recommendation 34.1. A core group of financial sector and education professionals will work with FINWEB to develop the content.

Recommendation 34.2. A core group of trainers, who would work with the content developers, will be part of the staff of FINWEB. This group of trainers will be used to train the trainers.

Recommendation 34.3. FINWEB will attempt to involve the following pipelines to reach target audiences:

34.3.1 Advisers. They are a key piece of the literacy work. They are the lowest-cost, highest-impact way to get the attention of investors at a time when they are most open to education. **The time of a product sale is a well-documented, 'teachable-moment'. This is a crucial piece of the financial literacy plan.** There are around 3 million insurance and mutual fund agents. Add the banking staff that sells products and the direct selling agents to this, and this army of product sellers reaches over 188 million consumers today. It will reach another 200 million in some years. If financial advisers can be made a participant in financial education, we have one of the least-cost ways to achieving a financially capable population. But for advisers to do this, a set of changes is

needed in the incentive structures that motivate them. India will have to move from a model of the product manufacturer, using the customer's money to compensate the agent, to the customer paying directly for the service.

34.3.2 Government Programmes. There are mass outreach programmes of the government that, if willing, can be embedded with financial education. Again, this is not an imposition. But if the head of the outreach programme considers this valuable, FINWEB will develop customised material and training for the training staff of the programme.

34.3.3 School Curriculum. Along with continuing the efforts to embed financial education in the school curriculum, FINWEB will also use a minimally invasive approach. **By simply converting the relevant maths problems into financial literacy-embedded problems, children could be introduced to financial literacy in a non-intrusive way.** Educationists and financial sector experts will need to work together to construct these problems.

34.3.4 Post-Class XII. FINWEB will work with universities and nodal higher education points to encourage young adults to become financially literate. The method, again, is demand-pull, rather than push.

34.3.5 HR Departments. FINWEB will work with HR departments of willing large corporations to embed into their existing training and HR programmes. Special modules for those entering the work force, considering a job change or retirement will be developed.

34.3.6 Life Transition Points. A person is most open to financial education at a life-transition point, like getting married, having a child, first job, job loss, retirement or even taking a home loan. These are the best 'teachable moments'. FINWEB will work on developing some of these as channel partners to carry financial education.

34.3.7 Social Organisations. FINWEB will work with organisations like Rotary Clubs to spread education. Willing resident's welfare associations (RWAs) could be involved in the financial education initiative.

34.3.8 NGOs. FINWEB will work with NGOs to develop specialised content for specific areas of work. For instance, HelpAge India will be keen to partner with an entity such as FINWEB, as it feels the need for

customised content and expertise in the area of old-age financial management and product choice.

34.3.9 Micro-Finance Companies. Over 80 million people have been covered through micro-finance in India. FINWEB will work with this large network of organisations to take financial education to the excluded population. One of the concerns in the micro-finance sector is the handing over of a large sum of cash, maybe for the first time, to a person. A financial education module embedded in the lending process will give inputs on how to use it.

34.3.10 Existing Efforts. FINWEB will offer its expertise to existing financial education efforts that are already on the ground with projects running and use their expertise in fine-tuning its own work.

Recommendation 35. FINWEB will have an outcome-specific role. Any intervention by FINWEB will result in a basic skill set getting created.

Recommendation 36. The content and training modules will have efficacy parameters as part of the programme.

Recommendation 37. FINWEB will develop a website that will become the clearing-house for all financial education efforts. **The material developed by FINWEB will be put on the website for downloading by anybody who wants to use it.** It may encourage smaller organisations to use it by moulding it to their own needs.

Recommendation 38. FINWEB will leave cost- and organisation-intensive areas like one-on-one counselling and consumer helplines for Phase-II of implementation.

Recommendation 39. FINWEB will operate in three distinct ways. One it will begin engaging with those who are already doing work. Two, it will reach out to large arteries who could carry this. Three, it will be available as a resource house for any other organisation that may want customisation for its specific purpose.

Measuring it

It is essential to measure each intervention. It is probably only pure research that can have non-measurable results of years of work. A system where public money will be used must have accountability and an outcome-linked mandate.

> *Recommendation 40.* To measure the change in behaviour, FINWEB will carry out a nationwide survey to fix benchmarks of current behaviour. Only then will subsequent surveys determine efficacy.

FINWEB will have an outcome-specific role. Any intervention by FINWEB will result in a basic skill set getting created. Each intervention will be tested with a view to measuring efficacy.