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Stifling innovation with regulation

If sharing platforms are regulated like goods and service-producing corporations, consumers will lose out

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Regulators are naturally a conservative lot. It is good we are that way, else there would be no speed breakers in the economy to slow its propensity to get into trouble. But we also should not stand in the way of innovation. There is a Chinese saying: 'Cross the river by feeling the stones'. The RBI has tried to follow that path of experimentation and incremental liberalization…"

Reserve Bank of India governor Raghuram Rajan recently delivered the C.D. Deshmukh address at the National Council of Applied Economic Research and spoke justifying the necessity of regulatory supervision of innovation in the financial sector. James Madison was one of the framers of the American Constitution. In *The Federalist No. 51*, Madison wrote in defence of a proposed national constitution that would establish a structure of "checks and balances between the different departments" of the government and, as a result, constrain the government's oppression of the public. With due respect to the governor, this piece will attempt a critique of his view through the Madisonian lens and then propose a few ideas that will address the issues raised by it.

Rajan argues that regulatory conservatism is a necessary antidote to the market forces that will "get into trouble" without regulatory intervention. In a well-functioning regulatory universe where the regulators are without any personal biases towards risk, this argument appears appealing. In such a world, the regulators can apply just the 'right' amount of regulation, liberalizing incrementally as evidence emerges, as Rajan points out. This theory of regulation is the so-called public interest theory of regulation in which the regulators are modelled as actors driven by enlightened public interest and act as such.

Unfortunately, in practice, regulators also have their self-interest to protect and frequently will act on it at the expense of (diffuse) costs the regulated sector will incur. Regulators face a collective action dilemma when faced with the issue of whether to regulate an innovation or otherwise. The benefits of an innovation are diffuse and shared by countless consumers. On the other hand, every innovation will potentially impose costs that may be relatively concentrated on few stakeholders including the regulators. In other words, regulators face asymmetric incentives when faced with innovation. If they let the innovation thrive and an odd transaction results in losses, or worse, is fraudulent, the lawmakers and consumers will blame them for not regulating with enough due diligence. They will be subpoenaed for a hearing in the US Congress and (in India) activist journalists will haul them over the coals.

In the face of such odds, the regulator is naturally inclined to prevent rather than permit. By preventing (for which liberalizing incrementally appears an elegant euphemism), the regulators diffuse the costs of undeveloped financial markets across consumers and through time. This regulatory approach also leads to trouble; it's just that unlike frauds or other financial crashes that present an opportunity to mould the regulatory architecture into better shape, this trouble is chronic and kicks the can down the road.

Take the recent innovation in the fintech space—the peer-to-peer (P2P) lending platforms that have sprung up. Think of them like the Uber of consumer financing. If you have spare cash lying around, these platforms have an aggregation of borrowers you can choose from to lend to. The platform requires the borrowers to disclose all relevant financial details, based on which potential lenders evaluate the underlying credit risk and decide whether to lend or otherwise. It is important to note that the platform as such is risk-neutral and all the credit risk is pass through.

Regardless, when a deputy governor of RBI was recently interviewed, he stated that RBI is floating a concept paper on P2P lending since "risks may emanate from such innovations". He even mentioned the possibility of such platforms being mandated to convert into non-banking financial companies. The interview reflects a potential failure to understand the new sharing economy that, it appears, will be dominated by a new business model—the platform (instead of the corporation). Unlike corporations that produce goods and services, platforms intermediate goods and services. Amazon, Uber, Facebook, Twitter, Lending Club are all platforms. If they are regulated like goods

and services-producing corporations, consumers will likely be the ultimate losers in not being able to capture all the benefits of the sharing economy.

So, what can we do in face of all this? As Ronald Reagan said in the context of the Cold War, “trust but verify”. All too often, Indian regulations rationalize the need for regulation under motherhood and apple pie statements like “financial stability” or “investor protection”. Such statements cannot be verified. So, lawmakers should craft statutes to require regulators to provide an objective rationale for a proposed regulation. Further the rationale should be justiciable in courts and subject to consultation with consumer groups complete with the requirement that the regulators disclose how the concerns raised by stakeholders are proposed to be addressed. The draft Indian Financial Code, for example, has similar notice and consult mandates.

There is an ocean of innovation waiting to reveal itself, Mr Rajan. Why stop at the river?

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