

Financial Consumer Protection Grid

A fiduciary standard has clean
product structures and alignment of
incentives as a prerequisite

Monika Halan, 31 August 2012

Investor protection needs a fiduciary system

- UK: RDR is a structural change in the way investment and insurance are produced and sold. No load products, suitability onus on seller
- Australia: From July 1 2012 a no loads, fiduciary system for advisors
- US: weak regulators and government mean small progress in investor protection
- Consumer Financial Protection Bureau is non-starter
- US follows the disclosure and financial literacy approach, diluting the fiduciary for advisors

John Kay report: fiduciary standard



- The John Kay report July 2012 asks: what are the goals of an equity market and is it doing its job?
- It is not. Short-termism has destroyed trust and confidence between savers and investors
- Need a fiduciary system across the investment chain

India's walk has been random

- UK and Australia reworked their rules post 2008
- USA is still fighting its Ayn Rand and Chicago School demons
- India has random walked on investor protection
- No load MFs, NPS structure work of a few good people
- Big business interest and no cohesive MoF policy harmed consumers most

If rules were rewritten

- India would have a fiduciary system that puts the onus on the seller and manufacturer of a financial product to look after the financial health of the consumer
- The regulatory cost and intrusion of such a system will be prohibitive unless we work on
- A 3-part market structure that cleans up the road that leads to a fiduciary system

Pre-fiduciary steps: 1. product structure

1. Product structure are clean and transparent
 - Costs and benefits are easy to see
 - Comparison on costs and benefits over time is easy
 - Not for average consumer, but for advisors and analysts
 - Clear benchmarks
 - Portfolio disclosure
 - Portability

Pre-fiduciary steps: 2. incentives

2. Incentives. Align incentives across the investment chain

- Producers and sellers “follow the money”
- Use money to drive better behaviour
- Fix incentives so that producers, seller and consumers are incentivised towards ‘right’ choices
- No loads, trail commissions, use of exit loads to drive tenure, preference to fee income

Fiduciary: Caveat Seller

- Clean product structure and aligning incentives is the necessary condition
- Fiduciary system needed to ensure that sellers and advisors stop trying to game the system and have a long-term view
 - The seller of the product looks after the interest of the buyer
 - Seller puts pressure on the manufacturer to create products that work for the final buyer

2 case studies

- Ulips (unit linked insurance plan)
- Mutual Funds
- Recent examples of how poor product structures and skewed incentives caused a multi-trillion rupee loss to Indian investors
- Total loss estimated at more than Rs 5 trillion over the past 6 years

Ulips 2005-2012

- LIC sold 'traditional' plans for >50 years
- Long term accumulation product, with costs front loaded and opaque product structure
- Privatisation in 2000 and new product allowed
- Ulip: market linked insurance plan
- UTI MF had pioneered it – mutual fund with a crust of insurance

Pre-2010 Ulip

- Textbook case of poor product structure and misaligned incentives that has caused at least

Rs 5 trillion

Rs 5,000,000,000,000

of loss over 2006-2012 in lapsed policies

Lapsed policies are those that die in year 1 and 2 of their lives. Money went to insurers and sellers

4 design features that made Ulip a trap

- Multiple charges with no effective cost caps
 - Allocation
 - Administrative
 - Mortality
 - Fund management
- 3 year lock in, with a high surrender charge
- No benchmarking or portfolio disclosure
- No portability

Ulip: charges

- Staggered annual loads front loaded on year one and two
- Front loads of 40% on year one premium
- Illegally insurers paid upto 70-80% as year one commission
- Administrative, mortality and fund management bit off another 5-10% a year

Example: limits of the literacy approach

- Media reports flagged high allocation charges
- Insurers moved costs under 'administrative' head and launched zero allocation charge policies
- Overall high cost remained the same, it got hidden under a head that investor did not know

What made Ulip a trap

- 3 year lock in and no caps on surrender charges
- Insurers deducted 70% of value if policy lapsed after year one
- 50-60% after year 2
- 30% after year 3
- Most investors lost everything if they lapsed after the first premium

Lapsed policies total Rs 5 trillion

- Rs 40,000 crore of Ulips lapsed in 2011-12
- The numbers are higher in previous years
- Some insurance companies have lapsation rates of over 80%
- Average persistency rates of 46% very low in India compared to world standard of 78%

POLICIES THAT DIED

Are you buying life insurance? Here are companies that have large graveyards of dead policies.*

	Dead policies (% of traditional business**)	Increase/Decrease from last year (percentage points)		Dead policies (% of traditional business**)	Increase/Decrease from last year (percentage points)
Birla Sun Life	72% (16)	↑ 33	Shriram	15% (24)	↓ -26
ICICI Prudential	46% (23)	↓ -35	ING Vysya	14% (78)	↓ -5
Tata AIG	33% (14)	↓ -9	Max New York Life	13% (58)	↓ -10
Aviva	31% (30)	↑ 7	Kotak Mahindra	12% (30)	↓ -2
Metlife	31% (32)	↑ 6	Bajaj Allianz Life	11% (30)	↓ -6
Future Generali	25% (62)	↓ -12	Aegon Religare	9% (28)	↓ -15
Bharti AXA	19% (27)	↓ -19	SBI	7% (41)	0
DLF Pramerica	19% (37)	↓ -61	IDBI Federal	6% (36)	↑ 6
Star Union Dai-ichi	18% (28)	↑ 14	HDFC Standard	5% (34)	↓ -3
Reliance	16% (43)	↓ -15	LIC	5% (20)	↑ 1
Sahara	15% (33)	↓ -6	Canara HSBC	3% (20)	↑ 3
			Average	19%	↓ -7

*New dead policies include the lapse rate, the below-par rate as a lapse rate by the policyholder during the year & policy the withdrawal (cash) of business & loss of the lagging and a "burst" of the year. **The related first year premium as a percentage of the total of your premium. For details, visit the website at iifd.com.

Source: IIFD annual report

INCOME FLOW

Insurance companies make huge profits from lapsed policies. (figures for FY11)

Bajaj Allianz Life Insurance

367.00

Profits from lapsed policies (₹ cr)

Profits from after tax (₹ cr)

1,057.00

HDFC Standard Life Insurance

223.20

-99.00

ICICI Prudential Life Insurance

730.00

807.60

Max New York Life Insurance

184.00

194.30

Source: Goldman Sachs Global Investment Research

Hit and run shows up in poor persistency rates in India

THREE-YEAR PERSISTENCY RATIO

Insurance company	March 2011-12	March 2010-11
SBI Life Insurance	21%	21%
Kotak Mahindra Old Mutual Life Insurance	24%	24%
ICICI Prudential Life Insurance	32%	30%
HDFC Standard Life Insurance	33%	29%
ING Vysya Life Insurance	38%	27%
Star Union Dai-ichi Life Insurance	42%	NA
Max New York Life Insurance	42%	49%
Birla Sun Life Insurance	72%	72%
IDBI Federal Life Insurance	86%	NA
AVERAGE	43%	36%

Developed markets average

78%

NA: Not applicable since company didn't complete the required number of years.

Where the break-up between premiums and policies is mentioned, the persistency is taken on the premiums basis. Only three companies—ICICI Prudential, IDBI Federal Life and HDFC Standard Life—have disclosed the manner in which they have calculated their persistency ratio. ICICI Prudential and IDBI Federal Life have reported their persistency on a reducing balance basis. As a result, other than the first-year persistency, their results may not be comparable with that of other insurers.

Data collected as on 31 May 2012; other companies are yet to declare their annual results.

IndiaFirst Life Insurance began operations in 2010 and is yet to complete the year.

Source: Insurance Regulatory and Development Authority of India

2009-2010

- Sebi debarred 14 life insurance companies from selling Ulips in December 2009
- Irda told them to carry on
- Ugly spat in the market
- Govt stepped in and handed over Ulips through an ordinance in June 2010 to Irda
- Irda told to clean Ulips up

Irda reformed Ulips in 2010



- J Hari Narayan (June 2008 onwards) after being in denial for two years, he began to clean up the mess
- June 29 2010 the new Ulip guidelines announced
- September 1 2010 the new Ulips came to the market
- All costs under one head (except mortality)
- 5 year term
- Rs 6,000 max surrender charge



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New Ulip rules rob market of insurance

Niladri Bhattacharya & N Sundaresha Subramanian / Mumbai Sep 29, 2011, 00:23 IST

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1Cr insurance for Rs.543 : cheapest term insurance in India Monthly offers from LIC,i-pru,B-axa
www.policybazaar.com

With flows for Ulips drying, life insurance companies invest just a fraction of what they did last year.



Indian bulls are missing their earlier close allies in the fight against the latest bear onslaught. Domestic life insurance companies, which had acted as a counterweight to fleeing foreign investors in the past, do not have enough dry powder now, as inflows into unit-linked insurance plans (Ulips) have fallen sharply.

Ulips, which used to account for 80 per cent of industry sales, have sunk since September 2010, when the Insurance Regulatory and Development Authority's new rules made the selling of these hybrid plans less lucrative for both life companies and agents.

[Ulip Life Insurance Plan](#)

Invest Rs 5000/pm, Get 52 Lac on Maturity. Unique Triple protection.

[investment-imaximize-aegonreli...](#)

SHRINKING FLOWS

Net investments by domestic institutions other than mutual funds

How incentives drive producers

- Industry moved to selling traditional plans
- Had high costs and were opaque

	First year premium in Rs crore	
	Ulip	Traditional
2008	69,613	24,101
2012	17,455	96,042
	-75%	298%

Follow the money: how incentives move the business

How commissions have moved		
	FY 2009	FY 2011
Ulip commissions as % of total commissions	89%	40%
Traditional plan commissions as % of total commissions	11%	45%
(For private insurers)		

Traditional plan redo

- The rules are being written
- The new structure will take care of most of the opacity and cost issues
- Portfolio, benchmarks and portability still remain unaddressed both in Ulips and traditional plans

The mutual fund story

- Began with a much cleaner product structure
- But the incentives were there to mis-sell and churn
- 3 successive Sebi chiefs worked to move the Indian mutual fund to one of the best products in the world today

Pre 2009 structure

- Maximum entry and exit loads of 7%
- Industry standard of entry load of 2.25%
- Annual cost caps of an average 2% a year
- New fund offers allowed to charge the fund 6% of the amount it collected from the market
- Portfolio disclosure
- Benchmarks according to investment mandate
- Portability (but entry load to be paid again)

6% entry load led to churning

- Rs 1,000 crore through a new fund offer meant Rs 60 crore amortized over 5 years
- Upfront loads were at 2.25%
- Distributors wagged the producer tail and took away 8% upfront
- Funds launched multiple NFOs, distributors churned investors

Change in costs began in 2006



- M Damodaran (Feb 2005-2008) took away the 6% NFO charge on open ended funds in April 2006
- MFs moved to launching closed end funds
- Removed it on open ended funds in Jan 2008

Incentives nudge products

NFOs	Rs crore	Total inflow	% of NFOs
Mar-06	38,018	52,005	42
Mar-07	23,702	72,356	25
Mar-08	44,011	89,745	33
Mar-09	2,488	32,069	7
Mar-10	6,092	61,673	9
Mar-11	3,577	67,883	5
Mar-12	420	53,466	1

4 April 2006
Open ended
funds cannot
charge 6%,
closed end can

31 Jan 2008
closed end can't
charge 6%

NFOs move with incentives

Year	Closed-end	Open-ended	
2005	-	43	
2006	10	44	Open ended lose the 6% charge (4 April 2006)
2007	24	35	
2008	10	39	Closed end lose it too (Jan 31, 2008)
2009	5	30	
2010	-	7	
2011	2	19	

Indian MF goes no load: 2009



- CB Bhave (Feb 2008-2011) bit the bullet and removed entry loads on mutual funds on 1 Aug 2009
- Indian MF became the first product to go no-load in the world

Loads are off the table: 2012



- UK Sinha has removed the re-entry of loads from the table
- MF structure is modified to become fungible within the expense ratio
- Outcome linked hike in expense ratio by 50 basis points

Sebi mystery shopping survey 2011

- Distributor survey across 17 metros
- 84 large and medium distributors covered
- Results show how the market has moved since 2005 when MFs were sold:
 - Rs 10 is cheaper than Rs 30 to sell NFOs
 - Portfolios were stuffed with funds
 - New funds sold over performing old ones
 - Sectoral funds sold to lower risk buyers

Survey 2011

- Almost 80% recommended investing in 1-5 schemes
- 82% said NFO at Rs 10 is not cheaper
- 91% of the distributors were of the view that the investment in a sectoral fund is riskier
- ALL distributors said that SIP are a better option
- 92% did not push for needless redemption

What next

- A move to a fiduciary standard
- MFs still churned to an extent by banks
- Need the final piece of making the seller accountable for what he sells
- And the market is better prepared for this with cleaner products and incentives that are aligned

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