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BACK TO BASICS

Post-Ulip reforms, life insurers peddle vanilla products, but consumers find them wanting

Ravi Nair wanted to secure his child's future and thought an ideal way to do so would be to buy an insurance policy. He bought a moneyback policy of Rs 10 lakh from a leading private life insurer. Little does he know that the moneyback policy which is a regular premium payment participating plan would not even return the premium he would invest for 19 years! The plan has a negative internal rate of return (IRR) of 1.2 per cent or -1.2 per cent. Today, the IRR of most traditional insurance policies range from 1 to 5.5 per cent, forcing us to question their purpose as a means for achieving one's financial goals.

Says Pankaaj Maalde, a certified financial planner, "Insurance should not be seen as an investment avenue but should be bought for protection. You should buy a pure term insurance plan that is at least 12-15 times your annual income and invest the remaining surplus in other avenues such as public provident fund (PPF) and mutual funds, which would give much higher returns."

In a bouquet of financial saving instruments, PPF has been offering tax-free returns of 8.7 per cent. Similarly, tax-free bonds offer 8-9.01 per cent tax-free returns. Gold, silver, real estate and equities have given much higher returns when compared to insurance.

It is very likely that your insurance agent these days would advise you to buy a traditional policy (moneyback policies, endowment plans, whole life plans) than recommend a unit linked insurance plan (Ulip).

After the Insurance Regulatory and Development Authority (Irda) revamped Ulips in 2010, bringing down charges and agent commissions, the life insurance industry has shifted to selling traditional insurance policies, bulk of which are participating policies. A participating policy is one which participates in an insurance company's profits by way of simple reversionary bonuses.

While the regulator has also revised, the norms for traditional plans in February 2013 such that all the products launched from January 2014 conform to the new rules, a lot more is required.

As per the revised norms for traditional products, the death cover has been increased, commissions have been linked to the tenure of the policy and surrender penalties have been reduced in products which were helping life insurers report better profits in the last many years.

As a result, the life insurance industry has shifted to selling traditional plans. The reasons for insurers shifting to participating plans are plenty — traditional policies offer high profit margins for insurance companies and offer up to 40 per cent commission in the first year to an agent. While in a Ulip policy, you know the amount of premium that has been deducted by the insurer as charges, you cannot do so in a traditional plan as they are opaque in terms of charges, and put the lapse risk on the consumer.

Also, in a traditional policy, if a policyholder does not pay his premium within the grace period, his policy can lapse. The insurer can usurp the premium which would help it shore up its lapsed profit. A participating plan also entitles the promoters to share a part in the profits. According to the insurance norms, if the first annualised premium is not paid in full then the policy lapses at the end of the grace period. In such a scenario, the insurance cover ceases immediately and no benefits are paid. However, if a policyholder pays two full years' premium and if the policy payment term is less than 10 years, the policy will acquire a surrender value. If the premium payment term of a policy is 10 years or more, the policy will acquire a surrender value after payment of three full years' premium.

According to a Goldman Sachs report, six big insurers profited by Rs 3,189 crore from lapsed policies in just two years: 2010-11 and 2011-12.

Since the Ulip regulations of 2010, of the total insurance sales that happen, more than 80 per cent constitute traditional plans while prior to the Ulip regulations, more than 80 per cent of the total sales constituted Ulips.

J Hari Narayan former chairman, Irda feels that this is the best time to usher in the next set of reforms for traditional insurance policies. He prescribes the concept of reduction in yield instead of making any changes to the product structure which, according to him, could kill innovation.

"In traditional insurance policies, the yield is arrived at by compounding the rate of interest on every premium paid. The rate of interest varies between 4 and 6 per cent. From this (yield) amount, the insurer deducts expense charges and risk charge. Since the deduction in charges is done year after year, the returns become positive only towards later years. So, there could be a cap on the maximum reduction in yield," said Hari Narayan.

Narayan during his term as Irda chairman is credited for revamping Ulips. At that time, insurers were selling Ulips in the guise of investment plans. Another category of Ulips called Ulip pension plans were sold with minimal insurance cover. Ulips then, had exorbitant charges including premium allocation charge where 40-70 per cent of the premium would get deduced. Besides there were numerous other charges such as policy administration charges, fund management charges, charges for switching between funds, miscellaneous charges such that the break even for customer would not be before 8-10 years. While the insurers shored up their profits made from the charges.

The Ulip regulations in 2010 capped the charges for insurance companies, thereby ensuring better returns for customers. Today a Ulip fares better in term of charges than a mutual fund. While the fund management charge in a mutual fund could be 2.25 per cent, in case of a Ulip plan it is capped at 1.35 per cent.

Says an executive director of a private life insurance company, “Now you cannot mis-sell a Ulip policy. From a customer proposition, Ulips are very good, give superior returns and the biggest benefit is that you don’t lose money from lapsation.”

According to financial planner Maalde, the regulator should make it mandatory for insurers to mention upfront the charges in the traditional policy being sold, lower agent fees and surrender penalties.

“When we were thinking of reforming Ulips, we had thought of giving design guidelines. But if you give design guidelines, you kill innovation. As a result, you would only see one type of product. Therefore we decided to bring in the concept of reduction in yield,” said Hari Narayan.

In case of Ulips, if a person has bought a policy before September 1, 2010 then he can go back to the insurance company, ask for surrendering the policy and the company, based on the current NAV minus the surrender charges, will refund the money. In case the policy has been bought after September 1, 2010 then there is a minimum lock-in period of five years. So, one can stop making the premium payment and even if one has made just one premium payment, then he does not have to make a payment for five years. The money gets transferred into the policy discontinuation fund and the insurance company is entitled to deduct maximum Rs 6,000 from that fund. The balance amount will remain in the policy discontinuation fund and be given at the end of five years, which is a minimum lock-in period. In the interim period, one gets an interest at the rate of a savings bank account, that is, 4 per cent.

“If a cap on the reduction in yield is stipulated, India would be the only country to do this. We would set a precedent. Now that the life insurance industry has adjusted to the product regulations, this is the right time to bring in the reforms for traditional products,” said Narayan.

Karni Singh Arha, chief financial officer, India First Life Insurance said, “Given the economic environment of past one year, if you do a 10 year IRR for both Ulips and traditional products, the returns would more or less be the same between the two products. Ulips might be marginally higher, but this could be equalled or even surpassed if the traditional product allots any terminal bonus to the customer. Thus stating that the customer mostly loses in a traditional product is untrue, in fact he makes steady consistent returns during the policy tenure.”

“If you calculate the returns of a traditional policy against real value of money (after taking into account the inflation rate) the returns are always negative but you get the risk cover,” says Narayan.

According to insurance laws, 90 per cent of the profit made from a participating traditional policy has to be distributed among policyholders as annual or terminal bonus while the remaining 10 per cent of the surplus is transferred to shareholders.

However, Narayan feels the promoters’ share in profits is low in India. “The investment returns are shared 90:10 as between policyholder and shareholder in India. In Canada it is 70:30 while generally in the world it is 80:20. To give meaningful guarantees, one needs a huge capital base. With 90:10 formula, no shareholder will commit this capital. In western Europe a certain portion of policyholders’ reserve is treated as capital. This helps the industry in giving meaningful guarantee. In a way it works for both, i.e., policyholders and shareholders,” remarks Narayan.

Arha of India First Life Insurance refutes the charges. “Due to regulated charges in Ulips, the insurer usually loses money in the first five years but recovers it in the second five years. Similarly, in a traditional policy the insurer needs to amortise the premium basis the sum assured plus any bonus provisions. Additionally, with guaranteed element in traditional products there is always the risk of weak investment performance further increasing the risk for insurer. Thus, stating that the insurer always gains from traditional product is also untrue," said Arha.

"In a Ulip, the investment risk is born by customers, and when equity markets fall, the customer may possibly get a negative or low IRR. Customers normally question the returns on the full premium paid and not the premium minus the allocation charges. So if the premium is Rs 2,000, and Rs 200 has been deducted as allocation charges then the customer expects high IRR on Rs 2,000 and not on Rs 1,800. However, in a traditional product, the customer is ensured a steady consistent return during the entire tenure of the policy," said Arha.

Reduce surrender penalties on traditional plans: Kapil Mehta, managing director at SecureNow Insurance Brokers, says the primary focus in traditional products should be to reduce surrender penalties as existing surrender penalties are still high.

The impact of reducing surrender charges will be to improve the overall returns delivered to customers. Customers need a simple exit if they realise what they bought was not what they need.

"The regulator should encourage a much higher amount of death cover — at least 20-25 times the premium paid. One idea to consider is to allow higher compensation for agents if death cover is increased. However, this must go hand-in-hand with lower surrender charges so customers always have an exit option," added Mehta.

Reduce agent commissions: "In traditional products, commissions are higher compared to Ulips. This causes distributors to concentrate more on the first year sales and not on renewals. It creates a churning opportunity as once a policy lapses, the agent could advise the customer to buy another new policy," says Arha.

"In a traditional policy, the first year expense margin can be high. However, this reduces dramatically in later years to amortise the sum assured payout at tenure completion. There is a possibility to smoothen the expense margins evenly for everyone's benefit. If the objective is to control mis-selling, one could look into evenly smoothening the expense margins, thereby adjusting commissions," he suggests.

According to Shivdutt Das, vice-president and head (products) at Tata AIA Life Insurance, companies are promoting participating plans as the interest rate risk is limited for insurers. "Interest rates are expected to fall in the future in developing economies. So, if a non-participating plan is committing an interest rate of 4.5–5 per cent, the insurer is taking an interest rate risk. In participating plans, the policyholder invests with the insurer where a bonus is given depending on the performance of the portfolio," said Das.

Ulip commissions have dropped with new regulations and are around 3-6 per cent in the first year, and around 1-2 per cent on renewals. In a traditional policy, an agent earns commissions for 15 years, hence his income is protected.

Das feels that India too should look at the advisory model which is practised globally. In an advisory model, an agent does the financial need analysis before suggesting an insurance plan to a customer and in return charges a service fee for advising their customers. Countries like Singapore have got organised and follow a regulated sales process, where the financial need analysis is detailed in a 24-page format.

"Much more improved customer service standards is what we are expecting in near future. Some will happen due to regulations and also because of improving customer awareness. While commission rates have dropped and we have seen decline in number of agents, this still remains an exciting earning opportunity where the current set of agents are using technology and transparent product proposition to sell more and earn more," said Das