

HARD LOOK

Taking the trick and trap out of insurance

The Somit Bose committee report suggests many changes that make insurance customer-friendly

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Most Money has always advised you to avoid traditional insurance policies that double up as investment products. This is primarily because of three reasons: high commission structures and poor investment returns from these policies, but if recommendations of the Somit Bose committee are implemented, most of these shortcomings will be addressed and you will have a product that you can understand, compare and contrast.

The committee, chaired by the former Union finance secretary, Bose, was set up to identify why financial products are misused and offer solutions.

The report severely criticises distributors' incentives as a root cause for misusing as products with a fat commission structure—such as insurance—get sold more. The report suggests that all financial products with the same function should have the same incentives so that the distributor becomes commission neutral. "It's the differential commission structure in financial products that leads to mis-selling. The recommendations rightly address the problem by asking to rationalise commissions according to the function of the product. However, one must be careful while deciding the incentives for long-term products because more than that you are not push products," said Hrishabh Mishra, chief executive officer and whole time director, IRII Federal Life Insurance Co. Ltd. "The report also rightly recommends that products should be regulated according to their function and not form," he adds.

In this insurance committee as well as product structure led to mis-selling. Roffly structured products and disclosures that obscure larger clear understanding. The report recommends greater transparency in product contracts by segregating insurance and investment components. It also recommends developing suitable benchmarks for the investment component but before going further into the recommendations, let's look at the basic structure of popular insurance plans.

Types of insurance
There are broadly two types of insurance policies, traditional

HOW TRADITIONAL PLANS MAY CHANGE

For unit-linked plans, the changes may be incremental. But for traditional plans, implementing the Somit Bose committee's suggestions will mean a big shift, here's how



	What your product looks like at present	What your product could change into
Costs	Charges you don't know what the costs are	Insurance and investment costs will be disclosed. The latter will be capped
Disclosures	Net return on paid investments not disclosed	Net return to be disclosed against for guaranteed products and as an ongoing basis for non-guaranteed plans. Agent will show you historical performance of non-guaranteed products
Commissions	Front loaded	Front loaded commissions are generally not paid or deferred for investment component
Pre-mortgage exit cost	20% of premium for at least 10 years are not paid	Reasonably lower and comparable to unit-linked plan, which charge a maximum of 15,000
Free benefits	Difficult to understand investment advice, freedom of guarantees and tax saving on the main sheet	Transparency and full disclosure for both in understanding benefits and making comparable

and unit-linked insurance plans (ULIPs). ULIPs are unguaranteed, market-linked products that invest your money (the premium) in funds of your choice and bundle this with an insurance cover. They are popularly explained as mutual funds wrapped with a cover of insurance. In ULIPs, the costs are visible and can be divided into four heads. The first is premium allocation charge, which is a straight deduction from the premium before any money goes to work for either insurance or investment. Balance is then invested in the funds of your choice and from the fund value the policy deducts a mortality charge, cost of life insurance, fund management charge (charge ranged at 1.5% of fund value) and policy administration charge. These are further capped by a maximum reduction in yield. In a ULIP with a policy term of more than 10 years, you'll have costs that drag the net yield on money down by more than 5.2%.

The other category, and also the one popular category, is the equity-linked insurance product that you also have as traditional insurance plans. Both costs and investments are not stable. This category can be further split into participating and non-participating plans.

Participating plans guarantee a certain dividend amount, typically, the sum assured, and premium payable addition, which means all necessary business. These bonuses, once declared, become guaranteed to be paid either on death of policyholder or on maturity of policy. The cumulative amounts not using the term 'bonus' since these are investment benefits and not paid out there 'net return'. The premiums go in the

participating fund, which is a common pool for all the participating plans of the insurer. The bonuses come from the surplus generated by the fund after all costs are factored in. The insurer is free to exercise its discretion while declaring the surplus. The sum declared, the policyholder is entitled to get 90% of the surplus, whereas the shareholders can keep up to 10%.

This is the process, but what is visible to you is the bonus, which is announced as a percentage of the sum assured, that accrues over time.

In non-participating plans, returns are guaranteed. This means what you get on maturity is declared upfront. These are products that split out the benefits right at the time of buying the policy. But the problem is that these policies restrict the benefits to absolute terms—you get 3.5 for 10 years and the policy will pay 7 on maturity. Or they mention it as a percentage of sum, the sum assured—say policies for 10 years and the policy will pay 6% of the sum assured for the next 10 years. The rate of return is not disclosed—say pay 3 and the policy will pay 7 after 10 years and this is a sum terms of 2%. The knowing the net return makes it difficult for a layperson to understand but terms on investment, and compare across products.

Recommendations
Product structure The report recommends simplifying product structures by splitting the premium into mortality and investment.

Accordingly, costs should also be bifurcated into mortality cost and investment cost. On ULIPs, this is done to implement as the

costs are visible, but for traditional plans, this may translate into a big actuarial exercise. "Features can be segregated into investment and costs. When insurers price the product, they look at individual components, but to incorporate that into the product structure will be a huge exercise as the entire product 'communications' will change. Companies with significant traditional products are likely to resist," said Kapil Mishra, associate director, SunamLife Insurance Broker Pvt. Ltd.

Further, the committee recommends that the costs of the investment component should be comparable to other similar products in the market. "Investment costs should be capped keeping in view the best practice in the rest of the market. For example, for non-participating plans, costs should be benchmarked by best practices in banking or other asset savings products that invest in similar returns. For participating plans, costs should be benchmarked to similar asset allocation products in the mutual fund space or the NPS (National Pension System)," suggested the report.

Insurers may not want to be benchmarked. "In a bank, the business model is based on net interest margin (NIM), CASA (current accounts and savings accounts) deposits, fixed funds, retail deposits and a whole lot of other parameters. The fixed deposit interest rate is not based on the earnings in the debt or equity market," said a senior executive of a private insurance company who did not wish to be named. "For mutual funds, returns are largely driven by discretionary fund management,

which is an extended arm of treasury. Retail engagement is small," the executive adds.

Disclosures The committee also emphasised on disclosures, particularly for traditional plans. An important recommendation was that insurance products need to disclose the net return as a product to the customer. For non-participating plans, which guarantee benefits, this is very important. Even as a large section of the industry maintains that these are goal-oriented products and should be seen as a product with guaranteed benefits in full long-term goals, it remains important to disclose the rate of return.

Doing so allows the customer to compare or reconsider selling for a long-term guaranteed product. Most of these plans return around 4% return while debt products that offer higher returns. Even in participating plans, disclosing the net return is very important. The variable addition, also known as bonus, as mentioned as a percentage of the sum assured and further described in terms of years. But this doesn't explain the process for the customer because it doesn't disclose all the these things to one place amount instead, amount accumulated and net return.

The recommendations suggest that the product should not only disclose the internal rate of return on an ongoing basis but also historical performance. This is important given that most people in the industry put the actual returns from these participating funds at 5-6%.

Investments In terms of distribution incentives, the committee has made two major recommendations. Inform the commission according to function

and make it similar to premium with similar function. It suggests that upfront commissions should be allowed for the mortality part of the premium, but not for the investment part.

The report recommends level or declining trail commissions. In the case of guaranteed products, it should be a percentage of the premium, and in participating traditional plans and ULIPs, commission should be a percentage of assets under management (as an NPS trail fee).

Insurers hold a different view. "The industry is cognizant of the fact that insurance products have been misused and it now taking significant steps in distribution training. The industry is aware that there is a direct correlation between right sale and premium, which, in turn, is important for profitability and solvency," said Sandeep Ghosh, managing director and chief executive officer, Bharat AXA Life Insurance Co. Ltd. "And there have been many regulatory changes. The Insurance Law (Amendment) Act, 2015, also increases the penalties significantly. But one must acknowledge that insurance is a high product and needs adequate incentive to be sold," he adds.

Some say that even benchmarking cover or returns to other products such as in banking is not appropriate.

"It is difficult to state that all insurance products should be benchmarked when they are different in structure and are used for different purposes, short-term, medium-term and long-term," said H.M. Vaidya, managing director and chief executive officer, IndiaFirst Life Insurance Co. Ltd. "There are aspects such as cost of guarantee and delivery margin that are specifically applicable to insurance products. Each product has its own merits and demerits, and it is unfair to compare customer segments. It's not possible to benchmark one against the other," she adds.

The other point that may pose an operational challenge is that regulators. "The broad principles of the report are in the right direction but if two regulators are going to have a view on the same product, it's going to pose a huge operational challenge for the industry," said Mishra. "The focus should be more on leveling commissions, controlling costs and making products transparent," he adds.

While the recommendations of the committee may pose challenges, they will also make insurance policies more customer-friendly and put pressure on the industry. You can read the full report here: <http://bit.ly/1W5W5M5>

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