

Do we trust our banks?

Monika Halan

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Globally banks are under fire

- Post 2008, the role of banks in the crises has made the average citizen mis-trust banks
- The bonus and profit-at-any-cost version of capitalism has cost banks their reputation
- Post crisis inability of the US regulators and government to curb banks' behaviour has added to the perception problem

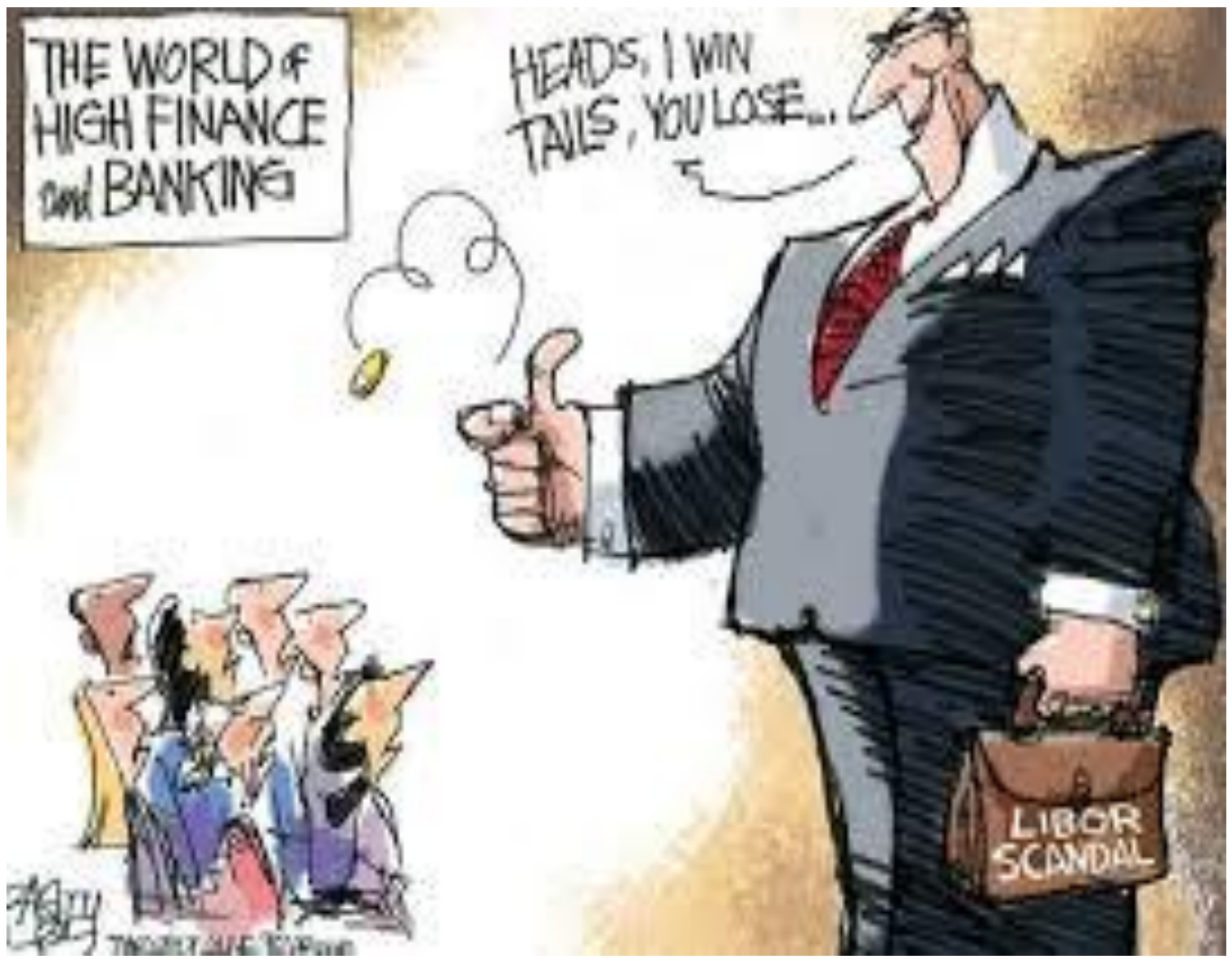
THE WORLD OF
HIGH FINANCE
and BANKING

HEADS, I WIN
TAILS, YOU LOSE...



LIBOR
SCANDAL


AGONY
THOMAS M. COOPER





RELAX. WE'RE
TOO BIG TO FAIL.

BOB BY WOODRUFF, 2003
TIMOTHY BALL, USA



**"THIS IS THE BANKING INDUSTRY'S
TOBACCO MOMENT.
IT'S THAT BIG."**

CEO OF A MULTINATIONAL BANK

The Economist

Indians trust banks or is it financial repression?

- India and China, both use low cost deposit money to fund the government
- The unwillingness to open up the market has made banks the only viable way to keep money safe
- The lack of regulatory clarity and road map has stopped money from flowing into alternate vehicles – funds and markets

What makes the money stay with banks?

- An unsafe regulatory regime with very tiny pay offs for violation of the rules
- Buyer beware system
- Disclose and financial literacy model
- No one to hand-hold the investor from zero risk to taking controlled risk

Regulatory confusion

- Indian financial sector regulators been behind the curve
- Worse, they've fought over turf
- Development role over consumer protection
- No clear direction on how consumer protection be carried out
- Regulators are not clear as to what kind of system we follow

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

Ulips: a case study

- Text book case of poor product structure, misaligned incentives and no fiduciary responsibility of sellers
- Recent examples of how poor product structures and skewed incentives caused a multi-trillion rupee loss to Indian investors
- Total retail investor loss estimated at more than Rs 1.5 trillion over the past 7 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

Pre-2010 Ulip

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

Rs 1.5 trillion

Rs 1,500,000,000,000

of loss over 2005-2012 in lapsed policies

Lapsed policies are those that die in year 1 and 2 of their lives. Money went to profits of insurance companies and the sellers – banks and agents

Poor product structure - 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

Mis-aligned incentives

- 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

Misaligned incentives

- 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

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% (26)	↑ 33	Shriram	15% (24)	↓ -26
ICICI Prudential	46% (27)	↓ -35	ING Vysya	14% (78)	↓ -5
Tata AIG	33% (34)	↓ -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% (4)	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 separate table for term policies written by the insurer during the year. Excludes the average (dead) policies in force for the reporting period from last year. **Percentages of new policies as a percentage of the total in your portfolio. To learn more, visit www.investor.gov.

Source: IFA 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.

EquityInvestment.com

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

Ulip story 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

How incentives drive producers

- Industry moved to selling traditional plans
- Had high costs and were opaque
- Banks are now selling traditional plans instead of Ulips

	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)		

The result of the Ulip scam

- Investors have lost faith
- Loss of faith in markets
- In banks as salesmen of financial products
- Rush of money into gold and real estate
- Investors have got burnt badly and the effects of this we'll have to bear for years to come

Would you trust a bank today?

- Would you say it is safe for your family to buy financial products from banks today?
- What financial products do you own?
- Most life insurance CEOs and senior staff have term life covers, but they sold Ulips
- What financial products do bankers have?

Trust is decaying at the core

- Large scale mis-selling of third party products
- Selling insurance to retired people
- Fraud in Ulip sales in branches
- Churning of mutual funds by wealth management cells
- Selling of art funds and other collective investment schemes
- Pushing rotten PMS schemes

Cobrapost and trust

- Cobrapost investigation raises questions about a systemic problem with Indian banks
- Banking is in denial
- Front line staff is being fired
- The problem of mis-selling is systemic
- Money laundering is yet to be proved, but the use of life insurance and gold cannot be ruled out in such sales

How did we get here?

- Banks used to be boring
- Banking used to be 3-6-3
- Universal banking
- From being simple collectors of deposit money, banks have become sellers of financial products
- The race to get ahead has thrown off prudential norms and it is a profit at any cost regime

Why financial products are different

- Invisible
- Description of the product defines it
- Seller knows more than the buyer
- Moment of truth is far away
- Financial products sales need a fiduciary
- At the minimum you need 'suitability' as a base level of regulatory hygiene

What is suitability

- Selling insurance to a 70 year old is like forcing a diabetic to eat sugar
- Matching a financial product to the financial need of the customer
- Financial products are not bad in their own right
- But the wrong financial product can kill

Role of a fiduciary

- One who looks after the customers' interest
- Australia – financial planning regulation
- UK – all financial products are now no-load
- Big ticket payouts by banks mis-selling insurance and other products have happened
- Most markets have strict rules around suitability

How should you treat customers?

- The way that you would like to be treated as a customer
- By looking after long term financial needs
- By helping them solve financial problems
- By recommending products that work for them

Why can't you do that today?

- Performance pressure
- Targets
- Incentives
- Senior management push without accountability
- The system of profit-at-any-cost is turning the average banker into sales practices that are bordering on criminal

Where does it go?

- Reform is coming
- PILs are coming
- RBI and MoF is tightening the structure around how banks behave with third party products
- The FSLRC's Indian Financial Code puts consumer protection at the heart of financial law

What could it look like?

- Banks are the most trusted retail sales point for both over the counter and advised retail financial products
- What happened in telecom can happen with banks
- We need a bank with the vision to roll this out
- Possibly the new banks when they come will provide the edge

Average bank customer feels like this



Should we trust banks today?

Monika Halan

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