



Report of the Committee
to recommend measures for curbing
mis-selling and rationalising distribution
incentives in financial products

Ministry of Finance
Government of India

August 2015

F.No.1/13/SM/2014
Government of India
Ministry of Finance
Department of Economic Affairs
Financial Market Division
Secondary Market Section

North Block, New Delhi
Dated the 20th November 2014

ORDER

At present various financial investment products have varying incentive structure regulated by different financial sector regulators. There is a plethora of incentives / charges cap imposed by different regulators across financial products making the incentive structure skewed. The Government has, therefore, decided to set up a Committee to go into this question in detail. The composition of the Committee is given below:

- | | | |
|------|---|-------------------|
| i | Shri. Sumit Bose
Former Union Finance Secretary | - Chairman |
| ii | Shri. S. B. Mathur
Chairman, NSE & former Chairman, LIC | - Member |
| iii | Shri. Manoj Joshi
Joint Secretary (FM), DEA | - Member |
| iv | Shri. Partha Ray
Professor (Economics Group), IIM-Calcutta | - Member |
| v | Ms. Monika Halan
Editor, Mint Money | - Member |
| vi | Ms. Manju Puri
Research Adviser, CAFRAL | - Member |
| vii | Shri. S. Vishvanathan
Retd. MD of SBI and SBI Capital Markets | - Member |
| viii | Shri. Prithvi Haldea
Chairman, PRIME database | - Member |
| ix | Shri. Anupam Mishra
Director (Secondary Markets) | - Member Convener |

2. The terms of reference for the Committee are as follows:

- a) The Committee would study the prevailing incentive structure among various financial investment products taking into account the historical evolution of such

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structure in India and globally and also the differential nature of the product itself.

b) The Committee would suggest policy measures such that differential regulatory norms do not favour any particular financial product and prevent mis-selling. The study would also address issues with respect to hidden costs and identical financial products under different regulatory jurisdiction.

c) Suggest measures to rationalize the incentive structure across financial products.


3. The Committee may co-opt other Experts in the relevant fields as may be necessary.

4. The NIPFP-DEA programme team will be the secretariat for the Committee and all expenses related to the Committee's activities will be met from the budget of the NIPFP-DEA programme supplemented as and when necessary.

5. The Committee would meet as frequently as necessary for fulfillment of its objectives. The Committee would also meet with concerned regulators, if required, before finalizing the report.

6. The committee will prepare and submit a report in **three** months' time containing recommendations to address the issue of providing level playing field in the commission / incentive structure of financial products.

7. This issues with the approval of the Finance Minister.


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Acknowledgement

In the world of retail finance, most advisors provide financial advice and sell financial products. Financial advisors don't charge the consumers for advice. They make their money from sale of financial products. This could place the advisors at a conflict and the consumers at a disadvantage. This situation gets aggravated as norms applicable to similar products, including those related to sales incentives vary due to them being covered by different regulators. The remit of the Committee was essentially to suggest measures to raise the balance in favour of the consumer.

This daunting mandate became less challenging as the Committee comprised of renowned members with decades of relevant industry experience and knowledge of financial investment products. I am extremely grateful to the Committee Members for having put in so much of their time and effort in the deliberations and the drafting of the report.

The Committee felt it imperative to consult a cross section of industry and consumer practitioners as part of the work process. It acknowledges the intellectual and practical insights provided by representatives from Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority of India (IRDAI), Pension Fund Regulatory and Development Authority (PFRDA) and practitioners in life insurance and mutual fund industry. The Committee benefited immensely from its interactions with various industry bodies of financial intermediaries including the Association of Mutual Funds of India (AMFI) and Financial Intermediaries Association of India (FIAI).

The Committee is grateful to all of them who accepted our invite and frankly shared their views. The full list of consultations is annexed to this Report. Special mention is made for Sanjeev Pujari, SBI Life Insurance, for providing innumerable clarifications on insurance related aspects.

Vidhi Centre for Legal Policy provided valuable inputs on regulations and judicial precedents on mis-selling of financial products in India.

The Committee acknowledges with great satisfaction the interactions with the team at

the ministry of finance comprising Manoj Joshi, Anupam Mishra and Abinash Dash.

Last but not the least, the Committee would like to thank the team of Consultants at the National Institute of Public Finance and Policy comprising Ashish Aggarwal, Sanhita Sapatnekar and Rachna Sharma, and Renuka Sane at the Indian Statistical Institute, Delhi, for research support.

New Delhi
7 August 2015

Sumit Bose

Executive summary

Background

Regulating the financial sector is a tightrope walk in any jurisdiction, but more so in a country like India. On one hand, loose regulations can result in fraud or mis-selling as firms use regulatory arbitrage and a soft regulatory regime to maximise their profits at the cost of investor. On the other hand, a very tight regulatory regime has the potential to stifle innovation, and consequently the deepening of financial markets in the economy.

One of the big challenges in the Indian context has been the weaning of the household from real assets such as gold and real estate, both of which are used as insurance and investment vehicles, towards formal sector finance. In the pre liberalisation era, with an absence of a large middle class and a state run economy, the two state monopolies, the **Life Insurance Corporation of India (LIC)** and the **Unit Trust of India (UTI)**, were perhaps sufficient to provide the Indian household a safe vehicle to channelise savings into investments. Relatively low rates of return, as long as they were safe, were acceptable to the household in the nascent stage of the Indian financial market. The role of regulation was limited since the government was the vendor. As a consequence, there was little focus on evaluating sales incentives, product structures and disclosures. However, over the decades as the market grew both in terms of demand for and supply of financial products, there was a need for changing the rules of the game.

Two other factors led to the need to bring about a change in the way the financial system was managed. The opening up of the market to private players meant that there was need for a set of rules by which the private and state firms could do their business. Also, market linked products needed a different mindset than a public monopoly mindset where the government decided every economic variable in the system - not just interest rates but even the price at which an **Initial Public Offering (IPO)** could come to the market.

The need for a change in rules is obvious when one considers the evolution of the

financial system from *hundis* to a modern stock exchange.¹ While verbal and personal relationships were adequate to run an efficient system of *hundis*, these obviously did not work for stock exchanges.

Modernisation of the stock markets have often followed large scams. The modernisation of the Indian mutual fund industry came in the wake of the **UTI** crisis and the imploding of the US 64 pool. Several lessons have since been learnt in terms of what attributes a modern financial product should have and what regulation should and should not do.

Modern financial products should be such that costs and benefits are clearly visible to the buyer. Costs should sit in one place under a common head and that cost head must have a regulatory cap. Within that cap, the firms should be free to manage costs and profits. The buyer should be able to clearly understand the contract. Market linked products should declare a benchmark that must reflect the investment mandate of the product. Market linked products must be portable to allow investors to move from less efficient fund managers to more efficient ones. Incentive structures should be such that the problem of asymmetric information is solved. Once these ground rules are in place, the regulator should be able to catch the errant driver jumping the red signal.

Consumer protection in finance has taken centre stage post the 2008 global financial crisis - which was essentially a mis-selling episode at a massive scale. Unsuitable loans were sold to consumers and the assets on the books of the mortgage companies and banks were further resold to institutions. When consumers defaulted, the entire system collapsed. In India too, we have witnessed mis-selling across various financial products.

Household finance is now a rapidly growing academic discipline. The overwhelming evidence from household finance points towards agents maximising their own income at the cost of selling unsuitable financial products to households. It is well documented that non-transparent product structures encourage mis-selling by agents and advisors. Corroborating this work are the learnings from a new field of economics - Behavioral Economics - which prove that an average human being is not predisposed to taking rational decisions in finance, with emotions, anchoring and loss aversion driving investor behaviour. There is increasing evidence to show that a move to a seller-beware market is the road ahead in financial regulation. The proposed **Indian Financial Code (IFC)** that is in various stages of implementation, too envisages a seller beware market.

In the current stage of the Indian market, seller beware would perhaps have very high regulatory costs that might slow down the pace of the deepening and widening of the financialisation of the Indian economy. One way to reduce the regulatory cost is to reduce the potential of mis-selling by ensuring clean product structures, clear benchmarks and by aligning incentives of the manufacturer, seller and buyer to the outcomes that households derive from the purchase of the financial product.

An additional problem in the Indian market is the multiplicity of financial sector regulators with overlapping products and regulatory cracks. Overlapping products between regulators causes firms to gravitate towards markets with relatively weaker regulatory

¹Technically, a Hundi is an unconditional order in writing made by a person directing another to pay a certain sum of money to a person named in the order. For more details, see: http://web.archive.org/web/20131126010531/http://rbi.org.in/scripts/ms_hundies.aspx

oversight and poorer standards on consumer protection.

The IFC envisages a two regulator structure – with the Reserve Bank of India (RBI) and the Financial Authority (FA). A pre-requisite for a unified financial sector regulator would be the removal of arbitrage in product structures, costs and incentives across products in the system. Not only will this remove the skew in the market, but would also prepare the ground for better consumer protection through the proposed Financial Redress Agency (FRA). The report of this Committee needs to be seen in the larger context of a deep change in the Indian financial sector regulation to get it ready for the job of taking India from a \$2 trillion economy to a \$20 trillion one in the coming decades.

Mandate

Given this background, the mandate of the Committee, as laid out in the terms of reference, was to study the prevailing incentive structure among various financial investment products taking into account the historical evolution of such a structure in India and globally and also the differential nature of the product itself with a view to

- M1** Address the issue of providing level playing field in the commission / incentive structure of financial products;
- M2** Suggest policy measures such that differential regulatory norms do not favour any particular financial product and prevent mis-selling;
- M3** Address issues with respect to hidden costs and identical financial products under different regulatory jurisdiction; and
- M4** Rationalise the incentive structure across financial products.

Work process of the committee

The Committee held twelve meetings between December 2014 and July 2015 and Dr. Manju Puri attended the meetings through skype. In its very first meeting, the Committee decided to limit its focus to examine financial products where the degree of responsibility with which such products are sold to the retail consumer was a matter of concern. These products were generally those (i) which did not offer assured returns and/ or (ii) had high and more importantly, non transparent cost structures. These are, what are called, push products.

This narrowed down the focus to insurance, mutual fund and pension products. As a corollary, products like bank deposits, public provident fund, post office small savings got excluded from the review. The reason for excluding them was not only that they were essentially pull products but also that returns on these products were relatively predictable. More importantly these products did not have opaque, high or misaligned cost structures.

The Committee studied the current scenario of the retail financial sector in detail. It drew on international experience, as well as the Financial Sector Legislative Reforms

Commissions (FSLRC) recommendations on consumer protection, financial regulatory architecture, financial inclusion and market development. It also reviewed the approach taken by the **Financial Stability and Development Council (FSDC)** to implement **FSLRC**'s principles relating to regulatory governance, transparency and improved operational efficiency that do not require legislative action.

The Committee followed a consultative approach by hearing the concerns of the stakeholders in the retail financial sector, including regulators, product providers, distributors, and actuaries. The complete list is provided in Annexure F. These guided the formulation of the recommendations.

Broad recommendations

Financial sector reform is an ongoing process. It must be remembered that due to historical reasons, certain products in the industry may have lagged behind the reforms that other parts of the market have embraced. Given this, certain product categories have a larger focus in the eyes of the Committee so that they are brought to par with the rest of the market. The endeavour of the Committee is to ensure that there are no dark patches in the industry or product category that lead to mis-selling and investor anguish resulting in loss of trust in the financial sector.

The Committee believes that consumer interests will be served by more transparent disclosures that enable consumers to understand products, compare them, and consequently choose those that serve their interests.

It is commonly recognised that tax breaks and assured returns work as pull strategies. This can be seen from the pull towards taxable bank deposits. What is perhaps not commonly recognised is that presence of assured returns and/or tax breaks can in fact, make the product more susceptible to irresponsible sales where the products also have opaque or mis aligned cost structures as well as opaque benefits, as can be seen in some traditional insurance products.

The recommendations of the Committee are in two parts (described in detail in Section 6). The first part, outlines the broad principles that should be applicable to any retail financial product. These are sub-divided into recommendations on product structure, costs and commissions and disclosures, followed by generic recommendations. Part two deals with recommendations for specific products. The Committee suggests that the regulators frame a time-bound road map to implement the recommendations.

The spirit behind the recommendations is the idea that customers must be treated fairly. Firms must understand the spirit behind the recommendations in order to implement these in a holistic manner. The summary of recommendations is as follows:

1. Regulation of financial products must be seen in terms of the product function and not form. These functions (for the purpose of this committee) are: Insurance, Investment and Annuity.
2. The lead regulator, according to function, should fix the rules of the game. In bundled products, the lead regulator for the function of the sub-part must fix rules

of the game.

3. Investment products and investment components of bundled products should have no upfront commissions.
4. All investment products, and investment portions of bundled products, should move to an **Assets Under Management (AUM)** based trail model.
5. Upfront commissions on pure insurance products and pure risk portions of bundled products should be allowed, and should be decided by the lead regulator since pure risk is a difficult product to sell.
6. Financial products should have flexible exit options. The cost of exit must be limited. The current rules as decided by **Securities and Exchange Board of India (SEBI)** for mutual funds and **Insurance Regulatory and Development Authority of India (IRDAI)** for **Unit Linked Insurance Plans (ULIP)**s are robust. The same principles should govern surrender and lapse costs in traditional plans, and form the basis for future products as they are innovated by the industry.
7. The costs of surrender for each product should be reasonable. After deduction of costs, the remaining money should belong to the exiting investors.
8. Lapsation profits, or profits from exit charges, if any, should not accrue or be booked by product providers.
9. At the point of sale, returns should be clearly disclosed and should be a function of the amount invested. Returns in bundled products should be shown on the invested amount.
10. At the point of sale a one page disclosure form that both the customer and the seller sign off on should be included. The disclosures should be in a manner that an average customer can understand what the product costs, what the benefits are and for how long should the customer hold the product.
11. On-going disclosure should show historical returns as an average annual number based on the **Internal Rate of Return (IRR)** of the product. The norms of this disclosure for investment products should follow the rules set by the lead regulator.
12. Machine readable disclosures enable creation of web-based tools and mobile apps that help consumers make smarter choices in the marketplace and as such all disclosures should be machine readable. Machine readable does not mean soft copy. Machine readable is when data can be processed by a computer for further analysis and interpretation. **Comma Separated Values (CSV)** is a basic example of machine readable.
13. For similar products, there should be a similar structure with regard to service tax, stamp duty and rural and social sector norms.
14. Similar products should have a similar free look-in period.
15. Regulators should create a common distributor (including employees of corporate agents) regulation. Each regulator may add rules specific to products regulated by them.
16. Regulators should create a single registry of all distributors. Anybody facing the customer should be registered. The registry should identify each individual distributor with a unique number. The registry should have the past history of regulator actions and awards for each individual distributor. Strict penalties should be defined for distributors who are not registered.

1 — The market

Indian financial markets have been through two distinct phases. The first was that of nationalisation starting from the 1950s, and the second of privatisation starting from the 1990s. In the early 1950s, avenues for investment were limited. Retail investors could choose between bank deposits, and postal savings schemes. Provident funds and pension schemes were only available to individuals employed in firms with more than 20 employees, or to civil servants. In that environment, the LIC and UTI, were crucial for channeling household savings into investments. Composite products which combined insurance with long-term savings vehicles were the entry level products for a nascent market.

In the 1990s, several reforms took place in Indian financial markets. The first major steps included setting up of SEBI, the securities market regulator; National Stock Exchange (NSE), a modern stock exchange that introduced real time screen based trading that broke the broker cartels and introduced transparency and lower costs in the system, and National Securities Depository Limited (NSDL) an electronic depository. In the mid 1990s the Indian mutual fund market was opened up to competition breaking the monopoly of the UTI. But real reform in the industry came post the UTI crisis where the non mark to market pools of UTI were dismantled. The early 2000s saw the opening of the insurance sector to private players after the formation of the regulator, the IRDAI, in 1999.

The trajectory of pension reforms was different from that of mutual funds and insurance. In 2000, the Old Age Social and Income and Security (OASIS) report submitted to the Ministry of Social Justice and Empowerment, established the thinking about the need to design an individual account defined contribution pension system for the large mass of excluded workers. At the same time, concerns on the expenditures on civil servants pensions were rising. This led to the formation of the NPS, which was made mandatory to new recruits to civil servants from January 2004, and opened up to all retail consumers in 2009.

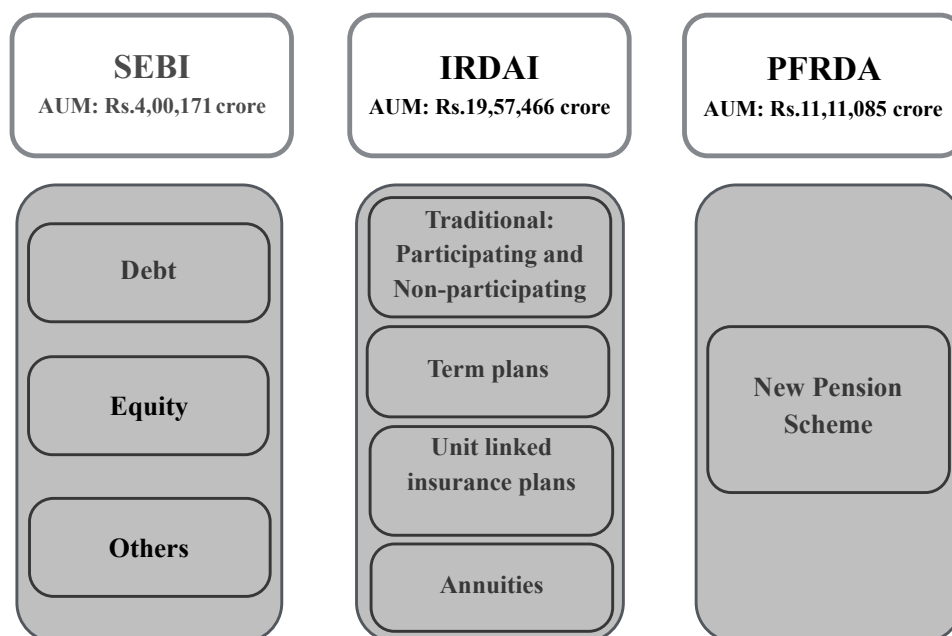


Figure 1.1: Retail finance in India (as of March 2014)

1.1 Financial products

Retail financial markets in India offer consumers products which are designed, distributed and regulated in silos, independent of each other. The driving principle behind the organisation of the industry seems to be form (mutual fund, insurance, pension) rather than function (investment, risk coverage, income replacement).

Figure 1.1 depicts the industry and also shows the size of the three industries.

Mutual funds

Mutual fund **AUM** has doubled over the last five years (2008-09 to 2013-14) and has grown nearly eleven times since 2001-02.

As of March, 2014 there were 44 mutual funds in the country with an **AUM** of Rs.9,05,120 crore (USD 142 billion).² The share of the retail investors (includes the retail and high networth individuals) of **AUM** stood at Rs.4,00,171 crore (or 48.5%) and that of the institutional investors (includes Corporates, Banks/FI's and the FII's) was Rs.4,25,071 crore (51.5%).³ The number of folios stood at 395 lakh.⁴

²Table 1, Mutual fund data for the month, March 2014, **The Association of Mutual Funds of India (AMFI)** Monthly, <http://portal.amfiindia.com/spages/ammr2014repo.pdf>

³The retail and institutional figures do not add up to the figure mentioned earlier (Rs 9,05,120 crore). The discrepancy or data mismatch is on account of reference to the two tables referred for total and the breakup for retail and institutional contribution, <http://portal.amfiindia.com/spages/ammr2014repo.pdf> and <https://www.amfiindia.com/research-information/aum-data/age-wise-folio-data> respectively

⁴Table 1, Asset Under Management And Folios - Category Wise - Aggregate - As ON March 31, 2014,

AMFI, the industry body, classifies the schemes as money market, gilt, debt oriented, equity oriented, balanced and ETFs (gold and non-gold). The largest share of the AUM, at 56 percent was of debt oriented schemes (Rs.4,60,671 crore) while equity oriented schemes accounted for 23 percent of the AUM (Rs.1,91,107 crore).⁵

The latest available mutual fund data shows that the AUM has risen significantly, to Rs.19,94,985 crore (USD 192 billion) by May 2015, the share of income funds has become 43 percent, while that of equity funds, has become 30 percent.⁶

Life insurance

The life insurance market has more than doubled in AUM and in sum assured during the last five years (2008-09 to 2013-14). The AUM in 2013-14 stands over eight times its size in 2001-02.

As of March 2014, the market comprised of 24 life insurance companies and 28 general insurance companies, and one national reinsurer.⁷

The four main products sold by the life insurance industry include: i) traditional endowment plans⁸, ii) ULIPs which gained popularity in the early 2000s, iii) pure term insurance and iv) annuity/pension plans. The first two are composite products i.e. there is an investment component over the insurance component. Pure term insurance has no investment component. Pension plans, or deferred annuities, may have an investment component. A fifth kind of product, called the Index Linked Insurance Product (ILIP), where returns are linked to the 10-year government bonds or equity indices such as Sensex or Nifty has not been sold in the last two years.⁹

Traditional plans are of two varieties: participating and non-participating. Participating policies have both guaranteed (sum assured) and non-guaranteed benefits (the part of the profits shared by the companies that is earned from the policy pool fund). Non-participating policies provide only the guaranteed benefits when the policy matures (maturity benefit) or the death benefit in case the policy holder dies before the end of tenure of the policy. The premium payment for these policies can be single i.e. premium is paid only once, or recurring i.e. premium is paid over the tenure of the product.

In the insurance sector, the AUM is classified under (i) life fund, (ii) ULIP fund and (iii) pension & general annuity & group fund. The sum assured is the minimum amount payable to the nominee/dependent on the death of the life assured, or to the policy holder at maturity. As on March 2014, the AUM with life insurance companies, including its pension funds, stood at Rs.19,57,466 crore (USD 315 billion). This includes the life fund at Rs.12,88,225 crore (USD 204 billion), pension & general annuity & group fund at Rs.3,37,579 crore (USD 54 billion) and ULIP fund at Rs.3,31,661 crore (USD 52

<https://www.amfiindia.com/research-information/aum-data/age-wise-folio-data>

⁵Table 4, Mutual fund Data for the month, March 2014, AMFI Monthly, <http://portal.amfiindia.com/spages/ammay2014repo.pdf>

⁶<http://portal.amfiindia.com/spages/ammay2015repo.pdf>

⁷Page 8, Annual Report, 2013-14, IRDAI

⁸These are also referred to as non-linked plans

⁹This seems to be a reaction to regulations on the ILIPs in 2013. These are discussed in Chapter 3

billion).¹⁰ The sum assured on individual business stood at Rs. 67,96,602 crore (USD 1.1 trillion).¹¹ The number of in-force insurance policies stood at approximately 33.54 crore.¹²

Pensions

Pension markets consist of the accumulation phase in which contributions are invested in long-term fund management products, and the decumulation phase in which total accumulations over working life are drawn-down using annuity products. In India, the former is relatively better developed.¹³

The retirement market is fragmented across (i) mandatory **Employees Provident Fund Organisation (EPFO)** and **NPS**, (ii) private sector **NPS**, (iii) **NPS Lite** (co-contributory pension for low income workers) and (iv) pension products sold by life insurance companies.

Over the last five years, till March 2015, the **NPS** has seen its assets jump seventeen times and subscriber base grow by nearly eleven times.

The total retirement assets in India as on March 2014 stood at Rs.11,11,085 crore¹⁴ A large share of the voluntary pension market today sits with the insurance sector as described in the earlier paragraph. As of March 2014, the total **NPS** assets stood at Rs.48,136 crore (USD 7.8 billion) while that of **EPFO** were Rs.2,07,686 crore (USD 33.5 billion).¹⁵

As of May 2015, five years after opening to the public, the private sector **NPS** stood at Rs.6,443 crore (USD 1 billion) with just over 4,71,117 customers.¹⁶

The draw-down, or annuity market is less developed. The annuity products are manufactured by the insurance companies. **NPS** uses seven of these insurance companies as annuity providers for its pension scheme.

1.2 Distribution of financial products

Financial products are sold by an army of distributors. These distributors are either *agents*, which include individuals or corporations such as banks, and *brokers*. Agents (individual or corporate) are remunerated directly by the product provider and this could often lead them to represent the interest of the product provider. Brokers, on the other hand, represent customers and have fiduciary responsibilities towards their customers

¹⁰Table I.48, Investments of Life Insurers: Fund Wise, Annual Report 2013-14, **IRDAI**

¹¹Summary of Indian Life Insurance Sector, page 3, Handbook of Indian Insurance Statistics, 2013-14, **IRDAI**

¹²Source: Life Council of India.

¹³This is one of the reasons the Committee has focused more on investment products.

¹⁴The total retirement assets is sum of the investment corpus of Provident fund (Rs. 5,17,685 crore) & Pension Fund (Rs. 2,07,686 crore) of **EPFO**, the Pension fund of **LIC** (Rs. 3,37,579 crore) and the **NPS** corpus (Rs. 48,136 crore) (USD 180 billion).

¹⁵Source: Table on the Investment Corpus in the Summary of Statistical Abstract (2013-14). <http://www.epfindia.com/epfbrief.html>

¹⁶Pension Bulletin, May 2015, **Pension Fund Regulatory and Development Authority (PFRDA)**.

but are compensated by the manufacturer. When a customer interfaces with a distributor, it is unlikely that the customer is aware, or made aware of whether the intermediary is an agent or a broker, and what that implies for the customer. Anecdotes suggest that the customer is likely to believe what the distributor, most often the agent, says not fully realising that the agent is actually serving the interest of the company.

Traditionally, individual agents have been the major distribution channel for the sale of both, mutual funds and insurance. In recent times, corporate agents, especially private sector banks, have come to play an increasingly important role in distribution. This is especially true in the case of private sector insurance companies, which unlike the LIC, are increasingly utilising the corporate agent model. Thus, 15.6 percent of the total insurance premium in 2013-14 came from banks as opposed to 5.6 percent in 2006-07.¹⁷ Similarly, in the case of mutual funds, banks – and private banks, in particular – have come to dominate distribution with over 30 percent AUM share.¹⁸

The NPS distributor is known as the Point of Presence (PoP), and is completely separate from the product manufacturer i.e. pension fund manager. The PoP is remunerated upfront through customer investments, and not by the fund manager.¹⁹ This makes the PoP neither an agent nor a broker.

In the case of mutual funds, an agent may sell products of more than one manufacturer. An insurance agent can distribute products of only one manufacturer. An insurance broker can sell products of multiple insurers. Till recently banks were not permitted to act as brokers. This debate was settled with the Government announcement in Budget of 2013-14 to permit the banks to act as brokers and IRDAI making the requisite regulations thereafter. RBI also formalised this recently through the notification dated January 15, 2015.²⁰ Banks, however, can choose to be either agents or brokers, and have largely chosen to be agents without any fiduciary responsibility.

A new development in the mutual fund and insurance markets has been the sale of products directly through company websites. For example, the number of policies issued by insurance companies through direct selling has increased from 0.31 percent of total policies issued in 2006-07 to 1.7 percent in 2013-14, and the premium from direct selling has increased from 0.39 percent of total premium in 2006-07 to 3.09 percent in 2013-14.²¹ In the case of mutual funds as well, the direct channel now accounts for more than 30 percent of the AUM. However, it seems to be more popular with corporate and institutional clients, than with retail investors who still seem to prefer to invest through distributors.²²

¹⁷Source: Table 4, Channel Wise Individual New Business Performance Of Life Insurers, Handbook on Indian Insurance Statistics 2013-14.

¹⁸KPMG and CII, *Indian Mutual Fund Industry: The Future in a Dynamic Environment Outlook for 2015*, KPMG and CII Report, June 2009.

¹⁹See Ajay Shah, “Indian pension reform: A sustainable and scalable approach”, in: *Managing globalisation: Lessons from China and India*, ed. by David A. Kelly, Ramkishan S. Rajan, and Gillian H. L. Goh, World Scientific, 2006, chap. 7 for a detailed description of the NPS.

²⁰<http://rbidocs.rbi.org.in/rdocs/notification/PDFs/IBROKIN150115.pdf>

²¹Source: Table 4, Individual New Business Performance of Life Insurers - Channel Wise, IRDAI Handbook on Indian Insurance Statistics 2013-14

²²Indian Financial Distribution Industry at the cusp: Vision 2020, FIAI-CRISIL report on Indian Financial Distribution Industry, March 2015.

At the same time, the number of registered mutual fund distributors has significantly fallen from 92,500 as of March 2010 to approximately 40,000 active distributors as on March 2014. The number of insurance agents have also seen a significant drop from approximately 29 lakh insurance agents and 2,930 corporate agents as on March 2009 to 22 lakh insurance agents and 689 corporate agents as on March 2014.²³

1.3 The focus of this report

The saving rate in India is high, notwithstanding concerns about a decline in recent years. In 1990 the gross domestic saving rate in India was about 22.8 percent of **Gross Domestic Product (GDP)**. By 2012-13, this had become 30 percent of **GDP**.²⁴ These savings, however, do not translate to financial assets. For example, gross domestic savings of the household sector were 22 percent of **GDP** in 2012-13, of which savings in physical assets such as gold and real estate were 15 percent of **GDP**, while savings in financial assets were only 7 percent of **GDP**.

Only 3.4 percent of gross financial savings were invested in mutual funds, 17.3 percent in life insurance funds, and 11.7 percent in provident and pension funds.²⁵ While insurance funds account for the largest share of household savings between the three markets, their penetration (measured as ratio of premium to **GDP**) was only about 3.9 percent in 2013.²⁶

Why might this be so? Low access to finance cannot have one simple answer. And yet, one factor that can potentially explain the reluctance of households to engage in financial markets is low trust. This may come from poor financial literacy, as limited understanding leads to low trust. It may also come from the poor record of retail finance in serving the interests of the customers. Given a level of financial literacy and understanding of markets, instances of mis-selling can prove to be detrimental to participation.

There is reason to believe that this might be the case. The limited investments in retail finance have been accompanied by several allegations of mis-selling, at the point of sale, or during the product cycle, or sometimes both. Typical complaints include customers not been given correct information about products, not shown the full array of products, not told the exact amount of their contributions that will be diverted towards commissions and costs, not made clear about the exact contract that they are signing into, and made to churn their portfolios without any apparent benefit to them. Reported fines by regulators and convictions by courts for mis-selling may be low, but that does not take away from the problem.

This has been a cause for concern not only because of the losses borne by consumers but also because such instances, as discussed earlier, can erode trust in markets, and

²³Source: Table 28: Number of Individual Agents of Life Insurers & Table 29: Number of Corporate Agents of Life Insurers, Handbook on Indian Insurance Statistics 2013-14.

²⁴Source: Table II.3, Gross Domestic Savings: Sector-wise, Annual Report, Reserve Bank of India, 2014

²⁵Source: Table II.2, Financial Saving of the Household Sector, Annual Report, **RBI** 2014.

²⁶Source: Table I.7, Insurance Penetration and Density in India, Annual Report, **IRDAI**, 2013-14.

adversely impact participation. Households savings are important from the point of view of providing much needed funds for productive investment, and our inability to tap into these savings can prove to be expensive for economic growth.

Against this background of high savings rates, low savings in financial assets, and alleged mis-selling of financial products this report studies the evidence on mis-selling, and makes recommendations for reform. These recommendations should be seen as a baseline hygiene reform, across product structures, incentives and disclosures similar to the stock market reforms in India in the early 1990s.

2 — Mis-selling

A recurring complaint about the three investment products, insurance, mutual funds and pensions has been their inability to increase their reach to Indian households. Related to this has been that the sale of these products is fraught with mis-selling.²⁷

What do these alleged mis-selling practices imply? A dictionary definition of mis-selling is, “the practice of a salesperson misrepresenting or misleading an investor about the characteristics of a product or service”.²⁸ An example is where a salesperson suggests the purchase of one product without showing the array of products that a customer could potentially purchase. This is especially pertinent in the case of banks in India who are seen to have a high concentration of in-house sales to their **Asset Management Companies (AMC)s** (See Annexure A for details.) Other instances include a salesperson not disclosing features of the product that are material to the investor getting a benefit out of the product, mis-representing the returns that can be earned on a product and hiding the costs and commissions. Another common problem is that of rebates where agents lure customers to buy products by passing part of their commission to customers.

What is important to remember is that in all these cases, the optimal choice of product for a customer would have been different (sometimes opposite) of what has actually been recommended to a customer. Examples include telling customers to buy a particular mutual fund (when cheaper options are available), saying that a **ULIP** product would double their money (when there is no such guarantee possible in a market linked product), claiming that a traditional insurance product gives them returns of more than 100 percent (failing to mention that this return is a percent of sum assured and not the actual amount invested), suggesting an elderly person to buy a market linked insurance policy (when bearing market risk is not recommended at all, and where life insurance may not be needed at that age).

²⁷The evidence on mis-selling is described in detail in section 2.3

²⁸This definition has been taken from Investopedia. See <http://www.investopedia.com/terms/m/mis-selling.asp>

Mis-selling is thus related to the “suitability” of products. One could argue that mis-selling has come to mean that the product sold is not suitable given the customers circumstances and investment goals. In fact, a Joint Committee at the **Bank for International Settlements (BIS)** has defined suitability and mis-selling as, *the degree to which the product or service offered by the intermediary matches the retail client’s financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience. The term disclosure refers to any requirement that the firm disclose information to the retail client that could be material to the investment decision. In a sense, disclosure is intended to assist the retail client in making his/her decision, but is quite distinct from the requirement on a firm to make a determination of whether a particular product is suitable for the client. The term “mis-selling” generally refers to the situation where the firm sells a product to a client that is not suitable for that client, whether or not a recommendation is made.*²⁹ We must remember that, in itself, a financial product (that adheres to basics of transparency and costs) is not good or bad. It is in the unsuitable sale that there is a problem.

Regulatory regimes sometimes take it upon themselves to “approve” or “reject” products. While this is useful, it may lead to a situation when such “approved” products tick all the regulatory boxes but get sold in a manner that constitutes a mis-sale. The buy-in of the regulator in approving the product now makes it a regulatory failure rather than a firm malpractice making redress almost impossible. The regulator now becomes an incumbent to the market and is reluctant to see instances of mis-selling as real even though there may be enough anecdotal evidence to point to a systemic failure of governance.

But, let’s stay with the sales process for the moment. The first question that one has to answer is who is doing the selling? And why is selling fraught with such problems? What evidence do we have?

2.1 The role of the agent

The link between product providers and customers is the distributor or the advisor. In the early days, this was an individual agent, who was a trusted figure in the community, and would use her stature to convince people of the need to invest. Ties with the community ensured that transactions were in the best interest of the customers. The agents role in educating customers, doing risk evaluation and primary underwriting, long term servicing and claims assistance were emphasised by the life insurance representatives.³⁰ With the proliferation of new products and market participants, the form of the individual agent also began to change.

As markets acquired scale, community ties began to get replaced with anonymity. This meant that the individual agent was often, though not always, a stranger. Informal ties that bound the agent to the customer began to loosen. If a customer later complained

²⁹Basel Committee on Banking Supervision, *Customer suitability in the retail sale of financial products and services*, tech. rep., Bank for International Settlements, Apr. 2008.

³⁰Submission by life insurance representatives on insurance intermediation/agent remuneration.

of mis-selling, the agent would often pass the buck to the product provider. Corporate entities such as banks also began to distribute financial products.

The current distribution market thus has two features. First, the agent has looser ties to the community than before. Second, the agent gets paid, usually by the product provider mainly in the form of an upfront commission. Or in the case of an employee, like in a bank, has her bonus linked to meeting sales targets. This has meant that agents do not have to focus on serving the customer, but on meeting volume based targets. In the olden days, the agent may have lost her reputation, but in this new world order, the agent does not have much to lose if the trust with the customer gets broken.

In a competitive environment, the agents who recommend better products would get more customers, and the market would weed out those who are either not able to provide good advice, or willfully provide bad advice. Even though market forces would replace community ties, competition would ensure that good behaviour would prevail.

This logic begins to fail when the customer is ignorant about financial products, and does not see the outcome for many years to give feedback. The customer also does not pay the distributor directly, the distributor therefore has no incentive to service the customer. The distributors incentive is to maximise her income by selling the product that provides the highest commission (or get the sales-linked performance bonus), regardless of whether it is in the interest of the customer. This gets exacerbated when mis-selling is hard to prove because the sale process is verbal and undocumented and the regulatory regime takes a view that it is a buyer-beware market. Even if a mis-sale has been proved, the penalty is minuscule making this a market that is geared towards failure.

2.2 Incentives for selling

At this point, it is important to remember that we are not in a pull market. Financial products are still sold than bought, and distributors play an important role. Why would an agent sell one product over another? Since remuneration comes only from the sale of the product, the answer must lie in the remuneration structure.

Costs are levied at one or more of the three points: on entry, on going and at exit. Entry costs can be broken down into a transaction charge and seller commissions. On going costs comprise fund management, administrative, mortality, and profits. Exit costs include surrender charges and exit loads. Regulators stipulate the kind of fee and the maximum amount that may be paid under each of the heads. In some cases, expenses are required to be under an overall cost cap, whereas in some cases there are individual caps on each component without an over-riding cost cap. Table 2.1 presents the structure of the charges, as well as permissible amounts, for the three investment products. A more detailed table on costs across different products is presented in the Appendix.

Mutual fund fees comprise of upfront commissions, and **AUM** based trails. The fee structure is back loaded i.e. a distributors earnings increase as the **AUM** of the fund grows. Upfront commissions are not paid by the invested amount but are upfronted trails i.e. these are paid out of the capital or profits of the **AMC**. In addition to mutual

Table 2.1: Maximum fees stipulated by product regulators

This table presents the structure and permissible limits for distribution related expenses, or overall cost-caps where applicable.

¹: Liquid funds having zero exit charge and equity funds going upto 2% if exit before 1 or 2 or 3 years. ²: In the case of mutual funds, the overall **Total Expense Ratio (TER)** cap applies in slabs: 2.5% for the first Rs 100 crore equity (2.25% for debt), 2.25% for the next Rs 300 crore (2% for debt), 2% for the next Rs 300 crore (1.75% for debt) and 1.75% for the balance (1.5% for debt). ³: In the case of traditional insurance plans, costs at entry are lower for policies with tenure less than 12 years. This can go up to 40% for companies who are in business for less than 10 years. ⁴: In the case of **ULIPs**, the **Reduction in Yield (RIY)** is higher at 3% for policies with tenure less than 10 years. While the commission caps for **ULIP** are same as those for traditional plans, Year 1 commissions in practice are lower at 7-9% of premium. ⁵: In the case of the **NPS**, the Rs.150 comprises of a Rs.50 fee to the **Central Recordkeeping Agency (CRA)** as account opening charge levied as deduction of units. Rs.125 is **PoP** charge collected upfront. In addition, there are annual charges. ⁶: Other charges include a **CRA** charge of Rs.190 and Rs.4 per transaction; **PoP** 0.25% of transaction value subject to minimum of Rs.20, and another Rs.20 per transaction cost for all other requests.

	SEBI (Mutual (MF)s)	Funds	IRDAI (Traditional)	IRDAI (ULIPs)	PFRDA (NPS)
At entry	Upto 1% of investment		Upto 35% of premium ³ 2% in case of sin- gle premium	7-9% of invested amt. 2% in case of sin- gle premium	Rs.150 ⁵
On going*	Subject to cap. Ranges 0.25-1%	to TER from	7.5% in year two 5% thereafter		0.25%
At exit	Differs across product type ¹		Surrender charge varies+	Max. Rs.6000 surrender charge	
Overall cost cap	TER of 2.5% ²			RIY of 2.25% ⁴	Annual charges ⁶

*: Mutual fund on-going fees are a percent of **AUM**. Insurance on-going fees are a percent of premium. The costs for mutual funds are higher in B15 cities due to higher TER being permitted.
 *: **ULIP** commission caps are same as traditional plans but on-going fees on the ground are at around 2% year 2 onwards due to the **RIY** cap
 *: **NPS** on-going fees are paid to **PoPs** and are a percent of the amount invested in the year
 +: Surrender charges are hidden and difficult to evaluate. No cost cap if policy lapses within lock in.

funds, **ETFs**³¹ also allow customers to invest in a basket of securities. **ETFs** offer a fee structure on par with trading of securities on the stock exchange. Mutual funds also offer index funds that replicate stock exchange indices. Since index funds have no liquidity of their own, usually they have higher percentage of assets in cash and liquid securities than **ETFs**.

Life insurance commissions are a percentage of premium. The fee structure is front loaded i.e. most of the commissions are earned in the first few years of the policy tenure. **NPS** fee structure is neither front loaded nor backloaded. It is a combination of flat fee and transaction fees.³²

Given the structure of distribution costs, is there a difference in the remuneration earned by distributors for selling each of these products, and also if the structure of the remuneration is front or back loaded? If one product pays more than the other, the

³¹ An **ETF** is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an **ETF** trades like a security on a stock exchange and they experience similar price changes throughout the day.

³² **NPS** permits distributors a flat fee of flat Rs.100 on initial subscription and 0.25 percent of the initial subscription amount. Thereafter, every year on subsequent investments, the distributor is entitled to 0.25 percent of that amount. The minimum that a distributor can charge is Rs.20 and the maximum Rs.25,000.

distributor is likely to sell that product. If one product not only pays more than the other, but also pays upfront, then that product appears more lucrative. Thus, the quantum of payment, and the timing of payment are likely to influence distributors to sell one product over another. We evaluate if this is indeed the case.

2.2.1 Case 1: Regular premium paying products

We calculate the total commissions paid to a distributor on a yearly investment of Rs.1,00,000 (on an **Net Present value (NPV)** basis) over different tenures in a mutual fund **Systematic Investment Plan (SIP)**, a **ULIP**, and a traditional endowment plan.

The commissions for comparison purpose are taken for a hybrid mutual fund and not for a pure equity fund as both **ULIP** and traditional plans have debt and equity.³³ The net annualised returns for a consumers are assumed at 8 percent for the purpose of analysis. As shown in Table 2.2, on an **NPV** basis, for a 15 year investing term, a mutual fund distributor earns Rs.43,974, a **ULIP** distributor earns Rs.24,488, while a traditional insurance distributor earns Rs.66,221. This shows that total commissions on **NPV** basis can be materially higher for traditional life insurance products as compared to **ULIP** and **MF**³⁴, making them relatively expensive for the consumer and more attractive for distributors to sell. This distorts the market.

Table 2.2: Recurring premium plan, **SIP**: Total commissions

This table shows the total commissions paid on a recurring premium insurance plan, and a mutual fund **SIP** for a yearly investment of Rs.1,00,000. **MF** Commission: Zero upfront, Year 1 Trail: 1.00%, Year 2 onwards: 0.50% on **AUM**. The commissions for comparison purpose are taken for a hybrid fund and not for a pure equity fund as both **ULIP** and traditional plans have debt and equity. Long term trail on hybrid funds typically range from 0.20% to 0.50% and between 0.20% to 1.00% for pure equity funds. **ULIP** Commission: Year 1: 8% on premium (While the cap is same as traditional plans, 8% is taken based on industry trend of 7-9%), Year 2 onwards at 2% while the cap is 7.5% for year 2 and 3 and goes down to 5% year 4 onwards. Traditional Insurance Plan Commission: Year 1: 25% of premium (While the cap is 35%, 25% is taken to ensure the numbers are more representative), Year 2 onwards 5% (while the cap is 7.5% of premium for Year 2 and 3 and is 5% of premium for year 4 and beyond. For example, based on industry trend of fees to distributors, in a 15 year policy, a distributor could earn Rs.43,974 in a hybrid mutual fund, Rs.24,488 in a **ULIP** and Rs.66,221 in a traditional plan. Since each of the product has a significant investment component, dis-similar incentives skew the industry.

Plan/Scheme	Product Tenure (in Years)					
	5	10	15	20	25	30
MF Hybrid Fund (Rs.)	7,299	22,707	43,974	69,228	97,195	1,27,010
ULIPs (Rs.)	14,624	20,494	24,488	27,207	29,058	30,317
Traditional Plan (Rs.)	41,561	56,234	66,221	73,018	77,644	80,792

Note: All commissions are shown at **NPV** for comparison, discounted at 8%.

The costs for mutual funds are higher in B15 cities due to higher TER being permitted.

Annualised net return on investment for a consumer is assumed at 8%.

Differences in front loading of commissions

Not only is the total quantity important, but also how this gets structured over the tenure of the product. As can be seen in Table 2.2, the total commissions in a **MF** are comparable to traditional insurance plans over a 20 year tenure. Over a 25 year tenure and beyond, the **MF** commissions can be much higher. Mutual funds are largely open ended products where customers choose to invest for a tenure based on their

³³The commission assumed on the hybrid fund in our calculations is comparable to the industry average of equity funds.

³⁴For mutual funds, a hybrid product which comprises of equity and debt is taken for comparison as most insurance products also have a mix of equity and debt.

specific investment goals and exit the product at nil or relatively low exit fee. In the case of insurance, customers choose their product tenure upfront and have relatively high surrender costs, specially the traditional plans. In both cases, customers need to stay invested for their chosen tenure to benefit from the products. Given this, it is important that the incentives of the distributor who sells these products are as closely aligned to the goals of the customer. If a distributor earns most of her commission upfront she is unlikely to have interest in selling products which are suitable for the customer over the long term in a long-tenure product. A front loaded incentive and cost structure typically leads to perverse incentives for mis-selling which impacts the customer persistency.³⁵

Table 2.3 depicts the first year commissions as a percentage of total commissions earned over various tenure for mutual fund **SIPs** and recurring premium plans of investment oriented insurance products. We find that in case of a 15 year tenure, distributors in mutual funds would earn only 1.11 percent of total commissions as upfront commission, in comparison with traditional plans, where distributors could earn almost 26 percent of total commissions as upfront commissions. In the case of **ULIP** where the total commissions over long term are less than traditional plans and **MF**, the commissions are very much front loaded with year 1 commissions at about 22 percent. The front loading of commissions in insurance becomes even more acute for product with a ten year or lower tenure. Distributors are likely to sell those products which pay most commissions as an upfront. There is little incentive to ensure that the client continues in the product over the full tenure.

Table 2.3: Misalignment: Front loaded commissions

This table shows the first year commissions as a percent of total commissions earned. MF Commission: Zero upfront, Year 1 Trail: 1.00%, Year 2 onwards: 0.50% on AUM . The commissions for comparison purpose are taken for a hybrid fund and not for a pure equity fund as both ULIP and traditional plans have debt and equity. Long term trail on hybrid funds range from 0.20% to 0.50% and 0.20% to 1.00% in pure equity funds. ULIP Commission: Year 1: 8% on premium (While the commission caps are same as traditional plans, 8% is taken based on industry average of 7-9%), Year 2 onwards at 2% while the cap is 7.5% for year 2 and 3 and goes down to 5% year 4 onwards. Traditional Insurance Plan: Year 1: 35% of premium (While the commissions are capped at 35%, 25% is taken as a more representative number), Year 2 onwards 5% (while the cap is 7.5% of premium for Year 2 and 3 and is 5% of premium for year 4 and beyond. Based on the above assumptions, a distributor selling a 15 year traditional plan could earn in Year 1, upto 26% of the total commission he could earn over the policy tenure. In case of a ULIP this would be 22% of the total commission in year 1 even though overall commissions over 15 years would be less than mutual fund. However, a mutual fund distributor would only earn 1.11% of the total commissions in Year 1.			
Tenure (in Years)	Mutual fund (Hybrid scheme)	ULIP	Traditional plans
30	0.17%	12.0%	15.0%
25	0.30%	14.0%	17.0%
20	0.54%	17.0%	21.0%
15	1.11%	22.0%	26.0%
10	2.79%	31.0%	36.0%
5	11.0%	50.0%	56.0%
For single premium plans, the cost is 2% of premium. The costs for mutual funds are higher in B15 cities due to higher TER being permitted. Annualised net return on investment for a consumer is assumed at 8%.			

³⁵In the case of **LIC** for example, the 61st month persistency in 2013-14 was just 44 percent. This means that less than half of the policies sold in FY 2009 were retained.

2.2.2 Case 2: One-time premium paying products

In case of single premium insurance products and lumpsum mutual fund investment products the commissions in insurance are capped at 2 percent, while MF provide trail commissions even in a lumpsum investment. While comparing the two we must remember that one is a closed end product with charges on exit prior to three years and the other is an open ended product that becomes zero cost on exit after one or two years.

For comparison purpose in Table 2.4, MF commissions are taken on NPV basis with AUM based trail fee of 1 percent in year 1 and 0.50 percent thereafter.

Table 2.4: Single Premium, Lumpsum Investment: Commissions structure

This table shows the commissions where the customers buys a single premium traditional or ULIP plan and in case of a MF makes a lumpsum investment. The average holding period for mutual funds is 3-6 years. Therefore 5 year tenure is taken for commission comparison purpose. MF commission are taken as 1% AUM based trail in year 1 and 0.50% thereafter. Insurance commissions are taken as 2% of premium.						
Amount (Rs.)	5,00,000	10,00,000	15,00,000	20,00,000	25,00,000	30,00,000
Insurance Commissions (Rs.)	10,000	20,000	30,000	40,000	50,000	60,000
MF Commissions (NPV) (Rs.)	15,000	30,000	45,000	60,000	75,000	90,000
For single premium plans, the cost is 2% of premium.						
Annualised net return on investment for a consumer is assumed at 8%.						
The costs for mutual funds are higher in B15 cities due to higher TER being permitted.						
Discount rate for NPV basis is assumed at 8%.						

Single premium insurance plans provide sum assured of 125 percent of the premium to consumers less than 45 years of age and 110 percent of premium for those above 45 years age. This means a single premium of Rs.1,00,000 would result in a sum assured of only Rs.1,10,000 or Rs.1,25,000. Therefore, single premium would have to be of high value for it to have any meaningful insurance cover. Table 2.4 shows that for a single premium of Rs.20,00,000, an insurance distributor would earn Rs.40,000 as upfront commission. For the same amount invested in MF, an agent would earn Rs.60,000 (on NPV basis) over five years.³⁶

We have seen that there is wide variation in the amount, structure and definitions of charges on financial products in India. It is difficult to calculate the amount actually paid for each product, and even more difficult to compare the costs across products. The incentive structure is such that front loading of commissions on some products make them more lucrative to sell. There is global evidence that says that moving from an upfront to a trail model is more conducive to building a market with a deep foundation since upfronts encourage hit and run sales. Trail commissions align the interest of the producer, seller and the investor - so while the quantum of trail may look higher, it is on the base of a rising investor AUM.

2.3 Do commissions influence sales?

We now turn to presenting evidence on whether commissions actually influence sales. Economic theory shows that when sales agents are incentivised by remuneration structures to push financial products regardless of their suitability for the consumer, this can

³⁶More discussion on the single premium plan is provided in the Appendix.

Figure 17: Relationship between upfront commissions and advice that failed in our sample



Review of retail life insurance advice, Report 413, Australian Securities Investment Commissions (ASIC), October 2014.

Figure 2.1: Commissions impact: Regulatory audit by ASIC

lead to rampant mis-selling.³⁷ Ericson and Doyle (2006) carried out interviews with insurance marketing executives, sales agents, consumers, industry associations and market conduct regulators in international markets and pointed out that a sales culture where earning are entirely based on commissions, leads to practices where sales personnel frequently put their clients at risk.³⁸ A large literature has emerged internationally on this topic.³⁹

In an audit study of retail insurance advice, the **Australian Securities Investment Commission (ASIC)**, found that “..where an adviser is paid under an upfront commission model it has a statistically significant bearing on the likelihood of that adviser giving advice that did not comply with the law.”⁴⁰ (See Figure 2.1).

Over the last two decades, there have been several anecdotes about mis-selling. Early reporting in the media had begun documenting mis-selling in both mutual fund and insurance industries.⁴¹ Recently, an online survey by Money-Life also found that over 90 percent of consumers reported being mis-sold a financial product or service.⁴²

³⁷Roman Inderst and Marco Ottaviani, “Misselling through Agents”, in: *American Economic Review* 99.3 (2009), pp. 883–908.

³⁸Richard V. Ericson and Aaron Doyle, “The Institutionalization Of Deceptive Sales In Life Insurance”, in: *British Journal of Criminology* 46 (Sept. 2006), pp. 993–1010.

³⁹(White House, *The Effects Of Conflicted Investment Advice on Retirement Savings*, tech. rep., Executive Office of the President of the United States, Feb. 2015), provides a review of international academic studies.

⁴⁰Review of retail life insurance advice, Report 413, Australian Securities Investment Commissions (ASIC), October 2014.

⁴¹Monika Halan, *Ignore ULIP hardsell, look at costs instead*, Indian Express, May 2006; PersonalFN.com, *Case study: Mis-selling of ULIPs*, Aug. 2007.

⁴²MoneyLife Foundation, *Discussion on Right to Suitability and the Prevailing Practice of Mis-selling of Financial Products and Services by Banks*, 2015.

2.3.1 Commissions and mis-selling in mutual funds

Till about five years ago, the industry was substantially focused on institutional investors such as banks corporates. For example, as late as March 2009, retail participation constituted only about 20 percent of the total **AUM**. By March 2015, this was about 48 percent of the total **AUM**. The increase occurred because the industry realised that it needed to focus on retail customers to get more sticky and remunerative assets.

In this period of limited retail participation, there were several instances of mis-selling. Up until 2006, mutual funds could charge investors money up to 6 percent of the money collected in a **New Fund Offer (NFO)**. If an **NFO** collected Rs.1,000 crore, the mutual fund could deduct Rs.60 crore from investors' money over the next five years. In 2005-06, the **NFO** charge netted the industry Rs.2,281 crore (this would be recovered over five years). This was in addition to the 2.25 percent of the invested amount as a front load and the expense ratio of around 2 percent.

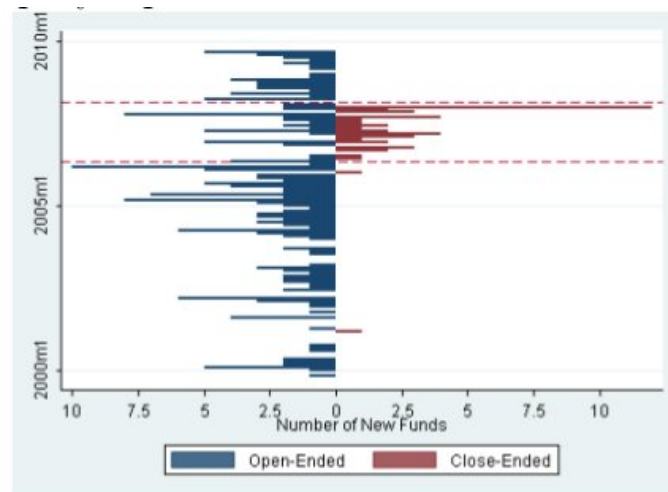
The high front fee in an **NFO** sale and rising markets combined to cause the great **NFO** rush from 2005 to 2008 with over 73 percent of the inflows in mutual funds in 2005-06 coming from **NFOs**. But high front-end commissions ended up in churning of investors, or the practice of sellers of retail financial products to move investors in and out of products with the sole aim of harvesting the commissions on each transaction. Rising markets usually make investors blind to the real cost of churning, but the capital markets regulator clamped down on churning by banning the 6 percent charge on open-ended funds on 4 April 2006. The industry quickly ramped up manufacture and sale of closed-end funds, which were still allowed to charge 6 percent.

For the 22 month period that this arbitrage existed, Anagol and Kim (2012) find that inflows into the more expensive funds were much higher.⁴³ Figure 2.2 shows the number of new equity open-ended and closed-end schemes started per month in the mutual fund market. During the regime when closed-end funds could charge more than open-end funds, a large number of closed-end funds were launched. The authors estimate that investors paid approximately Rs.21 billion in extra fees in this period.

SEBI closed the door on closed-end funds charging the 6 percent **NFO** fee on 31 January 2008. Closed-end **NFOs** dropped to 5 and open-ended continued to drop to 30 and **NFO**-related sales dropped to 8 percent of total inflow compared with 73 percent of inflows that were **NFO**-linked. Clearly, commissions were the major factor driving sales.

SEBI, therefore, banned upfront loads in August 2009. 100 percent of investor money was to be invested and the seller had to be compensated either by the investor paying a fee or through the trail model. **AMCs** began upfront trail commissions by dipping into their capital or profits. This shows that unless you move to capped upfront model, firms will find a way to skew compensation to the front of the product. The year 2014 saw the launch of closed-end schemes by several **AMCs**. In 2014, closed-end equity funds accounted for over three quarters of the total net inflows into the industry. In 2015 between January to June, as many as 100 **NFO** schemes have been filed with **SEBI** for

⁴³Santosh Anagol and Hugh Hoikwang Kim, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market", in: *American Economic Review* 102.1 (2012), pp. 576–93, URL: <http://EconPapers.repec.org/RePEc:aea:aecrev:v:102:y:2012:i:1:p:576-93>.



Anagol and Kim (2012)

Figure 2.2: Commissions impact: Mutual funds

approval. **AMCs** started “upfronting” the three-year and five-year trail commission that should have come at the end of each year to the first year, resulting in upfronts of as high as 7 percent or 8 percent. Instead of getting induced into buying into a pedigreed scheme with at least five years of performance history behind it, investors got sold new schemes with no track record. Worse, it encouraged even good advisers into churning a part of their client’s portfolio. **SEBI** leaned on the industry association **AMFI** that has now put a cap of 1 percent on the upfronting of the trail commission.

The various changes in regulatory norms by **SEBI** have gone in the broad direction of removing front end incentives that have proved to skew sales. The distributor and advisers are settling down into a full trail industry. The **AUM** of the equity part of the mutual fund industry (equity is the retail part of the fund industry) has continued to grow despite the squeeze on incentives upfront.

The industry saw a 24 percent growth in assets between May 2014 and May 2015. There were concerns that the growth had only been focused on top 15 metro towns since inception. This made **SEBI** allow higher commissions for increasing the reach in smaller towns. Thus, while the total growth has been 24 percent, growth in **AUM** from B15 cities between May 2014 and May 2015 has been 54 percent, while that in the T15 cities has been 18 percent.⁴⁴ This has led to concerns that this growth is on account of mis-selling especially given the fact that higher commissions can lead to aggressive sales in lesser financial literate towns. This needs to be investigated in more detail by the regulator.

⁴⁴Industry Trends, **AMFI**. <https://www.amfiindia.com/Themes/Theme1/downloads/home/industry-trends-may-2015.pdf>

2.3.2 Commissions and mis-selling in insurance

Until 2001, the life insurance industry in India was a state-owned monopoly enterprise, the LIC. The original rationale for offering non-linked policies was that such investments in addition to the pure life component could be used to fund any changes in the future costs of the insurance product arising out of changes in mortality or fees for other reasons. However, non-linked policies were popular with investors because they gave investors some access to long-term investment opportunities unlike the annuities or the term policies. Furthermore, there were no competing fund management avenues at the time that offered guaranteed returns.

Investors funded the policy once or twice a year in the expectation of getting a lump sum return in 15-20 years, or getting periodic returns after 10-15 years of funding the policy. In addition, these insurance products had attractive tax benefits, both as being eligible for tax benefits during investment, and after, with proceeds of the investment and final withdrawals being tax exempt.

After 1999, when the insurance regulator, IRDAI was set up, and the insurance industry was privatised in 2000, there were two significant changes in the market for insurance customers. The first was the entry of the ULIP, an investment linked insurance policy, where a large fraction of the premium was invested as in a mutual fund product with a small insurance pay-out in the case of death. The second was that national level corporate agents and banks, which were not regulated for their insurance services, became important distributors of insurance products. The AUM attributable to ULIPs grew at 534.82 percent between 2003 and 2004, and at 92 percent between 2009 and 2010. These were significantly higher growth rates when compared to growth rate in the sales of the traditional insurance products, which grew at 16 percent.

Anecdotal evidence suggests that investors bought the equity-linked ULIP assuming that they were buying a three-year guaranteed product that would double their money. The regulation on a three-year lock in period which allowed companies to keep the entire value of the policy if surrendered within three years, left very little incentive to the insurance companies to promote follow-on premium payments from their customers. The rule on front-loaded commissions, which were as high as 40 percent⁴⁵ in the first year, incentivised agents to sell products that earned them the highest pay-off. The tax benefits made this product even more attractive. When the product did not provide the (falsely) promised returns, a lot of customers stopped paying, and lost money as also in other financial products. This was reflected in the spike in the lapsation in insurance policies after the introduction of ULIPs in India. Halan, Sane, and Thomas (2014) find that investors lost more than a trillion rupees from mis-selling over the 2005-2012 period on account of these mis-sales.⁴⁶

Though there were no court cases filed by the investors, the government and the regulator took note of the media reports and letters written to the Ministry of Finance to change

⁴⁵Maximum commission of 40 percent in the first year is for insurers in the first 10 years of business and for the other insurers it is 35 percent.

⁴⁶Monika Halan, Renuka Sane, and Susan Thomas, "The case of the missing billions: estimating losses to customers due to mis-sold life insurance policies", in: *Journal of Economic Policy Reform* 17.4 (2014).

the product and cost structure of the **ULIP**.⁴⁷ The June 28, 2010 **IRDAI** circular came down harshly on the **ULIP** product and asked insurance companies to reintroduce the product with the following changes by September 1 2010, just two months later⁴⁸:

1. The three year lock in was moved to a five year lock in.
2. Insurers were required to distribute overall charges in an even fashion during the lock in period.
3. The minimum mortality was specified.
4. Surrender charges (through a July 1, 2010 notification) were capped at a maximum of Rs.6,000 for premiums above Rs.25,000. If discontinued within the lock in period, the paid up premium minus the maximum charge and mortality, would move to a fund (funds for discontinued policies) that would earn a minimum return and be returned to the policy holder once the lock in was over.
5. The costs, fixed vide a 2009 circular, were further explained. The cost structure applicable from September 1, 2010 was as follows:
 - The net reduction in yield for a policy of a tenor of 10 years or less can be no more than 3 percent at maturity.
 - The net reduction in yield for a policy of a tenor of above 10 years can be no more than 2.25 percent at maturity.
 - To keep the industry to stay on the cost course, sub cost caps according to tenure of the policy were mandated. For example, a 15 year policy could see a reduction in yield of no more than 3.30 percent in the 8th year.

However, traditional plans were left out of this clean up in the industry. These continue with a first year commission of upto 35 percent.

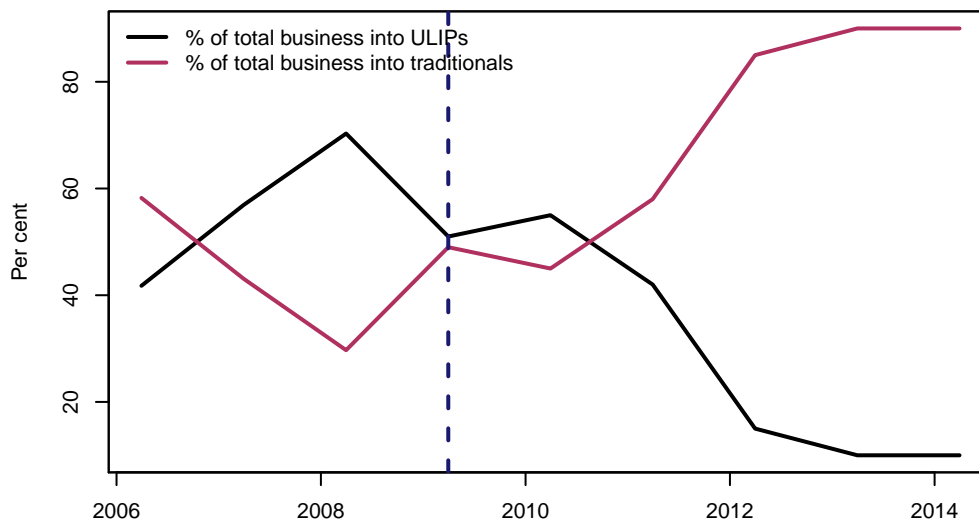


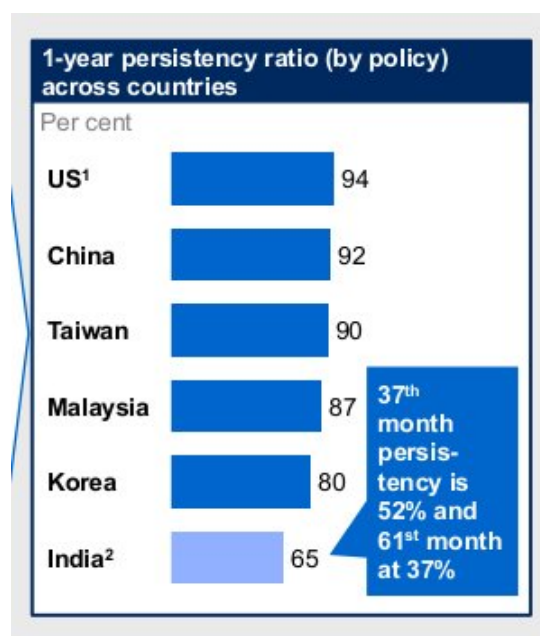
Figure 2.3: Business in **ULIPs** and traditional insurance

⁴⁷However, a **Public Interest Litigation (PIL)** was filed by an investor in Lucknow on mis-selling by an insurance company.

⁴⁸Guidance Notes On Recent Regulatory Changes Related To **ULIPs**, Circular No. IRDA/ACT/-CIR/ULIP/102/06/2010.

Insurance sales immediately moved towards traditional plans that continued to pay high commissions.⁴⁹ This is reflected in Figure 2.3. This is also reflected through an audit study of insurance agents carried out by Anagol, Cole, and Sarkar (2012).⁵⁰ They find that insurance agents overwhelmingly recommend products which provide high commissions to the agent and are unsuitable for the customers. This is greater for customers who appear to be less financially literate.

A manifestation of this is the low persistency of policies in India. Persistency tracks the behaviour across time of policies sold in a year. The 13 month persistency rate for insurance companies ranged between 41 - 76 percent in 2013-14. In the case of LIC for example, the 61st month persistency in 2013-14 was just 44 percent. This means that less than half of the policies sold in FY 2009 were retained. The persistency rate for LIC dropped from 51 percent in 2011-12 to 43 percent in 2012-13, it saw a marginal increase in the latest numbers.⁵¹



India Insurance Vision 2025: McKinsey Report, Prepared for the Confederation of Indian Industry (CII), February 2015. (Page 58 of the report)

Figure 2.4: Persistency of life insurance in India

A recent McKinsey report (See Figure 2.4) also finds that overall, the 1 year persistency ratio of Indian firms is 65 percent. This is much lower than countries such as the US, China, Malaysia and Korea, all of which have ratios more than 80 percent. The US and China, in fact, have persistency rates greater than 90 percent.⁵² While there are

⁴⁹It is possible that the market downturn also played a role in the shift.

⁵⁰Santosh Anagol, Shawn Cole, and Shayak Sarkar, *Understanding the Incentives of Commissions Motivated Agents: Theory and Evidence from the Indian Life Insurance Market*, Working Paper 12-055, Harvard Business School, Jan. 2012.

⁵¹Source: Table 27: Persistency of Life Insurance Policies (based on number of policies), Handbook of Indian Insurance Statistics 2013-14, IRDAI.

⁵²McKinsey & Company, *India Insurance Vision 2025: Building a USD 250 billion customer centric and value creating industry*, Prepared for Confederation of Indian Industry (CII), 2015.

aspects such as income disruption for various reasons including failure of monsoons, or intermittent incomes which impact persistency, the report also says that mis-selling and poor service by agents accounts for the poor performance. Another reason according to the insurance industry for low persistency is the rural mandate on insurance as well as the high rate of inflation over the last decade.⁵³

2.3.3 Commissions and low sales in ETFs and NPS

In a world of high incentives, similar products with low incentives end up being at a significant disadvantage. ETFs and index funds are relatively low cost investment products and offer returns comparable with their actively managed counterparts in the mutual fund space. In fact, ETFs have several advantages over traditional mutual funds, such as lower expense ratios, trading flexibility, tax efficiency, transparency, and exposure to diverse asset classes. While industry AUM data on index funds is not readily available the ETF AUM at Rs.14,705 crore, is a small fraction of the total mutual fund AUM at about less than 2 percent. Gold ETFs comprise half of the total ETF assets.⁵⁴

Similarly, it could be argued that one of the reasons that the private sector NPS market has failed to take off is that banks and other distributors find it profitable to nudge the customer towards insurance plans that pay higher front end commissions or mutual fund schemes which comes with asset based trail fees.

2.4 The role of poor disclosures in mis-selling

When an agent, motivated by high powered incentives, tries to sell financial products, disclosure documents of the product should ideally guide the investor towards choosing the product that is most suitable. Financial sector regulators in India, come to a joint view in 2013⁵⁵ that consumers must be provided with fair disclosure of information that is required to make an informed transactional decision. Appropriate disclosures need to be made both before the consumer enters into a financial contract and on a continuing basis.

Today, mutual funds are required to disclose total commission and expenses paid to distributors, distributor-wise gross inflows (indicating whether the distributor is an associate or group company of the sponsor(s) of the mutual fund), net inflows, average assets under management and ratio of AUM to gross inflows on their respective website on an yearly basis. Insurance has its own requirements. The IRDAI mandates a standard on public disclosures by insurance companies with a view to strengthen the corporate governance and market discipline of the insurers. In spite of this, returns and costs are not disclosed in a consistent manner by all insurance companies, and also relative to

⁵³Rural mandates are discussed in Section 4.

⁵⁴Source: Table 4 : Mutual fund data for month of March 2015, AMFI monthly <http://portal.amfiindia.com/spages/ammr2015repo.pdf>

⁵⁵8th meeting of FSDC October 24, 2013 standard on public disclosures by insurance companies http://finmin.nic.in/fsdc/Press_release_8th_meeting_FSDC.pdf

mutual fund products. This makes it difficult for customers to understand the products, or compare similar products sometimes even between the same regulatory domains.

The Committee studied the benefit illustration of life insurance, mutual funds and NPS. The disclosures in the traditional plans of insurance particularly offer a greater scope for improvement so as to provide greater transparency and clarity to the target customer. An analysis of issues arising from disclosures in a non linked participating plan and non linked non participating plan are illustrated below:

Non linked participating plan

We begin with an example of a product with the following characteristics

- Annual Basic Premium: Rs.2,881 (exclusive of taxes)
- Sum Assured: Rs.1,00,000
- Age of joining as per benefit illustration: 30
- Product term: 35 years.
- Benefit illustrations provided based on 4 percent and 8 percent return.
- Returns provided in the form of “bonus”.
- Illustrations also provide detailed table with possible surrender values and death benefit at various stages of the policy along with the benefit payable
- The illustrations are only for 35 year tenure for a 30 year old.

From these illustrations, it is difficult to understand:

- That *on maturity after 35 years, based on the 8 percent return illustration, the actual yield on premiums net of mortality cost would be 5.3 percent (or 2.4 percent based on 4 percent return).*
- That *bonus is not an extra payment being made.* In a participating plan, these are the only returns a customer can expect to get.
- *In case of premature exit during the policy tenure, the customer would not earn any return* and instead lose a part of her principal. This is despite the fact that a table with surrender values illustrations is presented.

Legitimate returns when called bonus create a skew in the minds of investors. The practice of providing returns in the form of bonus is not an appropriate disclosure.

Insurance companies provide the surrender value illustration to the consumer as part of their disclosure tables. However, this does not reveal the full impact on consumer's net return on account of the surrender charges. Table 2.5 illustrates the net yield on the investment (premiums after allocating mortality charges)⁵⁶ in case of premature exit and on maturity for a 35 year tenure policy.

As the surrender value is less than the total premiums paid, it implies that the consumer does not get the guaranteed additions or bonus accrued till date as the same is payable only on maturity or death. This fact is not obvious from illustrations provided.

⁵⁶As mortality charges are not disclosed separately in a insurance plan which combines investment and insurance, mortality charges are taken at Rs 3.00 per thousand for a 30 year old for 35 years (derived from mortality charges for a standalone term insurance plan by the same company). They are derived from a standalone term insurance product where the cost for a 30 year old for 25 year tenure is Rs 1.96 per thousand.

Table 2.5: Annualised Net Yield in Case of Premature Exit

This table shows the net yield on premiums (net of mortality cost) in case of a premature exit for a 35 year tenure policy with an annual premium of Rs.2,881 and a sum assured of Rs.1,00,000. The customer age on joining is 30 years. For example, based on the above scenario, in case of surrender after 25 year at customer would have earned a net negative yield of -0.1 percent on her investment

At end of Tenure (in Years)	At 4% Returns	At 8% Returns
5	-27.2%	-23.5%
10	-9.7%	-6.3%
15	-4.8%	-2.6%
20	-2.5%	-0.9%
25	-1.3%	-0.1%
30	-0.4%	0.6%
35	2.4%	5.3%

What is actually required is a disclosure on (i) the annualised net returns earned by consumer where returns are calculated on investments, ii) annualised net returns in case of premature exit along with the surrender value; and (ii) the loss of the guaranteed additions or bonus (based on whether it is a non participating or participating plan) for all the years in case of premature exit. Only when these disclosures are also made will the customer be able to evaluate the product in its totality. These disclosures should thus become clear and central. A similar product sold in the **United Kingdom (UK)** requires disclosure of the *reduction in investment growth rate* after leaving out the cost of life cover. This reduction is shown for scenarios covering surrender in early years as well as in later years of the policy tenure. This disclosure form is shown in Annexure E.

An identical investment product such as a mutual fund, when it illustrates returns, say at a similar 8 percent to the consumer, reflects these returns net of all its costs (**Net Asset Value (NAV)** is arrived at after costs) and the yield for the customer is therefore same. The only deduction that can happen from the **NAV** is on account of exit loads which are applicable on pre-mature exit and are pegged as a percentage of the investment corpus and converge to about 1 percent in most cases.

Non linked non participating plan

An analysis of issues arising from disclosures in a non linked participating non linked non participating plan are illustrated below: Here the disclosures provide

- Annual premium: Rs.1,23,125 (exclusive of taxes)
- Premium paying term: 5 years
- Age of joining: 35
- Policy tenure: 15 years
- Sum assured is Rs.5,00,000 and the guaranteed maturity benefit is Rs.11,00,000.
- The maturity benefit is stated as 220 percent of sum assured
- Returns are provided as guaranteed additions at 8 percent of the sum assured.

From these illustrations, it is difficult to understand:

- That *the net yield on premiums (net of mortality charges) over the policy tenure of 15 years would be 4.71percent and not 8 percent.* The mortality costs are taken at Rs. 2.05 per thousand for a 35 year old male from the same company's standalone term insurance plan.
- That *the returns and maturity benefit when pegged to sum assured rather than*

investment are misleading as sum assured is a function of mortality cost and not investment or rate of return. The *guaranteed additions as a percentage of sum assured* at 8 percent give an impression that this investment is generating 8 percent returns.

- That the policy tenure is 15 years but the entire premium is collected over the initial five years. However, *the surrender value for the consumer, even after 5 years is only 50 percent and starts growing beyond 55 percent in year 8.*

These illustrations point out that returns expressed as percentage must refer to the rate of return on investment as is understood in case of bank deposits or mutual funds. Higher premium in initial years also places greater possibility of lapse in the initial years. Collecting higher premiums in initial years also allows higher commissions to be paid to agents and higher costs to be allocated for expenses.

3 — Policy response

The overwhelming evidence on mis-selling leads to a natural question: What actions have regulators taken so far to address the problem? Before we study the Indian response, it would be useful to understand the thinking of regulators across the world on similar issues.

The demand for better regulation of financial product distribution has grown stronger after the 2008 financial crisis. While a large focus of these discussions is the mortgage and credit market, especially in the **United States of America (USA)**, the need for regulating distribution of other financial products is also well accepted. Reforms in each country are always a function of the condition of financial markets at the time of reform. For example, markets in the **USA** are fragmented, similar to that in India. The reforms in distribution in the **USA** have thus reflected this nature of the markets. While the **USA** has moved towards bringing consumer issues under a single **Consumer Financial Protection Bureau (CFPB)**, its success in doing so has been limited.

The two countries to have undergone the largest overhaul of their markets are the **UK** and Australia. Both function under a model where regulation is designed according to function i.e. prudential regulation and consumer protection, and not by product. This structure of the market is itself a result of the problems faced by these economies in early decades.

In the **UK**, the **Financial Conduct Authority (FCA)** oversees the distribution of financial products, while in Australia it is the **ASIC**. Both countries have moved away from a commissions based model of distribution, towards a fee-for-advice model. This has been accompanied by strong suitability requirements i.e. advisors have a duty to sell products that are suitable to customer requirements, making it imperative for them to understand customers situation and act in the interest of the customer. Reforms in the **USA**, **UK**, Australia, **European Union (EU)** and South Africa are described in Annexure C.

It is important to point out that in many of these markets, investment is often mandatory through retirement plans, and the penetration of investment products is also higher than

in India. Agents play an important role in educating the customer about modern finance as well as financial products. To impose a blanket ban on commissions, therefore, may not be the optimal response for a transition economy like India, as is the regulators stance today.

So how have Indian regulators responded in the form of policy changes that should prevent mis-selling? We describe the main reforms in the mutual fund and insurance markets in the past decade that directly address the problem described earlier. These have consisted of changes in rules on commissions, changes in responsibilities of agents, changes in disclosures, changes in product structure itself, and aligning penal power across regulators

3.1 Changes in commissions

The first reform on distributor incentives was the ban on entry loads of mutual funds by **SEBI** in 2009. This was done with a view to empower the investors in deciding the commission paid to distributors in accordance with the level of service received, and to bring about more transparency in payment of commissions and to incentivise long term investment.⁵⁷ This led to a huge furore with the industry claiming that it would lose out to other products, and the entry load would result in the death of the industry. However, this has not been the case. The industry has largely turned itself around, and re-organised to a trail-based model where the incentive of the distributor gets aligned with that of the customer. **SEBI** has required **AMCs** to provide direct plans with lower **TER** for investments not routed through intermediaries. A recent proposal by **AMFI** has suggested a commission of 1% upfront to be followed by all **AMCs**.

Similar rule change on **ULIPs** were brought about by the **IRDAI** in 2009. The **IRDAI** mandated that the cap on charges will be based on the difference between gross and net yields of any product. For insurance contracts which are of a tenor of less than or equal to 10 years duration, the difference between gross and net yields cannot be more than 300 basis points. Of these, fund management charges cannot exceed 150 basis points. For contracts whose tenor is more than 10 years, the difference between gross and net yields cannot exceed 225 basis points, of which the fund management charges cannot exceed 125 basis points.⁵⁸ Further changes to the **ULIP** product structure were made in 2011.⁵⁹ resulting in a major clean up of the product.

The commissions structure of the traditional endowment product has not undergone any change. Today, this product earns the highest commission, and as described in earlier sections, has become popular once again. The Insurance Laws Amendment Act, 2015 has led to the removal of the ceiling of 40 percent on the maximum commission, fee or remuneration. **IRDAI** now has the power to lay down the structure of commission/brokerage for intermediaries as well as the power to determine the expenses of management

⁵⁷ SEBI, *Mutual Funds- Empowering investors through transparency in payment of commission and load structure*, SEBI/IMD/CIR No. 4/ 168230/09, June 2009.

⁵⁸ IRDA, *Unit linked products - Cap on charges*, Circular No: 20/IRDA/Actl/ULIP/09-10, July 2009.

⁵⁹ IRDA, *Annual Report, 2010-11*, 2011.

which can be incurred by insurers. This may lead the regulator to lower commissions on these products in the near future.

Another recent policy response related to commissions pertains to using claw backs as a tool to curb mis-selling, mainly in open ended products. Claw backs allow for upfront commissions to be recouped from the agent in case the consumer exits partially or fully from the product before a predefined tenure. AMFI's code of conduct requires agents to refund to mutual funds, incentives/ commissions which are subject to claw back as per SEBI regulations. With effect from January 1, 2013, all upfront commissions paid to distributors are liable to complete and/ or proportionate clawback in case a consumer switches from a Regular Plan (agent sold plan) to a Direct Plan (offered directly by the mutual fund). The concept of claw back has also been extended by SEBI to additional distribution expenses permitted on account of inflows from beyond the top 15 cities. These are subject to clawback if such investments are redeemed within one year from the date of investment.

3.2 Changes in agent responsibilities

In September 2011, SEBI released a concept paper for regulating investment advisers, where it separated the role of an adviser from that of a distributor.⁶⁰ SEBI's proposal included the formation of a Self Regulating Organisation (SRO) which will regulate advisers who will charge clients for advise on various products. These advisers will not be remunerated by product providers. The *Securities and Exchange Board of India (Investment Advisers) Regulations, 2013* were notified in January 2013.⁶¹

SEBI also put in place the Employee Unique Identification Number (EUID), which is an alphanumeric code assigned to each individual advising/selling to the customer. This number stays with this individual as he moves jobs. This number can be used to track each sale back to the person who was credited with the sale. This makes it possible to hold agents responsible for their sales.

In 2011, the IRDAI issued guidelines to enhance the persistence of life insurance policies.⁶² The new guidelines mandated a persistence of 50 percent for agency renewals till the financial year 2014-15, and 75 percent persistence after that.⁶³ By requiring agents to achieve at least a 50 percent persistency rate, it was hoped that agents would be more circumspect in how they sold the policy, and in following-up with consumers about their premium payments. However, in February 2014, the IRDAI passed a new guideline⁶⁴ which allowed for renewal of agent licenses without regard to the persistency

⁶⁰For more details, refer to SEBI, *Concept Paper on Regulation of Investment Advisors*, Concept Paper, Securities and Exchange Board of India, 2011.

⁶¹SEBI, *Securities and Exchange Board of India (Investment Advisers) Regulations, 2013*, tech. rep. No. LAD-NRO/GN/2012-13/31/1778, SEBI, 2013.

⁶²Section 14(2) of the IRDA Act, 1999.

⁶³IRDAI Journal, August 2011, Page 12.

⁶⁴Guideline: IRDA/Life/GDL/057/02/2014, http://www.irda.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo2207&flag=1

record of the agents. From July 1, 2014, all life insurance companies will have their own company specific persistency criterion for renewal of individual and corporate agents.

3.3 Changes related to disclosures

In order to enhance transparency and improve the quality of the disclosures, **SEBI** has introduced many rules on mutual fund advertising and disclosures over the years.

The **AUM** from different categories of schemes such as equity schemes, debt schemes, and others, **AUM** from B-15 cities, contribution of sponsor and its associates in **AUM** of schemes of their mutual fund, **AUM** garnered through sponsor group/ non-sponsor group distributors are required to be disclosed on monthly basis on respective website of **AMCs** and on consolidated basis on website of **AMFI**.⁶⁵

When advertising scheme returns, **AMCs** have to show point to point returns on a standard investment of Rs.10,000 in addition to **Compounded Annual Growth Rate (CAGR)** returns (if the scheme has been in existence for more than 3 years).⁶⁶ This was done to give a more complete standardised picture of fund performance.

Further, **AMCs** have to show the 12 month returns (as many 12 month period as possible) since inception for the last 3 years along with the benchmark returns.

To standardise the advertising rule for scheme returns, **SEBI** has mandated fund houses to show the scheme's performance against a broad index like Sensex or Nifty (for equity schemes) and 10 year **Government of India (GOI)** security (for long term debt funds) and 1 year Treasury bill returns for short term debt funds.

While advertising the performance of a particular fund, **AMCs** have to also show the performance of all other schemes managed by the fund manager of that particular scheme. If the fund manager is managing more than six schemes, then **AMCs** have to mention the total number of schemes managed by the fund manager along with the performance data of three top and three bottom performing schemes.

In 2013, **SEBI** came out with another rule called scheme labelling. To depict the level of risk involved in mutual funds, **AMCs** are required to put colour code boxes in all schemes according to the objective of the scheme. **AMCs** are supposed to put colour codes in all their advertisement materials, front page of initial offering application forms, **Key Information Memorandum (KIM)**, **Scheme Information Document (SID)**s and common application forms. In April, 2015, colour codes were replaced by a new "Riskometer" which would more appropriately depict the level of risk in any specific scheme.⁶⁷

⁶⁵Press Release: http://www.sebi.gov.in/cms/sebi_data/pdf/files/27383_t.pdf

⁶⁶This is as per information compiled on www.cafemutual.com

⁶⁷SEBI Circular on Product Labeling in Mutual Funds, CIR/IMD/DF/4/2015, April 30, 2015, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1430388883147.pdf

3.4 Changes in the product structure

One of the biggest changes to product structures (including disclosures) has been the regulations regarding index linked insurance plans **ULIPs** and **Variable Linked Product (VIP)s**⁶⁸ and non linked insurance plans⁶⁹ by the **IRDAI**. These included regulations on charges, reduction in yield, discontinuance terms, surrender value, partial withdrawals, top-ups among others. Most importantly, these regulations required a separation of assets i.e. they required the insurer to earmark assets for each **VIP** on the linked platform separately, disclose the policy account value on a daily basis and do a daily disclosure of the **NAV** of **ULIPs**. The regulations for linked products also suggested that insurers and the life council move towards independent ratings of **ULIPs**. In case of **VIP** on the non linked platform, insurer were required to earmark assets for each **VIP** separately, disclose the policy account value on a daily basis and compute and disclose the **RIY**.

3.5 Aligning penal power across regulators

The levels of penalties and regulatory action on penalties in the past has varied from regulator to regulator creating different regulatory regimes. In the last two years 2013-15, some thinking has gone into aligning penalties and the penal powers of **SEBI**, **IRDAI** and **PFRDA**.

PFRDA Act, 2013 being a new legislation came in with strong penal provisions. **SEBI**'s penal powers were last upgraded through the Securities Laws(Amendment) Act, 2014. The antiquated penal powers of **IRDAI** were also finally revised through the recent Insurance Laws (Amendment) Act, 2015, in a move to align them with the powers of **SEBI** and **PFRDA**. This is illustrated by two examples. First, **IRDAI** has the power to remove the managerial persons of the insurance companies in case its affairs were being managed to the detriment of the interest of the policyholders. However, in case the order of **IRDAI** were contravened, till recently, the penalty was limited to Rs.250 per day of the contravention. This has now been brought in line with **SEBI**'s powers and the revised penalty is one lakh rupees for each day during which such contravention continues or one crore rupees, whichever is less. Second, rebating of commissions is a known practice in life insurance. Section 41 of the Insurance Act, 1938 forbids any kind of rebating. However, the maximum penalty for rebating was only Rs.500 which has recently been increased to rupees ten lakhs.

SEBI can levy penalties of Rs.1,00,000 per day or penalties upto rupees one crore on mutual fund for failure to comply with the regulations.⁷⁰

⁶⁸Insurance Regulatory and Development Authority (Linked Insurance Products) Regulations, 2013

⁶⁹Insurance Regulatory and Development Authority (Non-Linked Insurance Products) Regulations, 2013

⁷⁰Section 15D, Securities and Exchange Board of India Act, 1992, as amended by the Securities Laws(Amendment) Act, 2014

3.6 Judicial pronouncements

The courts in India regard mis-selling to be a major concern in the financial sector.⁷¹ In relation to financial products, courts and tribunals have discussed mis-selling in a variety of cases although in many of such cases, the term mis-selling has not been used to refer to the practice of deceiving consumers through non-disclosure or mis-representation. In this regard, different principles of law (typically consumer protection and contract) have been utilized to provide relief to the customer against mis-selling.

Mis-selling claims are typically based on violation of **Consumer Protection Act (CPA)** or regulations issued by the relevant regulator. In a recent 2014 decision (*Virendra Pal Kapoor v. Union of India*), the court held the insurance company liable under the **IRDAI** (Protection of Policyholders' Interest) Regulations, 2002 for misrepresentation of the returns under policy and directed the **IRDAI** to re-examine each and every insurance policy of the insurance company to ensure adherence to the guidelines laid down by the court in the said case.

Mis-selling in the form of alteration of fundamental attributes of a mutual fund scheme without the consent of the participant, non-disclosure and unsuitability of the scheme have been held by Indian courts/ tribunals to be in violation of the applicable regulations such as **SEBI** (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 and the **IRDA** (Protection of Policyholders Interest) Regulations, 2002 and relief has been granted to the consumer.

Consumer cases on mis-selling have been based on allegations of fraud, misrepresentation and unreasonableness of contracts involving financial products. For instance, the Madras High Court while stressing on the requirement of good faith in insurance contracts has held that suppression of material facts relating to an insurance policy is a violation of the contractual requirement of consensus ad idem (agreeing to the same thing in the same sense) between the parties.

Mis-selling also manifests in the form of adhesion contracts where consumers do not have the right to bargain the terms and conditions of the contract. Adhesion contracts have been considered as an unfair trade practice under the **CPA**, since there is a lack of disclosure and also an information asymmetry between the consumers and the sellers. In various cases, the courts have considered unilateral change of terms and conditions as an unfair trade practice and have given relief to the consumer.

Indian courts have developed various safeguards against mis-selling in an attempt to offer a favourable judicial environment to the consumers. These include non-enforcement of exemption clauses favoring the company/intermediary and usage of the principle of *contra proferentum* (sales contracts favoring the seller to be interpreted in favor of the buyer).

⁷¹We thank Vidhi Centre For Legal Policy for inputs on this section.

3.7 Policy reports

Besides actions by regulators, there have also been initiatives to think through the problem in its entirety. One of the more recent efforts was the Committee on Investor Awareness and Protection set up by the **High-Level Coordination Committee on Financial Markets (HLCCFM)** to *strengthen the ongoing efforts for imparting financial education and promoting investor protection* which submitted its report in March 2010.

The Committee's view was that problems in distribution led to lack of faith about market linked products among Indian households, which further led to low participation. It emphasised the importance of a *trustworthy, regulated retail intermediation industry, with common minimum standards* to facilitate the transition to greater household participation in financial markets. The Committee was the first to treat the sale of commissions based products as advice.⁷² The other aspect studied in great detail by the committee was investor education. It believed that investor protection and investor education would not work in isolation, and needed to be thought of together.

Sahoo and Sane (2011) describe the main recommendations of the committee. They are as follows:

1. All retail financial products to go *no load* by April 2011;
2. All financial advisers to undergo a minimum knowledge-linked training program, and selling of more complicated products to require a higher level of education ;
3. All financial advisers to be governed by a code of ethics that is standard across products and organisations;
4. All products to abide by a disclosure template which will display the most important terms and conditions of the products, and the amount an adviser earns from the sale and maintenance of the product;
5. The sales process to be documented, along with customer profiling that took place before a product was sold;
6. A common interface for grievance redress; and
7. Financial literacy modules for Advisers, School students, Post Class XII students, and other such entities to be developed by the Financial Literacy arm. The Financial Literacy arm to be the focal point for all financial literacy initiatives in the country.
8. Setting up of the **Financial Well-Being Board of India (FINWEB)**. The goal of the organisation would be to bring order to the adviser market and building a financially literate community. It will consist of two arms: one **SRO** arm that will be responsible for bringing advisers under one common standard, and a Financial Literacy arm that will work on promoting financial literacy.

The report tabled in 2010 was released to the public only in 2014. While none of the recommendations got formally implemented, regulators made several changes on the basis of the recommendations. In fact, while the committee was debating the issue of banning upfront commissions, **SEBI** announced them in August 2009. **IRDAI** announced changes in the product structure of **ULIPs** in 2010 that drastically reduced upfronts from 40 per cent to an average of about 9 percent. The draft **IFC** also credits its consumer protection approach to the report.

⁷²See section 3.3, Committee on Investor Awareness and Protection, *Minimum Common Standards for Financial Advisers and Financial Education*, A Consultation Paper, Chaired by D. Swarup, Chairman PFRDA, Government of India, 2010.

3.8 The Indian Financial Code

The most important change in consumer finance has been the draft **IFC** which proposes to bring in wide-sweeping reforms in the legal and regulatory framework for the Indian financial sector.⁷³ Three design features of the **IFC** are particularly relevant from the point of view of the problems outlined so far.⁷⁴

1. The **IFC** envisages two super regulators, the **FA** and the **RBI**. The functions of the **IRDAI**, **SEBI** and **PFRDA** will be subsumed under the **FA**. This will directly address the problems of regulatory arbitrage discussed earlier.
2. Under the **IFC**, *consumer protection* is considered as one of the core functions of regulation. The draft **IFC** creates the following legislative rights for all consumers of financial services:
 - (a) The right to expect professional diligence from financial service providers.
 - (b) Protection against unfair contract terms and unfair conduct.
 - (c) Right that the financial service provider shall maintain the confidentiality of the information provided by the consumer.
 - (d) Right to get fair disclosure from the financial service provider.
 - (e) Right to a dispute settlement system that must be maintained by the financial service provider.

These promise to bring in a legal and regulatory framework for consumer protection in a way that has not been done before.

3. The **IFC** envisages the setting up of a **FRA** which will accept complaints regarding all financial services. The **FRA** will mediate disputes and in the event of failure of the mediation, order the merits of the dispute through a process of adjudication.

The **IFC** gives certain rights and protections to retail consumers. Retail consumers are individuals and small organisations. It recognises that market failures resulting from information asymmetries and bargaining power differences are accentuated for such consumers. Moreover, such consumers also face enormous coordination challenges, because it is usually very difficult for a large number of small value consumers to influence a financial service provider to do the right thing in their interest.

The substantive provisions of the **IFC** will only take effect when the law is enacted. However, the **Ministry of Finance (MoF)** and all the regulators agencies have decided to adopt the non-legislative elements of the draft **IFC** articulated in the *Handbook on adoption of governance enhancing and non-legislative elements of the draft IFC*. A portal is being designed whereby regulators will be required to reveal if they have met with specific Handbook requirements. The process to bring forward in time the gains of the **IFC** has already been set in motion. The Government also announced the Task Force on **FRA** (**FRA**) to lay down the road map for setting up the **FRA**.⁷⁵

⁷³This is the result the **FSLRC** under the chairmanship of Justice Srikrishna. See Justice B. N. Srikrishna, *Financial Sector Legislative Reforms Commission*, vol. I and II, Ministry of Finance, Mar. 2013.

⁷⁴See Ila Patnaik and Ajay Shah, *Reforming India's Financial System*, tech. rep., Carnegie Endowment for International Peace, Jan. 2014, for an introduction to the **IFC**.

⁷⁵DEA, *Task Force on Financial Redress Agency*, Office Order No 16/3/2013-FSLRC (Part I), FSLRC Division, Department of Economic Affairs, Ministry of Finance, Government of India, May 2015.

4 — What is missing?

The policy response by regulators most of the times has been incremental. It appears that regulators have responded to each crisis at a time. This has meant that the policy changes do not add up to a comprehensive and internally consistent strategy for consumer protection. For example, though the regulations and circulars discuss the concept of mis-selling and have prescribed guidelines to curb it, the term mis-selling has been defined only by the **SEBI** in the **SEBI** (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.

One example where problems remain unaddressed is the mis-selling through the banking channel. The **RBI** has made some recent moves towards publishing a charter of consumer rights⁷⁶, but these have yet to be translated into changes on the ground. In several cases the regulators have not gone the whole distance. For instance, the provisions of the IRDA (Non-Linked Product) Regulations, 2013 and the IRDA (Linked) Product Regulations, 2013 are yet to be extended to traditional endowment (participating and non-participating) plans as well. As of date, there has been no move towards imposing product suitability obligations, or increases in the legal liabilities on companies for mis-sale of products by their agents. Reported instances of the regulator taking cognisance of mis-selling and penalising the company/intermediaries have also been low and the penalty meted out is paltry (on a case to case complaint basis).

Finally, regulatory changes also do not address the heart of the problem i.e. mis-alignment of incentives for agents that distribute products as well as differences in disclosures across different regulatory domains. We discuss them below.

Issues in commissions As described earlier, large differences in the cost structures of traditional insurance plans vis-a-vis mutual funds and vis-a-vis **ULIPs** remain. This has meant that the sale of insurance products is far more lucrative relative to the sale of **ULIPs** or mutual funds. Similarly **ETFs** and **NPS** get ignored by retail advisors.

⁷⁶https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=32667

Issues in disclosures Disclosure requirements and formats are also not similar across similar products.⁷⁷ Returns and costs are not disclosed in a consistent manner by all insurance companies, and also relative to mutual fund products. This makes it difficult for customers to understand the products, or compare similar products sometimes even between the same regulatory domains.

The Committee studied the benefit illustration of life insurance, mutual funds and **NPS**. The disclosures in the traditional plans of insurance particularly offer a greater scope for improvement so as it provide greater transparency and clarity to the target customer.

4.1 The challenge of composite products

An aspect important to the sale of retail financial products is the structure of composite products. In most cases, these end up being essentially investment products as mortality costs are a small fraction of the annual premium. This is especially true for a majority of customers who are under 45 years of age.

Insurance regulations do specify minimum sum assured or the death benefit in case of investment oriented life insurance policies. The sum assured should not be less than ten times the annual premium for individuals below the age of 45, and less than seven times the annual premium for those above the age of 45. Regulations also require that the sum assured is at least 105 percent of the premiums paid. However, for policies with a term of less than ten years, the minimum sum assured is only 5 times the annual premium.

Typically, the mortality premiums for a 30 year old is about Rs.1.6 per thousand (for a 20 year policy). This can go up to Rs.8 per thousand for a 50 year old (for a 20 year policy).

As shown in Table 4.1, for a 30 year old, the mortality cost could accordingly come to about 2.24 percent to 3.44 percent of the annual premium in most cases. These almost suggest that investment products are layered with a minimal insurance so as to be sold under the banner of insurance, instead of investment.

The table below separates the mortality cost from a composite product by applying illustrative standard term insurance mortality rate⁷⁸ for each age band along with the minimum sum assured, as required by the insurance regulations. The actual proportion of mortality cost in most composite product would be even lower. This is due to the fact that the mortality rate in a composite product, unlike a term insurance is not uniform and usually reduces over the product tenure. The life cover, in such products, is the sum of fund value (or bonus and assets backing the product) and sum assured. As the fund value increases over time, the sum assured required decreases resulting in proportionately

⁷⁷ Mutual funds are required to disclose total commission and expenses paid to distributors, distributor-wise gross inflows (indicating whether the distributor is an associate or group company of the sponsor(s) of the mutual fund), net inflows, average assets under management and ratio of **AUM** to gross inflows on their respective website on an yearly basis. Insurance has its own requirements. The **IRDAI** mandates a standard on public disclosures by insurance companies with a view to strengthen the corporate governance and market discipline of the insurers.

⁷⁸ http://www.licindia.in/LICs_Amulya_Jeevan-II_Plan_conditions.html

lower mortality cost, as against a pure term product where the sum assured does not decrease over time.

Table 4.1: Mortality Costs as percentage of Annual Premium

This table shows the mortality cost as a percentage of annual premium based on IRDAI norms. For instance, in case of a 30 year old for a 20 year policy, based on mortality cost of Rs. 1.64 per thousand, the mortality cost as a percentage of annual premium would be 3.44 percent i.e. Annual Premium (say, Rs. 100,000) x Tenure (20 years) x 105 percent of premium (1.05) x 1.64/1000.				
AGE TERM	20	30	40	50
10	1.21%	1.35%	2.53%	6.14%
15	1.81%	2.24%	4.68%	10.85%
20	2.42%	3.44%	7.50%	16.91%
25	3.07%	5.15%	11.10%	

A customer must be able to understand a composite insurance product which combines investment and insurance with an unbundled approach where, for example, a customer could buy a separate term insurance along with a mutual fund scheme for investment. Currently, it is not possible for a customer to compare the bundled insurance offering with the unbundled proposition either on the basis of cost or on the basis of investment returns. The opacity comes from the disclosures in the composite products, especially those that are managed on a pool basis i.e. where investments are not unitised, and underlying asset values are not disclosed periodically. The customer is not able to evaluate a) what the actual rate of return on investment (and not sum assured) is likely to be b) what part of returns earned by the insurance company are allocated to the customers' bonus and c) what part of the returns earned by the insurance company are allocated to costs.

The problem in such composite products is not unique to India. The UK for example allows the sale of these products with better disclosures (See Annexure E). However, it is increasingly discouraging the use of these products. New regulations by the prudential regulator as well as the conduct regulator are going to take effect in January 2016, which should remove some of the opacity in these products in the UK markets.⁷⁹ No such discussion has taken place in India at the time of writing this report.

4.2 Regulatory arbitrage

The current structure of the market has meant that each regulator implements policies in sectoral silos with wide divergences in regulations, practices and minimum standards. Definitions of key terms and regulatory approaches vary across regulators. We have already discussed differences in permissible costs of distribution, and disclosure standards. We present further differences in investment regulation, tax treatment and financial inclusion mandates. This fragmented regulatory architecture yields inconsistent treatment in consumer protection and micro-prudential regulation across all of them.

⁷⁹<http://www.out-law.com/en/articles/2014/october/changes-to-the-regulation-of-uk-with-profits-insurance-businesses-/>

4.2.1 Investment regulation

One crucial area of divergence is investment regulation. Regulatory norms do not prescribe the investment pattern for mutual funds. Instead, they specify norms for diversification for different type of funds.⁸⁰ Investments by insurance companies are subject to a prescriptive model with a substantial portion of funds channeled into government related investments. Rules require traditional endowment plans to invest not less than 50 percent of the fund in government securities or other approved securities, of which not less than 25 percent of the fund should be invested in government securities. The investment norms differ for non linked life business, pension and annuity plans and **ULIP** plans.⁸¹ The investment guidelines for **NPS** for private citizens allow investment in government securities (asset class G), corporate bonds (asset class C) and equities (asset class E) in various proportions (subject to condition that investment in equity cannot exceed 50 percent of the investible funds).

Fragmentation on investment guidelines has led to a loss of scale and scope that could be available from a seamless financial market with all its attendant benefits of minimising the intermediation cost. To illustrate, the **AUM** managed by life insurance companies is 165 percent of the **AUM** of mutual fund industry. The assets under the nascent **NPS** are already touching 63 percent of the **AUM** of the mutual fund industry.

4.2.2 Tax treatment

The other area of difference is the tax treatment of investment products. The *Income Tax Act, 1962* allows for certain tax deductions at the point of entry, during holding, and at exit (which differs based exit at maturity or premature withdrawal). These tax deductions are not applied consistently across all types of products and, as a result, similar products have to compete under very different tax regimes. In the case of **NPS** for example, there is a requirement that the deduction cannot exceed 10 percent of the employee salary in the previous year.⁸² The tax-deductibility of employer contributions is restricted to 10 percent of the employee's salary in the case of the **NPS**.⁸³ This is an inferior tax treatment when compared to other recognised funds where the employer's contribution is exempt from tax up to a limit of 12 percent of the employee's salary.⁸⁴

4.2.3 Financial inclusion

Concern for financial inclusion has manifested itself in the form of tax-sponsored schemes, as well as policy mandates for industry players.

The most recent efforts include seeding bank accounts, providing credit linked insurance, and pension accounts to low income workers through government led initiatives. The

⁸⁰To illustrate, in an equity fund, the investment in equity shares or equity-related securities of a single company must not exceed 10 percent of the net assets of the scheme. Mutual funds are also not permitted to advance any loans.

⁸¹IRDA (Investment)(Fourth Amendment)Regulations 2008

⁸²Section 80CCD(1), IT Act.

⁸³Section 80CCD(2), IT Act.

⁸⁴Rule 6, Part A, Schedule IV, IT Act.

Pradhan Mantri Jan Dhan Yojana (PMJDY) aims to *provide bank account to every household in the country and make basic banking services facilities*.⁸⁵ Life and accident insurance coverage rides on these bank accounts through the **Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)** and **Pradhan Mantri Suraksha Bima Yojana (PMSBY)**.⁸⁶ Pension initiatives include the **NPS-Lite** and the recent **Atal Pension Yojana (APY)**.⁸⁷

While the government has begun subsidised programs, regulators response over the last several decades has been to mandate regulated entities to reach out to “underserved” areas. The differences between **SEBI** and **IRDAI** are significant.

SEBI does not mandate financial inclusion obligations but it has been initiating steps to encourage mutual funds to deepen the markets beyond the top 15 cities. This has been done by relaxing the norms on expenses and commissions for business generated beyond the top 15 cities. Mutual funds are also required to annually set apart at least 2 basis points on daily net assets within the maximum limit of **TER** for financial literacy and investor education.⁸⁸ Mutual funds are required to disclose in the half yearly trustee report to **SEBI** regarding the investor education and awareness initiatives undertaken.

IRDAI, on the other hand, has responded by rural mandates, requiring insurers to underwrite 25 percent policies in the rural sector. **IRDAI**’s focus to develop the rural markets began as early as 2002 when it first developed rural and social sector obligation norms requiring insurers to achieve percentage of policies to be sold in rural areas, and number of lives to be covered in the social sector.⁸⁹ This is seen by the insurance industry to create additional cost structures for the industry which impacts their profitability and competitiveness, especially, if other sectors, primarily mutual funds, do not have the same policy compulsions. It is also not clear whether the new insurance programs, **PMJJBY** and **PMSBY**, will impose additional costs on insurance companies.

The concern about financial exclusion has been an over-riding feature of policy in the retail finance sector. Cost-benefit analysis of such policies should be undertaken on an on-going basis.

4.2.4 Multiplicity of regulations

Another factor that makes it difficult to resolve the issue the multiplicity of regulations, in the form of regulations, circulars, notifications, guidelines and orders issued by each sectoral regulator. This has created a general environment of confusion and perhaps contributed to uncertainty in respect of the legal status of their applicability to the financial institutions, banks and the intermediaries (advisers and distributors). For example, though the regulations and circulars discuss the concept of mis-selling and have prescribed guidelines to curb it, the term mis-selling has been defined only by the **SEBI** in the **SEBI** (Prohibition of Fraudulent and Unfair Trade Practices relating to

⁸⁵ See **PMJDY** website for details: <http://www.pmjdy.gov.in/>

⁸⁶ See **PMJJBY** website <http://financialservices.gov.in/PMJJBY.asp> and **PMSBY** website <http://financialservices.gov.in/PMSBY.asp> for details.

⁸⁷ See URL: <http://financialservices.gov.in/APY.asp> for details.

⁸⁸ Regulation 52 of the Regulations for investor education and awareness initiatives.

⁸⁹ See IRDA (Obligations of Insurers to Rural and Social Sector) Regulations, 2002.

Securities Market) Regulations, 2003).

Distributors often get regulated by more than one regulator. This creates confusion as to which regulator actually has oversight on the sales process. Similarly, there are multiple forums that have jurisdiction over mis-selling and consumer protection matters and the applicable forum depends on the financial product mis-sold. These forums have different capacities and processes. Redress capacities at different regulators have also evolved differently.

5 — Policy choices for India

Easy access to adequate capital, both long and short term, is one of the key drivers of economic growth.⁹⁰ A crucial part of this process is the conversion of long-term household savings into investment, thereby providing funds for productive business. On one hand, household savings in India are almost 20 percent of GDP⁹¹ On the other, firms consistently report being credit constrained.⁹² Given the importance of retail financial markets in facilitating the flow of funds between households and firms, and the specific mandate⁹³ of the Committee, the policy goals as follows:

1. *To create an environment of competitive pressure on industry:* Competitive pressure should enable the development of large scale distribution networks that are able to service across India. Such an increase in capacity should also drive down overall costs of reaching to households. The Committee believes that the two important aspects towards such a market include:
 - Elimination of regulatory arbitrage
 - Elimination of hidden charges and fees
2. *To create an incentive compatible compensation structure:* Overall costs do not ensure that customers are sold the most appropriate products. Ultimately, the compensation structure should create incentives for intermediaries to enroll customers into those plans that best meet their needs. This will also generate trust

⁹⁰Ross Levine, “Finance and Growth: Theory and Evidence”, in: *Handbook of Economic Growth*, ed. by Philippe Aghion and Steven N. Durlauf, Amsterdam: Elsevier, 2005, pp. 865–934; Michael D. Bordo and Peter L. Rousseau, “Historical evidence on the finance-trade-growth nexus”, in: *Journal of Banking & Finance* 36.4 (Apr. 2012), pp. 1236–1243.

⁹¹RBI, *Reserve Bank of India Annual Report*, tech. rep., Reserve Bank of India, 2014.

⁹²Abhijit Banerjee and Esther Duflo, “Do Firms Want to Borrow More? Testing Credit Constraints Using a Directed Lending Program”, in: *The Review of Economic Studies* 81.2 (2014), pp. 572–607.

⁹³As described earlier, the mandate of the committee is to a) Address the issue of providing level playing field in the commission / incentive structure of financial products, b) Suggest policy measures such that differential regulatory norms do not favour any particular financial product and prevent mis-selling, c) Address issues with respect to hidden costs and identical financial products under different regulatory jurisdiction; and d) Rationalise the incentive structure across financial products.

in the market that is important for continued household participation.

The Committee considered three potential regulatory solutions. These are as follows:

Complete ban on all kinds of commissions The Committee deliberated on the suggestion of a complete ban on commissions. This is especially pertinent because several economies such as the [UK](#), [EU](#) and Australia have already banned commissions, especially upfront commissions on the sale of retail financial products.⁹⁴ While it was agreed that commissions can influence distributors to not act in the interest of the customer, it was also felt that commissions play an important role in incentivising the distributors to seek new customers. The agents role in educating customers, doing risk evaluation and primary underwriting, long term servicing and claims assistance were emphasised by the life insurance representatives.⁹⁵ Considering the low access of financial markets, it was felt that this was an important function that could not be ignored. These views were also strongly expressed by the association of insurance and mutual fund distributors to the Committee. For example, the [Financial Intermediaries Association of India \(FIAI\)](#) expects that financial distributors will play a critical role for channelization of savings in proper asset classes for long term wealth creation, and a no-commissions world will make it difficult for intermediaries to function.⁹⁶ The Indian market also suffers from a lack of a market for advice. Retail customers are not accustomed to paying for holistic advice. A body of financial advisors capable on advising on the entire portfolio of products is also not available. It was, therefore, felt that a complete ban on commissions in such an environment would be counter-productive.

Complete freedom on commissions and rules on disclosures This would be accompanied by a) regulations that mandate improved disclosure, and b) Regulations that increase penalties on mis-sales.

The Committee also considered leaving the determination of the commissions entirely to the market. In this scenario, market players would be free to determine the amount as well as the type of commission they pay to intermediaries. The recommendations would only concern themselves with mandating improved disclosure, and designing increased penalties on mis-sales. In this set-up, improved disclosure would help decision making by customers, and increased penalties would serve as a deterrent. This would generate incentive compatible behaviour, and further competition may drive costs down.

There are, however, two problems with this approach. First, research on disclosure has shown ambivalent effects. For disclosure to influence decisions, it has to be an *eye-opener*. The format has to be simple that product features become salient. This is often hard to achieve. Sometimes, mandatory disclosures can have unintended consequences. Loewenstein et. al. (2011) find that under a regime of mandatory disclosures, advisors seem to be more comfortable giving biased advice.⁹⁷

⁹⁴Details of reform in [UK](#), [EU](#), Australia and South Africa are discussed in the Appendix

⁹⁵Submission by life insurance representatives on insurance intermediation/agent remuneration.

⁹⁶Submission by [FIAI](#), 24 March, 2015

⁹⁷Loewenstein et. al., *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, tech. rep., Papers and Proceedings, American Economic Review, 2011.

Second, the design of penalties is also non-trivial. Firms have to be worried about the probability of getting caught, and conditional on being caught, suffer larger damages. Thus there have to be continuous inspections with low fines, or fewer inspections but high damages. But this pre-supposes an enforcement capacity that is difficult to put in place immediately. Liabilities may not be enough to make it profitable for *high-road* firms to separate from *low-road* firms and offer low-cost products.

Ultimately, the combination of competition with disclosures and penalties requires that some firms will have an incentive to distribute low cost products, and this will generate pressure on other firms to follow suit. The danger is that compensation structure is an industry-wide problem, making it difficult for one player to change the system. The problem of hidden costs of similar products under different jurisdictions also does not get addressed in this framework. It was therefore felt that leaving the compensation structure entirely upto the industry was also not a viable solution.

Remove arbitrage and align incentives The starting point for discussions on the suggestion for a dynamic, and fair financial system for households is the belief that certain compensation structures are inherently unreasonable. A compensation structure that does not link intermediary remuneration to the well-being of the client will ultimately fail in serving the interest of the consumer. Similarly, disclosures and penalties on mis-sales by themselves will not align with improved choice and increased consumer welfare. The Committee arrived at a view that what was required was rationalisation of commissions and disclosures mandates across all financial products, such that products become comparable (on the demand side), and provide reasonable and comparable remuneration (on the supply side).

6 — Recommendations

Financial sector reform is an ongoing process. It must be remembered that due to historical reasons, certain products in the industry may have lagged behind the reforms that other parts of the market have embraced. Given this, certain product categories have a larger focus in the eyes of the Committee so that they are brought to par with the rest of the market. The endeavour of the Committee is to ensure that there are no dark patches in the industry or product category that lead to mis-selling and investor anguish resulting in loss of trust in the financial sector.

The Committee believes that consumer interests will be served by more transparent disclosures that enable consumers to understand products, compare them, and consequently choose those that serve their interests.

It is commonly recognised that tax breaks and assured returns work as pull strategies. Presence of even one of these works. This can be seen from the pull towards taxable bank deposits. What is perhaps not commonly recognised is that presence of assured returns and/or tax breaks can in fact, make the product more susceptible to irresponsible sales where the products also have opaque or mis aligned cost structures as well as opaque benefits, as can be seen in some traditional insurance products.

The recommendations of the Committee are in two parts. The first part (Section 6.1), described below, outlines the broad principles that should be applicable to any retail financial product. These are sub-divided into recommendations on Product features, Costs and commissions and Disclosures, followed by Generic recommendations. Part two (Section 6.2) deals with recommendations for specific products such that the *Terms of Reference* are served.

6.1 Broad principles

Product structure

1. Retail financial products must have product structures that allow costs and benefits to be easily understood by a retail investor.
2. Costs for similar functions across product categories should be the same. There are three basic functions that a financial product serves - protection, investment and annuity. In the investment function, the mark-to-market products must follow the cost structure decided by the capital market regulator. The non mark-to-market products must follow the cost structures of other deposit-like products such as bank deposits.
3. In all products, including closed-end and open ended products, other than pension products, the choice of withdrawal should remain with the investor. The regulator should determine a surrender cost that the investor may bear in such products. The cost of surrender should be reasonable. The remaining money should belong to the exiting investors.
4. Cool-off periods for similar products should be the same. Care should be taken that there should be no opportunity for non-naive investors to use the cool-off period to target a market movement.
5. Claw backs should be similar for similar products.
6. Tax regimes should be the same for similar products.

Costs and commissions

1. In bundled products cost caps should be fixed for each function. All costs within the function should collapse under one head. In addition, there should be an overall cost cap to the bundled product. This cost structure should be clearly disclosed.
2. The system of incentives should align the interest of the three parts of the market - the manufacturer, the advisor/distributor and the customer.
3. Upfront commissions in investment products and investment portion of bundled products skew seller behaviour and cause mis-selling and churning. These should be phased out completely.
4. Upfront commissions for pure mortality should continue since selling pure life cover is relatively difficult.
5. Special incentives may be given to the distributors when they have to reach out to a specific segment of the population under any mandatory provision (for example, insurance in rural areas)
6. For investment products, and investment portion of bundled products, commissions should move to an all trail model. These should be either level or declining.
7. Regulators should be harsh on manufacturers that are found to be violating the spirit of the cost recommendations by hiding costs paid to the distributors under other heads such as marketing or business promotion. Very stiff penalties and loss of license for repeated offences should be put in place.

Disclosures

1. Product disclosure should be such that a customer can very clearly understand what it costs (easier to do once the costs of each function are disclosed) and what the benefits are.
2. Returns should be disclosed as a function of investment and should disclose the **IRR** of the product. Returns should not be pegged to a third number. For example, returns should not be shown as a percentage of sum assured. **NAV** should reflect the value of investment which would allow the consumers to take the point to point **NAV** and arrive at net investment returns.
3. How much of the invested amount goes to work and how much is cut as a cost should be clearly disclosed in a manner that is understandable by a retail investor.
4. For a closed-end product with a defined tenure, the customer should be made aware of the consequences of a mid-way exit from the product. As an example, if a 15-year endowment plan is discontinued in year 8, the disclosure material should clearly show what money will return to the investor after such a period. In a 5-year closed-end mutual fund, the investor should clearly be told that a midway exit in year 3 is possible only through the secondary market where the **NAV** is always lower.
5. Machine readable disclosures enable creation of web-based tools and mobile apps that help consumers make smarter choices in the marketplace and as such all disclosures should be machine readable. Machine readable does not mean soft copy. Machine readable is when data can be processed by a computer for further analysis and interpretation. **CSV** is a basic example of machine readable.
6. All disclosures should be made available in multiple ways – on company websites, as feed to industry analysts that process the data, to advisors, sellers and consumer protection and financial literacy agencies.
7. The product provider and the distributor should ensure that they have built and implemented sufficient processes and systems to ensure that proper disclosures are actually made. The checks should be stronger for vulnerable categories such as senior citizens. The product providers should add a second layer of in-house approval before a sale is concluded for such customers. The product providers should be required to provide details of the same to their regulator on a periodic basis.
8. To focus on such disclosures and its format that can be easily understood by a retail investor (compared to the present unreadable information memorandum/offer document), a single-page Distributor-Investor Form should be mandated, which in bold states the key features of the product, its suitability and costs. The form should be in a machine readable format so that these can be easily databased for future reference, audit and analysis. For each sale, this form should be made available to the investor and a copy be available with the distributor, which may be inspected by the regulator when need be. These forms should be made available to the investor in the language preferred by her. Both the buyer and seller should sign on this form. An indicative form is shown in Annexure D. This is all the more important given the rising sales of mutual funds, for example, in the lesser literate B15 cities.
9. The regulators may also consider mandating a “Personal Illustration” format

which the product provider/distributor should give to the customers. An indicative format (used by LIC, UK) is shown in Annexure E.

10. The monthly/periodic statements sent by AMCs to the investors showing current NAV of the investment should show gross NAV, head-wise expenses charged to the investor and the net NAV.

Generic recommendations

1. Going forward, in order to bring uniformity and proper oversight, the function should decide the regulatory framework. This means that, IRDAI and PFRDA should harmonise their investment regulatory function with that of the lead investment regulator SEBI. IRDAI should take the lead on insurance and annuity function. With a base uniformity founded on function, IRDAI and PFRDA should have additional regulations related to the function only to the extent they are necessary for the specific needs of products regulated by them. For instance, in case of IRDAI and PFRDA, these could be on account of products being closed-end and of longer tenure.
2. In order to ensure that differential regulatory norms do not favour any particular financial product, the redress available to consumers should be of same high quality across the sector regulators to ensure consumers of products under a particular regulator are not placed at a disadvantage.
3. Enforcement should be strengthened around manufacturers over payment of commissions and fees over and above the prescribed limit to the distributors.
4. Personal information of the consumer should be protected.
5. Regulators should require financial service providers to follow norms related to suitability, documentation of the sales process and independent audit process for the same.
6. In case there are additional services provided to the customer, these should be articulated clearly. Charges, if any, on this account should be under the overall cost cap that is fixed by the regulator.
7. For similar products, there should be a similar structure with regard to Service Tax, Stamp Duty and rural and social sector norms. Like in the case of Applications Supported by Blocked Amount (ASBA) for retail investors in IPO markets, mutual fund NFOs should also have an ASBA process.
8. Financial products are advised products since average people are not able to make the needed calculations involving real return, time value of money, tax impact and the IRR. Over the long term, Indian markets should be guided to an advisory model where customers seek advisors, and remunerate them directly for holistic portfolio advice, plus the Over the Counter (OTC) model where customers purchase products over the counter without any intermediation. In this world, product provider led commissions will not be permissible, and advisors will function under a regime of higher fiduciary standards.
9. Banks are fast emerging as major distributor of financial products. Banks and other institutions tend to over-sell (and as a result could often mis-sell) products belonging to their group companies. The regulators may consider putting additional disclosures requirements on banks where they are explicitly required to

disclose (i) the products that originate from their group companies as such and (ii) the comparable products as comparison when selling products originating from their group companies. Each of the regulators should regulate the distributors for products which are under their mandate. For example, **SEBI** should regulate the banks directly for distribution of products regulated by it.

10. There is an urgent need to bring the distributors, and their sales employees (and sub brokers), under a regulatory framework. (**SEBI** has recently issued regulations for advisors but no regulations exist for distributors). All distributors, across regulators, along with their sales employees, should be assigned a unique number so that monitoring, surveillance and enforcement becomes unified and simpler. They should be subjected to detailed regulations incorporating rules, educational qualifications, entrance exams, code of conduct etc. There should be a combined database of all distributors across all financial products. The sector regulator can impose additional conditions on their distributors. Also, the database of customers of the distributors should be available for inspection by the regulators and for customers who are shopping for a distributor.
11. Ultimately, proper product selection would improve and mis-selling would decline if investors become more financially literate. The Government should step up its efforts to improve financial literacy among Indian households. One area of focus should be a powerful, multi-lingual financial education website. Additionally, as has been proven, investor education seminars being conducted by several bodies and companies are very ineffective, and the focus should therefore shift to financial education in schools, colleges and places of employment. Each of the regulators should implement a system of impact assessment of financial literacy actions. These should not be judged based on number of programs conducted or attendance.
12. Tax benefits should be given on function and not form. Since the government wants to encourage insurance penetration, tax breaks should be given on pure risk mortality and the treatment of the investment part should be harmonised across the different forms of the product across regulators.
13. Despite tax breaks for insurance, pure insurance products are not promoted. While online sales have helped informed customers purchase these products, insurance for purely protection purpose needs to be mass scaled. This would require greater effort in rural areas and for this all possible tools including financial literacy and awareness campaigns and special distribution incentives should be considered.

6.2 Product specific recommendations

6.2.1 Mutual Funds

Rules on selling and commissions in the mutual fund industry have been under a focused regulatory eye for just under a decade. In 2006, when the new issue related expenses of 6 per cent were removed on open ended funds to more recently when the market regulator nudged the industry association to stop upfronting of trail commissions in 2015, there has been a consistent road on which the regulator has traveled. In terms of product structure, mutual funds now have all costs that sit under one head - the annual

expense ratio. Costs are fungible under this head with the market free to price various costs as it deems fit. Investors find it easy to compare across products to search for the cheapest fund, other things being equal. Machine readability of disclosures and the data feed that **AMCs** give to third party analysts allow sellers, advisors and retail investors to compare across products across various attributes such as asset allocation, costs, returns, risk and portfolios.

Product structure

1. The benchmarks should be made more relevant than they are today. Schemes should be periodically tested to see if the asset allocation is conforming to the benchmarks chosen.
2. Similar schemes from the same fund house should be removed. Some of these were launched in the **NFO** boom to harvest the 6 per cent marketing cost. Such duplicate funds should be merged with others in the same fund house since they confuse investors.
3. The regulator should ensure that the mutual funds are *true to label*. This means that the investment mandate in the information memorandum should be reflected in the active portfolio of the fund.
4. The regulator should consider measures to encourage retail participation in **ETFs**.
5. The regulator should put in place a free look policy and define the period for which it will hold.

Costs and commissions

1. The cost caps within a overall **TER** should not be fungible.
2. Upfronting of commissions should be totally removed. There is a current cap of 1 per cent that comes from the fund house capital or profits. This too should be removed.
3. Distribution commissions should only be paid as level or reducing **AUM** based trail. In the case of lumpsum investment, or upon termination of a systematic investment plan, the trail commission should be declining (or nil after a specified period of time).
4. The extra commission in B15 should be removed and a level playing field be created in the country. Manufacturers and distributors should on their own tap such unexplored markets to increase their sales and market share.
5. No category of mutual funds should be exempt from the zero upfront (when it is put in place).
6. Distributors should not be paid advance commissions by dipping into future expenses, their own profit or capital.
7. Competition has not reduced costs much below the expense ratio that was fixed when the **AUM** of the industry was much lower. The regulator should lower the cost caps as the **AUM** rises over time.

Disclosures

1. On no account should sales of new fund offers happen pitching the product as a “cheap” product that the investor is getting “at par” value of Rs.10. The regulator should impose heavy costs on distributors reported as doing this.
2. The past returns of the scheme being sold, along with the benchmark returns, should be disclosed to the investor at the time of sale. Customers should be disclosed a range of past returns appropriate to the product tenure and should include returns of last 6 months and annualised returns since inception, and 2 year rests thereafter.
3. Trail commissions on mutual funds should be disclosed at the time of sale.
4. Disclaimer presently talks of a scheme’s performance being subject to market risks. Customers should be informed that in addition to market risk, the performance is also subject to fund house/manager’s competence.
5. Any change in scheme fund manager should be disclosed to all investors.
6. The **AUM** rankings published by the **AMCs** on their websites, Information Memorandum etc. are presently combined for all products, thereby giving a misleading picture. For retail products, the **AUM** rankings should be shown only for the retail **AUM**.

6.2.2 Insurance: Unit Linked Insurance Plans

The **ULIP** product came to limelight in India in 2001⁹⁸ as the first consequence of private sector being allowed into insurance. New insurance companies with foreign tie-ups wanted to bring the improved version of the old insurance policy – the traditional endowment policy – as a transparent and market-linked investment vehicle bundled with a crust of life cover. But the reform went only half way and a product was allowed into the market that was linked to the market, but in all other manner of costs and product structure was still using the traditional policy rules. This led to widespread mis-selling of the **ULIP** and the regulator came down heavily on the product in 2010 putting in place very strict cost caps and rules around what can be deducted from the investor’s money on lapsation and surrender.

The post 2010 **ULIP** is a much better product as compared to the pre-2010 product. It should be remembered that the endeavour of this Committee is to make the products as useful and transparent for the consumer as possible so that the regulatory cost of ensuring compliance is minimised. The following recommendations aim to take forward the reform that **IRDAI** began in 2010 on the **ULIP** product in a manner that aligns similar products across regulatory domains.

Product structure

1. Mortality and investment should be bifurcated. For the investor, this would mean a clear understanding of what part of the premium goes to service the life cover and what part of the premium goes to work as an investment.

⁹⁸The first **ULIP** was launched in India in 1971 by **UTI**

2. The customer should be easily able to compute her net investment return by taking the point to point **NAV** of the fund.⁹⁹ As an interim step, the insurance companies should be required to compute and disclose the net yield on the customer's annual premium net of mortality charges but before premium allocation charges.
3. The regulator should announce third party benchmarks that can be used to benchmark funds.

Costs and commissions

1. The product should move to a **TER** model from a **RIY**. The **RIY** model, in a closed-end product, causes a problem for insurance companies in managing costs and keeping them within the caps over the years as the market goes up and down. Cost of each function (i.e. insurance, investment and annuity) should be disclosed. An industry standard in costs will help the customer compare similar products across various parts of the marketplace.
2. Upfront commissions should be allowed only on the mortality part of the premium.¹⁰⁰
3. There should be no upfronts for the investment part of the premium. The investment part should attract only **AUM** based trail commissions. The trail commission treatment should be decided with consultations with the lead regulator in the market-linked investment space. These should be level or declining.
4. Mortality costs should be deducted before the premium is put in the investment fund. Thereafter, all the charges should collapse into one expense charge and there should be no separate (i) premium allocation charge or (ii) admin charge. **NAV** should be adjusted for this expense charge and customer should be able to take the point to point **NAV** and compute the growth in fund value.
5. The costs of surrender from a **ULIP** should continue to be reasonable. After deduction of costs, the remaining money should belong to the exiting investors.

Disclosures

Disclosures should be made in a manner that is easy for an average person to understand the break up of costs into mortality and investment. This break up should not change over the life of the policy.¹⁰¹

1. The life cover and premium in a bundled product should be disclosed. For comparison, the cost of a pure life cover for a similar sum assured should be disclosed alongside such that a customer is able to evaluate the true value of the product she is buying.
2. The return benefits should be disclosed keeping basic tenants of finance in mind. This means that all returns should be disclosed as a percentage of the investment

⁹⁹In the present scenario, this is not easily possible as the **NAV** is only adjusted for the fund management charge and mortality and administrative charges are debited separately. Moreover, as the premium allocation charges are deducted before the premium is put in the investment fund, the denominator is reduced for computing the returns. Therefore, the returns appear to be higher than they actually are.

¹⁰⁰The current caps are already in place for this.

¹⁰¹ The aim is to prevent firms from showing the most favourable cost structure to the investor and then padding costs in later years.

made by the customer.

3. The current practice of showing future returns benchmarked to four per cent and eight per cent should be discontinued since forecasting of returns is misleading. A risk meter or a colour coding system as used by the capital market regulator can be used to communicate the risk of the asset allocation chosen by the customer.
4. Benefit illustrations in the sales document currently showcase the numbers for one age, premium and sum assured. The seller/advisor should give in writing what the benefit illustration will be for the customer buying the product in a manner that takes into account all the recommendations on disclosure in the report. Both seller and buyer should sign this to ensure that a right sale has been made.
5. Asset allocation and portfolio disclosure should be made by all companies on their websites for consumers to access and the data feed be given to third party analyst firms to enhance research.
6. Past net returns should be disclosed to the customer. The current practice of showing gross returns is misleading since the customer is more concerned about the net returns rather than gross returns, i.e., returns after costs have been deducted. Customers should be disclosed a range of past returns appropriate to the product tenure and should include returns of last 6 months and annualised returns since inception, and 2 year rests thereafter.
7. All insurers should be required to provide online interactive calculators whereby a customer should be able to generate a customised and detailed benefit illustration based on her input of various available plan options.
8. All insurers should be required to disclose **NAV** such that a customer is able to easily compute her net investment return by taking the point to point **NAV** of the fund. For example the net **IRR** on the invested amount for the previous years in the product benefit illustration should be given since inception and then at two year intervals. The past 6 month **IRR** should be given as well.

6.2.3 Insurance: Traditional Life Insurance Policy

The traditional life insurance policy should be evaluated in its historical context. It was manufactured in the post colonial era when the economy was in a nascent stage with undeveloped capital and bond markets. As is experienced with a low income economy, there was a need to make available a zero-risk saving vehicle that would preserve capital. On the product side, fund management was unsophisticated by current standards with limited access to multiple assets for allocation, hedging and other risk management strategies. In such an environment, the traditional life insurance policy gave investors a long-term capital preservation vehicle and a guaranteed return of sum assured on death or maturity, that came with a small risk cover. The lack of alternate products made this product the only vehicle for corpus targeting households. The product served its mandate well enough.

However, over the years as markets have become sophisticated, financial products have reflected the change in the economy with features like investments getting marked to market to reflect the true value of the investment portfolio on a real time basis. However, reform in the traditional life insurance policy has lagged the other parts of the markets. It is in this context that the recommendations should be read. The aim is to bring this

product up to the first order basic hygiene standards as followed by other parts of the household facing retail financial products.

It would be fair to say that the Committee spent most of its time trying to find a way to suggest disclosure and cost changes in this product. One view was to leave the product as it is and make minor changes in the way costs and disclosures are treated. Another view was to take this opportunity and suggest deep changes in the product, not unlike the changes in the **ULIP** in 2010, towards a foundational change in the product to make it into a product that can survive in the new age of finance. It should be remembered that this Committee is thinking first of the consumer and her welfare. It is only when customers trust the marketplace that the financialisation of the economy will be deep and wide.

Product structure

1. There should be a clear split of the premium, at least for the investor, into mortality and investment.
2. All new traditional plans should conform to this structure. The older plans in the market can get grandfathered. **IRDAI** should work with both **RBI** and **SEBI** to mark its existing pools to the market.
3. Both participating and non-participating plans should follow the best practices followed by asset managers worldwide. These include marking the assets to markets, using relevant benchmarks created by an independent agency to truly reflect the performance of the investor's money.
4. For the loan portfolio of insurance companies, the best practices of loan valuation should be in line with those of the **RBI**.
5. Lapsation profits, if any, should not accrue or be booked by the insurance companies.

Costs and commissions

1. All costs should be bifurcated into two parts - mortality and investment.
2. Mortality costs should be benchmarked to the mortality tables created by third party actuarial firms.
3. Investment costs should be capped keeping in view the best practices in the rest of the market. For example, for non-participating plans, costs should be benchmarked to best practices in banking or other small savings products that invest in similar products that give guaranteed returns. For participating plans, costs should be benchmarked to similar asset allocation products in the mutual fund space or the **NPS**.
4. The costs of surrender should be reasonable. After deduction of costs, the remaining money should continue to belong to the exiting investors.
5. All charges should collapse into one single charge called the expense charge. This charge should be deducted from the gross yield before crediting the net returns to the customer's investment account. This charge should be within an annual expense ratio or expense limit specified by the regulator. No charges should be deducted as premium allocation charge or any other charge before allocating the

annual premium to investment and mortality.

6. Upfront commissions should be allowed for the mortality part of the premium. These can remain within the current limits fixed by the regulator. It is understood that life insurance is a difficult concept and the sellers should be compensated for the extra work done to sell a risk cover. In bundled products, upfront commissions should be permitted for mortality part of the premium. There should be no upfront commissions on the investment part of the premium.
7. Distribution commissions should not be front loaded. In a time-bound manner, the distribution commission should be set at a (i) level percentage of the premium over the tenure of the policy for non-participating products and at (ii) a percentage of asset (as an **AUM** trail fee) for participating products.
8. Distributors should not be paid advance commissions by dipping into future expenses, their own profit or capital.
9. The illegal practice of rebating should be punished harshly by the regulator as it distorts the market.
10. The current structure of paying upfront commission (which is today pegged at 2 percent of premium) on single premium insurance policies may be continued for the investment component of these policies, as these are closed-ended products and do not mis-align the market towards churning, and there should be no trail commission on this.

Disclosures

1. The cost of the life cover in a bundled product should be disclosed clearly. For comparison, the cost of a pure life cover as in a term policy for a similar life and tenor should be disclosed alongside such that a customer is able to evaluate the true value of the product.
2. Returns should be disclosed keeping basic tenants of finance in mind. This means that all returns should be disclosed as a percentage of the investment made by the customer and not as a function of a third number, such as a sum assured or the maturity benefit.
3. For non-participating plans that carry a guaranteed return, the return should be disclosed as a percentage of the investment made. The **IRR** should be a disclosure in the benefit illustration. The guaranteed return as a function of the investments made should be disclosed clearly as in a bank deposit. These products are directly comparable to bank deposits since the returns are fixed and there is no risk of capital erosion if held to maturity. This disclosed **IRR** should be compared to a relevant benchmark to allow investors to make informed choices when choosing financial products.¹⁰² Further, the return disclosures should be on two numbers – as a percentage of the total premium paid and as a percentage of the investment amount. This will allow retail investors to make comparisons more efficiently.
4. For participating plans the current practice of showing future returns benchmarked to four per cent and eight per cent should be discontinued since forecasting of

¹⁰²For example, an innovative product that staggers the benefit over many years in many forms – periodic lump sum, assured periodic income, final corpus – should disclose the internal rate of return of this future income flow

returns is misleading. A risk meter or a colour coding system as used by the capital market regulator can be used to communicate the risk of the asset allocation chosen by the customer.

5. Participating plans should show benefits as a function of the invested amount rather than as a function of any other number. An indicative disclosure is:
For participating plans, give the net **IRR** for the previous years in the product benefit illustration of a participating product. Companies without a 10/15 year history should give returns for the oldest possible period. For example, if a company has a policy history of 8 years, then the returns should be shown for 5 and 8 years. For a company with a 5 year history, returns should be shown for 2 and 5 years. For example:
 - (a) A standard life 30 year old with a 10 year product that matured in the last financial year (say, FY 15) got a net return of XX% (YY, ZZ) (Note, that YY stands for the **IRR** for the FY before last (FY14), while ZZ stands for the **IRR** for the FY two years before last (FY13))
 - (b) A standard 30 year old with a 15 year product that matured in the last financial year got a net return of xx% (YY, ZZ)
 - (c) A standard 40 year old with a 10 year product that matured in the last financial year got a net return of xx% (YY, ZZ)
 - (d) A standard 40 year old with a 15 year product that matured in the last financial year got a net return of xx% (YY, ZZ)
6. Benefit illustrations in the sale document currently showcase the numbers for one age, premium and sum assured. The seller/advisor should give in writing what the benefit illustration will be for the customer buying the product in a manner that takes into account all the recommendations on disclosure in the report. Both seller and buyer should sign this to ensure that a right sale has been made.
7. Asset allocation and portfolio disclosure should be made by all companies on their websites for consumers to access and the data feed be given to third party analyst firms to enhance research.
8. The current industry practice of using the word *bonus* to indicate return is misleading. The word bonus¹⁰³ is defined¹⁰⁴ as an extra amount of money that is added to a payment, especially to somebody's wages or salary as a reward such as a *Diwali bonus*. Disclosures should use the word *net return* instead.¹⁰⁵ Changing the way we call something has an impact on the way we think about it.
9. Customers should know very clearly the consequence of exiting a closed-end product earlier than maturity. The disclosure sheet should show the value of the entire premium paid at annual rests for products of a five year tenor, at two year rests for products upto 10 years tenor and at five year rests for all products of more than 10 year tenor. For example, for a 15 year policy with a premium paying term of 5 years and a premium of Rs.1 lakh a year, the value of Rs.1 lakh if the

¹⁰³The additional sum that the policyholder will get during the term of the insurance plan or at maturity of the plan, provided he has paid all premium amounts due for a specified minimum number of years. Bonus is the amount added to the basic sum assured under a with-profit life insurance policy.

¹⁰⁴Oxford Advanced Learner's Dictionary.

¹⁰⁵SEBI changed the nomenclature of the new mutual fund offers from **IPO** to **NFO** in June 2005 to better communicate the difference between a mutual fund and a direct stock listing. This happened after **AMCs** misled investors by a high octane marketing push that popularised an **IPO** at par.

person exits in year 5 and 10 should be disclosed. As another example, for a 10 year product with a premium paying term of 10 years and an annual premium of Rs.1 lakh, the value in hand should be shown for exit in year 2, 4, 6 and 8. The regulator should take harsh action if firms are found deliberately obfuscating this disclosure with the aim to enjoy lapsation profits or high surrender charges.

10. Since the space on the suggested disclosure sheet is limited, insurance companies should provide online calculators so that customers can better understand the consequence of exits across each year.

6.2.4 NPS

The NPS has grown in size owing to central and state government participation. The record of the NPS in attracting private retail customers has been very limited. While this is a cause for concern, it is the Committees view that the product and commissions structure on the NPS should not deviate from what was intended in the original NPS design.¹⁰⁶ The NPS participation will catch up when the incentive structure in other sectors is rationalised, and more efforts are made to improve participation through wholesale channels. The following recommendations should be seen as reforms for the growth of NPS.

Product structure

1. PFRDA should enable digital/ online transactions for all customer facing processes of NPS including account opening. Consumers should be able to transact online and over mobile apps irrespective of the PoP.
2. The rules and the processes for a customer to unfreeze her NPS account should be made simple and the customer should have an option to unfreeze her account instantly by paying the required fees online on the CRA or PoP portal. Customers who do not have access to the internet should be able to contact the CRA or PoP telephonically to find out the requisite fee. Once the fee is deposited, the account should be unfrozen automatically.
3. PFRDA should consider further developing the annuity options for NPS customers along with suitable disclosure norms for the same.

Costs and commissions

1. No change is suggested in the NPS incentive architecture of distribution incentives being delinked from product providers. This is already aligned with consumer interest.
2. AUM based commissions should be introduced for the PoPs for the private sector (all retail contributions) NPS. These should not be introduced for nodal offices for government employees for whom NPS is mandatory or for employers who facilitate their employees to participate in the scheme. The same should be accounted by CRA consistent with the NPS architecture.

¹⁰⁶See the OASIS Committee Report for details.

3. No change is suggested in the asset management fee of the **Pension Fund Managers (PFMs)**s as discovered through the auction process.
4. In situations where the distributors provide certain additional services to the consumers such as in the case of **NPS Lite/ Atal Pension Yojana**, the commissions or fees model should reasonably compensate for the same. The fees for such schemes should be borne by the Government.

Disclosures

1. **PFRDA** should disclose a **TER** comprising of **PoP** costs, fund management costs and **CRA** charges.

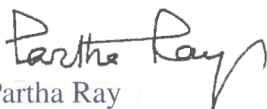
Others

1. **PFRDA** may set up and encourage mechanisms to promote employer-based, or tax-based participation.

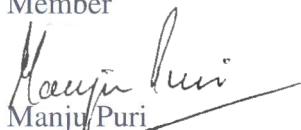
As suggesting a change in the market structure is beyond the mandate of this Committee, the recommendations are aimed at making it easier for investors and consumers to make the calculations and comparisons between products. The Committee suggests that the regulators frame a time-bound road map to implement the recommendations. The Committee hopes that these recommendations will take away the conflict of interest due to regulatory arbitrage and poor disclosures and remove ambiguity in costs and returns from Indian financial sector.



S B Mathur
Member



Partha Ray
Member



Manju Puri
Member



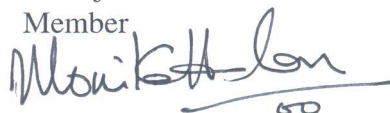
Prithvi Haldea
Member



Sumit Bose
Chairman



Manoj Joshi
Member



Monika Halan
Member



S Vishvanathan
Member



Anupam Mishra
Member Convener

New Delhi

Date: 7th August, 2015

Annex A: In house sales

Distributor Commission FY14-15

Conflict of Interest with in-house distributors

Proportion of Associate AMC commission received by Banks

Distributor	AMC	FY15		
		Industry Brokerage Received	Brokerage Received from AMC	% Share
HDFC Bank	HDFC	329	115	35%
ICICI Bank	ICICI Prudential	248	143	58%
Axis Bank	Axis	304	207	68%
State Bank of India	SBI	69	67	97%
IDBI Bank	IDBI	12	5	43%
Union Bank of India	Union KBC	5	5	91%
Canara Bank	Canara Robeco	10	10	100%
Bank Of Baroda	Baroda Pioneer	4	3	84%
Punjab National Bank	Principal	4	3	74%

- Banks showing **high concentration** of in-house sales to their AMCs
- **More than 1/3 commission payouts** sourced from in-house AMCs
- HDFC MF & ICICI MF have contributed to **35%** and **68%** of their bank's MF commission
- Concentration of in-house AMC commission as high as **97% for SBI** and **91% for Union Bank**

Source: AMFI/AMC websites

Annex B: Costs

Overview of Mutual Fund Products

Sn.	Category	Products	Type	Investment	Return	Manufacturer's cost/ charges	Commission	Industry Commission	Maximum Commission	Exit Charges/ Costs	Product Structure	Payment Plan
1	Investment	Equity/Hybrid/Debt Mutual Funds	Closed Ended	Market Linked	Variable	Refer Note 4 for cost cap details. In case of direct plans the costs for consumers are lower as no distribution cost is charged on plans sold as Direct.	Back Loaded	AUM Trail 0.1% to 1%	Commissions are same for Lumpsum and SIP investment. There is no entry load for any of these products. A transaction charge of Rs 100 is allowed for investors investing more than Rs 10,000 and Rs 150 for first time investors investing more than Rs 10,000. ETFs and direct plans in mutual funds do not have this charge.	Most MF charge exit load for withdrawal within one year. This is a percentage of AUM and usually ranges between 0 to 2 percent. The exit load charged, if any, after the commencement of the SEBI (Mutual Funds) (Second Amendment) Regulations, 2012, shall be credited to the scheme	Lock in for 3W5 years. Rest same as Sn.1	Lumpsum/ SIP
2	Investment	Equity/Hybrid/Debt Mutual Funds	Open Ended	Market Linked	Variable	Same as above	Back Loaded	Same	The commissions have to be within the TER. Additional expenses for investments arising from select cities. i) Equity: 0.30% ii) Debt: 0.20%.	Same	NAV based, NAV is net of expenses, Exit load as % of AUM. Total Expenses capped as TER. Exit load flows back to investment. Upfront commission not booked to Scheme. Trail based commission.	Lumpsum/ SIP
3	Investment B15 cities	Equity/Hybrid/Debt Mutual Funds	Open/ Closed Ended	Market Linked	Variable	Additional expenses as per note 5.	Back Loaded	Additional commission can be paid. No cap of 1% upfront commission		Same	Product structure is same as mutual funds sold in T15.	Lumpsum/ SIP
4	Investment	ETF	Open Ended	Market Linked	Variable	in case of an index fund scheme or exchange traded fund, the total expenses of the scheme including the investment and advisory fees shall not exceed one and one half percent (1.5%) of the daily net assets;	No Commissions	Investor pays a commission to the broker (same as purchasing securities). This is usually around 0.50% of the traded value.	As per the SEBI Rule no broker can charge more than brokerage of 2.5% of total traded value.	None	No Exit Load. No investment Management.	Lumpsum/ SIP

Overview of Insurance Products

Sn.	Category	Products	Type	Investment	Return	Manufacturer's cost/ charges	Commission	Industry Commission	Maximum Commission	Exit Charges/ Costs	Relapse Costs	Product Structure	Payment Plan
1	Insurance	Term Insurance	Closed Ended	NA	NA		Front Loaded	25% in Y1, 5% thereafter	2% of the Single Premium. For non single premium policies refer note 1. For Micro Insurance 20% every year (10% for single premium)	None		Risk Cover. No investment	Regular Premium Paying Term
2	Micro Insurance	Term Insurance	Closed Ended	NA	NA		Front Loaded	20% every year (10% for single premium)	20% every year (10% for single premium)	None			Regular Premium Paying Term
3	Investment + Insurance	ULIP	Closed Ended	Market Linked	Variable	Costs are capped as RIY.Refer note 2. Within the RIY, the insurers can charge premium allocation charges, policy admin charges and fund management charges. Fund management is capped at 1.35% of the fund value.	Front Loaded	Y1 U 8U10%, Y2 onwards 2U5%	2% of the Single Premium. For non single premium policies refer note 1.	Surrender charges are a percentage of the annual premium or fund value and are capped at a maximum of Rs. 6000 for surrender in year 1 and decrease for every year thereafter, becoming nil after	Refer note 10.	NAV based, NAV is not net of all expenses. Mortality and Policy/ Admin Charges are levied by cancellation of units. Premium Allocation charge is deducted before the savings are shown into the investment fund account. Total Expense capped as RIY. TER not disclosed. The IRDAI product Regulations allows the following to be excluded from the calculation of net yield: (i) mortality & morbidity charges (ii) extra premium due to health impairment etc. (iii) rider premium (iv) service tax on charges any explicit cost of guarantee. About 90U95% of the premium goes towards investment portion.	Regular Premium Paying Term
4	Investment + Insurance	Non Linked NonUPar Plans	Closed Ended	Pooled	Variable	Refer note 3	Front Loaded	Single premium policies: 2%. For others: 25% in Y1, Y2: 10/5%, 5% thereafter	2% of the Single Premium. For non single premium policies refer note 1.	Surrender charges are embedded in surrender value and are not a separate charge. Refer note 8 & 9 for minimum surrender value for single premium and nonSingle premium policies.		Fixed Return Or Guaranteed Savings Products: Based on Pooled Investment. Returns are called Guaranteed Additions and are specified as amount per thousand or percentage of sum assured. No NAV concept. Charges are not capped. Returns declared annually. High Upfront commission. Regular commission as a percentage of premium. TER not disclosed. Net Investment Returns Not disclosed. About 90U95% of the premium goes towards investment portion. Variable Insurance Products: Based on pooled investments. Return or additions credited to the policy account annually or more frequently as a percentage of the policy account. Charges are capped by RIY in a manner similar to ULIPs. No NAV concept. TER not disclosed. About 90U95% of the premium goes towards investment portion.	Regular Premium Paying Term
5	Micro Insurance + Investment	Non Linked Plans	Closed Ended	NA	NA		Front Loaded	20%				Micro Insurance, the max. sum assured is capped at Rs 200,000 for Term Insurance and other Life Insurance Products. The annual premium is capped at Rs 6,000 for non linkeded Variable Insurance plans. RIY is specified for nonUnlinked Variable Insurance plans. TER not disclosed. Net Investment Returns Not disclosed. About 90U95% of the premium goes towards investment portion for the savings products.	Regular Premium Paying Term
6	Investment + Insurance	Non Linked Par Plans	Closed Ended	Pooled	Variable	Refer note 3	Front Loaded	Single premium policies: 2%. For others: 25% in Y1, Y2: 10/5%, 5% thereafter	2% of the Single Premium. For non single premium policies refer note 1.	Surrender charges are embedded in surrender value and are not a separate charge. Refer note 8 & 9 for minimum surrender value for single premium and nonSingle		Based on Pooled Investment. Returns are not fixed, declared as Bonus. No NAV concept. Charges are not capped. Returns declared annually. High Upfront commission. Regular commission as a percentage of premium. TER not disclosed. Net Investment Returns Not disclosed. About 90U95% of the premium goes towards investment portion.	Regular Premium Paying Term
7	Micro Insurance + Investment	Non Linked Plans	Closed Ended		NA		Front Loaded	20% every year (10% for single premium)	20% every year (10% for single premium)				Regular Premium Paying Term

Overview of NPS

Sn.	Category	Products	Type	Investment	Return	Manufacturer's cost/ charges	Commission	Industry Commission	Maximum Commission	Exit Charges/ Costs	Product Structure	Payment Plan
1	Investment	NPS (Tier II)	Closed Ended	Market Linked	Variable Returns	Refer note 6 for fund management charges and note 11 for intermediation charges.	Not Front Loaded or Back Loaded	0.25% of contribution	CRA and POP Charges comprise of flat fees and POP also get 0.25% of contribution. Refer to note 11 for details.	Transaction charges of Rs 20 would apply. Refer note 11 for details.	NAV based, NAV is net of fund management expenses, Withdrawal is permitted. Minimum account balance is specified. All other charges related to CRA and POP charged as deduction of units or collected from customer directly. TER not disclosed.	Anytime
2	Pension	NPS (Tier I)	Closed Ended	Market Linked	Variable Returns.	Refer note 6 for fund management charges and note 11 for intermediation charges.	Not Front Loaded or Back Loaded	Flat fee + 0.25% of contribution		Premature exit not applicable except in special cases. Transaction charges of Rs 20 would apply. Refer note 11 for details on charges.	NAV based, NAV is net of fund management expenses, No Exit other than death or maturity. All other charges related to CRA and POP charged as deduction of units or collected from customer directly. Minimum annual investment is required. Fees and Commissions are flat fee and as % of premium. TER not disclosed.	Anytime

Overview of Government Schemes and Bank Deposits

Sn.	Category	Products	Provider/ Regulator	Investment	Return	Commission	Industry Commission	Maximum Commission	Product Structure	Payment Plan
1	Investment	Deposits	Banks/ RBI	Closed Ended	Fixed	Fixed	NA	0.5% to 1%. Incentive is only for agents doing door to door collection. Incentive for staff can be provided.	Returns are fixed and are net of all charges. Lower rate, Charges applicable in case of premature exit	Recurring Deposit / One Time
2	Investment	Postal deposits	Govt. Schemes	Closed Ended	Fixed	Fixed	NA	Term Deposits, MIS, KVP, Senior Citizen Scheme 0.5%	Returns are fixed and are net of all charges. Lower rate, Charges applicable in case of premature exit. NSC does not permit premature exit. Maximum investment in a MIS is Rs. 4.5 lakh in a single account.	Recurring Deposit / One Time
3	Investment	PPF	Govt. Schemes	Closed Ended	Fixed	Fixed	NA	PPF agents --- 1% of deposit if amounts are deposited through the agent.	Returns are fixed and net of all charges. Lock in restrictions, minimum annual investment apply.	Anytime
4	Investment	NSC	Govt. Schemes	Closed Ended	Fixed	Fixed	NA	Agents --- 1%,	No Premature Exit.	One Time
5	Investment + Insurance	Postal Life Insurance	Govt. Schemes	Closed Ended	Variable	Variable	Front Loaded	Front Loaded. PLI --- 1st Year 0.25% of Sum assured. 2% of premium on renewal. RPLI --- 1st Year 10% of Premium, 2.5% on renewal	Maximum sum assured is Rs 50 lakhs.	Regular Premium Paying Term/ Single Premium/ Limited Premium Paying Term

Note 1: Commission caps in life insurance

Table A.1: Commission caps in life insurance

Premium Paying Terms (Years)	Maximum Commission or remuneration in any form as % of premium		
	1st Year	2nd and 3rd Year	Subsequent Years
5	15	7.5/5*	5
6	18	7.5/5*	5
7	21	7.5/5*	5
8	24	7.5/5*	5
9	27	7.5/5*	5
10	30	7.5/5*	5
11	33/30*	7.5/5*	5
12 or more	35/30*	7.5/5*	5

* The maximum commission or remuneration, during the first ten years of a life insurer's business for all intermediaries, except for brokers, shall be 40 percent in the first year for policies with premium paying term of 12 and above. For brokers, it shall be a) 30 percent in the first year for policies with premium paying term of 10 and above; b) 5 percent in the subsequent years for all premium terms.

Note 2: Cap on Reduction in Yield (RIY) in ULIPs

Table A.2: Cap on Reduction in Yield (RIY) in ULIPs

Number of years elapsed (since inception)	Maximum reduction in yield* (percentage)
5	4.00%
6	3.75%
7	3.50%
8	3.30%
9	3.15%
10	3.00%
11 and 12	2.75%
13 and 14	2.50%
15+	2.25%

* Difference between gross and net yield in term of percent per annum

Note 3: Cost caps in traditional insurance

For insurers that have completed 10 years of operations with business in force of at least Rs.10 crore, for a regular life insurance policy with a premium paying term of more than 12 years, the insurer can deduct up to 90 percent of premium in expenses in the first year and up to 15 percent of the renewal premium.

For insurance companies that have been operational for lesser than 10 years, the limit is higher.

Note 4: Cost caps on Mutual funds

In the case of mutual funds, the overall TER cap applies in slabs:

1. 2.5 percent for the first Rs.100 crore equity (2.25 percent for debt),
2. 2.25 percent for the next Rs.300 crore (2 percent for debt),

3. 2 percent for the next Rs.300 crore (1.75 percent for debt) and
4. 1.75 percent for the balance (1.5 percent for debt).
5. In respect of a scheme investing in bonds such recurring expenses shall be lesser by at least 0.25 per cent of the daily net assets outstanding in each financial year.

Note 5: Additional Expenses permitted to MF for distribution in B15 cities

Additional expenses not exceeding of 0.30 per cent of daily net assets, if the new inflows from B15 are at least:

1. 30 per cent of gross new inflows in the scheme, or;
2. 15 per cent of the average AUM (year to date) of the scheme, whichever is higher:

If inflows from such cities is less than as specified above, such expenses on daily net assets of the scheme shall be charged on proportionate basis.

The expenses charged under this clause shall be utilised for distribution expenses incurred for bringing inflows from such cities.

The amount incurred as expense on account of inflows from such cities shall be credited back to the scheme in case the said inflows are redeemed within a period of one year from the date of investment.

Note 6: AUM based cost caps on NPS

1. Private Sector in NPS: 0.01 percent of AUM pa.
2. NPS Schemes for Govt.: 0.0102 percent pf AUM pa.
3. NPS Lite: 0.0102 percent pa.

CRA and POP Charges are outside of the PFM charge and comprise of flat fees and POP also get 0.25 percent of contribution.

Note 7: Discontinuation Charges

Table A.3: Discontinuation Charges

Discontinuance year	Annual premium less than or equal to Rs. 25,000, charge is	Annual premium greater than Rs. 25,000, charge is
1	Least of the following: (i) 20% of Annual Premium (ii) 20% of Fund Value (iii) Rs.3,000	Least of the following: (i) 6% of Annual Premium (ii) 6% of Fund Value (iii) Rs. 6,000
2	Least of the following: (i) 15% of Annual Premium (ii) 15% of Fund Value (iii) Rs.2,000	Least of the following: (i) 4% of Annual Premium (ii) 4% of Fund Value (iii) Rs. 5,000
3	Least of the following: (i) 10% of Annual Premium (ii) 10% of Fund Value (iii) Rs.1,500	Least of the following: (i) 3% of Annual Premium (ii) 3% of Fund Value (iii) Rs. 4,000
4	Least of the following: (i) 5% of Annual Premium (ii) 5% of Fund Value (iii) Rs.1,000	Least of the following: (i) 2% of Annual Premium (ii) 2% of Fund Value (iii) Rs. 2,000
5	NIL	NIL

Note 8: Surrender Charges on non-linked Products (other than single premium products)

The guaranteed surrender value shall be at least:

1. 30 percent of the total premiums paid less any survival benefits already paid, if surrendered between the second year and third year of the policy, both inclusive.
2. Subject to three below, 50 percent of the total premiums paid less any survival benefits already paid, if surrendered between the fourth year and seventh year of the policy, both inclusive.
3. 90 percent of the total premiums paid less any survival benefits already paid, if surrendered during the last two years of the policy, if the term of the policy is less than 7 years.
4. The surrender value beyond the seventh year shall be filed by the insurer under the File and Use for clearance. Such surrender value shall consider the premiums already paid and the possible asset shares on such products.

Note 9: Surrender charges on linked products, Single premium policies.

The guaranteed surrender value shall be the sum of guaranteed surrender value and the surrender value of the any subsisting bonus already attached to the policy. The guaranteed surrender value shall be at least:

1. 70 percent of the total premiums paid less any survival benefits already paid, if surrendered any time within third policy year.
2. Subject to three below, 90 percent of the total premiums paid less any survival benefits already paid, if surrendered in the fourth policy year.
3. 90 percent of the total premiums paid less any survival benefits already paid, if surrendered during the last two years of the policy, if the term of the policy is less than 7 years.

Note 10: Revival of policy

The insurer, at the time of revival:

1. shall collect all due and unpaid premiums without charging any interest or fee.
2. may levy policy administration charge and premium allocation charge as applicable during the discontinuance period. No other charges shall be levied.
3. shall add back to the fund, the discontinuance charges deducted at the time of discontinuance of the policy.

Note 11: Intermediation charges in NPS

Table A.4: Intermediation charges in NPS

Intermediary	Charge head	Service charges*	Method of deduction
CRA	PRA Opening charges	Rs. 50	Through cancellation of units at the end of each quarter.
	Annual PRA maintenance cost per account	Rs. 190	Same as above
	Charge per transaction	Rs. 4	Same as above
POP (maximum permissible charges for each subscriber)	Initial subscriber registration	Rs. 125	To be collected upfront
	Initial contribution upload	0.25% of the initial contribution amount from subscriber subject to a minimum of Rs. 20 and a maximum of Rs. 25,000	To be collected upfront
	Any subsequent transaction involving contribution upload	0.25% of the amount subscribed by the NPS subscriber, subject to a minimum of Rs. 20 and a maximum of Rs. 25,000	To be collected upfront
	Any other transaction not involving a contribution from subscriber #	Rs. 20	To be collected upfront

*Service tax and other levies, as applicable, will be levied as per the existing tax laws. # These include:

- Change in subscriber details.
- Change of investment scheme / fund manager.
- Processing of withdrawal request.
- Processing of request for subscriber shifting.
- Issuance of printed Account statement.
- Any other Subscriber services as may be prescribed by PFRDA.

Annex C: International experience

International evidence

USA

The USA does not have a single agency to oversee and regulate the entire spectrum of consumer finance products. Advisors are regulated at the state or federal level. If an advisor functions only in one state, regulations of that particular state apply. However, the federal *Investment Advisors Act of 1940* applies if the advisor functions:¹⁰⁷

1. In more than one state;
2. In one state but has assets under management of not less than US\$25 million; or
3. Is an advisor to a company registered under Title 1 of the Act

Advisors to hedge funds and private equity funds were outside its purview of the *Investment Advisors Act of 1940*.¹⁰⁸ In 2010, the *Dodd–Frank Wall Street Reform and Consumer Protection Act* was passed in an attempt to bridge this regulatory gap.

The latest effort to address the problem of multiple authorities overseeing advisors is the Bureau of Consumer Financial Protection¹⁰⁹ within the Federal Reserve, which was established under the *Dodd–Frank Wall Street Reform and Consumer Protection Act* to regulate products such as credit; deposits; on-line banking; property purchases; and financial advisory services. The Bureau aims to:

1. Educate customers against defensive practices;
2. Enforce federal consumer financial laws and restrict unfair, deceptive or abusive practices; and
3. Study consumers, providers and markets.

While the Bureau's first task is to solve the problems in the mortgage market, the Bureau is eventually expected to turn its attention to other consumer finance products. The Bureau's focus is on regulating disclosure and ensuring transparency in the products that are sold to the customer. In addition, the Bureau aims to promote financial literacy to enable customers to make better choices in the financial products space.

A recent debate in the US in the distribution space has been sparked by the report on the impact of conflicted advice on the roll over of retirement savings of Americans from 401(k) plans to Individual Retirement Accounts.¹¹⁰ The report points out that the roll over to IRAs is often motivated by advice which gains to earn larger fees from this switch, and results in investment losses to customers.

¹⁰⁷For more details, refer to Section 203A of The Investment Advisors Act of 1940.

¹⁰⁸Advisors to private funds were not required to register with the SEC because of an exemption that applied to advisors with fewer than 15 clients. This exemption counted each fund as a client, as opposed to each investor in a fund. As a result, some advisors remained outside of regulatory oversight even if they were managing large sums of money for the benefit of hundreds of investors.

¹⁰⁹<http://www.consumerfinance.gov/>

¹¹⁰White House, see n. 39.

UK

The most important reform in the UK with regards to financial intermediaries is the **Retail Distribution Review (RDR)**, which was launched by the **Financial Services Authority (FSA)** in June 2006 to scrutinize the way in which financial products were sold and how advice was provided to retail customers. The specific aim of the **RDR** was identifying and addressing the root causes of the persistent problems in the retail investment market (across banks, life insurers, financial advisors, building societies and fund managers).

The **FSA** identified the following five themes to be addressed by the review. These were:

- Sustainability of the distribution sector
- Impact of incentives
- Professionalism and reputation
- Consumer access to financial products and services
- Regulatory barriers and enablers

Post consultation, the **FSA** identified three measures that they regarded as fundamental to delivering the desired market outcomes, and were implemented on 31 December 2012.¹¹¹ The **RDR** has three main components:

1. Advisor charging;
2. Disclosing advice services; and
3. Professionalism.

The **RDR** requires all advisor firms offering investment advice to retail consumers to introduce advisor charging, where retail investment products include pensions; annuities; bonds; **ETFs**; and collective investments. As a result, advisors are now paid by customers instead of being paid by commissions from the product providers in return for recommending their products. The new advisor charging rules mean that all firms that give retail investment advice (such as banks, independent financial advisors, wealth managers, stockbrokers and product providers on their own products) have to:

- Set their own charging structure;
- Have a charging structure based on the level of service they provide;
- Disclose charges to clients upfront, using some form of price list or tariff; and
- Deliver an ongoing service when an ongoing fee is levied, unless the product is a regular payment product.

For non-advice services, advisors can choose whether they will be paid by commissions or through the advisor charging agreement. However, services related to personal recommendations (i.e. advice, such as arranging the execution of a transaction or conducting administrative tasks associated with the transaction) must be subject to the advisor charging agreements.

The **RDR** also addressed the role of platforms in the intermediation of investment products. Platforms serve two main goals in the retail investment market: administration and distribution. The current charging of an annual management fee of 150 bp is split into 75 bp for the fund manager and a rebate of 75 bp. This rebate is then again split

¹¹¹FSA, "Consultation Paper 09/18, Distribution of retail investments: Delivering the RDR", in: (2009).

into a typical advisor commission of 40-50 bp and a platform charge of 30-50 bp. The main elements of platforms under the RDR are:

- All commissions and fees must be disclosed to the client;
- Cash rebates will not be allowed but rather will be rebates of the fund manager's commission in the form of additional shares or units, which can be passed to the consumer;
- Platforms have to act to the clients' best interest;
- Communication has to be in defined quality;
- Platforms can facilitate Advisor Charging payments but need to follow rules as product providers do, as well as client instructions; and
- Payments to the advisor can be made from client's cash account at the platform.

In many respects the longer-term effects of the RDR are yet to become clear, but the evidence from the first stage of the review is positive. There are encouraging signs that the RDR is on track to deliver its objectives.¹¹² In particular, removing commission paid by providers to advisors and platforms has reduced product bias from advisor recommendations. This is reflected in a decline in the sale of products which paid higher commissions before the RDR was implemented. It has also made it easier for customers and advisors to compare platforms, increasing competitive pressure and significantly reducing Direct-to-Consumer (D2C) platform charges.

Product prices have fallen by at least the amounts paid in commission before the RDR was implemented, and some product prices have fallen even further. This is due in part to the introduction of simpler products and funds (which have a lower charge and advisors) and platforms exerting more competitive pressure on providers, with platforms increasingly able to negotiate lower product costs. Removing commissions also means that providers who sold lower or no commission products before the RDR was implemented are now competing on a more equal basis. Advisor charging is likely to have increased since the RDR was implemented, at least for some consumers. A longer-term review of prices will bring greater clarity on the effect of the RDR on the total cost of investment.

Most advisors are now qualified to the new minimum standards, and there has been an increase in the number of advisors going beyond these minimum standards. The increase in qualifications (along with greater focus on provision of ongoing advice services) indicate positive steps towards increasing professionalism in the advice market.

Overall, firms appear slightly better placed to deliver on their long-term commitments, with average revenues and profitability of advisory firms having both increased. The cost to firms of complying with the RDR has been in line with or lower than expectations, with ongoing costs largely absorbed into business as usual costs by the industry.

The FCA has, two years since the RDR was implemented, commenced the first phase of its post-implementation review. The review is being undertaken by external consultants, Europe Economics, in order to ensure independence. Phase one of the post-implementation review addressed the extent to which the RDR is on course to deliver its

¹¹²FCA, "Post-implementation review of the RDR - Phase 1", in: (December, 2014).

original aims, and to flag any immediate issues.¹¹³ Phase two of the post-implementation review will be published in 2017.

Australia

Australia is one of the first countries to have separated prudential and distribution regulation, and has a dedicated regulator for customer protection called the ASIC.¹¹⁴ The legal framework for regulating advisors under ASIC is guided by the *Corporations Act 2001* and regulatory guides provided by ASIC. Detailed definitions of what constitutes a financial product and financial service are given, where financial product advice is defined to be a financial service. All personal advice must comply with rules, i.e. the “suitability” rule or “reasonable basis for advice” rule, which require the advisor to understand clients’ personal circumstances, and ensure the appropriateness of advice.

Financial advisors must hold a **Australian Financial Services Licence (AFSL)**, and comply with the disclosure requirements. These include providing:

1. A Financial Services Guide to each retail client;
2. A detailed statement of advice that sets out the advice and the basis on which it was provided;
3. All information on remuneration (and other benefits) the advisor (or a related entity) may receive; and
4. Information on any relationship of the advisor that may have influenced the particular advice.

Advisors also have to meet certain training and competency requirements.

However, regulatory gaps and flaws in the distribution structure have resulted in financial scandals. In particular, existing remuneration arrangements has distorted incentives of product suppliers. Fee-for-service advisors are paid directly by the customer, and commissions; bonuses; and soft-dollar incentives financed by the product providers continue to exist. As customer-based and provider-based fees both exist, most remuneration still comes from the product provider, and development of a customer-focused market for advice has been diluted. These issues were emphasized during the global financial crisis, and after sever financial scandals (such as the Storm Financial scandal), Australia conducted a review with the aim of reforming the financial product distribution system in 2008.

This resulted in the **Future of Financial Advice (FOFA)** package. The FOFA reforms focus on improving the quality of financial advice and expanding the availability of more affordable forms of advice. The key proposals of FOFA include:

- Banning of up-front and trailing commissions;
- Banning of volume based payments;

¹¹³See Europe Economics, *Retail Distribution Review Post Implementation Review*, tech. rep., 2014, URL: <http://www.fca.org.uk/static/documents/research/rdr-post-implementation-review-europe-economics.pdf>, for findings from phase one.

¹¹⁴See <http://www.asic.gov.au> for details

- Banning of soft-dollar benefits¹¹⁵;
- Setting up a statutory best interest duty for financial advisors;
- An opt-in scheme whereby clients will have to agree to paying fees to advisors every two years;
- Providing the option of “scaled advise” instead of “holistic advise”; and
- A compensation scheme whereby clients will have to be compensated for bad/un-suitable advice.¹¹⁶

Australia has also ensured, unlike under the **UK RDR**, that there is no provision to allow for “tied-agents”.

EU

The **EU** established a group on **Packaged Retail Investment Products (PRIPs)** in 2009, under its **Markets in Financial Instruments Directive (MiFID)** Implementing Directive. The focus of this group was on pre-contractual product disclosures and rules on sales practices. The European Commission committed itself to developing a new, horizontal legislative approach in these two areas, drawing on the best of existing requirements but applying these to all relevant products and sales channels. The aim was to achieve a consistent and coherent overall approach.¹¹⁷ The key proposals include:

- Harmonised requirements for disclosure across retail investment products. This includes requirements for disclosures to be fair, and clear, using plain language and a short format; and
- Sales requirements.

After the publishing of this report, the debate in the EU was between a) banning commissions for all advisors versus just independent advisors, b) focusing only on enhancing disclosures without banning third party inducements.

The **MiFID II** proposals in 2012 retained the notion of independent advice, leaving open the possibility that commissions could be paid to non-independent advice. In 2014, the European Securities and Markets Authority (ESMA), published its final report on the MiFID II.¹¹⁸ These cover a wide range of topics including investment advice, commissions, complaints handling, product governance, and transparency. There are extensive product governance requirements on both manufacturers and distributors of investment products. One of these is to identify a “target market” at the time of product development. Distributors need to understand this market, and make their own assessment of the appropriate “target market” for each product. The document also proposes strict rules around inducements, include commissions.

¹¹⁵This is defined as any benefit received by a financial planning firm, its representatives or associates, other than basic monetary commissions or direct client advice fees.

¹¹⁶For more details see *Review of compensation arrangements for consumers of financial services*.

¹¹⁷EU, *Packaged Retail Investment Products: Issues for discussion*, PRIPs Workshop, Brussels, Oct. 2009.

¹¹⁸ESMA, *ESMA’s Technical Advice to the Commission on MiFID II and MiFIR*, Final Report ESMA /2014/1569, European Securities and Markets Authority, Dec. 2014.

The report is now with the European Commission, which is likely to draft and adopt Delegated Acts using these recommendations. These are likely to come into force within three to nine months, if accepted without any objections by the EU Parliament or Council.¹¹⁹

South Africa

The National Treasury of South Africa launched a formal review of the financial regulatory system in 2007. The scope of this review was expanded in 2008 after the global financial crisis and, in 2011, the National Treasury published a report entitled *A Safer Financial Sector to serve South Africa Better*,¹²⁰ to address the recession resulting from the crisis. The report reviewed the key challenges in South Africa's financial sector, and set out a new framework with the following four objectives at its core:

1. Financial stability;
2. Consumer protection and market conduct;
3. Expanding access through financial inclusion; and
4. Combating financial crime.

As part of the proposal on how to achieve these objectives, a 'twin peak' model was proposed, with separate prudential and market conduct regulators.

The **Financial Services Board (FSB)** (an independent institution aimed at overseeing the non-banking financial services industry in South Africa) is guided by the *Financial Advisory and Intermediary Services Act (FAIS Act)*, and is responsible for supervising financial advisory and intermediary activities in the financial services sector.

The **FAIS Act** made progress in raising intermediary professionalism, improving disclosure to clients and mitigating certain conflicts of interest. However, poor customer outcomes and mis-selling of financial products persisted. As a result, the **FSB** initiated the **RDR**.¹²¹

The **RDR** describes the current landscape in South Africa from the following three perspectives:

1. Types of service provided by intermediaries;
2. Types of relationships between intermediaries and product suppliers; and
3. Types of remuneration earned for the services concerned.

Key findings and current regulation structure

The key findings of the **RDR** can be grouped into under two categories.

¹¹⁹<http://blogs.deloitte.co.uk/financialservices/2015/01/mifid-ii.html>

¹²⁰Republic of South Africa National Treasury, *A Safer Financial Sector to serve South Africa Better*, 2011-02-23, URL: <http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf>.

¹²¹See Financial Services Board, *Retail Distribution Review 2014*, 2014, URL: <http://www.moneymarketing.co.za/files/2014/11/FSB-7-Nov-RDR-paper.pdf>, for details.

1. Advice and non-advice models

There is a clear distinction between advice and non-advice distribution models. Though the term “*Advice*” is defined in law, non-advice distribution activities come under the wider definition of “intermediary services”.

Execution only product sales (referred to as non-advised product sales) should fall within this definition of “intermediary services”, though differences in interpretation have resulted in some execution only models being designed to fall outside the regulatory net.

2. Commissions

The current commission based system (applied mainly to the insurance sector) requires full disclosure of commission to the customer. The maximum amount of commission payable (expressed as a percentage of the premium payable) and the way it is paid are both regulated.

The insurer pays commissions directly to the intermediary, which is then recovered through expense charges built into the insurance premium calculation i.e. they are not deducted directly from the premiums or from the policy value, but recovered indirectly over the life of the policy.

Commission are either paid:

- (a) Up front when the policy is entered into (life risk insurance policies);
- (b) On an ongoing basis as premiums are received (general insurance, called short-term insurance in South Africa); or
- (c) Partially up front and partially on an ongoing basis (investment policies sold by life insurers).

For non-insurance investment products, intermediaries are remunerated through advice fees authorised by the customer that are deducted directly from the value of the investment. Full disclosure of these fees to the customer is required, and these fees are either:

- (a) Up front in the case of lump sum single investments; or
- (b) On an ongoing basis in the case of ongoing instalment (usually structured as a percentage of the investment value from time to time).

Proposed regulatory reforms

The **RDR** approaches the current landscape in South Africa from three perspectives.

1. Services provided by intermediaries.

The **RDR** proposes defining the following three types of advice:

- (a) Financial planning (advice on structuring and arranging a customer's financial resources to meet goals);
- (b) Up-front product advice (a recommendation on the suitability of a product to the identified needs of the customer); and
- (c) Ongoing product advice (a recommendation on changes to product solutions during the life of a product, in response to changing market conditions or customer needs).

The **RDR** then sets proposed standards for each of these, including intermediary disclosure requirements and steps for mitigating and managing certain conflicts of interest.

2. Relationships between intermediaries and product suppliers.

In line with defining the types of advice that can be offered to a customer, the **RDR** proposes the following definitions of types of advisers:

- (a) **Independent Financial Advisors (IFAs)**;
- (b) Multi-tied advisers; and
- (c) Tied advisers.

The **RDR** proposes that an adviser qualifies as an **IFA** by meeting criteria relating to:

- (a) The choice of product and product supplier; and
- (b) Being free from product supplier influence.

A tied adviser has a relationship with a product supplier that restricts the adviser to providing advice only in relation to the products of that product supplier. An adviser that is not tied and does not meet the **IFA** criteria is a multi-tied adviser.

Standards for product suppliers' responsibilities are proposed for each type of adviser, with the product supplier taking full responsibility for the advice provided by its tied advisers. In the case of multi-ties advisers, product suppliers and multi-tied advisers are to share responsibility for the quality of advice provided to their shared customers. Standards are also proposed for a product supplier's responsibility for non-advice sales.

3. Remuneration earned for the services concerned.

Among the proposals relating to remuneration, the most notable is the one banning commissions for all investment products, stating that:

“product suppliers will be prohibited from paying any form of remuneration to intermediaries in respect of investment products, and from including any costs as-

sociated with intermediary remuneration in product charging structures, whether in the form of ongoing charges or early termination charges. Intermediaries will correspondingly be prohibited from earning any form of remuneration in respect of investment products other than advice fees agreed with the customer, in accordance with the applicable requirements for such fees.”¹²²

¹²²See FSB, see n. 121, for details.

Annex D: Disclosure form

DISTRIBUTOR-INVESTOR MUTUAL FUND DISCLOSURE FORM

Distributor's (Firm/Entity) Name:	
Distributor's Person's Name:	EUIN:
Investor's Name:	Date of Birth:

Asset Management Company Details:					
Name:					
Year of Establishment:					
Net Worth: <i>(Regulatory requirement: 50 Cr)</i>					
Scheme Details:					
Scheme Name:					
Scheme Type : NFO/Existing Scheme			Open Ended/Close Ended		
If Existing Scheme	Current NAV:				
	Number of folios:				
	Scheme AUM (in Cr):				
Asset mix(Equity/Debt/Gold---- in percentage terms):					
Benchmark:					
Riskometer:					
Past Returns Since Inception:		CAGR		Absolute Return	
Scheme Return (%)					
Benchmark Return (%)					
<i>(Past performance is not necessarily indicative of future results)</i>					
Investor Profile & Investment Details					
Investment Horizon or Scheme works best if held for:					
Investor's Existing Asset Allocation (in percentage terms):					
Equity:	Debt:	Gold:	Others:		
Investor Risk Profile: <i>(High/Medium/Low)</i>					
Investment Amount Upfront:			Periodic:		
If this investment is being made by first selling off another mutual fund scheme held by the investor, specify reasons for the same:					
Total Expenses(TER) charged to the Investor					
	< .5%	< 0.5% to 1%	< 1% to 1.5%	< 1.5% to 2%	>2%
Time of Investment :					
Annual (Trail Commission) :					
Exit Load:					
Any Other Expense :					
Signatures:					
Distributor's Person		Investor		Date:	

Annex E: UK benefit illustration

Bonus Builder Savings Plan

Your Personal Illustration

Life Insurance Corporation of India
 10th Floor, York House
 Empire Way
 Wembley, HA9 0PX

Date 28/05/2015

Mr ddd,

Please read this illustration together with the Key Features document for the arrangement prepared

Life Assured: Mr ddd ddd (Male)

Date of Birth: 01/01/1980

Age as on 28/05/2015 is: 35

Saving Period: 15 years

Your Contribution: £125.00 Monthly

The Guaranteed Cash Amount Initially is: £18,586.89

Sales channel : Non advised Direct

Accident Benefit Included

What might I get back after 15 years?

If your investment grew at 1.5% a year you would get back **£22,300.00**

If your investment grew at 4.5% a year you would get back **£27,500.00**

If your investment grew at 7.5% a year you would get back **£34,300.00**

==> These figures are only examples and are not guaranteed - they are not minimum or maximum amounts. What you will get back depends on how your investments grow and the tax treatment of the investment.

==> You could get back more or less than this, but the minimum amount you could get back, provided you maintain your contributions, is the Guaranteed Cash Amount.

==> All regulated firms use a standardised method for illustrations but their rates of return and charges may vary. The figures provided are purely for illustration purposes and the projected returns will vary as these figures include deductions for firm specific charges.

==> Do not forget that inflation would reduce the amount you could buy in the future with the amounts shown.

What happens if I die?

In the event of your death, during the savings period and whilst the plan is in force, the Guaranteed Cash Amount is payable as a lump sum.

Initially the Guaranteed Cash Amount is £18,586.89 and this may increase as bonuses are added over the years.

Annex F: List of consultations

The Committee met the following people for its consultations

- Second meeting, 23rd January 2015
 - Shri Parag Basu, CGM SEBI
 - Shri Vimal Bhattar, AGM, SEBI
 - Ms Meena Kumari, Head of Department (Actuarial), IRDA
 - Ms Sumeet Kaur Kapoor, GM, PFRDA, NPS Trust
 - Shri V.K. Sharma, MD, LIC of India
 - Shri Leo Puri, MD, UTI AMC
 - Mr Suraj Kaley, Group President (Sales & Marketing), UTI-AMC
- Third meeting, 24th March 2015
 - Shri B.N. Chary, Life Insurance Agents Federation of India
 - Shri. Gurpreet Singh, Financial Intermediaries Association of India (FIAI)
 - Shri Vishal Kapoor, Financial Intermediaries Association of India (FIAI)
 - Shri Rajesh Kumar Gupta, National Federation of Field Workers of India
 - Shri Satish Menon, Geojit BNP Paribas
 - Shri Vijay Bhushan, ANMI
 - Shri Naresh Tejwani, ANMI
 - Shri Sohan Lal Kadel, Insurance Brokers Association of India
- Sixth meeting, 16 April, 2015
 - Shri Sandeep Batra, ED, ICICI Prudential
 - Shri Sanjeev Pujari, ED, SBI Life Insurance
 - Ms Madhuri Kulkarni, Chief (Actuarial), LIC
 - Shri P.K Arora, Appointed (Actuary), LIC
 - Ms Pourima Gupte, WTM, Actuary, IRDA
- Seventh meeting, 22 April, 2015
 - Shri A. Balasubramanian, AMFI
 - Shri H. Bindal, AMFI Board Member
 - Shri Balkrishna Kini, Deputy Chief Executive, AMFI

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