

Misled and mis-sold: Financial misbehaviour by retail banks?

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Part I

Background

Problems of mis-selling in financial markets

- ▶ Savings in financial assets in India is 8 percent of GDP (Reserve Bank of India, 2012)
- ▶ Distributors play an important role in the sale of financial products
- ▶ Commission incentives and mis-selling episodes in retail finance
 - ▶ Shrouding of fees by mutual funds: Losses of upto **US \$350 million** (Anagol and Kim, 2012)
 - ▶ Mis-selling of ULIPs: Losses of upto **US \$28 billion** (Halan, Sane and Thomas, 2014)
 - ▶ Evidence on unsuitable sales by insurance agents (Anagol, Cole and Sarkar, 2012)
- ▶ This is not unique to India. For example, the subprime mortgage crisis in the US, the Payment Protection Insurance scandal in the UK

The response of regulators: Consumer protection

- ▶ Empower better decision making
 - ▶ Financial literacy training and disclosure regulation
 - ▶ Mixed results on their effectiveness (Kozup, Howlett, and Pagano, 2008; Loewenstein, Cain, and Sah, 2011)
- ▶ Direct intervention in to how financial products are sold
 - ▶ Capping or banning commissions to brokers
 - ▶ Example: SEBI ban on upfront commissions in 2008
 - ▶ Example: Ban on commissions in the UK and Australia since 2013
 - ▶ Very little research on their effectiveness (Anagol et. al. 2015)

The problem with studying regulations

- ▶ Regulations may be made, but not be enforced
- ▶ Regulators have little control over whether disclosures are made
- ▶ Even if they are made, the information disclosed may be inaccurate.
- ▶ Not enough evidence on whether agents intentionally or otherwise make mistakes.

This paper

- ▶ What products do bank based managers recommend? How does this vary when the auditor makes a specific request vs. when the auditor appears uncertain?
- ▶ What product features get disclosed? Do the more salient attributes of a product, such as returns, get disclosed more frequently, while complex product features such as costs, or charges on early exit get shrouded?
- ▶ Are these disclosures accurate?
- ▶ What might the drivers of product recommendations be? When remuneration is tied to sales-linked bonuses, are the most expensive products sold?
- ▶ Conduct an *audit study* on the sale of products through the banking channel.

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Part II

The research setting

Why study banks?

- ▶ Banks have become an important channel for the distribution of financial products.
- ▶ 70 percent of the Indians polled said they trusted banks (Gallup Poll, 2013)
- ▶ Important as there is a renewed emphasis on increasing financial access through banks.
- ▶ Media reports on mis-selling via the banking channel

Different incentives: Front loaded commissions

Tenure (in Years)	Mutual fund (Hybrid scheme)	Insurance plans	
		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%

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

Source: Bose committee report, 2015.

- ▶ 15 year tenure: distributors in mutual funds would earn only 1.11 percent of total commissions as upfront commission.
- ▶ Distributors of ULIPs and traditional plans earn 22 and 26 percent respectively.
- ▶ This is higher for shorter tenures.

Regulations on disclosures

- ▶ Bank managers, as distributors of financial products, required to comply with:
 - ▶ IRDAI (Protection of Policyholders' Interest Regulation 2002)
 - ▶ SEBI (Fraudulent and Unfair Trade Practices, 2012) regulations on disclosures
 - ▶ AMFI Code of Conduct
 - ▶ RBI (Para Banking Master Circular, 2015)

Part III

Research design

Treatments

- ▶ Customer looking for a tax-saving product.
- ▶ These products are listed in Section 80C of the Income Tax Code. The main ones are:
 - ▶ Equity linked mutual fund scheme (ELSS)
 - ▶ Insurance: unit linked plans (ULIPs) and endowment insurance plans
 - ▶ Fixed Deposits (FDs)
- ▶ **Informed** customer asks for the Equity Linked Savings Scheme (ELSS)
- ▶ **Uninformed**, and displays a vague sense of wanting some tax-saving product
- ▶ Investment amount is varied either Rs.25,000 or Rs.100,000.

Why ELSS?

- ▶ Better returns over the last ten years
- ▶ Lower costs than insurance products
- ▶ Transparent cost structure
- ▶ Portable after the three year lock-in period
- ▶ Evaluation of product recommendations does not really rely on the ELSS being the *optimal* product
- ▶ Focus is not so much about which is the better product, but about the **process** in which a product is sold.

Product features

- ▶ The auditors were required to note if the following features were talked about
 - ▶ Returns
 - ▶ Costs
 - ▶ Guarantees
 - ▶ Early exit
 - ▶ Optimal holding period
- ▶ Incorrectness of the disclosures decided by comparing information given by the manager with product brochures.
- ▶ In the case of optimal holding period, benchmark arrived at by discussions with certified financial planners.

Part IV

Audits

Audit logistics

- ▶ Hired a market survey agency
- ▶ Double blind study
- ▶ Two rounds: Round 1 in March 2015, Round 2 in July 2015.
- ▶ 6 males and 1 female in the 28-45 age group.
- ▶ The annual income of the auditors ranged from Rs.500,000 to Rs.2,500,000.
- ▶ All of the auditors were graduates, or above.
- ▶ 5 of the auditors were married, four of them had children.

Auditor training

- ▶ Trained by us
- ▶ Basic financial concepts
- ▶ Plethora of tax-savings products in the market
- ▶ How to ask for advice in a bank
- ▶ In Round 2, trained auditors on each specific attribute.
- ▶ Exit surveys.
 - ▶ The product suggested
 - ▶ The way the product was suggested
 - ▶ Information about the product that was suggested
- ▶ Also brought back product brochures, explanations on papers, and visiting cards of the bank managers.
- ▶ We also compared the illustrations made by the managers with the information our auditors had filled in the exit form.

Sampling

- ▶ Total universe of about 2000 bank branches in Delhi
- ▶ 400 audits
- ▶ Stratified sampling according to administrative zones of Delhi.
- ▶ Randomly sampled branches in each administrative zone.
- ▶ Round 1
 - ▶ Sample was drawn in proportion to the number of public and private sector branches
 - ▶ We did not require our auditors to ask questions about product features. We noted what was offered voluntarily
- ▶ Round 2
 - ▶ Over-sampled private sector and larger public sector banks.
 - ▶ Trained auditors to specifically ask for information on product features.

Banks covered

- ▶ **Private banks:** Axis Bank, HDFC Bank, ICICI Bank, Kotak Mahindra, Yes Bank
- ▶ **Public banks:** Bank of Baroda, State Bank of India, Punjab National Bank, Other state banks.
- ▶ **Smaller banks:** Canara Bank, UCO Bank, Vijaya Bank, South Indian Bank
- ▶ **Foreign banks:** Standard Chartered, Citibank, HSBC

Part V

Results

Outline of results

- ▶ Did the managers ask for information from auditors?
- ▶ Did managers distribute the requested product?
- ▶ What gets recommended?
- ▶ Are recommendations accompanied by disclosures?
- ▶ Are these disclosures correct?
- ▶ Driver of recommendations
 - ▶ Bank manager paternalism?
 - ▶ Incentive structure?
- ▶ What drives disclosures?

Overall goals

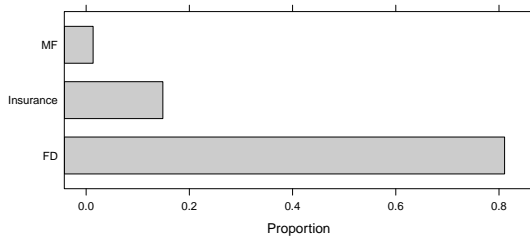
- ▶ 59 percent of managers asked customers for their overall goals, and previous tax-savings
- ▶ Private sector banks better at asking this information: 80 percent private banks vs. 40 percent public banks
- ▶ Foreign banks refused to speak to non account customers
- ▶ Private sector banks are more proactive
- ▶ But it ends here. No questions asked to probe further.
- ▶ Not having a account with a bank is not a showstopper either.

Did managers distribute the requested product?

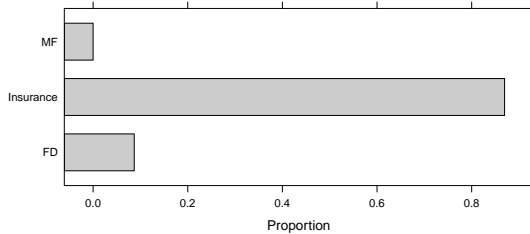
- ▶ Of those who requested an ELSS product, only **14 percent** were encouraged to buy it
- ▶ **30 percent** were actively discouraged
- ▶ **55 percent** were presented with a neutral response
 - ▶ **79 percent** of these the manager towards the end steered the conversation to another product.

Steered to where?

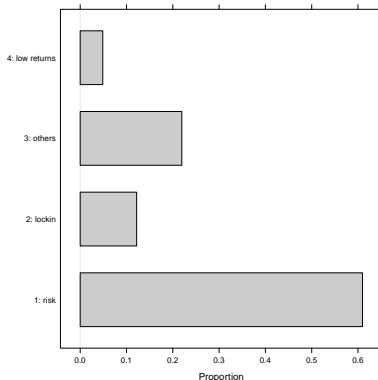
Public sector banks



Private sector banks



Why steered away from the ELSS?



- ▶ But ULIPs are also market linked
- ▶ In case of guaranteed insurance plans, managers did not educate that risk mitigation came at the cost of negative real returns.

What gets recommended?

Recommendation	Products recommended (%)			
	Fixed deposit	Insurance	Mutual funds	Others
Recommendation	51	35	8	6
Asked for ELSS	51	33	12	4
Asked for a tax saving instrument	53	36	2	8

- ▶ Fixed deposits most popular product among bank advisors
- ▶ Insurance is the second most popular - more insurance is sold to uninformed customers

Public vs. private sector banks

	Products recommended (%)			
	Fixed deposit	Mutual funds	Insurance	Others
Banks with tie-ups	45	8	41	6
Private sector (with tie-ups)	9	11	76	2
Public sector (with tie-ups)	72	5	14	9

- ▶ Of all the recommendations made by a **private sector bank**, more than 70 percent were **insurance**.
- ▶ Of all the recommendations made by a **public sector bank**, more than 70 percent were **fixed deposits**.

Are recommendations accompanied by disclosures?

	Round I			Round II		
	(1)	(2)	(3)	(4)	(5)	(6)
	Fixed Deposit	Insurance	Mutual Fund	Fixed Deposit	Insurance	Mutual Fund
Returns	6	39	93	93	99	93
Guarantees	95	73	7	97	40	27
Costs	0	0	0	3	60	60
Lock-in	0.8	0	0	90	90	87
Charges on early exit	NA	NA	NA	89	89	73
Optimal holding period	NA	NA	NA	100	100	100

- ▶ When **not asked**, returns on FDs disclosed 6% of the time, on insurance 39% of the time, and on mutual funds, 93% of the time.
- ▶ When **not asked** other product features are not disclosed.
- ▶ When **specifically asked**, returns numbers are most likely to be disclosed.

Were the disclosures correct?

Percentage of incorrect disclosures

	Fixed Deposit	Insurance	Mutual Fund
Returns	35	99	86
Guarantees	2	34	36
Costs	4	100	85
Lock-in	7	36	50
Optimal holding period	12	62	86

Returns disclosures

- ▶ Disclosures on returns were less likely to be vague, and more likely to be a specific number.
- ▶ FDs were the most correctly disclosed product (only 35 percent incorrect).
- ▶ One possible explanation for this is that bank managers have not updated themselves to the change in interest rates on these products.
- ▶ Of all the disclosures on insurance returns, 99 percent did not show the correct returns.
- ▶ Of all the disclosures on mutual fund returns, 86 percent did not show the correct returns.


Costs disclosures

- ▶ 4 percent misrepresentation of costs on fixed deposits
- ▶ All disclosures on costs of insurance products were incorrect
- ▶ 87 percent of disclosures on costs of mutual funds were incorrect.

Driver of recommendations: Bank manager paternalism?

Over a 10 year period:

- ▶ FD gave 7%
- ▶ Traditional insurance plan returned 4%
- ▶ Unit linked insurance plan returned 16.36%¹
- ▶ ELSS returned 17.17%
- ▶ The ULIP and ELSS returns had a standard deviation of around 25%.

¹Returns are lower since ULIP NAV does not include all the product costs. 

But what if insurance was optimal?

- ▶ We calculate the returns on a “bundled” insurance product vs. a “pure term” insurance product.
- ▶ If the manager felt that the customer required insurance, he should have sold a combination of term insurance plus fixed deposit.
- ▶ It is difficult to find a situation where a bundled insurance product does better than term plus fixed deposit.

Why are public sector banks not selling insurance?

- ▶ Public sector banks, even with tie-ups are less likely to sell insurance than private sector banks.
- ▶ Remuneration in public sector banks is not directly linked to sales volumes.
- ▶ Deposit mobilisation targets are more important than sales volumes on third-party products.

Results: Disclosures

- ▶ Those who ask for a tax product are less likely to be given information on returns and costs than those who asked for an ELSS.
- ▶ Public sector banks give more information on guarantees.
- ▶ They are less likely to disclose returns and costs information.

Part VI

Conclusion

Main results

- ▶ Poor sales practices of retail financial products
- ▶ Where remuneration is linked to sales, managers recommend the highest-fee paying product.
- ▶ Complex product attributes such as costs and lock-in rarely disclosed
- ▶ When made disclosures are largely incorrect
- ▶ We cannot distinguish between intention and incompetence of bank managers.

How do we think of sale of financial products?

- ▶ Two extremes: default FD or insurance product
- ▶ **Problem not as pervasive**: public sector banks only selling the FD
- ▶ **Problem deep**: private sector banks push the more remunerative product
- ▶ Disclosure regulation by itself not enough. Possibly because:
 - ▶ Limited enforcement
 - ▶ Perception that customers don't care
 - ▶ Poor training of the bank staff themselves
- ▶ How do we regulate when customers don't know that they don't know?

Questions/Comments?
Thank you