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	Insurance plans: 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?

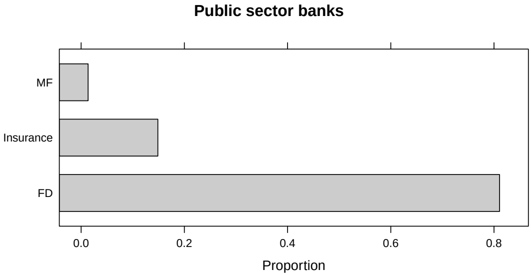
Overall goals

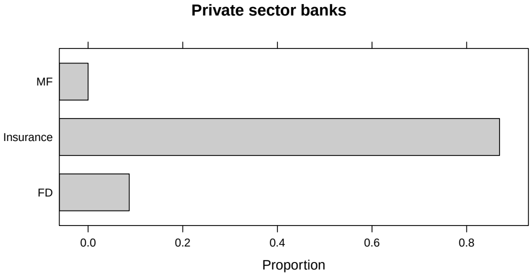
- 59 percent of managers asked customers for their overall goals, and previous tax-savings
- Private sector banks better at asking this information: 80 percent private banks vs. 40 percent public banks
- Foreign banks refused to speak to non account customers
- Private sector banks are more proactive
- 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?

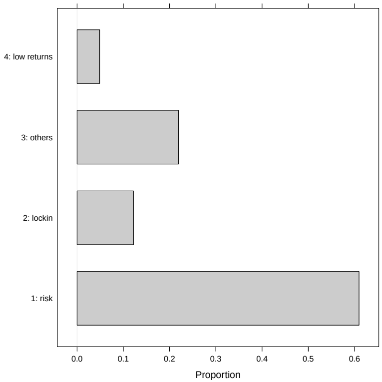
- Of those who requested an ELSS product, only 14 percent were encouraged to buy it
- 30 percent were actively discouraged
- 55 percent were presented with a neutral response
    - 79 percent of these the manager towards the end steered the conversation to another product.

Steered to where?





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?

	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) Fixed Deposit	(2) Insurance	(3) Mutual Fund	(4) Fixed Deposit	(5) Insurance	(6) 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%.

[1] Returns 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