

# The case of the missing billions: Estimating losses to customers due to mis-sold life insurance policies

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## Abstract

In 2011, regulatory constraints were imposed on the sale of unit linked insurance policies (ULIPs) in India, under the claim that ULIPs had been mis-sold as insurance products. This paper constructs two measures of the loss to customers due to mis-selling of ULIPs. The first is calculated using the value of lapsed policies, and the second uses the persistence of premium payments. The paper uses hand-collected data from the annual reports of the insurance regulator and annual reports of individual insurance companies. Both arrive at similar estimates of around USD 28 billion lost from ULIPs sold between 2004 and 2011.

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# 1 Introduction

Concerns about consumer protection have come to prominence in financial regulation in recent decades (Campbell, 2006; Inderst, 2009; Campbell et. al., 2011), and have become firmly entrenched after the 2008 financial crisis. In the economics literature, there has been a lot of research and policy focus on the conflict of interest in the distribution of retail financial products, which gives rise to mis-selling of financial products (Mullainathan, Noeth, and Schoar, 2012; Beyer, de Meza, and Reyniers, 2013). Customers who are naive about understanding complicated financial contracts can become particularly vulnerable to mis-selling by distributors incentivised by remuneration structures to push financial products, regardless of how suitable the product is for the customer (Inderst and Ottaviani, 2009).

Evidence about mis-selling can be found from research in other fields as well. Deceptive sales practices, including the use of improper statements about rates of returns or the price of the contract, have been documented from as early as the 1970s (Belth, 1974). Interviews with life-insurance marketing executives, sales agents, consumers, industry association officials, and market conduct regulators point out that a sales culture where earnings are entirely based on commissions, lead to practices where sales personnel frequently put their clients at risk, ironically by selling a product that is supposed to minimize risk (Ericson and Doyle, 2006). Cross-selling of products by financial firms has also been found to be against consumer interests (Federal Trade Commission, 2001; Ashton and Hudson, 2014)

Such practices have often culminated into full-blown public scandals. For example, the financial sector in the U.K. has recorded several misdemeanours over the last three decades: the pensions scandal in the 1980s (recognised by regulators only in 1993-94), the endowment mortgage scandal in mid 1990s, and more recently, the Payment Protection Insurance (PPI) mis-selling episode (McConnell and Blacker, 2012). The ponzi scheme engineered by Bernie Madoff in the U.S. is estimated to have defrauded investors of bil-

lions of dollars. The collapse of Storm Financial, a financial advisory firm in Australia, left investors with an estimated loss around of \$3 billion (Barry, 2011).

In an emerging market, where customers have a lower exposure to knowledge about choices in financial contracts, and where there is lower competition among financial firms, the problems of mis-sales can be exacerbated. In such a context, subsequent breakdowns in customer protection impose large costs, not just in terms of losses to customers, but also in leading to a general mistrust of finance and a persistent low reach and development of financial markets.

In India, there have been several instances of mis-selling by insurance companies and mutual funds, in response to which Indian regulators have banned upfront commissions (Anagol and Kim, 2012; Anagol et. al., 2013; Anagol, Cole, and Sarkar, 2012). In the case of mutual fund sales, this was enforced as early as 2009. Commissions caps have been tightened on some insurance products as well. A recent policy initiative to carry out wide-sweeping reforms in the legal and regulatory framework for the Indian financial sector, called the *Indian Financial Code*, visualises consumer protection as one of the core functions of regulation (Srikrishna, 2013).

However, much of these pervasive regulatory changes have been carried out with little support of empirical evidence. Unlike in the case of developed financial markets, little is known about the actual losses due to mis-sales of financial products. Perhaps as a consequence, when such episodes come to light, the focus is to use regulation to change practices by financial firms for the future, with little focus on providing redresses to customers who suffered losses as a consequence of mis-sales.

The current paper is motivated by questions of the evidence of losses due to mis-sales: What is the extent of the economic loss caused by mis-selling? What policy interventions are required, in addition to the ones already made, as a response to such loss? The paper uses the insurance market in India where there is a clearly identified episode when the sales of a particular product (Unit Linked Insurance Products, ULIPs) led to a breakdown

in customer protection products over a long time period. Given that financial markets in emerging economies typically suffer even more from a lack of transparency than those in developed economies, the focus of this paper is to estimate the magnitude of losses suffered by insurance customers as a consequence of the mis-sale of ULIPs during this period.

The paper proposes two approaches to estimate the losses of customers, from two publicly available sources of data. The first method captures the loss in renewal premiums that occurs due to lapsed policies, and is referred to as the *renewal premium method*. Lapsed policies are reported as policies that are not renewed by the policyholder, in the annual reports of the insurance regulator, the Insurance Regulatory and Development Authority, (IRDA).

The second method is called the *persistence method* which tracks the performance of the premium over subsequent time periods to measure the attrition to the business over time. The premiums are reported in the annual reports of the individual insurance companies. This allows for an examination of the life cycle of policies issued in a particular year.

The underlying assumption in both these methods is that when policies lapse for reasons other than those of death or financial emergencies, and when there is a sudden surge in the lapsation of policies, it is because the customer discovers that the policy is unsuitable, abandons it from his investment portfolio and treats the lapsed premia as sunk cost. Insurance is a long-term investment product, and it is unlikely that large scale lapsation is driven by return seeking investors switching products.

The paper examines the period of high growth of the insurance market between 2004-05 and 2009-10, when the ULIPs started being sold for the first time. ULIPs were long term policies that required continuous investment for ten to fifteen years, but which were sold as three-year money doubling policies. The data shows that the period of high ULIP sales is coincident with the period with the highest numbers of lapsed policies. Both the *renewal premium* and the *persistence* methods reveal that investors lost Rs.1.5 trillion

(US\$28 billion). In 2010 this was almost 2 percent of the Indian GDP.

This paper, to our knowledge, is the first to lay out the policy and institutional context of retail finance, and narrate a mis-selling episode that occurred within this framework, of a large emerging economy. It is also able to enumerate a method to policymakers and consumer protection practitioners to estimate losses from publicly available data in an environment of low transparency about such information.

The paper proceeds as follows. Section 2 provides the context of the life insurance industry in India, within which we study the economic losses that result from widespread mis-selling of financial products. Section 3 describes the methodology used in estimating customer loss. The estimated value of the loss is presented in Section 4. Section 5 is a discussion of who lost and who gained from the mis-selling, followed by a description of the policy response. Section 6 discusses the challenges of retail finance regulation followed by the policy imperatives for India. Section 7 concludes.

## **2 Changes in the Indian life-insurance industry**

Until 2001, the life insurance industry in India was a state-owned monopoly enterprise, the Life Insurance Corporation of India (LIC). Traditionally, LIC offered three types of life-insurance products: “term policies”<sup>1</sup>, “annuities”<sup>2</sup> and “non-linked policies”.<sup>3</sup> 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,

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<sup>1</sup>A term policy is a stand-alone pure life cover where there is a pay-out on occurrence of death. No money is returned if the insured survives the policy term. This kind of insurance gives the maximum life cover per rupee of premium since there is no investment component embedded in the policy.

<sup>2</sup>Annuities are long term investments where a given lump-sum investment resulted in a regular cash-flow to the customer till the time of his death.

<sup>3</sup>Non-linked policies have higher premiums than term policies, and accumulate returns from investments that are available both to the fund to adjust for rises in costs of fund management, or to the customer who can withdraw cash from the investments. The typical non-linked insurance product that LIC offered include money-back, endowment, and whole life policies.

non-linked policies were popular with investors in the Indian retail market 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 for Indian investors at the time that offered guaranteed returns.<sup>4</sup>

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<sup>5</sup>, and after, with proceeds of the investment and final withdrawals being tax exempt.

After 1999, when the insurance regulator, the Insurance Regulatory and Development Authority (IRDA)<sup>6</sup> 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 “unit-linked insurance policy” (ULIP), an investment linked insurance policy, where a large fraction of the premium was invested as in a mutual fund product with a small<sup>7</sup> 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. For example, 5 percent of the total premium in 2009-10 came from banks as opposed to 3 percent in 2006-07.<sup>8</sup>

The increase in the set of new distributors and the introduction of new products did not really affect the access to insurance. This is measured by insurance *penetration*, which is defined as the ratio of premium to GDP. Insurance penetration saw a relatively small

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<sup>4</sup>LIC policies are guaranteed by the Government of India. This adds to the perception that all insurance products are guaranteed.

<sup>5</sup>Under these tax laws, upto Rs.100,000 of investment in term policies are tax exempt.

<sup>6</sup><http://www.irda.gov.in>.

<sup>7</sup>The average sum assured was five times the premium. For example, a premium of Rs.100,000 would get a life cover of Rs.500,000. A similar pure life cover, or term cover, would cost around Rs.1000, for a similar age person for a similar number of years. The size of the cover did not differ across product type, since the regulator mandated that at least five times the premium should be given as a cover. After 2010, that number has been increased to 10 times the premium.

<sup>8</sup>From Table 4, “Channel Wise Individual New Business Performance Of Life Insurers” in the Handbook on Indian Insurance Statistics, 2009-10.

increase to 3.4 percent in 2011 from 2.2 percent in 2001.<sup>9</sup>

In contrast, the Assets Under Management (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.<sup>10</sup> Table 1 shows that there was also a steady rise in total premiums from ULIP products, which peaks in 2007-08, with almost 75 percent of the premiums from ULIPs.<sup>11</sup>

*Insert Table 1 here*

Although penetration of insurance among a wider set of customers did not take place, the commissions paid out by the industry for distribution matched the growth in the AUM of the insurance sector. The industry paid out net commission of Rs.1.13 trillion over the 2004-05 to 2011-12 period.<sup>12</sup> In the last few years, there have been many concerns about insurance distribution through agencies such as banks.<sup>13</sup>

A combination of these three factors – lack of penetration, significant growth of the AUM and the fees paid as commissions – makes a case that it is not obvious that end customers were benefiting from the new products, just as is the case that the industry – both the product providers as well as the distributors – clearly were.

## **2.1 The mis-selling of ULIPs**

When life insurance products are bundled with investments and the expected returns tend to be realised only over time, the insurance contract requires regular funding from the customer. In the case of the ULIP, the policies needed to be funded regularly for

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<sup>9</sup>Source: IRDA Annual reports

<sup>10</sup>One record of this remarkable growth is from Table 8, “Assets Under Management of Life Insurers” in the Handbook on Insurance Statistics in India, 2010.

<sup>11</sup>This share has steadily decreased since then, and is as low as 24 percent in the 2011-12 year. This is likely to be a result of the various reforms in the sale and product structure of ULIPs that were undertaken in 2010. These are discussed in more detail in Section 5.2.

<sup>12</sup>Source: IRDA annual reports.

<sup>13</sup>Chapter 8, IRDA (2011).

a period of at least 10-15 years for the full benefit to accrue to the policy holder. The policies offered a three-year lock in period i.e. after three years of funding the policy, the policyholder could withdraw. If, however, the policyholder withdrew before the three years were over, the entire value of the policy was surrendered to the insurance company.

Anecdotal evidence strongly suggests that distributors did not inform investors that the ULIP policies needed to be funded every year for 10-15 years before returns would accrue. On the contrary, the three year lock-in period was marketed as a tenure period. Investors bought the equity-linked ULIP as a safe investment in markets that would also result in high returns, 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 law on front-loaded commissions, which were as high as 40 percent in the first year, incentivised agents to sell products that earned them the highest pay-off. The tax benefits made this product more attractive than a mutual fund product which also faced short term capital gains provisions.<sup>14</sup>

### **3 Methodology: Estimating economic loss**

Performance evaluation and cross-product comparisons of financial products typically involve comparing their cash flows and the risk of these cash-flows. In the case of life insurance, this comparison becomes complicated because an investment product is bundled with insurance cover i.e. the investment of an individual has embedded in it an insurance premium for a life cover. There are three measures that are traditionally calculated and reported in an insurance product: the number of policies sold, the sum assured and the

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<sup>14</sup>Mutual fund products were cheaper than ULIPs and also did not have this lock-in period. Insurance agents however had no incentive to sell, or point their customers to such mutual fund products.



premium received. If there is risk or loss to the customer from holding these insurance products, then they must be calculated using one or more of these measures.

Of these measures, customer loss cannot be measured in terms of number of policies sold in a year or the sum that is assured to them by the company. However, premium payments do measure the real outflow from an investor. If the policy has been mis-sold, then the premium outflow reflects the loss to the investor. When a policy lapses, the premium forgone is considered to be the measure of the financial loss.<sup>15</sup> Based on this understanding, we propose two methods to measure customer loss from mis-sold insurance products.

The *renewal premium method* captures the loss in renewal premiums over the years 2004-05 to 2011-12. This loss is adjusted to exclude the premium loss due to reasons including death, maturity and income-shock to provide an adjusted loss number indicating the unexplained losses to the premium. These losses occur due to ‘lapsed’ policies, or policies that are not renewed by the policyholder. The regulator links this lapsation<sup>16</sup> of policies to mis-selling of policies. These unexplained losses constitute the customer losses.

The *persistency method* tracks the performance of the premium over subsequent time periods to measure the attrition to the business over time to examine the life cycle of policies issued in a particular year. The formula takes into account attrition in premium due to explained losses such as surrender and death benefit pay-outs, leaving the loss in premium as the amount due to mis-selling.

### 3.1 Renewal premium method

The insurance business has several flows of revenue in a year. There are three streams of inflows:

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<sup>15</sup>Two issues of the IRDA Journal have focused on the issue of lapsation and persistency (IRDA, 2011b,e)

<sup>16</sup>If premium paying stops within the lock-in period, it is industry practice to call this “lapsation”. If the payment stops after the lock-in period, it is termed as “surrender”.

1. Single premium policies: These are a lump-sum one-time investment that provide an insurance cover and returns. There are no regular premium flows from this product.
2. Regular premium policies: Both traditional and unit-linked, regular premium policies have a periodic premium paying tenor. This can be annual, semi-annual, quarterly, or monthly. The premiums are typically paid for a period of 10–15 years, and the pay outs begin thereafter. The customer has a life insurance cover over the life of the policy.
3. Renewal premium. Both traditional and unit linked are long term products and the premium is paid year on year for 10–15 years. For policies that originated in the years before the current year, the premium so collected is called the renewal premium.

The renewal premium is calculated as follows: a person buys a 10–15 year product in year one. In year two, he should pay the premium to keep the policy alive and continue to do so for the subsequent years in the life of the policy. A customer may not renew the policy for several reasons. First, in the event of his death there is a pay-out to the beneficiary. Second, the policy completes its premium paying term. Third, the customer wants to terminate this investment due to an income shock. Fourth, the customer may not want to continue with the policy if he has been mis-sold the product and finds it unsuitable. It is reasonable to assume that if a person has bought into a long term product fully understanding his premium commitment for each year, the only reason he would terminate the policy would be due to an income shock or because he discovers that the product is inappropriate for his financial needs.

To calculate the premium lost, the first step is to remove the inflows that should not be counted. Single-premium policies, which by their nature are a one-time investment, are excluded for this reason. The premium flows for linked and non-linked policies are considered. If an insurance company collects Rs.100 of premium in year zero and Rs.110 premium in year one, then the total premium collected in year one should be Rs.100 + Rs.110, or Rs.210. The Rs.100 from year zero becomes the renewal premium for year one. However, if the company collects less than Rs.210 in year one, there has been a

loss in the renewal premium income. The premium lost is estimated using the following formula, which uses data obtained from IRDA annual reports:

$$RP_t = NRP_{t-1} + RP_{t-1}$$

Here,  $RP_t$  is the renewal premium in a particular year, and  $NRP_{t-1}$  is the new regular premium in the previous year. If renewal premium in one year is less than the sum of the new regular premium and renewal premium for the previous year, it means that there has been a drop in the money reinvested in the policies. The formula to obtain the loss is as follows:

$$LP_t = NRP_{t-1} + RP_{t-1} - RP_t$$

where  $LP_t$  is the loss in the renewal premium for year  $t$  and NRP and RP are as defined previously. For example:

$$LP_{2005-06} = NRP_{2004-05} + RP_{2004-05} - RP_{2005-06}$$

### 3.2 The persistency method

Another way to estimate the lost premium number would be to estimate how much of the premium remains with the company over time (Diacon and Brien, 2002). This is called the persistency number and is disclosed by the regulator<sup>17</sup> as:

*A policy is said to be persistent at a particular point in time if all the premiums due on the policy at the date of measurement are received. . . . Persistency is about understanding how many life insurance policies have been issued to customers and out of these how many customers continue to regularly pay premiums on dates as per the terms set out in the policy contract. The per-*

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<sup>17</sup>The definition can be found in *Appendix B: Persistency* in (IRDA, 2010a)

*sistency rate measures the percentage of the issued business that remains in force and premium paying after a certain period of time.*

An insurance policy is a recurring renewal product and companies give policyholders a grace period of upto a month to renew the policy. The data on persistence, focuses on how much of the premium collected in a particular year stays with the policy year after year. IRDA estimates the persistence by asking the following question about premium received<sup>18</sup> as follows:

*How much of the premium issued in a financial year is renewed after 13 months, 25 months, 37 months, 49 months and 61 months?*

It is relatively easy to analyse individual year persistency and determine how much of the business remained with a particular company for policies generated in a particular year, using this approach. The following example illustrates this.

1. In the year 2005-06, Rs.100 worth of polices are issued.
2. The premium is measured again in the 13<sup>th</sup> month. Suppose this number is Rs.85. The 13<sup>th</sup> month persistency is said to be 85%.
3. Similarly, a premium of Rs.76 in the 25<sup>th</sup> month means that persistency is 76%. Rs.68 in the 37<sup>th</sup> month means a persistency of 68%, Rs.55 in the 49<sup>th</sup> month means a persistency of 55%, Rs.42 in the 61<sup>st</sup> month means that persistency is 42%.

However, not all companies use the same approach to report their numbers on persistence, even though it goes against the IRDA rules for calculating persistence. The alternative method is called the *reducing balance* method and the estimates of the premium are found to overstate the premium left in the business if taken at face value. This method considers persistency of the premium that returns as a percentage of the previous period's premium and not as a percentage of the original premium. We use the setting of the previous example to illustrate the difference between the IRDA approach and the *reducing balance* approach as follows:

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<sup>18</sup>This excludes the premium from single premium products.

1. In the year 2005-06 Rs.100 worth of policies are issued.
2. The premium is measured again in the 13<sup>th</sup> month. Suppose this number is Rs.85. The 13<sup>th</sup> month persistency is said to be 85%.
3. A premium of Rs.76 in the 25<sup>th</sup> month means that persistency is said to be 76/85 or 89%.  
Similarly, a premium of Rs.68 in the 37<sup>th</sup> month means that persistency is 68/76 or 89%.  
Rs.55 in the 49<sup>th</sup> month means that persistency is 55/68 or 81%. And Rs.42 in the 61<sup>st</sup> month means that persistency is 42/55 or 76%.

From this example, we can see that the reducing balance approach gives persistency values that are much higher than values from the IRDA prescribed method. In this paper, we use the IRDA prescribed method to calculate persistency.

## 4 Results: Estimated economic loss

We use the two methods described above, along with publicly available data, some of which is readily available, and some of which had to be hand-collected, to assess the loss to the Indian insurance customers during the high ULIP growth period between 2004-05 and 2011-12.

### 4.1 Renewal premium method

The data used for this estimation has been sourced from annual reports of the IRDA. The reports do not separate the premiums from linked and non-linked products. The estimates therefore reflect lost premiums and persistency ratios of all life-insurance products. However, in the years from 2004 to 2010, a large proportion of the premiums were from ULIPs (Table 2). To that extent, the estimates may be attributed to the ULIP market.

*Insert Table 2 here*

Table 2 shows the lost premium both in value and as a percentage of premium due in a particular year. The data shows that the total premium lost over the period is Rs 1.95 trillion. The data also shows that the premium lost as a percentage of the premium due shows a rising trend. In 2005-06, just 7 percent of the premium due was lost, but in 2011-12 this percentage rose to 24 percent.

Policy holders can stop renewing premiums in a regular paying policy for four reasons. First, policies may mature and the maturity benefit is then paid out. Second, the policy holder may die and the death benefit is paid out to the beneficiary. Third, policies may be unfunded due to an income shock suffered by the policy holder. Fourth, policies may lapse because the policy holder chooses to stop funding the policy upon discovering that the product is unsuitable. In this last case, we assume that the policy has been mis-sold. If it can be ascertained which of the four reasons lies behind the lapse of premium renewals, then the cause of the premium lost to the policy holder can be better understood.

There is no previous analysis that has been carried out to track the loss in premium due to lapsation, which is linked to mis-selling. For this paper, a survey of life insurance industry experts – including actuaries – was conducted to get their opinion on what fraction of the lapses depended on each of the above four factors. The survey results show that, in the opinion of the industry experts, not more than a sum of 20 percent of the premium lost could be attributed to the first three reasons. Thus, the survey suggests that lapsed policies contributed 80 percent of the premium lost by policy holders on average across firms, with the estimates for specific firms presented in Table 3.

*Insert Table 3 here*

Why would investors lapse their policies, especially when policy rules allow for the insurance companies to appropriate all the residual value in the policy in the lock-in period and the customer stands to lose all his money? The insurance regulator has connected

lapsation to mis-selling. The insurance regulator states the following in the annual report 2007-08:

*In case of lapse of a policy in the first few years, all or most of the premiums paid are usually forfeited by the insurer and the policy holder ends up losing whatever premiums have already been paid towards the policy. Majority of the lapses occurring in the first few years of the policy are caused by mis-selling – intentional or otherwise, and selling under duress – for instance, in consideration of a loan sanctioned by a bank or any other nature of ‘favour’ done by the insurance salesman to the policy holder or under ‘obligation’ to a relative or a friend.<sup>19</sup>*

Using the above survey, it can be assumed that 20 percent of the renewal premium loss can be accounted for by premiums that do not return due to maturing and surrendered policies, policies where the death benefit has been paid out and policies discontinued due to an income shock to the policyholder. Approximately 80 percent of the lost premium can be explained by lapsation due to mis-selling.

The lost premium for the period 2004-05 to 2011-12 is Rs.1.94 trillion. Upon removing 20 percent of the premium lost due to death pay-outs, surrender, policy maturity and income shock, the premium lost due to lapsation is *Rs.1.55 trillion*.

## **4.2 The persistency method**

Data for companies that have been in existence for more than three years were used to examine persistency. The data for companies that report persistency using the reducing balance method is normalised to make it comparable across firms and to bring this data to comply with the IRDA rules.<sup>20</sup>

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<sup>19</sup>IRDA Annual Report 2007-08, page 25.

<sup>20</sup>Tata AIG Life Insurance had to be excluded because their data disclosure was such that it could not be compared with that of the others. The company disclosed data differently for unit linked and non-linked policies while the others provided a consolidated number.

*Insert Table 4 here*

Table 4 presents the example of one insurance company. It reflects that for policies issued in:

- 2005-06, 31% of premium remained after five years.<sup>21</sup>
- 2006-07, 22% of the premium remained after five years.
- 2007-08, 27% of the premium remained after four years.
- 2008-09, 29% of the premium remained after three years.
- 2009-10, 60% of the premium remained after two years.
- 2010-11, 68% of the premium remained after one year.

This implies that, for example, if the premium collected in 2005-06 was Rs.100, then after 13 months, the premium that returned to the company was Rs.82. After 25 months, it was Rs.69, after 37 months, Rs.57 returned to the company. After 49 months Rs.37 came back and after 61 months, only Rs.31 came back.<sup>22</sup>

These data were further mapped to the premium data to see how much premium was lost over the years. The new regular premium collected each year was used to investigate how much premium was lost using the persistency ratios for that year. The data for the regular new business come from IRDA annual reports. This method examines the life of the total regular new business premium collected in a particular year over a five-year period.<sup>23</sup>

We calculate the total premium collected and retained for each company to arrive at the total premium lost. Adding across companies yields the following:

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<sup>21</sup>Persistency is calculated upto five years.

<sup>22</sup>Estimates for each insurance company separately are available upon request.

<sup>23</sup>Details of the calculation are available upon request.



Total premium collected	Rs.2.89 trillion
Total premium retained	Rs.1.27 trillion
Total premium lost	Rs.1.62 trillion

The persistency method gives a premium lost number for 2005-06 to 2011-12 of *Rs.1.62 trillion*. This comes closer to the real loss to the investor, because the way that IRDA calculates persistency takes into account premiums that do not return due to death and maturity.

## 5 Consequences of customer losses

We have not found a way to record the true customer loss but can only provide a minimum number based on the two methods above. Both the methods count the loss of premium to the insurance company, which becomes the investor's loss multiplied by the premiums he has paid. Therefore, it is very likely that customers lost greater than the estimated Rs.1.5 trillion presented in Section 4.

### 5.1 Where did the lost funds go?

Some of the losses accrued as gains to the distributors: individual agents, corporate agencies and banks selling life insurance. The rules allowed them to earn 40 percent of the first year premium as commission. Table 5 presents the total commission income for the period 2004-05 to 2011-12. While it will not be correct to state that all intermediaries were mis-selling, it will also not be incorrect to conclude that selling expensive products and not following up on subsequent premiums was a feature of insurance intermediation in the last decade. Commission gains of the order of trillion rupees on the back of unfair sales practices are unjustified. The commissions earned dropped sharply in 2011-12, perhaps as a result of the regulatory changes in commissions structure, which makes it less lucrative to promote grossly unsuitable products.

*Insert Table 5 here*

The profit and loss accounts of insurance companies point to their gains from lapsed policies. Insurance rules before September 2010 allowed insurance companies to levy 100 percent surrender charges on lapsed policies. This means that after paying commissions and accounting for other costs, the company could keep all the residual money left in the policy and account for it under ‘surrender charges’. After holding the money in a special reserve, this money becomes part of the profit and loss account after two years. The October 2012 Goldman Sachs Global Investment Research reports that “lapse profits”<sup>24</sup>, or profits accruing to insurance companies on account of lapsed policies, for just six companies amount to Rs.32 billion for just two years, ending 2011-12. Table 6, which is sourced from the Goldman Sachs report, shows the contribution of lapsed policies to company profits. This report states that:

*Now that the charges on lapse policies are minimal and most old policies that had higher lapse charges cross the three year mark, the pool of profit available for booking lapse profit will reduce gradually.*

*Insert Table 6 here*

## **5.2 Policy response**

Anecdotal evidence shows that by the time of the second or third premium payment, investors realized that almost all of their money had been deducted in costs. The lost premium was often treated as sunk cost by investors, most of whom chose to abandon the product altogether. In some cases, official complaints by customers started appearing in the public, along with articles in the media.<sup>25</sup> One example is a public interest litigation (PIL) against an insurance company for ULIP fraud filed by an customer with the high

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<sup>24</sup>Lapse profits is the money identified by the Appointed Actuary from lapsed policies that are entitled to be revived but not likely to be. Companies are required to hold this money in an earmarked reserve for two years, after which it is released to the profit and loss statement.

<sup>25</sup>Halan (2010), PersonalFN.com (2007), Halan (2006)

court in city of Lucknow.<sup>26</sup> More recently, a customer won a case at the High Court in Allahabad against a life insurance company, SBI Life.<sup>27</sup>

The first policy response was not from the insurance regulator but the securities market regulator, the Securities and Exchange Board of India (“SEBI”). SEBI took a proactive step by ordering the ban of the sale of ULIP products in early April 2010, with the argument that since a significant fraction of the premium was paid towards the “unit” equity investment, ULIPs were investment products that were in the regulatory ambit of SEBI (SEBI, 2010). This turned into a public regulatory turf battle. An intervention in the form of an Ordinance signed by the President of India was required to clarify that the regulation of the ULIPs was in the mandate of IRDA. The SEBI order was rescinded, and ULIPs continue to be regulated by the IRDA even at present (IRDA, 2010b).

There were several regulatory changes in the product structure of the ULIPs by the IRDA as a consequence of this. The changes which all have a customer protection focus included limits on costs charged, losses incurred by the customer and commissions paid for the sale of ULIPs. There was also a push towards decreasing the lapsing of policies. In 2011, the IRDA issued guidelines to enhance the persistence of life insurance policies.<sup>28</sup> The new guidelines mandate a persistence of 50 percent for agency renewals till the financial year 2014-15, and 75 percent persistence after that.<sup>29</sup> 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 IRDA passed a new guideline<sup>30</sup> which allowed for renewal of agent licenses without regard to the persistency record of the agents. From 1 July, 2014,

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<sup>26</sup>“PIL against insurance cos for ULIP *fraud*”, in the *Times of India*, 22 April 2010, [http://articles.timesofindia.indiatimes.com/2010-04-22/lucknow/28125969\\_1\\_irda-order-ulips-insurance](http://articles.timesofindia.indiatimes.com/2010-04-22/lucknow/28125969_1_irda-order-ulips-insurance)

<sup>27</sup>“How to shrink Rs50,000 to Rs248”, in the *LiveMint*, 17 June 2014, <http://www.livemint.com/Money/57wQlkkdLuC8GvifoJfdMK/How-to-shrink-50000-to-248.html>

<sup>28</sup>Section 14(2) of the IRDA Act, 1999.

<sup>29</sup>IRDA Journal, August 2011, Page 12.

<sup>30</sup>Guideline: IRDA/Life/GDL/057/02/2014, [http://www.irda.gov.in/ADMINCMS/cms/whatsNew\\_Layout.aspx?page=PageNo2207&flag=1](http://www.irda.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo2207&flag=1)

all life insurance companies will have their own company specific persistency criterion for renewal of individual and corporate agents. The regulator has not set any minimum standards the companies must meet in deciding the level of acceptable persistency. The rationale for this change was never articulated, and it is possible that any improvements in persistency may get reversed over time.

IRDA (2011a) lists other rules regarding the sale of products as follows:

1. Insurers must provide the prospect/policyholder all relevant information about amounts deducted towards various charges for each policy year, so that the customer can take an informed decision.
2. Guidelines relating to distance marketing address challenges relating to mis-selling using distance marketing methods.
3. The “IRDA (Sharing of database for distribution of insurance products) Regulations, 2010” aims to significantly reduce the scope for misuse of the system of issue of Referrals.
4. The *Integrated Grievance Management System (IGMS)*<sup>31</sup>, has been put in place from April 1, 2011, which allows for faster grievance redressal through an online portal that is connected to all insurance companies. The status of the complaint could also be monitored more regularly: if insurance companies did not fully attend to the customer complaint within fifteen days of lodging it, the IGMS could be used to escalate the complaint to IRDA.
5. IRDA also suggested that companies were required to have a Prospect Product Matrix, which matched a product with the investor requirement that was based on the Needs Analysis (of the investor).

There are also instances of regulators imposing fines or revoking the license of intermediaries. For example, IRDA revoked the license of a broker when found guilty of mis-selling (IRDA, 2011c). These, and several other, regulatory measures have had an impact on

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<sup>31</sup><http://www.igms.irda.gov.in/>

mis-selling of ULIPs. As a consequence, the growth of ULIPs dropped sharply from the peak levels seen during the 2004-05 to 2010-11 period. A finer assessment of the impact of the changes in 2011, and the reversal of some of these changes subsequently can only be carried out in the next two to three years when there is more evidence that builds up about insurance sales.

Where there has been little action is in providing *compensation* to those investors who got duped by financial service providers. There has been one example where the regulator, and later the courts required a financial firm to pay refund investors more than Rs.174 billion that it had raised from millions of small investors.<sup>32</sup> One counter example is an order passed by the IRDA in May 2011 where financial compensation over and above the policy refund was denied to the complainant because it was found that she had signed a “Declaration by the proposer/Life to be assured” and “Declaration for Unit Linked Products”, agreeing to the revelations made therein (IRDA, 2011d).

It is also important to remember that most of the policy changes initiated by the regulator are parametric changes. No systemic re-examination of the consumer protection framework has even been under consideration by the IRDA.

## 6 The challenges of regulating retail finance

Regulation of retail finance has been the subject of policy debate in several countries. [The Consumer Financial Protection Bureau \(CFPB\) was established in the US with the aim of education customers, enforcing consumer financial laws and studying consumer financial markets.](#)

The U.K., E.U. and Australia have moved towards a complete overhaul of their distribution policies.<sup>33</sup> One of the important interventions has been the ban on commissions,

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<sup>32</sup>[http://articles.economictimes.indiatimes.com/2012-08-31/news/33521343\\_1\\_sahara-group-subrata-roy-sahara-sebi](http://articles.economictimes.indiatimes.com/2012-08-31/news/33521343_1_sahara-group-subrata-roy-sahara-sebi)

<sup>33</sup>For more details see the Retail Distribution Review in the UK, the group on Packaged Retail Invest-

or conflicted remuneration structures, where the hope is that this will better align the interests of the distributor and customer. Firms are also required to ensure suitability of the product to the customer.

While the form of such regulations may be new, similar policy proposals have been in existence since the 1980s. In the UK, for example, the pensions mis-selling scandal in the 1980s occurred in an environment where commissions ban and suitability rules existed in some form. However, they were ineffective in stopping the mis-selling because neither firms nor regulators were aware of the broader risks, or interested in doing something about it. Regulators were not prepared to produce guidance on suitability, or to take a view on internal models of suitability used by firms (Black and Nobles, 1998). This led to a consolidation of regulators under the Financial Services Authority (FSA) in the early 2000s. In spite of the focus on consumer protection under the FSA, the UK experienced the PPI scandal, suggesting that even the most consumer-protection oriented regulator has found this an intractable problem.

The FSA adopted the policy of *credible deterrence*, after the PPI scandal which actively allowed for the targeted use of formal enforcement. There was a greater willingness to bring enforcement action, impose larger penalties and pursue managers and firms (Ferran, 2012). In 2011-12, for example, the FSA imposed fines of 78.5 million across individuals and firms (Hinton and Patton, 2012).<sup>34</sup>

The scandal along with the 2008 financial crisis, led to another review of the regulatory framework. Retail finance regulation in the UK has thus gone from loosely co-ordinated regulation between different regulators, to a principles based approach under the Financial Services Authority in the early 2000s, and finally to a more specialised Financial Conduct Authority (FCA) in 2013. The change in the UK is important as it broadly signals the

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ment Products (PRIPs) under the Markets in Financial Instruments Directive (MiFID) Implementing Directive in the EU, and the Future of Financial Advice reforms in Australia.

<sup>34</sup>The Australian regulator, the Australian Securities & Investment Commission (ASIC) found that failure to fully compensate investors who lost money can cause severe emotional and financial and have a corrosive effect on trust in the financial system (ASIC, 2011). Financial compensation is seen to be a crucial element in the regime for customer protection.

following important developments (Ferran, 2012):

- There is likely to be more scrutiny, both at the product level and at the board level of a firm. The FCA has an expanded array of powers, including specific powers to intervene in respect of products and of misleading financial promotions. The FCA can intervene earlier in the value chain, scrutinise products and ensure that governance arrangements are embedded in the product. The FCA will conduct closer supervisory scrutiny of senior management and board-level appointments.
- There is a rebalancing between principles and rules in the regulatory framework. While broad level guidance by the regulator will continue to be used, the FCA is likely to provide greater prescription to improve consumer outcomes. Some of the non-binding guidance in the Treating Customers Fairly (TCF) initiative is likely to be converted to rules.
- Competition is now an important part of the mandate of consumer protection. The FCA has a duty to promote competition, and a power to refer matters to the competition authorities.

Ferran (2012) further discusses the challenges ahead for the FCA in balancing the larger powers of scrutiny against the cost of excessive regulatory intervention. These challenges are exacerbated in India, where improving access to finance is a major policy goal, experience with adhering to broad levels of principles is limited, and enforcement is generally weak.

## **6.1 Policy imperatives for India**

Financial regulation in India is oriented towards product regulation. Each product is separately regulated. For example, fixed deposits and other banking products are regulated by the Reserve Bank of India (RBI), small savings products by the Government of India (GoI), mutual funds and equity markets by the Securities and Exchange Board

of India (SEBI), insurance by the Insurance Regulatory Development Authority of India (IRDA) and the New Pension Scheme by the Pension Fund Regulatory and Development Authority (PFRDA).

While protecting the interest of customers is in the mandate of each of the regulators, there is no common standard for distribution of financial products. Regulators have their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. The details of regulations often differ, leading to “regulatory arbitrage”.<sup>35</sup> In an example on differing standards of regulation on distributors, employees of banks who come under regulation by the RBI can distribute financial products such as mutual funds and insurance products, without adhering to the rules and regulation of SEBI and IRDA. The level of trust in financial markets and its regulators is low, and access to finance poor.

The Government of India formed the Financial Sector Legislative Reforms Committee (FSLRC) in 2011 to rewrite and review financial sector laws. This has led to the Draft Indian Financial Code. Consumer protection is one of the pillars of the draft IFC. It establishes certain basic rights for all financial consumers, and has for the first time in Indian regulation moved away from the principle of “buyer-beware” to “seller-beware”. Similar to the FCA, the IFC also considers competition to be an important part of consumer protection, and has allowed for co-operation between the regulator and the Competition Commission of India. Even though the IFC is not yet law, regulators have committed themselves to voluntarily implementing the consumer protection dimensions of the IFC, as articulated in the *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code* (DEA, 2013).

There are three pre-requisites for the success of broad level principles enshrined in the IFC. First, they can function in a regime of legal certainty. Second, firms have to have the incentive and capacity to generate and share information that is accurate and reliable

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<sup>35</sup>Sahoo and Sane (2011) provide a detailed description of the problems of retail financial regulation in India.



(Georgosouli, 2011). Organisational behaviour and sociology literature suggests that regulators, individuals and firms function in a organisational culture that normalises misconduct. Mis-selling practices begin to be perceived as normal, and legitimate because of the socially constructed worldview by top management (Aldridge, 1998; MacLean, 2008). This needs to change. Third, there needs to be a shared understanding of what they require so that they could be applied to situations without the need for specifications (Black and Nobles, 1998). Regulators in India will have to design specific regulations that are not rigid, but yet are able to guide firms to translate the principles into actions. The commitment to the *Handbook* has not yet translated into clear regulations on the ground. Finally, regulators in India have to be able to provide clear guidelines on the repercussions of mis-selling. For consumers to get a fair hearing in such cases, regulators will have to take stronger preconsent steps, such as mandating sellers to read out the provisions of the contract in the language in which solicitation was done, and to do some due diligence on the customer. Such rules are consistent with the suitability standards that require that an intermediary has to ensure that the product is suitable for the customer before signing-off on the contract.

## 7 Conclusion

It is possible to envision a world with fully rational consumers, in which conventional contract enforcement would suffice: the State would only need to get involved when financial firms fail to uphold promises they make. The emerging field of household finance has repeatedly uncovered evidence that consumers are often less than effective in understanding financial products, and can get misled by high powered sales campaigns. The ultimate objective of this field would be a body of research that guides us in understanding the mapping from alternative policy strategies to consumer welfare.

In the period under examination, India was an interesting laboratory, where insurance

companies vigorously pursued profit in an unregulated environment when it came to consumer protection. The laws and regulations as constructed in that period permitted a variety of egregious practices, which have been documented here and in the related literature.

The contribution of the paper lies in an approximate quantification of the losses to households under this environment. The numerical estimates obtained are fairly large: consumers lost Rs. 1.5 trillion over this seven-year period. This gives us fresh insights into the economic significance of the adverse consequences for consumers when financial law and regulation does not focus upon consumer protection.

While regulation has responded to the mis-selling episode with product disclosure guidelines and commissions caps, what remains is any compensation to investors who were the targets of the mis-selling carried out by insurance companies and their agents. In order for this to be a fair exercise, the first step is to assess the losses that were incurred by the investors. The two approaches discussed in the paper, both of which are based on data that is publicly available, can thus be used by any agency to assess reimbursements for customer redress.

The work in this paper connects up to a small emerging literature on the problems of consumer protection with mutual funds and insurance companies in India over this period, and would assist future explorations on these questions. The policy environment has swung from a lack of focus on the consumer interests to one where these interests are the foundation of policy recommendations and regulatory changes. These experiences have helped place consumer protection at the heart of the new legal framework which has now been proposed in India.

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