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

<table>
<thead>
<tr>
<th>Tenure (in Years)</th>
<th>Mutual fund (Hybrid scheme)</th>
<th>ULIP</th>
<th>Insurance plans</th>
<th>Traditional plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>0.17%</td>
<td>12.0%</td>
<td>15.0%</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>0.30%</td>
<td>14.0%</td>
<td>17.0%</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>0.54%</td>
<td>17.0%</td>
<td>21.0%</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>1.11%</td>
<td>22.0%</td>
<td>26.0%</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>2.79%</td>
<td>31.0%</td>
<td>36.0%</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>11.0%</td>
<td>50.0%</td>
<td>56.0%</td>
<td></td>
</tr>
</tbody>
</table>

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
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?

<table>
<thead>
<tr>
<th>Products recommended (%)</th>
<th>Fixed deposit</th>
<th>Insurance</th>
<th>Mutual funds</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recommendation</td>
<td>51</td>
<td>35</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Asked for ELSS</td>
<td>51</td>
<td>33</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>Asked for a tax saving instrument</td>
<td>53</td>
<td>36</td>
<td>2</td>
<td>8</td>
</tr>
</tbody>
</table>

- 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

<table>
<thead>
<tr>
<th>Products recommended (%)</th>
<th>Fixed deposit</th>
<th>Mutual funds</th>
<th>Insurance</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks with tie-ups</td>
<td>45</td>
<td>8</td>
<td>41</td>
<td>6</td>
</tr>
<tr>
<td>Private sector (with tie-ups)</td>
<td>9</td>
<td>11</td>
<td><strong>76</strong></td>
<td>2</td>
</tr>
<tr>
<td>Public sector (with tie-ups)</td>
<td><strong>72</strong></td>
<td>5</td>
<td>14</td>
<td>9</td>
</tr>
</tbody>
</table>

- 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?

<table>
<thead>
<tr>
<th></th>
<th>Round I</th>
<th></th>
<th>Round II</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>Fixed Deposit</td>
<td>Returns</td>
<td>Guarantees</td>
<td>Costs</td>
<td>Lock-in</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>95</td>
<td>0</td>
<td>0.8</td>
</tr>
<tr>
<td>Insurance</td>
<td>39</td>
<td>73</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Mutual Fund</td>
<td>93</td>
<td>7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>93</td>
<td>97</td>
<td>3</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>99</td>
<td>40</td>
<td>60</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>93</td>
<td>27</td>
<td>60</td>
<td>87</td>
</tr>
</tbody>
</table>

- 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?

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<th>Mutual Fund</th>
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<tbody>
<tr>
<td>Returns</td>
<td>35</td>
<td>99</td>
<td>86</td>
</tr>
<tr>
<td>Guarantees</td>
<td>2</td>
<td>34</td>
<td>36</td>
</tr>
<tr>
<td>Costs</td>
<td>4</td>
<td>100</td>
<td>85</td>
</tr>
<tr>
<td>Lock-in</td>
<td>7</td>
<td>36</td>
<td>50</td>
</tr>
<tr>
<td>Optimal holding period</td>
<td>12</td>
<td>62</td>
<td>86</td>
</tr>
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</table>
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