The role of advisors in financial distribution

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Very low penetration of financial products in India

Financial distribution industry close to Rs.230 billion around 2011.
Discussion

Problems of incentive alignment

- Households need sound and proper financial advice but the evidence appears to be that they are unwilling to pay for it.
- Currently, advice comes from producers and distributors. The former are obviously conflicted. The distributors are more troublesome:
  - Distributor remuneration comes from the product provider.
  - Incentives are driven by commissions and not by customer satisfaction.
  - The problem is exacerbated by the common agency problem, where multiple principals compete to influence an agent’s decision. For example, one distributor selling products of multiple product providers. Focus is on how to earn maximum fees rather than optimising how their customers would benefit.
Costs of incentive misalignment: Lessons from research

- Bergstresser et. al. (2009) find that risk-adjusted returns are lower for funds offered through brokers than through direct channels.
- Stoughton et. al. (2011) kick-backs to advisers from product providers are always associated with higher portfolio management fees and negatively impact fund performance, regardless of investor sophistication.
- Anagol and Kim (2012) document one example of shrouding by Indian mutual funds where they estimate investors lost US$500 million.
Part I

Regulatory approaches
Ban on commissions

- **International:**
  - Commissions to brokers to be banned from January 2013 in the UK
  - Commissions ban operational in Australia from July 2013
- **India:**
  - SEBI banned entry-loads on mutual funds in August 2009
  - SEBI proposal pending on distinguishing distributors from advisors
  - PFRDA does not allow for a broker-led model for the sale of the NPS
Evaluation of the two commission-less models in India

- **SEBI commissions ban:**
  - Industry convinced that large outflows from mutual funds are a result of the ban
  - Anagol et. al. (2012) do not find conclusive evidence
  - Commissions ban, however, has been modified as of August 2012.

- **PFRDA:**
  - Very poor sales
  - No effort at marketing the product by government, as was promised
  - A move towards dismantling the no-fee approach
Proposals for eliminating conflict of interest

- USAID (2007): Regulation of investment advice by one regulator across all financial products.
- The Committee on Investor Awareness and Protection (2010):
  - All retail financial products to go *no load*
  - All financial advisers to undergo a minimum knowledge-linked training program, and selling of more complicated products to require a higher level of education
  - The sales process to be documented, along with customer profiling that took place before a product was sold;
  - A Financial Literacy arm to be the focal point for all financial literacy initiatives in the country.
Separating advice from distribution

Sahoo and Sane (2011)

- Develop a market for holistic advice.
  - Registration of advisers
  - Setting standards for advice
  - Resolving disputes
- Develop solutions within the existing frame-work to ensure better distribution practices.
Part II

Implementation approaches
Defining financial advice

any explicit or implicit recommendation, either directly or through media i) to acquire, liquidate or continue to hold any product in the portfolio and/or ii) to use, discontinue or continue to use any service.
A business model for pure distribution: Tied-agency
Models combining advice and distribution
The grocery store model
Implementing guidelines

- Clarity on the list of *unsophisticated* products that can be sold through distributors, and do not require advice
- Clarity on the class of *sophisticated* customers who may be allowed to make their own decisions, regardless of the products
- Clarity on some minimum standard information that must be available for all financial products both (a) at the point of sale, and (b) during the life-time of the product
- A legal system which empowers customers to challenge the advice provided, with speedy resolution
Financial access

- A critical issue, especially for lower income households
- Important role for *unsophisticated* products that can be sold by distributors such as MFIs and NGOs.
- Consumer credit raises important and separate questions: here, obligations rest with the customer
  More discussion is required on the role of advice in debt products
Our work in the field


[http://www.igidr.ac.in/FSRR](http://www.igidr.ac.in/FSRR)