More customer-friendly Ulips

Once IRDA's recent ruling comes into force from September 1, Ulips will work much more in customers' favour. What remains to be seen is whether they will become as or more cost-effective than a combination of term plan and mutual funds

Following the row with the Securities and Exchange Board of India (Sebi) over the regulation of unit-linked insurance plans (Ulips), and its resolution through government intervention, the Insurance Regulatory and Development Authority (IRDA) brought about major changes in Ulip norms to douse the controversy surrounding these products.

Turf battle

Sebi had questioned the legitimacy of Ulips in the absence of approval from it. It had barred 14 life insurance companies from selling Ulips unless they sought prior approval from the equity market regulator. Sebi's contention was that Ulips are mutual funds in the garb of insurance products since a large portion of the money collected by them gets invested in equities. Therefore, it contended, Sebi should get to regulate the investment part of these schemes.

Its authority thus challenged, IRDA reacted strongly. It in turn fired off a circular asking all life insurers to ignore Sebi's order and keep selling Ulips.

With the two financial sector regulators slugging it out in public view, the finance minister made a statement saying the issue would be resolved in court. However, sensing the discomfort of the insurance industry and millions of investors, the government went out of its way to resolve the issue in favour of the insurance regulator by passing an ordinance.

In turn, IRDA was quick to plug the loopholes in Ulips that Sebi had highlighted, and which the mutual fund industry has been complaining about for long. It issued a comprehensive order effecting several changes in the way unit-linked products are structured and sold by life insurance companies. It increased the minimum lock-in period of Ulips from three years to five years, raised the minimum insurance cover from five times to 10 times the first-year premium, put a cap on surrender charges, and made it mandatory for all Ulip pension plans to guarantee a minimum 4.5 per cent annual return. All these changes will become effective from September 1, 2010.

Here is a look at the major changes that have been made and the impact they are likely to have on insurers and investors:

Lock-in increased from three years to five years.

This ruling underlines the long-term nature of the product. It is a positive development for investors, who are likely to benefit from a longer tenure with the scheme as their investments will have more time to compound. According to Jayant Pai, Vice President, Parag Parikh Financial Advisory Services, "It will encourage policy holders to adopt a longer-term approach than the current lock-in period of three years."

As for insurance companies, it could reduce their lapsation rate. Since the fund managers at insurance companies would have investors' money for a longer duration, they would be able to allocate the money in a better way and earn better returns.

Minimum insurance cover in Ulips other than pension and annuity products to double from five to 10 times the first-year premium.

For investors, it means a higher life cover from Ulips. This again is a positive development. After all Ulips are insurance products and their main purpose should be to offer adequate protection to their customers. With higher cover, mortality charges (fee for getting cover) would increase and hence less money would be available for investment.

For insurance companies, offering higher cover means increased capital requirement. Insurance companies are required to maintain a minimum capital of 150 per cent of total sum assured.

"Capital requirements of insurers are lower in case of Ulips as only a small portion of the premium goes towards providing insurance cover. However, with the minimum cover increased to 10 times, capital requirements would certainly go up," says Sumeet Vaid, Chief Executive Officer, Ffreedom Financial Planners.

All charges to be distributed uniformly over the lock-in period.

At present, up to 40-50 per cent of the first-year premium is deducted as allocation charges, leaving very little money for investment in the first year. Now, with charges to be uniformly distributed over five years, a larger portion of the first-year premium will be available for investment.

"With larger amount available for investment in the first year, investors will get better returns due to the compounding effect," says Girish Batra, Chairman and Managing Director, NetAmbit, a financial services distribution company.

Adds Pai: "Agents will now have to service policy holders for a longer period as they will receive their commissions in stages rather than upfront." Hopefully this will result in agents churning their customers a lot less.

For insurers, this means they will have to maintain a high level of persistency to recover the cost incurred in the scheme's initial period. "Usually, the cost incurred in the first year is high. Now with uniform distribution of charges, companies will have to recover that cost over a longer period," says Gorakhnath Agarwal, Chief Actuary, Future Generali Life Insurance.

A minimum annual guaranteed return on pension or annuity plans.

This change has generated the maximum controversy. Insurance companies claim that they would be forced to reduce the equity exposure of pension plans, thus making them less attractive for younger investors.

From investors' viewpoint, while their fear of losing money due to market risks would be completely eliminated, returns from these schemes would come down.

For insurance companies, this ruling would mean greater capital requirements and added financial burden. Says Batra: "This will increase insurers' capital requirements. They can still charge a guarantee fee, which is outside the cap on charges, but they will still not be fully compensated. The product will become less competitive and volumes may fall substantially. The new norm will also reduce insurers' flexibility in product design and innovation within their pension portfolios."

The net reduction in yield for policies with tenure less than or equal to 10 years shall not be more than 3 per cent at maturity. For policies with tenure above 10 years, the net reduction in yield at maturity shall not be more than 2.25 per cent.

Investors stand to gain as returns/yields are set to improve. However, insurance companies' profit margins could decline. Their ability to pay commission to distributors would also get hindered. This could lead to drop in sales of Ulips. "With caps on all kinds of charges, insurance companies will have to work toward reducing their operating costs so that their profit margins are not hit badly," says Agarwal of Future Generali.

All in all, once these changes are implemented, they will make Ulips much more investor-friendly. Insurance companies and agents/distributors will, however, have to tighten their belts and work harder in order to retain their earnings and profitability. WI

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