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Mis-selling in Insurance and how to prevent it

1. Mis-selling at a glance

By definition, mis-selling means selling a product by giving a wrong picture of a product, it may include, giving wrong information, giving unrealistic information, not giving full information about the product. You must have heard an insured, saying – but this was not I asked for. And, your agent accusing, but then I did mentioned all the details upfront, didn't I? Insurance is a business of selling commitments and here is a case where this was broken. Unfortunately the product was mis-sold. Mis-selling is not unique to insurance and happens in various lines of businesses (loans, credit cards, investment products, pharmacy, hospitality etc.), but Insurance being an intangible service – the principle of *Caveat emptor* prevails in insurance.

Often, the intermediary does not fully explain the policy details to the customer. Or the buyer (insured) is in a hurry and doesn't care to check the fine print. There have been cases reported where the agent deliberately misguided the buyer. Discussing an example of mis-selling: A person aged 54, having a handsome amount of savings with him and having no dependents (no kids and wife has passed away a few years ago), has no need of a term insurance (death benefit) but the agent may sell him this policy.

A common practice that is seen in this regard is where the agent sells the policy promising a single premium mode or a limited term policy but it actually turns out to be a regular premium mode. And the customer has no option but to surrender the policy or stop paying the premium. According to a survey conducted by Ernst & Young, compared to different types of frauds, insurance companies are most affected by "mis-selling" due to premeditated fabrication or fraudulent misrepresentation of material facts. Insurance continues to be mis-sold with senior citizens being the softest targets as they do not understand new products.

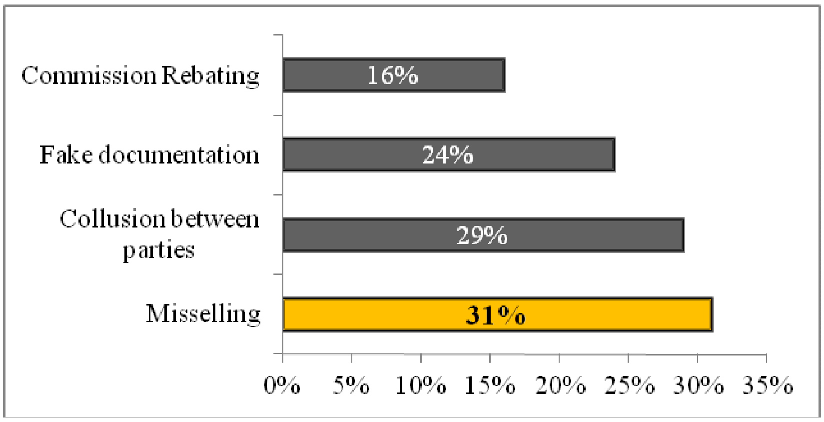


Figure 1. Different types of fraud affecting insurance companies.

Source: Ernst & Young Report on Frauds in Insurance.

2. Mis-selling and its consequences

- **Lapsation**

Lapsation has been one of the major concerns for insurance companies. Generally, once the policy is accepted in life insurance, the insurer undergoes costs for administrative processes, agent's commission and medical charges, which many times eat up almost whole the first years premium collected as well as the major part of second year premium. After incurring these expenses if there is an early lapse in the policy then it poses a major financial threat to the insurer. A major reason for lapsed policies is the lack of communication between the insured and insurer after the sale of policy, leading to strained relationships.

IRDA's annual report revealed that in 2010-11, policyholders surrendered policies worth Rs. 76,712 crores, more than double the amount (Rs. 36,225 crores) in the previous financial year. Also the total number of insurance policies – both public and private, that lapsed during FY 2010-11 stood at 1.40 crores, with an assured sum of Rs. 1.58 lakh crores as against 1.23 crores policies in the previous fiscal. There were 2,189 complaints of mis-selling registered with IRDA during the same period.

- **Cognitive Dissonance**

Often the misalignment in the objectives of the parties involved triggers mis-selling. For example, insured's major objective may be to save taxes or built a corpus rather than life protection whereas the agent may be looking at earning higher commissions and helping him reach his target faster. This misalignment at the initial stage of policy itself may cause a huge divide at later stages. In case of insurance, cognitive dissonance will cause a previously cheated customer to never trust an insurance agent again, however good the policy may be.

- **Bad word of mouth**

The industry is facing the risk of bad publicity due to mis-selling. There are instances when people decline insurance policies just because of bad publicity by friends, relatives etc as they lose faith in it.

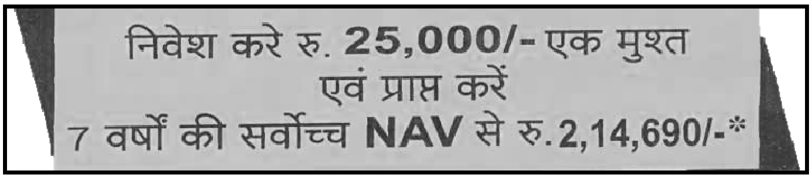
3. Factors leading to Mis-selling

The various factors can be broadly classified as:

- **Product related issues**

The complexity of the insurance product and asymmetry of information between the insured and insurer or his agent has led to a minefield of mis-selling. Also the policy document is full of jargons and fine prints which make it beyond the comprehensive ability of the insured to interpret the real meaning. This leads to controversies between the policyholder and the insurer.

- **Aggressive marketing**



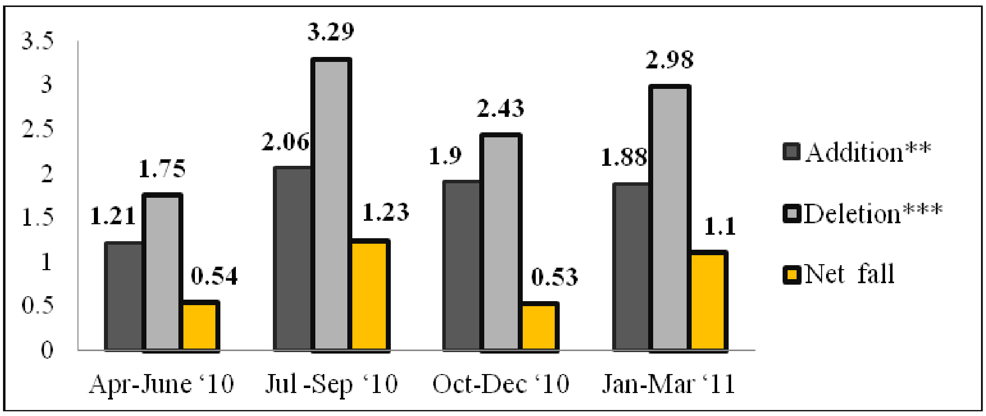
The insurance products are promoted aggressively by the companies and the agents have no option but to sell it by hook or crook. Often, they show a performance chart to the proposer which shows astronomical returns of 15% over a period of one year. Many times customers of ULIPS's complain that they were told that they need to pay the premium only for three (or five) years and would receive guaranteed tax-free returns, but when they check the actual condition after three years they get shocked to see that their fund had actually diminished. IRDA has recently brought out many corrective and preventives measures to curb this problem but it will take some time for the consumers to realize the consequences.

- **Lack of awareness**

Being literate is not sufficient for understanding the BFSI products but consumers have to be "financially literate". The major issue which needs immediate attention is financial literacy. In a situation where the prospect is not financially savvy, there is a greater probability that the sale would not be need based. People are not aware about their financial goals and hence they are not able to analyse their needs and buy products which are not in tuned with them. What they end up doing is help the agent in achieving his goals rather than theirs.

- **Dearth of qualified agents**

Most agents do not take this profession seriously and end up terminating their agencies sooner than later. The policies sold by these incompetent agents become "orphan policies" and without servicing they lapse. In the financial year 2010-11, 10.45 lakh agents left the insurance business while only 7 lakh joined which has led to a fall of 35 %. The companies are finding it really hard to recruit good agents.



*Number of agents in lakh **At the beginning of the quarter ***during the quarter

Source: IRDA

- **Lack of patience**

After the customer agrees to buy the policy, he does not see the policy literature carefully. They are in a hurry to wrap up the procedure and they don't even study the features properly . The agent no doubt should produce all the facts correctly, but the insured is also liable to check what he has purchased. Prompt inspection can lead to utilization of the "free-look period" in a better manner.

- **Reward system of Insurance agents**

Since agents are paid heavily front loaded commissions, they indulge in unethical practices. It brings in product bias as an agent has an incentive to recommend a particular product irrespective of the client's need. This fact became more evident when the agent commission's for ULIP products was capped post September'2010 IRDA guidelines. Insurance companies have lost almost 21% of their business after these reforms.

4. Mis-selling in various distribution channels

The "possibility" of mis-selling through various distribution channels are as follows:

- **Bancassurance**

Bancassurance model has been viewed as the future of the distribution that will help Insurance to increase its penetration. But there have been various cases of mis-selling reported in this channel where the policy was forced to the customer in order to clear a loan. The customer unwillingly buys the policy in order to get the loan and stops paying the premium after one year. This practice is not good for the industry and IRDA needs to strictly deal with it as early as possible.

- **Brokers**

Brokers are also found to be contributing to this malice by pitching for policies which fetch them higher ticket size. Brokers should act as advisors to the customers and should recommend them the products which suit them the best as per their needs (Need Based Analysis). But there needs to be a change in the paying pattern to brokers which will solve the problem of mis-selling to a great extent. Will we go to a doctor who examines for free but recommends buying medicines only from a particular company or to a doctor who charges a fee but provides the best possible medicine available in the market?

- **Online**

Various websites which present themselves as a source of expert knowledge for customers of insurance tend to go for comparison of various plans offered by different companies. But they fail to present their vested interests in running these websites as they sometimes compare products say of, health insurance cover provided by two companies having completely different attributes just on the basis of price. Though internet is a huge source of information but it lacks authentication aspects and many times prove to be misleading.

5. Mis-selling in other businesses

- **Mutual Funds**

Mutual Funds are often mis-sold, this happens when the intermediary recommends a mutual fund without the analysis of the risk profile of the customer. He tries to push the fund which fetches him the best commission.

- **Ponzi Schemes**

The biggest financial fraud of recent times was by Speak Asia; a Singapore based company. Based on Multi-level Marketing, the company enrolled 1.9 lakh panellists who were promised an annual return of Rs. 52000 by just paying a subscription amount of Rs. 11000. According to the Mumbai Police, the total fraud was as big as Rs. 1320 crores.

- **Credit cards**

The credit card business is also full of malaise and there have been numerous instances where cards are been sold without explaining the terms and conditions properly. The customer realises this fact when he sees the statement with various hidden charges.

6. Steps taken by IRDA and insurance companies to curb Mis-selling

- **Persistency norms**

It has been seen that persistency in the life insurance business is on a decline and this can be attributed to mis-selling. Companies are not able to retain customers and hence IRDA came up with a persistency norm which said that the license of the agent will get cancelled if 50% of the policies sold by him are not renewed. This is a bold move by the regulator and it will ensure that the policies are sold on proper advice. More stress should be laid on collection of renewal premium rather than generating new business.

- **Distance marketing guidelines**

IRDA also came up with the distance marketing guidelines to protect customer's interest. The regulator has proposed a standardised script to be prepared by the insurer for the sale of insurance products through the SMS, E-mail, Snail mail and telephone. The script will assimilate key product features, benefits, and all other solicitations. All the sale activities should strictly be in line with the script. Also IRDA wants the companies to record every conversation call. Moreover now life insurance companies are not allowed to sell ULIP's with annual premiums exceeding Rs. 50,000 for non-single premium policies and Rs. 1,00,000 for single premium polices or variable insurance products (VIPs) via telemarketing.

- **Online Grievance Management Portal**

With the launch of IGMS (Insurance Grievance Management System) portal and call centers, an aggrieved customer can escalate his complaint to IRDA in case the insurer is no able to resolve the grievance. IGMS provides a common base to all insurance companies to resolve policyholder issues.

- **Regulations for Web Aggregators**

In November'11, IRDA came up with some restrictions for the web aggregators which do not allow them to compare products. These websites push products on which they receive high commissions from the insurance companies and often the prospect lands up making wrong choice. Under the new guidelines, which come into effect from 1 February 2012, the commission which they receive has been capped and they have been banned from reviewing and rating products.

- **Customer Centric Initiatives**

Many companies have started taking customer centric measures to eradicate this problem like making 'welcome calls', in which the insured is again briefed on the product features and charges involved to ensure that he has taken an learned decision while buying the policy. HDFC Standard life also came up with their initiative "Most Important Document" (MID), a questionnaire to ensure that customers understand the product well before making a decision to purchase it.

7. Solutions which are workable

- **Regulatory Solutions**

- IRDA should consider the Swarup committee's recommendation of phased elimination of the agent's upfront commission. It calls for a fee based advised system and it can take cues from countries like Australia in this regards.

- The qualification limit for the agents should be raised at-least for those in the urban areas. Presently, a High School pass can become an insurance agent who may lack the required competency.

- IRDA should clearly demarcate or encompass the role of an agent with that of a financial advisor. Many agents today, are selling policies under the name of financial planners.

- IRDA should design a model to punish heavily the people who are involved in mis-selling and encourage incentives for those who are discarding such malpractices.

- **Industry Solutions**

- Drafting product literature in vernacular languages which will be easier for a layman to understand and it will also widen the reach. The terms and conditions, benefits, charges, lock-in period etc should be specified in bold and simple language.

- Agents are the face of the industry and it is the best interest of the companies to collaborate and devise superior training programmes for agents/advisors that can reduce mis-selling.

- When the application for the insurance is under process, the underwriter should contact the customer and elicit response from him regarding the product which has been sold to him . He should also ensure that the customer has bought what he has intended to buy.

- Strengthening the IT and provide risk profiling software's to the sales force to promote need based selling. In Vietnam, Insurers have developed an Agent Management Program which cross-checks agent names with policy sales. The software tracks three year performance of agents and they are fired if found indulging in illicit operations and they would not be recruited by another insurance company for next three years.

- Companies should simplify their terms and conditions to remove any hidden meanings or terms. They should take this as a part of their corporate governance to financially educate the insured.

- The interest of the distributor and the customer needs to be aligned by remunerating him throughout the term of the policy rather than heavily paying front loaded commissions. This will force the agents to sell products with long term perspective and will ensure proper policy servicing.

Conclusion

This problem of mis-selling can only be eradicated by the combined efforts of Insurers, Regulators, Intermediaries and Customers as well. Lapses on any one of the front will allow this malice to manifest its ugly head again.

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