

Investment Strategy

An attractive makeover

The new investor-friendly version of unit-linked insurance policies is a better bet compared with other insurance products

A tug of war between two surgeons over who will wield the scalpel can be unnerving to the patient on the operating table as well as to the others who have an interest in his quick recovery. The ugly spat between two regulators to wield authority over a product mired in controversies was no less perplexing for investors as well as issuers.

Unit-linked insurance policies, popularly known as Ulips, came under the spotlight when the Securities and Exchange Board of India (Sebi) on 9 April, asked 14 life insurers not to sell Ulips without its approval. Sebi's contention was that Ulips were in many ways similar to mutual funds and, hence, they should fall under its jurisdiction. This was strongly refuted by the Insurance Regulatory and Development Authority (Irda) and the insurance industry. Another fact that irked the private insurers was that Life Insurance Corporation of India had not been included in the list of 14 insurers targeted by Sebi. All this created confusion among investors.

The stand-off between Irda and Sebi continued for more than two months during which there was attempt by the ministry of finance to restore peace by mediating between the two regulators. However, the

matter was taken to the Supreme Court, forcing the Central government to step in and resolve the controversial issue. On 18 June the government brought out an ordinance (which was later approved by parliament) settling the issue in favour of Irda.

The ordinance stated that unit-linked insurance policies with investment component were insurance products and, thus, will come under the regulatory jurisdiction of Irda and not Sebi. It amended four Acts to make it clear that Ulips were not securities and they did not form part of collective investment schemes or mutual funds. To avoid similar regulatory turf war in the future, the government has also set up a high-level panel, called a joint mechanism with representations from the Reserve Bank of India (RBI), Sebi, Irda, Pension Fund Regulatory and Development Authority (PFRDA) and the government. It is now mandatory for the regulators to refer to the panel any dispute or difference of opinion over the regulation of a hybrid product. The panel will have to give its decision to the government within three months and it will be binding on all regulators.

Sebi's main attack on Irda was that payment of exorbitant commission to agents selling Ulips was a matter of serious con-

cern and immediate action was required to protect investors' interest. Irda immediately started cleaning up the Ulip regulatory structure, while simultaneously fighting with Sebi to retain its jurisdiction over Ulips. This was followed by guidelines issued on 28 June 2010, which became effective from 1 September 2010. The extent of the damage caused to the insurance industry by the new policy can be gauged from the fact that life insurers had to withdraw nearly 250 Ulip products from the market to make them compliant with the new norms. At present, there are over 70 approved products under the new regime, which are expected to increase in future. As far as the insurance agents are concerned the going will be tough for them in the short run due to the sharp cut in commission. But they are likely to recover in the medium to long term as volumes will rise as more and more investors start buying these products.

Ulip is a life insurance policy providing a combination of risk cover and investment. The dynamics of the capital market have a direct bearing on the performance of Ulips. The investment risk is generally borne by the investor. Depending on the performance of the fund chosen, the policy holder gains or loses on his investment. Further, past returns generated by a fund are not necessarily indicative of the future performance of the fund.

The quantum of premium used to purchase the units varies from insurer to insurer and also from product to product. The policyholder can seek refund of premium if he

Varied fare

Ulips offered by different insurers have different charge structure

Broadly, the different types of fees and charges levied by unit-linked insurance policies (Ulips) are as follows:

Premium allocation charge: It is a percentage of the premium that is appropriated towards charges before allocating the units under the policy. This charge normally includes initial and renewal expenses apart from the commission expenses.

Mortality charges: It is a charge to provide for the cost of life insurance coverage under the plan. Mortality charges depend on a number of factors such as age, amount of coverage and state of health.

Fund management fees: It is levied for

the management of the funds and is deducted before arriving at the net asset value (NAV).

Policy/administration charges: These charges are for administration of the plan and levied by cancellation of units. This could be flat throughout the policy term or vary at a pre-determined rate.

Service tax deductions: Before allotment of the units, the applicable service tax is deducted from the risk portion of the premium.

Besides these charges, surrender charge may be deducted for premature partial or full encashment of units wherever applicable, as per the terms and conditions stated in the policy.

disagrees with the terms and conditions of the policy, within 15 days of receipt of the policy document, which is also known as "free look period". In such a case, the policyholder shall be refunded the fund value including charges levied through cancellation of units subject to deduction of expenses towards medical examination, stamp duty and proportionate risk premium for the period of cover.

Around 30% to 40% of the first year's premium was being siphoned off in the form of commission to agents and other charges. Thus, investors lost out on their initial investment value. As agents were being paid higher commissions on new policies, it was in their interest to get the policies surrendered after every three years and enroll new investors. Thus, the agents enriched themselves at the cost of the investors. Keeping investors' interest in mind, Irda has mandated that from 1 September 2010 commission on Ulips have to be evenly distributed during the lock-in period. As charges will be equally divided over the initial five-year lock-in period, the amount available for investment right from the day one would be more, which will enhance the chances of capital appreciation. Not only this, Irda has also fixed caps on various charges, thereby reducing the overall charges and increasing transparency for the investor. Earlier there had been cases where even after three years of investment, policyholder was not able to recoup the original investment.

To avoid Ulips being projected as a pure investment product and getting backlash from

Sebi once again, Irda has mandated that henceforth all unit-linked products, other than pension and annuity products, have to mandatorily provide a mortality cover or a health cover. The mortality cover has been increased from the present five times to 10 times of the annualised premiums paid by the policyholder. The mortality cover (minimum sum assured) is to be arrived as per the following formula For persons below 45 years of age: $0.5 \times T \times$ annualised premium (subject to minimum of 10 times the premium paid). For persons of 45 years and above: $0.25 \times T \times$ annualised premium (subject to minimum of 7 times the premium paid). 'T' is taken as $(70 - \text{age at entry})$.

For single premium policies the amount of insurance cover is 1.25 times the premium paid for persons below 45 years of age and

it is 1.1 times for the persons above 45 years of age. The death benefit will not be less than 105% of the total premium paid. The minimum health cover for persons below 45 years of age is five times the annualised premiums or Rs 100000 per annum, whichever is higher. For persons of 45 years and above it is five times the annualized premiums or Rs. 75,000 per annum, whichever is higher.

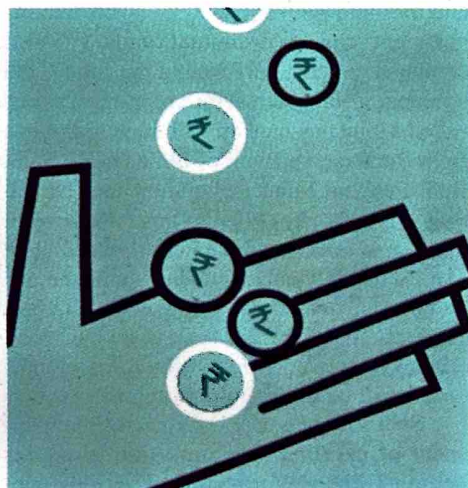
At no point of time will the annual health cover be less than 105% of the total premium paid. The increase in insurance cover may be beneficial for those who do not have any insurance policy. With the increase in insurance cover, the amount allocated towards risk cover also increases, thereby reducing the amount available for investment. This means lesser chances for capital appreciation.

The lock-in period for Ulips has been increased from three years to five years. Premium has to be paid compulsorily for five years. As the minimum lock-in period is five years, the capping structure starts from the 5th policy anniversary. This means that if an investor has held the policy for 10 years and at the 10th policy anniversary the investments have generated 15% return, the investor should get at least 12% return (maximum permissible charges being 3%). The net reduction in yield for policies with term less than or equal to 10 years is not to be more than 3% and for policies above 10 years not more than 2.25%.

The amendments of Irda are steps in the right direction. But the minimum guarantee of 4.5% on pension plans can lower return for policyholders. As return is guaranteed, fund managers tend to restrict their exposure to equity and all the investments may be diverted towards debt, which offers limited return but higher safety. Still it may be a good move for conservative investors, who want to avoid exposure to equity investments due to the risk involved.

All the traditional endowment policies offer the advantage of taking loans. Earlier, only few Ulips allowed loans against them. With the new rules, equity dependent policies can be put as security and 40% of the NAV can be taken as a loan. Thus, policyholder can obtain money without cancelling the policy. This will eventually reduce the cancellation of policies to meet emergency cash needs.

Sometimes, policyholders have no option but to surrender their policies to meet emergency cash needs. Irda has prescribed



Which is better?

After reforms, Ulips have become much more competent to effectively compete with mutual funds

Following are the key parameters to be considered before opting for unit-linked insurance policies over mutual funds:

Parameter	Mutual funds	Ulips
Regulator	Regulated by the Securities and Exchange Board of India (Sebi).	Regulated by the Insurance Regulator and Development Authority (Irda)
Nature of Investment	It is pure investment product. Entire funds raised are invested in equity or debt instruments or combination of both as per the terms and conditions stated in the scheme's offer document.	It is a combination of investment and insurance.
Entry Load / Fees	There is no entry load at the time of investment in a new fund offer as well as in an existing scheme at the prevailing NAV.	Many fees are associated with the premium. To safeguard the interest of the investors, Irda has put cap of 3% on gross yield. It is 2.25% for the policies with more than 10-year tenure.
Tenure	Mutual funds provide good investment avenue for the short, medium as well as long term. The tenure depends on the fact whether the scheme is open ended or close ended or a fixed maturity plan.	Ulips are good for long-term investment as the lock-in period is five years.
Risk involved	Low to high risk depends on the nature of the scheme.	Low to high risk depends on the nature of the scheme.
Exit Load	Exit load of 1% is charged if the amount is withdrawn before one year.	No exit load or charges are levied on maturity of the policy. However, if an investor surrenders the policy before maturity, charges are imposed.
Tax benefits	Equity-linked saving schemes of mutual funds, with a lock-in period of three years, are not only eligible for tax deduction under Section 80C of the Income Tax (IT) Act, 1961, but are also covered under exempt-exempt-exempt (EEE) method of taxation, i.e., the amount invested (subject to maximum of Rs 1 lakh) is exempt from tax, dividend paid by the mutual fund is also exempt, and finally the amount received on sale or redemption of units is also fully exempt from tax.	Ulips are also covered under the EEE method of taxation and, hence, provide the same tax benefits as mutual funds.
Liquidity	In open ended scheme of a mutual fund, an investor can offer the units for redemption at any time. If he does so within one year from the date of investment, 1% exit load is applicable and the short-term capital gain tax has to be paid at 15%. However, if he chooses to redeem the units after expiry of one year, there is neither exit load nor capital gain tax.	Ulips have a lock-in period of five years. If an investor is compelled to exit due to any personal emergency, then he stands to lose. As Ulips suffer from liquidity problem, investors should carefully plan their cash flows before investing.
Provisions of Direct Tax Code Bill, 2010, proposed to be made effective from 1 April 2012.	<ul style="list-style-type: none"> ● Mutual fund units will not be eligible for tax deduction presently available under Section 80C of IT Act, 1961. ● Equity mutual funds to attract dividend distribution tax (DDT) of 5%. Accordingly the dividend option of mutual fund schemes to be less tax efficient compared with the growth option. ● Capital gain arising on transfer or redemption of units of an equity oriented mutual fund, on which the securities transaction tax has been paid, to be fully exempt from tax if the units have been held for more than one year from the close of the financial year in which investment is made. It will be exempt to the extent of 50% if the units have been held for one year or less. Accordingly, 50% of the short-term capital gain from mutual fund units will be taxed at the personal marginal tax rate. 	<ul style="list-style-type: none"> ● Ulips will also not be eligible for tax deduction presently available under Section 80C of the IT Act. ● Ulips will also attract DDT. ● Income arising from Ulips will be taxable at the personal marginal tax rate. Hence, mutual funds will have an edge over Ulips as per the tax provisions post the Direct Taxes Code era.

new surrender charge structure to ensure that policyholders are not taken for a ride when they wish to discontinue their policies. The regulations stipulate that insurers recover only the incurred acquisition costs in the event of discontinuance of the policy. These charges are not to be excessive. The discontinuance charges have been capped both as percentage of fund value and premium and also in absolute value. On discontinuance, a policyholder will be entitled to exercise an option of either reviving the policy or completely withdrawing from the policy without any risk cover. Further, the regulations also enable Irda to order refund of discontinuance charges if these are found to be excessive on enquiry. Surrender charges (as percentage of fund value) are not to exceed the limits specified.

Even though there is no surrender charge after five years, an investor will stand to lose money if the policy is surrendered because it is difficult to recover the initial higher allocation charges in the short term. Insurers cannot impose surrender charges on the single premium policies and on top up premiums.

If a policy has lapsed due to non-payment of premium within the stipulated time period, the policyholder has the option within five years from the date on which premium fell due to revive or reinstate the policy. However, the insurer has the right to decline revival of the policy based on the grounds of moral hazard and or medical conditions.

The additional period of time given or allowed by the insurer from the date of premium falling to make the payment of premium without any interest or penalty is called grace period. The risk continues to be covered without interruption in case the payment is effected by the insured during the grace period. The grace period where the premium payment mode selected is monthly is 15 days and in all other cases it is 30 days.

The proceeds of the lapsed policies are to be invariably refunded to the policyholder after the expiry of the revival period or at any time after completion of three years term as and when demanded by the policyholder. If there is no demand from the policyholder for refund, the insurance company has to refund the amount on its own by means of a cheque or demand draft to be delivered to the insured or nominee at his last known address. However, the



insurer may deduct charges on account of pre-closure, which should not exceed the charges prescribed.

Irda has amended the Irda (Insurance Advertisements and Disclosure) Regulations to remove any scope for the involvement of unlicensed personnel or entities in the sale of insurance products. The insurance regulator revised the Irda (Licensing of Corporate Agents) Regulations to further tighten the code of conduct for corporate agents to ensure that the prospect does not deal with any unlicensed person. The new regulations further ensure that there is no scope for any kind of remuneration other than commission payable to agents. This measure will reduce the expenses of the insurer, thereby lowering the premium to be paid by the policyholder.

Irda has addressed the issue of referrals by bringing out separate regulations, leaving no scope for misuse of the system. Companies that wish to share their database of customers with insurers would need to get approval from Irda after having conformed to the requirements as laid down in the regu-

lations. There are restrictions on the business activities of the referral company to ensure that there is no misuse of the system. For instance, the referral company will not be in any business of extending loans and advances or accepting deposits, though there are exceptions such as for regional rural banks and co-operative banks.

New Irda rules have come as a relief for investors from the hefty charges and mis-selling practices adopted by the insurance agents. Till August 2010, it was possible for insurance companies to levy up to 100% as surrender charge on a lapsed or discontinued policy. The limit imposed on the surrender charges will protect the interest of the policyholders who are not able to continue to pay the premium. Insurance companies are also trying to cut various types of costs at the administration and operation levels to make Ulips remunerative to them and attractive to investors. All these initiatives will improve investor confidence and increase investment volume.

Last, but not the least, investors should not forget that Ulips should not always be compared with mutual funds. Rather they ought to be compared with traditional insurance plans. Ulips are far better than traditional plans of insurance, which neither offer flexibility nor provide good returns in the long run as they fail to beat the inflation rate. It is expected that with the passage of time, more and more investors would opt for Ulips instead of the traditional insurance policies.

In retrospect, the Sebi-Irda tussle over control of Ulips has proved beneficial to investors. Though Sebi lost the round, it was merely a symbolic victory for Irda, which had to re-examine Ulips, resulting in changes that make them investor-friendly.

— Rajesh Relan

**Capped
Surrender charges as % of face value**

YEAR	POLICY PERIOD	
	LESS THAN 10 YEARS	MORE THAN 10 YEARS
1st year	12.50%	15.00%
2nd year	10.00%	12.50%
3rd year	7.50%	10.00%
4th year	5.00%	7.50%
5th year	2.50%	5.00%
6th year	Nil	2.50%
7th year & onwards	Nil	Nil