The Distribution Roadmap

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The years 2009 and 2010 will go down in the history of Indian financial markets as the years when the second stage of reforms took place. If 1992 was the initiation year of big bang changes that marked the first stage of capital market reform (the securities market regulator, an alternate national screen based stock exchange, depositories were all set up to clean out a market after the 1991 stock market scam), 2009 and 10 will mark phase II. Phase II will be marked as a change in response to the distribution scam around retail financial products in general and the unit linked insurance plan (Ulip) in particular.

The first set of reforms built the grid for a fair system of securities trading where systemic risk was sought to be minimised, keeping the goal of transparency and fairness in sight for all market participants. The second set of reforms are geared toward rethinking the distribution system that reaches retail financial products to the final investors – some 188 million of them. The distribution pipeline is more than 3 million[1] strong comprising insurance and mutual fund sellers and advisors and bank officers (selling non-banking investment and credit products).

The current system and changes

The current distribution system is based on the tied-agency model in insurance and on an open architecture in mutual funds. Insurance agents can sell products of just one insurance company. Mutual fund sellers can sell products of all mutual fund houses. Till August 2009, both insurance and funds were based on a front-loaded distribution model, where the seller was compensated by the product manufacturer from the money embedded in the price of the product paid by the consumer. The product structure, where the agent represents the producer but is compensated by the consumer has an obvious inherent flaw. This flaw leads to profit maximisation by the seller, at the cost of the consumer, by selling products that maximise the seller's profit, without worrying about the financial well-being of the consumer. The producer perpetuates the system by designing products not for the consumer, but for the seller.

The Securities and Exchange Board of India (Sebi) took away the inherent flaw in this relationship by making mutual funds zero load in August 2009 – a first in the world. The distributor is now to be compensated directly by the consumer directly – a model that already works in the stock market where investors pay stock-brokers a transaction charge for buying and selling stocks and a higher fee for stock market related advice. The same model has been applied to mutual funds. The new model envisages a system where simple transactions will be charged lower and as the investor goes up the advisory and service ladder, she pays more, Since the cost has been divorced from the price of the product, the investor knows what she is being charged.

The insurance industry is also making changes in the same direction, but these are a bit haphazard, with frequent changes that incrementally solve problems, rather than a big bang change. The latest change in first week July 2010, makes the cost structure of a unit linked insurance plan a little fairer than the existing built-like-a-trap cost structure where the entire premium is forfeit if an investor does not continue the policy after year one or two, pushing investors in a gun-point decision of lose-all-or-continue-to-get-something-back decision and where costs of a 15-20 year product are front loaded into the first year making policy continuation a non-optimal financial choice for the seller of the insurance product. The current structure, that comes into effect (if the lobbies do not manage to get a reversal) has a Ulip product with a lock in of five years, at the end of which the annual charge must be 4%. This drops to a cost cap of 2.25% for policies that live for more than 10 years. The changes in insurance are far from over and the zero-load world, as envisaged by Sebi is yet to manifest, though the finance minster has said that this is the road ahead in a public speech.

Ulip = bread

Sebi's action has disrupted of a decades old sales system and has caused significant churn in the minds of the product manufacturers and distributors. The investors, of course, are doing the smart thing by staying away from the market till the rule makers decide whether a red light means stop or go at a traffic signal. Clearly, a new distribution model is needed that allows for a fair deal to all three participants in this market – producer, seller and consumer. But before we get into the shape of the new distribution system, an illiterate arguments need to be killed here. The argument goes like this: a financial product is like a soap or a loaf of bread and should be sold by a distribution model that the fast moving consumer goods companies use – by building a sales charge into the price of the product. A soap is sold for Rs 20 and the seller makes between Rs

2 to 5 on it. The argument goes that just as consumers are billed for the service of getting the soap to them in a manner that embeds the charge in the price, so can retail financial products be constructed.

There are two problems with this otherwise neat extension of a soap to a mutual fund. One, unlike soap or bread or a car, the financial product is invisible, it can neither be touched, tasted, smelled, sat in or otherwise consumed in any physical manner. The person selling a mutual fund or insurance plan has to describe it and its functions and what the outcomes are likely to be, what is costs and what the likely risks can be, for the consumer to understand it. If some part of the relevant information is withheld, the consumer will make a non-optimal choice. The consumer will not find out that she has made a non-optimal choice for many years because of the second problem: the moment of truth of this invisible product is in the distant future, sometimes a full lifetime away, as in pension plans. Finding out 15 years later that you have a financial product that is of no use to you (a whole life 99 year policy sold for a child's education at age 18, for instance, a sector fund sold to a low risk first time equity investor) is harmful for your financial well-being. Unlike a service, like a telephone service or a courier service that is invisible, the moment of truth of a financial product is detached from the current experience of the customer. These two attributes of a financial product make the sales process different from that of a soap. Or bread.

Sebi has taken note of this difference between a soap and a mutual fund and is the first regulator to go no load. Australia and UK are just a step behind and the most consumer-unfriendly nation, the US too is working on regulation that prevent financial products from 'exploding[2]'. But the move to change the distribution system to a model that is fair to all the three parties in the transaction – the manufacturer, the seller and the consumer – is causing distress in the first two. There is talk of a return to bank deposits and the killing off of insurance and mutual fund industries and of the entire distribution chain dying. But I think these are the pains of the transformation. It looks as if the world is coming to an end, but possibly it is a new beginning.

The new distribution model

Distribution will not die. It is an integral part of the handshake between consumers and product manufacturers. And distribution will not be free. It cannot be. But the manner of the distribution, and its compensation, will change. From a largely low-value-add agency business, a structure that has compensation linked to the service provided will emerge. There will be a disclosed transaction charge for the vending function. As the consumer chooses a higher value-added service, she will have to pay more. Advice and planning will cost just as lawyers and doctors charge for their advice.

At the mass level for the financially included population, the banks will be the biggest beneficiaries of the regulatory changes we've seen so far. They will vend funds, insurance and pension products, at a small transaction cost to their customers. The banks have the trust, the distribution reach and the customers to most efficiently sell products across the country. In addition to banks, there will be a few large retail distribution powerhouses, not unlike the Charles Schwab model of the US to build technology based distribution networks. The key to this model will be the financial muscle of the business to invest in technology and a distribution chain to reach pan-India. Once the technology platform is in place, economies of scale will allow even tiny transaction fees to make such a model viable.

Both the banks and distribution houses will have value-added services for customers who want it and are willing to pay. A graded model with different services being charged at different slabs could come in. Just advice on what fund to buy will cost x, advice on what insurances to build in will cost y, a full financial plan will cost z.

The small agent, who today just collects signatures and forms and has neither the knowledge nor the intent to advise, will either become an employee of one of the large distribution powerhouses or upgrade his services to become a stand-alone higher value-added financial advisor or planner. These will be boutique services by financial advisors and planners, and will be serviced by centralized administrative service providers like the platform that is already being put in place. There will be greater reliance on some form of certification to allow this market segment to distinguish itself from the pure vendors.

The third part will be the small (and in India, even small has many zeros) do-it-yourself population who will choose products and transact on their own. Most transactions will be online or through large clearing houses, such as stock exchanges. They will like the virtual comparison shopping and delivery modules and will be willing to pay a small transaction cost to avail of these services[3].

While this takes care of the financially included population (those who have a bank account), there is yet the issue of distribution to those outside the banking system. Expect mobile banking and the microfinance pipeline to transform this space. The banking regulator is already removing many roadblocks to mobile transactions and some microfinance initiatives are already moving beyond credit delivery. A uni-product distribution system is high-cost waste. Expect micro insurance, mutual funds, pensions all flowing through this pipeline in the times to come.

What will make it work

A level playing field for financial products is a necessary condition, but a sufficient condition is a set of common regulations for all sellers of financial products. These regulations must be written keeping the consumer in focus and not regulatory ease or the interests of producers or livelihood of distributors. This system will include a common set of compliance exams linked to a license, suitability criterion in the sales process and punitive action that ensures these are followed. The remainder of

2010 will see more change in this direction. But it will take another five years before India gets this well-oiled and humming efficiently.

Why is it essential to get this piece right? Beyond the reasons for good financial outcomes for millions of Indians and a market place that is free from institutional fraud, there is a macro reason that demands this change in the Indian distribution system. India is unable to transform its S to I, or savings to investment. India has a household savings rate of over 30% but less than 10% of the household saving comes to the market, preferring to stay with the risk-free deposits or even gold. Indians hold 18,000 tons of gold or about half the GDP in the form of household gold. One of the chief reasons for keeping money away from the markets is the lack of trust in the distribution chain. Unless a new system evolves, expect India to continue to use its money less than efficiently.

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[1] The numbers used for investor and distribution head count are from IIMS Dataworks 2007.

[2] A term mad e popular by Harvard law professor and bankruptcy expert Elizabeth Warren, 'exploding' financial products were seen in the US when unfair and unsafe loans were sold to those who did not fully understand the costs or the utility of these products. The sub-prime crisis has its origin in these 'exploding' products. http://bit.ly/31DbpW

[3] Parts of this piece are taken from an earlier column I wrote in Mint in December 2009. http://www.livemint.com/2009/12/29222835/Shape-of-distribution-market-i.html