The Paradox of ULIPs

By Dhirendra Kumar | Sep 18, 2008

A couple of days ago there were some announcements from the Life Insurance Council, a lobbying body formed by life insurance companies. Broadly, these announcements appeared to say two things. One, that the terminology of Unit-Linked Insurance Plans (ULIPs) would be made uniform. And two, insurance companies would refuse to underwrite insurance-linked schemes issued by mutual fund companies.

Behind both these issues is a struggle that is going on between the life insurance companies and mutual funds. Here's what this fight is all about. Mutual funds and life insurance are two distinct products, one being intended as a savings vehicle and the other a safety net. However, over the last few years this distinction has become blurred. Today, if one looks at the actual money that is flowing in, then the life insurance companies are also in the business of running mutual funds. These mutual funds are called Unit-linked Insurance Plans (ULIPs). ULIPs have a mixture of the characteristics of both insurance and mutual funds. Crucially, the mutual fund aspect of ULIPs is regulated by the government under a very different set of rules compared to the real mutual funds. From the investors' point of view (which is obviously the most important point of view), the biggest difference lies in how much of his money is actually used for his insurance and his savings and how much is taken away to pay the commissions to agents and the expenses of the insurance company. The second big, related difference is the quality of the information he is given about his investments.

Mutual funds deduct not more than 2.5 per cent as the agent's commission. And this deduction is 0 per cent (by law) if investors don't use an agent and go directly to a fund company. In ULIPs, the agents' commission varies, but in the first year, it could be anywhere between 25 per cent and in some cases, 75 per cent. There are a lot of things in finance that are difficult to understand, but the difference between paying 0 per cent commission and 75 per cent commission is not one of those. Even the difference between 2.5 per cent and 25 per cent is pretty easy to understand.

Next is the issue of transparency. One of the most interesting is the vast difference between the meaning of 'Net Asset Value' (NAV) between ULIPs and mutual funds. In a mutual fund, the announced NAV is net of all expenses and charges that the fund company deducts. If your investments were worth Rs 1 lakh when a fund's NAV is Rs 22, then it will be worth Rs 2 lakh when the fund's NAV is Rs 44. That's it. The arithmetic of insurance companies is different. ULIP's NAVs are effectively pre-deduction. The NAV may double, but your investments won't double because the insurance company will reduce the number of units you hold to pay for expenses and commissions etc. This means that the announced NAV has no clear and transparent relation to what the unit holders are actually earning.

However, ULIPs are phenomenally successful. News reports say that last year, a total of Rs 55,000 crore was invested (if invested is the right word) in ULIPs. In the same period, around Rs 16,000 crore was invested in mutual funds. We are often told by the insurance industry that this is because ULIPs are a superior product. That's complete rubbish. ULIPs are successful because the ultra-high commissions and charges make insurance agents far more aggressive salesmen than those of any other financial products. These charges also enable insurance companies to spend far more on advertising. All of which is the unitholders' money. The net result of high-pressure sales is that savings that would otherwise have ended up in mutual funds, bank FDs, PPF, post office and many other asset types is ending up in ULIPs, where a good proportion is diverted to pay commissions.

The direction that the India's insurance industry has taken in the last few years is a huge regulatory failure on part of government. This industry was opened up to foreign capital and provided with a relatively lenient regulatory framework so that it could bring insurance to India's under-insured masses. Instead, it has ended up focusing its energies (and capital) on selling expensive and opaque mutual funds that are dressed up as insurance. It's tragic that there is no move to even recognise that this problem exists. Now, even higher foreign ownership is on its way, supposedly because more capital is needed to ULIP the under-ULIPed masses even harder.

It simply isn't in anyone's interest to bring up these issues. Most large mutual fund companies aren't bothered either because they are part of financial conglomerates that have flourishing insurance businesses.

It's up to you, as an investor, to understand the issues and do what you think is in your best interest.