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MIS-Selling of Financial Products: A Review

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ABSTRACT

This paper describes the mis-selling of financial products as it has been documented in the literature. The evidence pointed out that agents are maximising their own income at the cost of selling unsuitable financial products to retail investors. It is well documented that non-transparent product structures encourage mis-selling by agents and advisors. To structure the discussion, literature review is segregated into three parts: Mis-selling and Misconduct in Financial sector. Commission structure and Impact on the quality of advice. Impact of Regulatory reforms: Commission and Disclosure. After reviewing the literature, it is clear that there is a requirement to study the regulatory reforms like changes in the commission structure and advisory model and their impact on the retail financial sector. It will help to curb the large-scale mis-selling of the financial products in India.

Keywords: conflicted advice, disclosure, financial literacy, investor sophistication, misleading, misconduct

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INTRODUCTION

The Indian Financial Services sector has witnessed exponential growth in the last decade. Mutual Funds asset base reached Rs 19.26 lakh crore (US$ 299.04 billion) at the end of April 2017. The Indian life insurance industry has begun to recover and is likely to report 12% to 15% growth in FY 2016-17 [1].

Over the last two decades, there have been several incidents about mis-selling. One of the key causes of the great financial crisis of 2008 was the mis-selling of subprime mortgages in the USA and their securitization which spread the sub-prime crisis throughout the world [1]. Financial fraud can be broadly defined as an intentional act of deception involving financial transactions for purpose of personal gain [2]. Although financial fraud is not new in any sense, both the frequency with which it occurs and the monetary cost associated with it seem to have increased.

A conceptual distinction is made between three types of financial fraud:

(1) Financial statement fraud
(2) Financial scams
(3) Fraudulent financial mis-offering

Various late improvements have encouraged the event of money related extortion, including:

(1) The advancement of new principal irreconcilable circumstances and unreasonable motivating force structures in the money related industry.
(2) A deluge of unsophisticated, guileless members in the budgetary commercial centre.
(3) The expanding multifaceted nature associated with budgetary market exchanges because of quick mechanical, legitimate, and money related advancement and a regularly extending menu of monetary items.

(4) An expansion in the utilization of legitimized mystery as strict classification governs around keeping money and lawful administrations and the utilization of wobbly sheet developments and shell organizations situated in mystery purviews [3].

Concept of Mis-Selling

Mis-selling is "the practice of a salesperson misrepresenting or misleading an investor about the characteristics of a product or service" (www.investopedia.com). SEBI has notified Mis-selling as a fraudulent practice by adding the following clause into the Prevention of Fraudulent and Unfair Trade practices relating to Securities Market Regulation via a notification on 17th July 2003.As per the notification mis-selling of units of a mutual fund scheme by any person, directly or indirectly includes.

(1) Making a false or deceiving articulation or
(2) Concealing or overlooking material realities of the plan or
(3) Concealing the related hazard components of the plan or
(4) Not taking sensible care to guarantee appropriateness of the plan to the purchaser

Mis-selling of life insurance and pension plans resulted in major scandals and regulatory actions in the United States in the 1980s [4, 5], in the United Kingdom in the 1990s [6–9], and in the Netherland and India in the 2000s [10, 11].

Early reporting in the media had begun documenting mis-selling in both mutual fund and insurance industries [12]. Investors lost up to US $ 28 billion to mis-selling of unit linked insurance schemes during 2005–2012 [11]. Shrouding of fees by Indian Mutual Funds resulted in an estimated loss of US $ 350 million [13]. An online survey by Money-Life also found that over 90% of consumers reported being mis-sold a financial product or service.

The evidence pointed out that agents are maximizing their own income at the cost of selling unsuitable financial products to retail investors. It is well documented that nontransparent product structures encourage mis-selling by agents and advisors [14].

REVIEW OF LITERATURE

Mis-Selling and Misconduct in Retail Financial Sector

Mohamed (2013) assessed the strategies aimed at countering insurance fraud in Malaysia at a national, industrial and company level to grasp the fraud control strategies and the current trends in Malaysia. The study concluded that the practice on combating fraud can be within the insurers systems with the help of professionals that enable them to achieve certain abilities and competences to overcome the problems.

Brown and Minor (2015) examined misconduct in financial services using sales complaint data for insurance agents and found that agents working exclusively for large branded firms are more likely to be the subject of justified sales complaints, relative to smaller independent experts, despite doing substantially less business. In addition, more experienced experts attract more complaints per year.

Matvos et al. (2016) studied misconduct by financial advisers through a novel panel database of all financial advisers (about 1.2 million) registered in the United States from 2005 to 2015. The study found approximately 7% of financial advisers has been disciplined for misconduct and/or fraud and the costs of misconduct amount were $40,000. The study revealed that those firms which specialize in misconduct with several unscrupulous financial advisers are targeting relatively high incomes, low education, and elderly populations, while other firms use their reputation to attract sophisticated consumers.

Subashini and Velmurugan (2016) studied the reasons for mis-selling of policies in public and private sector insurance companies in Coimbatore district. The result of the study disclosed that agents making quick buck in form of insurance commission, heavy sales pressure, providing fake NAV units for the past data, managing fake medical tests and proposal form filled by agents and other sales men, are the reasons for the mis-selling at LIC where as heavy sales pressure, providing fake NAV units for the past data, managing fake medical tests, agents making quick buck in the form of insurance commissions and role ambiguity are the main reasons for mis-selling at private insurance companies.

Commission Structure and Impact on the Quality of Advice

The incentive problem has been exacerbated by the introduction of new layers of intermediaries (e.g., fund managers, financial advisers, mortgage brokers, insurance agents) in the financial value chain and the new forms of compensation that have come with it [3].

Chance and Ferris (1991) examined the characteristics of the funds that have distribution plans in comparison to the funds that do not have the distribution plans, and used f test to analyse whether there were differences in age, size, investment policy, objective, load status, and load charge data from the years 1984–1988. The study revealed that there was a growing tendency of funds, particularly load funds, to adopt the plans.

Gravelle (1994) examined the relationship between compensation and the quality of advice through a rigorous model in life insurance mark. The study found that the intermediaries who are compensated by insurer-paid commissions reduce consumer costs but those intermediaries who are compensated by fees paid by policyholders provide better advice.

Bolton et al. (2007) studied the compared conflicts of interest in two different firm structures, specialized banking and one-stop banking. The study considered a situation in which financial intermediaries have better information about which financial products are best for their customers. The analysis presented a new model of competition between banks, where price competition influences the ensuing incentives for truthful information revelation. In such an environment financial services companies do not sell simply financial products and may also provide financial advisory services.

Bluethgen et al. (2008a) examined the clients of German bank that provided financial advice to customer. The study found that advised accounts are more diversified, but pay higher fees and have the same portfolio volatility as unadvised accounts.

Bluethgen et al. (2008b) analysed the adviser's quality of independent financial advisers in German. The study concluded that advisers vary substantially in quality; advisers charging fixed fees (vs. commissions) and those with more skill provide better advice.

Inderst and Ottaviani (2009) analysed the implications of the inherent conflict between prospecting for customers and advising on the product's "suitability" for the specific needs of customers by direct marketing agents. The study found equilibrium amount of mis-selling depends on features of the agency problem including: the internal organization of a firm's sales process, the transparency of its commission structure, and the steepness of its agents' sales incentives.

Broker-sold and direct-sold funds from 1996 to 2004 and failed to find that brokers deliver substantial tangible benefits. Relative to direct-sold funds, broker-sold funds deliver lower risk-adjusted returns, even before subtracting distribution costs.

Inderst (2010) studied the limit for internal compliance and showed that this implies an upper boundary for the feasible "standard of advice", up to which the standard increases with commissions.

Marisetty and Venugopal (2010) studied whether mutual funds are sold or bought in the Indian Mutual fund market. The results of the study supported that investor sophistication and incentives for selling efforts determine whether mutual funds are sold or bought.

Hackethal et al. (2012) analysed the performance in advised accounts of German bank and unadvised accounts of on-line brokerage. The study revealed that Presence of financial advisor lowers net returns, worsens risk-return trade-off, and increase account turnover, consistent with commission-maximization.

Mullainathan et al. (2012) conducted field experiment using randomized audit study in which testers ask for advice, starting with 4 different artificial portfolios. The study found that advisers favoured actively-managed portfolios with high fees; "the market for financial advice does not serve to de-bias clients but in facts exaggerates biases that are in the adviser's financial interest, while leaning against those that do not generate fees."

Fullerton (2013) studied the perceived levels of unethical selling in the financial services industry in Ireland. It contained ethics and ethical behaviour of financial advisors, sales targets & managerial pressures and remuneration of financial advisors. The study found financial advisors sold unethically to gain more commission from their sales within the Financial Services Industry in Ireland.

Beyer *et al.* (2013) studied that whether financial advisor commissions distort client choice or not through experimental design. The study found that varying the commission received by financial advisors strongly influenced insurance purchase.

Firth *et al.* (2013) investigated that whether the business relations between mutual funds and brokerage firms influence sell-side analyst recommendations or not, using a unique data set that discloses brokerage firms' commission income derived from each mutual fund client as well as the share holdings of these mutual funds. The study revealed that an analyst's recommendation on a stock relative to consensus is significantly higher if the stock is held by the mutual fund clients of the analyst's brokerage firm. The optimism in analyst recommendations increases with the weight of the stock in a mutual fund client's portfolio and the commission revenue generated from the mutual fund client. Mutual funds increase their holdings in a stock that receives a favourable recommendation but this impact is significantly reduced if the recommendation comes from analysts subject to client pressure.

Livingston and Zhou (2015) analysed fund-level data of U.S. equity mutual funds from 2001 to 2011 to find out whether the premium commissions paid by mutual funds create value for investors or not by examining the impact of brokerage commissions on net mutual fund performance. The study found that brokerage commission per dollar traded has a positive and significant impact on mutual fund performance, indicating that funds paying premium brokerage commissions were able to improve performance net of all expenses. The positive impact of premium brokerage services (better execution quality, timely research reports, etc.) purchased through higher commissions was more pronounced during volatile market times.

Schwarcz and Siegelman (2015) examined the legal and economic literature on intermediaries operating in consumer-driven insurance markets, analysing the extent to which competition and/or regulation promote objective and high-quality coverage information and advice. It concludes that neither market forces nor legal or regulatory rules substantially constrain insurance agents' capacity to advance their own interests by providing biased advice, though direct empirical evidence about the frequency of such misbehaviour is limited.

Tseng *et al.* (2016) examined the role of attitude, sales compensation, information asymmetry and sales orientation to study the insurance agents' intention to make the inappropriate product recommendations. The study found that the insurance agents would exhibit a higher acceptance of the inappropriate product recommendations when they experience the manipulation of sales compensations and sales orientation in the insurance companies.

Halan and Sane (2016) studied financial misbehaviour in retail banks in New Delhi and found that in private sector banks with high sales incentives, the high commission product was recommended while in public sector banks, where there are deposit mobilisation targets, fixed deposits were recommended. Banks rarely make voluntary disclosures on product features and more complex features of a product, such as costs are not disclosed voluntarily.
Franke *et al.* (2016) investigated a fair balance between the conflicting interests of banks and clients to prevent mis-selling by the banks. The study found the different approach to protect retail clients through the translation of MiFID II (Markets in Financial Instruments Directive) rules into a three pillar approach with more principles and fewer rules. Pillar 1, principles for fair treatment of clients in Pillar 2. A supervisory review process to check the bank's interaction with retail clients and in Pillar 3 Market discipline.

Anagol *et al.* (2017) investigated the quality of advice provided by life insurance agents in India through field experiments. The study found evidence that commissions-motivated agents recommend unsuitable advice, agents recommend strictly dominated expensive products 60–90% of the time which provide high commissions to the agent.

IMPACT OF REGULATORY REFORMS: COMMISSION AND DISCLOSURE

From the last many years financial product mis-selling on a vast scale and huge levels of consumer detriment and the consequential massive cost to banks and financial institutions in handling consumer complaints and paying compensation the U.K. financial regulatory system has finally determined that commission-driven incentives to intermediaries are at the root of the problem [37].

REGULATORY CHANGES RELATED TO COMMISSION

Slattery (2008) analysed regulatory change to identify the policies and events which may be hypothesised to affect the operation of the market. The empirical evidence showed that over an extended period of time (from the mid-1980s to 2007) regulation affected product development, product pricing, demand, the evolution of distribution channels, producer costs and margins and ultimately the industry structure.

Sahoo and Sane (2012) proposed isolation of monetary exhortation from money related conveyance. The investigation proposed a Financial Advisers Bill, 2012, to advance the improvement of a business opportunity for counsel. The Bill recommended that monetary counsels be perceived as experts and be controlled under another statutory body called the Institute of Financial Advisers of India. The paper recommended that control of wholesalers keep on remaining under the domain of item controllers. It additionally called attention to that the Ministry of Finance and the Financial Stability and Development Council need to assume a dynamic part in coordinating the setting of regular gauges for dissemination over all item controllers.

Inderst and Ottaviani (2012) analysed the pros and cons of various policy interventions, such as imposing mandatory disclosure, banning commissions, and regulating contract cancellation terms through a simple model of financial advice. The study found that consumers frequently receive advice from agents without understanding the potential impact of inducements and other incentives paid to those agents.

Anagol and Kim (2012) conducted an experiment in the Indian mutual funds sector that created a 22 month period in which closed-end funds were allowed to charge an arguably shrouded amortized fee whereas open-end funds were forced to charge standard entry loads and found that allowing closed-end funds to charge the shrouded type of fee led to a proliferation of closed-end funds.

Anagol et al. (2013) evaluated the impact of the policy change related to charge distribution fees to pay broker commissions on the mutual fund flows in the Indian mutual fund market through natural experiment. The study concluded that Indian mutual fund growth in the post-policy period was lower for reasons independent of this policy change, such as a general move away from mutual funds towards real assets such as gold and real estate after the 2008 financial crisis.

Anagol et al. (2016) analysed the impact of a ban on entry loads whose purpose was to reduce the amount of commissions that fund companies would pay to brokers in the Indian mutual fund sector. The study revealed that commission's reform did not have a major impact on the relative attractiveness of funds and that the entry load ban is unlikely to have played an important causal role in the aggregate decline in flows into mutual funds.

Kaur and Bansal (2016) investigated the causes of mis-selling of ULIPs after revised guidelines regarding ULIPs by the Insurance Regulatory and Development Authority (IRDA) in September 2010. The study found that in the year 2010-11, the unit linked business declined by 10.65% whereas the complaints relating to ULIPs increased by 40.64%, in comparison to the previous year. The downfall in Indian stock market affected the performance of market based ULIPs which caused reduction in ULIPs business and the increase in complaints, as the customers' expectations were not fulfilled. During 2011–2013 there was a fall in the unit linked insurance business and the number of complaints also declined which meant that the numbers of complaints was directly correlated to sale of ULIPs. The share of mis-selling complaints increased to 44.51% in 2012–2013 from 32% in previous year 2011–2012.

Disclosure, Customer Suitability and Financial Literacy

Joint Committee at the Bank for International Settlements (2008), defined suitability and mis-selling as, the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience. The term disclosure refers to any requirement that the firm disclose information to the retail client that could be material to the investment decision. In a sense, disclosure is intended to assist the retail client in making his/her decision, but is quite distinct from the requirement on a firm to make a determination of whether a particular product is suitable for the client. The study found that the notion of suitability is recognised in regulatory requirements across all sectors, but to a varying extent. The survey results indicated that firms take their suitability and disclosure obligations seriously. In the insurance sector, however, gaps existed in disclosure of conflicts, particularly around remuneration. Financial product decision-making is particularly difficult because individuals with low levels of financial literacy may not be in a good position to determine which products are appropriate for them [40].

Atkinson *et al.* (2006) conducted exploratory, methodological study to design a baseline questionnaire that used to measure levels of financial capability in the UK between June and September 2005. In this study, indicator of financial capability may be conceived as encompassing four different areas or domains (managing money, planning ahead, choosing products and staying informed). The study found that individuals may be particularly capable in one or more areas, but lack skills or experience in others.

Hung *et al.* (2010) investigated the potential effects of different information disclosures regarding risk on retirement investing behaviour through an experiment using a nationally representative internet survey. The study revealed that the effects of the alternative disclosure forms do not seem to vary across individuals with different levels of financial literacy, or across individuals with different levels of risk aversion. Order effects were stronger than the disclosure form effects, but were independent of the risk characteristics of the investment options: the first and last investment options presented tend to receive larger allocations.

Akinbami (2011) analysed the ways to deal with shopper insurance in UK monetary administrations when the worldwide budgetary emergency. The examination audited the writing on behavioural financial aspects and brain science and utilizations it as the reason for an evaluate of the way to deal with the supervision of money related administrations firms and the assurance of their purchasers. The investigation found that non-interventionist ways to deal with buyer insurance, which depended on the customary hypotheses of the Law and Economics development, fizzled. Thus, there is currently a move in deduction towards more interventionist approaches.

Pellinen et al. (2011) investigated the monetary capacities of shared reserve financial specialists, familiarity with the terms and dangers of common store ventures utilizing capacity estimation methods in Finland. The examination discovered contrasts between various sorts of speculators as far as monetary learning. The channel utilized by the financial specialists in making speculations separated the more learned web speculators from the less educated branch office financial specialists.

Beshears *et al.* (2009) used an experiment to estimate the effect of the SEC's Summary Prospectus, which simplifies mutual fund disclosure and found no evidence that the Summary Prospectus affects portfolio choices and does not alter subjects' investment choices. The study concluded that portfolio choices do not respond sensibly to loads and redemption fees, whether they receive the Summary Prospectus or not.

Smith (2010) proposed substantial modifications to the regulatory regime's information disclosure requirements to maximize protections for Indian mutual fund investors. The study found that better a country's regulation of mutual funds, particularly in the case of disclosure; the larger is its fund industry.

Muller *et al.* (2014) examined the potential detriments and benefits to consumer and the Single Market of various financial products to protect the consumer's interest. The study found that improved transparency and better informed transactions resulting from such policy will lead to better solutions for consumer and greater market efficiency.

Gentile *et al.* (2015) investigated the subjective understanding and perception of financial information and their impact on investment decisions of the Italian investors. The study found the impact of costs on the internal rate of return, costs on principal and interest and unbundles the product fair value into its bond and derivative components, with specific indication about costs. The study showed that risk perception was context-dependent and mainly determined by the way financial information was disclosed.

GAP OF THE EXISTING STUDIES

After reviewing the literature researcher came to know that there is a huge gap between the studies conducted till now and the real problem existing in Indian retail financial market.

- Most of the studies are conducted in foreign countries rather than India.
- Most of the studies consider only commission structure and conflicted advice.
- None of these studies focused on the changes in the commission structure and advisory model and their impact on the Indian retail financial sector.

SUGGESTIONS FOR FUTURE RESEARCH

From the above discussed gap it is clear that there is a requirement to study the regulatory reforms like changes in the commission structure and advisory model and their impact on the retail financial sector. It will help to curb the large-scale mis-selling of the financial products in India.

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