Unit Linked Pension Products – Challenges and Opportunities in the Indian Context

By - P.Jagan Narayan

Unit-linked policies are life insurance policies characterised by their high financial content. They are a logical combination of an investment fund and a life insurance policy.

They are different from traditional policies because they allow the customer to define the underlying type of investment by choosing from a vast range of asset classes differentiated by the type of investment. This could range from the conservative to the aggressive depending up on each individuals risk appetite. The investment can also be modified / switched over time.

Unit linked business has its roots in unit trusts (mutual funds) which were introduced in the UK in 1931. The first unit linked policy was issued in UK apparently in the year 1957 and its investments were linked to an external unit trust.

There are different types of unit linked life insurance contract that can be designed starting from endowment, money back, whole of life policy, deffered annuity scheme, and the managed pension fund.

The available products are characterised by their transparency, yield, convenience, flexibility and price/performance equilibrium.

I would try to dwell up on this last product (managed pension fund) more and try to highlight the challenges and opportunities available for an insurance company in the Indian context.

The two most popular schemes among the corporates in the pension fund category are the group gratuity and group super annuation scheme.

Group Gratuity

Under the Payment of Gratuity Act 1972 (POGA) most employers with more than 10 employees must provide a minimum level of lump sum gratuity benefit to staff when they leave service. The amount of benefit is defined in terms of service and salary. Employers often pre-fund the liability to pay gratuity by setting up a separate fund under a Trust. Pre-funded arrangements enjoy special tax privileges.

Employers are obliged under The Payment of Gratuity Act 1972 (POGA) to provide for the payment of gratuity to their eligible employees.

The Act applies to most companies which employ 10 or more employees (or have employed 10 or more employees any day in the last 12 months).

The broad terms of the benefits are :

Section 4(1) states that a Gratuity shall be payable to an employee on *termination* of his employment,

- On his superannuation, provided five years or more of continuous service has been completed, or
- On his retirement or resignation, provided five years or more of continuous has been completed, or
- On his death or disablement due to accident or disease (payable irrespective of length of service).

Group Superannuation

The Group Superannuation Scheme allows an employer/trust to build up retirement funds for the members of the scheme. This scheme is usually provided to a particular class of employees of the company.

A separate fund exists for each individual and the contribution in respect of each individual is applied to their own fund. The amount of the fund is equal to the contributions (applied for that member) plus investment returns less expenses. Investment returns are applied to the fund using the unit-linked method. At retirement the accumulated fund is then used to buy an annuity for the member to provide an income in retirement (plus a tax-free lump sum payment).

The super annuation scheme can be either defined contribution plan or a defined benefit plan, it is increasingly popular to have a defined contribution plan rather than a defined benefit plan.

The important decision points that needs to be made at the time of developing the product are as follows:

i) Acceptability of Unit linked approach
ii) Fund Management
iii) Charges and Expenses
iv) Administration
v) Products offered by other market players
vi) System Support
vii) Training and Education
viii) Regulatory constraints

Till now, the companies (Indian corporates) in India were not exposed to this type of a scheme where the entire investment risk and hence the reward being borne by the company / Trustees. It is hence extremely difficult to predict how the Indian corporates would react to this. Also, there is a great deal of education that needs to be done at the time of selling this concept and hence setting the right expectation in the mind of the employers.

An essential element for the development of investment-linked products is the existence or development of a stable securities market. Insurance companies, like pension funds, are important catalysts for change in this regard but change will not come overnight.

Although, the fact that Indian corporates invest in mutual funds cannot be totally neglected and hence can give a certain degree of comfort to the insurance companies. The fact remains that in case of gratuity and super annuation it is employees money and hence the company may not want to take the downward risk.

Fund Management

The crux of the entire product is the returns that this product can generate and this is dictated by the management of the fund. There is no great value in doing well in all other aspects of the product delivery if the fund does not perform well.

The insurance company has two options with regards to the management of the fund i.e. external and internal. External funds usually have a proven track record that could be used as a significant

marketing tool. In India many of the insurance companies, which are a part of the larger financial services group, already have a sister fund management company and they could bank on their performance. For others, they would usually be having an in-house investment team and this could be extended to management of the funds too.

The expenses and hence the cost should be kept in mind as by nature the unit linked insurance product is a very transparent product and hence this would become a significant selling point in the long run.

Charges and Expenses

There are different charges that can be levied by the insurance companies, some of the more common ones are:

1) Initial charges
2) Annual charges
3) Investment charges
4) Mortality charges
5) Surrender charges

Initial Charges

Initial charges are applied at the time of setting up the policy, this could be in the form of a bid offer spread and also in the form of allocation of units known as the allocation factor. It is also possible to be levying a per member level charge.

Annual Charges

The annual charges can either be fixed or can be linked to the size of the fund. It could also be linked to the number of members in the scheme. This charge is usually taken to cover the maintenance expenses of the insurer.

Investment Charges

A fund management charge is levied to take care of the fund management expenses depending up on whether the fund is managed internally or externally.

Mortality Charges

It is possible to have an insurance element built into the super annuation contract and in case of a gratuity there would be an element of insurance the degree and the form could differ from company to company.

The insurance premium can be taken as a part of the gratuity contract or it can be administered outside this but packaged to look as if it is a whole some product offering gratuity and insurance to the employees of the organisation.

Surrender Charges

The surrender charges can be used in multiple ways. It could be used as a way of recouping the initial outlay of the insurer in case the company decides to withdraw in the early years of the contract or it could be used as a deterrent for the company to shift the service provider at any point of the contract. Usually the surrender charges / penalty would decrease over a period of time and would be expressed as a percentage of the fund.

Expenses

The biggest start up expenditure for unit linked policies is the unit linked administration system and this has to be recouped over a period of time by the charges that are levied and the business volumes that the product would generate.

The key thing to all this is that the Indian corporates till now have not been exposed to the explicit form of charges and hence they would have to be sensitised to the different charges and the hierarchies on which they operate. This could be a point where significant negotiations at the time of pre-sales can happen hence, at the time of product development the insurance company should design the product making provisions to accommodate such contingencies.

Administration

The unit-linked policies are significantly complex to administer and also would need a very highly technically trained customer service department to handle enquiries. Much of the administrative capabilities would be dictated by the kind of system that is used to administer the policy. As the allocation of units would be time dependent it is extremely important to have a very robust system that can take care of allocation, de allocation and reallocation of

units. It is essential to have a system that would be able to talk / interact with other systems to capture the unit price details, to give outputs to accounting packages, report generators etc.

Products Offered by Other Market Players

The domain of competition does not stop with the insurance companies but also extends to products offered by the unit trusts. There could be a strong tendency to compare the returns of this product with those available with the unit trusts although the investment philosophy and the asset class on which both of them would be operating could be entirely different.

System Support

The success of a market player especially in this unit-linked market would be dictated by the service that he could provide. It is imperative that the insurance company has a sound system. The options that are available with the insurance company is to either build a in house system or to buy it from a vendor. Developing an in-house system would require substantial amount of expertise and skilled IT resource. There are a few systems that are available but would require some amount of customisation depending up on the scope of the product.

Training and Education

This product by its very nature is very transparent and hence very complex. Also the intended target market are the corporates hence the necessary skill set that would be required to sell this product would vastly different in comparison to the traditional products. Some of the distribution channels like the bancassurance may not be the ideal way to channelise the product. Also by the very nature of the product it is open for abuse and hence the insurance company should properly train the sales force and also should educate the potential policy holders through its communication about the investment risk that the policy holder is taking as opposed to traditional policies.

Conclusions

1. The acceptability of the unit linked approach with the Indian corporates is a debatable issue and only the market can answer this. Nevertheless with a little education and proper positioning of the product there is a market place for this type of a product.

2. Although the insurance companies would be able to invest in equities while the trusts are not allowed, the present climate may not be totally conducive for this approach. The

insurance company would have to clearly communicate its investment philosophy to the clients and hence set and meet their expectations.

3. The key success factor would be efficient administration of the scheme, this can be achieved only with the help of a proper IT and a knowledgeable customer service staff.

4. Care should be taken at the time of system selection and a proper testing of the same is essential before the launch.

5. Proper training needs to be done to the front line staff not only in the area of Insurance but also in the area of mutual funds.

In all there is a great future for the unit-linked product in India if a long-term view is taken and if a cautious approach is taken at the time of setting up the policy.

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