



# **THE NEWSMAKER**

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## **DISTRIBUTION STRATEGIES BY LIFE INSURANCE PLAYERS**

*by Suresh S.*

**Director, DMS Financial Services Co. (P) Ltd.**

The Insurance market premiums in India are annually worth Rs.200,000 crores according to ICICI PruLife MD V.Vaidyanathan, and this is expected to double in four years' time. But the costs of winning a customer is so prohibitive in Life insurance, the companies need to be as innovative as possible to leverage on existing Distribution strengths.

Here are some examples based on strategy analyses of Life Insurance players:

- **Future-General Group**, a tie-up between Kishore Biyani's Future Group and Italian Genrali has rolled out a unique distribution model using shopping malls operated by it. Even the product is called **Mallassurance**. Here are 2 million shoppers visiting malls on a daily basis. *A 2% conversion rate is enough to generate a 10,000 Policy volume per day.* And that's exactly the number that has been reached though not in a day, but in two days, after the launch over 40 stores. This is going to be extended to 100 branches and 340 distribution points so as to reach by May 2010 the target of 1 million policies. The Genrali Group has for precedence its accomplishments in selling two million bicycle policies in Switzerland and other parts of Europe but trying it out in a mall is the first time.

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- **Max New York** is rolling out an *aam aadmi* insurance product called *Max Vijay* across more than 10000 outlets including telecom, retail stores, micro-finance institutions and NGOs. Targeting the 100 million low end income earners in the urban and rural households, Max is departing from the fixed premium policy route by offering cover for 10 years on a one-time enrolment premium of Rs.1000. The sum assured is five times the premium paid and the Policy does not lapse even if no further premium is paid. Just as there is a top up for mobile cards the insured can top up with as low an amount as Rs.10 and expand the life coverage at any time.
- One of the innovations is that Max looks at a simple identity proof. Receipts would be generated through GPRS-enabled hand-held terminals and the Policy would get activated within seven days.
- This is the first time that a new product aimed at masses is being launched. The paper work, medical examination, agents' commission, and servicing being expensive, the customer acquisition was becoming expensive but Max has through the use of technology substantially reduced this cost. It has tied up with Indian Oil Corporation to sell products through the latter's retail outlets. IOC has 2000 Kisan Seva Kendras across the country. It is also being sold as FMCG at retailers in UP and through distributors' wholesale networks in W.Bengal and Andhra Pradesh. It has also tied up with the Indian Mercantile Co-operative Bank for selling products through its network of 9 branches.
- **Bharti AXA** is leveraging on its huge base of telephony customers.
- **AXA Religare** is using its broking outlets of Religare Securities.
- **BNP Paribas Assurance.** Traditional methods can be equally effective when the application is made to the largest player in size. For example BNP Paribas Assurance is very satisfied with its tie-up with SBI Life. Their size has doubled in the banc-assurance mode as it has access to 15000 branches across the country. *Banc-assurance is still just 7% of the Insurance market as against 50% in several countries.*
- **IDBI-Fortis** a joint venture between IDBI, Federal Bank and Holland based Fortis has positioned itself differently. Its brand is **Wealth-surance**, an investment solution incorporating the tax-free element of life insurance. Likewise it also offers **Homesurance**, to offer protection against liability on mortgage products through term plans.
- **Bajaj FinServ**, which has a presence in general insurance, life insurance and consumer finance business, is using its strong network of branches and sales force to market insurance products. Bajaj Auto has a network of 498 dealers, over 1500

authorized service enters and 162 exclusive three-wheeler dealers apart from 1400 rural outlets in towns with a population of 25,000 and below.

- **Life Insurance Corporation (LIC)** has incentivised the ‘highly productive’ agents to recruit new agents. Over 20,000 agents have thereafter enrolled over one lakh new salespersons. These new recruits have brought in 6% of LIC’s total premium.
- Last year LIC had floated CLIA that is, the chief life insurance agent scheme. Top agents were offered the option of becoming ‘Chief agents’ who could enroll and mentor new agents under them and from the commission earned by these new agents, they would get credited with a portion. Each of the chief agents was told to enroll 5 new agents. As of mid-09 the new agents brought in (in absolute terms) Rs. 211 crore premium, which increased to Rs. 1100 crores last year and in FY 10 it is expected to be around Rs. 3300 crores. *The first year premium from the CLIA scheme is so significant, this alone is 6<sup>th</sup> in rank amongst is 22 life insurance companies, not counting other premium.*
- Another masterpiece from LIC was that instead of serving the ultimatum on non-performing agents by saying ‘sell 12 lives in a year’, they said ‘sell 36 lives in three years’ so that new agents had two more years to achieve targets.

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## **ARE STRUCTURED FINANCIAL PRODUCTS STILL RISKY?**

**by Padmalatha S.**

The recent sub prime crisis has been largely attributed to structured products in the form of securitizations, CDO pools and so on. Is structured finance really risky?

Year 2006 witnessed an innovative infrastructure financing deal in India. **Reliance Petroleum [RPL]** tied up an USD2bn dual tranche syndicated project financing with a group of 52 lenders that included Indian public and private sector banks, foreign banks and private equity firms. The facility is split into a USD1.26bn 7.5 year A tranche and a US\$733m 10-year B tranche. Tranche A pays a margin of 80bp over Libor for the first 48 months, while tranche B pays a margin of 85bp for that same period. For the remainder of its tenor, tranche A pays a margin of 140bp, while tranche B pays 165bp. The fixed and current assets form the security for the loans.

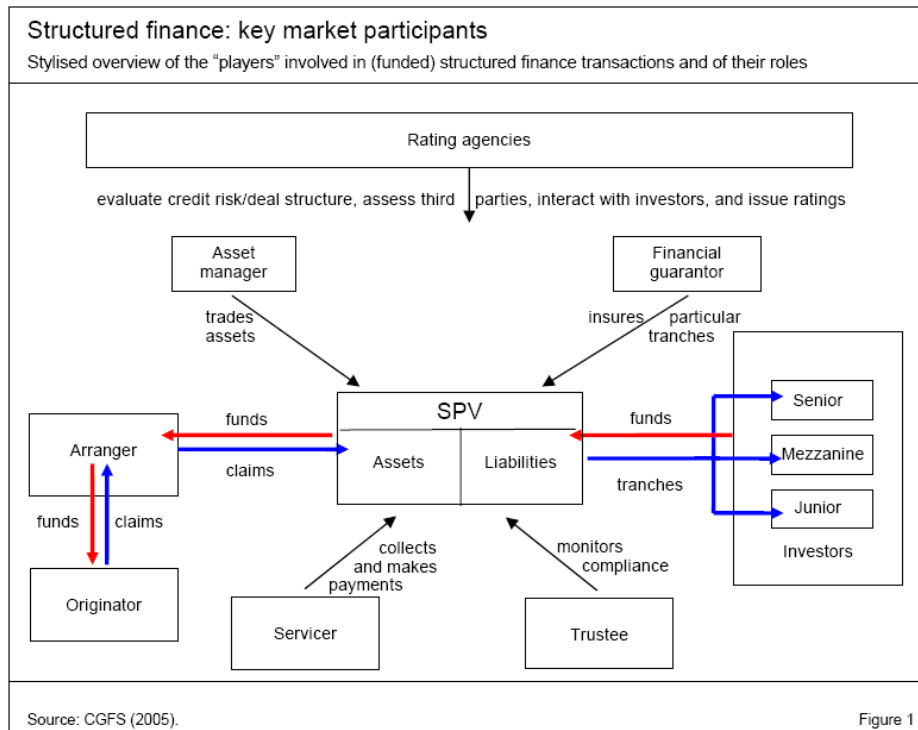
This innovative method of financing exhibited three features: pooling of assets, tranching of liabilities backed by the asset pool, and delinking of the credit risk of the collateral asset pool from the credit risk of the originator, through a stand alone, finite Special Purpose Vehicle [SPV]. The presence of these three features also signifies that the financing instrument was ‘structured’ to meet the unique needs of the project, which could not be met by an existing financial product or instrument. In short, the deal employed ‘Structured finance’.

Structured finance was becoming an increasingly important tool in financial markets both in the U.S. and Europe, as well as in most markets in Asia-Pacific, with issuance levels growing at extraordinary rates in the few years just before the financial crisis hit.

The growth of structured finance is spearheaded by the evolution of:  
 a) Traditional asset backed securitization pools; and b) CDO pools.

### Value creation in Structured finance

The figure below illustrates value creation for market participants and stakeholders?:



Source: Bank for International Settlements

It can be seen from the above pictorial depiction that each of the three key characteristics of structured finance contributes to value creation for various participants and stakeholders. For example, income streams from ‘delinked’ assets will tend to be more predictable than those of an ongoing firm, while conferring benefits similar to those of secured credit.

How do ‘pooling’ and ‘tranching’ add value? Let us start with a simple home loan of Rs 10 lakhs, with a 20 year repayment period and 10% interest. The bank creates the home loan with proper documentation and due diligence, and then pools this loan with similar home loans – same interest rate, maturity, etc – to create one giant pool. This process of pooling assets can occur with literally anything that has a cash flow – account receivables, loans or bonds- which can be pooled and carved into separate bonds or cash flows.

Assume a pool is created with 1000 such home loans, of which 10 borrowers eventually default. The basic investment concept of diversification would tell us that a few defaults would not impact the overall performance of the entire pool, since there are still 990 borrowers making timely payments. However, what happens when there are more problem loans, say 100? This is where 'structured finance' would add value. The bank would create different bonds from the large pool and allocate payments to these different bonds at different times, and at different rates!

This process is called 'tranching'. For all practical purposes, each of these "tranches" is a bond. Typically, three types of bonds are created from these pools. The riskiest, usually called an equity bond, bears most of the losses when there are problems with the underlying pool – in other words, this portion of the bond will absorb all the losses caused by default in the 100 loans in the above example. As a result, the other two bonds are still receiving their regular payments. Let us now assume the number of defaults increases to 20 percent, or 200 borrowers in the pool are not making payments. The investment bank or the entity managing the pool will now allocate most of the losses to the equity bond, but will also allocate any spillover losses to the next riskiest bond in the structure - the mezzanine bond.

Finally, there will be bonds which receive regular cash flows- these are the least risky because they are the last to be hit by defaults. These are investment grade bonds, which by the concept of diversification will usually not experience any problems.

Summing up, we have two methods to diversify the risk from the underlying loans - the first by pooling a group of assets into a larger, single pool, thus limiting the impact of a few defaults, and the second by allocating the default risk to specially 'customized' bonds that absorb the losses, protecting the senior, higher rated bonds. Thus, 'asymmetric information' and 'market segmentation' are seen to play important roles in structured finance.

### **Role of ratings in structured finance**

Due to the complexity involved, structured finance is largely a 'rated' market. With the growth in the market, structured finance ratings are now among the largest and fastest growing business segments for the world's three leading credit rating agencies – S&P, Fitch and Moody's – contributing to about 40-50% of their total revenues.

### **The flip side of structured finance**

It has to be understood that structured finance is 'complex'. Pooling and tranching, the key value creators in structured finance, could also be its sources of risk. For instance, a prerequisite for pooling is evaluation of the risk and return of a structured security. This implies modeling the loss distribution of the underlying asset pool, whose complexity multiplies as the heterogeneity of the assets in the pool increases. Further, tranching could add another layer to the analytical complexity, since cash flows from the asset pool have to be estimated with some accuracy. Hence, 'mark to model' risks cannot be ruled out.

The features of structured finance are defined through covenants, which spell out the terms and conditions for allocation of cash flows from the asset pool, as well as the rights and duties of various parties involved in the transaction. This can lead to 'non default' risks – that is, risks not

related to defaults in the asset pool, but which nevertheless affect the credit risk of the issued tranches, say, conflicts of interest among tranche holders could be a source of non default risk. The other parties involved in the transaction could also pose non default risks. For example, servicer performance is of paramount importance for traditional ABS instruments. Losses could be substantial if the servicer performance is not robust, coupled with legal and default risks that could be spin off risks.

To structure complex deals, high transaction costs are involved, as can be seen from the variety of participants and specialized services required. This could lead to market imperfections. Another important source of market imperfection could be the agency cost. For example, equity holders can influence initial portfolio selection, sacrificing credit quality in exchange for increased upfront yield payments. However, structured finance market has potential to grow...

Unperturbed by the fallout of the recent US sub-prime crisis globally, India's structured finance market, wherein banks and other entities arrange funds by partly selling their loan books, has more than doubled in 2007 reaching \$14.6 billion. This growth, reported by Moody's Investors Service and ICRA, have also said this segment is likely to witness another year of growth. One reason for this is the implementation of Basel II at banks, who expect capital relief due to treatment of securitized assets by the international framework.

India's gains contrasted with more developed economies where markets shrank because of losses linked to the U.S. subprime crisis.

#### **In conclusion...**

While structured finance instruments are capable of contributing positively to market completion and diversification of credit risk, they are also seen to have potential negative implications for overall financial stability. The recent developments in the markets have led to pointed questions on whether adding structured instruments to an institution's portfolio might lead to unexpected concentration of risk, or whether ratings are effective in defining maximum levels of risk. However, as the need for financing complex deals grows, new structures and asset classes have to be introduced. Provided the challenges are understood and tackled by policy makers and market participants, and maximum disclosure is ensured, the rapid evolution of structured finance markets would only lead to more sophistication in financial markets, and ultimately contribute to economic growth and financial stability

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### **Services offered by DMS Financial Services Co. (P) Ltd.**

- **Outsourcing in the financial function**
- **Placement of human resources in the BFSI and finance functions**
- **Training in finance, sales, operations and soft skills**

**For details, please contact Mr.Karthi on 044-24995672.**