

# Principles and Practice of Life Insurance



*Committee on Insurance and Pension*  
**The Institute of Chartered Accountants of India**  
New Delhi

This Publication has been prepared for use by the members of the Institute. The views expressed herein do not necessarily represent the views of the Council of the Institute.

© The Institute of Chartered Accountants of India, New Delhi

All rights reserved. No part of this publication may be reproduced, stored in retrieval system or transmitted, in any form, or by any means, electronic, mechanical, photocopying, or otherwise, without permission, in writing, from the publisher.

Month and Year of Publication

First Edition : October, 2003

Second Edition : February, 2005

Third Edition : July, 2005

Fourth Edition : October, 2008

E-mail : [insurance@icai.org](mailto:insurance@icai.org)

Website : [www.icai.org.in](http://www.icai.org.in)  
: [www.insuranceicai.org](http://www.insuranceicai.org)

Price : Rs. 250/-

ISBN : 978-81-8441-083-9

Published by : The Publication Department on behalf of Dr. T. Paramasivan, Secretary of the Committee on Insurance and Pension of the Institute of Chartered Accountants of India, 'ICAI Bhawan', Indraprastha Marg, New Delhi-110 002.

Printed at : Repro India Ltd., Plot No. 50/2, T.T.C. MIDC Industrial Area, Mahape, Navi Mumbai 400 710  
October/2008/2000 copies.

This book is a Study Material for Paper-1 of the DIRM Course of the Institute of Chartered Accountants of India, covering Life Insurance portion of the syllabus. For General Insurance portion (of Paper 1), the members may refer the book entitled 'Principles and Practice of General Insurance'

# FOREWORD

A successful insurance sector is fundamental to every modern economy since it encourages the savings habit as well as provides a safety net to rural and urban enterprises and productive individuals. The global and national insurance sector provides enough role to play by the members – both in practice and in service – of the Institute in view of their established brand in India as Complete Business Solutions Provider. With an objective to develop the width and depth of the professional reach, members of the Institute are being groomed to enter the insurance field with appreciable level of technical and practical acumen for which our profession is known for during all these years.

The fact that the Government of India has duly recognised our Institute by nominating the President in office as a member in the Insurance Regulatory and Development Authority of India clearly vindicates the emerging importance of our profession in this most dynamic field. Multi-pronged strategies are being adopted by the Institute such as the introduction of Post Qualification Course in Insurance and Risk Management (DIRM) to facilitate the members and students to acquire the technical and practical knowledge in the field of insurance.

The Committee on Insurance and Pension which administers the DIRM course has completely revised the DIRM Study Materials as a measure to provide the latest possible technical inputs for the members who are pursuing that Course. The material has brought out to enable other members of the Institute – who are not pursuing the DIRM course – to develop expertise on the key areas of insurance and pension fields.

I appreciate the efforts put in by Chairman, CA. Pankaj Jain and other members of the Committee. I wish that the members at large should make use of this material to the maximum possible extend in the overall interest of the stakeholders of our profession.

**(Ved Jain)**  
President



# PREFACE

With the appreciable level of contribution by insurance funds to financial savings and the GDP of India, development of insurance is necessary to support continued economic transformation of our country. Insurance is very necessary to protect enterprises against various risks.

It is our sincere belief that to enable the members of the Institute to play an appreciable level of role in the insurance and pension sectors, they need to be provided with a general framework for thinking about the effects of risk and a broad knowledge of risk management and insurance. They need to be aware of the many public policy issues related to risk, including legal liability and economic security issues apart from strong conceptual foundation for understanding institutional details.

I wish to take the pleasant privilege of presenting before the members of the Institute the revised study materials for the Institute's Post Qualification Course on Insurance and Risk Management (DIRM). The study materials have been grouped and brought out in such a way that members of the Institute - apart from those who have registered for the DIRM course - could peruse these publications to acquire strong technical foundation in the areas of insurance and risk management.

I wish to express my gratitude to the President of the Institute CA.Ved Jain and Vice President CA.Uttam Prakash Agarwal for their constant motivation to enable the Committee to move forward on its various endeavours. I wish to place on record my sincere thanks to the members of the Committee and Special Invitees on the Committee for their guidance and involvement in bringing out this publication. We are grateful to Mrs. V. Padmavathy of International Institute for Insurance and Finance, Hyderabad for preparing the basic draft of this material and Shri Krishnan of Hyderabad for reviewing the materials.

It is my sincere hope that the members of the Institute would find the contents of the book professionally enriching. With humility I invite your constructive comments to further improve the contents of the book.

**(CA.Pankaj Jain)**

Chairman,  
Committee on Insurance and Pension



# CONTENTS

*Foreword*

*Preface*

|                   |                                                      |     |
|-------------------|------------------------------------------------------|-----|
| <b>Chapter 1</b>  | : Introduction to Insurance                          | 1   |
| <b>Chapter 2</b>  | : The Fundamental Legal Principles of Life Insurance | 20  |
| <b>Chapter 3</b>  | : Pricing Elements                                   | 43  |
| <b>Chapter 4</b>  | : Underwriting                                       | 50  |
| <b>Chapter 5</b>  | : Life Insurance Products                            | 67  |
| <b>Chapter 6</b>  | : Social Security Schemes                            | 100 |
| <b>Chapter 7</b>  | : Group Insurance                                    | 127 |
| <b>Chapter 8</b>  | : Financial Gerontology and Super Annuating Policies | 147 |
| <b>Chapter 9</b>  | : Distribution Channels of Life Insurance            | 166 |
| <b>Chapter 10</b> | : Claim Settlement                                   | 179 |
| <b>Chapter 11</b> | : Lapsation and Revival of Life Policies             | 207 |
| <b>Chapter 12</b> | : Actuarial Valuation                                | 222 |



# Insurance

## CHAPTER – 1

### INTRODUCTION TO INSURANCE

#### OUTLINE OF THE CHAPTER

- What is insurance?
- Main characteristics of insurance
- Probability theory and dual application of law of large numbers
- Essential features of an insurable risk
- Insurance and wager
- Insurance and hedging compared
- Classification and types of insurance
- Economic basis of life and health insurance
- Costs and benefits of insurance to society
- Summary
- Questions

#### **LEARNING OBJECTIVES**

After reading this chapter you should be able to

- Define insurance and enumerate its main characteristics
- Describe the law of large numbers and explain its dual application in insurance
- Mention the requirements of an insurable risk
- Describe the types of insurance
- Describe the economic basis of life and health insurance
- List out the benefits and costs of insurance

Humans have always sought security. Families, clans, tribes and other groups were the outcome of the motivating force to get security in olden days. Even today groups exist may be employer, government, or an insurance company and the concept is the same. The physical and economic security formerly provided by the tribe or extended family diminished with industrialization. Insurance is the more formalized means to mitigate the adverse consequences of unemployment, loss of health, death, old age, law suits and destruction of property.

The insurance industry occupies a very important place among financial services all over the world. Today insurance affects people from all walks of life. Individuals as well as business firms turn to insurance for managing various risks. Everyday new coverage is added to the existing policy. The expanding scope of insurance highlights the growing importance of insurance to individuals and organizations alike. A proper appreciation of what insurance is and what it can do to help an individual or an organization is therefore necessary.

## **1. WHAT IS INSURANCE?**

---

Insurance can be defined as a contract between two parties, where one promises the other to indemnify or make good any financial loss suffered by the latter (the insured) in consideration for an amount received by way of 'premium'. In other words, the party agreeing to pay for the losses is the 'insurer'. The party whose loss makes the 'insurer' pay the claim is the 'insured'. The consideration involved in the contract or what the insured pays to the 'insurer' is called premium. The contract of insurance is referred to as the 'policy'.

Losses cannot be determined before hand, but certainly can be reimbursed if and when they occur, by insurance. For this, people facing common risks come together and contribute a fixed amount towards a pool, out of which they are reimbursed if and when loss occurs. This point can be made clear with the help of the following example:

If there are 100 houses in a locality each of the value of Rs. 2,00,000 and every year one house gets burnt down or destroyed, then the 100 owners will have to contribute an amount of Rs. 2,000 each to create a pool in order to be able to reimburse the loss amounting to Rs. 2,00,000 faced by the one unfortunate owner amongst them.

An asset of any nature that is the outcome of the efforts of the owner has an economic value and any damage that occurs to the asset making it non-functional in turn leads to a loss where the owner cannot derive benefits that he was enjoying earlier. Thus, it becomes necessary to replace or repair such an asset for the continued benefit of the owner. Every individual is endowed with a potential to earn. If he is disabled he cannot enjoy the same level of earnings. In the event of his death, his family suffers loss of earnings. It is in this context insurance assumes importance. If the asset had been insured, or the individual's life and earning capabilities are insured, then any loss or damage to the asset or to him would not affect the lifestyle of the owner or his dependents to a very great extent. The owner/individual may suffer a loss, but it is made good by the insurer as the owner/individual by getting his assets or himself insured, is transferring the loss to the insurer thus making him liable to reimburse it.

Insurance is therefore, from the point of view of an individual, a financial arrangement whereby the individual can substitute a relatively small definite cost (premium) for a large uncertain financial loss. The predictability of a loss forms the base of an insurance system.



## 2. MAIN CHARACTERISTICS OF INSURANCE

From the definition of insurance and the example given above, the following Important points relating to an insurance plan emerge:

- Pooling and risk reduction
- Payment of accidental and unintentional losses
- Transferred risk
- Principle of indemnity

### 2.1 Pooling and risk reduction

Pooling of losses means *the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss*. To accurately predict the future losses, exposure units in large numbers have to be grouped together to bring in the application of the law of large numbers. For this there has to be a large number of exposure units facing the same or similar kind of perils. In simple words, pooling in an insurance context implies two things:

- Sharing of losses by the entire group.
- Using the law of large numbers to predict future losses.

Loss sharing can be well understood with the help of the example already given where the house owners of a locality create a pool to reduce the burden on the owner in case of any damage to the house.

Also the future losses can be better predicted with the use of the law of large numbers. The use of the law of large numbers helps the insurer to minimise risk based on his experience.

**The law of large numbers** *states that the greater the number of exposures, the more closely will the actual results approach the probable results that are expected from an infinite number of exposures.*

This can be well understood by an example. While the probability of getting heads 5 out of 10 times by tossing a coin in the air is exactly half, it is not necessary that heads will appear 5 times only, it can appear 8 times also. However, as the number of tosses increases, the probability of heads and tails appearing equal number of times increases. Insurance is a business based on the previous experience of damage and loss. Actual loss comes close to estimated loss where the number of assets/individuals exposed to similar risk is large. The law of large numbers gains importance here since the amount of premium to be charged depends upon the expected loss, which should enable the insurer to meet all the expenses and claims that arise and also allow for reasonable profit.

### 2.1.1 Special note on probability theory and the law of large numbers

Probability refers to the numerical value assigned to the likelihood of occurrence or non-occurrence of an event and then predicting a future event. The theory assumes that though an event happens at random, it actually occurs in a regular pattern when a large number of trials are made. An event sure to occur has the probability value of 1 and the impossible event has the probability of 0. Thus the event with values nearer to 0 are least likely to happen and that events assigned a probability closer to 1 are most likely to happen. Thus probability always varies between 0 and 1.

Interpretation of probability: Probability is interpreted in two ways. (i) The relative frequency interpretation where the probability of an event is based on the repetition of an event occurring over a large number of trials. (ii) The other interpretation is subjective interpretation. This involves the degree of belief in the occurrence of an event. For example the chance of a scholar getting a job may be assigned 0.8 or even 0.2 based on different degrees of belief.

#### Determining the probability of an event

In relative frequency, probability is computed in two ways. First a prior probability that is based on underlying conditions causing an event. E.g. probability of a coin showing head when tossed is 0.5 or  $\frac{1}{2}$ . The coin is assumed to be balanced and that there are only two possible outcomes, which are equally likely to occur.

However this concept is of least relevance for a single trial. It is useful only when it involves a large number of trials. This is referred to as the law of large numbers, which states that the observed frequency of an event more nearly approaches the underlying probability of the population as the number of trials approaches infinity.

A prior method is not widely applicable because determining causality is rather impractical. Here the second approach of probability, which, is based on secondary data, is used. When the underlying probability of an event is unknown, this concept of posterior probability is used. e.g. the probability of an immunised child suffering a measles attack is 0.002. It implies that there was a survey on children affected by measles and the result shows that out of 1000 immunised children only 2 were affected by measles.

After considering the frequency of occurrence of various events under constant conditions over a long-term, an index is prepared of related frequency of each possible outcome. This index is termed as probability distribution. The probability of an event is estimated by the average rate of expected occurrence of an outcome.

We also use sampling a statistical technique, to estimate the probability relating to a population. When population is too large we take a portion of it, called sample, and



apply the estimate to the entire population. The larger the sample size, the more reliable will be our estimate.

## Dual application of law of large numbers

We have seen the role of the law of large numbers in sampling. We can also observe that not only we have close estimates of probability when large samples are used but also these estimates are not applicable to small sample sizes. We cannot take the deviation of 6% to be the same for the sample size of 1000 and 10,000. Thus the law of large numbers has dual application.

- large samples give accurate underlying probability
- this probability estimate must be applied to a large sample size, for the probability estimate to work itself.

So, the insurance company measures its risk based on the potential deviation of expected results from the actual. It reduces its risk to the extent of accuracy in its prediction. However, probability theory is important only when the insurance company is required to work on advance premium basis.

## 2.2 Payment of accidental and unintentional losses

Insurance deals with covering of losses, which are accidental in nature. The insurer should cover all unexpected and unforeseen losses, which occurs at random. To put it differently, the loss should be an accidental one and a result of chance and not deliberately caused. A person may fall while descending some steps and break a limb. Such a loss would be an accidental loss and hence covered under insurance.

## 2.3 Risk transfer

The contract of insurance is one where the risk of one party is transferred to the other, who is the insurer who is usually in a stronger position financially and can easily make good the loss of the insured. Risks of death, illness, theft, etc. are all examples where the risk of the insured can be transferred to the insurer. Thus the most commonly adopted form of risk transfer is insurance.

## 2.4 Principle of indemnity

Life insurance is not a contract of indemnity. But property insurance or personnel accident insurance contracts are contracts of 'indemnity'. Indemnity merely means to make good any financial loss suffered by the insured and to put him or her back in the same financial position as he or she was before the occurrence of the loss. It is the duty of the insurer to make good the loss suffered so as to enable the insured to again derive the benefits from the insured assets as he used to earlier. An example is the Householders Insurance policy where the insurer pays the actual loss to the policyholder in case of any theft or damage that has been caused to his household appliances or gadgets covered under the

policy. In accordance with this principle, the insured cannot claim more than the actual loss caused to an insured risk.

### **3. ESSENTIAL FEATURES OF AN INSURABLE RISK**

---

Though insurers prefer insuring only pure risks, all pure risks cannot be insured. For risks to be insured, they should meet the essential requirements indicated below:

- As insurance is based on the law of large numbers, it is necessary that there are a large number of similar exposure units, which makes possible prediction of future losses?
- The loss that may be caused must be measurable in financial terms.
- The loss caused should be the result of an accident or a fortuitous event in nature.
- Ideally, the loss should not be catastrophic (i.e. affecting a large number of exposure units at the same time). Insurance assumes that out of a large population only a small percentage of people will incur loss at one time. This is necessary; otherwise the pooling technique will not work. In reality though, catastrophic risks are insured.
- It should be possible for the insurer to calculate the chance of loss with a reasonable degree of accuracy, as this is a major consideration in determining premium.
- The premium fixed for the risk should be affordable. If the premium is too high, the insurance will not be appealing to prospective customers.

### **4. INSURANCE AND WAGER**

---

Gambling also known as wager is betting on chance and is highly speculative. One of the wagering parties loses whatever the other person wins from a wager. Before entering into a wager there is no chance of loss and therefore no risk. As soon as a wager is made a new risk of the prospect of losing the wager is created.

On the contrary, in case of say a fire insurance the risk already exists and no new risk is created. When insurance is affected all that happens is payment of the determined premium by the proposer and acceptance of risk by the insurer. In other words no new risk is created but an existing risk is transferred to the insurer through an insurance contract.

It is also relevant to note that insurance serves a socially relevant purpose as both the insured and the insurer have a common purpose namely loss prevention. It is a win-win case when no loss occurs. Even when loss occurs the insured is restored to his original situation financially in accordance with the terms of the contract. On the other hand, in gambling the loser is not indemnified under any circumstances.



Features common to gambling and insurance are:

- Promise of payment on the happening of a certain event.
- Amount receivable not commensurate or proportional to the amount Paid

## **5. INSURANCE AND GAMBLING**

---

- An insured must have an insurable interest in the subject matter of a contract of insurance, which is not required in the case of a wager, where the interest is only restricted to the stake won or lost.
- An insurance contract is guided by the principle of utmost good faith, which is not required in the case of a wager.
- The insured event may or may not take place in the case of insurance (except life insurance). But in case of a wagering agreement the event takes place at a fixed future date.
- Insurance is based on mathematical predictions but gambling is highly speculative in nature.
- Insurance is enforceable by law whereas in gambling none of the parties has any legal remedy.

## **6. INSURANCE AND HEDGING**

---

Hedging is a process where risk is transferred to a speculator through ways like purchasing a futures contract. Though insurance is not hedging, one similarity that can be drawn between the two is that an insurance contract is used to transfer the risk, without creating any new risks.

Some distinctions that can be drawn between the two are:

- the risk that can be transferred in insurance is an insurable risk; in the case of hedging, the risks are uninsurable.
- by application of the law of large numbers, the insurer can reduce the risk, whereas in hedging risk can only be transferred and not reduced.

## **7. TYPES AND CLASSIFICATION OF INSURANCE**

---

In some of the foreign countries insurance is classified under following categories:

Government

- Social security
- Unemployment

Private

- Life
  1. Life
  2. Health
  3. Annuity
- Non-life
  1. Property
  2. Liability
  3. Miscellaneous

Government insurance programs are the insurance programs, which are carried out by the government. It can be classified further into social insurance and other Government Insurance. Social insurance is a specialized government insurance largely financed by the compulsory contributions from the employees. Since the employees make the contributions, they are entitled to benefits whether the need arises or not. The examples of social insurance are old age, survivors and disability insurance, Medicare, workers compensation insurance, compulsory temporary insurance, retirement etc.

Private insurance is classified into life insurance and non life insurance. Life insurance aims at providing financial security to the individuals and their dependents. The risk covered here is death in case of life insurance, sickness and disability in case of health insurance. Annuity, on the other hand provides financial assistance to old persons with no earnings to meet their daily requirements. So, the risk covered here is survival.

Non-life insurance refers to the property, liability and miscellaneous insurance, which are covered in the Module II.

In the Indian context, insurance can be broadly classified into:

- Life insurance
- General insurance

## **Life insurance**

Life insurance deals with the insurance of individuals, groups, and pension plans. Since 1st September, 1956, transacting life insurance business in India was the exclusive privilege of the nationalised insurance company viz., LIC. However, with the passing of the IRDA Act, 1999, the life insurance sector has been thrown open to private players



Types of life insurance plans offered in our country:

- Term assurance plans
- Whole life plans
- Endowment assurance plans
- Assurances for children
- Family income policy
- Joint life assurance
- Health insurance benefits (Asha Deep II and Jeevan Asha II)
- For handicapped dependents (Jeevan Adhar)
- Pension plans
- Unit linked plan (Bima Plus of LIC)

A life insurance policy that provides coverage for the whole of the insured's life is called Whole Life insurance. A policy that covers a set time period, such as five or ten years, is called Term life insurance. Endowment policies are also term policies but the difference is it pays benefits when the insured dies during the policy term and pays benefits if the insured survives the policy term. And Annuity contracts promise to pay the insured a periodic payment.

Health insurance is a contingent claim contract on the insured incurring additional expenses or losing income because of incapacity or loss of good health. Payment becomes necessary because physical or mental incapacity prevents the insured from being able to work is called Disability Income Insurance. If the incapacity prohibits the insured's activities of daily living, it is called Long term care insurance. If the insured incurs hospital, physician, or other health care expenses it is called medical expense insurance. In India, only medical expense insurance is available.

### **A few differences between life insurance and general Insurance**

- The risk namely 'death' is certain in life insurance. The only uncertainty is as to when it will take place, whereas in general insurance, the insured event may or may not take place.
- A life insurance contract is a long-term contract, while general insurance contract is a one-year renewable contract.
- It is difficult to determine the economic or the financial value of life, whereas the financial value of any asset to be insured under a general insurance policy can be determined.
- The life insurance contract is not a contract of indemnity. The general insurance contract is a contract of 'indemnity' where the exact value of loss is reimbursed. (Personal accident insurance being an exception)

- The Premium charged under a life insurance policy is based on a mortality table, but the premium for a general insurance policy is calculated on the basis of past loss experience, probable risk factors and fixed Tariff plan.

### **Classification of life and health insurance**

**Group Insurance** – Group insurance is a means through which a group of persons, who usually have a business or professional relationship to the contract owner, are provided insurance coverage under a single contract. Generally it is provided by employers for the benefit of their employees. Creditor – debtor groups like the loanees of a housing finance company and miscellaneous groups like professional associations, religious groups, customers of large retail chains, and savings account depositors, poorer sections of the society, landless agricultural workers also can avail the benefits of group insurance.

**Ordinary – individually issued policies** – The great majority of policies fall within the ordinary category.

**Industrial Insurance** – it includes life and health insurance policies issued to individuals in small amounts, with premiums payable on a weekly or monthly basis. These policies are not popular in India.

**Credit insurance** – This is issued through lending institutions to cover debtors' obligations if they die or become disabled.

## **8. ECONOMIC BASIS OF LIFE AND HEALTH INSURANCE**

---

Any kind of loss due to death or disability of the earning member or the breadwinner leads to a decrease or termination of regular income besides any future income that he would have been able to earn, had normal circumstances prevailed.

The main function of life insurance is to provide protection to the family, by ensuring continuity in income even after the death of the breadwinner.

Economists have for long acknowledged the fact that people are an important part of a nation's wealth. Although they cannot be held similar to marketable assets like property, they are nevertheless assets and their economic value, is dependant on their knowledge and skills. They represent the human capital of the country. It is the presence in abundance of the human capital, which makes certain countries of the world more advanced than others.

A noteworthy feature of our present day economic system is the huge growth in human capital largely due to education, which is an investment in human capital. Human capital represents the production potential of an individual. But by human life value we mean the actual future earnings of an individual. To be precise human life value is the capitalised value of a person's net future earnings reduced by the cost of the man's own maintenance expenses. This is the value of the bread earner as far as



his dependants are concerned and should ideally be the value of the insurance the bread earner should have. Thus, the Human Life Value concept propounded by S.S. Huebner became the economic foundation of life insurance. This concept received wide acceptance and it is quite different from the earlier held view that life insurance meant only payment of a certain amount on death arbitrarily determined at the time of insurance without regard to the need of dependants. The emergence of Human Life Value concept and other such concepts acknowledged the importance of professional counselling in the buying and selling of life insurance.

Let us now determine the different economic uses life insurance offers:

- Life insurance makes the family financially secure after the untimely death of the breadwinner.
- Life insurance is also a savings instrument.
- Life insurance helps in meeting responsibilities of people even after death like higher education of children, their marriages, etc.
- Helps in repaying the mortgage loans by acting as a collateral security.
- Life insurance also provides old age benefits, which can be had in the form of annuities or a lump sum after retirement.
- Creditors can also use it in case the debtor dies without repaying the loan amount by getting the lives of the debtors insured, where the policy money or the sum assured will belong to the creditor in case of non-repayment.
- Partners of a partnership firm can get the lives of the partners insured in order to repay the share of the dead partner to the heirs.
- A firm can get the life of its key man insured as the death of the key man may cause the firm to suffer huge financial losses, and this money so got can be used to recruit a new person in place of the deceased employee and also meet the losses during the transitional period (i.e. from the time of death of the key person till the recruitment and training of a new employee).
- Group insurance policies can also be taken as a welfare measure on the lives of the employees as a whole, improving and boosting the morale of the employees resulting in improved productivity.

As with all other products and services that are bought, sold, or traded, life and health insurance is subject to the laws of supply and demand. As with most other products and services, it is reasonable to assume that the higher the price, less will be demanded and more will be supplied, and vice versa.

## **Demand for and supply of life and health insurance**

Demand for life and health insurance is influenced by

- **Human life Value:** HLV is the capitalized value of an individual's future net earnings after subtracting self-maintenance costs. An individual's HLV is the measure of the value of benefits that the dependents can expect from their breadwinner or supporter.
- **Individual's work and leisure:** Economic theories of consumption seek to explain consumer consumption and saving behavior over one's lifetime. These theories explain the purchase of life and health insurance—Insurance purchases reduce current consumption [by virtue of the premium payment] to protect the later consumption- ability of individuals or their dependants.
- **Human needs** – Mc gill segmented the needs that determine the demand for insurance as
  - a) clean up fund [nurses, doctors' bills, burial expenses, legal fees etc.]
  - b) Readjustment shock
  - c) Critical period income for children
  - d) Life income for surviving dependant spouse
  - e) Special needs [mortgage redemption, educational needs, emergency needs]
  - f) Retirement needs

## **Factors which influence the supply side of life insurance**

- Risk bearing capacity of insurer
- Price of the product
- Technical expertise
- Capital
- Management capabilities.

The economic bases of demand for and supply of insurance determine how much life and health insurance should be carried like any other product.

## **The production of life and health insurance**

The production of insurance services—as with other financial services—relies on financial and human capital. The most important operations in the production process include—



- **Insurance pricing** – product is priced before actual production costs are known. Actuaries determine insurance premiums and necessary reserves using their best estimates of future losses and expenses.
- **Underwriting** – underwriters determine whether and on what terms to issue a requested insurance policy.
- **Claims handling** – claims personnel negotiate and settle claims.
- **Investment management** – life insurers manage significant investment portfolios to maximize risk-adjusted investment returns because this can be a major factor in determining product competitiveness and profitability.
- **Financial management** – financial management requires decisions on investment quality and quantity, including asset\liability matching and diversification.
- **Distribution** – insurers sell insurance in one or a combination of three ways: 1. Through direct response. 2. Through agents. 3. Through banks

Though there are many changes in insurance practices over a period of time, the fundamentals of risk and insurance however do not change. But our understanding of them deepens with time.

## **9. BENEFITS DERIVED BY SOCIETY THROUGH INSURANCE**

Some of the benefits derived by society through insurance are given below:

- Reduces worry and fear
- Makes available large funds for investment at low cost
- Provides employment to a large number of people
- Insurance enhances credit worthiness and reduces credit risk
- Invisible earnings
- Social benefits

### **9.1 Reduces worry and fear**

Insurance helps in reducing the anxiety and fear before and after the loss occurs, as it is known that the insurance company will compensate the loss. Even large insurance companies gain peace of mind by reinsuring their extra risk. This way they can perform better in their operations.

### **9.2 Makes available funds for investment**

Insurance industry is a major provider of capital for business and industry. The funds of insurance companies are also available for national development activities.

Details of LIC's socio purposive investments given in a separate box tell the story of how its funds have been put to use in developing the infrastructure in the country.

## People's money for people's welfare

The following chart amply illustrates how the funds of insurance companies can be utilised for nation building activities. It is truly a case of 'peoples' money being put to use for the welfare of the people.

## LIC'S Investments – Some Highlights

| Investments Upto<br>(Rs. in crores)                           |             |               |               |
|---------------------------------------------------------------|-------------|---------------|---------------|
| Type of investment                                            | 31.3.1977   | 31.3.2002     | 31.3.2007     |
| 1) CENTRAL GOVT. SECURITIES                                   | 981         | 109938        | 272498        |
| 2) STATE GOVT. & OTHER GOVT. GUARANTEED MARKETABLE SECURITIES | 715         | 21463         | 64285         |
| 3) ELECTRICITY (SEBs)                                         | 733         | 13447         | 37881         |
| 4) HOUSING                                                    | 618         | 19054         | 22451         |
| 5) WATER SUPPLY AND SEWERAGE                                  | 203         | 4000          | 7500          |
| 6) STATE ROAD TRANSPORT CORP.                                 | –           | 893           | 1516          |
| <b>MISCELLANEOUS</b>                                          |             |               |               |
| 7) POWER GENERATION (PVT. SECTOR)                             | –           | 3797          |               |
| 8) LOANS TO INDUSTRIAL ESTATES                                | 31          | 768           | 4398          |
| 9) LOANS TO SUGAR CO-OPERATIVES                               |             |               |               |
| 10) DEVELOPMENT AUTHORITY                                     |             |               |               |
| 11) ROADWAYS, PORT, RAILWAYS                                  |             |               |               |
| 12) MUNICIPALITIES                                            |             |               |               |
| <b>TOTAL</b>                                                  | <b>3281</b> | <b>173360</b> | <b>410529</b> |

Source: LIC Diary 2008

## 9.3 Provides employment to a large number of people

Insurance industry offers regular full-time employment to a large number of people in the country. Besides, a number of agents, professionals like actuaries, accountants, brokers, medical examiners, legal advisors etc., are also engaged by the industry to render professional services. LIC, the leading life insurance company in the country alone has more than one lakh officers and employees and over 8 lakh agents.



## **9.4 Insurance enhances credit worthiness**

Life insurance policies are often offered as collateral security for credit. Property insurance affords protection to the lenders' financial interest. It is not unusual for lenders to insist on insurance for business assets such as plant, machinery, vehicles, inventory etc. Thus, insurance enhances the amount of credit that can be secured against assets.

## **9.5 Invisible earnings**

In the way risk is spread within the country, it can also spread among the countries. The benefits derived by a country through such spread of risk widely are termed as invisible earnings. England acting as a centre of international widely insurance is a good example of this. U.K. insures overseas risk and the earnings from these transactions, after meeting the costs, represent invisible earnings for the country.

## **9.6 Social benefits**

From all the above benefits we derive social benefits. People with secured jobs and peaceful mind tend to carry on their operations properly and in a better way. This contribution to the economy as a whole is valuable. It ensures that unnecessary economic hardships are avoided.

## **10. COSTS OF INSURANCE TO SOCIETY**

Though insurance provides vast benefits to individuals and society, it carries some social costs that must be realized. Heavy expenditure is incurred in running of insurance companies, which are increasing over time. This results in scarce economic resources being diverted for the development of insurance industry.

Besides, insurance sometimes has the effect of encouraging unscrupulous individuals to resort to fraud, which is a heavy cost to the companies and the nation. Also, it has now become increasingly common to make highly inflated claims particularly in motor insurance and health insurance to cover 'deductibles'. This results in heavy underwriting losses to insurance companies who are forced to raise premiums. In our own country, most of the nationalized insurance companies all along have been incurring heavy underwriting losses. The huge increase in motor insurance and health insurance premiums is a direct result of this factor. The costs of insurance thus also include:

- Fraudulent claims
- Inflated claims

## Scope of coverage of risks

Consistent with the principle of 'identity of minds' in an insurance contract, it is necessary that the extent of cover a policy offers be clearly known to both the insurer and the insured. Based on the understanding, the insured may seek additional coverage to fill gaps, if any, thus enabling the insurer to collect appropriate premium for the additional insurance required by the insured. However, unless the policy conditions provide otherwise, coverage will not be available in respect of loss caused under the following conditions:

- Loss resulting from the insured's own act
- Loss is the result of a criminal act on the part of the insured.

**Loss resulting from the insured's own act:** In life insurance, an act of suicide within a period of two years from the commencement of risk is not covered in many countries. In our own country in policies issued by LIC a 'suicide clause' is incorporated with policy conditions in terms of which the insurer is free from any liability (except to the extent of a third party's beneficial interest acquired in the policy for valuable consideration of which notice had been given in writing at least one calendar month prior to death) when suicide occurs within one year from the commencement of risk.

**Loss caused by a criminal act of the insured:** Yet another accepted principle of law is that a person cannot benefit by a criminal act. Killing husband to get policy monies is a moral hazard.

## 11. HOW MUCH INSURANCE DOES A MAN NEED?

---

It is true that the economic value of life is the very foundation of life insurance. However, life insurance should not be purchased as an indemnity to cover this economic value. On the contrary, life insurance should be purchased to cover particular needs that could not be met by other assets should death occur suddenly.

Given below is a typical list of post death needs for resources, which have to be met through life insurance planning.

1. Funds to cover immediate expenses after death. This includes medical expenses for terminal illness, expenses for the performance of last rites and religious ceremonies connected with death.
2. Funds for meeting expenses for education and marriage of dependant children.
3. Regular income fund for meeting the day-to-day expenses of dependant spouse and children.
4. Fund for paying off debts. This includes outstanding house mortgage loan dues, car loan and credit card dues and other miscellaneous dues.



## Summary

- Insurance is a financial arrangement for redistributing the costs of unexpected losses through a legal contract whereby an insurer agrees to compensate an insured for losses.
- The law of large numbers helps insurers to predict losses accurately. It states that the greater the number of observations of an event based on chance, the more likely will the actual result approximate the expected result.
- Every risk is not an insurable risk. The following are the essentials of an insurable risk:
  - The number of exposure units must be large
  - The loss must be accidental and unintentional
  - The loss must be measurable
  - It must be possible to measure the chance of loss
  - The premium must be fair and affordable by the policyholders.
- Insurance is different from gambling and hedging. Insurance deals with existing risk and involves a transfer of pure risk.
- Insurance has the following benefits
  1. Indemnifies losses
  2. Reduces worry and fear
  3. Low cost source of investment funds for industry
  4. Prevents losses
  5. Enhances credit worthiness
  6. Creates employment
  7. Provides invisible earnings for countries
  8. Offers social benefits

Insurance also entails losses due to

- i. Fraudulent claims
- ii. Inflated claims

## A. Case study- the story of a bachelor

Madhu was a young sales manager in an FMCG MNC in Delhi taking home a handsome salary. A bachelor, he maintained a high lifestyle and spent all the money he earned without a thought of saving. Among his acquaintances there was a highly successful LIC agent Mr. Jogender Singh who had been chasing him to book him for a policy and every time he raised the matter, Madhu always good-humouredly brushed him aside saying “I don’t need insurance because I have no dependants”. There was nothing Jogender Singh could do to prevail upon Madhu to insure himself.

### Questions on the Case



1. Do you agree with the view that a bachelor without dependants needs no insurance?
2. If you feel that he needs insurance, state the reasons in support of your view.



### Discussion Questions

1. Life insurance in short is concerned with two hazards that stand across the life path of every person ‘that of dying prematurely leaving the dependant family to fend for itself’ and ‘that of living too long without visible means of support’. Of the two hazards which is more serious and difficult to manage? Give your views with reasons.

### Questions

1. Define insurance.
2. What are the main characteristics of insurance?
3. Write a note on the essential features of an insurable risk.
4. State the law of large numbers and explain how it helps to estimate future losses.
5. Differentiate insurance from hedging
6. How does life insurance benefit society?
7. What do we mean when we say ‘cost of insurance’?
8. Is insurance different from gambling? Support your argument with relevant points.



## Multiple-choice Questions

1. The following is the similarity between insurance and gambling:
  - a) Promise to pay on the happening of an event.
  - b) The amount of loss to be paid is known beforehand.
  - c) Both the parties win on happening of an event.
  - d) Both are enforceable at law.

**Ans. (a)**

2. The principle of indemnity is not applicable to life insurance because
  - a) it doesn't meet the requirements of life insurance contract.
  - b) it is applicable to general insurance contract.
  - c) the monetary value of a person cannot be measured accurately.
  - d) none of the above.

**Ans. (c)**

3. Human Life Value forms the economic foundation of
  - a) Property insurance
  - b) Life insurance
  - c) Liability insurance
  - d) Miscellaneous insurance

**Ans. (b)**

4. Insurance business is based on
  - a) the theory of probability and law of large numbers
  - b) Parkinson's Law
  - c) Newton's law
  - d) Boyle's law

**Ans. (a)**

# Insurance

## CHAPTER – 2

### THE FUNDAMENTAL LEGAL PRINCIPLES OF LIFE INSURANCE

#### OUTLINE OF THE CHAPTER

- Introduction to the principles of insurance
- Distinguishing characteristics of insurance contracts.
- Fundamental principles of life insurance
  - The principle of utmost good faith
  - The principle of insurable interest
- Rules of contract construction
- Summary
- Questions and answers

#### LEARNING OBJECTIVES

- To develop a good understanding of the fundamental principles related to life insurance contracts
- The need for basic principles
- The importance of basic principles
- Use of the fundamental principles
- To determine the legal validity of insurance contracts with respect to basic principles

#### INTRODUCTION TO THE PRINCIPLES OF LIFE INSURANCE

A contract is defined as an agreement between two or more parties to perform or abstain from an act with an intention to create a legally binding relationship.

An enforceable contract must have the following requisites:

- Offer and acceptance
- Consideration
- Capacity to contract



- Prior consent of all the parties
- Legality of object

**1. Legal capacity** – The parties to the contract must be legally capable of making a contract. Incompetence in this respect suggests that one party could take unfair advantage, because of information asymmetries, of the other. In connection with the legal capacity for the contract, it is voidable if the applicant is

- A minor
- Intoxicated or under the influence of other drugs
- Mentally incompetent
- An enemy alien

A void agreement has no legal force or effect, whereas a voidable agreement is one that can be made void at the option of the innocent party.

**2. Mutual assent** – An agreement must exist based on an offer made by one party and an **acceptance** of that offer by the other party on the same terms. However, the process by which an insurance contract is somewhat different from that for other contracts. Most applicants for individually issued life and health insurance do not approach an insurance company seeking insurance. Instead, the applicant is usually first contacted by an agent, who solicits an application that is submitted to the insurance company.

**3. Consideration clause** – Consideration clause summarizes the factors that lead the insurer to issue the policy and represents the insured's part of the insurance agreement. It generally is a simple statement that the insured has completed an application and paid a premium in exchange for the company's promise to provide insurance.

**4. Legal purpose** – To be valid, a contract of insurance also must be for a legal purpose and not contrary to public policy. For example, gambling transactions are illegal and, therefore, unenforceable at law.

As per the Indian Contract Act, 1872, Insurance is a specialized type of contract where apart from the above essentials of a valid contract, insurance contracts are subject to additional principles. The business of life insurance aims to protect the economic value of the life of a person. Through a contract of insurance the insurer agrees to pay a defined amount of money or provide a defined service if covered event occurs during the policy term provided the policy owner or insured pays a stipulated consideration called the premium.

## DISTINGUISHING CHARACTERISTICS OF INSURANCE CONTRACTS

---

- a) Insurance contract is characterized as one of adhesion – terms and provisions are fixed by one party [the insurer] and, with minor exceptions, must be accepted or rejected *en totale* by the other party [prospective policyowner].
- b) Insurance contract is also conditional – insurer's obligation to pay a claim depends upon the performance of certain acts, such as payment of premiums and furnishing proof of death.[this is designed to protect insurer from moral hazard]
- c) Insurance contract is unilateral in nature – only one party, the insurer, gives a legally enforceable promise.
- d) Insurance contract is an aleatory contract – involves the element of chance, and one party may receive more in value than the other.

## FUNDAMENTAL PRINCIPLES OF INSURANCE

---

### 1. The Principle of Utmost Good Faith

#### 1.1 Introduction

Insurance contract is one of **utmost good faith**. The rule of **caveat emptor** [let the buyer beware] does not generally apply. This doctrine is supported by

- Representation through an application
- Concealment
- Warranty

#### *The application and its interpretation*

**An application** for life and health insurance is the applicant's proposal to the insurer for protection and is the beginning of the policy contract. The proposed insured is required to give accurate answers to questions in the application relating to his personal and family history, habits, employment, insurance already in force, and other applications for insurance that either are pending or have been postponed or refused etc. A failure to do so leads the insurer being *estopped* [i.e., prevented] from denying the correctness or truth of information in the application. Insurers place great reliance on this information to issue the requested policy. This principle of insurance stems from the doctrine of "Uberrimae Fides" which is essential for a valid insurance contract. It implies that in a contract of insurance, the concerned contracting parties must rely on each other's honesty.

Insurance contracts are different from other contracts. Normally the doctrine of "Caveat Emptor" governs the formation of commercial contracts which means 'let the buyer



beware'. The buyer is responsible for examining the good or service and its features and functions. It is not binding upon the parties to disclose the information, which is not asked for.

However in case of insurance, the products sold are intangible. Here the required facts relate to the proposer, those that are very personal and known only to him. The law imposes a greater duty on the parties to an insurance contract than those involved in commercial contracts. They need to have utmost good faith in each other, which implies full and correct disclosure of all material facts by both parties to the contract of insurance.

The term "material fact" refers to every fact or information, which has a bearing on the decisions with respect to the determination of the severity of risk involved and the amount of premium. The disclosure of material facts determines the terms of coverage of the policy.

Any concealment of material facts may lead to negative repercussions on the functioning of the insurance company's normal business. For instance life insurance companies normally segregate the quality of lives depending upon the state of health of the people. Healthy people are accorded a higher status in the table and different (lower) rates of premium are applicable to them since their risk of ill health is lower. If a person suppresses facts about his ill health and manages to buy a policy at rates applicable to the low risk group then other policyholders in the same group have to share his risk. This results in adverse selection.

Hence as per the principle of utmost good faith it is binding on the part of parties, the insured and the insurer, to expressly disclose all the relevant material facts pertaining to the contract.

This doctrine is incorporated in insurance law and both the parties are expected to adhere to a high degree of honesty. Based on such faith, the insurer and the insured execute the contract of insurance. Thus each party believes that on fulfillment of the conditions for which the insurance policy was purchased, the other party would perform his duties as promised by him.

Non-compliance by either party or any non-disclosure of the relevant facts renders the contract null and void.

## **1.2 Representation**

All disclosures relating to an insurance policy must be made at the time of entering into the insurance contract. The insurance company hands over the application proforma to the person buying insurance seeking complete details. The person has to mention his profession, income, age, family, history of family, general health, ailments suffered, medical reports, matters relating to conduct and character, any criminal record, etc.

Similarly in case of general insurance while insuring an asset all facts regarding the condition, frequency of usage, wear and tear that may have occurred have to be disclosed by the buyer.

These details given by the proposer known as **representations**, demand correct and full disclosure by the buyer of insurance.

Though it may not be possible in the proforma to ask all the required questions since the details vary from person to person, the insurance company determines the materiality of the given facts by exercising due diligence through proper scrutiny.

It is also open to an insurer to seek clarification regarding gaps in information to be furnished. If required, further enquiry is made. This is important, because based on this, the severity of risk is assessed and the amount of premium to be charged can be determined.

The application also mentions the stipulations and conditions which when fulfilled obligates the insurance company to fulfill its promises. It has to be noted that it is the duty of the insurer to inform and explain the insured about the working of those stipulations and broadly set the conditions in which the insurer may be relieved of such obligations to give the insured an idea about the performance of the contract. This helps in dispelling any misunderstanding or ignorance.

Of course certain information, which is normally assumed to be of common knowledge to everyone need not be disclosed. Thus while buying insurance for an electric generator in India it is not necessary to mention that power failure is common in India and that the gadget will be used more often. Also when a person buys a second policy from the same insurer it is presumed that the insurer will check for the relevant facts about him by referring to the first policy and without seeking explanation all over again. Information related to following matters need not be disclosed:

- Facts related to law
- Facts of common knowledge to all
- Facts which can reasonably be discovered by the insurer
- Facts which could have been revealed by a survey
- Facts which have been covered by policy conditions
- Facts which reduce the risk

### **1.3 Implications of concealment, non disclosure or misrepresentation by the insured**

It may turn out from the representations furnished by the customer that the details are incomplete or any important information is concealed or is misleading.



In such circumstances it is the choice of the insurer whether to:

1. Incorporate the required changes in the contract and charge a different premium.
2. Accept the policy and pay compensation especially if the facts have negligible importance.
3. Avoid any obligation on its part as per the policy.

It has to be proved by the insurer that the non-disclosure or misrepresentation was intentional on the part of the insured to commit fraud and deceive the insurer before it can stop payment of compensation. As per section 45 of the Insurance Act the insurance company can resort to this stance before the passage of two years after which it cannot take such recourse.

Non-disclosure may be unintentional on the part of the insured. Even so such a contract is rendered voidable at the insurers option and it can refuse any compensation.

Any concealment of material facts is considered intentional. In this case also the policy is considered void.

Suppose a person discovers that he has cancer, which is in its last stages and is hopeless to go for medical treatment. Immediately he buys a life insurance policy where he conceals this fact from the insurers. He dies four months after buying the policy. The insurance company can contest the claim for payment of policy proceeds to his beneficiary on the ground that a vital fact material to the contract was concealed.

## **1.4 Implications of non-disclosure by the insurer**

It is true that in a contract of insurance the insured has to furnish more information about him. But there are certain covenants in a contract, which have to be thoroughly elaborated to the insured. These relate to the conditions in which the insurance company may or may not perform its promises.

It has to be noted that it is the duty of both the insurance agent and the company authorities that this particular aspect is looked into. Any laxity at this point may tilt the judgments in favor of the insured in case of a dispute.

### **Example**

In the case of LIC vs. Shakuntalabai, the insured had availed a life insurance policy from LIC. Before taking the policy he had suffered from indigestion for a few days and at the first instance had availed treatment from an ayurvedic doctor. This fact was not disclosed by the insured.

The insured died of jaundice within a few months after buying the policy. Eventually LIC refused to accept the claim on the ground of non-disclosure of information.

However the court rejected this stand of LIC since it had not explained this covenant clearly to the insured, which amounts to non-compliance of its responsibilities.

Such casual ailments are common and occur many times over and they can be treated by over the counter drugs. It is normally not possible for a person to distinguish a potentially serious ailment inherent in such symptoms. Also it is not possible for a person to remember the details of all such illnesses like cough, cold, headaches, etc., and the medications taken for them after a few months.

So these facts are not to be considered as material to the contract and thus their non-disclosure does not invalidate the contract.

## **1.5 Warranty**

In case where such minute details, statement of facts or promise made by the insured (known as warranties) are expressly included in the insurance policy with the active consent of both the parties it is binding on both the parties to adhere to it. Only upon the fulfillment of those conditions the insurer is bound by the contract.

Warranties are collateral to the main purpose of the contract, i.e., they are secondary to the main covenants of the contract and form a condition cited by the insurer.

Thus if a person buying medical insurance cites regular all round medical checkups and avails a lower premium based upon it he has to do it regularly. In case he discontinues his checkups in some instances then it amounts to breach of contract and the insurer can take refuge in this and deny payment.

## **1.6 Waiver and estoppel**

*Waiver is the voluntary relinquishment of a known right by the insurance company which in turn confers this privilege upon the insured as a right and it can be claimed by him later if need arises.* While entering into a contract of insurance, the insurer may relieve the insured from strictly adhering to some conditions or disclosing certain information related to the contract. When this is made known to the insured by an express agreement or statement it gives a right to the insured not to follow those conditions and the insurer cannot later put a question mark over this matter at the time of settlement.

*Estoppel is a stipulation, which prevents the insurance company from enforcing or claiming a right due to its previous acts, which were in such a way as to forego any desire to preserve that right.*

Thus, if on previous occasions the insurer has provided concessions to the insured and this has been followed in practice in course of time then it cannot enforce this commitment upon the insured later.

**Example:**

In the case of Wing vs. Harvey an agent of the insurance company accepted premium for a policy in spite of having the knowledge of a breach in the policy condition by the insured. It was held that since the agent is the representative of the insurance company, the insurance company is liable for his actions. The acceptance of premium amounted to an estoppel in favour of the insured and he cannot be denied compensation in this regard.

## **2. PRINCIPLE OF INSURABLE INTEREST**

---

### **Introduction**

All risks are not insurable. In order to be insurable, the risk must be quantitatively measurable in terms of money and there should be insurable interest in the asset that is to be insured. Insurable interest provides the right to insure.

Insurable interest means the policyholder must have a pecuniary or monetary interest in the property, which he has insured. Any damage to the property must result in financial loss to the policyholder. Only then insurable interest is said to exist.

In a life insurance context, insurable interest is deemed to exist in the case of certain relationships based on sentiment. (E.g. husband & wife, parent & child).

The insurance company can make an insurance contract by basing it on this interest, i.e., anything of monetary or sentimental value to the insured. The presence of insurable interest makes insurance of the asset possible which has to be protected or compensated in case of its loss. Without insurable interest no contract of insurance is possible.

### **Importance of the principle of insurable interest**

There are certain legal requirements to be met in the actual working of insurance contracts. The principle of insurable interest ensures some of these requirements are met resulting in the creation of a valid legally enforceable contract. These are as follows:

1. The principle adds legal validity without which such contracts would be wagering or gambling in nature according to Indian Contract Act.

### **Example**

Two parties enter into a private agreement wherein one party agrees to pay the other Rs. 1 lakh in case Sachin Tendulkar recovers from his ailment before the tournament begins. This contract is a wagering agreement since the principle of insurable interest is absent here. The concerned parties don't suffer any loss in case Sachin misses the tournament.

2. Presence of insurable interest prevents fraudulent practices.

### **Instances of life insurance contracts where the extent of insurable interest need not be proved**

While purchasing insurance on one's own life, insurable interest is presumed to be present to an unlimited extent. However the amount of the policy is determined by the insurer depending on the earning capacity of the person and other relevant factors such as age, health, etc.

When purchasing insurance on the life of another person the presence of natural love and affection between the contracting parties is enough to create insurable interest. Close ties and blood relationship are presumed to create natural love and affection.

In the following cases of life insurance contracts insurable interest need not be proved:

- Own life (up to the limit acceptable to insurers)
- Spouse's life
- Life of children

### **Instances of life insurance contracts where the extent of insurable interest has to be proved**

i. Employer and employee

Employers are at risk of loss in the event of loss of life of an employee and particularly so when the employee is highly skilled and experienced.

Keyman insurance policies (on the life of the Key official) serve to protect the insurable interest of the employer.

Group insurance contracts are often entered into by employers as an employee welfare measure, which promote employee loyalty and improve morale thereby resulting in higher productivity and reduce employee attrition.

ii. Creditor and debtor

The creditor stands to lose when the debtor dies. So the creditor can take out a policy on debtor's life for protection against any possible loss.

iii. Partners

The loss of life of a partner may affect the business of a partnership firm and inflict financial losses to other partners. Here a partner can purchase a policy on the life of the other partners stating the presence of insurable interest.



#### iv. Guarantors

The guarantor or surety can take a policy on the life of the debtor, as he will be liable to pay the debt in case of death of the debtor or his inability to pay the debt.

### Time of existence of insurable interest

The time when insurable interest should be present differs with the type of insurance contracts. In **Life insurance** insurable interest (presence of mutual love and affection) has to be present at the inception of policies and need not be present at the time of death. Whereas in **Property insurance**, insurable interest has to be present at the time of inception of the insurance contract and also at the time of loss.

### 3. THE PRINCIPLE OF INDEMNITY

The principle of Indemnity ensures that the insurer is liable to pay up to the amount of loss and not more than that. In other words it implies that the insured should not derive any unwarranted benefit from a loss.

Normally the principle of indemnity applies to property and liability insurance contracts and it promises that the insured be restored to the same financial position that existed prior to the occurrence of loss. But, this principle of indemnity is an exception to the rule with respect to life insurance.

The life of a person is different from a material or property. The principle of valuing material property like replacement cost less depreciation and discounted cash flows cannot be applied to determine the monetary value of the life of a person.

The value of life is broadly determined by certain qualitative factors and is subject to one's opinion. The most important factor here is the earning capacity of the person and the insurable value is the value of the policy taken up by the person.

Hence a life insurance policy is not subject to the principle of indemnity but is a valued policy wherein the agreed upon amount in full is paid to the beneficiary in case of loss of life.

These distinctive features are based on the basic principles of law and are applicable to all types of insurance contracts. These principles provide guidelines based upon which insurance agreements are undertaken.

A proper understanding of these principles is therefore necessary for a clear interpretation of insurance contracts and helps in proper termination of contracts, settlement of claims, enforcement of rules and smooth award of verdicts in case of disputes.

## Rules of Contract Construction

Life and health insurance policies are typically written using standard forms containing much technical language. The applicant does not have any opportunity to negotiate modifications in this policy. This adherence nature led judicial authorities to adopt special rules of insurance contract construction that favor the policyowner. The three common classes of contract construction rules are:

1. **Doctrine of contra proferentum** – any ambiguities in contract language is construed strictly in favor of the insured.
2. **Doctrine of good faith and fair dealing** – each party to the contract is to avoid impairing the rights of the other. The duty requires insurers to make prompt and full settlement with insureds and beneficiaries and to consider the insured's interest in settling claims.
3. **Reasonable expectations doctrine** – “marketing patterns and general practices” of an insurer will be honored.

### Other rules

4. **Presumption of death and disappearance** – When a person leaves his usual place of residence and is neither heard of nor known to be living for a term of seven years, is the person presumed to be dead. Therefore, if [1] an insured disappears for a period of seven years and [2] the absence is unexplained; the insurance company may be required to pay the policy death proceeds. The issue usually revolves around the second of the two conditions.
5. **Insuring agreement** – the insuring clause contains the company's promise to pay benefits. It also may describe the types of losses that the policy will cover, or it may simply tie the promise to all of the terms and limitations of the policy.
6. **Insurer's liability for delay, improper rejection, or failure to act** – many courts have held that when an insurer retains an applicant's premium but has not issued the insurance policy, elementary justice dictates that a contract of insurance is in existence or else the company is liable for damages caused because of its delay or failure to insure.

## The law as it pertains to the agent

Life and health insurance companies worldwide rely on agents for product sales and customer advice. An Agent is the legal representative of the insurer. [Broker is the insured's legal representative]. The misalignment may occur because the incentives that motivate the agent usually differ from those that motivate the principal. This may lead to principal-agent problems. To avoid this problem, an entire body of law has evolved that attempts to establish clear rules of authority and conduct in connection with this relationship.



## Powers of the agent

- **Actual or express** – granted to an agent by the principal in specific language or terms. It may involve wide or general authority, or it may be limited to a narrow field or even to a specific act.
- **Implied** – is that associated with certain duties, such as the cashier's authority to take payment for merchandise at a checkout counter.
- **Apparent or perceived** – is that which a third person believes the agent possesses the authority because of circumstances made possible by the principal and upon which the third party is justified in relying. This authority is based on the principle of estoppel. The principal will be prohibited [i.e. estopped] from declaring later that no agency existed.

## Two classes of agents exist in law

- **General agent** – has powers coextensive with those of his or her principal within the limit of the particular business or territory in which the agent operates. But life insurance agent has limited authority.
- **Special agent** – has more limited powers, extending only to acts necessary to accomplish particular transactions for which he or she is engaged to perform.

## Policy limitations

As a general practice, life insurance companies insert a provision in their policies or application forms prohibiting their agents from altering the contract in any way.

1. Wherein the company or any agent clothed with actual or apparent authority has waived, either orally or in writing, any provision of the policy.
2. Wherein the company, because of some knowledge or acts on its part or on the part of its agent, is estopped from setting up as a defense the violation of the terms of the contract.

Courts generally are reluctant to allow parol [oral] evidence to alter the interpretation of a written document. However, whether the courts rely on an oral waiver of policy provisions or upon the doctrine of estoppel, the company is held bound. This holds even though some provision of the contract has been violated and the policy contains a provision limiting the agent's power to make policy changes.

## Agent's liability to principal for misconduct

The agent should never further his or her own personal interests by disobeying or exceeding the principal's instructions. The agent must indemnify any loss or damage to the principal. In practice, most cases involving serious violation of agency agreements are resolved by the agents' discharge and a revocation of licence.

## Market conduct and the law

The conduct of insurers and agents in marketing life and health insurance is subject to statutory and common-law legal standards.

### PROVISIONS PROTECTING THE POLICY OWNER

These provisions can be considered mainly to protect the policy owner from the lemons problem of the insurer possessing greater knowledge than the policy owner.

- **Entire contract clause** – provides that the policy itself and the application, if a copy is attached to the policy, constitute the entire contract between the parties.

This clause protects the policy owner in that the company cannot, merely by reference, include within the policy its procedural rules or, unless a copy is attached to the application or any statements made by the medical examiner.

This clause also protects the company in that the application for seeking **reformation** [redraft when there is a mistake] and **rescission** [cancellation or avoidance of a contract when there is a fraud or material misrepresentation].

- **Incontestable clause** – provides that the validity of an insurance contract may not be contested after it has been in effect for a certain period of time, such as two years. And it also provides greater assurance to the public that relatively innocent misstatements by applicants would not be the cause of a claim being denied.
- **Grace period provision** – requires the insurer to accept premium payments for a certain period after their due date, during which period the policy remains in effect. During this period the insurer [1] is required to accept the premium payment even though it is technically late [i.e., it is past the due date] and [2] may not require evidence of insurability as a condition of premium acceptance.
- **Nonforfeiture provision** – stipulates the options available under a cash-value policy if the policyowner elects to terminate the policy and explains the basis or method used to determine these optional values. This provision is relevant only for life insurance policies with cash values and with some long-term care policies.
- **Reinstatement clause** – gives the policyowner the right to reinstate a previously lapsed policy under certain conditions. The two most important conditions are 1. Furnishing of evidence of insurability 2. Paying past due premiums.
- **Misstatement of age or sex provisions** – stipulates that if the insured's age is found to have been misstated, the amount of insurance will be adjusted to be that which would have been purchased by the premium had the correct age been known. If the error in age is discovered while the policy is still in force, the procedure followed depends upon whether the age has been understated or overstated. If it is understated, the policy owner is given the option of paying the difference in premiums with interest or of having the policy reissued for the reduced amount.



If it is overstated, a refund is usually made by paying the difference in reserves. Incontestable clause does not apply to age misstatements. Misstatements of sex are not common and usually occur because of a transcribing error, not because the proposed insured was unsure of his or her sex.

- **Renewal provisions** – Individual health insurance contracts are classified according to their renewal rights, of which the most common are:
  1. **Noncancellable** – gives the insured the right to renew the policy, typically to age 65, by timely payment of a stipulated premium. During this period, the company cannot cancel the policy or make any unilateral change in its benefits. This renewal category generally is limited to disability income insurance.
  2. **Guaranteed renewable** – This policy also gives the insured the right to renew the policy, typically to age 65, by timely payment of the premium. During this period, however, the company has the right to change the premiums for all insured of the same class at their original insuring ages, but it cannot cancel the policy or make any unilateral change in its benefits. This renewal category is used for medical expenses, long-term care, and disability income insurance.
  3. **Conditionally renewable** – this policy gives the insured a limited right to renew the policy to age 65, or some later age, by timely payment of the premium. But the insurer has the right to refuse to renew coverage for insureds of the same class. This renewal category is used for medical expense and disability income insurance. This provision is used in most specialized business disability income forms other than overhead expense insurance.

## PROVISIONS PROVIDING POLICY OWNER FLEXIBILITY

---

### I. The beneficiary clause

It permits the policy owner to have policy death proceeds distributed to whomever and in whatever form he or she wishes.

#### a) Nature of designation:

**Primary beneficiary** – the person named as the first to receive policy death proceeds.

**Contingent or secondary beneficiary** – a person is named to receive death proceeds if the primary beneficiary is not alive at the insured's death.

**Revocable designation** – is a beneficiary designation that may be changed by the policy owner without the beneficiary's consent.

**Irrevocable designation** – is one that can be changed only with the beneficiary's express consent.

b) **Clarity in designating the beneficiary:**

Insurers wish to avoid disputes involving beneficiary designations. The issue ordinarily is not whether policy proceeds are due but rather to whom they are to be paid.

**A minor as beneficiary**—A minor is not legally competent to receive payment and cannot give a valid release for it. To avoid the possibility of having to pay a second time, insurers generally will not make payment of any substantial amount directly to minor beneficiaries but instead require the appointment of a guardian.

**Change of beneficiary** – The policyowner usually may change the designation whenever and to whomever he or she wishes, provided the original designation is not irrevocable. If the policy owner has done all that he or she can to effect a beneficiary change but did not follow the procedure because of factors beyond his or her control, using the doctrine of substantial compliance can do a beneficiary change.

**Common disaster** – If the insured and the beneficiary die in the same accident and no evidence shows who died first, the question arises as to whom to pay the proceeds. By using **Uniform Simultaneous Death Act**, the proceeds of the policy shall be distributed as if the insured had survived the beneficiary.

## II. **Settlement options**

The manner in which death proceeds will be paid. Failure to arrange for the proper payment of proceeds may defeat the very purpose for which the insurance was intended.

### Types of settlement options

a) **Cash**

b) **Interest option** –The proceeds remain with the company and only the interest earned thereon are paid to the beneficiary. A minimum interest rate is guaranteed in the contract. Companies frequently limit the length of time that they will hold funds to the lifetime of the primary beneficiary or 30 years, whichever is longer.

1. **Fixed period option** – Provides for the payment of proceeds as an annuity certain over a definite period of months or years, usually not longer than 25 or 30 years. It is based on the concept of systematically liquidating principal and interest over a period of years, without reference to life contingencies.
2. **Fixed amount option** – It is also an annuity certain but with the income amount rather than the time period fixed. A specified amount of income is designated, and payments continue until the principal and interest thereon is exhausted.



- c) **Single life income option** – Liquidates principal and interest with reference to life contingencies. It is a single-premium immediate life annuity. The most common forms of life income options are
1. Pure life income option – installments are payable only for as long as the primary beneficiary [the income recipient] lives. This form is inappropriate for many widows and widowers with young children, as it affords no protection to the children in the case of early death.
  2. Cash refund annuity or installment refund annuity – A lumpsum settlement is made following the primary beneficiary's death instead of the installment payments being continued.
  3. Life income option with period certain – Installments are payable for as long as the primary beneficiary lives, but should this beneficiary die before a predetermined number of years, installments continue to a second beneficiary until the end of the designated period.
  4. Joint and survivorship life income option – Life income payments continue for as long as at least one of two beneficiaries [annuitants] is alive. The insurer may continue payments of the same income to the surviving beneficiary or reduce the original amount and continue the payment of this reduced amount for the surviving beneficiary's lifetime.
- d) **Other settlement arrangements** – Options designed to meet a specific need or serve a particular purpose like educational plan, flexible spending account etc.

### III. Assignment provision

Insurance policies are also subject to law of property because of ownership rights [rights of possession, control and disposition]. The current owner can transfer it to another person. Such transfers are referred to as **assignments**. Assignments are of two types.

- a) **Absolute assignment** – Is a complete transfer by the existing policy owner of all his rights in the policy to another person. It is a change of ownership. The new owner, of course, can change the beneficiary by following the customary procedures.
- b) **Collateral assignment** – Is a temporary transfer of only some policy ownership rights to another person. These are ordinarily used in connection with loans from banks or other lending institutions [and persons]. Such assignments are partial in that only some policy rights are transferred. They are temporary in that the transferred partial rights revert to the policy owner upon debt repayment. The assignee obtains the right to

- collect the proceeds at maturity
- surrender the policy pursuant to its terms
- obtain policy loans
- receive dividends
- exercise and receive benefits of nonforfeiture rights

**On the other hand, the policy owner retains the right to:**

- collect any disability benefits
- change the beneficiary [subject to the assignment]
- elect optional modes of settlement [subject to the assignment]

**Under the form the assignee agrees**

- to pay the beneficiary any proceeds in excess of the policyowner's debt
- Not to surrender or obtain a loan from the insurance company unless there is default on the debt or premium payments.
- To forward the policy to the insurer for endorsement of any change of beneficiary or election of settlement option.

#### **IV. Change of plan provision**

Granting the policyowner the right to change the policy form. Flexible-premium policies, in essence, contain a broad change of plan provision.

#### **V. Change of insured provision**

Permitting a change of insureds under the policy. This provision is useful for business life insurance.

#### **VI. Non forfeiture options**

These options afford policyowners who choose to terminate their cash-value insurance policies the option of utilizing the cash surrender value in several ways. They typically stipulate the surrender value may be taken in one of three forms.

- Cash
- A reduced amount of paid-up insurance of the same kind as the original policy – This option permits the policy owner to use the cash surrender value as a net single premium to purchase a reduced amount of paid-up insurance of the same type as the original basic policy, exclusive of any term or other riders.
- Extended term insurance for the full-face amount – gives the policyowner the right to use the net surrender value to purchase paid-up term insurance for the full-face amount of the policy.



## **VII. Policy loan clause**

Under this clause insurers must make requested loans to policy owners, subject to certain limitations. If the insured dies, the loan is repaid by deducting the loan balance from the policy's death proceeds.

## **VIII. Provision regarding surplus distribution**

Participating [with profits] life and health insurance policies carry the right to share in distributable surplus. The mechanism by which par policies participate is via Dividends and Bonuses. Common methods of allocating bonuses are

- Simple reversionary bonus
- Compound reversionary bonus
- Terminal [or capital] bonus.

Dividend options are

- pay in cash
- offset the premium payment
- purchase paid-up additional insurance
- accumulate at interest
- purchase one-year term insurance
- vanish pay option
- add-to-cash-value option

## **PROVISIONS PROTECTING THE INSURANCE COMPANY**

Several provisions of a life insurance contract primarily protect the life insurance company against adverse selection and other market imperfections. These include

### **I. The suicide clause**

The clause is intended to protect against adverse selection or moral hazard. This exclusion is generally up to two years

### **II. The delay clause**

This grants the company the right to defer cash-value payment or making a policy loan for up to six months after its request. This provision, which does not apply to the payment of death claims, is intended to protect the company against “runs” – a type of negative externality – which could cause the failure of an otherwise financially sound company.

### III. Exclusion and hazard restriction clauses

- a) Exclusions in life insurance policies
  1. Aviation exclusion
  2. War exclusion - status clause [the insurer need not pay the policy face amount if death results while insured is in the military service, regardless of the cause of death.] and result clause [the insurer is excused from paying the face amount only if the death is a result of war]
- b) Exclusions and restrictions in health insurance policies
  1. Pre-existing condition
  2. Any loss caused by war or act of war
  3. Losses caused by intentional self-inflicted injury.
  4. Military suspension provision

### CREDITORS RIGHTS IN LIFE INSURANCE

---

Harsh treatment of debtors may result in negative spillovers [externalities] to families and societies as a whole. Thus laws were enacted to provide for an equitable distribution of the assets of debtors while giving them an opportunity for rehabilitation. These laws came to have particular relevance for life insurance because of its special relationship to family economic security.

**Rights of the policy owner's creditors in the U.S.A. are governed by** Bankruptcy Reform Act and State exemption statutes. In India, it is governed by Indian Contract Act, Bankruptcy Act and Indian Insolvency Act.

#### **Rights of the beneficiary's creditors**

- **Prior to Maturity** – creditors can not reach the cash value of the policy, as the beneficiary does not possess the right to obtain the cash value without the consent of the owner. This facility is available in India also.
- **At maturity** – in the absence of an exempting statutory provision, the beneficiary's creditors are entitled to the insurance proceeds as soon as those rights vest in the beneficiary. However many State Statutes exempt insurance proceeds, even in the possession of the beneficiary, against the creditors of both the insured and the beneficiary.



## SPECIAL PRIORITIES AND CONSTRAINTS

1. **Tax liens** – The government need not prove that the debtor or taxpayer is insolvent when it places levies on the taxpayer's assets. If the policyowner retains certain rights under a policy, these rights can be reached by the government, inspite of state exemption statutes.
2. **Misappropriation of funds** – When a policyowner's clear intention is to defraud his or her creditors by taking out insurance or by assigning it, the beneficiary is not protected against claims of the policyowner's creditors.
3. **Spendthrift trust clause** – This clause may provide that the beneficiary has no power to assign, transfer, or otherwise encumber the installment payments to which he or she is entitled under the settlement option.

### Summary

- The fundamental principles of insurance set the broad guidelines, which form the very basis of insurance contracts. These principles help in the formation, interpretation, and settlement of insurance contracts.
- Insurance contracts are specialised contracts which have the following special features:
  1. Utmost good faith
  2. Insurable Interest
- Insurance contracts require utmost good faith on the part of both the insurer and the insured. Hence both the parties are supposed to disclose all the material facts relating to the insurance contract to each other.
- In a contract of insurance there should be a subject matter of monetary or sentimental value to the buyer of insurance that has to be insured. It is this, which confers on him the right to secure insurance on the subject matter.
- Special rules of insurance contract construction that favor the policy owner are
  1. Doctrine of contra proferentum
  2. Doctrine of good faith and fair dealing
  3. Doctrine of reasonable expectations
  4. Presumption of death and disappearance
  5. Insuring agreement and insurer's liability for delay, improper rejection, or failure to act.
- To avoid the principal-agent problem, body of law has established clear rules of authority of an agent into actual, implied and perceived.

- Some provisions in the law protect the policy owner. They are
  1. Entire contract clause
  2. Incontestable clause
  3. Grace period provision
  4. Non-forfeiture provision
  5. Reinstatement clause
  6. Misstatement of age or sex provision
  7. Renewal provisions
- Some provisions provide flexibility to the policy owner. They are
  1. Beneficiary clause
  2. Settlement options
  3. Assignment provision
  4. Change of plan provision
  5. Change of insured provision
  6. Non- forfeiture options
  7. Policy loan provision
  8. Surplus distribution provision
- Some provisions protect the insurance company. They are
  1. Suicide Clause
  2. The delay clause
  3. Exclusion and hazard restriction clause
- Policy owner's and beneficiary creditors rights are governed by Indian contract Act and Indian Insolvency Act.

### Discussion Questions



1. Is the insurer's decision to deny compensation on the ground of non-disclosure of material facts justified? If so explain how?
2. Explain in this context how material facts and their concealment affect the amount of premium charged from a person and results in adverse selection.



## Questions



1. What is adverse selection with respect to life insurance?
2. Are warranties and representations same as material facts? If so how?
3. Explain how the principle of insurable interest adds legal validity to an insurance contract. Cite the instances of life insurance contracts where insurable interest has to be proved.
4. Why is the principle of indemnity not applicable to life insurance contracts?
5. Explain the distinguishing characteristics of an insurance contract.
6. What are the requirements for forming an insurance contract?
7. Explain various rules to construct a life insurance contract.
8. Explain the law in India as it pertains to the insurance agent.
9. Explain the provisions in an insurance contract aimed at protecting the policy Owner.
10. Explain the provisions protecting the insurance company against adverse selection and other market imperfections.
11. "If the beneficiary clause is not drafted with care, its intended purpose may not be fulfilled". Discuss how can unexpected circumstances or ambiguity in the beneficiary clause complicate the settlement of life insurance proceeds?
12. Explain in detail various types of settlement options.
13. Distinguish absolute assignment from collateral assignment.
14. Explain the nonforfeiture options available to policyowners when they want to terminate their cash-value policies.
15. Evaluate the statement: "When you take out a policy loan, you should not have to pay interest because you are borrowing your own money".
16. Why might a policyowner elect to receive his or her share of distributable surplus in a form other than cash?
17. List out the provisions, which provide flexibility to the policy owner to enhance the value of the contract.
18. How do Indian Laws protect the rights of beneficiaries'?
19. How do Indian Laws protect the rights of policyowners' creditors?

## Multiple choice Questions



1. As per the doctrine of insurable interest, insurable interest should be present in the case of life insurance:
  - a) At the time of claim settlement
  - b) At the time of revival only
  - c) Only at the inception of the policy
  - d) At inception and at the time of revival

**Ans. (d)**

2. The doctrine of 'caveat emptor' governs
  - a) Commercial contracts
  - b) Marine insurance contracts
  - c) Group insurance contracts
  - d) All general insurance contracts

**Ans. (a)**

# Insurance

## CHAPTER – 3

### PRICING ELEMENTS

#### OUTLINE OF THE CHAPTER

- Principles of Insurance
- Pricing Individual Life and Health Insurance
- The saving aspect of Life Insurance
- The investment aspect of life insurance
- Experience participation in insurance
- Interaction among insurance pricing elements
- Questions

#### LEARNING OBJECTIVES

After reading this chapter you will be able to:

- Understand the importance of Law of large numbers in the principles of insurance
- Understand the life insurance Pricing objectives
- Understand the Pricing elements
- Understand the Rate computation
- Analyze the saving and investment aspects of life insurance products
- Understand the experience participation in insurance
- Study the interaction among insurance pricing elements

#### 1. PRINCIPLES OF INSURANCE

The function of insurance is to safeguard against misfortunes [like personal losses from disability and death or property losses from fire or windstorm] by having the losses of the unfortunate few paid by the contributions of the many who are exposed to the same peril.

Thus, the essence of insurance – The sharing of losses

Insurance relies on the law of large numbers to minimize the speculative element and reduce volatile fluctuations in year to year losses.

**Law of large numbers:** The law of large numbers in relation to insurance, holds that the greater the number of similar exposures [e.g., lives insured] to a peril [e.g., death], the less observed loss experience will deviate from expected loss experience. Risk and uncertainty diminish as the number of exposure units increases.

Insurance is the antithesis of gambling. Risk is created in gambling. **Insurance transfers an already existing risk.**

## 2. PRICING INDIVIDUAL LIFE AND HEALTH INSURANCE

---

### Pricing objectives

#### 1. Rate adequacy

To avoid financial problems and insolvency, insurance company rates must be adequate in the light of benefits promised under the company's insurance products. Rate adequacy means that, for a given block of policies, total payments collected now and in the future by the insurer plus the investment earnings attributable to any net retained funds are sufficient to fund the current and future benefits promised plus cover related expenses.

#### 2. Rate equity

Equity means charging premiums commensurate with the expected losses and other costs that insureds bring to the insurance pool. The pursuit of equity is one of the goals of **underwriting** [classification and selection of insureds].

#### 3. Rates not excessive

Rates should not be excessive in relation to the benefits provided. By establishing a ceiling on the rates, this objective is achieved. Competition discourages excessive pricing.

### Pricing elements

#### 1. The probability of the insured event occurring

It is shown by mortality tables in life insurance and morbidity tables in health insurance. The part of risk premium can be calculated by multiplying sum assured with relevant information in these tables.

#### 2. The time value of money

The time value of money through rate of interest is the second factor taken into account for calculation of premium. By deducting interest component from risk premium, net premium can be calculated.



### 3. Loading to cover expenses, taxes, profits, and contingencies

By adding all these office expenses to net premium, tabular premium can be calculated.

### 4. The benefits promised

The fourth factor is the benefits promised under the contract. A loading in this respect is also included to arrive at the actual premium payable.  $\text{Tabular premium} + \text{benefits promised} = \text{office premium}$ .

A favorable experience by the insurer, in respect of the above factors, leads to the generation of surplus. The surplus so generated is shared among the eligible policyholders and the owners.

An unfavorable experience leads to creation of deficit, which has to be taken care of by the management/owners.

## Rate computation

### 1. Yearly renewable term life insurance

This plan provides coverage for one year only but guarantees renewal irrespective of the insurability of the policy owner. Premium depends on the rate of mortality. As age increases, premium rate increases. Therefore, there is a possibility that those in good health discontinue the policies because of burdensome premium.

### 2. Single premium plan

In this system, premium will not increase year after year. Only one single lump sum is collected at the inception to cover risk for the selected period of insurance. The present value of total death claims anticipated to be paid by the insurer over the period of insurance is calculated at a chosen rate of interest. The single premium payable by each policyholder is arrived at by dividing the total value by the number of persons taking insurance at inception. The total fund created by collection of single premiums will be utilized to pay claims year after year.

### 3. Level premium plan

In this system, premium payable throughout the period of insurance is level or uniform. In this system, reserve builds up under each policy because the premium charged in the initial years of the policy is more than what is required to cover the death risk. The difference between the face value of a policy and the reserve under the policy is called the 'net amount at risk'.

### 4. Flexible premium plan

Flexibility of deciding the amount of premium to be paid is allowed by many insurers to policy owners. Ex. Universal life policies. Out of the amount paid, mortality charges and expenses are deducted and balance accumulates and the insurer gives interest credit to the insured.

### **3. THE SAVINGS ASPECT OF LIFE INSURANCE**

---

Conceptually, all life insurance policy cash values can be derived in the same way and all evolve for the same basic reason – prefunding of future mortality charges. As a practical matter, however, policies are usually viewed in different ways. With traditional forms of life insurance, the savings element is considered a by – product of the level premium method of payment. Under this, premium is not divisible into risk and saving elements. With universal life and some other newer policy forms, the savings element is often considered as a more independent part of the policy, specifically designed to build a savings fund from which mortality and loading charges are withdrawn. Under this premium is divisible into risk and saving. The key elements of product pricing are open to the policy owner. The higher the premium the higher will be the cash value.

### **4. THE INVESTMENT ASPECT OF LIFE INSURANCE**

---

Unit-linked plans are essentially similar to mutual fund products wherein the premium is invested in various funds in keeping with policyholders' risk appetite. However, the difference in a mutual fund investment is that the money is virtually at call by the customer. In case of unit-linked insurance plans, it is impossible to predict whether the market will be in an upswing on the day of the policyholder's death or on maturity. The Net Asset Value [NAV] will reflect the underlying value of assets, which in turn is dependent on the movement of the Sensex.

In case of death during the premium paying term or the term of the policy, the sum assured or value of policy fund, whichever is higher, is paid to the beneficiaries. In case of survival up to maturity, the value of the fund is paid out. The returns on that day [maturity or death] on the plan depend upon the performance of the market, be it equity or debt. So if the fund value falls below amount invested on that day, the policyholder will receive a lesser amount. Hence one can see that the risk here is transferred to the policyholder as nothing is guaranteed.

These plans give an option to the investor to choose between three fund options – debt, equity, and balanced. In these products, premiums can be paid quarterly, half yearly or yearly. Out of the premium amounts, deductions will be made towards

- Initial administrative charges
- Investment management charges [there will be an extra charge if the policyholder utilizes the switch over (from equity to debt or debt to balance) option]
- Annual administration charges
- Risk cover and the balance will be invested in a selected fund [debt or equity or balance].



Insurance Companies charge anywhere between 20 -35 percent as upfront charges for their unit-linked plans. So, every time when policyholder makes premium payment, only a part of it is actually invested in the fund of policyholder's choice.

### **Benefits**

- A Unit linked plan providing an opportunity for the discerning investor to benefit from the returns available in the Capital Market without going for direct investment in the capital market.
- Unlike traditional products where investment details and various charges are kept under wraps, ULIPs project all these information upfront.

## **5. EXPERIENCE PARTICIPATION IN INSURANCE**

---

Classifications of life and health insurance policies:

1. Guaranteed – cost, non participating insurance policies  
[without profit] – provide that all policy elements like the premium, the benefits, and the cash values, if any are fixed at policy inception, guaranteed, and make no allowance for future values to differ from those set at inception.
2. Participating insurance policies  
[with profits] – give their owners the right to share in surplus funds accumulated by the insurer because of deviations of actual from assumed experience. The distributable surplus is paid to policy owners as dividends or bonuses. It is in this sense that dividend payments represent each policy's share of accumulated surplus.
3. Current assumption policies  
like participating policies, allow policy values to deviate from those illustrated at policy inception – both favorably and unfavorably – but, unlike participating insurance in which adjustments are based on the insurer's past experience, current assumption policy adjustments are based on the insurer's anticipated future experience. Participating policies take a retrospective approach to experience participation. In contrast, current assumption policies take a prospective approach to experience participation.

## **6. INTERACTION AMONG INSURANCE PRICING ELEMENTS**

---

An interaction exists among the various life and health insurance policy pricing elements.

Different facets that enter into insurance pricing – competitive nature, expected termination of contracts, any legal obligations to maintain minimum reserves, level of

dividends, inflation, incentives to agency force, level of customer service etc. Insurance pricing focuses on a simulated test of a block of policies.

Asset – share calculation is an example of such simulation of the anticipated operating experience for a block of policies, using the best estimates of what the individual factors will be for each future policy year. It makes clear the differences among cash surrender values [the amount made available, contractually, to a withdrawing policy owner who is terminating his or her protection.], reserves [a higher value measures the company's liability for a given block of policies for financial statement purposes.], and asset shares [the *pro rata* share of the assets accumulated on the basis of the company's anticipated operating experience, on behalf of the block of policies to which the particular policy belongs]. The purpose of this asset – share calculation is to enable the insurer take policy decisions regarding modifications in operations.

## Summary

- The essence of insurance is sharing of losses and it relies on the law of large numbers to minimize the speculative element.
- Objectives of insurance pricing are rate adequacy, rate equity and rates not excessive.
- Elements of life insurance pricing are mortality rates, interest rates, office expenses and benefits promised to the customer.
- Insurance rate or pricing computation depends on the type of plan, such as yearly renewable plan, single premium plan, level premium plan and flexible premium plan.
- Saving aspect and investment aspect is also included in the pricing computation.



## Questions



1. What is law of large numbers? Explain how this concept is applied to life insurance?
2. Explain the essence of insurance.
3. Explain why the rates of insurance are fair [equitable], adequate, and not excessive.
4. Explain various elements, which influence effective pricing of life insurance products.
5. What are the various premium payment plans? Explain why there are various premium payment plans in the market for life insurance policies.
6. What is the difference between the traditional cash value insurance and universal life insurance?
7. Classify life and health insurance policies based on their values.
8. Explain interaction among insurance pricing elements and how asset share calculation provides a perspective on the relationship among the cash surrender value, policy reserve, and asset share of a life insurance policy.

# Insurance

## CHAPTER – 4

### UNDERWRITING

#### OUTLINE OF THE CHAPTER

- The origin of underwriting
- Definition
- Objectives
- Principles
- Underwriting process
- Need for underwriting
- Underwriting authority
- Underwriting activities
- Underwriting policy
- Underwriting guides
- Rate making
- Underwriting results
- Summary
- Questions

#### **LEARNING OBJECTIVES**

After reading this chapter you will be able to:

- Define underwriting
- Know the various underwriting activities
- Understand the concept of adverse selection
- Recognize the types of risk involved while underwriting
- Identifying sources of information used by life and health insurers for underwriting
- Describing the methods of classification of risks
- Classifying substandard risks
- Describing special underwriting practices and laws affecting underwriting



## 1. ORIGIN OF UNDERWRITING

---

**Insurance** as a readily recognizable business first emerged in Britain at the end of the 16th century. In fact, Marine Insurance was one of the earliest forms of non-life insurance business that was transacted. Britain's prominent position in the world of sea borne trade created a need for security for commodities that were traded across the great seas. It was in this maritime setting that one of the world's most famous insurance providers Lloyd's of London was born. Edward Lloyd was running a coffee shop where London Merchants, maritimers and bankers met informally to do business. These financiers wrote their names under the specific amount of risk that they would exchange for a certain amount of premium and in this practice we see the origin of the term 'Underwriting'. Put simply, underwriting is a formal acceptance of a risk for a price which is termed 'Premium'.

The concept of insurance has constantly been evolving and now it is a full-fledged subject. Of the many facets of insurance, underwriting has always been considered one of the most important and therefore critical features. During the 1950s, there were specialists who worked as underwriters and covered almost every type of insurance. The years since then have seen underwriting emerge as an art in it.

The importance of underwriting can be well understood by the fact that even though several activities of insurance company such as marketing, accounting, claims processing etc., are sometimes outsourced, underwriting is an area over which the company always retains complete control.

## 2. DEFINITION

---

Underwriting can be termed "assumption of liability". It means signing an insurance policy and thereby becoming liable in the face of a specified loss. Underwriting involves the selection of policyholders after thoroughly evaluating all hazards, establishing prices and then determining the terms and conditions of the insurance policy.

The underwriting framework of a company plays a major role in determining the company's standing in the market. The underwriter must aim to generate profits and minimize losses through a well-balanced underwriting policy. One aspect that the underwriter must always bear in mind is that the underwriting must neither be too strict nor too lenient. If the acceptance criteria are very stringent, then the insurer will miss out on several acceptable businesses and may even face losses because of the expenses involved in cancelling business that the marketing person might have initially agreed to. This can be remedied by including enough conditions to make the risk acceptable. On the other hand, if the acceptance criteria are too liberal, the insurance company may face substantial losses and be forced to withdraw from a given line of business.

Once the risk involved is deemed acceptable, underwriting then fixes the rate of premium, and subsequently, all other terms involved. There are certain guiding objectives and principles that the underwriter must follow.

### 3. OBJECTIVES

---

Underwriting has three-fold objectives:

- Producing a large volume of premium income that is sufficient to maintain and enlarge the insurance company's operations and to achieve a better spread of the risk portfolio;
- Earning a reasonable amount of profit on insurance operations;
- Maintaining a profitable book of business (by ensuring underwriting profits) - that contains all the policies that the insurer has in force.

### 4. PRINCIPLES OF UNDERWRITING

---

Insurance is a concept of creation of a fund of premiums collected from various persons by pooling all of their risks, from which the financial losses of those few who suffer from the insured perils are compensated. The theory of probability, which can predict with a certain degree of precision, the possibility of a certain event occurring that can give rise to a claim provided there is sufficient data on past experience, is invariably the basis on which the concept of underwriting rests.

It follows that a prudent underwriter will necessarily have to build up data on claims lodged and this has to be done on a continuous basis. Further this data base has to be separately compiled for each of the different insurance portfolios – Fire, Marine & Miscellaneous. Having put this practice in place, he should follow certain basic principles before accepting a risk.

The principles that guide an underwriter before accepting a risk are:

- **Selecting insureds that fit the company's underwriting standards**

only those insureds whose actual loss experience does not exceed the loss experience assumed in the company's rating structure will be selected. The rate is based on a low loss ratio. For example, if the expected loss ratio is 20 percent and a rate is set accordingly, only those insureds will be selected, who can meet the required criteria, so that the actual loss ratio for the group will not go beyond 20 percent.

- **There should be proper balance within each rate classification**

the underwriter must be able to group insureds in such a way that the average rate in the group is enough to pay for all claims and expenses. Therefore, units with similar loss- producing features are placed in the same class and charged the same rate, ensuring that a below average insured is compensated for by an above average insured.



- **Charging equitable rates**

the rates that apply to one group should not be charged to another group as well. This would mean that one group is unduly subsidising another group. For example, in the case of life insurance, charging the same premium rate for people in the age group of 20-25 years and those in the age group of 50-55 years will result in the younger lot subsidising the older people. This amounts to overcharging and the younger persons will then look out for some other insurance company that has a more equitable system.

## 5. THE UNDERWRITING PROCESS

The underwriting process follows a series of stages, at the end of which the status of a risk is decided. It is only after the risk has been weighed and all possible alternatives evaluated that the final underwriting is done. When a proposal for insurance is received, the underwriter has four possible courses of action:

- Accept the risk at standard rates
- Charge extra premium depending on the risk factor
- Impose special conditions
- Reject the risk.

### Factors Affecting Insurability

In deciding whether to issue insurance [selection], and if so, on what terms and conditions and at what price [classification], life insurance companies examine several factors to achieve and ensure that rates should be adequate, equitable and not excessive to insureds for insurance coverage. Life insurance underwriting factors are:

- **Age** – Expected future mortality is highly correlated with chronological age. So age is a key factor in determining the rate an individual is to be charged for life insurance. But it is rarely a selection factor. Proof of age is required only at the time of immediate annuity purchase.
- **Sex** – Is rarely used as a selection factor, but it is routinely used as classification [rate setting] factor with respect to individual life insurance.

- **Medical aspects**

1. **Physical condition** – The determinants of physical condition are build [includes weight, height and distribution of the weight], nervous, digestive, cardiovascular, respiratory, or genitourinary systems, and glands of internal secretion etc., which reveal an average expected mortality rate.
2. **Personal history** – Individual's health record, habits, driving violations, and amount of insurance already owned bear his or her expected mortality.

3. **Family history** – Transmission of characteristics by heredity is also important for classification of insureds.
4. **Tobacco use** – Using tobacco in any form is an important risk factor by itself, causes expected future mortality to be worse than the average, and is a warrant for separate classification.
5. **Alcohol and drugs** – Excessive alcohol use is associated with higher than standard mortality.

- **Occupation**

The occupation may present environmental hazard [exposure to violence], the physical conditions [persons who work in close, dusty, or poorly ventilated quarters] risk from accident [professional automobile racers, professional divers] Because of this, ratings have been reduced or eliminated for many occupations.

- **Hazardous sports and avocations**

Scuba diving, mountain climbing, competitive racing and skydiving clearly involve a significant additional hazard to be considered in the underwriting process.

- **Aviation**

The Company may charge an extra premium to compensate for the aviation hazard or this cause of death may be excluded from the policy entirely.

- **Military service**

The adverse selection involved when individuals are engaged in or facing military service during a period of armed conflict can constitute an underwriting problem.

- **Residence**

The mortality rate in most developing countries is higher than in most developed countries, primarily because of general living conditions. So it will be included in the insurer's premium rate structure.

- **Financial status and speculation**

Determining the motivation for the proposed insurance is a primary element in financial underwriting. When motivation is questionable, it is essential to resolve any doubts and establish that the purchase is not speculative.

## **Sources of Information Concerning Life And Health Insurance Risks**

Insurers obtain information about proposed insureds from several sources.



- **Application**

Consists of two parts.

**Part I of life insurance application contains questions requesting**

1. Information regarding name
2. Present and past home addresses
3. Present and past business addresses
4. Occupation
5. Sex
6. Date of birth
7. Name and relationship of beneficiary
8. Amount and kind of insurance for which application is being made
9. Amount of insurance already carried
10. Driving record
11. Past modifications or refusal to issue insurance
12. Past and contemplated aviation activities
13. Avocations, and plans for foreign residence or travel.
14. In addition, the company will ask if the life insurance applied for is intended to replace insurance.

**Part II of life insurance applications consists of**

1. Medical history, furnished by the proposed insured to the medical or paramedical examiner.
2. If the policy is applied for on a nonmedical basis, to the agent, in response to questions regarding illnesses, diseases, injuries, and surgical operations experienced, regarding physician whom the proposed insured has consulted in last 5 years.
3. Present physical condition.
4. Use of alcohol, tobacco and drugs.
5. Individual's parents and siblings, and their present health condition, and the date and cause of any deaths that have occurred.

- **Physical examination**

Insurance companies routinely use paramedical personnel in lieu of physicians. The frequency of medical examination use and the detail involved are not as great for health insurance applications as for life cases because of expense considerations.

- **Laboratory testing**

The scope of blood and urine testing for life and health insurance is one of the major source of information regarding applicant's health condition.

- **Agent's Report**

Most insurers request a report about the proposed insured from the agent. If a company does not require an agent's report, it relies on its general instructions to its agents to prevent them from writing applications on persons who are unacceptable risks. If the agent believes the risk is doubtful, he may be instructed to submit a preliminary inquiry. But financial incentive on sale for agents may lead to the principal-agent problem.

- **Attending physicians statements**

Are used when the individual application or the medical examiner's report reveals conditions or situations, past or present, about which more information is desired.

- **Inspection companies**

Life insurance companies often obtain consumer reports [information about individuals' employment history, financial situation, creditworthiness, character, personal characteristics, mode of living, and other possibly relevant, personally identifiable information] from Inspection Company or consumer reporting agency on all persons who apply for relatively large amounts of insurance.

- **Industry sponsored databases**

Another source of information regarding insurability in some countries is an industry sponsored database of personal information.

- **Government records**

These records include information from civil and criminal courts, property tax records, bankruptcy filings etc. These may be referred to if required.

## **6. NEED FOR UNDERWRITING**

---

The need for underwriting arises because of some basic reasons. To avoid adverse selection and certain other hazards, to maintain fair prices and subsidisation and stay ahead of competition.

### **6.1 Adverse selection**

This term is used for a situation where the insurance applicant presents a possibility of loss that is higher than the average expected from a random sample of all applicants. It arises when the information presented to the insurer and the actual material facts relating to the risk are different.



The underwriter must safeguard against this kind of risk, as otherwise the insurance company would be selling insurance to those whose probability of loss is much higher than the average, at rates applicable to an average risk. This would mean higher than expected losses and hence higher claim payments leading to an increase in premiums. And finally, only those people facing very high chances of loss would find the insurance coverage feasible.

For example, people already suffering from a disease or belonging to the group of high mortality will be eager to claim coverage while those enjoying good health may not go in for insurance.

Insurance, as a product, is normally not eagerly bought but mostly sold and if an underwriter senses that there is a perceptible 'eagerness', bordering desperation on the part of the intending buyer, then it is a likely case of adverse selection by the insured.

If the underwriter looks closely at the possible higher risk cases, identifies and blocks the doubtful risks, then such situations can be deterred. Therefore, underwriters must exercise caution while dealing with adverse selection.

Along with adverse selection there are certain types of hazards that an underwriter must watch out for. These are –

- Physical hazards
- Moral hazards and
- Morale hazards

#### Physical hazards

These are hazards that affect the physical characteristics of whatever is being insured. Any harm to the tangible qualities of the subject matter of insurance can be called a physical hazard. For example: occupational hazards like working in mines.

#### Moral hazards

These hazards refer to the defects that exist in a person's character that may increase the frequency or the severity of loss. Such a character may tend to increase the loss for the company. Ex: killing wife to get death proceeds of insurance.

#### Morale hazards

The fundamental postulate of insurance is that the insured should always conduct him as if he is uninsured and that his having taken insurance should not offer him any licence to be any less careless than he otherwise would be. However, if there is a situation of a willful carelessness on the part of the policyholder because of the existence of insurance, then it is a case of Morale Hazard. By such negligence and indifference the possibility of loss is increased. For example, careless acts like keeping

the door of one's house open and going out, thereby increasing the possibility of a burglary, or leaving the car keys in the car and increasing the risk of theft are instances of morale hazard.

## **6.2 Fair pricing and subsidizing**

Underwriting helps in determining the expected loss potential of the proposed insured and selecting a price in line with this expected loss. Insureds with an approximately equal loss potential are put into one group and charged the same rate. When the premium paid by some insureds in the group does not correspond to the risk attached to them, the other insureds will have to pay the deficit. That is, those likely to suffer fewer losses will be subsidizing those likely to suffer more losses. This inequity will affect the whole group by increasing the premium rates. Here, the underwriter should be guided by previous records in order to safeguard the company against potential high-risk cases.

## **6.3 Competition**

An underwriter can also help an insurance company stay one step ahead of its competitors. Some of the ways this is done is through lower premium rates, innovative marketing strategies etc. The underwriter provides all necessary information and thus helps the insurer make the best possible decisions. For example, in life insurance, suppose the underwriter does a thorough job and studies the research done on mortality and morbidity, the insurer will have a much better idea about the factors that influence mortality and will consequently be able to fix a better price.

This can be better understood with an example. Insurers, despite knowing that chewing gutkha adversely affects health, pay no attention to this fact and do not take it into account while fixing the premium rate. Then one insurance company decides to charge two separate rates for chewers and non-chewers of gutkha, with lower rates for the latter. As a result the people who chew gutkha will continue to buy insurance from companies with the previous rate, whereas more and more non-chewers will start buying coverage from the company charging lesser rates. If this continues, the other companies will end up providing coverage only to users of ghutka. In the long run, this will prove detrimental to the company, since all gutkha users belong to the high-risk group. This shows how well researched underwriting-which prompted the insurer to charge lower rates, can influence competition and provide benefit to the industry as a whole.

## **6.4 Other risks**

There is also another category, the 'Declined Risks'. These are extra hazardous risks that have been rejected. Yet in certain cases, a premium is fixed after imposing restrictive conditions, clauses and warranties. This is done in order to reduce liability, and the acceptance of such risks is called 'Accommodation'. Ex. War Clause, Aviation Clause



## 7. UNDERWRITING AUTHORITY

---

Underwriting authority refers to the degree of autonomy granted to individual underwriters or groups of underwriters. This authority will differ by position and experience. Different insurance organizations have varying degrees of decentralization. In India, the underwriting authority vests with the insurance company. Post opening up of the insurance sector, some private insurers are decentralizing certain classes of business like travel insurance, where an insurance intermediary is allowed to issue the policy.

### The Scenario Abroad

Specialty lines like aviation and livestock mortality have retained centralized underwriting authority, while some other insurers are delegating a considerable part of their authority to selected brokers. Insurers who follow the decentralization system state that it eliminates duplication and makes the most of the producers' familiarity with local conditions. In return, brokers receive a higher commission rate and a larger share in the profits.

The degree of decentralization permissible depends upon several factors like the line of business involved, the experience and the track record of the producers. There may be insurers who allow their brokers to issue personal lines policies and bill the policyholders. This is certainly a significant amount of underwriting authority. Some other insurers may permit a high degree of authority but restrict policy issuance only to the company, so that control over the brokers' activities is maintained.

There are also lines of business where the producer may have no underwriting authority at all. These usually include very hazardous or specialized classes of business.

## 8. UNDERWRITING ACTIVITIES

---

Underwriting activities can be divided into two types –

- **Line underwriting** – Where daily underwriting tasks are carried out; the underwriters are usually located in regional offices of the insurer.
- **Staff underwriting** – Where the underwriter helps the management in formulating and implementing underwriting policy. They are usually located at the Head Office.

## 9. THE UNDERWRITING POLICY

---

The basic purpose of an underwriting policy is to transform the objectives of the management into rules and guidelines that will direct the company's underwriting decisions. The underwriting policy decides the composition of the book of business.

An underwriting policy must take into consideration the following dimensions – the lines of business, the territories involved and the rating plans. Any change in the underwriting policy must be evaluated on the basis of the other dimensions. Changes must also recognise the effects of certain limiting factors that influence the underwriting policy. These include:

- **The capacity** – the relation between the premiums written and the size of the policyholders' surplus is called the capacity. It helps to gauge an insurer's solvency. Insurers have limited capacity to write business and therefore they must make the best possible use of what they have. Allocation of capacity is a policy issue that is frequently re-evaluated.
- **Skilled human resources** – insurers require skilled personnel to efficiently market the product, employ loss control efforts and adjust any loss that occurs. The insurer must ensure that there are enough personnel and that they are conversant with the company's policies.
- Insurers must also follow the rules and regulations laid down by the insurance regulator in whose territory they operate. The impact of regulation varies from country to country. They must obtain licenses for writing insurance by individual line within each state, and all rates, rules and other documents must be filed with Government regulators.
- Finally, the availability of reinsurance sets limitations on what the underwriter can write. Reinsurance refers to the contractual relationship by virtue of which, risks are shared with another insurer. It helps in reducing the impact of expanded writings on an insurer's surplus. It also helps in increasing capacity, because the insurer can shift the monetary outcome of a loss and the legal obligations for reserves.

## 10. APPLICATION OF THE UNDERWRITING POLICY

---

Once the underwriting policy is set, it must be communicated to all concerned, as well as applied. Underwriting bulletins and guides are utilised for this purpose. Once the policy is established, underwriting audits are conducted to review the effectiveness of the policy. The underwriting results mirror the efficiency of the underwriting policy.

Applying the provisions given in the underwriting policy involves communicating whatever decision has been taken, to the agent. If any modifications are necessary before acceptance, then the reasons for the same must be conveyed to the agent/broker and to any other insurance personnel. Controls must be put in place to ensure that the modifications have been incorporated. The necessary documentation like binders and certificates of insurance must be issued. Also, all information concerning the policy and the risk involved must be documented.

Data about the policyholder including the class, location, risks involved and coverages must be coded, so that the information can be used later. This information will help to



follow the progress of the account and notify the insurer in case of losses. Underwriters make use of the underwriting guides to see to it that all information is passed on to relevant members in the company.

## **11. UNDERWRITING GUIDES**

---

Underwriting guides outline the ways to realise the objectives stated in the policy. They contain the standards for acceptability and summarise the underwriting authority requirements. The chief purposes of an underwriting guide are as follows:

- Supplying a basic framework for formulating underwriting decisions: underwriting guides identify the principal factors that should be weighed when a particular type of insurance is written. The guides also identify the major hazards associated with any class of business and make sure that these hazards are properly evaluated. Guides also serve as a ready reckoner to the company's underwriting policy.
- The underwriting guide is a means of making sure that the selection process is uniform and consistent. Submissions that are identical in all respects must be treated in the same way. The guides are also a means of informing individual underwriters of a suitable approach to evaluate policyholders.
- Underwriting guides help to unite the insights of experienced underwriters, which will help those less familiar with a particular line of business. The guides contain significant observations that have been gathered on the basis of the insurer's past experiences.
- The guides enable routine decisions to be handled at lower levels of authority and allow the experienced underwriters to concentrate on the more difficult cases. There is a distinction made in the delegation of authority.

Some insurers have detailed underwriting guides that contain detailed instructions on how to handle the various classes. These guides will contain information about hazards, the various alternatives available, criteria used to evaluate a risk, making the final decision and then implementing and reviewing that decision.

There are also guides that may not be so comprehensive. Some may contain only the list of classes and acceptable business. Yet others may only contain information that indicates the desirability of an exposure.

## **12. RATE MAKING**

---

Rate making, also known as insurance pricing, has an important part to play in the overall profitability of the company. Rate making involves the selection of classes of exposure units on which statistics can be collected regarding the possibility of loss. The underwriter must think about all aspects before deciding on the pricing of a policy. The rates charged must have three basic characteristics –

- Firstly, the rate must be high enough to pay for any expenses or losses incurred. This will take a lot of consideration because the actual cost of the policy when it is first sold is not known. It is only when the period of protection comes to an end that the actual cost can be determined.
- Secondly, the rate must not be too high. Applicants must not be asked to pay rates that are higher than the actual value of their protection.
- Finally, the rates must not be inequitable i.e., if two exposures are similar as far as losses are concerned, they should not be charged significantly different rates.

There are also certain business considerations that must be met before deciding on the rates charged.

- The system of rating must be simple and understandable so that premiums can be quoted promptly. Commercial insurance purchasers should be able to follow how premiums are determined, as this will help them take the necessary steps to reduce their insurance costs.
- The rates must not keep fluctuating i.e., they must be stable. Otherwise irate consumers may look to the government to regulate the rates.
- The rating system must provide the insured with a strong incentive to adopt loss control.
- The rates must change with the changing economic conditions – rates must increase when loss exposure increases.

## 12.1. Rate making in life insurance is based on Methods of Risk Classification

Once underwriting information about proposed insured has been assembled from various sources, it must be evaluated for selection and classification. It should 1. Measure accurately the effect of each factor affecting the risk, 2. Assess the impact of interrelated factors including the conflicting ones, 3. Produce equitable results; and 4. Be relatively simple and inexpensive to operate. Two basic systems are there to accommodate these concerns.

- **Judgment method** – Under this method the company depends upon the combined judgment of those in the medical, actuarial, and other areas who are qualified for this work to make underwriting decisions. This method is useful when there is only one unfavorable factor to consider for making a decision. When there are multiple factors to consider for making a decision insurers follow the numerical rating system.
- **Numerical rating system** – The numerical rating system is based on the principle that a large number of factors enters into the composition of risk and that the impact of each of these factors on longevity can be determined by a statistical study of



lives possessing that factor. Under this plan, 100 percent represents a normal or standard risk, one that is physically and financially sound and has a need for the insurance. Each of the factors that might influence a risk in an unusual way is considered a debit or a credit. Ex. If the mortality of a group of insured lives reflecting a certain degree of overweight, or a certain degree of elevated blood pressure, has been found to be 150 percent of standard risks, a debit [addition] of 50 percentage points will be assigned to this degree of overweight or blood pressure. Numerical ratings range in most companies from 75 or less to a high of 500 or more. In most companies, ratings below 125 are considered preferred or standard. Proposed insureds who produce a rate in excess of the standard limit are either assigned to appropriate substandard classes or declined. Use of computers in underwriting is intended to provide consistency, cost savings, and quick turnaround time.

Preferred \ standard \ substandard \ ..... \ uninsurable

---

75 85 100 115 130 150 180 ..... 500 600

---

### Classifying Substandard Risks

The classification of substandard life insurance may be done by charging an extra premium or by other methods for higher than standard mortality. Wide experience of reinsurers and Articles in medical journals is useful to underwriters to seek standard insurance.

Incidence of extra mortality – Majority of companies categorize substandard insureds into three broad groups

- Those in which the number of extra deaths is expected to remain at approximately the same level in all years following policy issuance.
- Those in which the number of extra deaths is expected to increase as insureds grow older.
- Those in which the number of extra deaths is expected to decrease with time.

**Methods of rating** – The objectives in establishing an extra-premium structure are that it be:

- equitable between impairments and between classes
- easy to administer
- easily understood by agents and the public

Several of these premium structures are

- Multiple table extra – Under this method, a special mortality table is developed for each substandard classification that reflects the experience of each, and a set of gross premium rates is computed for the classification.
- Flat extra premium – This method is used when the extra mortality, measured in additional deaths per thousand, is expected to be constant.

- **Limited death benefit** – It is equal to a refund of premiums if death occurs in the first few years.
- **Graded death benefit** – It is another form of limited death benefit, with the amount payable increasing in each of the first three to five years, after which the full death benefit is payable.

**Improvement in expected mortality** – Insureds expect reconsideration when an apparent reduction in expected mortality is due to change in residence, occupation, or avocation. To prevent insured persons from withdrawing, companies generally make some provision for handling these improvements. Some companies require a probationary period of one or two years prior to rating removal. This protects the company against the possibility that the insured will return to the former occupation.

**Extra premiums** – Most companies offer full coverage to certain impaired risks at an extra premium

**Modification of type of coverage** – This device is useful for cases in which the medical history involves short-term disabilities only.

**Renewal underwriting** – It is concerned with the health history of the insured and also changes in occupation, income, residence, or habits, all of which may have made him or her a less desirable risk. With optionally renewable policies, the company has an opportunity to reevaluate its insureds periodically.

## **Special Underwriting Practices**

Usual underwriting practices are relaxed in several areas. In the process, special underwriting concerns are created. They are

- **Non medical insurance** – No physical examination is ordinarily required. Medical information is gathered from the proposed insured by the agent who asks medically related questions from the application [and possibly from attending physician statements and other sources]. Important safeguards built into the nonmedical underwriting rules are limitation on the amount available and a limit on the ages at which the insurance will be issued.
- **Guaranteed issue insurance** – if the group is acceptable, the insurance company dispenses with individual underwriting and agrees in advance to accept applications for insurance on all employees who are actively at work. With this arrangement, there is no underwriting of individuals' lives; being actively at work is the only requirement. The mortality experience on these arrangements is higher than usual mortality, as would be expected. To offset the anticipated extra mortality under guaranteed issue plans, many companies pay lower commissions, and either charge a higher premium or classify the policies separately for dividend purposes.
- **Reinstatements and policy changes** – When a life insurance policy lapses for nonpayment, the policy owner has the contractual right to apply for policy



reinstatement. The owner must pay past-due premiums, plus provide **evidence of insurability** that is satisfactory to the insurer to avoid adverse selection.

- **Highly impaired risks** – In some cases, individuals with significant impairments have opportunities to obtain insurance at a cost that they can afford, even though the original application may have been declined by one or more companies. These opportunities can be found with companies that specialize in this market.

### 13. UNDERWRITING RESULTS

Underwriting results are an indication of the effectiveness of the company's underwriting policy. Statistically, it is represented by the insurer's combined loss and expense ratio. Evaluation of results by the line, territory etc., will help identify all the problem areas. Besides these, over the years, the entire insurance industry has become cyclical in nature, thus providing industry average performances against which the performance of any insurer can be measured.

The causal mechanism for this cyclic nature of the industry is yet to be determined. Certain factors like inflation, regulation and competition have had a considerable impact. For example, slow regulatory response to requests for rate increase in times of inflation could have been responsible for unsatisfactory underwriting results.

#### Summary

Underwriting involves the selection of a policyholder after recognising and evaluating the hazard, fixing a premium and deciding all other terms and conditions. The underwriter must be wary of adverse selection that occurs when an insurance applicant presents a higher-than-average probability of loss than is expected from a random sample of all applicants. The underwriter must also safeguard the company against any moral, morale or general hazard. Underwriting activities are of two types – line underwriting and staff underwriting.

Effectual implementation of underwriting is a must for the success of the insurance company. This implementation involves communication of the company policy to all concerned; along with follow up of all actions to ensure that the underwriting instructions are being followed. This can be done with the help of underwriting guides and bulletins. Underwriting audits are conducted on a regular basis to find out how well individual underwriters, underwriting branch offices and agents are following the underwriting policy standards.

Rate making is also called insurance pricing and has an important part to play in the overall profitability of the company. The underwriter must think about all aspects before deciding on the price of a policy. Underwriting results are an indication of the effectiveness of the company's underwriting policy.

## Questions



1. What undesirable consequences might follow if underwriting were not permitted in the private, voluntary markets for life and health insurance?
2. How does society benefit from the practice of underwriting?
3. What are the guiding principles in underwriting life and health insurance?
4. To achieve adequate, equitable, and non excessive rates, what factors do insurers consider in underwriting life and health insurance?
5. How advances in technology are changing the importance and use of traditional factors in underwriting life and health insurance?
6. What are the objectives of underwriting?
7. What are the activities of a line underwriter?
8. What is adverse selection?
9. Give a few examples of occupational hazards.
10. What is numerical rating?
11. Discuss the sources of information concerning life and health insurance risks?
12. What is Judgment method?
13. What are the methods of risk classification? Explain advantages and disadvantages of each of the methods.
14. What is the method of classifying substandard risks in life and health insurance?
15. Explain the theory behind nonmedical life insurance and indicate which underwriting safeguards are used with this type of insurance.
16. What is special underwriting practice? Explain how reasonable results can be obtained from it?
17. Explain various laws affecting underwriting practices.
18. Explain limitations on insurers' freedom with respect to collection, maintenance, use, and disclosure of personally identifiable information.

# Insurance

## CHAPTER – 5

### LIFE INSURANCE PRODUCTS

#### OUTLINE OF THE CHAPTER

- Term insurance plans,
- Whole life plans,
  - With profit and without profit policies
- Endowment plans,
  - Children's policies
  - Women's policies
  - Combination plans
  - Interest sensitive products
  - Investment plans
  - Unit linked policies of UTI
- Available insurance policies in the Indian market
- Questions

#### **LEARNING OBJECTIVES**

- To provide a recapitulation of the various kinds of life insurance policies offered in the market
- To create awareness about products offered by major insurance companies for various kinds of life insurance policies
- To find out about the features of different policies
- To give an insight to the reader for deciding and selecting an appropriate policy for a person
- Recognizing various types of Term, Endowment and Whole life insurance policies
- Understanding the flexibility and transparency in universal life policies
- Understanding the evolution and design of universal life policies

- Understanding the risks and returns associated with universal and variable life products
- Understanding the entry of other flexible premium policies into the market
- Explaining the purpose of various optional benefits and riders

Life insurance policies can be constructed and priced to fit a myriad of benefit and premium-payment patterns. Historically, however, life insurance benefit patterns have fit into one or a combination of three classes:

- Term life insurance
- Whole life insurance
- Endowment insurance

This life insurance classification scheme remains valid today, although it is not always possible to determine at policy issuance the exact class into which some types of policies fall. Some policies permit the policyowner flexibility effectively to alter the type of insurance during the policy term, thus allowing the policy to be classified as to form only at a particular point. For presentation purposes, these flexible forms of life insurance are discussed as if they were an additional classification, even though all can properly be placed [at a given point in time] into one or a combination of the three traditional classes.

The relative importance of each of these three types of life insurance varies from market to market and over time within a single market. For example, term life insurance is quite popular in the United States and endowment life insurance is popular in India, and in most Asian and many African, European and Latin American Countries.

## **TERM ASSURANCE PLANS**

---

### **Nature of term insurance**

- Furnishes protection for a limited number of years.
- It terminates with no maturity value.
- The face amount of the policy is payable only if the insured's death occurs during the stipulated term.
- Nothing is paid in case of survival.
- Issued for a short period but customarily provides protection for at least a set number of years, such as 10 or 20 years, or to a stipulated age, such as 65 or 70 years.
- It is more comparable to property and liability insurance contracts than to any other life insurance contract.
- Initial premium rates are low compared to other life products because the period of protection is limited.



- Prices of term products of different insurers can be easily compared.
- The term market is more price competitive than the market for cash value policies.
- Usually, term products have no cash values and often no dividends, thus permitting policy comparisons on the basis of premiums.
- Term lapse rates are higher than other policies because these are price sensitive, easily replaceable and only a few penalties for early termination.

## Features

Three features applicable to many term life policies.

- **Renewability** – continuation of the policy for another term without reference to insured's insurability; premiums increase at each interval.
- **Convertibility** – is an option to change over to a cash value policy [whole life or endowment] without reference to insured's insurability; conversion allowed on attained age method or on original age method.
- **Re-entry** – is the facility to pay lower premium than otherwise if insureds can demonstrate that they meet certain continuing insurability conditions. Insurers use three types of mortality tables. 1. Select [mortality experience of newly insured lives - generally exhibit lower mortality], 2. Ultimate [mortality experience beyond the select years - generally it exhibits higher mortality], and 3. Aggregate [includes both select and ultimate] mortality tables.

Traditional term premiums are based on aggregate mortality experience

Reentry term premiums are based on select / mortality split.

## TYPES OF TERM LIFE INSURANCE POLICIES

### 1. Level face amount

- a) Increasing premium – yearly renewable term
- b) Level premium policies – Life expectancy term based on specific mortality table or Term – to – age – 65 [or 70] provides protection for a somewhat shorter period than do life expectancy policies and consequently, have slightly lower premiums.

A cash value often develops during the policy term, increasing for some years then decreasing to zero by policy expiry.

### 2. Non level face amount

- a) **Decreasing term policies** – These policies are commonly used to pay off a loan balance on the death of the debtor\ insured. **Mortgage protection plan**, which clears a mortgage loan when the insured dies. **Payor benefit plan** [a rider] provides waiver of premiums in juvenile insurance when the parent dies. **Family income policy** provides monthly income to the surviving spouse.

**b) Increasing term** is not issued as a separate policy but only as a rider – Cost - of living – adjustment [COLA] rider provides automatic increases in the death benefit depending on the increase in inflation. **Return – of – premium** feature provides for return of all premiums in case of death.

### **Uses and Limitations of Term Insurance**

- Can be useful for persons with low income and high insurance needs.
- To individuals at the threshold of careers or who started new businesses.
- To indemnify businesses on the death of key employees.
- Supplement to an existing life insurance program during the child rearing period.
- Can be useful as a hedge against financial loss already sustained.
- For ensuring that the mortgage and other loans are paid on the debtor/insured's death.
- Vehicle for ensuring juvenile education in the case of payor's death.
- Natural for all situations that call for temporary income protection needs.
- It can be the basis for one's permanent insurance program through a so called 'buy – term – and – invest – the difference [BTID] arrangement. The hope is that the term + the separate investment will out perform the cash value life insurance policy.

**The BTID program may fail in its mission if the individual fails to set aside the planned amounts regularly.**

## **WHOLE LIFE INSURANCE POLICIES**

---

### **The nature of whole life insurance**

- Whole life insurance is intended to provide insurance protection over one's entire lifetime.
- It provides for the payment of the face amount upon the insured's death regardless of when death occurs.
- Universal life policies can function as whole life insurance if they have sufficient cash value.
- The face amounts payable under whole life policies typically remain at the same level throughout the policy duration, although dividends are often used to increase the total amount paid on death.
- In most policies, the gross premium also remains at the same level through out the premium payment period with some exceptions.



## **Whole life as endowment or term insurance**

- Terminal age in all mortality tables – 100 years. The company pays the policy face amount to those few persons who live to the terminal age – as if they had died.
- It is also referred as ‘endowment – at – age 100 policies’.
- Actuarial principles same as ‘term insurance’. Hence also called ‘Term-to-age-100’.

## **Whole life cash values**

- All whole life policies involve some pre funding of future mortality costs.
- Cash values are available to the policy owner at anytime by surrendering the policy.
- Loans can be obtained on interest. [ up to the policy’s cash value]
- Loan is deducted from the gross cash value when death claim is payable.
- Policy loan may, but need not, be repaid at any time and is a source of policy flexibility.

## **With profit and without profit whole life policies**

- Most whole life insurance policies are participating.
- A significant proportion is non-participating, but with some non-guaranteed element.
- Dividends actually paid may exceed illustrated dividends when investment returns are high.
- In India it is known as with and without profit policies.

## **Types of whole life insurance policies**

1. Ordinary life insurance
2. Limited payment whole life insurance
3. Current assumption whole life insurance
4. Variable life insurance
5. Modified life insurance
6. Enhanced ordinary life insurance
7. Graded premium whole life insurance
8. Single premium whole life insurance
9. Indexed whole life insurance
10. Special purpose life insurance

## 1. Ordinary life insurance

also known as 'straight life', 'continuous premium whole life', 'whole life' – provides whole life insurance with premiums that are payable for the whole of life. The features of ordinary life insurance are

- Permanent protection at a relatively modest annual outlay.
- Cash values normally increase at a fairly constant rate, reaching the policy face amount at age 100.
- Early years cash values are low because high costs of policy sale, commission, underwriting and other administrative expenses.
- Flexibility in this product – 'vanish pay' [possibility of no further payments by the policy owner through accumulated dividends and paid up additions] and 'premium deposit rider' [policy owner deposits amounts to pay future premiums].

Uses of ordinary whole life insurance are

- Offer greater flexibility and value.
- Useful to accumulate savings via life insurance.
- Outlays can be relatively modest because level premium payments for the entire duration.
- Enjoy favorable income tax treatment.

Limitations of these policies are

- Life policies are costly for those whose life insurance need is less than 15 years. It is also costly for persons whose careers are just beginning because their incomes would not permit purchasing such long term insurance policies.

## 2. Limited – payment whole life insurance

The features of limited payment whole life insurance are

- The policy remains in full force for the whole of life but premiums are payable for a limited number of years only, after which the policy becomes paid up for its full face amount.
- It is contractually guaranteed, never to require premium payments beyond the stated premium payment period. There is no such guarantee with 'vanish pay' policies.
- It contains the same non-forfeiture, dividend, settlement options of ordinary life policy.
- The extreme in limited – payment life insurance is the single – premium whole life policy.



Limitations of these policies are

- It is not well adapted to those whose income is small and whose need for insurance protection is great.
- This policy is fit for many business insurance situations.

### **3. Current assumption whole life insurance**

The features of current assumption whole life insurance are

- It is referred to as interest – sensitive whole life and as fixed premium universal life.
- In cash value determination this policy uses changing money interest rates and current mortality charges.
- Two versions – low premium version and high premium version.
- Flexibility in premium payments and maintaining death benefits.
- It is a blend of old and new [universal life] [control and flexibility].

Limitations of these policies are

- Unlike universal policy, it will lapse if a required premium is not paid. Hence it gives the discipline to pay flexible premiums.

### **4. Variable life insurance**

It is also called unit linked life insurance. The features of these policies are

- It could help offset the adverse effects of inflation on life insurance policy values.
- ‘Separate account ‘ - distinct pool of investments – acts as a mutual fund.
- The policy cash values are directly related to the investment performance.
- Regardless of the investment performance, the death benefit is guaranteed.
- Cash values are not guaranteed [passing investment risk to the policy owner].
- Policy loans are to be made available of 75% of the cash value at a fixed or variable rate of interest.
- It is appealing to those who desire whole life insurance at a fixed, level premium and also the potential for important equity type gains [losses].

Limitations of these policies are

- It is riskier than other policies.
- Regulations require greater disclosure than other policies.

## **5. Modified life insurance**

The features of modified life insurance are

- premiums are redistributed over a period of time
- lower during the first few years
- increase in later years.

## **6. Enhanced ordinary life insurance**

The features of enhanced ordinary life insurance are

- dividends are used to provide a level coverage at a lower than usual premium
- face amount reduced after a few years and dividends are used to purchase deferred paid-up whole life additions.

## **7. Graded premium whole life insurance**

The features of Graded Premium whole life insurance are

- Premiums begin at a level that is 50 % or less than those for comparable ordinary policies.
- Premiums increase annually for a period of 5 to 20 years and remain level thereafter.
- Cash values evolve slowly than ordinary policy
- More akin to YRT policies.

## **8. Single premium whole life insurance**

The features of single premium whole life insurance are

- a large single premium is paid
- mortality and expense charges deducted annually from the cash value
- Wealthy older persons purchase it

## **9. Indexed whole life insurance**

The features of indexed whole life insurance are

- Face amount increases with increases in the inflation.
- Insurance company bills the policy owner each year, if policy owner assumes the risk.
- Not to require evidence of insurability for these increases.
- If the policy owner declines in any year to purchase the increase, no further automatic increases are permitted.



## 10. Special purpose life insurance

- Special purposes – synonymous with industrial insurance and home service insurance.
- Family policy
- Juvenile insurance
- Pre need funeral insurance

Insurance covering multiple lives:

- Survivorship life insurance or second- to-die life insurance – pays death proceeds on the death of the second [last] insured.
- Joint life insurance or first –to-die insurance – promises to pay the face amount of the policy on the first death of one of two insureds covered by contract.

## UNIVERSAL LIFE [U.L.] INSURANCE

**Origin and growth:** Though the concepts upon which UL is based are 100 years old, the credit of conceiving of UL as a product goes to George R. Dinney of the Great West Life, a Canadian insurer in 1962 & 1971.

- The high interest rate environment in mid '80s influenced initial high growth rate of UL.

### Nature

- Flexibility in premium payment [whatever amounts, whatever times] even skip after making an initial minimum premium payments, the provided the cash value will cover policy charges.
- Adjustability of death benefit.
- Superior value through reduced distribution costs.

### Challenges

- Agents resisted the commission structures.
- Many companies failed to secure adequate margins because of lower than expected sales.
- Administrative costs are high.
- Uncertain cash flows have proven a challenge in the operation of a UL policy.

### Operation of UL policy

- Similar to CAWL [current assumption whole life] policies.
- Differ from them in that neither the premium level nor the death benefit is fixed.

- Mortality charges based on insured's attained age.
- UL policies levy high first year surrender charges.
- The cash value less surrender charges yields the policy's cash surrender value.
- The process [flexible premium – expense charges – mortality charges + interest = cash value] is repeated for third, fourth and later periods.
- If the cash value at any time were insufficient to sustain the policy, it would lapse without further premium payments.
- No further premium need be paid, however, if the cash value is sufficient.

## UL Product design

- **Death benefit patterns** – UL policies offer two death benefit patterns [level death benefit pattern and a level net amount at risk (NAR)]. From these two the purchaser selects one. Of course, the pattern may be changed at any time, but, in the absence of a change request, the selected pattern will be followed during the policy term.
- **Premium payments** – UL policyowners pay premiums of whatever amount and whenever they desire, subject to company rules regarding minimums and maximums.
- **Policy loadings** – Identifiable loadings are imposed on UL policies in one or both of two ways: 1. Front end loads and 2. Back-end loads. [Front-end loads are first year expenses, commissions, mortality margins, marketing etc. and Back-end loads are surrender charges]
- **Mortality and other benefit charges** – Mortality charges are deducted each month from UL cash values. Most UL mortality charges are indeterminate and differentiated. Interest credits and loadings also must be factored into the analysis [other than mortality charges].
- **Cash values** – Cash value is simply the residual of each period's funds flow. It results from taking the previous period's ending cash-value balance [if any], adding to it any premium paid, subtracting expense and mortality charges, then adding current interest credits to the resulting fund balance. The result is the end-of-period cash value. UL policies also permit policy owners to obtain policy loans on the security of the policy's cash values. The surrenders must be for at least a minimum amount and may carry a processing charge. The policy death benefit is reduced by the exact amount of any partial surrender. [To avoid adverse selection]. Policy surrender involves a surrender charge.

## Uses of Universal Life Insurance

- A single UL policy can serve the needs of a family throughout their life cycle.
- A UL policy can be used, as can most other cash value policies.



- It can be used in virtually every circumstance in which a whole life policy could be used.

## **Limitations**

- Flexibility in premium payment may lead to poor persistency and consumers may lose money.
- Undue emphasis on current interest rate, to the exclusion of other potentially important elements such as expense loadings, mortality charges, and surrender charges.

## **Variable Universal Life Insurance**

It is also called flexible premium variable life. It is a combination of flexible characteristics of universal life with the investment flexibility of variable life.

### **Nature of Variable Universal Life insurance**

- Same regulations as VLI [Variable Life Insurance].
- Flexibility in premium payments + option of increasing or decreasing the policy death benefit.

### **Uses**

- Useful for those persons who desire to treat their life insurance policy cash values more as an investment than a savings account.

### **Dangers**

- If separate account investment results are not favorable, the policy's cash value could be reduced substantially and the policy could require substantial additional premium payments.

## **Other flexible premium policies**

### **Adjustable Life [AL] Insurance**

- Level premium
- Level death benefit life insurance policy
- Assumes the form of any traditional term or whole life policy.
- Offers the policy owner the ability, within limits, to change the policy plan, premium payment, and face amount.
- AL policies require certain minimum annual premium payments.
- In some respects they are similar to fixed premium policies.

## **Flexible Enhanced Ordinary Life**

- Combination of whole life, term and paid-up additions in such proportions as to allow the policy owner to establish a comfortable premium level, within limits, and to adjust the policy amount, also within limits.

## **ENDOWMENT INSURANCE**

---

Unlike term policies Endowment policies promise not only to pay the policy face amount on the death of the insured during a fixed term of years, but also to pay the full-face amount at the end of the term if the insured survives the term.

### **Concepts of endowment insurance**

#### **1. Mathematical concept**

Endowment Insurance = Term life insurance + pure endowment [to pay the face amount if the insured dies during the period + to pay the maturity amount only if the insured is living at the end of a specific period, with nothing paid in case of prior death]

#### **2. Economic concept**

Divides endowment insurance into two parts:

- a) Decreasing term insurance
- b) Increasing savings
  - The savings part of the contract is available to the policy owner through surrender of the policy.
  - The increasing savings feature is supplemented by decreasing term insurance, which, when added to the savings accumulation, equals the policy's face amount.

An endowment policy has the following features:

- Endowment plans promise protection from risk in the event of death of the insured during the policy term as well as an assured sum upon the maturity of the policy. In this type of policy the maturity of the policy is usually chosen to coincide with the retirement of the person.
- These policies are issued for specific terms chosen by the proposer who can choose the duration of the policy which may be 10, 15, 20 or 30 years. Where the duration is short the premium involved is higher.
- It is to be noted that whether the assured meets a premature death or not the full amount of the policy has to be paid by the insurance company provided the premiums have been paid as stipulated in the policy.



- The endowment amount at the end of the term can be used to
  - Purchase an annuity policy for getting a stream of monthly pension for the rest of his life.
  - For parking the money in some investment to generate returns.
- These policies are eligible for loans within the surrender value of the policy.
- If a person wants to meet expenditure like his children's education and marriage, he can go for this plan since he is entitled to the proceeds under the plan on maturity of the policy. The term can be selected to suit these contingencies.

## Types of endowment policies

- Single premium endowment policies
- Retirement income policy – the amount payable at death is the face amount or cash value, whichever is greater.
- A semi endowment policy – pays upon survival.
- Modified endowment policy – provides for payment periodically.
- Deposit term – first year premiums were set to be higher than renewal premiums.
- Juvenile endowment policies – designed to cover child's education, marriage, and independence.

## Optional benefits and riders

1. **Disability benefits** – A common practice is to attach riders that provide certain benefits in the event of the insured's disability. The two most common disability benefits are
  - waiver of premium
  - disability income
2. **Accelerated death benefits** – This provision involves the payment of all or a portion of a life insurance policy's face amount prior to the insured's death because of some specified, adverse medical condition of the insured. It typically takes one of the three forms.
  - terminal illness coverage
  - catastrophic illness coverage
  - Long-term care coverage.
3. **Accidental death benefit [double indemnity]** – This provision may be added to most life insurance contracts, which provides that double of the face amount is payable if the insured dies as a result of an accident. The expression accidental insists that both the cause and result of the death must be accidental.

4. **Guaranteed insurability option** – It was developed to permit young individuals to be certain that they would be able to purchase additional insurance, as they grew older, regardless of their insurability.
5. **Cost of living rider [COLA]** – This rider can be useful when one's needs for insurance are expected to change over time in approximately the same proportion as changes in the cost of living.
6. **Additional insurance coverage** – Attaching term riders to basic policies enhance the total death benefit.

**The practice of these benefits to insurance contracts permits flexibility in adapting basic plans to individual needs.**

### **Children's Policies**

- These are a type of *money back plans* to get an accumulated value at the end of a certain period (when the child attains majority). Some plans provide options to the buyer to withdraw lumpsum amounts in periodical installments say every 2, 3, 4 or 5 years after a deferment period. This scheme is designed to provide finance to incur expenses related to the child's education or for helping him to make his livelihood by setting up/starting his profession/business when he grows up.
- Parents or the legal guardian can also take out a policy on the life of their children from their birth.
- The risk cover generally commences when the children attain the age of 12, 17, 18 or 21 years of age (known as the date of risk) and it is vested on the child on attainment of his/her majority.
- Until the child attains majority, the ownership of the policy rests with the parents, who have to pay the premium regularly.
- One important point to note here is that a child's policy should be considered only after the major income earner of the family has been adequately insured. This is because a children's policy is quite useless if the primary breadwinner of the family dies. In the event of his death, the policy may lapse, as the child may not be in a position to pay the premium. To take care of this contingency it is possible for the proposer to avail the premium waiver benefit by paying additional premium from inception.
- The policy has two stages – The first stage covers the period from the date of commencement of the policy to the deferred date that is the date under which the risk commences under the policy. No loans are granted under the policy during the deferment period and no risk of death is covered until the child attains the prescribed age as per the policy contract. If the child dies during the deferment period, the policy stands cancelled and the amount paid under the policy by way of premium without any deduction is refunded to the proposer. The second stage covers the risk period.



## **Women's Policies**

Women are exposed to as many risks as their male counterparts. They are required to perform in the work place as well as fulfill their obligations towards family.

If a female member in a home dies it is very difficult to compensate her position by her dependants. So, it is advisable for women from every socio economic environment to purchase a woman's policy to safeguard against the risk of her demise.

These policies provide funds for the purpose of education, marriage or sickness.

With guaranteed loyalty and loyalty additions during the policy term period these policies have been tailored to encourage women to save for their own safety and security.

Survival benefits can be claimed as per requirement.

## **Insurance for handicapped dependants**

- It provides for insurance cover that provides for monthly payments for a specific period after a covered illness or injury occurs.
- Insurance must be purchased prior to illness or injury.
- Under this policy an individual or a member of a HUF can take cover on his own life to provide for a payment of the lump sum and an annuity to the handicapped dependant.
- It provides a way for protection of income and maintenance of standard of living of the policyholder and his family.

## **Combination Plans**

The life insurer has to satisfy various needs of policyholders. Sometimes traditional policies like Whole Life and Endowment needs to be combined, including the annuity element so as to meet the requirements of certain policyholders, who would be covered for maximum risk, with not much provision for maturity element. The Jeevan Mitra Policy of LIC fulfils such needs. Here, the basic sum becomes payable on maturity, but on death twice the sum assured becomes payable. In case of accidental death, one more sum assured becomes payable.

Recently, LIC launched a triple cover Jeevan Mitra, where the death cover is 3 times the basic sum assured. In case of death by accident, four times of the basic sum assured becomes payable.

Insurance is limited only to the premiums paid if death occurs due to natural reasons within six months of the policy's first year and during the later part of the year, the cover is provided at half of the sum assured.

## **Interest Sensitive Products**

Interest sensitiveness is a feature of all savings scheme. Due to inflation, interest rates have become volatile and the rupee is depreciating steadily. Life insurance products

are also exposed to interest rate risks and often life insurance salesmen learn from the market that life insurance return is not attractive. To counter these problems, insurers have come up with the following to compensate for the low return.

By providing extra benefits, accruing to the policy every year in the form of additions, on a predetermined scale or a rate.

By providing a periodical return of a portion of the sum assured without reducing the death cover during the initial years of the policy or at the end of the term. A policyholder can exploit the benefits of the investment climate prevailing during that time and put the refund money in investments with higher returns.

LIC's Jeevan Chayya Plan (a Children's policy) is an interest sensitive scheme where the sum assured is returned during the last four years of the policy in four equal annual installments. The death cover is for double the sum during the currency of the policy.

Investment oriented policy holders usually go for such policies. Since, the insurer gives periodical repayments of the sum assured to the insured, he does not grant a loan within the surrender value of the policy.

## **WITH PROFIT AND WITHOUT PROFIT POLICIES**

---

### **With Profit Policies**

These are participating plans in which the policyholder is entitled to participate in the profits or surplus of the insurer.

The surplus is determined through the periodical valuation of assets and liabilities as per statutory requirements.

The surplus is usually distributed in the form of bonus, declared after such a revaluation and is paid along with the contracted amount.

These plans are very popular in India, because a majority of them purchase life insurance policies for savings purposes.

The premium rate charged for these policies are higher than that of "Without Profit" Plans.

### **Without Profit Policies**

These are non-participating plans in which the policyholder does not receive a share of the surplus of the insurer.

The rate of premium is lower for these policies than that of With Profit Plans.

#### **Investment plans**

The premium proceeds of the policy are invested by the insurer in the capital markets and other market oriented instruments. The returns are not predictable and they



fluctuate depending upon the market conditions. However these policies promise higher returns than other policies.

#### Plans:

- Bima Nivesh double and triple cover of LIC
- Bima Plus (a Capital market linked plan) of LIC
- Lifetime pension plan of ICICI Prudential (a pension plan)
- Unit Linked policy of UTI

#### Unit Linked Policy of UTI

It is a unique investment scheme from Unit Trust of India. This policy offers higher rates of return to policyholders and at the same time reduces interest and mortality guarantees offered by traditional products.

These products enable policyholders to:

Choose a means of savings vehicle.

Have greater amount of flexibility than traditional products by offering very little limitation on premium payment and withdrawal of money.

Avail tax rebate under Section 88 of the Income Tax Act and get a tax-free dividend and benefit of longterm capital gains after maturity.

Some other features of the policy are:

Yield is quite high if entry is at a younger age and it declines gradually with the increase in age of the policyholder.

The maximum target amount is restricted to Rs. 75,000.

It is available in two term periods, 10 and 15 years.

It provides numerous advantages to the policyholders in the form of life insurance cover at a fairly low rate, accident cover, decent rate of returns and tax benefits under Section 88.

Insurance is limited only to the premiums paid if death occurs due to natural reasons within six months of the policy's first year and during the later part of the year, the cover is provided at half of the sum assured.

A maturity bonus of 5% and 7.5% is also granted on the 10 and 15 year plans respectively.

Life and accident covers are not granted to minors under this plan.

It has no nomination facility.

## **AVAILABLE LIFE INSURANCE PLANS IN THE INDIAN MARKET\***

---

### **Life Insurance Corporation of India**

The life insurance plans which are available in LIC are listed below.

#### **I. Basic Life Insurance Plans**

1. Whole life Assurance (Table Nos. 2, 5 & 8)
2. LIC's Jeevan Tarang (Table No. 178)
3. Endowment Assurance (Table No.s 14 & 48)
4. Jeevan Anand (Table No. 149)

#### **II. Term Assurance Plans**

1. Anmol Jeevan (Table No. 164)
2. Amulya jeevan (Table No. 177)

#### **III. Specific Plans for children**

1. Children Deferred Endowment Assurance (Table Nos. 41 & 50)
2. Komal Jeevan (Table No.159)
3. Jeevan Kishore(Table No.102)
4. Jeevan Chhaya (Table No.103)
5. Child future plan (Table No.184)
6. Child career plan (Table No.185)

#### **IV. Unit Linked Plans**

1. Market Plus (Table No.181)
2. Fortune Plus (Table No.187)
3. Profit Plus (Table No.188)

#### **V. Micro Insurance Plan**

1. Jeevan Madhur (Table No.182)

#### **VI. Plans for Handicapped Dependants**

1. Jeevan Aadhar (Table No. 114)
2. Jeevan Vishwas (Table No.136)

---

\* It may be noted that the details given are indicative only. Very few Companies' products have been given to through light on the available products.



## VII. Other plans

1. New Jana Raksha (Table No.91)
2. Fixed term (marriage) endowment/educational Annuity. (Table No. 90)
3. Jeevan Anurag (Table No.168)
4. Money Back Plans (Table Nos.75, 93)
5. Jeevan surabhi (Table Nos.106, 107 & 108)
6. LIC's Bima Bachat (Table No.175)
7. Jeevan Saathi (Table No. 89)
8. Jeevan Mitra (Table Nos.88 & 133)
9. Jeevan Shree (Table No.162)
10. Jeevan Pramukh (Table No.167)
11. Jeevan Bharathi (Table No.160)
12. Jeevan Saral (Table No.165)
13. Bima Nivesh (Table No.171)
14. New Bima Gold (Table No.179)
15. Jeevan Amrit (Table No.186)

### I Basic Life Insurance Plans

1. Whole Life Assurance (Table Nos. 2, 5 & 8)  
A low cost with profits insurance plan where the assured is payable on the death of the life assured along with bonuses, whenever it occurs. The claim can also be had after the life assured attains 80 years of age- subject to certain conditions.
2. LIC's Jeevan Tarang (Table No.178)  
It is a with-profits whole life money back plan which provides for annual survival benefit at a rate of 5.5% of the sum assured after the chosen accumulation period.
3. Endowment Assurance (Table No. 14 & 4)  
Under this plan, the sum assured is Payable along with accrued bonuses on maturity or on earlier death of the life assured.
4. Jeevan Anand (Table No. 149)  
This is a unique with-profits plan which combines the features of Endowment and whole life plans.

## **II Term Assurance Plans**

### **1. Anmol Jeevan – I (Table No. 164)**

It is a pure term assurance plan where one can choose any term from 5 to 25 years. It provides for payment of the sum assured on the death of the life assured during the term of the policy.

### **2. Amulya Jeevan (Table No. 177)**

It is a term assurance plan with a minimum sum assured of Rs. 25 lakhs.

## **III Specific Plans for Children**

Various children's plan are available, viz. Children's Deferred Endowment Assurance (Table Nos. 41 & 50), Komal Jeevan (Table No. 159), Jeevan Kishore (Table No. 102), Jeevan Chhaya (Table No. 103), Child Future Plan (Table No. 184) Child Career Plan (Table No. 185), with facility of premium waiver benefit.

## **IV Pension Plans**

### **1. Jeevan Akshay – VI (Table No. 189)**

An Immediate Annuity plan with a number of options.

### **2. New Jeevan Suraksha –I (Table No. 147) & New Jeevan Dhara –I (Table No. 148)**

Deferred Annuities. The annuitant has five options of annuity payments to choose from. Premium paid under New Jeevan Suraksha-I up to Rs. 1,00,000/- are exempted from income tax under Section 80 CCC.

### **3. Jeevan Nidhi (Table No. 169)**

It is with-profit deferred pension plan which provides death cover during the deferment period.

## **V Unit Linked Plans**

### **1. Market Plus (Table No. 181)**

A Unit-linked pension plan with option of risk cover and commutation of 1/3rd pension. Pension can start at minimum age of 40 years.

### **2. Fortune Plus - (Table No. 187)**

Unit Linked Endowment Plan with 4 Fund types, 5 to 20 year policy term, and 5 years premium paying term.



3. **Profit Plus-(Plan No.188)**

Unit Linked Endowment Plan with 4 Fund types, 5 to 20 year policy term, and single premium & 3 to 5 years premium paying term.

## **VI Micro Insurance Plan**

1. **Jeevan Madhur (Table No. 182)**

A micro insurance cum saving plan with profit where premiums can be paid in weekly, fortnightly, monthly, quarterly, half-yearly or yearly intervals over the term of the policy. Sum assured varies from Rs. 5,000/- to Rs. 30,000/-.

## **VII Plans for Handicapped Dependants**

Following plans are designed for the benefit of handicapped dependents. Benefits are payable partly in lump sum and partly in the form of annuity.

1. **Jeevan Adhar (Table No. 114)**

It is a limited payment Whole Life Policy with guaranteed additions at the rate of Rs.100/- per thousand sum assured p.a. upto 65 years of age of the life assured or on earlier death.

## **VIII Other Plans**

1. **New Jana Raksha (Table No.91)**

Ideal for all but especially for people with irregular income.

2. **Fixed Term (Marriage) Endowment/Educational Annuity (Table No.90)**

An ideal plan for making provision for education/start-in-life or marriage of children. Claim/Annuity is payable after expiry of policy term.

3. **Jeevan Anurag (Table No. 168)**

It is a with-profit plan suitable for making provisions for educational and other needs of children.

4. **Money Back Plans (Table NO.75 & 93)**

Besides providing life cover during the term (20 & 25 years) of the policy survival benefits linked to the sum assured during the term of the policy will be available.

5. **Jeevan Surabhi (Table No. 106,107 & 108)**

A money back plan where premiums are payable for a limited period, with periodically increase in insurance cover by 50% of the basic sum assured after every five years.

6. LIC's Bima Bachat (Table No. 175)  
It is a single premium money back policy with policy term of 9,12 and 15 years. Survival Benefits during the term of the policy are available.
7. Jeevan Saathi (Table No. 89)  
A with-profits Joint Life Endowment Assurance Plan for husband and wife.
8. Jeevan Mitra (Table No. 88 & 133)  
An Endowment Assurance plan providing for twice or thrice the sum assured payable on the death of the life assured during the policy term.
9. Jeevan-Shree-1 (Table No.162)  
A limited payment Endowment Assurance plan with guaranteed additions for the first five years and bonus additions thereafter.
10. Jeevan Pramukh Plan (Table No.167)  
It is a niche market with-profits plan.
11. Jeevan Bharati (Table No.160)  
Money Back plan exclusively for ladies with additional benefits such as female critical illness benefit and congenital disability benefit.
12. Jeevan Saral (Table No.165)  
A Plan that provides the life assured insurance cover with the flexibility of partial withdrawal.
13. Bima Nivesh 2005 (Table No. 171)  
A single premium plan with compounding guaranteed additions of Rs. 50/- per thousand per annum payable on death or maturity.
14. New Bima Gold (Table No. 179)  
A regular premium money back plan with return of total premiums in installment at prespecified intervals with loyalty additions, if any, at maturity & extended free risk cover.
15. LIC's Jeevan Amrit (Table No.186)  
Plan where premium payment is limited to 3,4or 5 years and premium payable during first year is higher than the premium payable in subsequent years Riders available: LIC also offers rider benefits on its Endowment and Money Back type plans such as Accident Benefit rider, Term Assurance rider and Critical illness rider.



## ICICI Prudential Plans

### Life Guard (Term Level Assurance-Single premium)

- This plan provides assurance proceeds in case of the policyholder's unfortunate demise during the term of the policy.
- The eligible age ranges from 18 to 50 years. The maximum age at maturity is 65 years.
- The term of the policy ranges from 5 to 15 years.
- The minimum sum assured for the product is Rs. 2 Lakhs.
- This is a single premium plan.

### Life Guard (Term Level Assurance - Installment premium plan)

- On death, the sum assured is paid to the beneficiary. There are no maturity benefits in this plan.
- The minimum age at entry is 18, and the maximum is 50 years to avail the policy. The maximum age at maturity is 65 years.
- The minimum sum assured is Rs.1,00,000 and the maximum sum assured is Rs.10,00,000.
- A policy acquires a paid up value after premia are paid for 3 years, hence a guaranteed surrender value is payable if the policy is terminated after 3 years premia are paid. But in such a case the insurance protection provided under this policy ceases.

## Add-ons or Riders

- An option for add-ons exists on payment of extra premium. But during the extended life cover, no rider benefits are available. The benefits are:
- Accident Disability Benefit
- Critical Illness Benefit
- Major Surgical Assistance Benefits

### Lifeguard Level Term Assurance with Return of Premium

- Age at entry ranges from 18 to 50 years while the maximum age of coverage is 65 years.
- The term ranges from 5 to 25 years.
- This is an instalment premium plan. The amount of instalments depends on the quantum of the policy cover.

- Survival benefit is paid after maturity wherein all the premiums paid are returned. No interest accumulates on this.
- In case of death during the term, the sum assured under the plan is paid to the nominee.
- Add-ons/riders available with the earlier policy are also available under this plan.

### **ICICI Pru Saven Product**

- This is an endowment assurance policy with extended life cover.
- The eligible age at entry for the policy is 0 to 60 years. The cover ceases at 70 years.
- The minimum sum assured is Rs. 50,000 and the premium is paid in yearly installments of Rs. 4800.
- The term is for 10 years.
- The death and maturity benefits consist of the sum assured, accrued bonus and the guaranteed additions.
- An extended term insurance for 5 years after maturity of the policy for 50% of the sum assured. No extra premium is required to be paid for this facility.
- Other options are available which can be opted for by the insured at the time of purchase of the policy for which appropriate premiums are charged. Such options are:
  - Accident benefit
  - Disability benefit
  - Critical illness benefit
  - Major surgical assistance benefit

### **ICICI Pru Assure Invest**

- This plan provides life insurance cover along with savings benefits.
- This is a single premium plan.
- The plan term is of 7 to 10 years.
- The age at entry for availing the policy is 7 to 62 years. The maximum age at expiry is 67 years.
- The sum assured can range from Rs. 25,000 to Rs. 50 lakh.
- The survival benefits consist of single premium, additions at a fixed percentage (between 7.6 to 8.5% depending on the quantum of premium) compounded annually.



## **Separate death benefit is provided as per the following**

- 10% of the single premium paid to the nominee if death occurs within the first year or if caused by an accident.
- Surrender value of the policy can be encashed by the nominee if death occurs during the term of the policy. The surrender value is quoted at the time of sale of the policy.
- The surrender value accrues after the first year.
- Tax benefits under the Income Tax Act are available.
- The policyholder is eligible for loans under the policy.

## **ICICI Pru Cash back plan (anticipated endowment assurance)**

- This is a 3 in one plan combining savings, liquidity and insurance protection for a fixed term of 15 to 20 years.
- The survival benefits are paid at regular intervals.
- The premiums are paid at regular intervals.
- On death, the survival benefits are paid to the beneficiary wherein the full sum assured is paid with guaranteed additions and the vested bonus.
- There are options for money back payouts after 3, 6, 9, 12, and 15 years or after 4, 8, 12, 16, 20 years or after 10, 15, 20, 25 years. At the end of the term, the balance sum assured, the guaranteed additions and the vested bonus is paid.
- Certain riders are available for extra premium like accident and disability benefits, critical illness benefit, major surgical assistance benefit, and level term insurance.
- The minimum sum assured is Rs. 75,000.
- If the policy is discontinued after 3 years of premium payment the surrender value is eligible to be paid but the insurance cover is stopped.

## **HDFC STANDARD PLANS**

---

### **Loan cover term assurance**

- This is a pure term cover plan where the assured sum is paid if the insured dies within the term period
- The amount of cover depends on the assured's requirements. The eligible amount of the cover decreases with age.
- There are no survival benefits
- The minimum entry age is 18 and the maximum is 55 years while the maximum age to avail this policy is 65 years

## **Term assurance plan**

All the points 1 to 6 covered under (I) are applicable here.

This policy provides some amount as death benefit due to accident if death occurs within 90 days of the accident.

## **Endowment assurance plan**

- The policy operates as a normal endowment plan.
- The lumpsum benefit consists of the basic sum assured plus any bonus additions.
- The minimum age for entry ranges from 12 to 18 years for different plans. The maximum age for entry is 60. The maximum age at expiry is 75 years.
- The different plans (require different premium amounts) under the scheme are:

### **Classic plan – here the basic sum assured is paid.**

- Plan A – the basic sum assured plus double the sum assured is paid as benefits.
- Plan B – the basic sum assured plus double sum assured along with accident death benefit is paid.
- Plan C – the basic sum assured plus waiver of premium benefit in case of disability is available.
- Plan D - the basic sum assured, double sum assured along with the waiver of premium (for disability) is paid as benefits.
- Plan E - the basic sum assured, waiver of premium (for disability) with critical illness benefits are paid under this plan.

## **MONEY BACK PLAN**

---

- The age for availing the scheme ranges from 12 to 60 years, which differs for different options and benefits offered by the scheme. The maximum age at expiry ranges from 60 to 75 years.
- The minimum term is 10 years while the maximum term is 30 years.
- Lumpsum cash amounts (part of the basic sum assured) are paid back at 5-year intervals.
- On survival upto maturity the payment is equal to the basic sum assured, the bonus additions, less cash lumpsums paid earlier is provided.
- In case of death of the insured, an over and above payment of the basic sum assured plus the bonus additions are given out as death benefits.



Additional riders are available which can be opted for by the insured:

- Critical illness benefit – this exists for 6 recognised illnesses. An additional amount is provided (only once) where the sum assured is the basic sum assured (if the person survives for 30 days after the date of the claim). The policy continues after the claim on this benefit is paid.
- Double sum assured – this is payable in case of untimely death of the assured.
- Waiver of premium benefit – this is provided if the insured becomes disabled.
- Accidental death benefit – a higher amount equal to the basic sum assured is provided if the insured dies within 90 days of an accident.

## **BAJAJ ALLIANZ TERM PLANS**

---

### **Risk care**

- This is a pure term cover plan.
- The premiums can be paid as a one time single payment or in instalments.
- The acceptable age for availing the scheme is 18 to 50 years.
- This policy comes with other additional benefit options. These have to be chosen by the assured on payment of additional premium at the time of purchase of the policy:

#### **Option I**

- Accident death benefit under which double the sum assured is paid to the beneficiary.
- Permanent total or partial disability benefit due to accident.
- Waiver of premium benefit in case of permanent total disability.
- Protection package for the regular premium payment option.

#### **Option II – with additional health benefits**

- Critical illness benefits where an assured sum is provided which are equal to the sum assured, if the insured succumbs to any of the 11 recognised illnesses.
- Hospital cash benefit where the insured is paid the amount of hospital expenses in case he is hospitalised (only for diseases covered).

#### **Option III**

- This includes all the benefits offered under the above two options.

### **Term care plan**

- This plan promises the return of the premium that is paid under the policy on maturity. The amount is equal to the single premium paid or the sum total of all the instalment premium payments.
- The plan term ranges from 5 to 40 years.
- The surrender value under the policy accumulates after 3 years.
- All the other policy benefits available under the Risk care plan are applicable to Term care plans also.

### **Life time care – economy plan**

- Under this policy, assurance is provided along with bonus payments.
- The minimum age for is 15 years while the maximum age is 60 years, the maximum age at maturity is 80 years.
- The minimum sum assured is Rs. 50,000.
- Survival benefits and death benefits are provided if the premiums have been paid for 15 years.
- There is flexibility in coverage combination. The add on benefits are:
  - Accident death benefit
  - Permanent total or partial disability benefit
  - Waiver of premium benefit when disabled

These benefits can be excluded or included at each policy anniversary for a different premium or in exchange for a changed policy cover.

All other features under the Bajaj Save care – Economy plan (see endowment plans) are also applicable.

### **Cash care health plan**

- Most of the features under the Lifetime care – economy plan are available under this plan.
- In addition, a critical illness benefit (for a fixed sum for 11 identified illnesses) is paid as a fixed promised sum.
- Hospital cash benefit under which the hospital bills and room charges are paid.
- All the benefits have to be separately opted for and paid for.



## Life time care total plan

- All the features and benefits under the economy and health plan can be opted for by the assured.

## Save care economy plan

The plan provides life coverage, savings growth by way of compounding of annual bonuses at the prevailing rate. The minimum age for entry is from 7 to 60 years, which is different for different plans.

## The plans are of four types:

Basic, Double, Triple and Quadruple cover

The survival benefits consist of the premium amount paid, terminal bonus paid on maturity and the compounded amount of the annual bonuses at a prevailing rate.

Riders are available under the policy, which have to be availed separately by the insured. They are:

The death cover can be reduced and the rider benefits can be combined or increased at each policy anniversary or else the death cover can be increased and the benefits can be given up or reduced.

Accidental death benefit

Accidental permanent total or partial disability benefit

Waiver of premium benefit

Apart from the above a higher risk cover is provided in the form of addition of an amount equivalent to 50% of the risk coverage at the time of the insured's marriage and birth of the first or second child.

The policy offers a discount on the premium paid by women policyholders. The premium amount applicable to them is equal to the amount paid by a younger male, preferably 2-years younger.

The policy can be surrendered after a 3-year premium has been paid.

Loans are available within 90% of the surrender value of the policy. This is available after the 3-year premium has been paid.

## Money Back Policy

The following are the *features* of these policies:

- Under these plans the policy premiums are paid to the insured in a number of separate cash payments.
- In return the insurer pays back the survival benefit in a number of fixed intervals. The timing of receipt of payments can be as per the available option.

- As in case of other policies life insurance cover is provided. The premium can be paid by the insured in a single lumpsum payment or in a number of separate instalments.
- On the demise of the policyholder, during the term of the policy, the death claim payable is the full sum assured without deducting any survival benefit amounts that may have been already paid.
- Payment of bonus is allowed.
- Such a policy can be used for various purposes like down payment for a house, for the purchase of an asset, or investment in business. Variants of such plans exist for children's education and marriage wherein the periodical receipts can be used as required.

## **TATA- AIG PLANS**

---

### **TATA mahalife**

- The minimum age at entry is 30 days while the same for maximum age is 50 years.
- The premium paying term is 12 years.
- The minimum sum assured is Rs. 50,000.
- The rate of premium depends on the age, which differs under the 3 different age bands.
- The policy provides guaranteed annual payments for life from the 13th year onwards.
- The bonus under the policy is provided from the 6th year onwards. This can be accumulated under the policy with interest and can be encashed when he wants.
- The cash dividends are tax-free. Policy benefits are eligible for tax benefits.
- Loans are provided under the policy.
- There is a 15-day money back guarantee if the assured is not satisfied with the policy.
- There are options to attach TATA\_AIG's other benefits like accident benefits, disability benefits, terminal and critical illness benefits.
- Death benefit in case of death or on maturity the entire sum assured is paid, which is tax-free.

### **Assure security and growth plan**

- This offers the basic endowment insurance benefits.
- The minimum sum assured is Rs. 1 lakh.



- The term is for 10, 20, 30 years. The minimum age for entry is 18 years. The maximum age is 65, 55, 45 years respectively for the different terms.
- The mode of premium payment can be made monthly to yearly.
- The term riders can be opted for different terms like 5, 10, 15, 20, 25 years till the age of 60 years.
- The following riders (add ons) are available: an additional accident death benefit equal to the full sum assured is paid.
- The policyholder is eligible for loans under the policy.

### **Assure 15 years Life Line (return of premiums) plan**

- The age of availing the policy ranges from 18 to 50 years. The maximum age at maturity is 65 years.
- The minimum sum assured is Rs. 1 lakh.
- Survival benefits are paid back, which consist of the premium payments and the additions.
- The plan can be converted to an endowment plan.

### **The following are the policies available from different insurers meant for children:**

- Bal Vidya Smart Kid plan of ICICI
- Children's Endowment Policy of Max New York Life Insurance
- Young Scholar of Birla Sun Life

### **Discussion Questions**



1. "The endowment plan continues to be a great favorite among the insuring public in the country even today". Why? State your reasons in detail.
2. "Not withstanding the thrust given by the new insurance companies the sale of term insurance products is yet to pick up in the insurance market". Examine the reasons for the same.
3. The whole life plan, which sells the most in the western world, does not find many takers in our country. Why?
4. Should the government continue to extend tax relief as an incentive for purchasing Life Insurance products?

## Questions



1. Analyze Term life insurance with its features, types, uses and limitations.
2. Term and endowment are two forms of life insurance. Compare and contrast the product characteristics and objectives of these two coverages.
3. What are the various types of endowment policies? Explain each of the policy's uses and limitations.
4. Explain the nature of whole life insurance. Compare and contrast with endowment and term life insurance.
5. Explain different types of whole life insurance policies available in India.
6. What is the recent product innovations brought out by insurers to enhance value of the existing policies?
7. Differentiate between with and without profit policies. Why without profit policies are seldom bought in our country?
8. What are the features and benefits of interest sensitive products?



## Multiple-choice questions

1. The Whole life plans in India,
  - a) Pay death benefits after a persons expiry
  - b) Pay death benefits after retirement.
  - c) Pay policy benefits after the person attains a certain age, say 80-85 years.
  - d) None of the above.

**Ans. (c)**

2. Term assurance provides the following benefits
  - a) Death benefits if the person dies.
  - b) Death and survival benefits.
  - c) Periodic payments at predictable intervals.
  - d) Death benefits with bonus.

**Ans. (a)**

3. Endowment plans
  - a) Always participate in profits
  - b) Are not eligible for loans
  - c) Are most popular in India
  - d. Non of the above

**Ans. (c)**

4. Which of the following is a children's policy?
  - a) Jeevan Sneha
  - b) Jeevan Vishwas
  - c) Jeevan Dhara
  - d) Jeevan Sukanya

**Ans. (d)**

5. Which of the following is a health insurance scheme?
  - a) New Jeevan Dhara
  - b) Jeevan Aadhar
  - c) Jeevan Chayya
  - d) Asha Deep

**Ans. (d)**

# Insurance

## CHAPTER – 6

### SOCIAL SECURITY SCHEMES

#### OUTLINE OF THE CHAPTER

- History and philosophy of social security
- Social security in India through life insurance
  - LALGI
  - GISIRDP
  - RGLIS
  - Janashree Bima Yojana
  - Varishta Bima Yojana
- Social security in India through General insurance
  - Gramin personal accident insurance
  - Hut insurance
  - Agricultural pump set policy
  - Personal accident social security
  - Workmen's compensation
  - Payment of Gratuity
- Social security in India through
  - Provident Fund
  - Employees family pension scheme
  - Employees deposit linked insurance scheme
  - Employees' state insurance scheme
- Financial social security benefit
- Social insurance in U.S.
- Unemployment insurance
- Summary
- Questions



## LEARNING OBJECTIVES

---

- To know the definition and causes of economic insecurity
- To learn about social security schemes in India
- The OASIS report on financial social security benefit
- To know about the social insurance in U.S.

*“We want to teach the people that the government is not a rich uncle. You get what you pay for...we want to disabuse people of the notion that in a good society the rich must pay for the poor. We want to reduce welfare to the minimum, restrict it only to those who are handicapped or old. To others, we offer equal opportunities...everybody can be rich if they try hard.”*

**[Mr. Rajaratnam, former Senior Minister, quoted in Vasil (1984)]**

## 1. HISTORY AND PHILOSOPHY OF SOCIAL SECURITY

---

Social security became a major area of concern in many countries of the world when society was slowly shifting from agro-based economy to an industrial economy. People started moving to cities from villages in order to satisfy their economic needs and to get some security. This change came about in Europe for the first time during the 19th century.

This development, which later came to be known as industrial revolution had its own advantages and disadvantages. It resulted in inappropriate living conditions for the migrant population and created friction between the upper and lower classes in the society. This happened first in Europe and later in USA. In order to deal with this situation the governments in these countries came up with the idea of providing “social security” through various schemes to the weaker section of the society which consisted mainly of the migrant population working in the industries, the industrial revolution had given birth to.

The intention of the German chancellor Otto von Bismarck, who introduced social security, was to provide benefits to the workers. The basic idea behind this scheme was to help the retired workers through the contribution of the present workers. This led to development of social security measures (accident insurance, disability and old age insurance), which were adopted in the 20th century.

In USA, during the time of depression, the government felt the need for social security legislation. It became vital to support the employees who lost their jobs due to the depression. Necessary legislation was passed in 1935 and it later became effective in 1937.

## **Economic security**

Economic security, which is a vital aspect of our society, can be defined, “ as a state of mind or a sense of well being by which an individual is relatively certain that he or she can satisfy basic needs and wants, both present and future”. If a person is not happy, unable to satisfy his wants, depressed, psychologically uncomfortable, experiencing fear etc. it means he is insecure. If large number of people are placed in this situation it certainly requires government intervention.

## **Nature of Economic Insecurity**

It has been found that feelings of insecurity are caused by the following:

- Additional expenses
- Uncertainty about the future
- Loss of income
- Insufficient income

### **Additional expenses**

Sometimes it so happens that a family faces an unexpected crisis (for example a serious injury, major illness, death etc.) which gives rise to an urgent need for money. Without any savings it becomes very difficult for the head of the family to meet such expenditure. In such situations insurance could really come in handy if policies had been taken to deal with the contingencies. In the absence of savings or insurance the family would indeed be in serious trouble.

### **Uncertainty**

Job security is something that every employee looks for especially when he is otherwise satisfied with his job. In a period of depression in the industry fear of losing the job can be a really serious threat to the family's security.

### **Loss of income**

When we mention loss of income it's understood that the person has lost his job. During this time, if the person has adequate financial assets or savings it would be of help to meet his needs. But the distressing fact is that the large majorities have no such 'cushion' to fall back upon. Loss of income could also result from decease and disability.

### **Insufficient income**

A person might be working, but that might not be enough to satisfy his basic needs and expenses.



## Causes of economic insecurity

The following are some of the major causes of economic insecurity:

- Unemployment
- Premature death
- Old age
- Poor health
- Inflation
- Substandard wage
- Natural disaster
- Personal factors

Let's discuss them briefly:

### Unemployment

This is one of the vital factors that cause economic insecurity. People lose their job due to restructuring of organisation and technological changes. This results in:

- Loss of income
- More people are forced to go in for part time jobs (leading to reduced income)
- Uncertainty about income
- No jobs

### Premature death

It occurs when the head of the family expires without fulfilling his obligations. It could be his child's education, marriage of his son or daughter, payments of bills, instalments etc. Again the level of insecurity is more when the head of the family has not insured his life or health or has previously saved very little. But if a person who dies has a very little by way of commitments to fulfill with regard to the other family members, it's not considered a premature death in insurance parlance.

### Old age

After the retirement age, people no longer have a steady income and even if they seek re employment, they earn less. People in this category often develop health problems and poor health leads to more expenditure. These expenses can be faced only if there is reasonable savings or financial assets or annuities and health insurance.

### Poor health and disability

It can be due to illness or injury, which affects the earning capacity. The inability to pursue gainful employment as a result can be long term or short-term. From the family's

point of view it is a major medical expenditure. If the head of the family is the victim, the insecurity increases all the more as the source of income itself is blocked.

### Inflation

If there is an increase in prices without a comparable increase in income, inflation occurs. This is a problem especially for salaried people and pensioners. They find it difficult to manage the increase in price level.

### Substandard wage

The government should fix up a minimum wage to alleviate poverty and exploitation by the employer. A minimum level of income is needed to meet the basic expenses. By substandard wage we mean wage lower than the minimum subsistence wage level.

### Natural disasters

The most unavoidable are the natural disasters like earthquakes, famines, floods and hurricanes. They cause huge losses. Nothing can be done about it as most of the properties are uninsured or underinsured. The level of economic insecurity is at its highest in such times.

### Personal factors

Till now we have seen the external factors that cause economic insecurity. But economic insecurity can also develop on account of factors within us. Self-motivation is the key to success in life. If we lose that, low income or no income would be the consequence. There may be other personal reasons for economic insecurity like:

#### Addiction to alcohol and drugs

This can lead to two things: loss of income, and loss of health. Both of them are interrelated. Addiction to these can cause a heightened level of insecurity.

#### Divorce

The most affected people as a result of divorce are children and the women. This situation is more prevalent in western countries than in India. Lack of income and emotional needs lead to a higher level of insecurity. In order to overcome these social maladies, governments set up suitable social security programs.

#### Gambling

This unnecessary expenditure leads a person to huge debts. This may also drive a person to fraud, forgery and other such practices.



## 2. SOCIAL SECURITY IN INDIA

The literature relating to developmental issues mentions that it is not easy for developing countries to pay for social security systems. This assumption has to be challenged. Studies by UNICEF and World Bank prove that the success of social security programs depend on the support of the public.

In India social security is still in the early stage of development while in reality a large number of people are in need of social security support. Since these people live below the poverty line just earning enough to make both ends meet through agricultural operation their livelihood depends on the vagaries of weather. When they are hit by natural calamities such as drought, cyclone, failure of monsoons etc. they have no choice except to look to the government for relief and support. The need for social security support is also felt when the breadwinner of the family dies and especially when it is a premature death.

The situation with regard to regular workers in the industrial sector is a lot better as they enjoy many social welfare benefits as employees. However there are large number of seasonal workers in the industry whose situation is no better than the agricultural workers particularly in times of industrial depression when they have to face unemployment for long period. They are forced to join during such times, the unorganised sector in urban areas. Thus the need for social security support is felt most by people in two categories: the agricultural worker in the villages and the labourers belonging to the unorganised sector in the urban areas.

Since the number of people involved who need social security support is huge, finding resources is the major issue for the government. However the government has made a beginning by affording some form of social security to these people through social insurance.

In India the government has launched several social insurance schemes. All these have been developed and implemented through nationalised insurance organisations.

### **Social security in India through life insurance schemes**

The following are some of the social insurance schemes introduced through Life Insurance Corporation of India.

- Landless Agricultural Labourers and Group Insurance Scheme
- Group Insurance Scheme for beneficiaries of the Integrated Rural Development Programme
- Rural Group Life Insurance Schemes
- Krishi Shramik Samajik Suraksha Yojana

### Landless Agricultural Labourers Group Insurance Scheme (LALGI) (1977)

*This is a free group insurance scheme often described as the largest group insurance scheme in the world. The then Prime Minister, Rajiv Gandhi introduced this scheme. However, this scheme has since been withdrawn.*

#### Scheme:

- Covers all landless agricultural labourers
- No premium needs to be paid
- Life assured must be head of the family
- Age group between 18-60 years
- Death risk cover Rs. 2,000/-

#### Settlement of Claims - Requirements - Role of officials

Claim form consists of four parts to be completed as detailed below:

- Part I: To be completed by Claimant
- Part II: To be completed by VAO
- Part III: Discharge voucher on Re.1/- Revenue Stamp executed by MRO & Claimant as per instructions
- Part IV: By MRO

Xerox copy of ration card duly attested

Death certificate issued by MRO

In case of delayed submission of claim forms after one year from the date of death- to be certified by Collector/RDO/any official authorised by Collector.

Designated LIC Branch at District Headquarters processes the application and settles the claim.

### Group Insurance Scheme for Integrated Rural Development Program (IRDP) Beneficiaries (1988)

A free group insurance scheme

#### Scheme:

- All IRDP beneficiaries between the ages 18-60 years are covered
- No premium needs to be paid
- Insurance cover Rs. 5,000/-
- In case of accidental death Insurance coverage Rs.10, 000/-



- Duration of coverage: 5 years from the date of the loan or up to 60 years of age, whichever is earlier.

### Settlement of Claims - Requirements – Role of Officials

Claim form consists of 4 parts to be completed as detailed below:

- Part I: To be completed by Claimant
- Part II: To be completed by Gram Panchayat
- Part III: To be completed by MPDO
- Part IV: Discharge voucher on Re.1/- revenue stamp by claimant duly attested by Gram Panchayat

Certificate from the bank that disbursed the loan under IRDP.

Death certificate issued by MRO.

Accidental death: 1. Post mortem report, 2. Police inquest report.

In case of delayed submission of claim forms after one year from the date of death- to be certified by project Director DRDA apart from MPDO.

Designated LIC branch at district headquarters processes the application and settles claim.

### Social Security Schemes

*A scheme of insurance with 50% premium subsidy from the social security fund created by the government.*

Scheme:

Applicable to 24 occupational groups identified and notified by Central Government.

Age group between 18-60 years

Flat yearly premium Rs.50/- per member. But 50% subsidy is available

Uniform insurance coverage payable on death: Rs. 5,000/-

In case of accidental death: Rs. 25,000/-

In case of total permanent disability: Rs. 25,000/-

Loss of 2 eyes or two limbs or one eye and one limb: Rs. 25,000/-

Loss of one eye or one limb: Rs. : 12,500/-

No extra premium for accident benefit

A single master policy will be issued in favor of nodal agency or association or union

Minimum membership as per rules

This scheme covers persons who belong to one of the following 24 groups.

1. Beedi workers 2. Brick kiln workers (Jalandhar) 3. Carpenters 4. Cobblers 5. Fishermen 6. Hamals 7. Handicraft artisans 8. Handloom weavers 9. Handloom & khadi weavers 10. Lady tailors 11. Leather & tannery workers 12. Papad workers attached to self employed women's association 13. Physically handicapped self-employed persons 14. Primary milked producers 15. Rickshaw pullers/auto rickshaw drivers 16. Safai karmacharis 17. Salt growers 18. Tendu leaf collectors 19. Scheme for the urban poor 20. Forest workers 21. Sericulture 22. Toddy tappers 23. Power loom workers 24. Women in remote rural hilly areas.

### Rural Group Life Insurance Scheme (RGLIS)(1995)

**Objective:** To provide life insurance protection to rural people at a low premium.

#### Features:

Eligibility age 20 to 50 years.

Insurance (death) cover: Rs. 5,000/- each member.

Types of schemes: 1. General 2. Subsidised.

**Premium  
per year**

**General Scheme:** Category. 'A'  
(between ages 20 to 40 years)

Rs. 60/-

Category 'B' (between ages 40 to 50 years)

Rs. 70/-

**Subsidised Scheme:** Those who are below poverty line are eligible. For such cases, only one person from each household can be covered.

Category 'A'  
(between ages 20 to 40 years)

\*Rs. 30/- /year

Category 'B'  
(between ages 40 to 50 years)

\*Rs. 35/-/year

\*Balance premium subsidised by state and central governments equally.

Role of different officials at various levels - for implementation of scheme

**VLO:** Canvass the scheme - enroll members - obtain data-collect premium according to category- maintain record as per annexure - Form I.

Prepare list of members admitted to the scheme in triplicate (Form II) - separate list for two types of schemes (General -subsidised) category wise (Category A and B) - Two copies of the lists to intermediate level Panchayat (MPDO) along with premium remitted by members.



**MPDO:** Consolidate the data received as above in Form II A and submit to the designated LIC branch along with one copy of Form II and premium (including share of state government). Separate consolidation for each type of scheme category wise as well.

**Designated LIC branch:** After receiving the premium along with consolidated statement LIC branch will arrange for issue of master policy in favour of MPDO.

**Scheme:** Operative from 15th August to 14th August following year.

### **Settlement of RGLIS Claim - Flow Chart**

Claim form (Form III) to be completed by beneficiary and submitted to village Panchayat Officer along with Death Certificate.

Village Panchayat Officer has to certify that the deceased is a member of the scheme and paid the premium up to date.

#### **(Forward to MPDO)**

Executive officer of the intermediate level of Panchayat i.e., MPDO has to certify the bonafides of the claim- sign the discharge voucher.

#### **(Forward to designated LIC branch at district headquarters)**

After processing the papers LIC settles the claim amount in favour of nominee/ beneficiary.

**Shiksha Sahayog Yojana 2001:** the scheme is designed to provide at no additional cost, an educational allowance of Rs. 300/- per quarter to students studying in classes 9th to 12th (including I.T.I. courses) whose parents are below the poverty line and are members of Janashree Bima Yojana.

### **Janashree Bima Yojana**

The latest social security insurance scheme from Life insurance corporation Janashree Bima Yojana was introduced by life insurance corporation for people living below the poverty line. This new policy targets people living in towns and villages concentrating more on the weaker or poorer sector of the society.

The Prime Minister introduced this policy on 10th August, 2000. This policy is applicable to people belonging to the approved occupations. The list of approved occupations consist of forty-eight categories. Registered bodies like co-operatives, associations and self-help groups are considered as nodal agencies with a minimum of twenty-five members. Every member, society, organisation, association etc. shall contribute half of the annual premium (annual premium Rs. 200) i.e. Rs. 100/- will be paid. This will be payable either on the entry date or on annual renewal date. This scheme will be managed with subsidy from the social security fund administered by the LIC.

The object of this scheme is to provide insurance protection to the rural and urban poor below the poverty line or marginally above it. 50% of the premium is subsidized from the Social Security Fund maintained by LIC and the remaining 50% is contributed by members / Nodal Agency / State Government.

Persons aged between 18 and 59 years are covered for an amount of Rs.30,000/- each under this scheme. In case of death or total disability (including loss of 2 eyes / 2 limbs of use) due to accident, a sum of Rs. 75,000/- and in case of partial permanent disability (loss of 1 eye / 1 limb of 1 use) due to accident, a sum of Rs. 37,500/- is payable to the nominee / beneficiary.

The corporation may modify the rates and premium of the assurance provided they give three months notice to the nodal agency on the basis of the annual renewal rate.

#### Eligibility:

- (a) A person (male or female) who has completed 18 years of age and has not crossed more than 60 years is eligible for this scheme. He or she must mention the occupation and should also mention whether he is a member of a society, association or a union. The person should be in the poverty line or slightly above that to be acceptable under the scheme.

#### Benefits:

If the insured member dies before the terminal date, then the Rs. 20,000 will be paid by the nodal agency as benefits to the insured member.

|                            |              |
|----------------------------|--------------|
| On natural death           | Rs. 20,000/- |
| Death due to accident      | Rs. 50,000/- |
| Permanent total disability | Rs. 50,000/- |
| Loss of 2 eyes or limbs    | Rs. 50,000/- |
| Loss of 1 eye or 1 limb    | Rs. 25,000/- |

#### Administration of the scheme:

The benefits in case of accidents will not be applicable to the policyholders who are physically handicapped even before taking the policy.

Nodal agencies must fill and send the Master Proposal Form (Annexure I) and the details of the members (Annexure IV).

Annexure III containing the details of members and their signatures must be kept with nodal agencies. They must be submitted to the LIC in case of death claims along with other forms.

Definitions, terms and conditions are mentioned in the policy in English.



This policy is meant to provide the insurance benefits for one year only. However refund, surrender, maturity value and others are not applicable to this policy. Later every year premium has to be paid according to the details provided by LIC through renewal notice.

#### Functions of Nodal Agency:

The nodal agency will perform all functions on behalf of the insured members, with regard to the schemes. The nodal agency will provide the corporation with information such as entry of new members, death of insured member and other related particulars. It is the responsibility of the nodal agency to gather evidence from the members with regard to the age at the time of joining to satisfy the corporation. The nodal agency can anytime discontinue the scheme provided it gives 3 months notice to the corporation before the annual renewal date. All claim payments will be made by LIC to the nodal agency, which in turn will pay the same to the named beneficiary as per their records.

### **LIC's Varishtha Bima Yojana Pension scheme for older people**

The government of India in the Union Budget 2003-2004 announced the launch of '**Varishtha Pension Bima Yojana**' for citizens aged 55 years and above. The scheme will provide a yield of 9% p.a. This is a government-subsidised scheme and LIC has been given the privilege to operate the scheme. Age proof is required for the purpose of determining eligibility. There will be no other underwriting requirements. The benefit, that is, the pension will be paid on monthly basis only.

#### Premium and Premium

Only single premium is payable i.e. premium is to be paid in one lump sum.

Minimum premium Rs. 33,335/-

Maximum premium Rs. 2,77,490/-

The annuity rates are not age specific.

#### Benefit Illustration:

An investment of Rs. 2,00,000/- will fetch a pension of Rs. 1,442/- monthly. The amount of pension may vary according to the amount invested, subject to the minimum and maximum ceilings prescribed.

#### Government Subsidy:

This is a government-subsidised scheme, which will provide benefits in such a way that the pensioner gets an effective yield of 9% per annum on his or her investment. The scheme will be opened for sale during the financial year 2003-04 and was withdrawn during 2004-05.

## Social security in India through General insurance schemes

The government has come up with several schemes and policies for small farmers and workers. All these schemes and policies have been categorised under Integrated Rural development programme. Central and state governments on equal basis fund IRDA. The objective is to support the rural people financially for better living.

Some of the schemes are as follows:

- Cattle Insurance
- Sheep and goat insurance
- Poultry insurance
- Aqua culture (shrimp/prawn) insurance
- Sericulture (silk worm) insurance
- Animal driven cart insurance
- Failed well insurance
- Salt works insurance

Given below are those schemes, which require some explanation:

- Gramin personal accident insurance
- Hut insurance
- Agricultural pump set policy
- Personal accident social security scheme

Let us discuss them here:

### Gramin Personal Accident Insurance

This policy provides the following benefits in case of accidents.

Death or loss of two eyes

Two limbs Rs.10,0000

Permanent disability

Loss of one eye or one limb

Rs.5, 000

The premium of the policy is Rs.5 and the minimum and maximum age for entry is 10 years and 70 years.

### Hut insurance

Hut insurance emerged with funds given by banks, financial institutions and co-operatives. This policy was initiated in rural areas to insure against fire, earthquakes



etc. The maximum coverage was Rs. 6,000 (Rs. 5,000 for structure and Rs. 1,000 for contents).

This policy covers upto two hundred huts in a single area, with Rs.3 rate per thousand. The state government covers rural and semi rural areas under this policy. The following risks are covered:

- Fire
- Lightning
- Flood
- Cyclone
- Terrorism
- Landslide
- Impact by rail/vehicles or animals

#### Agricultural Pump Set Policy

This policy is given to centrifugal pump sets both electrical and diesel up to 25 HP. The risks covered under this policy are:

- Burglary
- Fire and lightning
- Mechanical and electrical breakdown
- Flood risk (extra premium)
- Terrorism, strike and riot

The following are the exclusions:

- Dismantling cost while in transport
- Faults during the making of the policy

The sum insured must be equal to 100 per cent of the new replacement value

The premium rates however would differ according to the type of pump set. E.g. Oil and electricity.

#### Personal Accident Social Security

This scheme was launched in 1985 especially for providing benefit to the poor families. According to the policy poor families include landless labourers and traditional craftsman whose annual income is not more than Rs.7,200.

This scheme provides a benefit of Rs.3,000, for an individual who dies due to accident and is an earning member of the family, belonging to the age group of 18 to 60 years.

The beneficiaries under this policy are as follows:

- Surviving spouses
- If not the wife, the amount will be equally shared by the children
- If not the children, then the amount will be payable to dependent surviving parents

The procedure is as follows:

An application has to be made to the claims enquiry and settlement officer for the purpose of compensation. The claims enquiry and the settlement officer will perform the following duties:

- To receive the applications from the claimants
- To enquire into the claims if required
- To ask reports from police and the medical authorities
- To select and pay the right claimant

Once the amount payable is authorised, the state government would pay the beneficiaries from its funds. The amount will be reimbursed again from the insurance company officer to whom the reports are sent.

## **Workmen's Compensation under Workmen's Compensation Act, 1923**

As mentioned earlier, persons employed in the organised sector are certainly much better off than their counterpart in the unorganised sector and others who are mainly engaged in agricultural operations in villages. This is because the persons employed in the organised sector enjoy several statutory benefits such as workmen's compensation, employee provident fund, employee state insurance, employee deposit linked insurance and payment of gratuity as per the act. All these benefits together afford a certain measure of security to the worker in the organised sector.

There are millions of workers who have been subject to occupational hazards including accidents in course of their jobs. Workers compensation helps these employees by providing them medical care, cash and rehabilitation services.

Workmen's compensation law covers workers in almost every industry. However adequate attention has not been given to the farm, domestic and casual workers. If a firm consisted of just three to five employees then compensation benefits will not be available to them.

### **Eligibility Requirements**

- The employee must work under the given occupation
- The accident or the disease must be associated with the job



## Objectives of Workers Compensation

- Covering employees who have suffered from accidents and disease arising out of the job
- To protect the income of the employee
- To provide medical care and other services
- Ensure safety
- Reduce litigation

## Workmen's Compensation Benefits

The following benefits are available under the scheme:

*Unlimited Medical care:* Most of the states restrict this to a particular medical procedure. Majority of employers use the health maintenance organisations (HMOs) and preferred provider organisation (POPs) to treat the employees.

*Disability Income:* If a disabled worker satisfies the waiting period covering three to seven days, then he will be eligible for the disability income benefit. The benefits are paid on a weekly basis keeping in mind the wage of the worker. The weekly wage is mostly two-thirds of normal wages. Disability is classified as temporary total, permanent total, temporary partial and permanent partial.

*Death Benefits:* Applicable to the survivors (employees family members), in case the employee dies while performing his duty. The benefit can be paid either through burial allowance or through weekly benefit scheme. It can be paid to the child and spouse depending upon the situation.

*Rehabilitation Services:* Introduced with an aim to initiate productive employment. Apart from the benefit they also pay for the travel, books etc. In some states they also pay for the training. Employers can take an insurance policy to cover their liability under the Workmens' Compensation Act.

## Compensation as per Workmen's Compensation Act

An employee while performing his duty got injured and died because of rash driving by a tractor driver. The Madhya Pradesh court noticed that it was obvious that the employee was sitting next to the driver. Once it was evident, that the deceased was a part of the company and was sitting along with the driver, it would not exonerate the insurance company from indemnifying the owner.

## Employees Provident Fund Scheme

Any employer who has more than twenty employees working under him is statutorily obliged to have a Provident Fund. The objective of provident fund is to save money both at the employer and the employees end. This will enable them to save a reasonable

amount of money inclusive of interest. Later this money will be utilised for economic security during the time of retirement.

The Central Board manages the employees provident fund scheme. The government appoints these trustees. The provident fund has its own rules and regulations that are provided in Employees Provident Fund Scheme, 1952. The employer and the employee would contribute a certain percent of their wages including dearness allowance and retaining allowance. Such contributions would go to Regional Provident Fund Commissioner, who will manage the whole scheme. The accumulated fund with interest forms part of the terminal benefit payable to the employee or his beneficiary in the event of death.

### Employees Family Pension Scheme

This scheme was launched in 1971 with the objective of offering pension to widow, in case the employee died in the course of his service. It also provided life insurance benefit. In this social security scheme the contribution was made by three of them: the employee, the employer and the government. The contribution made by employer and the employees were reduced from the provident fund. The employer pays this to Employees Family Pension Fund and the rest is paid to the Regional Provident Fund Commissioner. They maintain the family pension fund calculations.

With regard to **membership** this scheme is applicable to the following employees:

All those under Employees Provident Funds and Miscellaneous Provisions Act, 1952.

All those under the above act and are granted exemption under Section 17 of the Act.

The benefits under the scheme is payable by Regional Provident Fund Commissioner.

### Employees Deposit Linked Insurance Scheme

The contributions made by the employee and the employer takes time to build a huge amount. What if employee in the early days of his working life is deceased? The standing balance would be paid to his family. The amount in this case will be very less. To enhance the benefits, government introduced Employees Deposit-Linked Insurance Scheme, 1976 (EDLIS) by modifying the Employees Provident Funds and Miscellaneous Provisions Act, 1952.

The Central Board of Trustees manages the EDLIS scheme. The employer makes a contribution, which is based on the salary of the employee and pays it to the regional provident fund commissioner every month along with the PF contribution. The PF trustees pay a death benefit to the employee's nominees in the event of his death while in service. However if the employer adopts Group Insurance Scheme offering



better benefits in lieu of the EDLI scheme the Regional Provident fund commissioner is allowed to exempt the employer from the implementation of the EDLI Scheme.

## **Employees' State Insurance Scheme of India**

The E.S.I. act is applicable to non-seasonal factories that use and don't use power, with certain restrictions relating to number of employees. This act allows the central and state government to extent their provisions of the scheme to industrial, commercial, agricultural and other sectors. To be more specific in case of hotels, restaurants, shops, cinemas, transport, newspaper, etc. the number of employees should be more than twenty to be covered under the scheme.

The employer and the employee make contributions in this scheme. Employee's contribution at present is 1.75 per cent and employer contribution 4.75 per cent of the wages. The employees drawing wages up to Rs.6,500/- per month are part of this scheme. Those employees who earn Rs.25 per day are exempted to pay the amount but still they will receive the benefits of the scheme.

Medical benefit under this scheme is provided to workers and their dependants. The medical services are provided through hospitals, E.S.I. dispensaries, diagnostic centres and occupational disease centres. The medical services under E.S.I. scheme are broadly divided under three categories: preventive services, promotive services and curative services. It consists of family welfare services, health education and check up, basic health care, surgical procedures etc. Cash benefit is payable to employees under this scheme if they are sick or disabled temporarily or permanently due to employment. The benefit payable in case of sickness is about 50% of the wages. In case of temporary or permanent disablement the cash benefit is paid at higher rates.

## **Statutory Retirement Benefits for employee under the 'Payment of Gratuity Act'**

In addition to the above statutory benefits the fortunate few who are employed in the organised sector, who in our country are a small percentage, are entitled to payment of gratuity in accordance with the provisions of the Payment of Gratuity Act, 1972. If the employer had adopted an insured gratuity scheme the dependents of the employee who dies prematurely would also get a substantial sum as gratuity.

Progressive employers also adopt Group Pension Schemes for the benefit of their employees, which ensure a regular income to them after retirement. However it may be noted that this is not a statutory benefit and as such it is up to the employer to adopt it or not.

## 5. FINANCIAL SOCIAL SECURITY BENEFIT

### Current Financial condition of Social Security and Medicare: OASIS report

The population of India is expected to increase by 49% from the year 1991 to 2016. However, the number of aged people (65 and above) is estimated to rise by 107%, which would be 8.9% of the total population. This report states that in future this percentage is likely to increase further.

Traditionally governments and societies have been providing security to people in the older age group through pension provisions. This had helped in reducing the problems of these people to a considerable extent. But if the number of people in this category is high and keeps increasing as in our country then definitely it would be a very big expenditure to the government. Finding resources to tackle this matter is a serious problem for the government today.

The Ministry of Social Justice and Empowerment is concerned with issues relating to care of old persons. The Ministry is also aware that launching poverty alleviation measures alone for this group is not enough. Having this in mind the Ministry came up with the project called "OASIS" (Old Age Social and Income Security). An eight-member committee with Mr. S.A. Dave as chairman was set up to study the matter and make recommendations.

#### Recommendations of OASIS committee

The OASIS committee recommended a new pension system insisting that it should be on the basis of **individual retirement account (IRA)**. An individual under this system will open an IRA account at the early stage of his life. He will be provided with an IRA number, which will stay with him throughout. Each IRA contributor is given a passbook. This account will remain with the individual even if there is a change in the job or if he is unemployed. This is applicable anywhere across India. At the end when the individual retires he will obtain his monthly pension by purchasing annuities.

This system can be accessed through Points of Presence (POPs), which will be located throughout India. This will enable the individual to get access to his IRA account and conduct transactions.

### Pension Funds Management

To begin with, there must be at least six pension fund managers (PFM's). They must be professionals so that they take care of the retirement funds. Every scheme will be defined in its own way by the PFM's. This system offers three styles:

- Safe income
- Balanced Income
- Growth



Each schemes will be taken care by these PFM's, in these styles, resulting in 18 schemes in total.

### Retirement Advisors

This system would consist of members who belong to a limited financial background. Guidelines as to how to accumulate and manage the wealth will be a part of this system. The plan of this pension system would include Self Regulatory Organisation (SRO), which is listed in the Indian Pension Authority. SRO would provide training and certify retirement advisors. Retirement Advisors who are registered by the IPA will provide help individuals in finance planning.

### Benefits

The pension system completely depends upon annuity providers, as they convert the huge assets into fixed pension on monthly basis until death. The committee feels that insurance company can provide fair annuity price to individuals who are a part of this pension system, depending on their age.

### Normal withdrawals

The individual will receive the benefits after his retirement at the age of 60. To begin with, Rs. 2,00,000 will be used for buying the annuities. This would result in an inflation-indexed pension of approximately Rs.1,500/- per month. It is up to the individual to decide how his asset should be organised.

### Micro Credit Withdrawals

The principle of pension system does not allow the individual to withdraw money till he is retired. However funds may be required during times of emergency. Hence micro credit facility was introduced in this pension system wherein individuals could raise loans against their own savings.

## Reforms to Employees Pension Schemes 1995

This fund management in EPS 1995 is far from efficient. If better fund management is initiated, the individuals can gain more with the same contributions. But there is always a doubt as to how far the benefits are in line with regard to the contribution rate and that EPS 1995 is perhaps grossly under funded and therefore may not be able to deliver the commitments made.

The problem right now is that EPS does not have adequate funds. The government is currently providing 1.16% on pension and accruals. This subsidy is not required.

The following recommendations were made by the Committee:

- EPS 1995 must have standard benefits for all, with employer's contribution being 10%.

- Government's contribution of 1.16% must be stopped.
- The EPS funds should be managed professionally.
- The investment guidelines should be amended as per the report's recommendations.
- The report of EPS 1995 after actuarial evaluation every year must be disclosed to the public.
- At present the EPFO is charged with fund management and annuity provisions. There may arise a need to convert the assets into annuity, for a monthly pension, by outsourcing assets management and payment of pension benefit to a professional fund management organisation.

## **Reforms to Public Provident Fund**

The committee reviewed the present PPF\PPF-1 schemes and suggested setting up a new PPF-2 scheme.

The present contribution to the PPF-1 should stop, but its commitments towards the present participants will still be valid.

A new scheme should be launched which should accept all new contributions.

No premature withdrawals before the age of 60 should be accepted except in the case of death or permanent disability.

Efficient Board of Trustees should manage PPF 2.

The investment in the government securities should be linked to 40% of the assets.

The government should have nothing to do with the rate of return but leave it to fund managers to strictly show the rate of return as reflected in the investment earnings.

The committee also recommended the creation of National Senior Citizen's Fund.

## **SOCIAL INSURANCE IN U.S.**

---

In the USA during depression many people lost their income and savings due to unemployment and the failure of banks. About 25% of the people were jobless. There was a dire need for promoting economic security and the government initiative to meet the situation came in the form of 'social security'. Social security is neither a public assistance programme nor a private insurance programme. Social security is a part of social insurance system. The federal government operates social security. The perils covered by social security programmes are premature death, disability, income loss and Medicare for the old people. Private insurance companies also provide protection from these. In social security system the cost of these perils is shifted from people who suffer losses to all those who are exposed to them. "Social insurance is a government-run insurance programme operated soundly using actuarial techniques but funded primarily by current contributions while relying on the taxing power of the government to guarantee solvency".



## Principles of social insurance

1. ***It is universal:*** Government and the societies the world over have accepted the idea of social security. This has led to the spread of social security in all employment sectors with the aim to create a stable society.
2. ***It is an earned right:*** Social security is an earned right apart from being a statutory right as it is related to employees past earnings and pensions.
3. ***It is based on wage:*** There is a close relationship between the employee's past earnings and the benefits they receive on cessation of employment. Normally the higher the wages, the more benefits one receives. But even those who get low salaries get much more in return for what they contribute as the objective is to provide a certain minimum benefit post retirement.
4. ***It is self-funded:*** Employees contribute from their wages for the purpose of social security. Tax acts as a source of finance for the functioning of the system. The administrative expenditure on the other hand is met without the support of the government.
5. ***It involves the principle of redistribution:*** Some employees in spite of their low income contribute funds systematically. Some credit should be given to these employees. Redistribution formula takes care of that. If the contributor is a low wage earner he will receive more from social security in relation to his contribution when compared to high wage earner.
6. ***It does not take into account the present income:*** In other words the present income from other sources of the disabled or the retired employee is not enquired into for any purpose. Social security thus augments current income from other sources.
7. ***Wage indexed:*** Social security is always related to the employee's current wage. This means benefits are revised even if the employee changes his job for better prospects. This reflects in the increased productivity and better living standards of the employee.
8. ***It takes care of inflation:*** Social security gives protection from inflation through Cost of Living Adjustments (COLA), which is linked with consumer price index. This is one of the noteworthy features of social security. Pension and welfare plans do not come under COLA.
9. ***Compulsory:*** Social security system is a must for a stable society. It is therefore compulsory for industrial workers and other individuals.

## Basic Characteristic of Social Insurance

The social insurance programmes of countries are drawn up based on their specific needs. In the United States the following are the characteristics of social insurance:

1. **Compulsory programmes:** Social insurance is considered as a compulsory programme with few adjustments here and there. If it is taken seriously we can be assured of two things. One is the income and two protection of health of the population.
2. **Floor of income:** The main aim of social insurance is to provide minimum required benefit to meet the needs.
3. **Social adequacy rather than individual equity:** The living standard of the contributor should remain reasonable regardless of the contribution.
4. **Benefits loosely related to earnings:** Social benefits are related to employee's earnings. The more the earnings, the greater the benefit.
5. **Benefits prescribed by the law:** Law approves social programmes including eligibility requirements. The government has a role to play here when it comes to administration or supervision.
6. **No means test:** These benefits are given as a right. No formal test is needed. If they are eligible that is more than enough.
7. **Full funding unnecessary:** Full funding is not required as there is no chance of the programme getting terminated in the future.
8. **Financially self-supporting:** This programme is designed in the USA in such a way that the contributions are made by employees, employers and the self-employed.
9. **Medicare:** Medicare programme was passed in 1965. During that time OASDI (Old Age, survivors and disability insurance) was renamed OASDI-HI (Hospital insurance). If one considers this as a jungle with rules, regulations, question etc as a part, then Medicare is a deep jungle. It covers the medical expenditure of people who are 65 and above.

The Medicare programme can be divided under two headings:

- Basic hospital insurance benefits. (Part A)
- Voluntary supplementary medical benefits. (Part B)

**Part A** of the Medicare programme functions the same way like that of the Blue Cross Insurance. Here participation is a must. The patient does not pay for any covered services like a semiprivate room, hospital nursing care, operating room cost and drugs furnished by the hospitals. It provides a benefit of 90 days plus 60 days provision after the expiry.

**Part B** of the Medicare programme provides services like that of Blue shield plans. Unlike Part A, it is voluntary. An interesting aspect of this programme is that the government pays same premium that the participant pays or pays at least half the



cost. Doctors bill, hospital diagnostic studies, dental surgery, outpatient care, home health care etc. are the following benefits provided by the Part B of the Medicare Programme.

In addition the Medicare has the following programmes:

1. Medical plus choice programme
2. Original medicare plan
3. Managed care plan
4. Private fee-for-service plan
5. Medicare medical savings

## 10. Disability Benefits

The US government in 1956 introduced old age disability benefit. Since then this programme has been widened in scope.

**Definition of Disability:** “The inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to last for a continuous period of not less than twelve months”.

This income or benefit can be paid to the disabled employees who fulfill the following conditions:

- They must be disabled and must be insured
- Must cover a period of five months waiting
- Must meet the definition of disability

From the following points it's evident that the payment commences in the sixth month of disability. The definition of disability according to this programme is as follows: *The worker must have a physical or mental condition that prevents him or her from doing any substantial gainful work and is expected to last (or has lasted) at least 12 months or is expected to result in death.*

The following are qualified to receive the old age, survivors and disability insurance (OASDI) benefits:

**Disabled workers:** If a disabled employee fulfils all the three points of eligibility and has at the same time completed his retirement then he will receive a benefit that is equivalent to the primary insurance amount. Benefits are also available to

1. Spouse of the disabled worker
2. Unmarried children younger than age 18
3. Unmarried disabled children

## UNEMPLOYMENT INSURANCE

Unemployment insurance was a component of the American Social Security Act of 1935. About 25% of the people were unemployed during the 30's. A new deal was developed to generate employment and bring money back to the economy. The government created employment by hiring people to execute projects like construction of bridges, schools etc. This added flow of money in to the economy.

Unemployment insurance is meant to compensate people who have lost their jobs. A majority of employees in the US have taken this insurance except for a few people who work in the agricultural sector. Change in the business cycle, outsourcing of jobs, mechanisation, and new inventions cause unemployment. Seasonal workers too are left with no work during parts of the year. Unemployment insurance is meant to cover not all but some of these cases. The compensation is 6.2 percent on the wages that is being paid.

In simple terms the objectives of unemployment insurance are as follows:

- To give income at the time of involuntary unemployment.
- To find jobs for the unemployed
- To enable stabilised employment
- To stabilise the economy as a whole

### Summary

This chapter to begin with briefs us about the history and philosophy of social security. Social security has become a vital need. This concept first started in the western countries during the 30's at the time of depression. In one way we can say that social security emerged as result of economic insecurity. Social security in India has not developed truly to meet the need of the target group. This is due to two reasons: scarcity of funds and large numbers involved.

Earlier when people used to get injured while working, the company in the absence of any law was compelling them to meet the medical expenses on their own. Today the worker in the organised sector has the necessary legislation in place to ensure that the employer does not run away from his responsibility of providing relief to the injured or disabled worker. But one has to admit that India has a long way to go to meet its social security obligation to its citizens in full and therefore social security will continue to be a pipe dream for a long time to come for many a citizen in dire need.



## Discussion Questions

1. Is Social Insurance, insurance at all?
2. Discuss social security in the Indian context?

## Questions

### Answer the following questions briefly

1. Define social security and describe its nature.
2. What are the causes of economic insecurity?
3. List the principles of social insurance.
4. What are the characteristics of social insurance?
5. Write short notes on:
  - a) Employees Provident Fund scheme
  - b) Employees Family Pension scheme
  - c) E.S.I. Act

## Multiple-choice questions

1. What is the name of the social security scheme pension plan launched by LIC for people aged 55 and above?
  - a) Landless Agricultural Labourers's Group Scheme
  - b) Rural Group Scheme
  - c) Varishtha Pension Bima Yojana
  - d) Krishi Shramik Samajik Suraksha Yojana

### Ans. (c)

2. Janashree Bima Yojana was introduced
  - a) For the middle class people
  - b) For the upper middle class people
  - c) For poor people
  - d) For people living below the poverty line, belonging to specific occupation/profession.

### Ans. (d)

3. OASDI stands for:

- a) Old Age Satisfying and Direct Insurance
- b) Orphan Aged Seriously Disabled Illiterate
- c) Old Age Survivors and Disability Insurance
- d) Old Age Senior and Disability Insurance.

**Ans. (c)**

4. Unemployment Insurance is a component of:

- a) E.S.I. Act
- b) Social Security Act
- c) Workers Compensation Act
- d) None of the above

**Ans. (b)**

5. OASIS report recommended a new pension system on the basis of:

- a) Individual Retirement Account
- b) Workers current account
- c) Balance account of worker after he is deceased
- d) None of the above.

**Ans. (a)**

# Insurance

## CHAPTER – 7

### GROUP INSURANCE

#### OUTLINE OF THE CHAPTER

- Introduction to employee benefit insurance plans
- Group insurance fundamentals
  - Meaning
  - Features
  - Advantages
  - Limitations
  - Eligible groups
- Group insurance schemes
  - Group life insurance
  - Group gratuity scheme
  - Group superannuation scheme
  - Group insurance scheme in lieu of EDLI
  - Group saving linked insurance scheme
  - Group disability income insurance
- Marketing of group insurance
- Alternatives for group benefit plan funding
- Comparison between a trustee-administered plan and an insured plan
- Summary
- Questions

#### **LEARNING OBJECTIVES**

After reading this chapter, you should be able to

- Present an overview of the growth and development of employee benefit plans
- Differentiate group insurance from individual insurance
- Give examples of groups eligible for group insurance

- Explain the different types of group insurance schemes
- Describe how group insurance is sold
- Identify the funding alternatives available to the employer

## 1. INTRODUCTION TO EMPLOYEE BENEFIT PLAN

---

Employee benefit schemes are plans sponsored by employers, under which benefits are paid if the employee dies, falls sick, is disabled or retires. Thus, employee benefits include benefits covering the risks of premature death, disability, superannuation and unemployment. In other words, the employer provides some financial security to the employees and their dependents through these employee welfare schemes. Employees in the organised sector thus have a clear advantage over their less fortunate brethren in the unorganised sector and those engaged in rural occupations related to agriculture.

Employee benefits differ with the type and scale of the organisation. Generally large progressive organizations in addition to their statutory obligations offer many employee benefits. Such benefits are included with the total employee compensation package. While designing these benefits the employer should keep in mind his objectives, employee's needs, options available and their costs.

### Development of employee benefit schemes:

Employers, having recognised their responsibility towards their employees besides paying salaries and wages, started providing additional rewards for their service. These benefits besides provident fund, gratuity and life assurance also included vacation benefits, employee discounts on the firm's products etc.

The employer provided such benefits with the objective of promoting a sense of security among the employees, to improve their morale and to enhance their productivity. This also resulted in better employer-employee relationship, improved the industrial relation climate and prevented strikes and lockouts. It helped the employer to reduce labour turnover and promoted employee loyalty.

Some of the benefits were made compulsory by law while some were introduced by mutual agreements between the employer and the employees.

## 2. GROUP INSURANCE FUNDAMENTALS

---

### 2.1 Meaning of group insurance

Many employees were aware of the economic security provided by insurance-oriented service benefits. The employers on the other hand also appreciated group insurance as an easy method of providing life insurance to the employees. Group insurance developed in India in the early 1960s. It is the coverage of many persons under one policy. Under group insurance, the insurer drafts a single policy known as a **master policy** for the insured group.



Under employee group insurance, the contract of insurance is between the insurer and employer. So it is the employer who pays the premium. Further it is the employer who can decide upon the members and the extent to which they shall be insured. The employer nominates employees for the pension scheme based on different criteria like their earnings potential, their seniority, age and post.

Employees have no say in choosing the extent of their cover. However, the employer while introducing the group insurance scheme for the first time may give an employee the option to join or not to join the scheme. This is necessary, especially when the employees have to contribute for the plan or forego another benefit in order to be covered under a group insurance plan.

Certain features of group insurance differentiate it from individual insurance. Let us now discuss the distinguishing features of group insurance.

## 2.2 Features of group insurance

**Group policy:** Under group insurance a single policy known as a master policy is issued to the group policyholder who may be the employer or the authorised person representing the group. Certificates and summary evidence of insurance is given to the members of the group insured. The master policy is a detailed document that states the contractual relationship between the insurer and the group policyholder. A list of persons eligible for coverage with relevant information such as age, occupation etc is sent by the employer or nodal agency to the insurer. The insurer examines the list, quotes the premium payable and confirms coverage for the listed persons when the premium is paid.

**Underwriting group:** This is the most important distinguishing feature of group insurance. In group insurance, the insurer underwrites the group as a whole. Therefore group characteristics are important rather than the individual characteristics of group members. This means the underwriter considers the size, age composition, occupation and stability of the group as a whole rather than health and other insurability aspects of the individuals.

For the reasons stated above, insurers prefer to underwrite larger groups rather than smaller ones to avoid the possibility of adverse selection. Underwriters favour a regular flow of new employees, as the old ones will be replaced with the younger ones, so that the average age group remains more or less constant. Further, actively and efficiently working employees can be assumed to be in average health.

**Cost effective:** Group insurance generally costs less than individual insurance. This is because the group insured generally needs no medical examination. Secondly, the acquisition cost for the insurer is also low. The insurer pays less commission to agents of group insurance than to the agents of individual insurance. Moreover, the employer offers administrative services such as collection of premiums, where the employees share the premiums. The cost of administering the scheme for the employer

is minimal. So the group coverage is provided to customers at prices lower than that of individual insurance.

**Experience rated premiums:** The insurer charges experience rated premiums when the group is too large. In group insurance, the premium reflects the loss. In simple words, the group is charged higher premiums if the loss experienced in the previous year is higher than expected losses. Where the loss experience is considerably less than expected loss experience over a period of time the saving is passed on by the insurer to the master policyholder by way of reduction in premium.

## **2.3 Advantages of group insurance**

Some of the advantages of group insurance are as follows:

- With group insurance, persons with less or no life insurance are also able to get some measure of insurance protection.
- Coverage is also available to those employees who are otherwise uninsurable.
- Life insurance companies can reach a vast number of clients at less cost within a short span of time.
- It is a tax effective tool. The employer gets tax relief for the premium paid by him on behalf of the employees. Employers are also entitled to tax relief for premiums paid by them if the scheme is partly contributory.

## **2.4 Limitations of group insurance**

There are also some limitations to the group insurance schemes, which are discussed below:

- The nature of group insurance is temporary. It means once the member is out of the group, the coverage ceases. The employee also loses insurance coverage in the event of termination of the group plan.
- The master policy issued by the insurer is not very flexible. It does not meet the individual needs for insurance. The insurer under group insurance cannot focus on the financial needs of the individual, which is possible in individual insurance.
- A few members who could have been charged fewer premiums if individual insurance had been taken, have to pay higher premiums because the premium is fixed for the group as a whole.

## **2.5 Group eligibility**

A group to be insured under the group life insurance scheme has to fulfill the following conditions

- The group, which should be homogenous, should have been formed for purposes other than to seek insurance.



- The group should allow new comers to enter into the group for the continuity of the group.
- The method of determining the amount to be insured should preclude individual selection.
- Safeguards should be established to produce a normal distribution of risk and to avoid the inclusion of undue proportion of the total insurance of the group upon unhealthy lives or on a few lives or on the lives of advanced ages.
- A universal administrative organisation referred to as nodal agency in our country, must be in existence that is able and willing to act on behalf of the insured.
- Besides the insured members there should be some party who can pay a proportion of the total cost.

## 2.6 Eligible groups

Earlier, group insurance was taken only for the employees of an organisation. Later on, other groups were also included like groups of professionals, co-operative societies, debtors of one creditor, etc. Let us now discuss some of the groups that are eligible for group insurance.

**Individual employer groups:** Employees may be working with a single large company, a sole trader or in a partnership firm. The employees of any of the above are referred to as individual employer groups. So far, individual employer groups have been the most common groups insured. This was due to the favourable characteristics of such groups, which are mentioned below:

- The employer can represent the employees as a single person dealing with the insurance company.
- Authentic employee data is readily available
- Payment of premiums is easy and regular.
- The employer has the required machinery to collect the claim money from the insurance company and pay it to the beneficiaries.
- The employer would have already screened the employees at the time of employment through a pre-recruitment medical examination. Besides, such employees also enjoy medical facilities offered by employers and therefore enjoy better health. So, it is convenient for the insurer to grant a cover without medical evidence.

**Multiple employer groups:** Employers may be financially or in any other way, connected to each other as associated companies. Such employers can form a group and take a group policy covering the employees of each employer of the group. There is a principal company who is a policyholder and deals with the insurance company. It collects the required data and premium from other employers as per the agreement.

**Labour union groups:** Under labour union groups, the insurer covers the members of a labour union by issuing a contract directly to the union. It is the union that pays the premium. The union may be meeting the premiums wholly out of the union funds or jointly with the members. It should be ensured in such cases that the coverage benefits individual members rather than the union or its office bearers.

**Creditor-debtor groups:** In creditor debtor group insurance, lives of the debtors are covered through a group policy issued to the creditor. The creditor, such as a bank or a finance company, insures its debtors as collateral security against the credit given to the debtors. In the event of the death of the borrower, the insurer pays the benefit to the creditor. The creditor sets off the outstanding loan and any balance of the policy proceeds is paid to the legal heirs of the debtor.

**Miscellaneous groups:** Different other groups can also be insured under a group insurance scheme. Such groups include associations of public and private employees, associations of professionals such as lawyers, doctors, accountants, teachers, unit holders, veteran associations, religious groups, retail chains etc.

### 3. GROUP INSURANCE SCHEMES

---

The two main types of group insurance are *group life insurance and group accident and sickness insurance*. The group life insurance allows the members to name the beneficiaries of their choice. The employee/member has a special privilege to convert the policy on termination from the group. This can be highly beneficial, especially for an uninsurable person. Group accident and sickness policy have different components. And the technicalities differ from company to company. Let us now discuss the various schemes available to an employer.

#### 3.1 Group life insurance

Three types of group life insurance are common in India – the group term insurance scheme, group gratuity scheme and group superannuation scheme.

Group life insurance is the most common group insurance provided to employees. Group life insurance is a simple and economic way of providing life insurance to employees. Under this policy, generally a fixed sum is paid to the dependants of a covered employee on his death. It is also possible to offer what is known as graded cover that offers different covers to different categories of employees within the same group.

This scheme is renewable every year. As the premium rates are very low when compared to individual insurance, the employees and the weaker sections find it convenient and helpful. It helps their dependents in reducing debt burdens.

**Definition:** *Group life insurance is that form of life insurance covering not less than 25 employees with or without medical examination, underwritten under a policy issued to the employer, the premium on which is to be paid by the employer or by the*



*employer and employees jointly and insuring all of his employees or all of any class or classes thereof determined by conditions pertaining to the employment for amounts of insurance based on some plan which will preclude individual selection.* Where the group is small, say less than 100, the insurer may insist on 100% participation of employees in the scheme, if the scheme involves contribution from employees also. For very large groups however, the insurer generally accepts the scheme if 75% of the employees participate.

### 3.1.1 Group gratuity scheme

The group gratuity scheme is an insurance scheme covering the employer's liability to pay gratuity under the Payment of Gratuity Act, 1972. The amount of gratuity to be paid is at the rate of 15 days wages based on the wages last drawn, for each completed year of service. However this is subject to a maximum limit. The Act requires that the gratuity be paid to those employees who have served the employer continuously for at least five years.

### 3.1.2 Group superannuation scheme

After retirement, employees need financial security. The provident fund and the gratuity provided by the employer may not be sufficient in an inflationary economy. Secondly such lump sum payments are often utilised by the employees to meet their current contingent liabilities. The employers observed that the employees actually also need a periodical payment over and above the normal terminal benefits. Such payment is made in the form of pensions by creating a superannuation fund. Superannuation scheme aims at providing old age pensions to employees after retirement.

### 3.1.3 Group insurance scheme in lieu of EDLI

Group insurance scheme in lieu of EDLI is also a type of group insurance scheme offered by life insurance. All employers who come under the Employee's Provident Fund and Miscellaneous Provision Act 1952, have a statutory liability to subscribe to the Employee's Deposit Linked Insurance Scheme, 1976, to provide for the benefit of life insurance to all their employees. Under the scheme in effect from 24th June, 2000, the insurance benefit is equal to the average balance to the credit of the deceased employee in the provident fund during the last 12 months, provided that where such balance exceeds Rs. 35,000, insurance cover would be equal to Rs.35,000 plus 25% of the amount in excess of Rs.35,000, subject to a maximum of Rs.60,000. Hence if the length of service is inadequate and /or the salary is low, the benefit to the family of the employee in the event of his death would be meagre.

Where the employer provides for a better insurance benefit through an alternative insurance plan, he may be exempted from participating in this scheme. LIC's group insurance scheme in lieu of EDLI has been recognised as one such scheme.

### **Benefits to the employer**

1. The premium payable by the employer in general is lesser than the total contribution, which has to be made under the EDLI scheme, especially when the salary level of the employees is high and the average age of the employee group is low.
2. Settlement of claim for this scheme is quicker; the insurer just asks for the death certificate and the claim form from the employer.
3. The premium paid by the employer is admissible as normal business expenses for income tax purposes.

### **Benefits to the employee**

1. The coverage offered by LIC scheme is higher than that offered under EDLI scheme by the Provident Fund authorities.

### **Group savings linked insurance scheme**

Group savings linked insurance scheme is a group insurance scheme, which is very popular since it offers a survival benefit in addition to the death benefit available under a group term assurance policy.

Where life insurance benefits are not linked to any statutory requirement, there is often a demand to link it with a survival benefit, particularly when the employees come forward to make contributions. The central government employee's group insurance scheme is an example of such a combination.

This scheme was introduced with the objective of providing, low cost insurance on a wholly contributory and self-financing basis, with a survival benefit to help the families of the government employees in the event of death of the employees while in service, and a lump sum payment to the employees on cessation of employment.

Insurance companies now offer a similar scheme, which was originally formulated to suit the requirements of large public sector organisations like BHEL, HHAL, HMT, LIC, GIC, etc. The scheme has since been extended to reputed private companies and educational institutions.

The group savings linked insurance scheme can be a contributory or non-contributory scheme. Part of the premium collected is the savings premium that is accumulated at the rate declared from time to time; a part is utilised to provide life cover in case of death.

### **Main features:**

- The employer acts as a facilitator and coordinator in maintaining the scheme and in making monthly deductions from salary.
- Contribution consists of risk premium and the savings portion. The savings portion earns interest at the declared rate, compounding yearly.



- As per regulations, the life cover premium and contribution for savings should be in the ratio 1:2 respectively.
- Employees are grouped into several agreed categories based on their salary and therefore the contribution and coverage depend on the category to which the employee belongs.

### **Benefits**

1. In the event of death of the employee, the nominee gets an assured sum with accumulated savings and interest on the same.
2. On retirement/resignation/termination, only the accumulated savings portion with interest is payable. Monthly contribution of employees is exempted under Section 88, of IT Act, 1961.

### **Requirements**

The number of members joining the scheme has to be atleast 75% of the total number of employees. The scheme has to be made compulsory for all the new employees.

The premium payable is based on weighted mean of the ages of the members.

Contribution is uniform for each category.

## **AVAILABLE GROUP INSURANCE SCHEMES IN THE INDIAN MARKET**

---

### **Group Insurance Schemes of LIC**

LIC offers life insurance protection under group policies to various groups such as employee - employee, professionals, co-operatives, weaker sections of society, etc. It also provides insurance coverage to people at subsidized rates under Social Security Group schemes. Besides providing insurance coverage, the Corporation also offers group schemes to employers, which provide funding of gratuity and pension liabilities of the employers.

### **Group Term Insurance Schemes**

Employer-Employee groups may be offered group insurance schemes providing uniform or graded cover. Group insurance schemes providing uniform cover can be granted to associations of professionals, members of co-operative banks, welfare funds, credit societies and weaker sections of society.

### **Group Insurance Scheme in lieu of EDLI**

The Employees' Deposit Linked Insurance scheme is applicable to all establishments and undertakings contributing to Employees' Provident Fund under the EPF and MP Act, 1952, with effect from 1.8.1976, unless exempted under Section 17 (2A) of the

Act. The scheme provides for an insurance cover to an employee, which is linked to his balance in the PF Account, subject to a maximum of Rs. 60,000/-.

Under LIC's scheme, the insurance cover starts from Rs. 5,000/- and depends on the service put in by the employee and the current monthly salary on each Annual Renewal Date. The cover provided is at least Rs. 2,000/- more than the cover given by the EDLI scheme.

### Group Gratuity Scheme

Gratuity is a statutory liability of most of the employers, which accrues to an employee for every year of service put in by him. In the event of the premature death of an employee, his dependants are entitled to the amount of gratuity payable on retirement of the employee at the age of superannuation had he survived.

### Group Superannuation Scheme

The Group Superannuation Scheme is designed to provide pension to employees on their retirement from service. A decreasing group insurance cover in conjunction with superannuation benefits may also be provided under the scheme. The scheme is of two types.

(a) Money Purchase Scheme (b) Benefit Purchase Scheme

### Group Savings Linked Insurance Scheme

The Group Savings Linked Insurance Scheme (GSLI) offers insurance cover together with a savings element. The scheme is allowed to select Employer-Employee groups. Under the scheme, out of the contributions received in respect of each employee, a portion is utilized for the insurance cover and the balance known as contribution for savings, is accumulated till exit, at an optimal rate of interest. In case of death during service, the amount for which the member was covered at the time of death is also paid along with the accumulated savings with interest.

### Group Annuity Scheme

Employers who have a privately administered Superannuation Fund, where moneys are invested by Trustees as per Income Tax Rules can purchase pensions for employees as and when due under 'Group Annuity policies from LIC.'

### Group Leave Encashment Scheme

According to Accounting Standard (AS-15) of January, 1995 and amended Section 209 (3) of the Companies Act, 1956, it has become necessary for employers to provide for the liability of leave encashment facility available to employees in the annual books of accounts. The Group Leave Encashment Scheme (GLES) is designed to fund such liabilities of employers.



### Group Mortgage Redemption Assurance Scheme

This scheme covers the borrowers of Housing/Vehicle Loans from financial institutions where loans are recovered in EMI. Insurance cover allowed to borrower upto the outstanding loan excluding the EMI interest, subject to conditions applicable to the scheme.

### Group Insurance Scheme for Deposit holders of Banks

This scheme covers account/deposit holder of a Bank. The cover allowed is Rs. 1,00,000/- per member with/without double accident benefit.

### Unit-Linked Gratuity Plus

With effect from June 2006, LIC has brought out a Unit-Linked Group Gratuity Plan, called “Gratuity Plus” for management of Gratuity Funds. It is a market-linked plan, which offers greater flexibility and transparency.

The hallmark of the scheme is its competitive cost structure. Over and above low fund management charges and administrative expenses, it provides for life insurance cover at a minimal cost.

## 3.2 Group Social security schemes

In many developed countries, insurance coverage either under individual plans or under group insurance is not available to persons belonging to the weaker sections of the community who are engaged in various occupations in the unorganized sector. For such people, social insurance is the only answer for providing a certain minimum of insurance cover. Therefore social security insurance is the growing concern of many nations. In most of the developed countries, insurers actively participate in social welfare measures. In our country also, insurance companies provide protection to weaker sections under group term insurance policy. The poorer section groups include handloom workers, rickshaw pullers, rural artisans, landless agricultural labourers, barbers, tailors co-operative milk producers etc. In the event of death of the member, a fixed sum is paid to the dependents. In case of an accident, the dependents can get double the sum.

## 4. GROUP DISABILITY INCOME INSURANCE

Workers compensation provided to employees in the event of work-related disability is often inadequate. These benefits also fail to cover disability due to accidents that are not work-related.

The group disability income insurance available in most of the foreign countries (but not in India) provides economic security to the employees in the event of disability. Group disability income insurance is of two types - short term plans and long-term plans.

## **4.1 Short-term disability income insurance**

This plan is also known as the sick leave plan. It pays benefit to the employees for a short period of about six months. The employees are credited with a certain number of sick days for each month worked. If the employee takes more sick days than he actually earned, then his salary is reduced accordingly.

Such plans also have an elimination period, generally for a week. It means that the benefits are not paid for the first week of illness or disability. By imposing such a condition, the employer tries to reduce the moral hazards like malingering and excessive absenteeism. Under short-term plans, only disability that is not work-related is covered. The amount to be ascertained as disability income benefit depends upon the earnings of the employee. The short-term plan may or may not be insured.

## **4.2 Long-term group disability income plan**

The long-term group disability income plan pays benefits for a minimum period of two years and upto a maximum age of 65 years. Such benefits are normally paid on a monthly basis. Long-term benefit plans also require a waiting period of about 3 months or more. These benefits are generally offered to fulltime employees only. Under long-term disability plans, benefits are given to the employees for both work-related and non-work-related injuries or disability. Disability in this context generally means total disability.

## **5. MARKETING OF GROUP INSURANCE**

---

Life insurance has been from the beginning marketed through agents. Group insurance is no exception. But the agents have to take special permission for canvassing group insurance from the office. However the percentage of group insurance sold through agents is meager. This is due to the lack of expertise on the subject among agents. Group insurance is a technical subject that requires special knowledge. Also, the commission rates paid by the insurer for group schemes to the agents are very low. Further, the agents are required to deal with high level executives and the senior officers of the companies. The average agent therefore finds it rather difficult to enter the area of group schemes selling.

A large number of group schemes were directly sold by the executives of pension and group schemes department of LIC. These departments were originally located only in the metropolitan cities. However, now they have been established in all the divisions of LIC. Marketing officials of the pension and group schemes department market the product directly.

Occasionally schemes are also sold through approved agents. But the agent's role here also is restricted to that of a spotter. Efforts to educate the agents on group insurance scheme and develop a cadre of group insurance agents has not been successful except in the metros where the experiment was a limited success.



It is often said that life insurance is always sold, never bought. But group life insurance is sometimes bought because progressive employers are interested in employee welfare schemes. They aim at reducing taxes and promoting employee loyalty to reduce employee turnover. Group insurance schemes, group gratuity scheme, group insurance in lieu of EDLI and group superannuation scheme, are often purchased by the employers on their own initiative.

While in India, group insurance is mostly marketed either directly or through agents in foreign countries, group insurance is marketed by career agents, brokers and independent benefit consultants. In some of the foreign countries banks are also now permitted to market group insurance.

**Emergence of new insurance intermediaries:** In the present market in India there are new insurance intermediaries like brokers and institutional agents, particularly banks. Such intermediaries are better placed to market group schemes.

## 6. ALTERNATIVES OF FUNDING GROUP INSURANCE

Employers examined the alternatives of funding the benefit plans with the following objectives:

- To control and use reserve funds
- To reduce or eliminate payment of premium taxes
- To enjoy better tax benefits

After examining various conventional alternatives of funding and the present demands of employers, the following methods of funding a group insurance plan were developed.

### 6.1 Fully insured plan variations

**Retrospective premium arrangements:** Under this arrangement, the insurer retains the right of charging additional premiums if the costs or losses are higher than expected. Thus, instead of keeping a margin for contingency while calculating premiums, the premiums are calculated on the basis of actual costs and expected claims. The additional premium that an insurer is allowed to collect is normally restricted to a level so as to equate the premium schedule that includes margin for contingencies.

**Cost plus funding:** Under this method the employer shares the risk of the insurer and pays lower premium, so that the employer can use the reserves, which were otherwise used by the insurer. The employer here also bears a part of the administrative costs on a monthly basis.

**Extended grace period:** The employer can also retain the funds available to him by adopting this method. The insurer extends the grace period for payment of premium from 31 days to 60 or 90 days. With the extended grace period the employer can retain and use the two or three months' premium in other channels.

**Release of reserves:** The master policyholder also can appeal to the insurer to release the reserve it holds on his contract. This way the employer can use a portion of the reserve for his other requirements.

**Flexible funding life insurance:** It is also a cost-plus approach to group insurance funding where the employer's monthly premium equates the claims paid in the previous month including reserve adjustments, premium taxes and other expenses of the insurer. The employer or the group policyholder can accept liability for all claims or restrict his liability to the extent of a conventional fully insured plan.

## 6.2 Self funding benefit plans

An alternative to the insured plan is self-funding by the employer. It is a conventional method that was most commonly used for workers' compensation benefit. The employer can opt for self-funding considering the size of the group and the cost of self-funding compared to insured plans. When the employer chooses a self-funding plan additional staff is required for administration of funds. The organisation may appoint an outside claims administrator, but this means it has to forego the benefits of expertise of the insurance company in claim settlement and other aspects like cost containment. An efficient employer therefore considers all these points in addition to the cash flow requirements of the employer before selecting from among the alternative of funding employee benefits plan.

However these alternatives exist only in the foreign countries. These are not in vogue in our country.

## 6.3 Funding alternatives in India

In India also, the employers have alternatives of funding available, which range from fully funded plan to a fully insured plan. When the employer opts for a fully funded plan he also has to decide whether to self-administer the plan or to retain an external administrator. The following are the funding alternatives of different schemes practiced by employers in India.

### 6.3.1 Funding gratuity scheme

The employer may choose either of the following ways of meeting his gratuity liability:

**A) Pay as you go method:** He can pay the gratuity out of current revenues as and when it's due. The gratuity value generally varies from one financial year to another. This is because the number of employees may change every year and also the level of gratuity liability increases with the increase in service of the existing employees. A prudent employer generally does not follow this method.



**B) Creation of reserve method:** He can create a reserve in the books of accounts to provide for his gratuity liability. Such a reserve is not a separate fund but merely an accounting provision in the books. The management needs to be very rigid and disciplined to ensure that the organisation does not use such reserves for meeting current requirements.

**C) Setting up a Trust Fund:** Alternatively the employer, to safeguard the interest of the employees, can set up a gratuity trust that is irrevocable. The trustees may opt to manage it themselves or enter into a group gratuity scheme with an insurance company.

### **Advantages of group gratuity scheme with the insurer**

- The employer can benefit from the expertise of the insurance company in the investment of funds that the trustees may not have.
- The insurer has a large portfolio. This enables the insurer to secure optimum benefits from the market. The insurer enjoys a better spread and is protected from fluctuations.
- The actuarial skills of the insurer in evaluating the adequacy of fund are unmatched. They can also update it from time to time.
- The insurer ensures that the dependents of an employee covered under the scheme get the same gratuity even if an employee dies young.

Due to these factors, employees generally insist on the insured scheme rather than a trustee administered fund. Moreover, employees feel insecure if the funds are in the hands of the employer. Therefore insured schemes are generally preferred.

### **6.3.2 Funding superannuation scheme**

The employer may agree to pay pensions to his employees. He selects the categories of employees who should be covered under the scheme. The employer grants pension to all these employees of the selected category with the intention of providing financial security to them even after their retirement. Under the superannuation scheme, the following two alternatives for funding are available to the employer.

**A) Payment by employer:** The employer need not make any reserve for such pensions. If the 'pay as you go' method is adopted, any amount due can be paid out of the current revenues of the employer at that time. However this is not advisable, as the payment of pension under this method depends on the future earnings of the organisation. This again involves uncertainty as to the level and continuation of the payment of premium.

**B) Funding through trust:** The employer can establish a trust fund with his contributions and the contributions of employees if any. The employer appoints trustees to administer the fund. These trustees are entrusted with the responsibility of investing the funds as

per investment pattern prescribed by the government to secure the pensions of the employees. As per the provisions of Schedule IV Part B of the Income Tax Act, 1961 the approval of such a fund by the income tax commissioner is obligatory. In this way, the employees covered under the pension scheme are granted complete financial security after their service.

The appointed trustees can exercise either of the two options available to them for managing the fund. They themselves can administer the fund or can take an insurance scheme with any insurance company. Let us discuss these options in detail.

**Trustee administered fund:** Where the trustees administer the fund, they have to accumulate the contributions as per the requirements of the Central Board of Direct Taxes. The trustees can buy annuities from an insurance company for the member employees when the pensions become due. The trustees of the fund carry out the following functions:

- i) Collecting contributions
- ii) Buying and selling of securities
- iii) Collecting interest
- iv) Obtaining tax exemption certificates
- v) Purchasing the annuities from insurance companies
- vi) Maintaining the books of accounts

**Insured schemes:** Where the trustees obtain a group superannuation scheme with the insurer, the trustee's duties of management and administration of the fund are transferred to the insurer. The trustees pay the contributions to the insurance company as premiums and the insurance company issues a master policy to the trustees. The insurance company pays the premium as and when they fall due. So, all the members of the group are insured under a single policy.

The contributions made by the employer and the employees may be predetermined as a certain percentage of the salary pensions and are then paid accordingly. Alternatively, the pension may be agreed upon beforehand and accordingly the contribution rate can be determined on an actuarial basis. Where the rates are fixed on the actuarial basis, it is to be noted that such rates have to be reviewed periodically. This helps in maintaining the relationship between the contributions and pensions at the appropriate level so that the insurance company has sufficient funds to provide the benefits to the members of the scheme.



## **7. TRUSTEE-ADMINISTERED FUND VS. INSURED SCHEME**

An insurance company is well experienced and efficient in administering the pension plan. Trustees may lack such expertise. Therefore a prudent employer may prefer to entrust the administration and management of the pension scheme to the insurance company. This way, the employer can concentrate on other promotional activities of the business.

It is observed that the costs involved in insurance schemes are high when compared to a trustee-administered scheme.

To choose between these two alternatives, employers in our country keep in mind the expected yield on contribution and the size of the group. Where the number of employees is large the employer may go for the trustee-administered fund. In such organisations, experienced and trained staff can efficiently administer and invest the large contributions. On the other hand, the employer selects an insured scheme where the number of employees covered under the pension scheme is small. This is because with small contributions, the trustees cannot follow the suggested investment pattern and they also lack the expertise required for managing the pension scheme.

With a trustee-administered fund, employees are provided with a wide range of benefits. Such benefits include disablement pension, discretionary pension, early retirement pension and ill health retirement pension. On the other hand, in an insured scheme the benefits available for the employees are limited to pensions that are dependent on life. The insurance schemes available to the employer are standardized and not tailor-made.

The rate at which a fund is built may be changed if required under a trustee-administered fund. This is not possible in an insured scheme.

The most favourable characteristic of an insured scheme is that it makes sure that the employees get their pensions regularly and without any difficulty. It relieves the trustees from the responsibility of administering the fund and at the same time, offers financial security to the employees. The insured pension scheme also has the advantage of offering a reasonable pension in the event of the premature death of a member, if the employer adopts a gratuity insured scheme in conjunction with the superannuation scheme.

### **Summary**

- Employee benefit plans are sponsored by employers to provide financial security to the employees or their dependants in the event of their death, disability or retirement.
- Group insurance is coverage of many persons having a business or professional relationship with the policyholder, under one master policy.

- Group insurance has the following distinguishing characteristics:
  - Individual underwriting unit is substituted by the group underwriting unit.
  - There is issue of a single policy known as a master policy.
  - The administrative costs involved are comparatively very low.
  - Experience rating is used for the large groups to be insured.
- The major types of group insurance schemes are as follows:
  - Group life insurance: a group life insurance is further classified into three types- group term life insurance, group gratuity scheme and group superannuation scheme.
  - Group disability income insurance: group disability income insurance can be a short-term disability or a long-term disability plan.
- Group insurance in India is mostly marketed directly by executives of the insurance company. But in the present market, banks and other institutional agents have also emerged as the market intermediaries for group insurance.
- Group benefit plans can be funded in different ways. The major alternatives available to the insurer are as follows:
  - Employer funded plans
  - Trustee-administered fund
  - Insured schemes

### Case study

'Annapoorna oils' was a fast growing company started three years ago, engaged in the manufacture of edible oils. Although a relatively new company, it already had a market share of 10% in its home state, Andhra Pradesh. The wage agreement with the employee's union, which was for three years had ended, and the union had submitted a charter of demands. The union, taking note of the high profits the company had been generating in the last two years, wanted a 25% wage increase across the board for all employees. The management was more or less inclined to agree. However there were no demands for any employee welfare insurance schemes from the union.

At this point of time the group insurance manager, LIC, was making a routine business call for introducing group schemes in the company.

**Question:** If you were the group insurance manager what suggestions would you give to the company management at this point of time?



## Discussion Questions

1. "Group insurance is an ideal arrangement to meet the insurance needs of an employed person at minimum cost". Discuss.

## Questions

1. What are the major objectives of group employees benefit schemes?
2. How does group insurance help an employer to discharge his statutory responsibility while at the same time offering additional benefits to the employees? Discuss with two examples of group insurance where it happens.
3. How can an employer help his employees to manage their retirement risk through group insurance?
4. Make a comparison between the trustees administered gratuity scheme and an insured scheme in terms of advantages to the employer and the employees.
5. What are the income tax benefits to employer and the employees flowing out of the implementation of the group schemes?

## Multiple-choice questions

Choose an appropriate answer for the following questions:

1. For the introduction of a group scheme we need a
  - a) Homogeneous group
  - b) Insured group
  - c) A small group of persons
  - d) A large group

**Ans. (a)**

2. The group scheme specially designed to discharge the gratuity liability of the employer is called
  - a) Group superannuation scheme
  - b) Group gratuity insurance scheme
  - c) Group insurance scheme
  - d) EDLI scheme

**Ans. (b)**

3. Group superannuating scheme in conjunction with group insurance scheme is taken
- a) To meet statutory requirements
  - b) To offer group insurance protection
  - c) To ensure that even in the case of premature death, the employee's widow gets a reasonable pension
  - d) None of the above.

**Ans. (c)**

4. Group savings linked insurance is a
- a) Group insurance scheme with a survival benefit
  - b) Scheme offered in lieu of EDLI scheme
  - c) Scheme for meeting employer's liabilities under Payment of Gratuity Act, 1972
  - d) Scheme offered by National Savings Organisation

**Ans. (a)**

5. In India, most group insurance schemes are marketed by the insurance companies through
- a) Agents
  - b) Brokers
  - c) Directly by the company
  - d) Banks

**Ans. (c)**

# Insurance

## CHAPTER – 8

# FINANCIAL GERONTOLOGY AND SUPER ANNUATING POLICIES

### OUTLINE OF THE CHAPTER

- Introduction
- Problems of ageing
- Dynamics of financial security
- Financial needs of the aged
- The situation in India
- Financial planning for retirement
- Describing the objectives of annuity
- Explaining the classification and design of annuity products
- Outlining the various uses of annuities
- Pension plans and the different policies offered in the market
- Summary
- Questions

### LEARNING OBJECTIVES

- To know about the problems of ageing and the financial needs of the aged.
- To understand the dynamics of financial security.
- To learn about the current family system and the position of the aged in society today.
- To learn about the basics of financial planning for managing the retirement risk.
- Explaining the classification and design of annuity products.
- Outlining the various uses of annuities.

### 1. INTRODUCTION

The meaning of the term “Gerontology” according to the Oxford English dictionary is the scientific study of old age, the process of ageing and the particular problems of old people. As one approaches old age, the concern for security and comfort become vital

issues. Of course, science and technology have increased the life span but then along with it, the aged have to worry about the need for funds to carry on for a much longer time after retirement. If people carefully plan for the future during their productive years they can be carefree and enjoy the later part of their life. But sadly very few people take such initiative or have the savings to be able to do so. Retirement planning has thus never been taken seriously especially in our country. Today insurance companies provide a variety of financial product to suit the individual's needs. The customer is considered to be the King of the market. He can select the appropriate financial product depending upon his retirement needs.

But for the vast majority of the Indian population today, getting two square meals a day is itself a problem. In such circumstances, savings for old age is therefore simply ruled out. Financial planning for life after retirement will therefore remain and will continue to remain a luxury affordable only to the middle and upper classes for a long time to come. Those who retire from service in government and the organised sector are also relatively better off as they have employer-sponsored schemes which give them a certain measure of security.

Old people have to overcome two problems both having very important financial implications: (a) declining earning power (b) poor health. Declining earning power is the result of physiological changes, lack of knowledge and skills. These unfavourable effects are aggravated by public and private policies that minimise the incentive for the employment of older persons thereby increasing the cost of the employers who employ older persons.

India is a developing country and a vast majority of workers are employed in informal sector inclusive of agriculture and other related activities. This does not give them sufficient income to survive especially during their old age. Employees in the formal sector on the other hand enjoy the benefits of pension and other retirement benefit schemes.

Most of the people appreciate the seriousness of losses relating to premature death, long period of unemployment and accident or sickness. Old age along with reduction in earnings is usually not considered as a financial loss. As an individual grows older the earning capacity also reduces while expenses tend to grow. The only solution is to save and invest during the younger and more productive years.

## **2. PROBLEMS OF AGEING**

---

In India the age structure is changing rapidly. The percentage of old people in the population is constantly increasing. People are living longer. For developing countries where the population of the elderly people is rapidly increasing, making adjustments for this is a strong challenge. This challenge should be accepted and dealt with. We should rebuild the social structure in such a way that the aged population can spend the last years of their life in a productive manner and live a life of dignity and minimum comfort.



The earlier this challenge is faced by governments, enterprises, social organisations and families, the closer we will be to the solution.

There are two processes in the ageing of population; one is ageing at the base and second ageing at the apex of the population. The former is due to the decline in the fertility and latter because of reduction in mortality among the older persons. "When the population ages, the share of older people in population increases while the share of children and youth decrease resulting in a rise in the median age" (Conception, 1996). Median age summarises the age structure of the population.

These people become more vulnerable to health problems. This leads to physical disabilities such as blindness, deafness and other health related problems.

Earlier problems faced by the older persons in India were not considered serious, mainly because their number was relatively small and there was always social protection, from the other family members. But now due to the socio economic changes taking place, the needs of the aged are no longer met by the younger members of the family.

Studies related to age distribution discuss the concept 'ageing of population'. The population is said to be ageing when the proportion of the population over the productive age increases. The increase in the number of aged people needs consideration, as their needs are quite different from that of an adult or any other young person. They have to prepare themselves to the changing social situation and should be able to lead a dignified life without depending on charity.

In Indian society, transition is taking place in social and economic fronts. The aged people are no longer respected the way they used to be. Emerging changes in technology have minimised the role of the elderly people, as their knowledge and skills are outdated.

Joint families are still found in India, but nuclear families are growing at a much faster rate. In this situation who will take care of the elderly is the question. There has also been a vast improvement in the field of medicine and health care, which has extended the life span of many. Dealing with the problems of the aged has thus emerged as a major area of concern.

Concerned with the magnitude of the problem and recognising the urgent need for action Government of India launched the project called "OASIS" (Old Age Social and Income Security). This study indicated that between year 1991 and 2016, the population of old aged i.e. 60 years and above would increase by 107% to 113.0 million and would continue to grow rapidly in the year 2026 to 179 million which will be 13.3% of the population.

The table below gives us an idea of the expected population till 2050. The first table gives a clear picture of the older population from the year 1951-1991 and the second table from year 2000-2050. The Census of India Publications and the United Nations Population prospects have projected these.

## Total and older population and their increase, 1951-2050

| Year | Total population<br>(in million)    |                                         | Total aged population<br>(60+) (in million) |                                         | Decennial change (%) |                   |
|------|-------------------------------------|-----------------------------------------|---------------------------------------------|-----------------------------------------|----------------------|-------------------|
|      | Indian<br>census and<br>projections | UN<br>estimations<br>and<br>projections | Indian<br>census and<br>projections         | UN<br>estimations<br>and<br>projections | Total<br>population  | Old<br>population |
| 1951 | 361.1                               | 357.6                                   | 19.6                                        | 20.1                                    | 13.3                 | 8.9               |
| 1961 | 439.2                               | 442.3                                   | 24.7                                        | 25.1                                    | 21.6                 | 26.0              |
| 1971 | 548.2                               | 554.9                                   | 32.7                                        | 33.2                                    | 24.8                 | 32.4              |
| 1981 | 683.3                               | 688.9                                   | 43.2                                        | 43.2                                    | 24.6                 | 32.1              |
| 1991 | 846.3                               | 850.8                                   | 56.7                                        | 56.7                                    | 23.9                 | 31.3              |

**Source:** Census of India publications, Government of India, Report of the Technical Group on Population Projection 1996 and United Nations Population Prospects Vol. 2 Age and sex distribution, UN, New York, 1999.

The information derived from Indian census show that in the last one hundred years the population of older persons has been climbing steadily. In year 1901 the population of the aged was 12.1 million out of 238.4 million. The population doubled in six decades and reached 24.7 million in year 1961. In two decades or so it again doubled and stood at 56.7 million in year 1991.

### Projection

| Year | Total population<br>(in million)    |                                         | Total aged population<br>(60+) (in million) |                                         | Decennial change (%) |                   |
|------|-------------------------------------|-----------------------------------------|---------------------------------------------|-----------------------------------------|----------------------|-------------------|
|      | Indian<br>census and<br>projections | UN<br>estimations<br>and<br>projections | Indian<br>census and<br>projections         | UN<br>estimations<br>and<br>projections | Total<br>population  | Old<br>population |
| 2000 | 997.0*                              | 1013.7                                  | 68.5*                                       | 77.3                                    | 19.8                 | 36.3              |
| 2010 | 1162.3*                             | 1152.2                                  | 92.5*                                       | 101.2                                   | 13.7                 | 30.9              |
| 2020 |                                     | 1272.2                                  | —                                           | 141.7                                   | 10.4                 | 40.0              |
| 2030 |                                     | 1382.7                                  | —                                           | 197.0                                   | 8.7                  | 39.0              |
| 2040 |                                     | 1467.1                                  | —                                           | 255.3                                   | 6.1                  | 29.6              |
| 2050 |                                     | 1528.9                                  | —                                           | 323.9                                   | 4.2                  | 26.9              |

**Source:** Census of India publications, Government of India, Report of the Technical Group on Population Projection 1996 and United Nations Population Prospects Vol.2 Age and Sex distribution, UN, New York, 1999.

According to Technical Group projections the older population in 1991 will double in next 25 years and will reach 113 million by 2016 (Registrar General, India 1996). UN projects the doubling of the same population by 2035.

As per available data in the U.S., the older population has increased from 8 per cent to 14 per cent of the total population between 1950 and 2000. It is expected to increase by 26 per cent by 2050 (United Nations 1999).



In India older population is taking lesser time to double. In the next half century the population of older persons in India is expected to reach 324 million.

The decennial change in the older population indicates that except from 1941 to 1951 there has been a steady increase in older population. From 1961-71 onwards there has been an uninterrupted decline in the decennial change in total population. But decennial change in case of older population has been increasing. It is expected to reach the highest in year 2010-2020 by 40 per cent and then decline.

### State wise differences

| Serial number | States         | Per cent Aged | Index of ageing | Median Age  | Expectation of life at birth |             |
|---------------|----------------|---------------|-----------------|-------------|------------------------------|-------------|
|               |                |               |                 |             | Male                         | Female      |
| 1.            | Andhra Pradesh | 6.8           | 18.1            | 22.6        | 60.3                         | 63.4        |
| 2.            | Assam          | 5.3           | 13.6            | 20.4        | 57.2                         | 56.9        |
| 3.            | Bihar          | 6.3           | 14.7            | 19.9        | 59.5                         | 58.6        |
| 4.            | Gujarat        | 6.4           | 16.7            | 21.6        | 59.6                         | 62.1        |
| 5.            | Haryana        | 7.7           | 18.6            | 19.8        | 64.3                         | 63.1        |
| 6.            | Karnataka      | 7.0           | 18.8            | 22.2        | 63.2                         | 64.3        |
| 7.            | Kerala         | 8.8           | 28.9            | 24.4        | 67.4                         | 73.1        |
| 8.            | Madhya Pradesh | 6.6           | 16.2            | 20.6        | 57.7                         | 56.4        |
| 9.            | Maharashtra    | 7.0           | 19.6            | 22.9        | 63.0                         | 64.4        |
| 10.           | Orissa         | 7.2           | 19.2            | 22.2        | 58.6                         | 56.8        |
| 11.           | Punjab         | 7.8           | 21.2            | 22.1        | 66.1                         | 65.9        |
| 12.           | Rajasthan      | 6.3           | 14.9            | 19.8        | 59.2                         | 60.0        |
| 13.           | Tamil Nadu     | 7.5           | 23.2            | 24.5        | 61.6                         | 62.0        |
| 14.           | Uttar Pradesh  | 6.9           | 16.4            | 19.9        | 55.6                         | 51.2        |
| 15.           | West Bengal    | 6.1           | 16.6            | 22.2        | 61.0                         | 60.7        |
|               | <b>INDIA</b>   | <b>6.7</b>    | <b>17.6</b>     | <b>21.6</b> | <b>59.4</b>                  | <b>60.4</b> |

**Source:** Rajan, *et al*, India's Elderly: Burden or Challenge? Sage Publications, New Delhi, 1999.

Out of the 15 states, the population comprising the aged is the least in Assam (5.3%). States like Haryana, Karnataka, Kerala, Maharashtra, Orissa, Punjab and Tamil Nadu

have 7 per cent and more of the aged population. Kerala has the highest of 9 per cent. Median age in Bihar, Haryana, Rajasthan and Uttar Pradesh indicates young population. Kerala and Tamil Nadu have the highest percentage of maturing population.

It's expected that in the year 2011 (as per Technical Group on Population Projections), percentage of aged in Kerala and Tamil Nadu, will increase to more than 10 per cent. However states like Assam, Bihar and Uttar Pradesh are expected to have 6 to 7 per cent of the older population.

It is now clear that the aged population refers to people who have crossed at least 60 years. They are not a homogeneous group. The attributes are not similar. To actually understand the problems of ageing, the diversity must be understood. Some of the characteristics of aged persons are given below:

- **Sex Composition:** Age and sex are the basic tools for any demographic analysis. For elderly population it is an indication of differential mortality that took place during their life. Males when compared to females have higher mortality rate. This leads to sex imbalance when they become old. According to the Census so far, unlike other countries, India has more number of males. The same was also true for the elderly population till 1991. It is interesting to note according to UN projections, the number of women population (80+) is likely to increase.
- **Age Composition:** Almost two-thirds of the aged population, i.e. 60 to 69 is declining by each decade while others are increasing. But in absolute terms, population is increasing in almost all age group categories. In 1961 there was an increase in the age group category of 70-79 when compared to other categories.
- **Place of Residence:** It is seen that three out of four elderly are found in rural areas. This is expected since three-fourth of the Indian population live in rural areas.
- **Marital Status:** The distribution of marital status among the elderly is vital. It is an age wherein everyone requires a partner. Children and grandchildren tend to spend less and less time with the elderly people, as they are busy with their own activities. A study shows that the percentage of widowed women was more when compared to those who are currently married and in case of males it was the other way round. This indicated that the wives were much younger to their husbands and therefore tended to outlive their husbands.
- **Literacy Level:** Majority of elderly population is illiterate and that includes both males and females. In 1961 only 29% of males and 4% of females (60+) were literate. In 1991 it jumped to 41% and 13%.
- **Employment:** Usually during old age the level of income reduces, and simultaneously expense pertaining to health increases. Remaining employed even after the age of 60 is not desirable. But this at the same time has certain advantages. It reduces boredom, loneliness and unwantedness.



### 3. DYNAMICS OF FINANCIAL SECURITY

If an individual starts saving in the early days of his working life, then it is certain that he is going to enjoy the fruits of it when he is old. But what if an individual dies prematurely? If he is the breadwinner, the family faces severe economic hardships. Thus from the individual's point of view he or she must plan for both the contingencies, namely, the risk of premature death and the problem of living too long after retirement.

To understand the overview of the retirement risk let us take an example. For the young employed person on the threshold of a bright career, retirement appears to be something too far away for him to feel seriously concerned about. He has other priorities and retirement planning is the last thing in his mind. In the intensely competitive work situation today, he moves higher and higher in his career till retirement creeps in on him. By then he finds himself retired, tired and with no clear plans for life after retirement. He is not aware that for people of his generation, the life after retirement is much longer and therefore required careful retirement planning.

The retirement risk has assumed serious proportions with increasing life expectancy thanks to improvements in health care. At present the current population is living a longer life span after the retirement age. Simultaneously people are retiring earlier as organisations are also providing early retirement packages to the employees so that they can employ younger people with better skills at much less cost.

There are actually two risks linked with retirement. The first being the risk of the person being left with insufficient assets to manage during the post retirement phase. The second risk is the risk of outliving the assets that had been accumulated. Even if the assets are utilised properly after retirement, it is difficult to calculate how much of the asset should be used every year in order to ensure that the income from the assets lasts till the end of the individual's lifetime.

The second risk is much easier to explain. The annuity principle can be utilised to change an accumulation into an income so that an individual cannot outlive the asset collected. Annuities are considered as vital tools in administering and managing retirement risk and they are the best solution for the second problem.

**Alternatives ways of managing the retirement risk:** There are many individuals who work even after their retirement age to receive income. They fully avoid the risk of outliving their income. Even if the person continues to work, it is for sure that after a certain age (65 and above) he will not be physically strong to give his best and earn sufficient income.

#### **Retirement planning process:**

Retirement planning is similar to that of life insurance planning. It consists of three steps.

- The first step is to estimate the future income needed after retirement. It is also important to identify existing resources to meet these needs.

- The second step is to decide how these funds will be accumulated. The fund must be sufficient enough to contribute the difference between the resources that are available and will be needed to give the necessary retirement income. Further appropriate amount needs to be added to meet health care and hospitalisation expenses, as the old are more prone to health related problems.
- Finally the individual has to decide how the fund is to be consumed. He needs to consider his likely period of life after retirement and the provisions to be made for the spouse.

#### **4. FINANCIAL NEEDS OF THE AGED**

---

As the individual grows older his stamina decreases. There comes a time when the individual is no longer able to work and at this time his income ceases. Even if the individual gets into a part time job, it would be strenuous for him and would give him very meager income. It has been estimated that at least 80% of the income earned during service is necessary to maintain the same standard of living after retirement. If the part time employment and the interest from savings/annuities do not make up this 80% there is a problem. The individual concerned will have to reconcile himself to a fall in the standard of living.

As an individual grows older he tends to spend less for items of luxury. Expenses relating to health increases for him. It might be a temporary sickness, or some long-term disability. In such a situation what can the individual do? He should have planned in advance the accumulation of funds to meet the expenses directly or through insurance.

##### **The situation of the aged population in the west**

In the west, retirement needs are met through three sources:

- Social security
- Employers sponsored benefit schemes
- Private savings

These 3 are traditionally considered the three legs on which the retirement stool stands. Let us discuss each of them one by one.

##### **Social Security**

It is the first source of retirement income available to the citizens in the western world. Social security was mainly introduced in these countries to help low wage earners. It normally provides 60 per cent of the retirement income requirements to low wage earners and 30 per cent to high wage earners.



## **Pensions and profit sharing plans**

Some people have employer sponsored pension or profit sharing plan, which complement the benefits provided by social security. Almost all organisations in these countries have pension plans. Lately there has definitely been a shift from defined benefit pension plan to defined contribution pension plans. These schemes are usually part financed by the employer and part financed by the employee himself. The objective is to ensure a reasonably comfortable retirement to the employee on cessations of employment. It may be mentioned here that the percentage of citizens in the organised sector in these countries is very high and the employer sponsored schemes are therefore able to make life after retirement relatively easy for a sizeable percentage of the population.

## **Private savings**

Benefits that are provided by social security and employer sponsored pension may not all times cater to the needs of the retired person sufficiently. Annuities and health insurance may be purchased to supplement the benefit from the two sources. It can be held through life insurance and annuities, government bonds, corporate bonds, mutual funds, real estate and limited partnership. Proper consideration has to be rate of return, vulnerability to inflation, tax principal and safety of principal. Annuities are considered to be the best for retirement accumulation since they have favourable tax treatment.

## **5. THE INDIAN SITUATION**

The situation in India is quite different. We do not have a social security scheme in place here as in the majority of the countries in the west. The problems are also aggravated by the fact that the number of aged persons in need of social security is very vast. The government just does not have the resource to extend the benefit of social security to this growing population of the aged.

Also the percentage of the population in the country in government service or in regular employment in the organised sector is relatively small. Hence the employer sponsored welfare benefits are available only to the fortunate few who belong to these sections.

The situation of the persons who retire from regular employment in government or in organized sector is a lot better as they have employer sponsored retirement benefit schemes. The employer sponsored welfare schemes for these categories of people include the following benefits:

- Provident fund
- Gratuity in accordance with the provision of the Payment of Gratuity Act
- Insurance benefits under group insurance schemes, EDLIS scheme, GSLI schemes
- Pension benefits

Government employees also enjoy the benefit of health schemes even after retirement. These schemes are covered in detail elsewhere in the course.

The major issue for the government therefore is to deal with the problems of senior citizens belonging to the unorganised sectors in urban areas and those in the villages engaged in various agricultural occupations.

There was a time, when the joint family system took care of many social problems in our country. This system, which had developed into a well-established social system in our own country had a solid foundation in Indian society and afforded a measure of protection for the aged, the sick, the disabled, the unemployed, and the widows. The winds of change blowing through the society brought about the breakdown of this system. It is now the age of nuclear families in our country and the aged people along with the other categories mentioned above are now left to fend for themselves. With no savings to fall back upon, no insurance, no social security and no family support the lot of these people is indeed pitiable. In addition old age brings with it many health related problems. Even though there is a great improvement in health care facilities in the country these facilities are available only to the rich and those others who have employer sponsored or privately financed health insurance schemes.

## **6. FINANCIAL PLANNING FOR RETIREMENT**

---

- Need for funds after superannuating
- Estimating the needed funds
- Financial planning to meet the needs

### **All these three are relevant factors that shape the retirement plan**

The objective of estimating the retirement need is mainly to plan the retirement accumulation. Determining the volume of retirement fund has two estimations: 1. The total retirement income that is required 2. Existing resources available and the balance required for bridging the gap between the existing resources and the estimated requirement of funds.

A realistic assessment of post retirement financial commitments will enable a person to determine the need for regular income after retirement. How much of that amount will be adequate also depends upon the present standard of living, the rate of inflation and the expected standard of living to be maintained after retirement.

There are actually two ways to estimate the regular income needed in post retirement. One can prepare a budget for post retirement living. That would include housing, medical, food and other necessary expenses and contingencies. The accumulated assets should be able to generate sufficient income to meet these needs.

The second method that is generally followed involves maintaining retirement income at a certain level and restricting the expenses within that level. Many studies indicate



that for a retired person and his spouse who have already fulfilled their commitments to the family such as children's education, marriage etc. the regular income needs every month would be roughly 80% of the income during the earning years.

Another aspect that needs to be looked at is the effect of taxes on income after retirement. The retirement annuity benefit is usually taxable. Thus it is necessary to know the post retirement income after tax.

Once the total retirement need is known examining the availability of resources is the next step.

If resources are adequate for generating the required income with a provision for emergencies, the individual and his spouse can look forward to a reasonably worry free retired life.

One way of assuring that a part of the accumulated assets provide regular income as long as one is alive is through the purchase of annuities.

## Pension Plans and Annuities

**Annuities and pensions** mean the same thing in India. These are avenues, which provide for post retirement income to individuals. While life insurance offers protection against loss of income in the event of the demise of a person, annuities provide financial support to the person when he loses his capacity to earn on attaining old age.

*Annuities refer to periodical receipts by an individual from an insurance/finance company. These are the returns from a lump sum investment or smaller investments made in installments over a specific number of years, which are accumulated and invested for appreciation in value. This amount is disbursed to the individual as a fixed sum either annually, semi annually or monthly over the period of his life or for a specific number of years.*

Tax benefits can also be availed under this scheme for premium payments made to the insurer but annuity installments are taxed as salary.

On retirement or on maturity of the scheme the person can commute the value equivalent to 1/3 of the fund, i.e., upto one-third of the corpus of the total pension benefits can be withdrawn by the person and this is tax-free.

Nature of annuities:

- **An annuity** is a series of periodic payments over a person's lifetime.
- **Pure Life Annuity** is an annuity whose payments are contingent upon the continued existence of one or more lives.
- **An annuity certain** is an annuity whose payments are not contingent on the annuitant being alive.
- **A temporary life annuity** is a life annuity payable for a fixed period or until the death of the annuitant, whichever is earlier.

- **A whole life annuity** is a life annuity payable for the whole of the annuitant's life.

Differences between life insurance and annuities.

Annuity is the basic mechanism for developing the fund to be liquidated

- The principal mission of life insurance is the creation of a fund whereas the basic function of an annuity is the **systematic liquidation of fund**.
- The purpose of life insurance is protection against the loss of income through premature death where as annuity's basic purpose is to protect against the possibility of **outliving one's income**.
- In life insurance, the outliving group contributes to the pool for those who failed to survive to their life expectancy whereas in annuities **who die before attaining their life expectancies** contribute for the outliving.

Despite the differences in function, annuities are simply another type of insurance, and both life insurance policies and annuities are based on the same fundamental principles of pooling, and the computation of premiums on the basis of mortality tables.

Classification of annuities:

Annuities may be classified in numerous ways.

- Number of lives covered – one life or multiple lives [joint and last-survivor annuity, joint and two-thirds annuity (or joint and one-half), joint life annuity].
- Method of premium payment – single or periodic premiums.
- Time when income begins – deferred or immediate.
- Method of disposing of proceeds.
- Denomination in which benefits are expressed – fixed currency units or units of ownership in an investment fund.

Nature of insurance company's obligation:

An annuity can be considered as having an **accumulation** [during which time annuity fund values accumulate] and a **liquidation period** [during which time annuity fund values are paid to annuitant].

During Accumulation period:

- The insurer is obligated to return all or a portion of the annuity cash value if the purchaser dies or voluntarily terminates the contract.
- The contract owner is entitled to the cash surrender value on contract termination.



During the liquidation period:

- Annuities certain – with annuities certain, amounts are to be paid irrespective of whether the annuitant is alive or dead.
- Pure life annuities – income payments continue for as long as the annuitant lives but terminate on the annuitant death or, temporary life annuity, at the end of the designated time period, if earlier.
- Life annuities with refund features [life annuity certain and continuous or life annuity with installments certain] –
  1. **Installment refund annuity** – [if the annuitant dies before receiving income installments equal to the purchase price, the payments will be continued to a beneficiary until this amount has been paid.
  2. **Cash refund annuity** – promises to pay in lump-sum amount to the beneficiary the difference, if any, between the purchase price of the annuity and the simple sum of the installment payments made prior to the annuitant death.

### **Types of annuity contracts:**

- Flexible-premium deferred annuity.
- Single-premium deferred annuity
- Single-premium immediate annuity
- Variable annuity [whose cash values and benefit payments vary directly with the experience of assets designated to back the contract.]
- Equity-indexed annuity [is a non-variable annuity contract whose interest crediting mechanism is tied directly to some external index].

### **Uses and limitations of annuities:**

Annuities can be useful in both the tax-qualified and nonqualified markets.

- The annuitant has the benefit of the investment management offered by insurers.
- Annuitants would enjoy monthly incomes at retirement age.
- When tax benefits are considered, the net return often will exceed those of comparable savings media.
- The income is certain: the annuitant may spend it without fear of outliving it.

**With fixed value annuities, inflation can erode the purchasing power of the annuity payments.**

## **AVAILABLE ANNUITY AND PENSION PLANS IN THE INDIAN MARKET LIC PLANS**

---

### **New Jeevan Dhara**

- This scheme provides a regular life long pension along with guaranteed percentage returns, security of income payments and lumpsum payments as death benefits to the annuitants heirs.
- The premium payment can be in a single or multiple instalments (up to 35 years).
- The premium period is one year less than the deferment period.
- A rebate of 2.6% of the premium is provided if the premium payment is made on yearly basis.
- The vesting age of pension payments is 50-years (start of premium payments).
- A surrender value of 90% is recoverable if the policy is surrendered after 3 years of premium payment. This is not available after the pension payments start.
- In addition to payments during the annuitant's lifetime this plan offers lumpsum payment to the annuitants estate on his death.
- 25% of the vested amount can be commuted.
- No medical examination is required.
- The plan offers cash accrual plus reversionary bonus plus any additional bonuses. The same amount is provided if death occurs after pension payments commence and in addition a higher lumpsum bonus is available to the heirs.

On vesting the following modes can be opted for:

- Life annuity with a guaranteed period of 5, 10, 15, 20, years.
- Joint life or last survivor annuity (50% of the assured amount is paid to the survivor).
- Life annuity with return of purchase price.
- Life annuity with annuities increasing at a simple rate of 3% per annum.
- A term assurance option.
- The survival benefits include a guaranteed maturity addition at a fixed percentage of the above benefits for each year of deferment period.

### **New Jeevan Akshay**

- The age to avail the policy ranges from 40 to 79 years. There is no maximum maturity age (lifetime payment).



- No loan is provided on the policy.
- This is a single installment plan (minimum purchase price is Rs. 25,000).
- This provides periodic returns at a flat rate of interest calculated on the sum insured.
- The annuities commence after the first installment is paid. The dependants are compensated with the guaranteed/insured amount plus the final terminal bonus on the demise of the person.
- The policyholder can withdraw 30% of the insurance sum after 7 years. Hence the annuities reduce in amount.
- Surrender value is not available under this plan.
- All the options available under New Jeevan Dhara plan are available.

### **New Jeevan Suraksha (plan 147)**

This scheme corresponds with the New Jeevan Dhara plan.

### **Varistha Pension Bima Yojana**

- This is a new plan from LIC for citizens above 55 years of age (upto 79 years).
- An effective yield of 9% p.a. is provided on the policy and this is a Government subsidised scheme.
- The premium has to be paid in a lumpsum at the beginning.
- Only one person in a family can purchase a policy.
- Pension is paid during the lifetime of the pensioner.
- In case of unfortunate death of the pensioner, purchase price will be paid to the nominee.
- No policy loan is available.
- No surrender value is allowed ordinarily. But in case the investor is critically ill this may be allowed with approval of higher authorities.

## **ICICI PRUDENTIAL PLANS**

### **ICICI Pru Forever life (deferred pension plan)**

The policy provides regular income, health cover, tax benefits and life insurance cover.

The annuity payments differ as per the option chosen.

The age to avail the policy ranges from 18 to 60 years while the vesting age ranges from 45 to 65 years under different plans.

The minimum sum assured is Rs. 50000 and the minimum term is 5 years.

Annuity benefits are provided for life and the policyholder can commute 25% of the sum assured plus the guaranteed additions plus the vested bonuses in a lumpsum.

**There are different options available:**

Market option – the policy amount can be used to purchase annuity from any other company at any point of time.

Life annuity option – annuity is provided for life.

Life annuity certain – under which 5, 10 or 15 years annuity is paid and for life thereafter if the insured survives.

Life annuity certain with return of purchase price – life annuity is provided with return of purchase price to the beneficiary in case of death of the policyholder.

Joint life, last survivor annuity with return of purchase price- basically this provides life annuity payments to the insured, then to the survivor after the death of the insured. The purchase price is returned on the death of the joint life survivor to the last survivor.

The death benefits, which is paid during the deferment period under which regular income is provided to the beneficiary based on the sum assured plus any guaranteed additions and vested bonus till date.

Riders are available like accident and disability benefit, critical illness benefit, major surgical assistance, insurance benefits, etc.

If the policy is discontinued after 3 years the guaranteed surrender value is payable. But the insurance protection ceases.

**ICICI Pru Reassure plan**

The eligible age to purchase the scheme is for 7 to 62 years.

The term is for 5 and 7 years.

This is a single premium payment plan.

The sum assured ranges from Rs. 50,000 to Rs. 50 lakh.

The survival benefits are paid at the end, which gets compounded at a fixed percentage of the sum (between 7.5 and 8% depending on the quantum of the policy) along with the entire amount of single premium is paid back on maturity.

If death occurs after first year then 110% of single premium to the beneficiary. The same benefit is paid if the death is caused due to an accident. In case death occurs in other circumstances the net single premium is paid out where the payments are not deducted.

The surrender value accumulates after the first year.



## **ICICI Pru Lifetime Pension plan**

This is a deferred pension plan.

This is a market linked plan wherein the policy proceeds are invested in market linked funds.

The policy value is calculated as value per unit based on market conditions. This value is paid to the policyholder upon exit.

Future returns are not guaranteed under this plan as the investments are subject to market moves.

The basic options mentioned in the Forever Life plan apply here.

## **HDFC STANDARD PLANS**

### **HDFC pension plan**

This is a savings cum pension plan whereby income after retirement is provided.

The premium can be paid in installments or in a single payment.

The survival benefits consist of notional amount as sum assured plus bonus. A part of this can be commuted and the rest can be converted to annuity at the prevailing rate offered. This can also be used to buy annuity from other insurance companies.

A reversionary bonus is paid in addition to the benefits while terminal bonus may be paid.

If death occurs after the first year then all the premiums paid till date are returned with interest at a fixed percent subject to a maximum of the sum assured and the bonus declared till date. This is applicable to policies with regular installment payments. For single premium plans the sum assured plus the bonus declared till date is paid. Also interim bonus may be payable.

No loans are provided on the policy value.

The surrender value is paid if the policy is discontinued after 3 years (less the pension outgo)

Riders are available if opted for.

### **Summary**

This chapter explains the meaning of the term “Gerontology” and describes the problems of ageing. The need for social security is felt more among the aged people today. Earlier since joint families existed, the aged people always depended upon their family members during hard times. But now because such joint families are breaking up, the elderly people are left alone. Thus the need for financial planning after retirement is required. Individuals who work for government and other organised sectors are in a better position when compared to others since they are offered employer-sponsored schemes.

The individual should plan his retirement step by step. He must estimate the future income that is required during post retirement. Once that is known he should plan how to accumulate these funds. Finally the individual should decide how to utilise those funds. In western countries the retirement needs are met through three sources: Social security, employers sponsored benefit schemes and private savings. In India the situation is completely different - the government does not have sufficient funds to meet the requirements of the growing population of aged.

## Discussion Questions



1. Discuss the importance of 'Retirement Planning' and indicate how insurance and annuity plans have an important place in such planning.

## Questions



1. Why annuities are have an important place in the retirement plan of an individual?
2. What are the financial needs of the aged?
3. Describe the purposes annuities serve.
4. Classify and discuss annuities based on
  - Number of lives
  - Method of premium payment
  - Method of disposing of proceeds
  - Time when income begins
  - Denomination in which benefits are expressed.
5. Explain various types of annuity contracts.
6. Analyse the uses and limitations of annuities.
7. Explain various optional benefits and riders that are available in annuity insurance contracts.



## Multiple-Choice Questions

1. In India the percentage of old people in the population is:
  - a) Increasing
  - b) Decreasing
  - c) Remain the same
  - d) No data available to reach any conclusion

**Ans. (a)**

2. The person employed in organized sector are better off than those in the unorganized sector because:
  - a) They have assured income and employee benefits.
  - b) They are better educated.
  - c) They are subject to very strict rules and regulations framed by the employer.
  - d) They are under the control of the trade union

**Ans. (a)**

3. OASIS means in this context:
  - a) A green patch with water resources in the midst of the desert.
  - b) A water fall.
  - c) The project called Old Age for Social and Income Security.
  - d) A project for the welfare of the female child.

**Ans. (c)**

4. The insurance plans specifically meant to meet regular income needs, post retirement, are referred to as:
  - a) Annuities
  - b) Endowment plan
  - c) Whole life plan
  - d) Term assurance

**Ans. (a)**

# Insurance

## CHAPTER – 9

### DISTRIBUTION CHANNELS OF LIFE INSURANCE

#### OUTLINE OF THE CHAPTER

- Developing and Maintaining a Marketing Program
- Distribution Channels
- The National Dimension of a Distribution System
- The International Dimensions of Distribution
- The Role of Multinational Insurers
- Compensation in Marketing
- The future of Life Insurance Marketing
- Questions

#### LEARNING OBJECTIVES

- Describing various channels for distribution of life insurance.
- Discussing international dimensions of distribution and role of multi national insurers.
- Identifying practices used in compensating for marketing life insurance.
- Discussing the future of life insurance marketing.

Marketing refers to various methods for selling. Focusing on **consumer needs** and achieving **long-term profits** through satisfaction of consumer needs is the new marketing concept in the recent intense competition within the life insurance business and from other financial service organizations. Historically, the agent in the insurance industry did this. But today insurers seek ways to augment and enhance the service provided by the agent.

#### DEVELOPING AND MAINTAINING A MARKETING PROGRAM

Marketing is the provision of products well suited to consumers' needs through effective, appropriate distribution channels or marketing channels. A marketing program is a tactical plan that deals primarily with the product, price, distribution and promotion strategies that a company will follow to reach its target markets and to satisfy their needs. Use of sophisticated data warehousing, data mining, and database management techniques can materially increase a marketing program's effectiveness. Once the



insurer's marketing plan is initially documented, management evaluates its growth and profit goals, and the capabilities and core competencies of the home office and marketing operations. The results of this planning and development activity will be a quantification of what the company wants to achieve, reflecting a balance between long-term and short-term goals. With priorities established, specific goals set down, and a product portfolio established, the stage is set for selecting and utilizing one or more distribution channels to deliver products to the markets selected.

## DISTRIBUTION CHANNELS

Three broad categories of distribution channels

### Marketing intermediaries

Includes agents and brokers. They sell insurance products, on a face to face basis with customers for a commission on each sale

### Financial institutions

Include commercial banks, investment banks, thrifts, credit unions, mutual fund organizations and other insurers sell insurer's products.

### Direct response

No face-to-face contact is involved, with the customer responding to some type of solicitation directly from the insurer, such as through the mail, television, or telephone.

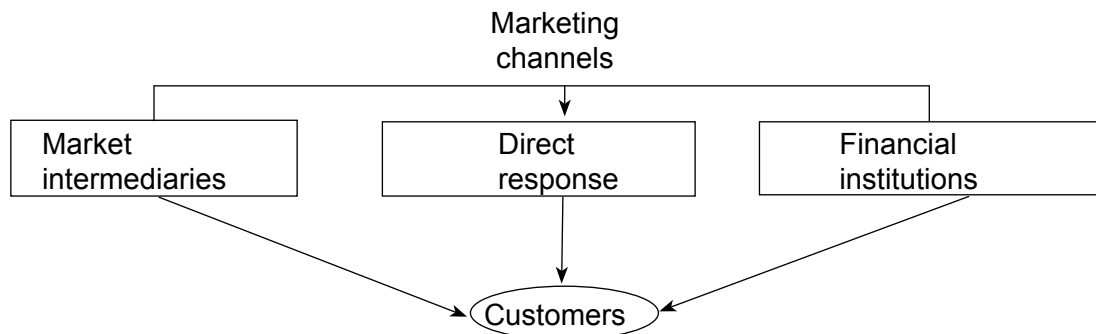


Figure 1- Categories of Life & Health insurer marketing channels

## Distribution through Marketing Intermediaries

Marketing intermediaries can be divided into two broad classes

- Agency-building distribution – under this insurers recruit, train, finance, house and supervise their agents
- Non-agency building distribution – under this insurers do not seek to build their own agency sales force. Instead, they rely on established agents for their sales.

### Agency Building distribution

There are four types of agency-building distribution.

1. Career agency – Career agents are commissioned life insurance agents who primarily sell one company's products. There are two approaches in career agency distribution
  - The branch office system – This is also called managerial system. The insurer establishes agencies in various locations; each headed by an agency manager who is an employee of the insurer. He is charged with the responsibility of recruiting new agents within a given territory and training them. He is assisted by an office manager, assistant managers, supervisors, specialist unit managers, or district managers.
  - The general agency system – The Company appointed general agents typically represent the company within a designated territory over which he or she is given control. Insurer pays a stipulated commission on the first year's premium plus a renewal on subsequent premiums to them in return, the general agent agrees to build the company's business in that territory. He is responsible for agent recruitment, and supervision, as with the agency manager. He also receives a commission on agents' sales, called an **override or overriding commission**.
2. Multiple-line exclusive agency [MLEA] – Multiple-line exclusive agents are commissioned exclusive agents who sell life and health and property and liability insurance products of a single group of affiliated insurers. As contrasted with other agency-building distribution system, MLEAs often are not all housed in the same office. Rather each agent has his or her own office clerical support that services clients and supplements the agent's personal sales efforts.
3. Home service – This is also known as the **Combination or debit distribution system**, which relies on exclusive agents who are assigned a geographic territory. The target market for home service distribution is lower-income consumers. Originally, much of the business consisted of industrial insurance with weekly collections of premium. Many insurers have abandoned the distribution system as being too costly. In India, Janata policy, which was introduced by LIC of India on the same lines, was not popular.



4. **Salaried** – Even though most life insurance is sold by commissioned sales people, a small share is sold by agents who are paid by salary. It generally occurs in group insurance. It involves three distinct product lines – retirement, group life, and group health products. The insurer markets through group sales representatives who are salaried employees of the insurer, charged with promoting and possibly servicing the insurer's group business. Group sales representatives usually are also paid incentive bonuses based on achievement of production goals.
5. **Worksite marketing** – Some employers offer their employees individual insurance through payroll deduction, called Worksite marketing. This coverage was designed for employers that were ineligible for group insurance because of their small number of employees.

Most of these agents are **exclusive agents** [also **called** tied or **captive agents**], meaning that they represent a single insurer only.

### Distribution through marketing intermediaries

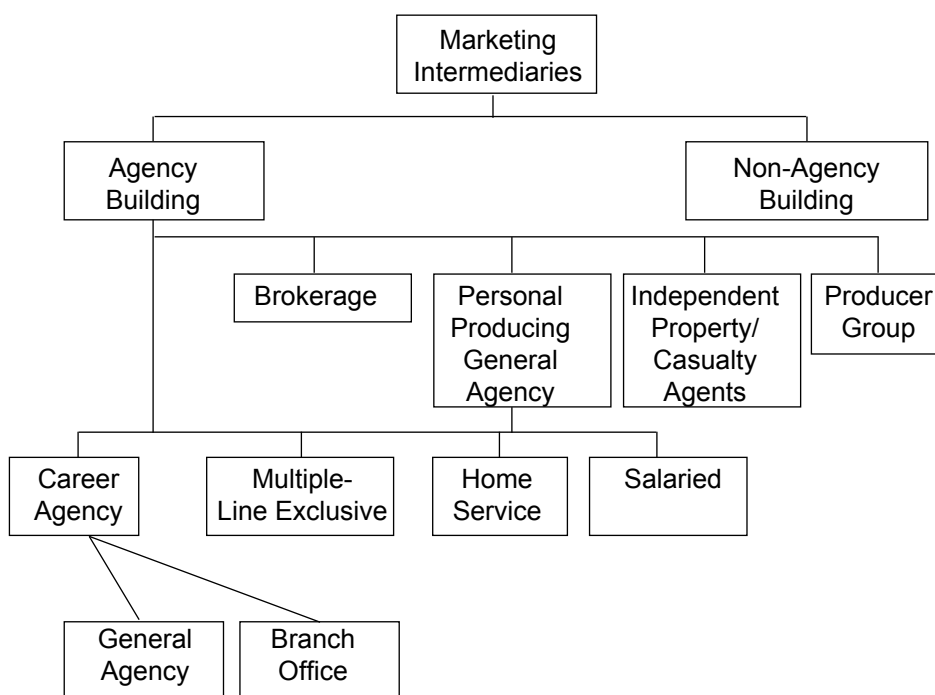


Figure 2 - Life insurer distribution channels: Marketing Intermediaries

## Agency Management

Effective field management is essential to the success of agency-building distribution systems. In terms of activities, an agency head's responsibility consists of

- manpower development, including product and sales skills training
- supervision of agents
- motivation of agents and staff
- business management activities [office duties, public relations activities, interpreting insurer policy, and expense management]
- personal production
- For agent recruiting he has to find sources of prospective agents, determining acceptable qualifications, approaching prospective agents, using selection tools, interviewing candidates, contracting with qualified individuals, replace the turned over agents, raising the standard for new agents and in increasing their productivity, appropriate and effective continuing education program for all agents.

In addition to these basic activities, the agency head also must carry out many normal business management activities including expense management and interpreting company policy.

### Non-Agency – Building Distribution

It is a system in which an insurer sells its products through established agents [with a proven sales record] who are already engaged in selling life insurance. This agent receives higher commissions than the typical agent. He may have contracts with more than one insurer. Such agents typically pay their own expenses.

There are four common non-agency-building distribution channels.

- brokerage
- personal-producing general agents
- independent property and casualty agents
- producer groups

**Brokerage:** The term broker can refer to at least three distribution channels 1. Most career agents broker business - the practice of full time agents of one company, occasionally selling the policies of other insurers. 2. Independent life insurance producers who specialize in particular products. These brokers are former career agents who have become independent producers, meeting their own office and other expenses. 3. A sales person whose primary product is not insurance but who sells insurance as an ancillary service to his customers. This category includes real estate agents, automobile dealers, accountants, lawyers, and financial consultants.

**Personal producing General Agents [PPGA]:** They are independent commissioned agents who typically work alone and focus on personal production. Although personal-producing general agents usually have contracts with more than one insurer, companies



using the traditional approach try to be the PPGA's primary carrier. The basic difference between brokerage and PPGA is the former resembles a career agent contract and the latter has elements of general agent contract.

**Independent property and casualty agents:** They are commissioned agents whose primary business is the sale of property and casualty insurance for several insurers. They take advantage of property insurance customer relationships to sell life insurance.

**Producer groups:** Producer groups are independent marketing organizations that specialize in the high-end market. The group is self-supporting. And the minimum production requirements apply to members. The marketing organization typically provides its own continuing education program, administration, illustration services, presubmission underwriting, and case management [after submission] to the producer. It also provides market-specific or sales-concept support.

**Financial Institutions:** Financial Institutions engaged in the distribution of insurance can be classified into

- Deposit taking institutions – Bancassurance was started in India with the opening of insurance to private sector. Banks, indicate, however, that with the changing regulatory environment they will strengthen marketing efforts related to term life insurance, cash-value life insurance, long-term care insurance, and disability income insurance and annuities.
- Investment banks – Investment banks like ICICI and their retail marketing divisions are important distribution channels for variable and fixed annuities as well as some life and health insurance.
- Other financial institutions - Mutual fund organizations like UTI [Unit Trust of India] also offer insurance through policies like ULIP [Unit Linked Insurance Plan] to investors.

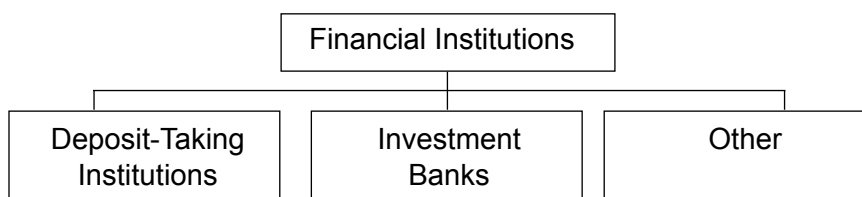


Figure 3 - Life insurer Distribution channels: Financial Institutions

For selling life insurance, traditional methods have been modified and these are some of the examples of new marketing models in life insurance. Financial institutions are gaining market share as more and more institutions develop relationships with life insurance companies and strengthen their own distribution system. Over time, as sectoral barriers continue to fall, more financial institutions will undoubtedly develop or acquire life insurance companies and operate them as subsidiaries.

**Direct Response System:** Under this system life and health insurance are sold directly without the services of an agent. Even workers who are no longer employed can keep their old policies in force by paying premiums directly to the insurance company. Under this, **Direct mail** is the oldest method of direct-response marketing. A **sponsored arrangement** provides mailing lists of similar groups to offer products to its members. **Newspapers, magazines**, and other **print media** reach a large number of consumers on a broad basis. **Broadcasting** and using **television** can reach specialized groups of people. Personalization and mass marketing are combined in **Telemarketing**. **Internet's worldwide web** provides shopping for financial products and services and on-line premium quotations and accept applications for coverage. The process of adopting **automated teller machines** and **electronic sales may need some time for their appearance** in India. Meanwhile, networks will play a significant role as sources for communication and information. The effects will be felt in the other distribution channels through customers being better informed.

### Direct-Response Distribution

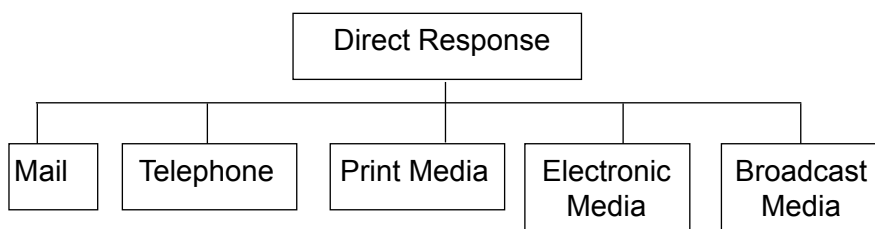


Figure 4 - Life insurer distribution channels: Direct Response

## THE NATIONAL DIMENSION OF DISTRIBUTION SYSTEM

The insurers in India no doubt started exploring the use of alternative channels, yet the army of agents (tied agents) – 11 lakhs (10 lakhs with LIC plus 1 lakh with private players) are calling shots in the market. Alternative channels like banks, brokers and corporate agents are slowly penetrating the market.

The linking of each customer segment to appropriate distribution channel is adopted to reach different segments. The urban upper middle class customer is well informed and has access to modern communication including web and direct approach like telemarketing and internet marketing.

The urban lower middle class customer has market knowledge, but is more concerned with savings and investment, tax hassles and insurance. Bancassurance and Brokers offer them customized insurance products.

Semi-urban customer is normally average earner who can afford little amount of savings and who has little knowledge. They can be reached through agents and bancassurance channels.



The corporate customer is interested in workers compensation, liability insurance, group insurance and health care insurance products. They are largely confined to metros and cities. It requires altogether a different strategy to reach them as they well informed and cost conscious. Typically brokers, corporate agents and direct marketing with customized products would be ideally suitable to mobilize the business.

By and large, the insurance companies are aiming at non-traditional channels and multi – delivery system wherein customer can pick up an insurance product from any supermarket, departmental store, bank, post office, ATM, internet kiosk, hotel, bus station and railway station.

There has been continuous Product innovation with target segment approach and product cannibalization. The distribution system in developed countries has been influenced significantly by cost pressures. Changing demographics are creating a greater demand for asset accumulation products. Competition for consumers' savings is also intensifying, primarily from outside the mainstream of the life industry. The Unit Linked policies are case in point.

## **THE INTERNATIONAL DIMENSIONS OF DISTRIBUTION**

Multi-national insurers continue to be prominent in life insurance Distribution worldwide.

### **Life insurance distribution worldwide:**

In **Canada**, full time **career agents** generate about 60 percent of life insurance premium income.

In **U.K.** the number of career agents has fallen by more than 50 percent. Most insurers have switched to **IFAs** [independent financial advisors – insurance brokers, banks, building societies, lawyers, and accountants] and **direct-response channel**, particularly in personal lines.

In **France** more than 50 percent of life insurance is sold through **bancassurance, post office or the Treasury**.

**Swiss and German** life insurers rely primarily on **exclusive agents** for distribution.

In **Japan** life insurance distribution is dominated by large network of **female exclusive agents**.

**Latin American countries** are mostly dominated by career agents though, in recent years, independent agents, brokers, marketing organizations and international brokers have developed.

**Taiwan** and **Korea** recently have opened their markets to foreign insurers.

**China** and **Indonesia** and many **Eastern European countries** are experiencing strong growth in career agents.

## THE ROLE OF MULTINATIONAL INSURERS

Mergers, acquisitions, joint ventures, strategic alliances, and new entrants are changing the face of the life insurance industry. There is an increasing interest by life insurers from traditional markets in the possibility of expanding operations internationally. With the process of globalization and liberalization, floodgates are opened to private insurers in India both in the life and non-life insurance sector. Most of the private insurers have joint ventures with foreign insurers.

European insurers have invested enormous sums buying into insurance markets worldwide. They have positioned themselves with mergers, acquisitions, and joint ventures. Insurance subsidiaries of banks are among the largest producers of new life insurance premiums in Europe insurers.

Korea, Singapore, and Taiwan insurers are beginning to expand outside their own borders. Entering U.S. market is relatively easy for acquiring a company through a joint venture. But entering U.S. market as a reinsurer is not attractive to many non-U.S. firms because of the virtual absence of a capacity problem for the life and health insurance industry. There is a trend toward demutualization in U.S. In U.S. many small and medium size insurers will not be able to survive the competitive U.S. environment. Only a handful of U.S. insurers are truly multinational. The prime reason that many U.S. insurers are not participating in international markets is that U.S. insurers have long enjoyed a large, expanding domestic market, so that relatively few companies have felt a need to establish a presence abroad. And the tendency of U.S. companies is generally to be overly concerned with short-term results. Recently, several major life insurers of other countries have established operations in Europe and the Far East, but the move of U.S. insurers into world markets is expected to continue to be limited to a relative handful of insurers.

### Compensation in Marketing

- Management Compensation.
- Marketing intermediary compensation in agency building distribution channels and in non-agency building distribution channels.
- Financial institution compensation.
- **Management Compensation:** The agency manager is compensated for services according to the terms and conditions of a written compensation contract. Expense control is often reflected specifically as an aspect of performance measurement for managerial compensation. An adequate amount of production per agent, regardless of agency size, is critical. Sufficient capitalization and sound business judgement and management also are significant factors in agency success.



- **Marketing Intermediary Compensation in Agency Building Distribution:**

**Career agents** contract is devoted to the compensation he or she is to receive. Common practice is to **annualize first-year commission** [total commission is paid at the time the policy is issued], **vesting** [renewals will continue to be paid even if he terminates his connection with the insurer. It is more common with general agency distribution channel].

Many companies pay a **service fee** that continues as long as the agent remains with the company and the policy stays in force. Many insurers also pay **additional commissions or bonuses** based on satisfactory production [e.g., premiums, volume, or number of lives sold]. **Fringe benefits** such as retirement, life, health and disability insurance benefits are provided by many insurers. Insurers commonly **finance income** to fill the gap of income in **straight-commission contracts** [the agent earns nothing until he make sales]. This includes **training allowance plan [TAP] and line of credit plan**. TAP pays earned commission plus an additional percentage of commissions. This type of plan is production driven. The higher the agent's production, the more training allowance he or she receives or to maintain a stable income with fixed TAP, commissions must increase as training allowance decreases. In line of credit plan an account is established for the agent, which is credited with commissions and fixed or variable training allowances. If the agent has a debit balance in the account at the end of the program, some companies require the agent to repay it, usually by withholding commissions. A few companies have **salary plans**.

Compensation arrangements, including financing plans, for **Multiple-Line Exclusive Agents [MLEAs]** do not differ greatly from those career agents, although commission rates for MLEAs are sometimes lower than those of career agents. Additionally, **vesting usually is nonexistent or less generous**.

Compensation for **home service agents** basically tracks that for career agents, unless the agent collects premiums for the insurer. In these instances, the agent receives a percentage of the amounts collected as a **servicing fee**. These fees usually are greater than renewal commissions and can represent a substantial proportion of the home service agent's total compensation.

**Salaried** Group representatives are compensated by salary and most are eligible for bonuses based on performance. Commission rates paid to these agents are considerably lower than commission rates for individual insurance. In group insurance, brokers and consultants are legally agents of the buyer and owe their allegiance to the buyer rather than to the insurer through which they place their clients' coverages. For large cases, it is common for the compensation to be a **negotiated amount**.

## **Marketing Intermediary Compensation in Non-Agency Building Distribution Channels**

**For brokers**, compensation often resembles that provided to career agents. This treatment even can include a full range of benefits. But they do not have annualized commissions because it is sometimes difficult to retrieve unearned commissions if contracts lapse. Most agents receive no service fee allowance on brokered business.

**For personal-producing general agents**, first year overrides and expense allowances equal to an additional 30 to 40 percent may be paid. Companies also pay overrides on renewal commissions. In addition to these commissions, general agents and brokers may be eligible for production bonuses and be invited to sales conferences.

**Independent property and casualty agents** normally are provided the opportunity to qualify for sales contests, trips, awards, and other special prizes. They may also be provided production bonuses, fully vested renewal commissions, service fees payable after expiration of renewal commissions, and commission overrides if the agency possesses a general agent contract. A significant difference between the contracts offered to independent agents and those offered to MLEAs pertains to agent financing plans, which are not made available to independent agents. A major reason for this is that property and casualty agents usually begin their careers with a book of business.

## **Financial Institution Compensation**

Commissions are the primary method insurers use to compensate financial institutions for insurance sales. Other methods include lease fees, service fees, expense reimbursement, and percentage of commissions. Producers are most often compensated on a salary-plus-incentive basis for selling life and health products. For annuity sales, they are compensated either by commissions with a draw or on a salary-plus-incentive basis. Some commercial banks rely on commissions exclusively, with a few relying exclusively on salary.

## **THE FUTURE OF LIFE INSURANCE MARKETING**

---

There have been major revolutions in life insurance marketing, most notably with the introduction of soliciting agents in the 1840's, the rise of the debit agent in the 1880's, the advent of group insurance in the 1930's and the growth of non-exclusive producer companies since the end of world war II. Radical change therefore is not unknown in life insurance marketing. The view of future marketing of insurance is outlined here.

- Increased competition from non-insurance organizations - may alter the marketing orientation.
- A non-agency building strategy may rise enormously.



- Insurers may aim at reducing the more visible agent commission. Increased sophistication of both consumers and insurers may produce a closer alignment of agent compensation with the value of services delivered. Some of the non-traditional approaches to agent and manager compensation are level commissions, assets under management [agents and managers are paid to align their goals with those, salary plus bonus, partnering [percentage of profits].
- A more informed and demanding consumer, competition for consumers' savings from outside the mainstream of life industry may heighten price sensitivity and cost transparency.
- Insurance business becomes a global business with entry of foreign insurers and they may modify their distribution methods.
- Demographic shifts like increase in the age of workforce, increase in the participation of women in the workforce, increase in the participation of minorities and immigrants in the work force may change the recruitment of producers and their operation.
- With increase in life expectancy, the focus of life insurance business is turning more to living benefits like annuities than death benefits. As these products have lower margins they may not be able to support the cost of existing distribution systems.
- Corporations will continue to be active in assisting employees in achieving a measure of financial security at the employees' expense.
- Governments' will reduce taking responsibility for individual economic security. Hence individuals become more concerned about providing independently for their personal financial security.
- In the difficult financial environment, companies may try to reduce the cost of their distribution system or look for other lower cost methods of distribution with planning and direction. This may lead to pluralism in distribution system [using different channels]

In addition to the introduction and effective management of newer distribution channels, alignment will be the most important force shaping future trends in compensation and distribution.

## Questions



1. Discuss the strengths and weaknesses of three major distribution channels in life and health insurance. What competitive advantages might each of these distributions possess in the marketing of specific life and health products?
2. What is the role of multinational insurers in Indian life insurance market?
3. Describe the various compensation practices used for management and intermediaries involved in the marketing of life insurance.
4. How do different compensation practices seek a balance between the interests of both the owners and employees of a life insurer?
5. Discuss the future of life insurance marketing in India.

# Insurance

## CHAPTER – 10

### CLAIM SETTLEMENT

#### OUTLINE OF THE CHAPTER

- Concept of Claim
- Meaning of Claim
- Claims Dept.
- Nature of Claims and Requirements in the settlement of claims
- Claims Management Systems and Organizational structure
- Claim Settlement
  - Role of Central Govt.
  - Role of Ombudsman
  - Role of IRDA
  - Role of Consumer Protection Act
- Future Outlook
- Questions

#### LEARNING OBJECTIVES

- After studying this chapter we should know the concept of claim, meaning of claim and types of claims.
- The role of Central Govt. Ombudsman, IRDA, Consumer Protection Act and Information Technology in settling the disputed claims.
- Discussing the future scenario of claim settlement.

#### 1. CONCEPT OF CLAIMS

Concept of claim with reference to the insurance contract differs from the angle of the parties to the contract. The insurer is under an obligation or responsibility to perform the contract as per the terms of promise made. The insured is in an advantageous position once the premium as demanded by the insurer is paid. The payment of insurance premium and acceptance of the contract by the insurer creates contractual obligation upon the parties to perform some of the duties before or after the claim is made or on happening of event or the loss is suffered by one of the parties to the contract.

## 2. MEANING OF CLAIM

Claim is a right of the insured to receive the amount secured under the policy of insurance contract. It is the consideration of the insurance contract. It is a promise made by the insurer to pay the compensation to the insured on happening of some uncertain event resulting in loss or damage to asset insured. It is the pecuniary interest in the insurance contract. It is the insurance amount that is incorporated in the policy document of insurance contract. The claim is a right of the insured in all classes of the insurance contract. The payment of consideration is linked to the insurable interest of the insured. The insurable interest of the insured or the beneficiary under the insurance contract makes the insurance contract a valid contract. The claim payment and compensation payable as indemnity to the insured are related and are synonyms in the claims management of the insurance policy. The payment of premium is one set of promise whereas promise to pay for the loss suffered by the insured is the second set of promise and form reciprocal promises and considerations for one another.

Claims are to be paid either to the insured or the nominees of the insured by the insurer under the agreement or the terms of the contract of insurance. The important terms of the insurance contract and payment of the insurance claims are the payment of insurance claim either on happening of event or on the date of maturity.

## 3. CLAIMS DEPARTMENT

The claims department is one of the key departments in an insurance company. The claims department has the following functions to perform.

- To provide customers of insurance and reinsurance companies with a high quality of service, so that the company is able to differentiate from the rest of the companies. This can also be viewed as a unique selling proposition of a company. This role of the claims department gives a long-term edge to the company and hence is referred to as the *strategic role*.
- It is the claims department that monitors the claims and sees that whether the benefits of insurance exceed the costs of claims. This role is referred to as the *cost-monitoring role* of the claims department.
- The claims department has to see that the expectations of the customers are met with regard to the speed, manner and efficiency of the service. This is called the customer *service role* of the claims department.
- It is the responsibility of the claims department to meet the standard of service, to keep up to the customers' expectations and still operate within the budget. This is the *managerial role* of the claims department.

Both the quality of service and cost of claims is the responsibility of the claims department. The department has to look after the proper mix of the two. The cost of claims must not exceed a given level in trying to render a very good service to the customer. So the claims



department should work with due diligence to balance the two parameters. The department must be able to find out the difference between fake and genuine claims. In trying to create a good public image, the cost of claims should not be overshoot. The importance of cost of claims in the insurance industry cannot be undermined. At any point of time the cost of claims should not exceed the available resources to pay the liabilities. If such a situation arises then the insurance company is technically insolvent. So estimation of future liabilities is just as important as control over the claim payments. As the claims department is in direct touch with the customer, the quality of service has to be ensured by the department.

The management of claims is a very daunting task for an insurance company. The claims department has the sole responsibility of managing claims. Claims management by far is the most complex issue in an insurance company. It involves a variety of specialized tasks, which only specialized people can perform. Various disciplines it involve are marketing and sales, study of human behavior, finance, control systems and business strategy making. The management of so many disciplines into a single department makes the job of persons more difficult. The presence of so many specialized people in a single department will obviously lead to formation of groups. A healthy relationship within the groups is required. The people in the claims department should have good interpersonal skills. If the employees in the claims department are not able to work in harmony customers will not get the kind of quality in service. So it is important from the departments' point of view to have sufficient number of people as managers so as to simplify job and proper human resource systems in place so those persons are recruited whose philosophy goes with the mission and vision of the organization. It has become imperative for the claims department to provide quality service to the customers so that the corporate goals are achieved. The claims department in effect acts as an interface between the customer service quality and insurance company's objectives. It has to be given proper weightage and motivation so that the business as a whole functions well.

#### **4. NATURE OF CLAIMS AND REQUIREMENTS IN THE SETTLEMENT OF CLAIMS**

The procedure for handling of claims varies according to the types of cover, the amount of claim whether it is a personal or commercial claim. Claims process is the procedure of handling claims and differs from case to case.

Basically, the following are the different types of claims which come up before an Insurance Company.

1. Maturity Claims and Survival Benefits
2. Death Claims
3. Accident and Disability Claims and
4. Annuity Payments

Settlement of claims under life insurance policies depend upon the nature of a claim, eligibility to policy moneys, proof of the happening of the event insured against, proof of title, etc.

## **Maturity Claims**

Payment of Maturity Claims is by far the easiest to manage. These include benefits payable during the period of assurance called '*Survival Benefits*' under certain types of policies popularly known as 'Money Back' policies. Payment in these cases is easy because (a) there is no need on the part of the policyholder to prove the happening of the event (b) the policyholder is alive so Proof of Title does not pose any problem, and (c) the Insurance company need not await any claim from the policyholder and take initiative to settle the claims expeditiously.

At the beginning of every calendar year, the Data Processing Department (now called I T Department) of a Branch Office generates on the computer a list of policies under which maturity and survival benefit payments will fall due during the next financial year. This list is prepared due month wise in strict policy number order. Of late, due to the introduction of software package for claims, this list also provides information regarding the premium status of each policy and also the actual claim amount payable including Vested Bonus, Interim Bonus and Terminal Bonus. These lists are again of two types – one in respect of Maturities where the contracts are to be terminated and the other in respect of survival benefits under 'Money Back' type of policies which continue to be on the books even after the payment of the benefits.

The reasons for initiating action in advance in this area of operations are several. The speed of settlement of claims is very important in building up the image of the insurance company. Maturity and Survival Benefit payments are due on particular dates and the aim is to ensure that the moneys due are received by the respective policyholders on those due dates. If they receive such payments on the very dates they are due, the Insurance Company would have fulfilled its obligations. The policyholders would feel very happy and satisfied at the service rendered. It is also a great boost to the field force because they can approach the respective policyholders for converting a part or whole of the claim amount into premium for another policy and/or to canvass a new life insurance policy for one of the family members or close friends of the policyholder. From accounting point of view also, it is a good and prudent practice because the claim amounts, which are liabilities for the company, are cleared expeditiously.

One more reason for initiating action early is the presence of a large number of policies in the list of maturities which have lapsed after acquiring paid-up value. The time lag between the dates of lapse of these policies and their respective dates of maturity is always considerable. In many such cases, it is not unusual that the policyholders might have changed residence, information about which will not be available with the insurance office. Hence, by initiating action at least three months earlier to the maturity



dates, the insurance company will have sufficient time to locate the policyholders and arrange payment of the moneys due to them.

The requirements for settlement of these claims are very simple. They are:

1. A Discharge Voucher to be sent in advance
2. Policy Document
3. Any Deed of Assignment, if the same was executed on a separate Stamp Paper.

As the policyholder is alive, obtaining these requirements poses very little problem. A few problems are likely to arise when a Policy Document is misplaced. Usually, in such cases, the Corporation settles maturity claims on the basis of an Indemnity Bond to be executed on a Non-Judicial Stamp Paper of the value of Rs. 100 by the policyholder along with a surety of sound financial standing. While settling survival benefits, however, the corporation insists on issue of a duplicate policy because the contract continues even after the payment of the survival benefit.

## Death Claims

Life insurance is basically for providing financial security to the families of deceased policyholders. Death claim settlement naturally assumes very great importance in the total operations of any Life Insurance Company. Despite several problems encountered, still Life Insurance Companies struggle to efficiently and effectively attend to this function. Unlike in Maturity and Survival Benefit Claims, the Policyholder is not alive. This itself poses many problems. Broadly the problems in settlement of Death claims are

1. Obtaining satisfactory Proof of Death, and
2. Obtaining satisfactory Proof of Title

These two requirements are independent of each other. It is necessary for an insurance company to decide first whether any liability lies in a death claim. This not only depends on the proof of the happening of the event, i.e. death but also the status of the policy as on the date of death. It is necessary to verify whether the policy in question is in force or in a reduced paid-up condition. In these cases, some money becomes payable. But there may be cases where the policy had lapsed without acquiring any value. It is also necessary for the office to verify whether any claims concessions or administrative concessions (already mentioned earlier) are applicable or whether the claim can be considered on ex-gratia basis. Cause of death also assumes importance. If it was suicide, it is to be considered whether it was within one year from the date of the policy. If it was accident, it is to be verified whether Accident Benefit becomes payable. Once liability is admitted, the office will have to verify the position of title to the policy moneys and arrange payment to the persons legally entitled to receive the same. Let us discuss these issues in greater detail.

The Life Insurance company is not expected to know about the death of a policyholder unless the same is intimated by the claimants. Any action can therefore be initiated only after receipt of such intimation. The letter of intimation should contain certain particulars:

- Policy number and name of the life assured. These two should match; otherwise the policy number must be wrong.
- Date of death, on which depends the status of the policy and amount payable.
- Name and address of the claimant as requirements are to be called from them. Usually, the death intimation should be sent by the nominee or assignee or some one near and dear to the deceased life assured. If the intimation is received from a stranger, the office should be careful to verify as to why a stranger should be interested in the policy moneys.

Once a proper intimation is received, the insurance office will process the same to know whether anything is due at all under the policy. This usually depends on the status of the policy on the date of death. A calculation of the claim amount will be made and requirements are called for from the claimant. If there is a valid nomination or assignment under the policy, duly registered in the books of the insurance company, requirements will be called for from such nominee or assignee only and not from the claimant.

In considering a death claim, it becomes necessary to verify the duration of the policy, i.e. the time elapsed from the date of commencement of risk under the policy (or date of revival of a lapsed policy) to the date of death. Normally, if the duration is two years or less, such a claim is considered as an 'Early Claim'. If the duration is more than two years, such a claim is considered as a 'Non-Early Claim'. This becomes necessary because of application of Section 45 of the Insurance Act, 1938, which is otherwise called 'Indisputability Clause'. This provision of law is of great significance and it was incorporated in the Insurance Act as a protection to policyholders and their claimants. The clause reads as under:

"No policy of life insurance, after the expiry of two years from the date on which it was effected, be called in question by an insurer on the ground that a statement made in the proposal for insurance or in any report of a medical officer, or referee, or friend of the insured, or in any other document leading to the issue of the policy, was inaccurate or false, unless the insurer shows that such statement was on a material matter or suppressed facts which it was material to disclose and that it was fraudulently made by the policyholder and the policyholder knew at the time of making it that the statement was false or that it suppressed facts which it was material to disclose."

The importance of the principle of Utmost Faith has already been discussed in the chapter on 'Legal Framework'. It is, therefore, redundant to discuss the same again



here. To ensure that the insurance companies do not go to unreasonable levels and repudiate liability under a policy invoking the principle of utmost good faith, the Insurance Act provides protection to the policyholders and the claimants under Section 45. To avoid liability under a policy of life insurance two years after the policy was effected (i.e. date of commencement of risk), the life insurance company will have to prove

1. that there was suppression of facts by the life assured,
2. that what was suppressed was a material fact, and
3. that such suppression was done intentionally with a view to defraud the insurance company.

The onus of proof of all the above lies on the insurance company only. The above also is an indication that when the death of a policyholder is within two years after the policy was effected, the company can avoid the liability after proving suppression of material facts by the life assured at the time of taking the policy. It is not necessary to prove whether such suppression was intentional or unintentional in such cases.

The said provision in the Insurance Act refers to the period elapsed from the date on which the policy is effected. But a typical and different situation arises when a policy lapses due to non-payment of premiums and subsequently revived. The question arises whether the duration of the policy should be reckoned in such cases from the date on which the policy was effected or from the date on which it was revived. The legal provision, i.e. Section 45 indicates the former but is silent on the latter. The Life Insurance Corporation of India treats revival of a lapsed policy as a Novatio, i.e. a New contract and so applies the provisions of Section 45 of Insurance Act to a case where death of the policyholder takes place within two years from the date of revival of the policy. In one case, the Supreme Court set aside the repudiation of liability made by the LIC of India on the grounds of suppression of material facts by the life assured at the time of revival of his lapsed policy as not coming under Section 45. The point is debatable. If the Section does not apply to cases of revival of lapsed policies, then there is always a possibility of policyholders taking policies on their lives, immediately lapsing the same and get them revived just when they are on death bed by suppressing facts about their health. If the Life Insurance companies have to assume liability and cannot dispute the same, it will be against public policy.

The duty of disclosure of material facts by the applicant is not limited only to the statements made by him in the Proposal Form. It continues till the date of acceptance of the Proposal by the Insurance Company. The following extract from the declaration made by the proposer at the bottom of the proposal is significant:

“And I hereby declare that if after the date of submission of the proposal but before the issue of the First Premium Receipt (1) any change in my occupation or any adverse circumstances connected with my financial position or the general health of myself or that of any members of my family occurs or (2) if a proposal for assurance or an application for revival of a policy on my life made to any office of the Corporation has been withdrawn or dropped, deferred or accepted at an increased premium or subject to a lien or on terms other than as proposed, I shall forthwith intimate the same to the Corporation in writing to reconsider the terms of acceptance of assurance. Any omission on my part to do so shall render this assurance invalid and all moneys which shall have been paid in respect thereof shall stand forfeited to the Corporation”.

This condition is also called ‘Continued Insurability’ condition.

It, therefore, becomes necessary for the insurance company, when they receive an intimation of death of a life assured, to verify the duration of the policy, i.e. from the date of commencement of risk or date of revival of the policy to the date of death. If the cause of death is such that it can be only a long duration disease, it leads to the suspicion of suppression of material facts about the health of the life assured in cases where the duration as mentioned is two years or less. For this reason, the requirements to be called for in cases of Early Claims are to some extent different from those needed for considering Non-Early Claims. The Life Insurance Corporation of India calls for the following requirements in cases of death claims:

1. Death Certificate in original issued by Municipality/ Corporation/ Revenue Officials in the form Prescribed by the Government.
2. Claimant’s Statement: here the claimant furnishes information (a) about the deceased life assured, his/her age, date of death, cause of death, place of death, if hospitalized during a period of three years earlier to death, details of the same; (b) details of the claimant – name, address, how related to the life assured, in what capacity claim is being made and (c) details of any other policy/policies of the life assured so that all claims can be considered together.
3. Statements from the hospital/nursing home where the life assured had treatment for terminal illness in which the hospital/nursing home authorities furnish information about the life assured, his/her address, date of admission, date of discharge/date of death, time of death, reasons for admission, primary cause of death, secondary causes, duration of illness, whether treated in the same hospital/nursing home at any time earlier for any ailment, if so details; whether treated by any other doctor earlier, if so details, etc.
4. Statement from the Doctor who attended to the diseased life assured last; the identification of the life assured, how long the doctor treated him, for what ailments, whether the doctor is the usual medical attendant of the life assured and, if so, for what ailments he treated him etc.



5. Statement by a gentleman who is not related to the deceased life assured and who is not interested in the policy moneys, who has attended the Burial/Cremation of the deceased life assured – particulars of the life assured, how long had he known him, any relationship, when did he see him last alive, date, time and place of death, cause of death, whether the body was cremated or buried, date, time and place of cremation/burial etc.
6. If the deceased life assured was an employee of any organization, a statement from the Employer furnishing details of the life assured, date of joining service, designation, date last attended duty, date of death, details of any leave availed on grounds of sickness (for periods of a week or more at a time) during the period of three years earlier to the date of commencement of risk up to date of death, medical benefit facilities, if any, availed by the deceased life assured – copies of leave letters, medical certificates submitted for sanction of sick leave, copies of medical prescriptions and bills produced for settlement of medical benefits, etc.
7. In case of death due to unnatural causes like accidents, suicide, etc. the following records are called for:
  - First Information Report of the Police
  - Panchanama Report/Police Inquest Report
  - Postmortem Report
  - Chemical Analysis/Forensic Report in cases where postmortem is not conclusive about the cause of death
  - In very rare cases, Police Final Investigation Report

Specimens of some of the reports obtained by LIC of India are enclosed as annexures. In Early Claim cases, Reports Nos. 2 to 6 mentioned above are called for. In addition, an Investigation Report by one of the officials of the Corporation into the genuineness of the claim is also called for. Where death is due to unnatural reason, reports as mentioned at No.7 are called for. Where a claim to consider Double Accident Benefit is received also the reports mentioned at No.7 are called for.

For considering Non-Early claims, some of the above may not be necessary.

A few cases arise where it may not be possible for the claimants to obtain and submit Original Death Certificate issued by the concerned authorities. In such cases alternative proofs also are considered. Here are a few examples:

- Death in an Air crash – where there are no survivors, the list of passengers as per the records of the Airlines Company can be accepted as an alternate proof of death.
- Disappearance on board a ship – the logbook maintained showing the list of passengers on board the Ship when it sailed off a particular port and similar list after

it reached the next port – if the name of the passenger (who was the life assured under the policy) appeared in the former register but not in the latter, it should be presumed that he fell into the sea and drowned as there can be no other way of explaining the disappearance.

- **Presumption of Death** – As per Section 108 of the Indian Evidence Act, 1872, if a person has not been heard of for seven years by those who would naturally have heard of him had he been alive, there is presumption of law that he is dead. Here also what is presumed is death of the life assured but not the date of death. Hence the date of the order of the court declaring presumption of death is taken as date of death.

On receipt of the requirements, the Insurance office decides whether there is any liability or not. In cases where the office could obtain documentary evidence of suppression of material facts by the deceased life assured at the time of taking the policy or at the time of revival of the lapsed policy, the liability is repudiated. Where the liability is admitted, the office proceeds to the next step viz., verifying the title to the policy moneys.

## **Evidence of Title**

There are different kinds of evidence of Title to Policy moneys. The simplest of these are Nomination and Assignment effected as per Sections 39 and 38 respectively of the Insurance Act, 1938.

### **Nomination**

Nomination under Section 39 is naming of a person or persons to give a valid discharge to the insurance company and receive policy moneys in case of death of life assured during the period of the policy. Nominee can only receive the moneys. In case of survival of the life assured till the date of maturity, nomination will be ineffective.

Nomination can be done by making suitable entries in the proposal to the policy in which case it will be incorporated in the text of the policy. Otherwise, it can be done by an endorsement made on the back of the policy by the life assured. But this will be effectual only if it is communicated to the Insurance Company and got registered in their records.

Nomination can be done only by a Policyholder under a Policy on his own life and not otherwise. For example, when a policy is assigned to a third party, the latter cannot nominate because the policy is not on his life. Similarly, if a parent obtains a policy on the life of a child, the child cannot nominate any one till he attains age of majority because during minority he is not the owner of the policy though the policy is on his own life. After attaining majority, the child can nominate.

Nomination can be done in favour of one or more persons. But those nominees who are alive on the date of death of the life assured only will receive the policy moneys. For this reason, while nominating more than one person, the life assured should not indicate shares of the policy moneys for individual nominees.



Nomination can be in favour of a minor, in which case, the life assured can appoint an appointee to receive policy moneys on behalf of the minor nominee in case of the death of the life assured during the minority of the nominee and before date of maturity.

During the lifetime of the life assured, he/she can deal with the policy in whatever way he/she may desire and the consent of nominee is not necessary.

Nomination once made can be changed by the life assured at his will (i.e. without any consent from the nominee) at any time but before the policy matures for payment.

Nomination once made is automatically cancelled by (1) cancellation/further change of nomination (2) assignment in favour of a third party—in case assignment is done in favor of the insurance company for a loan out of surrender value of the policy, then nomination will not get cancelled (3) a Will.

Nomination should be normally in favour of some one near and dear. If a stranger is named as a nominee, there may be a suspicion of absence of insurable interest.

In a Joint Life Policy, normally there is no need for nomination because, in case of death of one life, policy moneys become payable to the surviving life. However there can be a joint nomination providing for a particular contingency, viz the simultaneous death of both lives in a common calamity. Even in such cases, there can be a presumption of law, for example Section 21 of Hindu Succession Act, 1956 reads as follows:

“Where two persons have died in circumstances rendering it uncertain whether either of them, and if so which, survived the other, then, for all purposes affecting succession to the property, it shall be presumed, until the contrary is proved, that the younger survived the older.”

Even where there are rival claimants, the Supreme Court ordered in a case that the Life Insurance Corporation should pay the policy moneys to the Nominee under Section 39 of the Insurance Act, provided the nomination is effective and there is no injunction order from any court of law.

Nomination is an instrument, the insurance law created, to secure an immediate payment of the policy moneys by the insurer, without prejudice to the decision on the question as to who are entitled to succeed the estate of the deceased life assured. Proceeds of the policy do not vest in the nominee though they are payable to the nominee in the event of the death of the holder of the policy. They do not, by virtue of nomination under Section 39 alone, become a part of nominee's estate before or after the policy matures.

## Assignment

Assignment of a policy of life insurance, under Section 38 of Insurance Act, 1938, is a transfer of the property contained in the policy by the assignor to the assignee.

Unlike a nominee under Section 39, Assignee under Section 38 has all rights under the policy not only to receive the policy moneys when they are due but also to deal with the policy in any way he desires without the consent of the assignor.

A policy of life insurance is a property. Hence, like any other property, it's owner can deal with it in any way he/she likes. But transfer of a policy of life insurance is covered by Section 38 of Insurance Act, 1938 but not the Transfer of Property Act. Where the Insurance Act is silent about any particular feature of transfer of a policy, the provisions of Transfer of Property Act, 1882 are applicable.

To assign a policy, the assignor should be the holder i.e. owner of the policy. It means that the policy need not be on his life. It also means that a person who is an assignee under a policy of life insurance can further assign it to any other person, for which act he need not obtain the consent or concurrence of the original assignor. However, the assignor should not be a minor. A child cannot, during his minority, therefore, assign a policy on his life to another.

Assignee can be anybody including a minor. In case of death of the assignee, the property will devolve upon his/her legal successors. There can be more than one assignee. In case of the death of any one or more assignees, the policy moneys will have to be paid to the legal heirs of the deceased assignee/assignees.

Assignment is transfer of property. So it cannot be effected till a policy is issued. It can be effected by an endorsement on the back of the policy or on a separate stamped deed. It is effective the moment it is done in one of the above methods and duly signed by the assignor and witnessed. But as against the insurer, it will be effective only if it is got registered by the insurer in their records. But, where there are more than one assignment, the priority of settlement of claims by the insurer depends on the date of receipt of notice of assignment along with the policy document carrying the endorsement or the stamp deed by the insurer. Notice of assignment can be given either by the assignor or the assignee or any one authorized by them.

Sub-section (1) of Section 38 of Insurance Act, 1938 mentions that an assignment can be made 'whether with or without consideration'. But all assignments without consideration are not valid. Assignment for natural love and affection between parties standing in the near relation to each other is valid. But in any other case absence of consideration may render the assignment invalid.

Both absolute and conditional assignments are recognized under the Act. An absolute assignment transfers to the assignee all right, title and interest of the assignor in the policy to the assignee. The policy vests in the assignee absolutely and forms part of his/her death. A conditional assignment also creates an immediate vested interest in the assignee but such interest is liable to be divested on the happening of the contingencies set out in the assignment.



A gift cannot be made by a Mohammedan subject to a condition. However, a conditional assignment of a life insurance policy by a Mohammedan would nevertheless be valid under the Act.

As already stated, the insurer's task is very easy in settling a death claim under a life insurance policy, if there is a subsisting, effective nomination or assignment. The only problem, in respect of a nomination, is when the nominee is a minor at the time of the death of the life insured and there is no appointee appointed under Section 39 or the appointee is incapable to act. In such cases, the insurer can settle the claim only in favor of the legal heirs to the estate of the deceased life insured.

## **MARRIED WOMEN'S PROPERTY ACT**

It is also possible that the policy was taken under Married Women's Property Act, 1874. In such a case, there will be neither nomination nor assignment. Section 6 of the said Act states as under:

"A policy of insurance effected by any married man on his own life, and expressed on the face of it to be for the benefit of his wife, or his wife and children, or any of them shall ensure and be deemed to be a trust for the benefit of his wife and children, or any of them according to the interest so expressed, and shall not, so long as any object of the trust remains, be subject to the control of the husband, or to his creditors, or form part of his estate."

The object of the above provision of law is to enable a married man to provide for his wife and children and to create a trust in their favour. The term 'married man' includes a widower or a divorced man. Similarly the word 'children' means issues in the first generation, that is sons and daughters and will not include grand children. But it includes 'adopted children' in case of any one whose personal law permits adoption.

The beneficiaries may be given equal or specified unequal shares. In the event of beneficiary who has a specified share of interest, such share would go to his or her legal representatives in case of the death of the beneficiary. It is also possible to provide that the benefit under the policy shall go to the beneficiaries jointly or the survivors or survivor of them.

A trust may also be created in favour of wife and children as a class. In such a case, the benefit would go to the person who at the death of the life assured shall become the widow of the assured and those of the children by any marriage and whenever born, who shall survive him. However, this facility of beneficiaries as a class is not applicable in respect of Mohammedans because as per their personal law, a gift to a person not yet in existence is void. Hence a Mohammedan can create a trust under the provisions of MWP ACT only in favor of wife and/or children who must be named and who must be existing at the date of the policy.

The procedure to create a trust under the said act is very simple. The policyholder should, at the time of proposing for insurance, indicate that he wishes to take the policy

under Section 6 of the MWP Act. He should not however nominate any one under Section 39 of Insurance Act. He will have to complete an Addendum to the proposal. The form of addendum depends upon two factors, viz. the type of beneficiaries – named or as a class and the nature of trustees – individuals or corporate bodies like Banks. There can be one or more trustees but they must be capable of contracting as per the provisions of the Indian Contract Act. Their consent, however, is essential to act as Trustees. They should signify their assent by subscribing their signatures in the Addendum to the proposal for life insurance. The life assured can give other specific powers to the trustees to raise any loan on the policy for the benefit of the beneficiaries or reserve to himself powers to appoint new trustees in case the appointed trustees become incapable to act or die. Once it is decided to accept the proposal, the insurance company issues the policy document showing on its face that it is taken under 'MWP ACT'.

Where, therefore, the policy is under the said Act, in case of payment of policy moneys, either on the death of the life assured or on maturity of the policy, the insurance company will have to make the payment to the Trustees appointed. If no trustees are appointed by the life assured then payment is made to the Official Trustee of the State. Thus a valid discharge for payment of the policy moneys is obtained by the insurance company from the Appointed Trustees or in their absence the Official Trustee of the State. It is for the Trustee/s later on to pass on the benefits to the beneficiaries according to the terms of the Trust.

In the absence of a valid nomination or assignment or a Trust under the MWP Act, the title to the policy moneys will have to be proved to the satisfaction of the insurance company in one of the following ways:

A Probate of the Will if the life assured died testate

1. Letters of administration
2. If the life assured died intestate, a Succession Certificate from a competent court of law specifically mentioning the policy of life insurance and the amount payable thereunder.

A will is the disposition of one's property to take effect after his death. As per Indian Succession Act, 1925:

- 'Will' means the legal declaration of the intention of the testator with respect to his property which he desires to be carried into effect after death.
- 'Probate' means the copy of a will certified under the seal of a court of competent jurisdiction with a grant of administration to the estate of the testator.
- 'Executor' means a person to whom the execution of the last will of a deceased person is, by the testator's appointment confided.
- 'Administrator' means a person appointed by competent authority to administer the estate of a deceased person when there is no Executor.



'Probate' is granted only to an Executor appointed by the Will. The Life Insurance Company will have to act as per the Probate while settling death claims.

Where (a) the deceased has made a Will, but has not appointed an Executor, or (b) the deceased has appointed an Executor who is legally incapable or refuses to act, or who has died before the testator or before he has proved the Will, or (c) the Executor dies after having proved the Will, but before he has administered all the estate of the deceased, a Universal or a Residuary Legatee may be admitted to prove the Will, and Letters of Administration with the Will annexed may be granted to him of the whole estate, or of so much thereof as may be unadministered.

A Residuary Legatee is the one who is designated by the testator to take the surplus or residue of the property after distribution of the other bequests.

The Executor or Administrator, as the case may be, of a deceased person is his legal representative for all purposes and all the property of the deceased person vests in him. A life insurance company should, therefore, make payment of the policy moneys on the death of the life assured to the Executor or Administrator.

A Succession Certificate may be applied for under Section 372 of the Indian Succession Act in respect of any debt or debts due to the deceased or in respect of portions thereof, of the securities to which he is entitled. A policy of life insurance, especially where the policy is for a definite sum, comes within the definition of 'debt' and a Succession Certificate can be granted with respect to it.

Succession Certificate is not granted in those cases where Probate or Letters of Administration are necessary under the Indian Succession Act.

Where a Succession Certificate is granted, it is conclusive as against the persons owing such debts specified therein. It shall afford full indemnity to all such persons as regard all payments made in good faith in respect to such debts to the person to whom the certificate was granted. (Section 381).

In view of the above, the insurance company will pay the policy moneys to the person holding a Succession Certificate.

The Hindu Succession Act, 1955 provides for the devolution of the property of a Hindu (which includes a Buddhist, Jain or Sikh).

The Class I legal heirs of a male Hindu dying intestate are son, daughter, widow, mother, children and widow of each predeceased son, children of each predeceased daughter, children and widow of each predeceased son of each predeceased son. Similarly the Act defines the Class II, III and IV legal heirs. The heritable property devolves firstly upon the first category and if there is no Class I legal heir then upon the second category and so on.

The property of a female Hindu dying intestate shall devolve upon sons and daughters (including children of any predeceased son or daughter) and the husband (Class I heirs) and failing them upon other classes (Class II, III and IV legal heirs).

The Act also contains rules for distribution among the members of the class entitled to succeed to the estate.

The Mohammedans are governed by their Personal Laws, for example, the first class legal heirs of a Male Muslim are Widow, Sons and daughters, Father and Mother. If he has no sons then, Widow, Daughters, Father and Mother, Brothers and Sisters.

A situation may arise when in respect of a policyholder, there is neither Nominee (or nominee is a minor and there is no Appointee) nor Assignee; neither he left a Will. In such cases, it will be possible for the insurance company to settle a death claim on the basis of a Succession Certificate obtained from a Court of Law. But this will be a long drawn process. The very purpose of life insurance is not served if there is delay in providing the much needed financial assistance to the bereaved family of the life insured. Hence LIC of India has evolved a process by which strict legal proof of title is waived under certain circumstances.

There should be a request from the legal heirs of the deceased life assured to waive production of strict proof of title. In such a case, all the legal heirs have to submit an affidavit declaring their names, relationship to the deceased life assured, etc. On receipt of such affidavit, the office will consider waiver sought for subject to the following conditions:

- the life assured should have died intestate, i.e. should not have left a Will,
- there should not be any dispute among the legal heirs,
- there should not be any other property of the deceased life assured for which the legal heirs have to approach a court for a Succession Certificate.

Subject to the above, the office will decide to waive proof of title. They will settle the claim in favor of the legal heirs (Class I, Class II or Class III) on the basis of an Indemnity Bond duly executed by all the legal heirs along with a Surety of sound financial status.

Irrespective of whether there is a valid proof of title or it is waived, a valid discharge has to be obtained by the insurance company before the payment is made of the policy moneys on the death of the life assured. A discharge form duly filled and completed by all the legal heirs and duly witnessed will have to be submitted to the company. The policy document will also have to be submitted along with the discharge voucher. On receipt of these requirements, the insurance company will arrange payment.

A situation may arise when the legal heirs are not able to produce the original policy document as the same might have been lost or misplaced. In such cases, the insurance company insists upon an Indemnity Bond duly executed by all the legal heirs along with a Surety of sound financial status. This Indemnity Bond is different from the Indemnity Bond obtained for payment of the policy moneys waiving strict proof of legal title.



## ACCIDENT AND DISABILITY BENEFIT

We shall now turn our attention to settlement of Accident and Disability Benefit claims; first, Accident Benefit:

- Death should be due to Accident, i.e. by External, Violent and Visible means. Death must be directly due to the accident and there should be no intervening cause. For example, if a person meets with an accident, admitted to hospital, develops Gangrene due to his Diabetic condition and then dies, it is not taken as death due to accident because there is an intervening cause viz., Diabetes.
- Death should take place within a specified period of time after the accident. As per the rules of LIC of India, this period is 120 days.
- Proof satisfactory to the insurance company should be submitted. Usually the requirements called for are (a) First Information Report (b) Panchanama or Police Inquest Report (c) Postmortem Report. If Viscera was sent for Chemical Examination, then the Report of the Forensic Laboratory is also called for. These reports indicate the cause and circumstances of death, whether it is accidental in nature, etc.
- The policy must be in full force at the time of death. Policyholder should have availed of the Accident Benefit by paying the necessary additional premium. He must not have been aged 70 years and above at the time of death.
- None of the exclusions should apply for consideration of sanctioning accident benefit in a case. There are also several exclusions in considering granting Accident Benefit. The life assured should not be under the influence of any intoxicating liquor, drug or narcotic at the time of the accident. The accident should not be because of the life assured being engaged in an activity which is a Breach of Law. The accident should not have happened when the life assured is involved in war or war like operations, or when the life assured was flying in an aircraft other than as a passenger, or in police or police like operations; he must not have been engaged in hazardous sports like car or motor cycle racing, mountaineering, steeple-chasing, hangg-liding, sky-diving, scuba-diving, or the life assured making an attempt to commit suicide (whether sane or not at that time).

Subject to all the above conditions being satisfied, the insurance company decides to allow the extra benefit. The benefit is generally paid along with the normal liability under the policy.

There are two types of Disability Benefits. One is waiver of premiums and the other is payment of an income to the life assured apart from waiver of premiums. The exclusions mentioned in respect of Accident benefit are equally applicable to Disability benefits also. In addition, disability itself is defined as permanent loss of two limbs due to accident, by amputation or other wise. The life assured should not be in a position to pursue the same occupation he was engaged in earlier to the accident.

The proof of disability should be satisfactory to the insurance company. Usually, the following requirements are called for:

#### First Information Report of the Police

- A declaration from the life assured explaining the details of the accident and the treatment undergone and the type of disability suffered.
- Records of the Hospital where treatment was given.
- A statement from the Hospital about the extent of disability, whether permanent or temporary, details of any surgery performed, the percentage of disability, etc.

Subject to the above being found satisfactory, the insurance company considers granting the disability benefits to which the policy is eligible.

This leaves us with the subject of 'Payment of Annuities'. Payment here depends upon the type of annuity and also the mode of payment of pension chosen by the annuitant. The common rule is that before an annuity vests, the entire purchase price must have been paid by the Annuitant to the insurance company. If it is an immediate annuity, the entire purchase price would have been paid in a single installment. In this case, the payment of annuity commences immediately, the first installment becoming due exactly one payment interval later, i.e., if monthly payment of pension is chosen by the annuitant, the first annuity will fall due exactly one month after the receipt of the purchase price. So is with the other modes of payment. If it is a deferred annuity, then all the installments of premium falling before the deferred date should have been received. In such a case, payment of annuity commences exactly one payment interval after the Deferred Date. Irrespective of the type of annuity (except annuity certain), evidence of survival of the annuitant will have to be submitted to the insurance company at periodical intervals. In case of a Joint Life or Joint and Survivorship Annuities, when one of the annuitants dies, proof of death is to be submitted to the insurance company.

It is usually the practice of insurance companies to obtain advance vouchers from annuitants and send cheques in advance for a period of six months or one year. This avoids the administrative work of issuing cheques every month to all the annuitants.

## **5. CLAIMS MANAGEMENT SYSTEM AND ORGANIZATIONAL STRUCTURE**

---

The effectiveness of the claims management is dependent on two important elements such as well defined structure of claims department and well defined working of the department. The effective working is again related to quality of services, timely settlement of claims, avoiding of litigations, cost effective settlement, retention of customers and customer relations management. To achieve these objectives the information of the insurance business should be accessible, the information received or the settlement of the claims should be economical, the information received should be compact and should provide all the information required for the purpose of making



some decisions. The management system should contain some facility of cross references and settled precedents. The claims management system is effective only when it is able to make timely decisions on the following elements.

- Decision relating to the use of information technology. The decision will be related to the extent of use of computers in place of human workforce, cost factors of establishment, sharing of information which is stored by the servers or the computers of certain individual department such as marketing, underwriting, staff and public relations department with that of the claims management.
- Decision relating to the use of services of outsourcing, particularly for the settlement of claims. The outsourcing refers to either having an agreement with some technically skilled persons for their services whenever the need arises, or hire services of the people at the time of requirement.
- Using of intermediaries is another area where the managerial decision is required. As such the organization may be required to use the offices of some persons like agents, staff, professionally skilled and licensed personnel like loss assessors or surveyors or loss adjusters for the settlement of the claim.
- Customer relations management is one of the important factors of the organization. The satisfied customer relations not only improve the business of the organization and avoid complications and complexities in claims settlement. A number of consumer disputes can be avoided by having effective customer relations.
- Decision-making relating to costs of claims is also an important element of the claims management. Costs of claims enquiry, costs of intermediaries, costs of the outsourcing, costs of litigations and settlements, costs of claims due to delay such as interest payments, are to be considered while making decisions relating to costs. Estimation of costs, allocation of funds for claims payments, budget and control of claims fund, analysis of costs, decisions to avoid some of the costs or expenses relating to claims payments, making reserves, planning of claims reserves, designing of reserves of catastrophe claims and bulk claims, reserves for expected events, resources planning to meet the need of claims payments, auditing of claims payments are some of the areas where expert managerial decisions are to be made.
- Management of resources of the organization and allocation and use of the available resources is another important functional area of the management. It is very much important in claims management. Forecasting the budget for claims payment, existing and future claims, establishment of reserves, reserves for unexpected claims and catastrophe claims are the areas where the decisions have to be made. Thus, claims management is having an important role to have concentration on planning of the management system and organizational structure of the insurance company to provide effective services and deliver services on faster mode.

## **ROLE OF INFORMATION TECHNOLOGY IN CLAIM SETTLEMENT**

---

### **Advent of the Information Technology in Claims Management**

Information technology involves the use of computer systems, digital electronics and telecommunications to store, process and transmit information. In the context of claims management, it involves storage, processing and transmission of information relating to settlement of insurance claims. IT plays an important role in the present insurance and reinsurance scenario. Its role is expected to be further strengthened in the coming future. The insurance companies are expected to harness new developments in claims management. This results in better distribution channels to policyholders, effective service to customers and reduction of operating costs. The IT strategy encompasses the whole of insurance organization. All the information generated in various fields will expedite and increase the quality in claims management.

### **E-Business and Claims Management**

#### **Features of Insurance claims**

- The number of insurance transactions entered into everyday is numerous. Today, there are a number of insurance companies and a lot more are expected to come up. Every business and every individual has insurance of one type or the other. There are a number of insurance products in the market. All these result in greater claims transactions to be processed.
- Some of the insurance products such as commercial insurance involves more than three to four insurance companies. As a result there is a complexity in the method of risk distribution and other parameters.
- A large number of transactions are handled by brokers and other intermediaries. This results in the complexity in claims settlement, increases the necessity of maintaining records, updated information, and important data and analysis of data.
- The insurance process has become so complex and involves a number of steps. It involves loss adjuster, legal experts, witnesses, etc.
- The requirement of investigating is largely felt due to increase in fraudulent, repeated and exaggerated claims.
- The need for reinsurance also adds to complexity in claim.
- The insurers are faced with new challenges, new issues as a result of increase in the number of products.



## **Advantages of an IT system in claims management**

1. Elimination of duplication: Once all the details regarding the insurance policies issued are entered into the electronic data entry systems, the data can be stored and becomes available to multi-use. Thus it eliminates duplication of both the data and the effort.
2. Reduced paper work: In such a system the files are created electronically. Supporting documents, images of damages and reports of loss assessors can also be stored electronically. This eliminates the necessity to maintain a number of files manually and expedite the settlement process.
3. Electronically communicated information leads to quicker communication of the origination of risk, the occurrence of loss etc.
4. Electronic authorization, accompanied by payments made through central settlement system results in expediting the claims payment.
5. The use of electronic funds transfer. This leads to faster settlement of claims.
6. It helps in reducing administration costs. As paper work decreases the need to maintain piles of stationery decreases.
7. Faster agreement of valid claims and faster settlement of claims leads to a greater satisfaction of the insured. This adds to the goodwill of the insurer.
8. An automated check against fraudulent, exaggerated and repeated claims.
9. Expediting payments to be made to brokers, intermediaries, loss adjusters, etc.
10. Information on fingertips for decision making purpose is available.

## **Disadvantages**

1. There may be an adverse effect on the cash flow position, as the claims settlement is expedited but the premium collections and the reinsurance recoveries may be delayed.
2. IT systems are more suited to standardized insurance products. They are less suited to big, more complex liability claims and non-standardized insurance claims.
3. These systems are less flexible, difficult to operate.
4. IT is rapidly changing and the pace is so fast that even experts in this field are finding it difficult to cope with. This results in hardware and software products becoming obsolete in ridiculously short periods of time.
5. Difficulty may arise in finding the right type of personnel to handle the systems and data.

6. The use of electronic communication coupled with a centralized claims function results in a biased approach to the delivery of services.
7. The cost of installation and operating a system are heavy.
8. The application of the system must be accompanied by a review of claims procedures and practices. This also involves increased cost and work.
9. A powerful, flexible and adaptable computer system is valuable but not a substitute to experienced people.
10. Physical control over records and assets is critical. The concentration of data processing assets and records also increase the loss that can arise from computer abuse or disaster.
11. Changes in technical and business environment will pressurize the need to upgrade the systems and processes which entails expenditure.
12. The claim management should be continually reoriented to changing priorities and changes in software technology or it shall not serve the purpose.
13. Security and safety of data, information and the system are necessary to ensure success, which is lacking today.

The success of a claims management system depends on the satisfaction of the insured/customers. The ultimate customer is the insured or potential customer who may be attracted to the insurance company by its state of art claims service. Therefore before designing an IT system for claim management customer's expectations are to be taken into account. Both commercial and personal customers today are more aware of their needs, knowledge of how the market works and are more determined to get what they want. The insurance industry till today has overlooked the expectations of its customers in designing of claims management systems. It now tends to deploy modern technology to stream line operations and generate economies of scale. In the designing of the systems a careful quantification and documentation of the expectations of the consumer is required for the success of IT in claims management.

## **6. CLAIM SETTLEMENT**

---

### **Role Of Central Govt. In Claims Settlement**

In view of the economic importance of the insurance sector the Central Government concerns with protecting the interest of the consumers. The Central Government in the year 1993 also set up a Reforms Committee to examine the structure of the insurance industry and especially examine areas relating to expenses, customer services, claims settlement and resolution of disputes. The dynamic role of the Central Government in claims settlement is summarized hereunder:



- The Central Government shall make policy statements relating to payment of claims. It shall fix norms for disposal of claims and fix time period for particular activities.
- The Central Government shall scrutinize the reports submitted by the insurers and the IRDA relating to payment of claims, amount reserved for the purpose of settlements, amount of claims unsettled, amount of claims unpaid, total of claims applications pending processing and settlements etc. The Central Government shall direct the IRDA to investigate and report on the pending claims or investigate delay in settlement.
- The Central Government shall in general or in a particular case direct the insurance companies to improve upon their claims settlement machinery or speed up the process and quality of claims settlement.
- The Central Government, if it feels that it is necessary to do so can make amendments to the existing laws to facilitate and smoothen the claims settlement process.
- The Central Government shall control and improve upon social insurances and welfare insurance business and shall also monitor the working of special insurance programs such as rural insurance etc.
- The Central Government shall depending upon the circumstances and requirements appoint the Claims Tribunal for the purpose of settlement of Claims and specify the jurisdiction for the purpose of their functioning.
- The Central Government shall appoint or remove officials for the purpose of achieving expeditious settlement of claims. It shall also withdraw the licenses of insurers who fail to adhere to its directions in respect to settlement of claims.
- The Central Government shall provide for alternative dispute resolution methods such as Arbitration, Mediation, or Negotiation, and Conciliation to provide a non-litigatory solution to claims settlement.
- Make laws binding on the insurers and other authorities responsible for settlement of claims.
- The Central Government has been instrumental in the appointment of Ombudsman claims.

All the above methods employed by the Central Government prove that it indirectly expedites the process of settlement of claims. In the Consumer Protection Act, 'facilities in connection with insurance' has been specifically included within the scope of the expression 'service'. A complaint relating to the failure on the part of an insurer to settle the claims of the insured within a reasonable time and the prayer for the grant of compensation in respect of such delay shall fall within the jurisdiction of the Consumer Redressal Forum constituted under the Consumer Protection Act.

## **Role of Ombudsman in Claim Settlement**

‘Ombudsman’ is a Scandinavian term, which means an ‘entrusted person’ or ‘grievance representative.’

An ‘Ombudsman’ is an office constituted by the Constitution, or by the action of a legislature, or Parliament. An Ombudsman receives complaints from the aggrieved persons, investigates, recommends action and issues report on the outcome of an investigation. Individual policyholders take their complaints up with the insurer’s senior management and then, if necessary, with the Ombudsman. The reluctance of the public to go for arbitration has led to the establishment of Ombudsman as a machinery for settlement.

An Ombudsman helps speed up independent settlement of dispute. The Ombudsman receives references in relation to complaints, disputes and claims made in connection with or out of policies of insurance. It is a machinery which facilitates satisfactory settlement or withdrawal of claims, by way of award or such other means. The office of an ombudsman is established for the protection of the rights of the insured (being individual) against the insurer (company). The Central Government has been conferred the power to frame rules by the Insurance Act, 1938. To exercise such power the Central Government has framed the Redressal of Public Grievances Rules, 1998. These rules provide for the appointment of Ombudsman. Customer service is one of the major areas of concern for the Government. As a part of this exercise, steps have been initiated to set up the Ombudsman for further control over personal life insurance claims of both Life and Non-life sectors. By a notification in the Official Gazette, the government notified the Ombudsman Scheme on November 11, 1998 for the expeditious settlement of insurance claims. The “Ombudsman” can also act as a counselor and mediator, for matters within the terms of reference, if requested to do so by the insurer and the insured. An Ombudsman scheme is presently set up in 12 centres in India. Four have been set up in metropolitan cities like Delhi, Mumbai, Kolkata, and Chennai and others in some major cities like Lucknow, Hyderabad, Bhopal, Kanpur, Bhubaneswar, Bangalore and Chandigarh. The jurisdiction of each Ombudsman is defined and fixed by a notification.

### **Scheme of Ombudsman:**

Complaints of the following types come within the purview of the Ombudsman’s consideration.

- Repudiation of liability under claims.
- Delay in settlement of claims.
- Any dispute regarding premiums paid or payable in respect of the policy.
- Any dispute regarding the legal construction of the policies in relation to a claim; and
- Non-issue of insurance document to customer after receipt of premium.



## Role of Irda In Claim Settlement

In exercise of the powers conferred by clause (zc) of sub-section (2) of section 114A of the Insurance Act (4 of 1938) read with sections 14 and 26 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), the Authority in consultation with the Insurance Advisory Committee, hereby makes the following regulations namely:

- A life insurance policy shall state the primary documents which are normally required to be submitted by a claimant in support a claim.
- A life insurance company, upon receiving a claim, shall process the claim without delay. Any queries or requirement of further documents, to the extent possible, shall be raised all at once and not in a piecemeal manner.
- A claim under a life policy shall be paid or be disputed giving all the relevant reasons, within 30 days from the date of receipt of all relevant papers and clarifications required. However, where the circumstances of a claim warrant an investigation in the opinion of the insurance company, it shall initiate and complete such investigation at the earliest.
- Subject to the provisions of section 47 of the Act, where a claim is ready for payment but the payment cannot be made due to any reasons of a proper identification of the payee, the life insurance company shall hold the amount for the benefit of the payee and such an amount shall earn interest at the rate applicable to a savings bank account with a scheduled bank (effective from 30 days following the submission of all papers and information).
- Where there is a delay on the part of the insurer in processing a claim for a reason other than the one covered by sub-regulation (4), the life insurance company shall pay interest on the claim amount at 10% p.a. effective from the date of submission of all information and papers.
- Every insurer shall set up a proper grievance redressal machinery at its Divisional / Regional / Zonal / Head Office/Central Office, headed by a senior executive not having any direct responsibility for underwriting or settlement of claims.

Every insurer shall place before its Board of Directors at least once every quarter, statistics of:

- the number of claims intimated during the preceding quarter;
- the number of claims settled during the quarter;
- the number of claims outstanding at the end of the quarter;
- analysis of the claims paid by duration elapsed from the date of loss, namely, 0-6 months, 6-12 months and more than 12 months together with explanatory observations regarding delays in settlement in each case;

- analyzing claims outstanding by duration, namely, 0-6 months, 6-12 months and more than 12 months.

## **Role of Consumer Protection Act In Claim Settlement**

The insurer to bring profit to his company makes every possible attempt to lessen liability by invoking the agreement clauses of the policy, the terms and conditions of the policy, the nature of occurrence of the event to see whether it is covered under the policy or not, the payment of premium etc. The insurer invariably looks at facts and figures, whether material or non-material to the policy to find an excuse and repudiate the claim made by the insurer. True, the investigation and review of a claim is necessary so that no claimant gets an amount more than what he should be indemnified with. But this practice of the insurers has adversely affected the uneducated and the innocent. That is the reason why there is a Consumer Protection Act.

The insured is the only person who will be approaching the consumer protection machinery for the settlements of the claim because of the following grounds;

- the difference of services,
- delay in services, i.e., settlements of claims and payments,
- not providing information required as the consumer of product,
- not hearing to the consumers and helping them in the claim applications filing, and
- taking advantage of innocence and helplessness conditions of the consumer and rejecting the policy payments.

The insurer wants to avoid the payments to reduce the liability on a pretext of some failures or non-performances of conditions required to be performed by the insured. However, the provisions of consumer protection provide life to the insured in the settlement of grievances of insurance claims.

### **Claims Review Committee:**

The Life Insurance Corporation of India settles a large number of death claims every year. Only in case of fraudulent suppression of material information will the liability be repudiated. The number of death claims repudiated is, however, very small. Even in these cases, an opportunity is given to the claimant to make a representation for consideration by the Review Committees at the Zonal Office and the Central Office. As a result of such review, depending on the merits of each case, appropriate decisions are taken. The claims Review Committees at the Central and Zonal Offices have among other members a retired High Court/District Court Judge.



## Consumer Protection Machinery

The redressal mechanism as set up under Section 9 of the Consumer Protection Act, 1986 consists of a three-tier jurisdiction system. There are forums at district level called the District Forums; the ones at State level called the State Commissions and at the national level called the National Commission.

## 7. FUTURE OUTLOOK

The insurance industry has grown up to become a veritable institution, with over 6000 insurance companies worldwide collecting \$ 800 billion in premiums each year and holding assets with an estimated value of \$ 2.7 trillion. Among the various insurance companies are those that offer general insurance coverage including health, automobile, homeowners, life and disability, etc., and those who specialize in one or more of the aforementioned types of insurance. With the deregulation of the banking and brokerage industries, large conglomerates have been formed that offer every imaginable financial service. It is now common for these large corporations to offer a variety of insurance plans. In this regard with a large consumer base it becomes necessary for any provider of insurance services to have claims management staff and support systems. With more stringent regulations in place, it will be difficult for insurance companies to repudiate claims for every other reason. Information technology is helping the insurance companies to manage claims. Many softwares for insurance claims have hit the market. A popular one among them is Claims Management Systems (CMS). It is called Managing, Organizing and Documenting Every Loss (MODEL). This software is developed by Scott Insurance. The highlights are –

- Automatic completion of state required forms
- Internal claims management training
- Adjuster-to-adjuster claims planning and oversight
- Physician-to-physician medical reviews
- Organization of all information in one place
- Conversation/event documentation
- Internal/external claims information communication
- Progress tracking
- Follow-up for timely return to work, closing or settling claim
- Entries for workers' compensation, property, general liability and automobile claims.

A study reveals that the costs of claims are increasing at an annual rate of three times the rate of inflation. In such an environment it becomes imperative to have a claims management department to monitor and control the costs.

## Questions



1. What is a 'Claim' in regard to Life Insurance Contract?
2. List out the functions of claims department
3. Discuss different types of claims and the procedure to settle those claims.
4. What are the basic requirements to settle.
  - a) Death Claims
  - b) Maturity Claims
5. The effectiveness of the claims management is dependent on two important elements such as well defined structure of claims department and well defined working of the department – discuss.
6. Discuss the role of Information Technology in claims settlement.
7. Discuss the powers of
  - a) Central Govt.
  - b) Ombudsman
  - c) IRDA and
  - d) Consumer Protection Act in claim settlement
8. Discuss the future scenario of claim settlement.

# Insurance

## CHAPTER – 11

### LAPSATION AND REVIVAL OF LIFE POLICIES

#### OUTLINE OF THE CHAPTER

- Meaning of lapsation
- Concept of lapsation
- Causes of lapsation of life insurance policies
- Consequences of lapsation
- Suggestions to improve the lapsed conditions
- Revival of lapsed policies
- Questions

#### LEARNING OBJECTIVES

- To know the meaning and concept of lapsation.
- To understand the causes of lapsation of life insurance policies.
- To know the importance of continuation of insurance policies for the policyholder, industry, society and the government.
- To know various schemes of revival of policies.

#### 1. MEANING OF LAPSATION

Life insurance is a valued property, which will be a live with periodic payment of premia as stipulated in the contract. However, on account of **non-payment of premiums** on due dates the contracts cease to be in force i.e., the policy lapses and consequently insurance protection. Depending on the number of premiums paid before the policy holder stopped paying them, the policy becomes totally lapsed or becomes a 'paid-up' policy.<sup>1</sup>

---

1. Permanent Policies acquire 'paid-up' value if premiums under the policy are paid for at least 'three years'. The paid-up value will be proportionate to the sum assured in the same proportion as the number of premiums paid to the total number of premiums originally payable as per the contract. This paid value is payable on the maturity date or death of the life assured if it takes place earlier. The policy holder has also got a right to surrender his policy without waiting for maturity date, but he would get a certain percentage of the paid-up value which is called the 'surrender value'.

Though the term 'lapsation' had not been directly defined in the Insurance Act, 1938 - a study of insurance literature suggests that lapsation can be termed in the following 3 ways.

- Pure lapse [the policy is discontinued within 3 years]
- Lapse [the policy is discontinued after 3years]<sup>1</sup>
- Zero duration lapse [policy is discontinued within the financial year of issue].

## 2. CONCEPT OF LAPSTATION

A committee which was constituted by Department of Economic Affairs, Insurance Division, Ministry of Finance, and Government of India under the chairmanship of A.V. Ganesan termed lapsation in the following ways:

- Lapsation of policy after payment of the first premium only
- Lapsation of policy before it acquires a paid-up value i.e, in respect of LIC, before payment of premiums for the first 3 years from commencement of the policy (2 years in respect of policies issued prior to 1.4.73) and
- Lapsation of policies within the financial year of issue, i.e. "zero duration lapse".

Perhaps the most disturbing feature of Indian life insurance business is the high proportion of lapses. The traditional indices for measuring lapsation are

- (i) Overall net lapse ratio, i.e., percentage of lapse to the mean business in force,
- (ii) Percentage of net lapses to new business according to duration.

[Mean duration is year of lapse minus year of new business]

LIC of India is following the concept of 'zero duration lapse' for collecting data on lapsation of policies. It is reported to be having 17 to 18% lapsation of life insurance policies. Most of the private players are also facing the same problem. The consequences of this lapsation are very costly. The Government of India appointed various committees on the issue of lapsation of insurance policies in India. The views and recommendations of the Morarka Committee [1969], Era Sezhian Committees [1980], Malhotra Committee [1994] is very important in regard to the magnitude of lapsation of life insurance policies for a developing country like India.

Considering this importance, A.V.Ganesan Committee [1995] was appointed by the Government of India to study exclusively the magnitude and causes of lapsation of life insurance policies in India. Ganesan Committee Report revealed that LIC, immediately after nationalization, experienced lapse rates, which were very high. The rate went down in the late sixties and early seventies; again the rate went up in the late seventies and moved in a narrow range in the eighties and has again started showing a upsurge/rise in nineties. The current experience of the insurance industry all over the world brings out the fact that the problem of lapsation exists universally, though levels of lapsation in the developed countries is lower than that prevalent in India.



### **3. CAUSES OF LAPSATION OF LIFE INSURANCE POLICIES**

Ganesan committee identified that the early lapsation of insurance policies is the combined result of both external and internal factors with some element of interaction between the two. The committee identified the following factors.

#### **External factors:**

1. Economic decision making of the policyholder
2. Economic-social background
3. Availability of alternative investment options
4. Client specific Features
  - Wealth and savings
  - Education
  - Age
  - Gender
  - Location - rural/urban
  - Financial difficulties
  - Resource availability
5. Macro economic factors
  - Disposable income
  - Inflation
  - Government policies with regard to taxation
  - Fiscal incentives
  - Development of industrialized areas.

All these factors are beyond the control and influence of an insurance company. But the internal factors are under the control and influence of an insurance company. They are

#### **Internal factors:**

1. Product design and choices
  - Types of plans
  - Mode of premium payment
  - Policy term

2. Marketing and personal strategies

- Planning of business activities [budgets, time frames]
- Sales personnel agents, development officers, branch marketing supervisors
- Customer education
- Market research
- HRD linked to marketing [Recruitment and Training, appraisal, incentives and disincentives].

**Other factors:**

- Policy mismatch [lack of need based approach]
- Absence of insurance awareness/consciousness
- Saving element [no element of risk management]
- Tax based
- Lack of Agency professionalism
- No dignity to agent profession
- No importance of after sales service
- Commission Structure [high commission for first premiums and low commission for renewal premiums]
- Knowledge gap among the field personnel
- Selling high Premium/expensive policies
- No quality consciousness in training programs to sell insurance
- High agent turn over
- Deficient training of agents
- Business Target Structure (Commences in March - Ends in April)
- Rebating
- Poaching/churning
- Disservice in the offices



## 4. CONSEQUENCES OF LAPSATION

- a) **Consequences of lapsation to the policyholder:** Lapse of policies will not be beneficial to any parties to the contract. The insured not only loses Life Insurance Protection, but also a portion of the savings accumulated with considerable effort over a period of time. The loss is disproportionately high because of the concept of the level premium<sup>2</sup> system. It is also viewed that the surrender values of policies are low and so policy holders lose a significant amount even if a policy is made paid-up and surrendered.
- Hence the lapsed policy does not cover the loss [life] of the policyholder.
  - The much-desired family security is not in force on account of the lapsed policy. The purpose for which it is taken namely management of the financial consequences of the death of its earning member for the family or for organization is grossly defeated.
  - Policyholders lose a significant amount even if a policy is made paid-up and surrendered.
  - The policyholders, on the other hand, lose their amount paid by way of initial premiums.
- b) **Consequences of lapsation to the industry:** Lapsation of insurance policies is also detrimental to the business of the insurer, particularly when the policy is lapsed within one or two years of taking the policy. This is because the insurer incurs heavy expenditure at the time of issue of policy which the insurer assumes to recover in subsequent years' premium.

In the level premium system, the assumed 'expense loading' which is a third factor<sup>3</sup> taken into account for the calculation of premium is spread over the entire term of the policy.

- 
2. Level premium – The fundamental idea of the level premium plan is that the company can accept the same premium each year [a level premium], provided that the level premiums collected are the mathematical equivalent of the corresponding single premium. As a result, the level premiums paid in the early years of the contract will be more than sufficient to pay current death claims but will be less than adequate to meet death claims that occur in later years. Life insurance was, thus, one of the first products marketed on the installment plan.
3. Basically four factors are involved in calculation of life insurance rates [premium].
- a) The probability of the insured event occurring
  - b) The time value of money
  - c) Loadings to cover expenses, taxes, profits, and contingencies.
  - d) The benefits promised

- The life insurance industry uses, persistency [The measure of how long a policy or a block of policies remains in force.] to monitor its marketing and service quality. Higher the Persistency Rate [the number of policies in force at the end of a given year divided by the number of policies in force at the beginning of that year] higher the product performance. Moreover, Persistency directly affects profitability because policies that have been in force for a long time are more profitable for insurers than policies that lapse quickly.
- With the continuation of paying premiums, policies stay on the books longer.
- The longer a policy remains on the books, the greater the likelihood that it will fill the need it was sold to cover.
- Customer retention is a key driver of profit for any business organization especially for an insurance company.
- Lapse rates can be viewed as a proxy for policy owner satisfaction. Insurers with low lapse rates must be providing their customers with the quality of products and services they desire. High lapse rates may reflect policy owner dissatisfaction [the quality of products are not matching with the desires of the customer].
- Policyholder, whose policy is lapsed, seldom speaks well of the insurance company with which he was insured.
- The ego of the policyholder is hurt and thereby, wherever lapsation is in large numbers, the social sentiment on insurance is adversely affected.
- The initial cost of issuing policy is high and it is expected to be recovered through installment premiums paid over a number of years [generally from 3 to 5 years]. Every policy discontinued after payment of the first premium or in its early years causes, a loss to insurance industry.
- The commission paid on such policies becomes an undeserving benefit conferred on the agents involved. It leads to a financial burden to industry.
- Apart from this direct loss, the unproductive efforts involved therein also result in forgoing opportunities to generate genuine business, serving large number of customers. Besides this loss, the organization suffers the loss of public image through adverse publicity.



- Excessive lapses for an insurer can have a negative impact on *Expenses, Investments and Selection of lives*.<sup>4</sup>

**c) Consequences of lapsation on intermediaries, society and Government:**

- The negative effect of lapsation is not only for the main parties of the contract but also the **efforts of the intermediaries'** right from agents, branch-marketing supervisors, branch managers, assistant branch managers who have toiled to bring in the policyholders to the books of their company become futile.
- And the cost of lapsation **on society** is also high because Lapsation reduces financial security of individuals. The presence of risk with the lapsation of policies results in certain undesirable social and economic effects. A severe burden of risk of lapsation on society is the worry and fear. This leads to mental unrest. And also dependence on public assistance or welfare or financial assistance from relatives and friends would increase in the case of loss occurrence.
- Lapsation of life insurance policies increases **pressure on the social welfare** system in many states. It is a disadvantage in the context of public finance. It is a burden for government to bear the growing financial difficulties of the old age pension systems.

It will, thus, be seen that there is a colossal wastage of efforts and cost on account of lapsation and if steps can be taken to reduce lapses there will be not only a far more rapid growth of business in force and premium income, but it will also have very favourable impact on (i) the expenses of management, (ii) the return to the policyholders by way of increased bonus and (iii) the image of the Insurance Company in the eyes of the Public.

- 
4. Expenses – For the insurance company the negative impact on expenses is that the company will be unable fully to recover initial expenses: Thus the company must be passed on to persisting policy owners, raising their costs.

Investments – the insurer may lose planned investment cash flows: this may result in forced sales of investments at a loss in order to meet surrender demands.

Mortality or morbidity adverse selection – In general, insureds who have adverse health or other insurability problems tend not to lapse, causing the insurer to experience a greater proportion of claims than expected if the lapse rate is high.

Thus, lapses can negatively affect each of the three other major pricing factors, because of this fact and because it is a proxy measure for policy owner satisfaction, if one had to select but a single proxy for product performance, it probably would be the lapse rate.

By understanding causes and consequences of lapsation of life insurance policies steps can be taken to bring down the rate of lapses in India, which is very high by international standards. If reduction of lapsation results in lowering the premium rates, the 'insurance cover' can reach to the poorest of the poor. Those resources can pave the way to economic progress and economic development. All the Committees, which were appointed by the Government of India, were before the privatization of the insurance sector in the country.

## **5. SUGGESTIONS TO IMPROVE THE LAPSED CONDITIONS**

Some of the suggestions to improve the lapsed conditions in Indian Life Insurance industry are

- a) Need for public education.
- b) Need for training field personnel.
- c) Need for Research in Marketing and public needs.
- d) Highlighting risk management factor in selling life insurance products.
- e) Professionalism in marketing - at the contact level, a portion of the time spent is to counsel the prospect on the possible economic risks and consequences in his family or business economics, while another portion of that in follow-up contacts are devoted to persuading the prospect to do something about the solutions suggested.
- f) Indiscriminate recruitment of large number of agents should be stopped.
- g) Pre-recruitment training should be followed by a test and interview.
- h) Career Agency should be encouraged.
- i) 'Know your Customer' - understand the customer - Insisting on Need based selling.
- j) The Bonus Commission which is now payable to agents on 1st year premium income should be paid on the basis of the average of first year, second year and third year income.
- k) Hereditary Commission should be replaced by payment of an appropriate lumpsum.
- l) After sales service from Agents, Development Officers.
- m) Continuation of Relation with customer after sales and after claim also.



## **6. SOME OF THE REVIVAL METHODS OF LAPSED LIFE INSURANCE POLICIES**

---

### **Revival of lapsed policies**

When a policy lapses this condition enables the policyholder to apply for its revival within 5 years from the due date of the first unpaid premium. The revival must be effected during the life-time of the life assured. Medical and/or other evidence of any alteration of the risk is called for by the Corporation. If there is any adverse change in health or insurability, the insurer reserves the right to impose its own terms on which revival can take place. The overdue premiums with interest or revival fee must be paid before the Corporation assumes full liability again. The Corporation revives policies within 6 months from the due date of the first unpaid premium without asking for evidence of health but only on payment of overdue premiums with interest subject to a minimum revival fee.

The interest charged for arrears of premiums is presently 9% per annum thereof reckoning from the due date of each premium paid late subject to a minimum payment of Rs. 2/-. If revival is completed within 14 days from the expiry of the days of grace a simple revival charge of Rs. 2/- will be required along with interest for one month only. If the total period from the due date is 45 days or more interest for 2 months will be charged.

### **Schemes of Revival of Policies**

Corporation offers following schemes of revival:

#### **Ordinary Revival**

Generally, policies which are in lapsed condition for not more than 5 years only can be revived. The requirements for revival are normally, payment of arrears of unpaid premiums with interest thereon and submission of evidence of health. The requirements of revival in various circumstances are briefly explained below:

**For endowment type of policies:**

- (i) 12 months prior to Maturity Date : Only arrears of premia + interest.  
No evidence of health except for Anticipated Endowment Plans for which personal statement of health also necessary.
- (ii) 12 to 24 months prior to Maturity Date : Arrears of premia + interest + personal statement of health

For all policies (whether issued under Non-medical (Gen.) Non-Medical (Special) or Medical Scheme, except those issued under Temporary Assurance and Convertible Term Assurance – Plans

| Period for which Premiums have been paid under the Policy as on the date of lapse | Requirements for Revival                    |                                                                      |
|-----------------------------------------------------------------------------------|---------------------------------------------|----------------------------------------------------------------------|
| At least 5 years                                                                  | (i) Within 12 months from the date of lapse | Arrears + interest only                                              |
|                                                                                   | (ii) After 12 months from the date of lapse | Arrears + interest and evidence of health as per usual revival rules |

| Period for which Premiums have been paid under the Policy as on the date of lapse               | Requirements for Revival                           |                                                                      |
|-------------------------------------------------------------------------------------------------|----------------------------------------------------|----------------------------------------------------------------------|
| 10 years or $\frac{1}{2}$ of the Term (Premiums Paying period) of the policy, whichever is more | (i) Within 12 months from the date of lapse        | Arrears + interest only                                              |
|                                                                                                 | (ii) Within 12 to 18 months from the date of lapse | Arrears + interest + P..S.in 680 (Rev.75)                            |
|                                                                                                 | (iii) After 18 months from the date of lapse       | Arrears + interest and evidence of health as per usual revival rules |

**Where Policy has not run for 5 years on the date of lapse**

- Policy, whether issued under Non-medical or Medical Scheme can be considered for revival on the strength of personal statement of health if, overdue premiums and interest thereon are received within one month from the expiry of "Six Months' Period" from the date of first unpaid premium (i.e. within 7 months from the date of



first unpaid premium) and if the personal statement of health called for is submitted within 2 weeks of its being called for and provided further that:

- (i) The original Policy is issued at O.R.
- (ii) If the Policy was issued or subsequently revived with an Extra, Lien or Endorsement, such Extra, Lien or Endorsement was due to occupation or sex only.
- (iii) There is no adverse information regarding health, habits, or occupation etc. of the Life Assured either on our records or is not disclosed in the personal statement of health which is received for consideration of revival.
- A policy issued under “Medical Scheme” only, which has remained in lapsed condition between 7 months and 1 year (exceptions – policies issued under Table 43 and 58) can be considered for revival within one year from the date of lapse, only on collecting arrears of premium and interest thereon together with personal statement of health, provided:
  - (i) Sum at risk is Rs. 10,000/- or less for plans other than Multipurpose (and Rs. 5,000/- or less for Multipurpose).
  - (ii) Life is 1st Class, accepted at O.R. or with standard extra for occupation, sex or physical impairments like loss of eye, limb, etc.
  - (iii) Our record or personal statement of health received for consideration of revival, does not reveal any adverse information regarding health and habits of the Life Assured.
  - (iv) Life Assured has undergone medical examination for the same or for any other policy within last 5 years from the date on which revival is considered.

When the revival of the policy cannot be considered on any of the basis mentioned at 1 to 3 above (where arrears and interest with or without personal statement of health is generally required) the usual revival requirements have to be called for. These requirements will depend upon whether the policy can be revived under Non-Medical (General), Non-Medical (Special) or Medical Scheme.

In general, it can be stated that the criteria for determining as to whether the policy can be revived under Non-Medical (General), Non-Medical (Special) or Medical Scheme, is to determine as to how a new proposal on the same life for sum assured equal to sum at risk under the policy to be revived, would have been dealt with.

Our usual requirements for revival under Non-Medical and Medical Schemes are briefly given below:

**(i) Non-Medical (General) Scheme (Male Lives only):**

Policy can be considered for revival under this Scheme provided inter-alia the age of the Life Assured as on the date of revival is not over 40 years nearer

birthday and sum at risk is not over Rs. 25,000/- with maximum SA under non-medical scheme being Rs. 50,000/-.

### Requirements

Arrears + Interest + personal statement of health and Special Report by Development Officer/Agent/Branch Manager when revival is being considered after 9 months from the date of lapse.

### (ii) Non-Medical (Special) Scheme:

Policy can be revived under this scheme, subject to the following conditions being satisfied.

| Category |                                                                                                                                                | Age on the date of revival | Sum at risk              |
|----------|------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|--------------------------|
| I.       | (a) Both male & Female lives                                                                                                                   | 31 – 45 years<br>1,00,000) | Rs. 50,000/-<br>(maximum |
|          | (b) Commissioned Officers in Armed Forces Falling in Category A-1                                                                              | 1,25,000)                  | Rs. 50,000/-<br>(maximum |
| II.      | The life assured should be in service for at least one year, and the employer should be an approved employer for Non-Medical (Special Scheme). |                            |                          |

### III. Medical Scheme:

If a policy cannot be considered for revival under Non-Medical Scheme, the same has to be considered for revival under Medical Scheme.

### Requirements:

Arrears + Interest + personal statement of health and S.M.R. or F.M.R. as indicated below and Special Reports where necessary as mentioned in Revival Manual.

| Sum at Risk<br>i.e. sum to be<br>revived | Within 6 months<br>from the date of<br>lapse | After 6 months<br>but before<br>5 years from<br>the date of lapse |
|------------------------------------------|----------------------------------------------|-------------------------------------------------------------------|
| Upto Rs. 25,000/-                        | Nil                                          | S.M.R.                                                            |
| Over Rs. 25,000/-                        | Nil                                          | F.M.R.                                                            |

For revival of policies issued under Pure Endowment & Deferred Annuity, no evidence of health is necessary. Only arrears of premia and interest thereon will suffice.



### Some Important Points to be noted

- Interest on arrears of premia should be charged at 6% for policies issued upto 15-9-1972 and 7 ½% for the policies issued after 15-9-1972 and upto 31-12-1986 and 9% for the policies issued on or after 1-1-1987.
- To decide whether the Policy can be revived on Medical basis or Non-medical basis, the amount to be revived should be taken as original sum assured less **paid-up value as on the date of lapse**. However, to decide the nature of the medical report, i.e. whether S.M.R. or F.M.R. is required, the amount to be revived should be taken as original sum assured **less paid-up value as on the date of revival**.
- Personal Statement for revival is generally required. Hence, when S.M.R. or F.M.R. is called for, personal statement of health is to be called for.
- For Female Life Personal Statement in F.No.680 submitted for revival can be considered valid for 3 months from the date of last menstruation if the revival is not completed during the period, provided:
  - a) Policy is issued to the female life with earned income on the same terms as applicable to the male life;
  - b) Life Assured did not have many miscarriages in the past;
  - c) Life Assured should be an educated lady with minimum S.S.C. qualification and is expected to seek medical assistance for confinement.

### Special Revival

- The policy can be revived under the Scheme provided:
  - i) It has not acquired any Surrender Value;
  - ii) It has lapsed for not less than 6 months and not more than 3 years as on the date of revival; and
  - iii) It has not been revived under this Scheme on earlier occasion.
- On revival, the Policy will be dated back for such period as the lapsed policy was in force subject to the condition that the date of commencement of the Policy on Revival does not fall beyond two years from the date of commencement of the original lapsed policy. A fresh policy will be issued on revised conditions. However, if the original policy were assigned in favour of a minor an endorsement will be issued;
- The revised premium payable from the new date of commencement of the policy should be calculated for the same term of Assurance as that of the original policy, at the rate applicable to the Life Assured's age nearer birthday as the new date of commencement of the policy;

Although, the Policy revived under this scheme will have generally the same term of Assurance, as mentioned above, there will be exceptions to this rule when the term of Assurance under the Policy to be revived will have to be reduced, when maturity age is to be restricted in some cases e.g. Maximum Maturity Age under Multi-purpose Plan should not exceed 60 days;

- The Life Assured will be required to pay the revival charge. This charge will be the difference between the aggregate of the premium originally paid and the amounts that would have been paid at the new rate of premium on revival, accumulated from the new date of commencement with interest at  $7\frac{1}{2}\%$  p.a. compounding half-yearly reckoning from the date of each premium with reference to the new date of commencement together with the premiums that have already fallen due on the Policy with respect to the new date of commencement, after allowing for the premiums already paid before the policy lapsed, accumulated at  $7\frac{1}{2}\%$  p.a. compounding half-yearly reckoning from the due date of each such premium. If the total revival charge calculated in the above manner does not exceed the minimum revival charge of Rs. 1/- shall be charged. In addition, a premium for a minimum period of three months at the revised rate as at the date of revival will be required to be paid. In case of policies issued on or after 1-1-1987, interest will be charged at the rate of  $9\%$  compounding half-yearly subject to a minimum revival charge of Rs. 2/-.

### **Installment Revival**

- Revival under this Scheme will be permitted:
  - (i) Where the Policyholder is not in a position to pay the arrears of premiums in one lump sum and the Policy cannot be revived under our Special Revival Scheme;
  - (ii) Where the arrears of premia are for more than one year;
  - (iii) There is no Loan Outstanding under the Policy at the time of revival (Outstanding Loan, if any, must be repaid with interest to avail of the facility of Installment Revival); and
  - (iv) No Survival Benefit falls due immediately after the revival.
- The arrears of premia will be calculated in the usual manner as under Ordinary Revival Scheme. Depending upon the Mode of Payment, the Life Assured has to pay initially six monthly premiums, or two Quarterly Premiums or one Half-yearly Premium or half of the Yearly Premium and balance of the arrears will be spread over in the remaining premium due dates in the current policy Anniversary (current on the date of Revival) and two full Policy Anniversaries thereafter;
- If the lapsed policy is under SSS, the installment Revival Scheme should be offered only if Policyholder agrees to get the policy excluded from the purview of the Salary Savings Scheme and transferred to Ordinary Class;

---

\* "Interest rates are subject to market interest rates."



- If the lapsed policy is issued under Table 218, within the 1st five years, the balance of arrears amount calculated should be spread over as mentioned in (2) above but it should not go beyond the option ate of 5 years;

Similar consideration is to be given to the policies issued under Anticipated Plans when the same are revived under this Scheme, so that the period over which the arrears are to be spread over, does not conflict with the date on which Survival Benefit Payment falls due;

- The evidence of health, for revival under this Scheme will be the same as mentioned under the heading “ORDINARY REVIVAL”.

### **Loan-cum-Revival Scheme**

As the name itself indicates, it involves two functions, viz. granting of loan and revival of the policy simultaneously. This facility is utilized by policyholders who would like to avail of loan to cover the arrears of premiums to revive policies.

The arrears of premiums required for revival is calculated as in the ordinary revival scheme. The loan available under the policy, treating the premiums as paid upto date as on the date of revival, is calculated and the amount available as loan is utilized to adjust the arrears of premiums. In case any balance of amount is required, the same is called for. In case where the available loan is more than the arrears of premium with interest thereon, the excess of loan is paid to the policyholder. The life assured can also avail such amount of loan as required just to cover the arrears of premium with interest. The assured has also to submit evidence of good health, wherever required and also the loan papers duly completed.

### **Questions**



1. What is lapsation?
2. Identify some of the causes of lapsation of life insurance policies.
3. Discuss the consequences of lapsation of life insurance policies on
  - Insurance companies
  - Policyholders
  - Intermediaries
  - Government
4. Discuss various revival methods of lapsed life insurance policies?

# Insurance

## CHAPTER – 12

### ACTUARIAL VALUATION

#### OUTLINE OF THE CHAPTER

- Introduction
- Methods of valuation
- Measurement of risk in life insurance
- Using probability for future predictions
- Nature of surplus
- Distribution of surplus
- Frequency of distribution
- The contribution principle
- Special forms of surplus distribution
- Risks in providing insurance – assets risk, pricing risk, interest rate risk and miscellaneous risks
- Underlying principles
- Summary
- Questions

#### LEARNING OBJECTIVES

- This chapter aims at providing comprehensive knowledge about the valuation process followed by life insurance companies.
- It gives an insight into calculations involved in the valuation process and types of valuation.
- This chapter deals with the different types of actuarial risks that an insurance company faces, like assets risk, pricing risk, interest rate risk and miscellaneous risks.
- It deals with the types of surplus, methods employed for calculations and the different ways in which it is distributed.



## INTRODUCTION

We know that during the early years of a policy the premium received by an insurance company surpasses the required amount due to the Level Annual Premium system. Thus there is collective excess, corresponding to the premiums of all the policies. This excess then constitutes a funds pool, which enables the company to, settle claims and meet deficit during years when the premium is not sufficient.

It now becomes essential to determine whether the premium accumulated is on the same lines as the calculated premium. This enables the company in determining its solvency. Thus the process by which the value of all the existing policies is ascertained is called **valuation**.

It is also called valuation of liabilities of the insurance company. And since the process of valuation is taken up by an 'actuary' by applying actuarial principles it is termed as **actuarial valuation**.

The premium charged on policies covers the expenses incurred by a company. The pool of funds formed as a result of premium balance accumulated after deducting the expenses is called **Life Fund**.

## METHODS OF VALUATION

Valuation of liabilities is the process of arriving at the value of policies existent on the day of valuation.

There are different methods of valuation:

- Prospective method
- Net premium method of valuation
- Modified net premium method of valuation
- Gross premium method of valuation
- Gross premium method for with-profits policies
- Retrospective method

### Prospective method

When this method is used the prospective value of a policy at any time will be equal to the excess premium accumulated, as long as the business growth is anticipated as per the basis on which the premium was computed. Valuation also determines the adequacy of the life fund, because in a given situation the life fund is never sufficient, it is either in excess or will fall short of the requirement.

The formula applied to calculate valuation using prospective method is:

$$t_x^v = A_{x+t} - P_x a_{x+t}$$

where,

- $t$  is the duration elapsed since the date of commencement of the policy, it is reckoned in integral number of years.
- $x$  is the age as in during the latest birthday or next birthday as per the practice of the office.
- $T$  is obtained by calculating the difference between the calendar year of valuation and calendar year of commencement of the policy. But adjustment has to be made with regard to the month of valuation and the month in which the policy begins.
- $x + t$  is the valuation age. It is calculated by adding the duration elapsed ( $t$ ) to the age ( $x$ ).

In other words this method evaluates the current value of future premiums and the current value of future claims at a particular date. It can be more simplistically understood as:

**Valuation surplus** = (Life Fund + Present value of future premiums) – Present value of future claims.

There is **valuation deficit** if the present value of future claims is more than the sum of life fund and present value of future premiums.

Life insurance companies employ this method of valuation as for the purpose of calculation it considers the existent trends in interest, mortality and expenses, while it determines the present values of future premiums and benefits.

## Net premium method of valuation

Very often for valuation purpose there is a confusion regarding the premium, which should be considered for computations. The premiums charged by insurers are always inclusive of the expense loadings in addition to the net premium. And usually the actual expense incurred is covered in the premiums, while the expense loading is kept to meet any eventuality in the future. Therefore it is sufficient to consider net valuation for the purpose of valuation.

The net premium method of valuation is based on the following considerations:

- For determining the factors required to calculate the value of the insured sum or any additional bonuses declared previously, true mortality tables and true interest rates should be used.
- Similarly true mortality tables and true interest rates should be used for determining factors required for the calculation of future premiums.



According to this method of valuation, the valuation of a particular policy starts with zero on the day the policy comes into force. And with the life of the policy the value grows till the assured sum is reached, along with the declared bonuses.

We know that although the office premium for each policy is fixed and known at any date of valuation there can be a change in the office premiums as on different dates the office premiums of policies in force will be based on different scales. But this is not the case with the net premium, which has only one value for a particular age at entry in case of whole life assurance and for each age of entry and original term in case of endowment assurance. The difference in value between the office premium and the net premium is termed as valuation loadings.

If the valuation loadings are not utilised for expenses or contingencies then they add on to the assets of the company and become a source of disposable surplus. Thus there will be a surplus at the end of each year if mortality, interest and expenses do not deviate from the assumptions made for valuation. But if the insurance company intends to give bonus in the reversionary form then the surplus accumulated after successive valuations will cause a reduction in reversionary bonuses. But if the life insurance company intends to follow the reversionary bonus method on a regular basis for the distribution of surplus then it should reduce the valuation rate of interest to a rate less than what is currently earned by the life fund.

## **Modified net premium method of valuation**

In this method the net premium value of the policy is reduced and brought to a new value, which is called the modified net premium.

The deductions are made from the premium of the first year and the reserve formed as a result is termed as full net premium reserve. This implies that the net premium of the first year is set aside for expenses of that year and in doing so the entire modified net premium reserve becomes nil. But at the end of the term both the policy values become equal because the deduction from the net policy value gradually decreases.

This modified net premium method is suited for a prospective method of valuation as it takes into account a higher value of premium, so that deductions can be made from the benefits to be availed, but finally arrives at a low priced policy.

## **Gross Premium Method of Valuation**

In this method of valuation the entire premium or the office premium is considered. The part of the premium that remains after the percentage for expenses is set aside is employed for arriving at the policy values.

The percentage of the premium, which is set aside for the expenses in the end, will correspond to what total expenses bear to total premiums.

The expenses for which amount is set aside is chiefly calculated as the expenditure during the first year, which is heavy and not likely to be incurred again. This kind of

overall estimation of the expenditure works on the assumption that the proportion of new business to old business in the coming years will be the same as on the date of valuation.

For instance, if the insurance company intends to expand due to which the insurer had been writing a higher proportion of new business in comparison to the old business during valuation. In this case, there is a possibility that after some time the actual proportion of new business to old business is less than that assumed during valuation. Thus when such a situation arises, to arrive at the premium for valuation, it is better to use a lower expense ratio.

Once the percentage set aside for the first year expenses is removed, the extra expenses are to be met through renewal premium income. The expense ratio derived from the renewal premium income is called renewal expenses ratio, which is nothing but the renewal expenses.

It is essential for high priced businesses written by the insurance company that the amount set aside from the office premium to meet expenses is higher than the renewal ratio. However insurers carry out an analysis of the expense and designate it between the 'initial' and 'renewal' cost of business. And according to the premiums of initial and renewal, cost ratio for new business, renewal servicing and claims (renewal cost ratio) are determined.

In this method of valuation there is a considerable margin between the interest and mortality assumptions made during valuation and the actual experience. The mortality rate adopted for valuation is much higher than what would happen in future. With respect to the life fund, the yield earned on the life fund is lower than the rate of interest employed.

A serious fault with this form of valuation is that it overestimates the liability of the insurer, thereby reducing the share of the policy owners (in the form of bonus) from the surplus. It also makes it difficult to ascertain the kind of bonus the fund would support in the coming years.

## **Gross Premium Method for With-Profits Policies**

In the method of valuation we discussed above (gross premium method) a part of the office premium is thrown off to meet expenses. Likewise in a situation of expansion of business a percentage higher than the renewal expense ratio, but lower than the ratio of total expenses to total premiums is suitable. But such a case is not applicable for With-Profit policies and is only for without profit office premiums. This is because the with-profit office premiums in addition to expenses also contain bonus loadings.

Thus in the case of with-profit office premiums a larger percentage has to be thrown off at the time of valuation to meet future bonuses.

This can be better explained with the help of an example. Let us assume that 15% is set aside from a without profits office premium for future expenses. But for a with-



profit policy the insurer will have to set aside at least 20% or more for expenses and bonuses. And this will also depend on the rate at which the future bonuses are to be declared for the policyholders.

## **Retrospective Method of Valuation**

A retrospective method is employed to determine the policy values of all the existing policies. The excess of the existing life fund after meeting the value of all the policies is called valuation surplus. There is a valuation deficit if the life fund falls short of the total policy values.

## **MEASUREMENT OF RISK IN LIFE INSURANCE**

To price a policy as accurately as possible, it is necessary to scientifically estimate the risk involved. The laws of probability facilitate the mathematical estimation of risks.

### **Laws of Probability**

The three laws of probability considered for the measurement of risk in life insurance are:

- The law of certainty: It states that certainty may be expressed as unity or 1.
- The law of simple probability: Going by the possibility that an event may take place, it is represented as a fraction. The values will be between 0 and 1.
- The law of compound probability: Here the possibility is that two separate events will occur as a consequence of the product of two probabilities.

### **Using Probability to make future predictions**

Insurance companies to predict the future performance of the company have successfully used the laws of probability. The predictions can be logically understood by employing two kinds of reasoning:

**Deductive reasoning:** This method is not very applicable when it comes to insurance forecasts. This is because it calls for observation and self-opinion. That is, if we toss a coin, then we can deduce approximately the number of times it was heads and the number of times it was tails. We do not know what causes it, but by means of our observations, we arrive at a conclusion that half the times it is heads.

**Inductive reasoning:** This method is more applicable for insurance forecasts. Here the logic applied is that given the same conditions, an event, which has occurred in the past, will repeat itself. This is applied in life and health insurance. For the purpose of future predictions, certain factors like age during death, possibility of death and survival etc. are computed.

The law of mortality is used for the predictions in case of life insurance. That is to say that in a given group of individuals a certain number will die each year, until a state is reached when all the individuals in that group are dead. It is also known that the death rate or mortality rate would be influenced by the causes at work. But it is not necessary to study all the operating causes before making predictions.

Future prediction is an important consideration in an insurance company. It is essential to get all the inputs correct so as to arrive at the right prediction. For an insurance company, to do well in the business it is very essential that the predictions made regarding the future be in tandem with the actual experience.

For the purpose of accuracy it is very essential that the statistics employed for future predictions are authentic and it is essential that all statistics available be scrutinised. This is because if the right figures are not available then accurate mortality rate cannot be deduced. Furthermore working with the assumption that the mortality experience of the past will repeat in the future can cause serious discrepancies in the predictions.

Another important factor to be considered is the number of units being considered for calculation. More the number of units more accurate the calculations. That is, when the number of units used for the predictions is more, then the chances of large variations between the predictions and the actual experience are greatly reduced. And if a very large sample is used then the probable value and the actual experience coincide. This is also called the law of large numbers.

The law of large numbers has important applications when it comes to predictions based on mortality rates. This is with respect to the statistics used for the purpose of predictions and the population, to, which the predictions will apply. Because only if large numbers are considered will the predictions be right. If the statistics used for the purpose of predictions is not derived from a large sample then its reliability is questionable.

## **SURPLUS AND ITS DISTRIBUTION**

---

In life insurance the word 'surplus' signifies an estimated profit. This is because the calculation of profit in insurance business is slightly different from other businesses. We all know that normally profit is the excess over the cost price of a product. Thus in regular businesses, the difference between the cost price and the selling price decides the profit made or loss incurred.

But it is not the same in the case of an insurance business. Profit in insurance business is a result of margin kept on the basis adopted for the calculation of premium with regard to mortality, expenses, interest and other factors like surrender and lapse. Profits are also made when the actual earning is more than the projected value at the time of premium calculations.



Likewise if the actual experience of the insurer is the same as the projected value at the time of premium calculations then the difference between the liability of the insurer and the life fund is considered as profit achieved on the basis of margin provided while calculating premium.

Going back to a situation when the actual experience is better than the projected, the profit achieved is not only due to the margin kept during valuation of premiums but is also the profit arising as a result of favourable experience up to the time of valuation. This situation may arise when the life fund, which is an accumulation of the excess premiums after settling the claims for that year. As a result of favourable circumstances claims are few, so the expenses are reduced, hence the **outgo** from the company is less.

In an insurance business the actual profit cannot be determined, as the company is to meet future liabilities and has to receive premiums in future. Furthermore the excess of assets that remains after settling current liabilities cannot be termed as 'profit' as it will be required to meet the liabilities in future.

Thus it is very difficult for a life insurance company to declare the profit made at the end of a year. It is possible to declare profits only if the company closes its new business procurement operations, after which it should have met the liabilities to the last policy. After this the funds left with the company can be considered as profit.

## Nature of Surplus

Surplus is accumulated when there is a favourable deviation from the projected value with respect to mortality savings, excess interest and loading savings. That is, when the actual experience overshoots the assumptions made during valuation, which are very conservative estimates.

In life insurance there are five sources of surplus:

**Surplus from investment earnings:** Life insurance policies are long term contracts, thus it becomes essential for the insurance company to maintain a conservative rate of interest, so that there is a steady income as long as the policy is in force. The interest rates are often conservative. For example if the insurance company bases the reserves expecting to earn 4% but actually earns 7% then there is an excess of 3%, which should go to the policyholders.

**Surplus from mortality:** Usually the rate of mortality considered during reserve calculations is much higher than what exists on ground. This is because insurers employ conservative methods thereby retaining a broad margin to meet any eventuality. Usually the projected mortality is higher than the experienced, thus the surplus after settling all mortality claims is considered a gain.

Two factors required for the calculation of mortality surplus are expected death strain and actual death strain.

Death strain =  $(S - V)$ , in this equation  $S$  is the sum insured, and  $V$  is the policy value.

Now if we consider a situation where all the policies are of the age  $x$ , and if  $Q_x$  is the valuation rate of mortality and  $q_x$  is the actual rate of mortality,

$Q_x (S - V)$ , represents the expected death strain; and

$q_x (S - V)$ , represents the actual death strain

Thus mortality surplus is the difference between the expected death strain and the actual death strain.

Mathematically, mortality surplus =  $(Q_x - q_x) (S - V)$

**Surplus from Loading:** If an insurance company has to do well then the gross premium earned by the company should be sufficient to meet not only the regular expenses but any unforeseen expenditure also. Thus loading on policies is inclusive of policyholders' dividend and gains from other sources.

**Surplus from surrenders:** The surplus gain as a result of the difference between the policy reserves released due to surrender and the surrender values permitted is called surrender surplus. This form of surplus also represents the amount that was originally taken from the surplus to replenish the reserves.

In reality, this surplus is on paper i.e. it is the repayment of borrowed surplus, in a situation when the asset share is below the surrender value of the policy. But there is a gain when the assets share is far greater than the surrender value of the policy. These gains are often channelised for expenses incurred while distributing the divisible surplus to the policyholders.

## Distribution of surplus

At the end of a year's business the insurance company determines the surplus accumulated in addition to the surplus carried on from the previous years. After such a calculation, the company decides the percentage of surplus, which has to be retained as contingency fund, and also the percentage that should be distributed to policy owners. The amount set aside for distribution as dividend to policy owners is called **divisible surplus**.

The percentage to be set aside for distribution is decided by the trustees or directors of the insurance company. Once the divisible surplus is decided it is no more a surplus but a liability for the insurer.

There are certain basic norms that an insurance company has to abide with, while determining the divisible surplus. They are as follows:

- **Equity:** The distribution of surplus should be fair and proportionate, that is the policies contributing more to the surplus should be given a better share.



- **Flexibility:** The divisible surplus should be flexible according to the situation.
- **Simplicity:** The method employed in ascertaining the divisible surplus should be simple and uncomplicated for easy understanding by the shareholders. The process should also be transparent.
- **Consistency:** The dividend provided to policyholders should exhibit consistency, for, the sales force and the policyholders do not appreciate wide fluctuations in dividend.

### Different methods for distribution of divisible surplus

- **Contribution Method:** This is also called as fair distribution, but is an impractical method of surplus distribution. According to this method distribution is directly based on the contribution of the policies to the surplus accumulated from basic sources like interest, expenses, mortality etc.
- **Simple Reversionary Method:** In this method the bonus is paid in addition to the sum insured, when the event for which insurance is provided occurs, that is death during the term of the policy, or on maturity of the policy. Therefore it is termed as reversionary. It is a popular method as it allows the insurer to retain the surplus enabling him to earn interests on it. It also gives an incentive to policyholders to maintain their policies. Furthermore it is a very simple procedure.
- **Compound Reversionary Bonus System:** This method is also reversionary as the one discussed above. But the incentives provided to the policyholder by this method are better. In this process the bonus addition of each year is of an increasing nature, and the rate that is given is a percentage of the sum insured and the bonuses added during the maturing years of the policy.
- **Bonus in Cash:** In this method the bonus announced is paid in the form of cash to the policyholders.
- **Bonus in Reduction of Premium:** In this method the bonus is reduced from the premium payable by the policyholders to the company. But after a certain period there will be no premium to reduce from, so the company will have to change its way of distributing surplus. There is another disadvantage of this method; it reduces the profit acquiring capacity of the company due to loss of premium income and due to depletion of funds, as the surplus is distributed as cash.
- **Tontine Bonus:** In this process the bonus is distributed after a specific period to the survivors among the policyholders. To avail this kind of bonus, the policyholder should be alive on the date when the bonus is announced. In this method the distribution of divisible surplus is deferred to a future date, and for the first few years of the policy it is not considered eligible to participate in profit sharing. New entrants favour this method, as it enables them to conserve their resources and also removes the need to distribute surplus in early stages.

- **Interim Bonus:** In this the bonuses are announced on the basis of valuation of all the policies at the date of valuation. If some policies result in claim (in case of death) or maturity before the next valuation then they are not eligible for that bonus, as by then they will not be part of the company records, but an interim bonus according to the previous valuation is provided.
- **Guaranteed Bonus:** This method is applicable for without profit policies, which are not entitled to surplus of actuarial valuation. In this process there is guaranteed addition of bonus at a fixed rate for every year, to the sum assured, as long as the policy is in force.
- **Final Additional Bonus:** This is an extra bonus paid by the company to policyholders apart from the usual annual bonus. This is generally paid to policies lasting for long durations, and due to the contribution made by these policies to the surplus. Considering the period for which the premium under a policy was received the company may decide to pay an additional bonus to the policyholder in case of claim or maturity of the policy. Life Insurance Corporation of India was following this process, provided the policies were in force at the time of claim or maturity, along with prior payment of 15 years premium.

## Frequency of Distribution

In many countries it is a statutory requirement to pay dividend annually, due on all participating policies. However there are certain policies on which dividends are paid only after the passage of the stipulated time like, 5, 10 and 20 years etc. This is called deferred dividend.

Policyholders are not entitled to the annual dividend if they fail to pay the premium within the stipulated time frame. The lost dividend is paid to policyholders who had been regularly paying the premium during the deferred dividend period.

## The Contribution Principle

The contribution principle aims to obtain equity during the distribution of surplus. According to this principle a way of obtaining reasonable equity ***“would be to return to each class of policy owners a share of the divisible surplus proportionate to the contribution of the class to the surplus.”***

### The three-factor contribution method

For proper surplus distribution, the contribution principle is widely used in many countries. This principle is applied practically by contribution method.

Contribution method involves proper assessment of the source of surplus for the insurance company. For simplicity in computation key sources considered as sources of surplus for the insurer are:

- Loading savings
- Excess interests



- Mortality savings
- Additional factors are included to accommodate disability and accidental death.

**After which the dividends are ascertained based on:**

- Plan of insurance
- Duration of policy
- Age of issue

The three-factor contribution method can be mathematically expressed as:

$$D_t = I_t + M_t + E_t$$

In the above equation:

- $D_t$  - dividend per Rs. 1,000 payable at the end of policy year  $t$
- $I_t$  - excess interest factor for policy year  $t$
- $M_t$  - mortality savings factor for policy year  $t$
- $E_t$  - expense savings factor for policy year  $t$

The three factors included in the above equation can be calculated by employing the following formulas:

1.  $I_t = (I'_t - I_t) ( {}_{t-1}V_x + {}_tP_x )$
2.  $M_t = (q_{x+t} - 1 - q_{x+t-1}) (1000 - {}_t^Vx)$
3.  $E_t = ( {}_tG_x - {}_tP_x - {}_te_x ) (1 + I'_t)$

Where:

- $x$  = age of issue
- $I'_t$  = dividend interest rate in policy year  $t$
- $I_t$  = reserve interest rate in policy year  $t$
- ${}_{t-1}V_x$  =  $t$  th policy year's terminal reserve per Rs. 1,000 for a policy issued at age  $x$
- ${}_tP_x$  =  $t$  th policy year's valuation annual premium per Rs. 1,000 for a policy issued at age  $x$
- $q_x$  = reserve mortality rate at age  $x$
- $q'_x$  = dividend mortality rate at age  $x$
- ${}_tG_x$  =  $t$  th policy year's gross annual premium per Rs. 1,000 for a policy issued at age  $x$
- ${}_te_x$  =  $t$  th policy year's expense charge per Rs. 1,000 for a policy issued at age  $x$

**Interest factor:** Interest factor is the excess interest on the initial reserve. The interest rate is a very important factor in the distribution of surplus especially when the initial reserve is very large.

The bases against which the dividend interest rate should be applied is the initial reserve less one half a year's cost of insurance.

The interest factor is a very important component of surplus calculations and becomes very complicated in application owing to the different bases used for determining it.

**Mortality factor:** This is a scale, which represents the decreasing value of the assumed cost of insurance with increasing age. This scale is also representative of the mortality table assumed by the insurer while determining his reserves.

**Loading factor:** Determining expenses are perhaps the most difficult task for an insurer, when it comes to the distribution of surplus. The charge to meet the expenses is usually included in the premium itself. But the percentage for the expenses is gradually reduced after the first few years when the expenditure is high.

However, insurers have different methods for ascertaining the gross premium and the expense. Thus the loading factor will vary from insurer to insurer according to the method employed. The loading factor is higher for insurer charging high gross premiums, while it is lower for those with lower gross premiums. The general trend is to have a high loading factor for the first few years, after which it either increases a little or remains unchanged.

## Special forms of surplus distribution

Sometimes insurance companies pay extra dividends or terminal dividend in addition to the annual payable dividends. This payment can be made to the policyholder as a lump sum once the policy has been in force for a long time or can be paid periodically. This serves as a substitute when initial dividend payments have not been made and reduces the stress caused due to initial expenses of paying dividends.

There is another dividend called terminal dividend, which is payable on termination of policy on the grounds of maturity, death or surrender, provided the policy had been in force for a stipulated period. This dividend is a way to return to the policyholder, his contribution to the surplus. Insurers to make the policy look more attractive use terminal dividend, this is done when high terminal dividends are quoted at the duration required for the purpose of cost index calculations.

Post mortem dividend is another special form of surplus distribution. It is payable on death. It is paid in proportion to the part of the policy year of death for which the premium has already been paid. It can also be paid as a one-time distribution of surplus.



## RISKS UNDERTAKEN WHILE PROVIDING INSURANCE COVERS

---

Insurers face various kinds of risks while providing the necessary cover to the customers. There are different types of risks faced by insurers; they are financial and actuarial in nature.

### Actuarial Risks

Risks are broadly categorised into four under actuarial risks. A body called the Society of Actuaries' Committee did this categorisation. They are as follows:

- Asset risk – C1
- Pricing risk – C2
- Interest rate risk – C3
- Miscellaneous risks – C4

### Asset Risk

The asset risk is called as Asset Depreciation (C1) risk. This involves the various factors that cause the value of an asset to fall.

Capital funds are directly affected by a decline in assets value. If the assets value fall, then there is a decline in the capital funds, while the liability values remain unchanged. As a result of leverage the impact of fall in asset value is felt on the capital. This can be better explained by using the following example: Lets assume that the capital available with an insurer is 20% of the total assets. Now, if there is a fall in the value of the assets he holds, say by 10%, then the fall in capital as a result of this 10% decline will be 50%. Thus it becomes evident that the effect of fall in assets value has a far more severe effect on the capital.

Some of the factors that cause a decline in the value of assets:

- When the insurer lends his funds and the borrower fails to fulfill his obligations towards the company.
- There is a fall in the market value of the insurer's investment assets, unless the change is due to interest rate movements.
- Default on part of the borrower in payment of principal.

Asset quality also poses risks for the insurer. If the assets are of poor quality then it will deter the insurer from paying the policyholder be it claims or dividends.

Two ways to counter assets risk are vigilant management by means of:

- Credit analysis
- Investment analysis

## Pricing Risk

This is also called as the Pricing Inadequacy (C2) risk. This is the risk caused due to inadequate pricing of product. The risk arises, as the future operating results are not as anticipated while pricing the product. Thus the price is inadequate for meeting future liabilities. Therefore, due to inadequate pricing of product liabilities increase. When the liabilities rise beyond the assets available, it causes insolvency.

We know that inadequate pricing causes an increase in liability, which in turn has an adverse effect on the capital. Management of pricing risk is not as easy as management of assets risk, as assets market values are easily available, but it is not so in this case.

As premiums and investment calculations of an insurance company are based on assumptions, and if the assumptions made by the insurer are inadequate then he will not be able to meet his liabilities, like payments to policyholders.

Inadequate pricing is the result of occurrence of events at rates higher than anticipated relating to the following:

- Mortality
- Morbidity
- Lapse or expenses
- Lower investment income
- Lower sales
- Increased costs to be met while providing health care as required under the policy.

## Interest Rate Risk

This type of actuarial risk is also called as interest rate (C3) risk. The alteration in the values of assets and liabilities due to interest rate movement is included in C3 category only. It is not included under C1 and C2. Here interest rate movements negatively affect the assets and liability values.

The values of assets and liabilities will depend on whether the interest rate is increasing or decreasing.

If the interest rate is on the rise then the values of assets and liabilities will decrease under normal circumstances. Now for instance if due to rise in interest rates, the fall in the value of assets exceeds that of liabilities, then it will cause a fall in the capital also.

Furthermore, increase in interest rates can cause a liquidity crisis. This is because increased interest rates will make policyholder (more than anticipated) to employ their



policy surrender and loan options, which will require forcible sale of assets at low prices, to meet obligations.

The opposite occurs in case of falling interest rates; that is value of assets and liabilities increases with a decrease in rates. Due to falling interest rates, there is a tendency for the liabilities to grow faster than the assets, which thereby depletes the capital.

In this situation more policy owners (more than anticipated) tend to add funds to their existing contracts, which calls for purchase of more assets at increased prices.

It therefore becomes clear that due to asset-liability variance the insurer is faced with a situation, where he lacks liquidity. Moreover, even if the assets exceed the liabilities, the cash assets available may be insufficient to meet the cash liabilities of the insurer. Fluctuating interest rates have a profound effect on the balance sheet of an insurance company. If the fluctuations severely affect assets than the liabilities then the company may face insolvency.

The risks faced by the insurer can be summarised as follows:

- Loss incurred on bond calls and mortgage prepayments as a result of fall in interest rates.
- Losses incurred due to liability-asset mismatches.
- Increased withdrawals by policyholders due to increase in interest rates.
- Fall in assets value due to an increase in the rate of interest.
- Loss incurred due to sales of assets by the insurer to meet obligations caused as a result of rise in interest rates.

### **Miscellaneous Risk**

This kind of risk faced by the insurer is also called as miscellaneous C4 risks. This risk as the name signifies includes all the risks that are not included under C1, C2 and C3. It includes all other risks that are social, political, legal and technological in nature.

This is the kind of risk faced by the insurer, which he cannot anticipate or provide for. It can be controlled only through efficient management.

The risk commonly faced by insurance companies under this category are due to:

- Tax claims
- Regulatory changes
- Product obsolescence
- Policyholders losing faith in the insurance company
- Liability incurred due to misconduct of employees or agents
- Market risk caused due to expansion of business in new areas

- Market risk arising due to geographical expansion of business
- Improper management
- Lawsuits
- Runs on assets for fear of insolvency

## Underlying Principles

Large amounts are accumulated as a result of fixed level premium or flexible premium on life insurance policies. These sums are held by the company and are simultaneously invested to produce income. This added income makes insurance companies to charge lower premiums from policyholders.

Thus it is clear that interests are a key in all computations involved in actuarial valuations. So it becomes necessary to delve in detail into the different aspects of interests.

Some of the terms commonly used in interest computations are:

1. **Principal:** It is the initial amount or the amount invested. It is denoted by **A**
2. **Accumulated Amount:** This is the sum that is accumulated by the end of a stipulated time period. It is represented by **S**
3. **Interest Rate:** It is the rate charged on the principal. It is denoted by **i**
4. **Interest Amount:** It is the difference between the accumulated amount (**S**) and the principal (**A**) at the end of a stipulated time frame.
5. **Time or the compounding years:** This is the time for which the interest is calculated on the principal (**A**) for a set rate (**i**). This is represented as (**n**)
6. Interest amount: (**I**)

From this we can arrive at various formulas for computation purposes.

Accumulated amount  $S = (A + I)$

Interest  $I = A i$

From the above we can derive,  $S = A + A i$

This can also be written as,  $S = A (1 + i)$ ; this equation states that the amount to which the principal will grow in one year at a particular rate of interest is equivalent to the product of the principal amount and the sum of 1 and the rate of interest.

There are two types on interests:

- **Simple Interest:** When the interest is paid only on the initial principal amount; then it is called simple interest.



- **Compound Interest:** In cases, where the interest earned on the principal amount is not distributed, but is also left intact to earn more interest is called compound interest.

### Functions of Compound Interest

Compound Interest functions are used for the computation of interest in insurance. We will be discussing the four basic compound interest functions employed in insurance calculations. They are:

**1. Accumulated value of 1:** In one year the principal amount will grow to a certain amount depending on the rate of interest. This can be expressed as  $S_1 = A(1 + i)$

Likewise if this sum were to be invested for another year then:

$$S_2 \text{ (accumulated sum for second year)} = S_1 + iS_1$$

$$= S_1(1 + i)$$

$$= A(1 + i)^2, \text{ since } S_1 = A(1 + i)$$

By applying the above method accumulated value of (A), that is the amount of interest, at end of many years can be represented as:

$S = A(1+i)^n$ , where n is the number of years. This equation can be used to project a future value of the interest tables show value for principal of 1, similarly the value of  $(1+i)^n$  can be found in the interest table and multiplied by the principal amount.

**2. Accumulated value of 1 per year:** In all kinds of businesses, to gain a certain amount of money at the end of a stipulated period, a certain amount has to be invested initially. The initial investment amount or the principal is called the *present value*.

Now to derive the present value mathematically, we use the equation  $S = A(1+i)^n$

To determine the principal or the present value, we need to divide the S that is the amount by

$$(1+i)^n$$

While we need to divide both the sides of the above equation by  $(1+i)^n$  to determine the expression for  $A = S/(1+i)^n$

Thus,

$$S/(1+i)^n = S[1/(1+i)^n]$$

On substituting v for  $[1/(1+i)]$  we get,

$$V^n = [1/(1+i)^n]$$

Interest tables with the value of  $V^n$  are available; this value is referred to as the present value 1. In this method multiplication is done to arrive at the future value.

**3. Accumulated value of 1 per year:** If an investment of Re. 1 is made in the beginning of every year for three years, to determine the accumulated amount at the end of three years it is sufficient to add the amounts to which each of the payments will grow into.

For instance, Re. 1 will grow to an amount of  $(1+i)^3$

Similarly after the second payment the amount will become  $(1+i)^2$

And the after the third payment of Re. 1 the amount will become  $(1+i)$ ;

Thus at the end of three years the total sum accumulated will be:

$$S_n = (1+i) + (1+i)^2 + (1+i)^3$$

Where n is the number of years at the end of which the total amount is accumulated is to be calculated.

**4. Present Value of Re.1 per year:** This is to determine the principal or present value that has to be invested so as to provide equal annual installments for n number of years.

The present value of each payment is summed to arrive at the total present value of payments.

For instance, if the present value of Re. 1 payable at the end of each year has to be calculated then considering  $V^1$ ,  $V^2$ ,  $V^3$  as the present value of the first, second and third payments respectively, the total present value can be determined by using the following equation:

$$A_3 = V^1 + V^2 + V^3$$

**Annuities:** An annuity is a series of payments or receipts. So a series of payments amounts to a series of receipts for the recipient. In this case the policyholder makes a series of payments at regular interval and the recipient is the insurance company.

When an annuity payment is regular and certain then it is called **annuities certain**. But if the annuity payment is contingent that is depending on whether the person is dead or alive is called life annuities. Such an annuity is meant for a few years, but terminating on the individuals death is called temporary **life annuities**. And the life annuity, which continues payment till either or both individuals are alive, is called joint and survivor annuity.

### Assumptions Underlying Rate Calculations

While computing the interest rate, insurance companies have several factors to consider. An insurer cannot neglect any one factor, as it will influence the calculations and thereby change the result.

Some of the factors that need to be borne in mind by the insurer while computing the interest rate:



- When is the premium paid? (Annually, semi annually, etc.)
- What is the duration for which the premium has to be paid? (Number of years)
- How will mortality rates be determined?
- What will become of the money from the time it is received till it is paid back to the policyholder?

Factors that are mandatory for the computations of interest rate on premium of a life insurance are as follows:

- Age of the assured
- Sex of the assured
- Mortality table to be used for that particular customer
- Rate of interest
- Sum set aside to cover the expenses incurred by the insurer, to meet contingencies and a margin for profit
- Benefits to be provided under the policy

Customers according to their convenience and the product they have purchased pay premiums differently. They can be paid as:

- It can be paid as a lumpsum, once the contract comes into force for the entire period for which the policy is providing cover. This is called single premium.
- It can be paid throughout the existence of the policy on a regular basis.

Thus it is evident that if it is a single premium policy the assured has to pay the premium at one go before the inception of risk. But in case of an annual level policy the assured has to make a payment on the date of issue of the policy after which he has to make regular payments annually on the anniversary of the issue date.

When the situation is as above then during valuation the insurer makes two assumptions. They are:

- a) That premiums be paid in the beginning of the year
- b) Claims will be settled at the end of the year

## Summary

- This chapter deals with actuarial valuation. The different methods used for valuation by insurance companies, like:
- Prospective method of valuation
- Retrospective method of valuation
- Net premium method of valuation
- Gross premium method of valuation
- Modified net premium method of valuation
- Gross premium method for with-profit policies
- The use of probability to forecast the future experience of the insurance company.
- The different kind of risks that an insurance company faces- assets risk, pricing risk, interest rate risk and miscellaneous risk.
- With the surplus that is accumulated after valuation and the methods employed for distributing it.
- Contribution principle which helps in the distribution of the accumulated surplus.



## Discussion Questions

1. Discuss the concept of 'fair distribution of surplus' with reference to the basic norms that a life insurance company has to abide by while determining the divisible surplus.

## Short Questions

1. What is meant by actuarial valuation?
2. Why is it necessary for a life insurance company to conduct an actuarial valuation?
3. What is 'surplus' in the life insurance context?
4. State the different methods of distribution of surplus.
5. Distinguish between surplus and profit in life insurance business.

## Multiple-choice questions

1. The process of valuation in a life insurance company is taken up by
  - a) An actuary
  - b) A chartered accountant
  - c) A financial analyst
  - d) A surveyor

### Ans. (a)

2. Valuation in life insurance means:
  - a) The process of arriving at the profit of a life insurance company.
  - b) The process by which the value of all the existing policies is ascertained in a life insurance company.
  - c) The process of determining the net premium for a life insurance policy.
  - d) The process of arriving at the 'bonus' in a life insurance company.

### Ans. (b)

3. The mathematical estimation of the risks involved in life insurance is based on:
- a) The laws of probability
  - b) The laws of gravity
  - c) Parkinson's law
  - d) Millers law of insurance

**Ans. (a)**

4. What is actuarial risk?
- a) It is the risk that actuaries are exposed to.
  - b) It is another expression for market risk.
  - c) It is the same as legal risk.
  - d) It is the risk that arises from an insurer developing funds vis-à-vis the issuance of insurance policies and other liabilities.

**Ans. (d)**

5. Pricing risk means:
- a) Risk arising out of pricing an insurance product too high.
  - b) The risk caused due to inadequate pricing of products.
  - c) Risk arising out of interest rate movements.
  - d) The risk of becoming insolvent.

**Ans. (b)**