CHAPTER 1

INTRODUCTION TO INSURANCE

Chapter Introduction

This chapter aims to introduce the basics of insurance, trace its evolution and how it works. You will also learn how insurance provides protection against economic losses arising as a result of unforeseen events and serves as an instrument of risk transfer.

Learning Outcomes

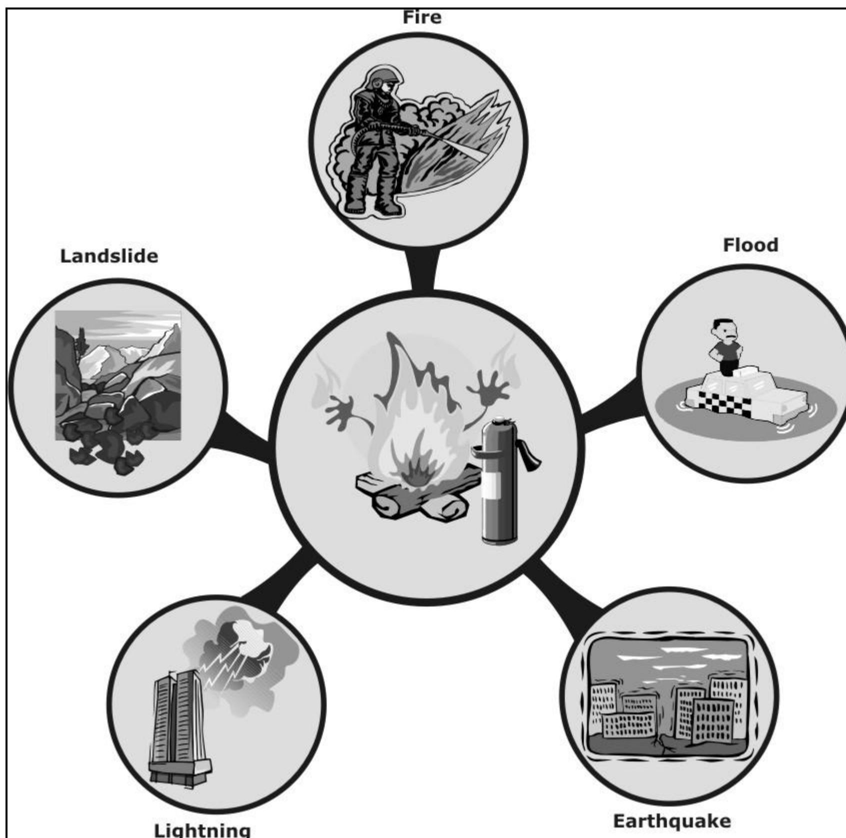
A. Life insurance – History and evolution
B. How insurance works
C. Risk management techniques
D. Insurance as a tool for managing risk
E. Role of insurance in society

A. Life insurance - History and evolution

We live in a world of uncertainty. We hear about:

- ✓ trains colliding;
- ✓ floods destroying entire communities;
- ✓ earthquakes that bring grief;
- ✓ young people dying suddenly pre-maturely

Diagram 1: Events happening around us



Why do these events make us anxious and afraid?

The reason is simple.

i. Firstly these **events are unpredictable.** If we can anticipate and predict an event, we can prepare for it.

ii. Secondly, such unpredictable and untoward events are often a **cause of economic loss and grief.**

A community can come to the aid of individuals who are affected by such events, by having a system of sharing and mutual support.

The idea of insurance took birth thousands of years ago. Yet, the business of insurance, as we know it today, goes back to just two or three centuries.

1. History of insurance

Insurance has been known to exist in some form or other since 3000 BC. Various civilisations, over the years, have practiced the concept of pooling and sharing among themselves, all the losses suffered by some members of the community. Let us take a look at some of the ways in which this concept was applied.

2. Insurance through the ages

Babylonian Traders	The **Babylonian traders** had agreements where they would pay additional sums to lenders, as a price for writing off of their loans, in case a shipment was lost or stolen. These were called 'bottomry loans'. Under these agreements, the loan taken against the security of the ship or its goods had to be repaid only if and when the ship arrived safely, after the voyage, at its destination.
Traders from Baruch and Surat	Practices similar to Babylonian traders were prevalent among **traders from Baruch and Surat,** sailing in Indian ships to Sri Lanka, Egypt and Greece.
Greeks	The **Greeks** had started benevolent societies in the late 7th century AD, to take care of the funeral – and families – of members who died. The **Friendly Societies of England** were similarly constituted.
Inhabitants of Rhodes	The **inhabitants of Rhodes** adopted a practice whereby, if some goods were lost due to jettisoning[1] during distress, the owners of goods (even those who lost nothing) would bear the losses in some proportion.
Chinese Traders	**Chinese traders** in ancient days would keep their goods in different boats or ships sailing over the treacherous rivers. They assumed that even if any of the boats suffered such a fate, the loss of goods would be only partial and not total. The loss could be distributed and thereby reduced.

3. Modern concepts of insurance

In India the principle of life insurance was reflected in the institution of the joint-family system in India, which was one of the best forms of life insurance down the ages. Sorrows and losses were shared by various family members in

[1]Jettisoning means throwing away some of the cargo to reduce weight of the ship and restore balance

the event of the unfortunate demise of a member, as a result of which each member of the family continued to feel secure.

The break-up of the joint family system and emergence of the nuclear family in the modern era, coupled with the stress of daily life has made it necessary to evolve alternative systems for security. This highlights the importance of life insurance to an individual.

i. **Lloyds**: The origins of modern commercial insurance business as practiced today can be traced to Lloyd's Coffee House in London. Traders, who used to gather there, would agree to share the losses, to their goods being carried by ships, due to perils of the sea. Such losses used to occur because of maritime perils, such as pirates robbing on the high seas, or bad sea weather spoiling the goods or sinking of the ship due to perils of the sea.
ii. **Amicable Society for a Perpetual Assurance** founded in 1706 in London is considered to be the first life insurance company in the world.

4. History of insurance in India

a) **India**: Modern insurance in India began in early 1800 or thereabouts, with agencies of foreign insurers starting marine insurance business.

The Oriental Life Insurance Co. Ltd	The first life insurance company to be set up in India was an English company
Triton Insurance Co. Ltd.	The first non-life insurer to be established in India
Bombay Mutual Assurance Society Ltd.	The first Indian insurance company. It was formed in 1870 in Mumbai
National Insurance Company Ltd.	The oldest insurance company in India. It was founded in 1906 and it is still in business.

Many other Indian companies were set up subsequently as a result of the Swadeshi movement at the turn of the century.

Important

In 1912, the **Life Insurance Companies Act** and the **Provident Fund Act** were passed to regulate the insurance business. The Life Insurance Companies Act, 1912 made it compulsory that premium-rate tables and periodical valuation of companies be certified by an actuary. However, the disparity and discrimination between Indian and foreign companies continued.
The **Insurance Act 1938** was the first legislation enacted to regulate the conduct of insurance companies in India. This Act, as amended from time to time continues to be in force.The Controller of Insurance was appointed by the Government under the provisions of the Insurance Act.

b) **Nationalisation of life insurance**: Life insurance business was nationalised on 1st September 1956 and the **Life Insurance Corporation of India (LIC)** was formed. There were 170 companies and 75 provident fund societies doing life insurance business in India at that time. From 1956 to 1999, the LIC held exclusive rights to do life insurance business in India.

c) **Nationalisation of non-life insurance**: With the enactment of General Insurance Business Nationalisation Act (GIBNA) in 1972, the non-life insurance business was also nationalised and the **General Insurance Corporation of India (GIC) and its four subsidiaries** were set up. At that point of time, 106 insurers in India doing non-life insurance business were amalgamated with the formation of four subsidiaries of the GIC of India.

d) **Malhotra Committee and IRDA**: In 1993, the Malhotra Committee was setup to explore and recommend changes for development of the industry including the reintroduction of an element of competition. The Committee submitted its report in 1994.In 1997 the Insurance Regulatory Authority (IRA) was established. The passing of the Insurance Regulatory& Development Act, 1999(IRDA) led to the formation of **Insurance Regulatory and Development Authority (IRDA)** in April 2000 as a statutory regulatory body both for life and non-life insurance industry.

5. Life insurance industry today

Currently, there are 24 life insurance companies operating in India as detailed hereunder:

a) Life Insurance Corporation (LIC) of India is a public sector company

b) There are 23 life insurance companies in the private sector

c) The postal department, under the Government of India, also transacts life insurance business via Postal Life Insurance, but is exempt from the purview of the regulator

Test Yourself 1

Which among the following is the regulator for the insurance industry in India?

I. Insurance Authority of India
II. Insurance Regulatory and Development Authority
III. Life Insurance Corporation of India
IV. General Insurance Corporation of India

B. How insurance works

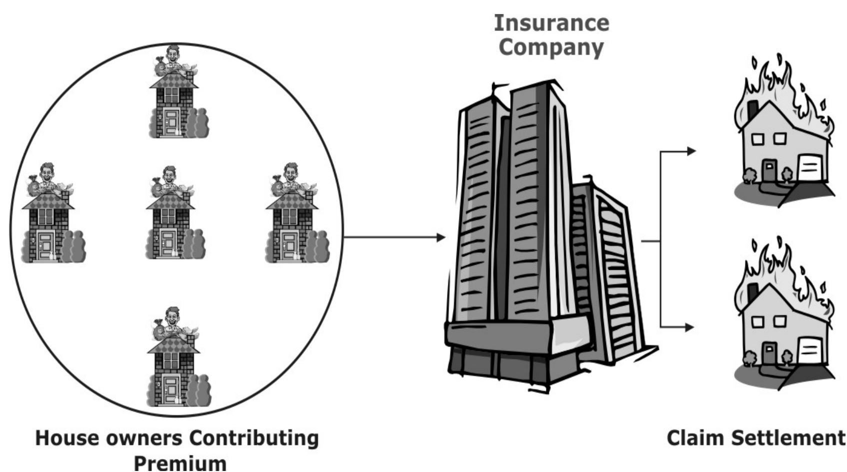
Modern commerce was founded on the principle of ownership of property. When an asset loses value (by loss or destruction) due to a certain event, the owner of the asset suffers an economic loss. However if a common fund is created, which is made up of small contributions from many such owners of similar assets, this amount could be used to compensate the loss suffered by the unfortunate few.

In simple words, the chance of suffering a certain economic loss and its consequence could be transferred from one individual to many through the mechanism of insurance.

Definition

Insurance may thus be considered as a process by which the losses of a few, who are unfortunate to suffer such losses, are shared amongst those exposed to similar uncertain events / situations.

Diagram 2: How insurance works



There is however a catch here.

i. Would people agree to part with their hard earned money, to create such a common fund?

ii. How could they trust that their contributions are actually being used for the desired purpose?

iii. How would they know if they are paying too much or too little?

Obviously someone has to initiate and organise the process and bring members of the community together for this purpose. That 'someone' is known as an 'Insurer' who determines the contribution that each individual must make to the pool and arranges to pay to those who suffer the loss.

The insurer must also win the trust of the individuals and the community.

1. How insurance works

a) Firstly, these must be an asset which has an economic value. The **ASSET**:
   i. May be **physical** (like a car or a building) or
   ii. May be **non-physical** (like name and goodwill) or
   iii. May be **personal** (like one's eyes, limbs and other aspects of one's body)

b) The asset may lose its value if a certain event happens. This chance of loss is called as **risk**. The cause of the risk event is known as **peril.**

c) There is a principle known as **pooling**. This consists of collecting numerous individual contributions (known as premiums) from various persons. These persons have similar assets which are exposed to similar risks.

d) This pool of funds is used to compensate the few who might suffer the losses as caused by a **peril.**

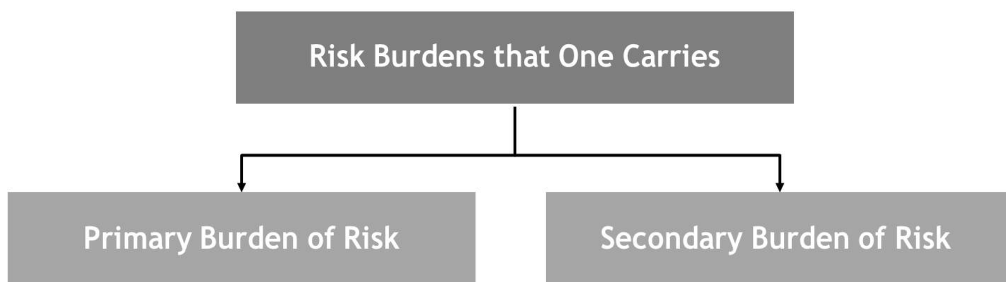
e) This process of pooling funds and compensating the unlucky few is carried out through an institution known as the **insurer.**

f) The insurer enters into an insurance **contract** with each person who seeks to participate in the scheme. Such a participant is known as **insured.**

2. Insurance reduces burdens

Burden of risk refers to the costs, losses and disabilities one has to bear as a result of being exposed to a given loss situation/event.

Diagram 3: Risk burdens that one carries



There are two types of risk burdens that one carries – **primary and secondary.**

a) Primary burden of risk

The **primary burden of risk** consists of losses that are actually suffered by households (and business units), as a result of pure risk events. These losses are often direct and measurable and can be easily compensated for by insurance.

Example

When a factory gets destroyed by fire, the actual value of goods damaged or destroyed can be estimated and the compensation can be paid to the one who suffers such loss.

If an individual undergoes a heart surgery, the medical cost of the same is known and compensated.

In addition there may be some indirect losses.

Example

A fire may interrupt business operations and lead to loss of profits which also can be estimated and the compensation can be paid to the one who suffers such a loss.

b) Secondary burden of risk

Suppose no such event occurs and there is no loss. Does it mean that those who are exposed to the peril carry no burden? The answer is that apart from the primary burden, one also carries a secondary burden of risk.

The **secondary burden of risk** consists of costs and strains that one has to bear merely from the fact that one is exposed to a loss situation. Even if the said event does not occur, these burdens have still to be borne.

Let us understand some of these burdens:

i. Firstly there is **physical and mental strain caused by fear and anxiety**. The anxiety may vary from person to person but it is present and can cause stress and affect a person's wellbeing.

ii. Secondly when one is **uncertain about whether a loss would occur or not**, the prudent thing to do would be to set aside a reserve fund to meet such an eventuality. There is a cost involved in keeping such a fund. For instance, such funds may be held in a liquid form and yield low returns.

By transferring the risk to an insurer, it becomes possible to enjoy peace of mind, invest funds that would otherwise have been set aside as a reserve, and plan one's business more effectively. It is precisely for these reasons that insurance is needed.

Test Yourself 2

Which among the following is a secondary burden of risk?

I. Business interruption cost
II. Goods damaged cost
III. Setting aside reserves as a provision for meeting potential losses in the future
IV. Hospitalisation costs as a result of heart attack

C. Risk management techniques

Another question one may ask is whether insurance is the right solution to all kinds of risk situations. The answer is 'No'.

Insurance is only one of the methods by which individuals may seek to manage their risks. Here they transfer the risks they face to an insurance company. However there are some other methods of dealing with risks, which are explained below:

1. Risk avoidance

Controlling risk by avoiding a loss situation is known as risk avoidance. Thus one may try to avoid any property, person or activity with which an exposure may be associated.

Example

i. One may refuse to bear certain manufacturing risks by contracting out the manufacturing to someone else.

ii. One may not venture outside the house for fear of meeting with an accident or may not travel at all for fear of falling ill when abroad.

But risk avoidance is a negative way to handle risk. Individual and social advancements come from activities that need some risks to be taken. By avoiding such activities, individuals and society would lose the benefits that such risk taking activities can provide.

2. Risk retention

One tries to manage the impact of risk and decides to bear the risk and its effects by oneself. This is known as self-insurance.

Example

A business house may decide, based on experience about its capacity to bear small losses up to a certain limit, to retain the risk with itself.

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3. Risk reduction and control

This is a more practical and relevant approach than risk avoidance. It means taking steps to lower the chance of occurrence of a loss and/or to reduce severity of its impact if such loss should occur.

Important

The measures to reduce chance of occurrence are known as '**Loss Prevention**'. The measures to reduce degree of loss are called '**Loss Reduction**'.

Risk reduction involves reducing the frequency and/or sizes of losses through one or more of:

a) **Education and training**, such as holding regular "fire drills" for employees, or ensuring adequate training of drivers, forklift operators, wearing of helmets and seat belts and so on.

   One example of this can be educating school going children to avoid junk food.

b) **Making Environmental changes**, such as improving "physical" conditions, e.g. better locks on doors, bars or shutters on windows, installing burglar or fire alarms or extinguishers. The State can take measures to curb pollution and noise levels to improve the health status of its people. Regular spraying of Malaria medicine helps in prevention of outbreak of the disease.

c) **Changes made in dangerous or hazardous operations,** while using machinery and equipment or in the performance of other tasks

   For example leading a healthy lifestyle and eating properly at the right time helps in reducing the incidence of falling ill.

d) **Separation**, spreading out various items of property into varied locations rather than concentrating them at one location, is a method to control risks. The idea is, if a mishap were to occur in one location, its impact could be reduced by not keeping everything at that one place.

For instance one could reduce the loss of inventory by storing it in different warehouses. Even if one of these were to be destroyed, the impact would be reduced considerably.

4. Risk financing

This refers to the provision of funds to meet losses that may occur.

a) **Risk retention through self-financing** involves self-payment for any losses as they occur. In this process the firm assumes and finances its own risk, either through its own or borrowed funds, this is known as **self-insurance**. The firm may also engage in various risk reduction methods to make the loss impact small enough to be retained by the firm.

b) **Risk transfer** is an alternative to risk retention. Risk transfer involves transferring the responsibility for losses to another party. Here the losses that may arise as a result of a fortuitous event (or peril) are transferred to another entity.

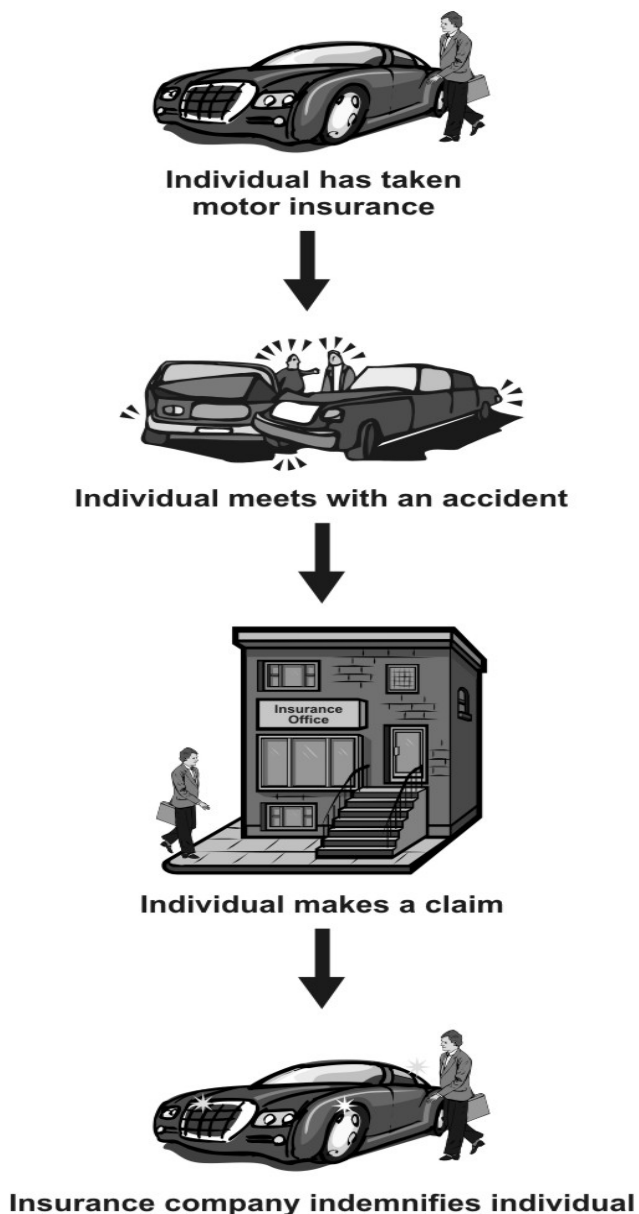
Insurance is one of the major forms of risk transfer, and it permits uncertainty to be replaced by certainty through insurance indemnity.

Insurance vs Assurance

Both insurance and assurance are financial products offered by companies operating commercially. Of late the distinction between the two has increasingly become blurred and the two are taken as somewhat similar. However there are subtle differences between the two as discussed hereunder.

Insurance refers to protection against an event that **might** happen whereas assurance refers to protection against an event that **will** happen. Insurance provides cover against a risk while assurance covers an event that is definite e.g death, which is certain, only the time of occurrence is uncertain. Assurance policies are associated with life cover.

Diagram 4: How insurance indemnifies the insured



There are other ways to transfer risk. For example when a firm is part of a group, the risk may be transferred to the parent group which would then finance the losses.

Thus, insurance is only one of the methods of risk transfer.

Test Yourself 3

Which among the following is a method of risk transfer?

I. Bank FD
II. Insurance
III. Equity shares
IV. Real estate

D. Insurance as a tool for managing risk

When we speak about a risk, we are not referring to a loss that has actually been suffered but a loss that is likely to occur. It is thus an expected loss. The cost of this expected loss (which is the same as the cost of the risk) is the product of two factors:

i. The **probability** that the peril being insured against may happen, leading to the loss

ii. The **impact** or the amount of loss that may be suffered as a result

The cost of risk would increase in direct proportion with both probability and amount of loss. However, if the amount of loss is very high, and the probability of its occurrence is small, the cost of the risk would be low.

Diagram 5: Considerations before opting for insurance

1. Considerations before opting for Insurance

When deciding whether to insure or not, one needs to weigh the cost of transferring the risk against the cost of bearing the loss, that may arise, oneself. The cost of transferring the risk is the insurance premium – it is given by two factors mentioned in the previous paragraph. The best situations for insurance would be where the probability is very low but the loss impact could be very high. In such instances, the cost of transferring the risk through its insurance (the premium) would be much lower while the cost of bearing it on oneself would be very high.

a) **Don't risk a lot for a little**: A reasonable relationship must be there between the cost of transferring the risk and the value derived.

Example

Would it make sense to insure an ordinary ball pen?

b) **Don't risk more than you can afford to lose**: If the loss that can arise as a result of an event is so large that it can lead to a situation that is near bankruptcy, retention of the risk would not appear to be realistic and appropriate.

Example

What would happen if a large oil refinery were to be destroyed or damaged? Could a company afford to bear the loss?

c) **Consider the likely outcomes of the risk carefully**: It is best to insure those assets for which the probability of occurrence (frequency) of a loss is low but the possible severity (impact), is high.

Example

Could one afford to not insure a space satellite?

Test Yourself 4

Which among the following scenarios warrants insurance?

I. The sole bread winner of a family might die untimely
II. A person may lose his wallet
III. Stock prices may fall drastically
IV. A house may lose value due to natural wear and tear

E. Role of insurance in society

Insurance companies play an important role in a country's economic development. They are contributing in a significant sense to ensuring that the wealth of the country is protected and preserved. Some of their contributions are given below.

a) Their investments benefit the society at large. An insurance company's strength lies in the fact that huge amounts are collected and pooled together in the form of premiums.

b) These funds are collected and held for the benefit of the policyholders. Insurance companies are required to keep this aspect in mind and make all their decisions in dealing with these funds so as tobe in ways that benefit the community. This applies also to its investments. That is why successful insurance companies would not be found investing in speculative ventures i.e. stocks and shares.

c) The system of insurance provides numerous direct and indirect benefits to the individual, his family, to industry and commerce and to the community and the nation as a whole. The insured - both individuals and enterprises - are directly benefitted because they are protected from the consequences of the loss that may be caused by an accident or fortuitous event. Insurance, thus, in a sense protects the capital in industry and releases the capital for further expansion and development of business and industry.

d) Insurance removes the fear, worry and anxiety associated with one's future and thus encourages free investment of capital in business enterprises and promotes efficient use of existing resources. Thus insurance encourages commercial and industrial development along with generation of employment opportunities, thereby contributing to a healthy economy and increased national productivity.

e) A bank or financial institution may not advance loans on property unless it is insured against loss or damage by insurable perils. Most of them insist on assigning the policy as collateral security.

f) Before acceptance of a risk, insurers arrange survey and inspection of the property to be insured, by qualified engineers and other experts. They not only assesses the risk for rating purposes but also suggest and recommend to the insured, various improvements in the risk, which will attract lower rates of premium.

g) Insurance ranks with export trade, shipping and banking services as an earner of foreign exchange to the country. Indian insurers operate in more than 30 countries. These operations earn foreign exchange and represent invisible exports.

h) Insurers are closely associated with several agencies and institutions engaged in fire loss prevention, cargo loss prevention, industrial safety and road safety.

Information

Insurance and Social Security

a) It is now recognised that provision of social security is an obligation of the State. Various laws, passed by the State for this purpose involve use of insurance, compulsory or voluntary, as a tool of social security. Central and State Governments contribute premiums under certain social security schemes thus fulfilling their social commitments. The Employees State Insurance Act, 1948 provides for **Employees State Insurance Corporation** to pay for the expenses of sickness, disablement, maternity and death for the benefit of industrial employees and their families, who are insured persons. The scheme operates in certain industrial areas as notified by the Government.

b) Insurers play an important role in social security schemes sponsored by the Government. The **Crop Insurance Scheme (RKBY)** is a measure with considerable social significance. The scheme benefits not only the insured farmers but also the community directly and indirectly.

c) All the **rural insurance schemes**, operated on a commercial basis, are designed ultimately to provide social security to the rural families.

d) Apart from this support to Government schemes, the insurance industry itself offers on a commercial basis, insurance covers which have the ultimate objective of social security. Examples are: **Janata Personal Accident, Jan Arogya** etc.

Test Yourself 5

Which of the below insurance scheme is run by an insurer and not sponsored by the Government?

I. Employees State Insurance Corporation
II. Crop Insurance Scheme
III. Jan Arogya
IV. All of the above

Summary

- Insurance is risk transfer through risk pooling.

- The origin of commercial insurance business as practiced today is traced to the Lloyd's Coffee House in London.

- An insurance arrangement involves the following entities like:

✓ Asset,
✓ Risk,
✓ Peril,
✓ Contract,
✓ Insurer and
✓ Insured

- When persons having similar assets exposed to similar risks contribute into a common pool of funds it is known as pooling.

- Apart from insurance, other risk management techniques include:

✓ Risk avoidance,
✓ Risk control,
✓ Risk retention,
✓ Risk financing and
✓ Risk transfer

- The thumb rules of insurance are:

✓ Don't risk more than you can afford to lose,
✓ Consider the likely outcomes of the risk carefully and
✓ Don't risk a lot for a little

Key Terms

1. Risk
2. Pooling
3. Asset
4. Burden of risk
5. Risk avoidance
6. Risk control
7. Risk retention
8. Risk financing
9. Risk transfer

Answers to Test Yourself

Answer 1

The correct option is II.

Insurance Regulatory and Development Authority is the regulator for the insurance industry in India.

Answer 2

The correct option is III.

The need for setting aside reserves as a provision for potential losses in the future is a secondary burden of risk.

Answer 3

The correct option is II.

Insurance is a method of risk transfer.

Answer 4

The correct option is I.

The bread winner of a family might die untimely leaving the entire family to fend for itself, such a scenario warrants purchasing of life insurance.

Answer 5

The correct option is III.

The Jan Arogya insurance scheme is run by an insurer and not sponsored by the Government.

Self-Examination Questions

Question 1

Risk transfer through risk pooling is called ________.

I. Savings
II. Investments
III. Insurance
IV. Risk mitigation

Question 2

The measures to reduce chances of occurrence of risk are known as _____.

I. Risk retention
II. Loss prevention
III. Risk transfer
IV. Risk avoidance

Question 3

By transferring risk to insurer, it becomes possible ___________.

I. To become careless about our assets
II. To make money from insurance in the event of a loss
III. To ignore the potential risks facing our assets
IV. To enjoy peace of mind and plan one's business more effectively

Question 4

Origins of modern insurance business can be traced to __________.

I. Bottomry
II. Lloyds
III. Rhodes
IV. Malhotra Committee

Question 5

In insurance context 'risk retention' indicates a situation where _____.

I. Possibility of loss or damage is not there
II. Loss producing event has no value
III. Property is covered by insurance
IV. One decides to bear the risk and its effects

Question 6

Which of the following statement is true?

I. Insurance protects the asset
II. Insurance prevents its loss
III. Insurance reduces possibilities of loss
IV. Insurance pays when there is loss of asset

Question 7

Out of 400 houses, each valued at Rs. 20,000, on an average 4 houses get burnt every year resulting in a combined loss of Rs. 80,000. What should be the annual contribution of each house owner to make good this loss?

I. Rs.100/-
II. Rs.200/-
III. Rs.80/-
IV. Rs.400/-

Question 8

Which of the following statements is true?

I. Insurance is a method of sharing the losses of a 'few' by 'many'
II. Insurance is a method of transferring the risk of an individual to another individual
III. Insurance is a method of sharing the losses of a 'many' by a few
IV. Insurance is a method of transferring the gains of a few to the many

Question 9

Why do insurers arrange for survey and inspection of the property before acceptance of a risk?

I. To assess the risk for rating purposes
II. To find out how the insured purchased the property
III. To find out whether other insurers have also inspected the property
IV. To find out whether neighbouring property also can be insured

Question 10

Which of the below option best describes the process of insurance?

I. Sharing the losses of many by a few
II. Sharing the losses of few by many
III. One sharing the losses of few
IV. Sharing of losses through subsidy

Answers to Self-Examination Questions

Answer 1

The correct option is III.

Risk transfer through risk pooling is called insurance.

Answer 2

The correct option is II.

The measures to reduce chances of occurrence of risk are known as loss prevention measures.

Answer 3

The correct option is IV.

By transferring risk to insurer, it becomes possible to enjoy peace of mind and plan one's business more effectively.

Answer 4

The correct option is II.

Origins of modern insurance business can be traced to Lloyd's.

Answer 5

The correct option is IV.

In the insurance context 'risk retention' indicates a situation where one decides to bear the risk and its effects.

Answer 6

The correct option is IV.

Insurance pays when there is loss of asset.

Answer 7

The correct option is II.

Rs. 200 per household should cover the loss.

Answer 8

The correct option is I.

Insurance is a method of sharing the losses of a 'few' by 'many'.

Answer 9

The correct option is I.

Before acceptance of a risk, insurers arrange survey and inspection of the property to assess the risk for rating purposes.

Answer 10

The correct option is II.

Insurance may be considered as a process by which the losses of a few, who are unfortunate to suffer such losses, are shared amongst those exposed to similar uncertain events / situations.

CHAPTER 2

WHAT LIFE INSURANCE INVOLVES

Chapter Introduction

Insurance involves four aspects

- ✓ An asset
- ✓ The risk insured against
- ✓ The principle of pooling
- ✓ The contract

Let us now examine the features of life insurance. This chapter will take a brief look at the various components of life insurance mentioned above.

Learning Outcomes

A. Life insurance business –Components, human life value, mutuality

A. Life insurance business - Components

1. The Asset – Human Life Value(HLV)

We have already seen that an asset is a kind of property that yields value or a return. For most kinds of property the value is measured in precise monetary terms. Similarly the amount of loss of value can also be measured.

Example

When a car meets with an accident, the amount of damage can be estimated to be Rs. 50,000.The insurer will compensate the owner for this loss.

How do we estimate the amount of loss when a person dies?

Is he worth Rs. 50,000 or Rs. 5,00,000?

The above question has to be answered by an agent whenever he or she meets a customer. Based on this the agent can determine how much insurance to recommend to the customer. It is in fact the first lesson a life insurance agent must learn.

Luckily we have a measure, developed almost seventy years ago by Prof. Hubener. The measure, known as **Human Life Value (HLV)** is used worldwide.

The HLV concept considers human life as a kind of property or asset that earns an income. It thus measures the value of human life based on an individual's expected net future earnings. Net earnings means income a person expects to earn each year in the future, less the amount he would spend on self. It thus indicates the economic loss a family would suffer if the wage earner were to die prematurely. These earnings are capitalised, using an appropriate interest rate to discount them.

There is a simple thumb rule or way to measure HLV. **This is to divide the annual income a family would like to have, even if the bread earner was no longer alive, with the rate of interest that can be earned.**

Example

Mr. Rajan earns Rs. 1,20,000 a year and spends Rs. 24,000 on himself.

The net earnings his family would lose, were he to die prematurely, would be Rs. 96,000 per year.

Suppose the rate of interest is 8% (expressed as 0.08).

HLV = 96000 / 0.08 = Rs. 12,00,000

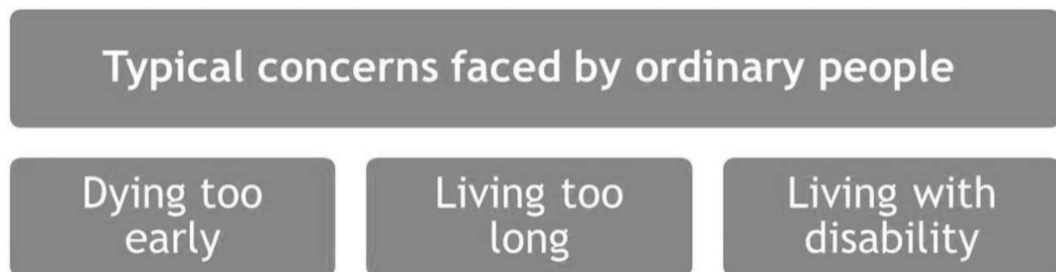
HLV helps to determine how much insurance one should have for full protection. It also tells us the upper limit beyond which life insurance would be speculative.

In general, we can say that amount of insurance should be around 10 to 15 times one's annual income. In the above example, one should grow suspicious if Mr. Rajan was to ask insurance of Rs. 2 crores, while earning only Rs. 1.2 lakhs a year. The actual amount of insurance purchased would of course depend on factors like how much insurance one can afford and would like to buy.

2. The Risk

As we have seen above, life insurance provides protection against those risk events that can destroy or diminish the value of human life as an asset. There are three kinds of situations where such loss can occur. They are typical concerns which ordinary people face.

Diagram 1: Typical concerns faced by ordinary people



General insurance on the other hand typically deals with those risks that affect property – like fire, loss of cargo while at sea, theft and burglary and motor accidents. They also cover events that can result in loss of name and goodwill. These are covered by a class of insurance called liability insurance.

Finally there are risks that can affect the person. Termed as personal risks, these may also be covered by general insurance.

Example

Accident insurance which protects against losses suffered due to an accident.

a) How exactly does life insurance differ from general insurance?

General Insurance	Life Insurance
Indemnity: General insurance policies, with the exception of Personal Accident Insurance, are usually contracts of indemnity	Life insurance policies are contracts of assurance. Indemnity means that after the occurrence of an event like fire, the insurer can assess the exact amount of loss that has occurred and pays compensation only to the amount of loss – no more, no less. This is not possible in life insurance. The amount of benefit to be paid in the event of death has to be fixed at the beginning itself, at the time of writing the contract. Life insurance policies are thus often known as **life assurance contracts.** An assured sum is paid to the nominees or beneficiaries of the insured when he dies.
Uncertainty: In general insurance contracts, the risk event protected against is uncertain. No one can say with certainty whether a house would be gutted by fire or whether a car would meet an accident.	In the case of life insurance, there is no question whether the event death would occur or not. Death is certain once a person is born. **What is uncertain is the time of death**. Life insurance thus provides protection against the risk of premature death.
Increase in probability: In general insurance, in case of perils like fire or earthquake, the probability of the happening of the event does not increase with time.	In case of life insurance the probability of death increases with age.

b) Nature of life insurance risk

Since mortality is related to age it means lower premiums are charged for those who are young and higher premiums for older people. One result was that individuals who were old but otherwise in good health, tended to withdraw while unhealthy members remained in the scheme. Insurance companies faced serious problems as a result. They sought to develop contracts whose premiums could be afforded and hence paid by individuals throughout their life. This led to the development of level premiums.

Level premiums

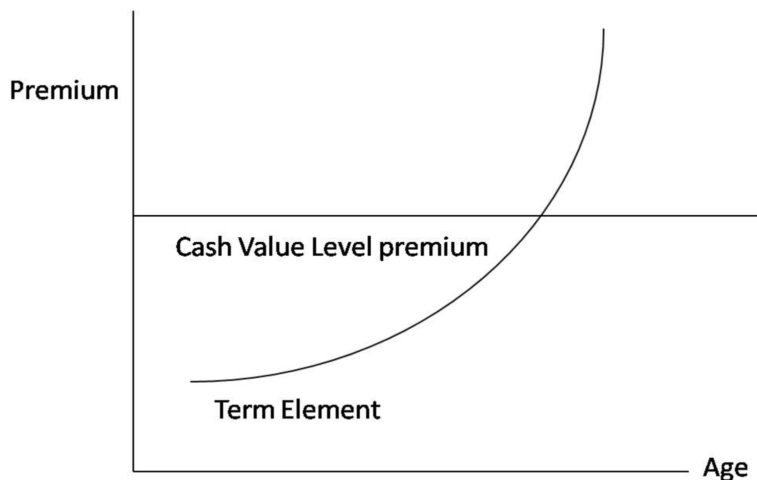
Important

The level premium is a premium fixed such that it does not increase with age but remains constant throughout the contract period.

This means that premiums collected in early years would be more than the amount needed to cover death claims of those dying at these ages, while premiums collected in later years would be less than what is needed to meet claims of those dying at the higher ages. The level premium is an average of both. This means that the excess premiums of earlier ages compensate for the deficit of premiums in later ages.

The level premium feature is illustrated below.

Diagram 2: Level Premium



Level premiums also mean, life insurance contracts are typically long term insurance contracts that run for 10, 20 or many more years. On the other hand general insurance is typically short term and expires every year.

Important

Premiums collected in early years of the contract are held in trust by the insurance company for the benefit of its policyholders. The amount so collected is called a "Reserve". An insurance company keeps this reserve to meet the future obligations of the insurer. The excess amount also creates a fund known as the "Life Fund". Life insurers invest this fund and earn an interest.

The level premium has two components.

i. The first is known as the **term or protection component**, consisting of that portion of premium actually needed to pay the cost of the risk.

ii. The second is known as the **cash value element**. It is made up of accumulated excess payments of the policyholder. It constitutes the savings component.

This means that almost all life insurance policies contain a mix of protection and savings. The more the cash value element in the premium, the more it is considered as a savings oriented insurance policy.

1. The Principle of Risk Pooling

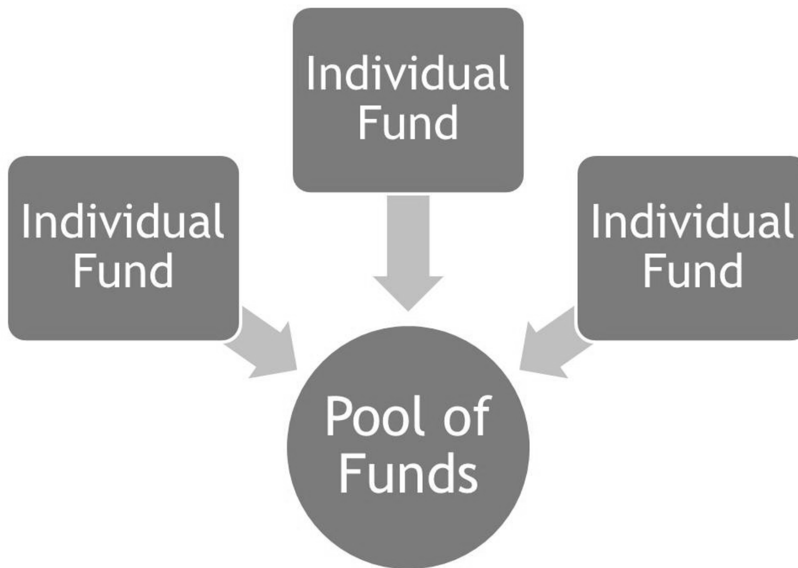
Life insurance companies have been classified as contractual financial institutions. This means that the benefits payable to policyholders have often taken the form of contractual guarantees. Life insurance and pensions have traditionally been purchased, above all things, for the sense of financial security they provide. This security arises as a result of the way the contracts are structured and certain safeguards are built to ensure that insurers are in a position to pay. The structure arises from the application of the mutuality or pooling principle.

Mutuality is one of the important ways to reduce risk in financial markets, the other being **diversification**. The two are fundamentally different.

Diversification	Mutuality
Under diversification the funds are spread out among various assets (placing the eggs in different baskets).	Under mutuality or pooling, the funds of various individuals are combined (placing all eggs in one basket).
Under diversification we have funds flowing from one source to many destinations	Under mutuality we have funds flow from many sources to one

Diagram 3: Mutuality

Mutuality (Funds flow from many sources to one)



Mutuality or the pooling principle plays two specific kinds of roles in life insurance.

i. The first is its role in **providing protection against the economic loss arising as a result of one's untimely death**. This loss is shouldered and addressed through having a fund that pools the contributions of many who have entered into the life insurance contract.

ii. The principle of risk pooling however goes beyond mortality risk. It can involve the **pooling and evening out of financial risk** as well. This is achieved by pooling the premiums, the funds and consequently the attendant risks of various kinds of contracts taken by individuals at different points of time. It is thus a case of pooling among different generations of policyholders. The outcome of this pooling is to try and ensure that in good as well as bad times the life insurer is able to pay a uniform rate of return (a uniform bonus) through smoothing out the returns across time.

2. The Life Insurance Contract

Diagram 4: Life insurance contract

The final aspect of life insurance is the contract. Its significance comes from the term sum assured. This amount is contractually guaranteed, making life insurance a **vehicle of financial security**. The element of guarantee also implies that life insurance is subject to stringent regulation and strict supervision.

Life insurers are required to maintain statutory reserves as a condition for writing the business. They may have stipulations governing investment of their funds, they have to ensure that their premiums are adequate and they may be subject to rules governing how they can spend policyholders' money.

A key question, often debated is whether the benefits provided to policyholders are adequate, compared to other financial instruments. Life insurance contracts, we must remember, involve both risk cover and a savings element. This makes it a financial product like other products in the financial market. Life insurance in fact has been less a protection product and more a way of holding wealth.

It is necessary to make a distinction here between pure term insurance, which provides only a death benefit and savings plans which have a large cash value or savings component. While the former has a low premium, the latter can be quite large and form a significant part of an individual's savings. This also means that the cash value has a large opportunity cost. The term 'opportunity cost' refers to the cost that one has to bear in terms of opportunities one forgoes by not placing one's money elsewhere.

In fact one of the major challenges facing conventional life insurance savings contracts came as a result of an argument termed as "Buy Term and invest the difference elsewhere". Essentially it was argued that one would be better off buying only term insurance from an insurance company and investing the balance premiums in instruments that could yield a high return.

It would be relevant to consider here the arguments that have been advanced for and against traditional cash value insurance contracts.

The advantages

a) It has historically proved to be a **safe and secure investment**. Its cash values guarantee a minimum rate of return, which may increase with contract duration.

b) Regularity of premium payments calls for compulsory planning of one's savings and provides the **discipline** that **savers require.**

c) Insurer takes care of investment management and **frees** the **individual** of this responsibility

d) It **provides liquidity**. The insured can take a loan on or surrender the policy and thus convert it into cash.

e) Both cash value type life insurance and annuities may enjoy some **income tax advantages.**

f) It may be **safe from creditors' claims**, generally in the event of the insured's bankruptcy or death.

Disadvantages

a) As an instrument with relatively stable returns it is subjected to the corroding effect of inflation on all fixed income investments.

b) The high marketing and other initial costs of life insurance policies, reduces the amount of money accumulated in earlier years.

c) The yield, while guaranteed, may be less than that on other financial market instruments. Lower yield is the result of a trade-off, which also reduces the risk.

Test Yourself 1

How does diversification reduce risks in financial markets?

I. Collecting funds from multiple sources and investing them in one place
II. Investing funds across various asset classes
III. Maintaining time difference between investments
IV. Investing in safe assets

Summary

- Asset is a kind of property that yields value or a return.

- The HLV concept considers human life as a kind of property or asset that earns an income. It thus measures the value of human life based on an individual's expected net future earnings.

- The level premium is a premium fixed such that it does not increase with age but remains constant throughout the contract period.

- Mutuality is one of the important ways to reduce risk in financial markets, the other being diversification.

- The element of guarantee in a life insurance contract implies that life insurance is subject to stringent regulation and strict supervision.

Key Terms

1. Asset
2. Human Life Value
3. Level premium
4. Mutuality
5. Diversification

Answers to Test Yourself

Answer 1

The correct answer is II.

Diversification aims to reduce risks in financial markets by spreading investments across various asset classes.

Self-Examination Questions

Question 1

Which of the below is not an element of the life insurance business?

I. Asset
II. Risk
III. Principle of mutuality
IV. Subsidy

Question 2

Who devised the concept of HLV?

I. Dr. Martin Luther King
II. Warren Buffet
III. Prof. Hubener
IV. George Soros

Question 3

Which of the below mentioned insurance plans has the least or no amount of savings element?

I. Term insurance plan
II. Endowment plan
III. Whole life plan
IV. Money back plan

Question 4

Which among the following cannot be termed as an asset?

I. Car
II. Human Life
III. Air
IV. House

Question 5

Which of the below cannot be categorised under risks?

I. Dying too young
II. Dying too early
III. Natural wear and tear
IV. Living with disability

Question 6

Which of the below statement is true?

I. Life insurance policies are contracts of indemnity while general insurance policies are contracts of assurance
II. Life insurance policies are contracts of assurance while general insurance policies are contracts of indemnity
III. In case of general insurance the risk event protected against is certain
IV. The certainty of risk event in case of general insurance increases with time

Question 7

Which among the following methods is a traditional method that can help determine the insurance needed by an individual?

I. Human Economic Value
II. Life Term Proposition
III. Human Life Value
IV. Future Life Value

Question 8

Which of the below is the most appropriate explanation for the fact that young people are charged lesser life insurance premium as compared to old people?

I. Young people are mostly dependant
II. Old people can afford to pay more
III. Mortality is related to age
IV. Mortality is inversely related to age

Question 9

Which of the below is not an advantage of cash value insurance contracts?

I. Safe and secure investment
II. Inculcates saving discipline
III. Lower yields
IV. Income tax advantages

Question 10

Which of the below is an advantage of cash value insurance contracts?

I. Returns subject to corroding effect of inflation
II. Low accumulation in earlier years
III. Lower yields
IV. Secure investment

Answers to Self-Examination Questions

Answer 1

The correct option is IV.

The elements of life insurance business include asset, risk, principle of mutuality and the life insurance contract.
Subsidy is not an element of life insurance business.

Answer 2

The correct option is III.

Prof. Hubener devised the concept of Human Life Value (HLV).

Answer 3

The correct option is I.

Term insurance does not have a savings element associated with it.

Answer 4

The correct option is III.

Air cannot be termed / categorised as an asset.

Answer 5

The correct option is III.

Natural wear and tear is a phenomenon and not a risk.

Answer 6

The correct option is II.

Life insurance policies are contracts of assurance while general insurance policies are contracts of indemnity.

Answer 7

The correct option is III.

Human Life Value is a method to calculate the amount of insurance needed by an individual.

Answer 8

The correct option is III.

Mortality is related to age and hence young people who are less likely to die are charged lower premiums as compared to old people.

Answer 9

The correct option is III.

Lower yield is one of the disadvantages of cash value insurance contracts.

Answer 10

The correct option is IV.

Secure investment is one of the advantages of cash value insurance contracts.

CHAPTER 3

LEGAL PRINCIPLES OF LIFE INSURANCE

Chapter Introduction

In this chapter, we discuss the elements that govern the working of a life insurance contract. The chapter also deals with the special features of a life insurance contract.

Learning Outcomes

A. Insurance contracts – Legal aspects and special features

A. Insurance contracts - Legal aspects

1. The insurance contract

Insurance involves a contractual agreement in which the insurer agrees to provide financial protection against certain specified risks for a price or consideration known as the premium. The contractual agreement takes the form of an insurance policy.

2. Legal aspects of an insurance contract

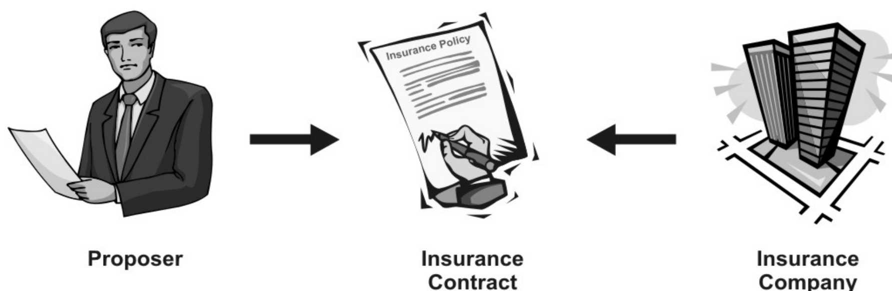
We will now look at some features of an insurance contract and then consider the legal principles that govern insurance contracts in general.

Important

A contract is an agreement between parties, enforceable at law. The provisions of the Indian Contract Act, 1872 govern all contracts in India, including insurance contracts.

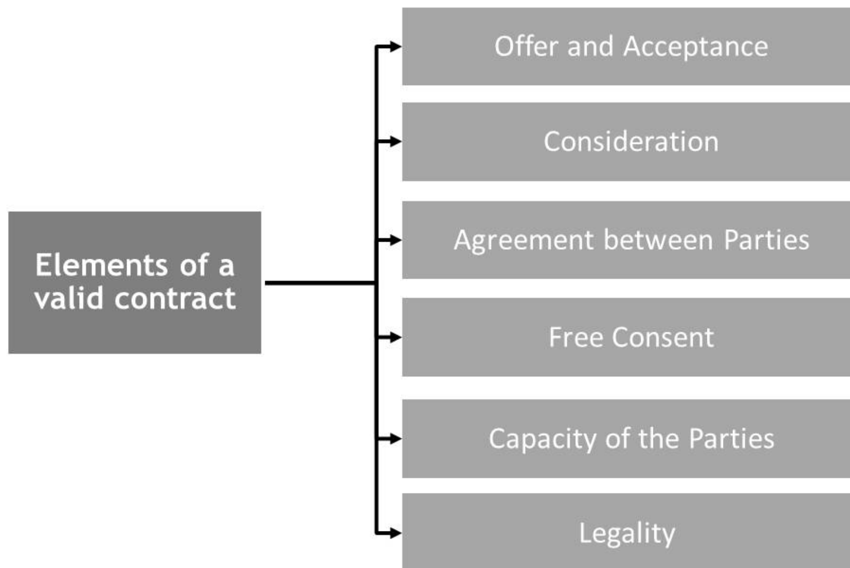
An insurance policy is a contract entered into between two parties, viz., the company, called the **insurer**, and the policy holder, called the **insured** and fulfils the requirements enshrined in the Indian Contract Act, 1872.

Diagram 1: Insurance contract



3. Elements of a valid contract

Diagram 2: Elements of a valid contract



The elements of a valid contract are:

a) Offer and acceptance

When one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of the other to such act, he is said to make an offer or proposal. Usually, the offer is made by the proposer, and acceptance made by the insurer.

When a person to whom the offer is made signifies his assent thereto, this is deemed to be an acceptance. Hence, when a proposal is accepted, it becomes a promise.

The acceptance needs to be communicated to the proposer which results in the formation of a contract.

When a proposer accepts the terms of the insurance plan and signifies his assent by paying the deposit amount, which, on acceptance of the proposal, gets converted to the first premium, the proposal becomes a policy.

If any condition is put, it becomes a counter offer.

The policy bond becomes the evidence of the contract.

b) Consideration

This means that the contract must contain some mutual benefit for the parties. The premium is the consideration from the insured, and the promise to indemnify, is the consideration from the insurers.

c) Agreement between the parties

Both the parties should agree to the same thing in the same sense. In other words, there should be "**consensus ad-idem**" between both parties. Both the insurance company and the policyholder must agree on the same thing in the same sense.

d) Free consent

There should be free consent while entering into a contract.

Consent is said to be free when it is not caused by

i. Coercion
ii. Undue influence
iii. Fraud
iv. Misrepresentation
v. Mistake

When consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is voidable.

e) Capacity of the parties

Both the parties to the contract must be legally competent to enter into the contract. The policyholder must have attained the age of majority at the time of signing the proposal and should be of sound mind and not disqualified under law. For example, minors cannot enter into insurance contracts.

f) Legality

The object of the contract must be legal, for example, no insurance can be had for illegal acts. Every agreement of which the object or consideration is unlawful is void. The object of an insurance contract is a lawful object.

Important

i. **Coercion** - Involves pressure applied through criminal means.

ii. **Undue influence** - When a person who is able to dominate the will of another, uses her position to obtain an undue advantage over the other.

iii. **Fraud** - When a person induces another to act on a false belief that is caused by a representation he or she does not believe to be true. It can arise either from deliberate concealment of facts or through misrepresenting them.

iv. **Mistake** - Error in one's knowledge or belief or interpretation of a thing or event. This can lead to an error in understanding and agreement about the subject matter of contract.

Test Yourself 1

Which among the following is an example of coercion?

I. Ramesh signs a contract without having knowledge of the fine print
II. Ramesh threatens to kill Mahesh if he does not sign the contract
III. Ramesh uses his professional standing to get Mahesh to sign a contract
IV. Ramesh provides false information to get Mahesh to sign a contract

B. Insurance contracts – Special features

1. Uberrima Fides or Utmost Good Faith

This is one of the fundamental principles of an insurance contract. Also called uberrimafides, it means that every party to the contract must disclose all material facts relating to the subject matter of insurance.

A distinction may be made between Good Faith and Utmost Good Faith. All commercial contracts in general require that good faith shall be observed in their transaction and there shall be no fraud or deceit when giving information. Apart from this legal duty to observe good faith, the seller is not bound to disclose any information about the subject matter of the contract to the buyer.

The rule observed here is that of **"Caveat Emptor" which means Buyer Beware**. The parties to the contract are expected to examine the subject matter of the contract and so long as one party does not mislead the other and the answers are given truthfully, there is no question of the other party avoiding the contract

Utmost Good Faith: Insurance contracts stand on a different footing. Firstly, the subject matter of the contract is intangible and cannot be easily known through direct observation or experience by the insurer. Again there are many facts, which by their very nature, may be known only to the proposer. The insurer has to often rely entirely on the latter for information.

Hence the proposer has a legal duty to disclose all material information about the subject matter of insurance to the insurers who do not have this information.

Example

David made a proposal for a life insurance policy. At the time of applying for the policy, David was suffering from and under treatment for Diabetes. But David did not disclose this fact to the life insurance company. David was in his thirties, so the life insurance company issued the policy without asking David to undergo a medical test. Few years down the line, David's health deteriorated and he had to be hospitalised. David could not recover and died in the next few days. A claim was raised on the life insurance company.

To the surprise of David's nominee, the life insurance company rejected the claim. In its investigation, the insurance company found out that David was already suffering from diabetes at the time of applying for the policy and this fact was deliberately hidden by David. Hence the insurance contract was declared null and void and the claim was rejected.

Material information is that information which enables the insurers to decide:

- ✓ Whether they will accept the risk?
- ✓ If so, at what rate of premium and subject to what terms and conditions?

This legal duty of utmost good faith arises under common law. The duty applies not only to material facts which the proposer knows, but also extends to material facts which he ought to know.

Example

Following are some examples of material information that the proposer should disclose while making a proposal:

i. **Life Insurance:** own medical history, family history of hereditary illnesses, habits like smoking and drinking, absence from work, age, hobbies, financial information like income details of proposer, pre-existing life insurance policies, occupation etc.
ii. **Fire Insurance:** construction and usage of building, age of the building, nature of goods in premises etc.
iii. **Marine Insurance:** description of goods, method of packing etc.
iv. **Motor Insurance:** description of vehicle, date of purchase, details of driver etc.

Insurance contracts are thus subject to a higher obligation. When it comes to insurance, good faith contracts become utmost good faith contracts.

Definition

The concept of "Uberrima fides" is defined as involving “a positive duty to voluntarily disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not".

If utmost good faith is not observed by either party, the contract may be avoided by the other. This essentially means that no one should be allowed to take advantage of his own wrong especially while entering into a contract of insurance.

It is expected that the insured should not make any misrepresentation regarding any fact that is material for the insurance contract. The insured must disclose all relevant facts. If this obligation did not exist, a person taking insurance might suppress certain facts impacting the risk on the subject matter and receive an undue benefit.

The policyholder is expected to disclose the status of his health, family history, income, occupation etc. truthfully without concealing any material fact so as to enable the underwriter to assess the risk properly. In case of non-disclosure or misrepresentation in the proposal form which may have impacted the underwriting decision of the underwriter, the insurer has a right to cancel the contract.

The law imposes an obligation to disclose all material facts.

Example

An executive is suffering from hypertension and had a mild heart attack recently following which he decides to take a medical policy but does not reveal the same. The insurer is thus duped into accepting the proposal due to misrepresentation of facts by insured.

An individual has a congenital hole in the heart and reveals it in the proposal form. The same is accepted by the insurer and proposer is not informed that pre-existing diseases are not covered for at least 4 years. This is misleading of facts by the insurer.

2. Material facts

Definition

Material fact has been defined as a fact that would affect the judgment of an insurance underwriter in deciding whether to accept the risk and if so, the rate of premium and the terms and conditions.

Whether an undisclosed fact was material or not would depend on the circumstances of the individual case and could be decided ultimately only in a court of law. The insured **has to disclose** facts that affect the risk.

Let us take a look at some of the types of material facts in insurance that one needs to disclose:

a) Facts indicating that the particular risk represents a greater exposure than normal.

Example

Hazardous nature of cargo being carried at sea, past history of illness

b) Existence of past policies taken from all insurers and their present status

c) All questions in the proposal form or application for insurance are considered to be material, as these relate to various aspects of the subject matter of insurance and its exposure to risk. They need to be answered truthfully and be full in all respects.

The following are some scenarios wherein material facts need not be disclosed

Information

Material Facts that need not be disclosed

It is also held that unless there is a specific enquiry by underwriters, the proposer has no obligation to disclose the following facts:

i. **Measures implemented to reduce the risk.**

Example: The presence of a fire extinguisher

ii. **Facts which the insured does not know or is unaware of**

Example: An individual, who suffers from high blood pressure but was unaware about the same at the time of taking the policy, cannot be charged with non-disclosure of this fact.

iii. **Which could be discovered, by reasonable diligence?**

It is not necessary to disclose every minute material fact. The underwriters must be conscious enough to ask for the same if they require further information.

iv. Matters of law

Everybody is supposed to know the law of the land.

Example: Municipal laws about storing of explosives

v. About which insurer appears to be indifferent (or has waived the need for further information)

The insurer cannot later disclaim responsibility on grounds that the answers were incomplete.

When is there a duty to disclose?

In the case of life insurance contracts, the duty to disclose is present throughout the entire period of negotiation until the proposal is accepted and a policy is issued. Once the policy is accepted, there is no further need to disclose any material facts that may come up during the term of the policy.

Example

Mr. Rajan has taken a life insurance policy for a term of fifteen years. Six years after taking the policy, Mr. Rajan has some heart problems and has to undergo some surgery. Mr. Rajan does not need to disclose this fact to the insurer.

However if the policy is in a lapsed condition because of failure to pay the premiums when due and the policy holder seeks to revive the policy contract and bring it back in force, he may, at the time of such revival, have the duty to disclose all facts that are material and relevant, as though it is a new policy.

Breach of Utmost Good Faith

We shall now consider situations which would involve a Breach of Utmost Good Faith. Such breach can arise either through Non-Disclosure or Misrepresentation.

Non-Disclosure: may arise when the insured is silent in general about material facts because the insurer has not raised any specific enquiry. It may also arise through evasive answers to queries raised by the insurer. Often disclosure may be inadvertent (meaning it may be made without one’s knowledge or intention) or because the proposer thought that a fact was not material.

In such a case it is innocent. When a fact is intentionally suppressed it is treated as concealment. In the latter case there is intent to deceive.

Misrepresentation: Any statement made during negotiation of a contract of insurance is called representation. A representation may be a definite statement of fact or a statement of belief, intention or expectation. With

regard to a fact it is expected that the statement must be substantially correct. When it comes to Representations that concern matters of belief or expectation, it is held that these must be made in good faith.

Misrepresentation is of two kinds:

i. **Innocent Misrepresentation** relates to inaccurate statements, which are made without any fraudulent intention.
ii. **Fraudulent Misrepresentation** on the other hand refers to false statements that are made with deliberate intent to deceive the insurer or are made recklessly without due regard for truth.

An insurance contract generally becomes void when there is a clear case of concealment with intent to deceive, or when there is fraudulent misrepresentation.

3. Insurable interest

The existence of 'insurable interest' is an essential ingredient of every insurance contract and is considered as the legal pre-requisite for insurance. Let us see how insurance differs from a gambling or wager agreement.

a) Gambling and insurance

Consider a game of cards, where one either loses or wins. The loss or gain happens only because the person enters the bet. The person who plays the game has no further interest or relationship with the game other than that he might win the game. Betting or, wagering is not legally enforceable in a court of law and thus any contract in pursuance of it will be held to be illegal. In case someone pledges his house if he happens to lose a game of cards, the other party cannot approach the court to ensure its fulfillment.

Now consider a house and the event of it burning down. The individual who insures his house has a legal relationship with the subject matter of insurance – the house. He owns it and is likely to suffer financially, if it is destroyed or damaged. This relationship of ownership exists independent of whether the fire happens or does not happen, and it is the relationship that leads to the loss. The event (fire or theft) will lead to a loss regardless of whether one takes insurance or not.

Unlike a card game, where one could win or lose, a fire can have only one consequence – loss to the owner of the house.

The owner takes insurance to ensure that the loss suffered is compensated for in some way.

The interest that the insured has in his house or his money is termed as insurable interest. The presence of insurable interest makes an insurance contract valid and enforceable under the law.

Example

Mr. Chandrasekhar owns a house for which he has taken a mortgage loan of Rs. 15 lakhs from a bank. Ponder over the below questions:

i. Does he have an insurable interest in the house?
ii. Does the bank have an insurable interest in the house?
iii. What about his neighbour?

Mr. Srinivasan has a family consisting of spouse, two kids and old parents. Ponder over the below questions:

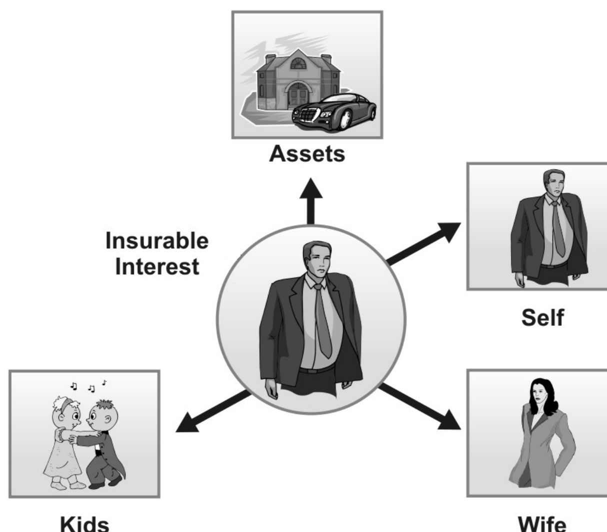
i. Does he have an insurable interest in their well-being?
ii. Does he stand to financially lose if any of them are hospitalised?
iii. What about his neighbour's kids? Would he have an insurable interest in them?

It would be relevant here to make a distinction between the subject matter of insurance and the subject matter of an insurance contract.

Subject matter of insurance relates to property being insured against, which has an intrinsic value of its own.

Subject matter of an insurance contract on the other hand is the insured's financial interest in that property. It is only when the insured has such an interest in the property that he has the legal right to insure. The insurance policy in the strictest sense covers not the property per se, but the insured's financial interest in the property.

Diagram 3: Insurable interest according to common law



b) Time when insurable interest should be present

In life insurance, insurable interest should be present at the time of taking the policy. In general insurance, insurable interest should be present both at the time of taking the policy and at the time of claim with some exceptions like marine policies.

4. Proximate Cause

The last of the legal principles is the principle of proximate cause.

Proximate cause is a key principle of insurance and is concerned with how the loss or damage actually occurred and whether it is indeed as a result of an insured peril. If the loss has been caused by the insured peril, the insurer is liable. If the immediate cause is an insured peril, the insurer is bound to make good the loss, otherwise not.

Under this rule, the insurer looks for the predominant cause which sets into motion the chain of events producing the loss. This may not necessarily be the last event that immediately preceded the loss i.e. it is not necessarily an event which is closest to, or immediately responsible for causing the loss.

Other causes may be classified as remote causes, which are separate from proximate causes. Remote causes may be present but are not effectual in causing an event.

Definition

Proximate cause is defined as the active and efficient cause that sets in motion a chain of events which brings about a result, without the intervention of any force started and working actively from a new and independent source.

How does the principle of proximate cause apply to life insurance contracts? In general, since life insurance provides for payment of a death benefit, regardless of the cause of death, the principle of proximate cause would not apply. However many life insurance contracts also have an accident benefit rider wherein an additional sum assured is payable in the event of accidental death. In such a situation, it becomes necessary to ascertain the cause - whether the death occurred as a result of an accident. The principle of proximate cause would become applicable in such instances.

Contract of Adhesion

Adhesion contracts are those that are drafted by the party having greater bargaining advantage, providing the other party with only the opportunity to adhere to i.e., to accept the contract or reject it.Here the insurance company has all the bargaining power regarding the terms and conditions of the contract.

To neutralise this, a free-look period has been introduced whereby a policyholder, after taking a policy, has the option of cancelling the it, in case of disagreement, within 15 days of receiving the policy document. The company has to be intimated in writing and premium is refunded less expenses and charges.

Test Yourself 2

Which among the following options cannot be insured by Ramesh?

I. Ramesh's house
II. Ramesh's spouse
III. Ramesh's friend
IV. Ramesh's parents

Summary

- Insurance involves a contractual agreement in which the insurer agrees to provide financial protection against specified risks for a price or consideration known as the premium.

- A contract is an agreement between parties, enforceable at law.

- The elements of a valid contract include:

i. Offer and acceptance
ii. Consideration,
iii. Consensus ad-idem,
iv. Free consent
v. Capacity of the parties and
vi. Legality of the object

- The special features of insurance contracts include:

i. Uberrima fides,
ii. Insurable interest,
iii. Proximate cause

Key Terms

1. Offer and acceptance
2. Lawful consideration
3. Consensus ad idem
4. Uberrima fides
5. Material facts
6. Insurable interest
7. Proximate cause

Answers to Test Yourself

Answer 1

The correct option is II.

Ramesh threatening to kill Mahesh if he does not sign the contract is an example of coercion.

Answer 2

The correct option is III.

Ramesh does not have insurable interest in his friend's life and hence cannot insure the same.

Self-Examination Questions

Question 1

Which element of a valid contract deals with premium?

I. Offer and acceptance
II. Consideration
III. Free consent
IV. Capacity of parties to contract

Question 2

______________ relates to inaccurate statements, which are made without any fraudulent intention.

I. Misrepresentation
II. Contribution
III. Offer
IV. Representation

Question 3

_________________ involves pressure applied through criminal means.

I. Fraud
II. Undue influence
III. Coercion
IV. Mistake

Question 4

Which among the following is true regarding life insurance contracts?

I. They are verbal contracts not legally enforceable
II. They are verbal which are legally enforceable
III. They are contracts between two parties (insurer and insured) as per requirements of Indian Contract Act, 1872
IV. They are similar to wager contracts

Question 5

Which of the below is not a valid consideration for a contract?

I. Money
II. Property
III. Bribe
IV. Jewellery

Question 6

Which of the below party is not eligible to enter into a life insurance contract?

I. Business owner
II. Minor
III. House wife
IV. Government employee

Question 7

Which of the below action showcases the principle of "Uberrima Fides"?

I. Lying about known medical conditions on an insurance proposal form
II. Not revealing known material facts on an insurance proposal form
III. Disclosing known material facts on an insurance proposal form
IV. Paying premium on time

Question 8

Which of the below is not correct with regards to insurable interest?

I. Father taking out insurance policy on his son
II. Spouses taking out insurance on one another
III. Friends taking out insurance on one another
IV. Employer taking out insurance on employees

Question 9

When is it essential for insurable interest to be present in case of life insurance?

I. At the time of taking out insurance
II. At the time of claim
III. Insurable interest is not required in case of life insurance
IV. Either at time of policy purchase or at the time of claim

Question 10

Find out the proximate cause for death in the following scenario?

Ajay falls off a horse and breaks his back. He lies there in a pool of water and contracts pneumonia. He is admitted to the hospital and dies because of pneumonia.

I. Pneumonia
II. Broken back
III. Falling off a horse
IV. Surgery

Answers to Self-Examination Questions

Answer 1

The correct option is II.

The element of a valid contract deals with premium is consideration.

Answer 2

The correct option is I.

Misrepresentation relates to inaccurate statements, which are made without any fraudulent intention.

Answer 3

The correct option is III.

Coercion involves pressure applied through criminal means.

Answer 4

The correct option is III.

Life insurance contracts are contracts between two parties (insurer and insured) as per requirements of Indian Contract Act, 1872.

Answer 5

The correct option is III.

Bribe is not a valid consideration for a contract.

Answer 6

The correct option is II.

Minors are not eligible to contract a life insurance contract.

Answer 7

The correct option is III.

Disclosing known material facts on an insurance proposal form is in tune with the principle of "Uberrima Fides".

Answer 8

The correct option is III.

Friends cannot take out insurance on one another as there is no insurable interest present.

Answer 9

The correct option is I.

In case of life insurance insurable interest needs to be present at the time of taking out insurance.

Answer 10

The correct option is III.

Falling off the horse is the proximate cause for Ajay's death.

CHAPTER 4

FINANCIAL PLANNING

Chapter Introduction

In previous chapters we discussed what life insurance involves and its role in providing financial protection. Security is but one of the concerns of individuals who seek to allocate their income and wealth to meet various needs of the present and the future. Life insurance must thus be understood in the wider context of "Personal Financial Planning". The purpose of this chapter is to introduce the subject of financial planning.

Learning Outcomes

A. Financial planning and the individual life cycle
B. Role of financial planning
C. Financial planning - Types

A. Financial planning and the individual life cycle

1. What is financial planning?

Most of us spend a major part of our lives working to make money. Isn't it time we began to consider that money can be put to work for us? Financial planning is a smart way to achieve this objective. Let us examine some definitions:

Definition

i. Financial planning is a process of identifying one's life's goals, translating these identified goals into financial goals and managing one's finances in ways that will help one to achieve those goals.

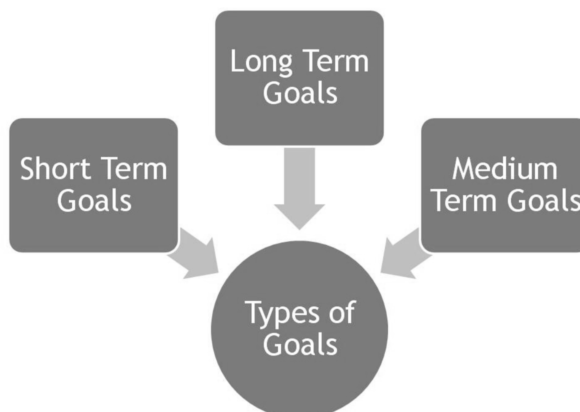
ii. Financial planning is a process through which one can chart a roadmap to meet expected and unforeseen needs in one's life. It involves assessing one's net worth, estimating future financial needs, and working towards meeting those needs through proper management of finances.

iii. Financial planning is taking action to turn one's goals and desires into reality.

iv. Financial planning takes into account one's current and future needs, one's individual risk profile and one's income to chart out a roadmap to meet these anticipated needs.

Financial planning plays a crucial role in building a life with less worry. Careful planning can help you set your priorities and work steadily to achieve your various goals.

Diagram 1: Types of Goals



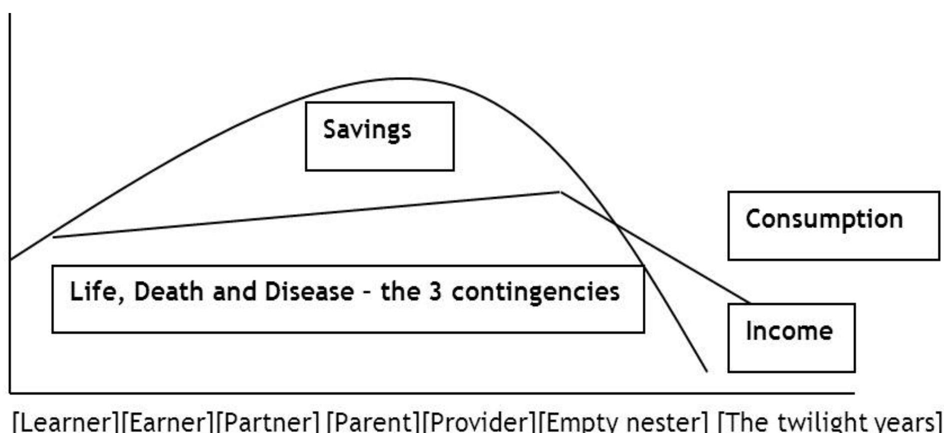
i. These goals may be **short term**: Buying an LCD TV set or a family vacation
ii. They could be **medium term**: Buying a house or a vacation abroad
iii. The **long term** goals may include: Education or marriage of one's child or post retirement provision

2. Individual's life cycle

It was William Shakespeare who said that the world was a stage. From the day a person is born till the day of his / her death, he / she goes through various stages in life, during which he / she is expected to play a series of roles – as learner, earner, partner, parent, as provider, as empty nester and the final retirement years.

These stages are illustrated in the diagram given below.

Diagram 2: The Economic Life Cycle



Life Stages and Prioroties

- **Learner [till say age 20 -25]** : a stage when one is preparing to be a productive citizen through enhancing his or her knowledge and skills. Focus is on raising value of one's human capital. Funds are required for financing one's education , For instance, meeting the high cost of fees for an MBA in a prestiegus management institution.

- **Earner [from 25 onwards]**: the stage when one has found employment and perhaps earns enough to meet his or her needs and has some surplus to spare. The individual at this stage may have family responsibilities and may also engage in safvings and investment towards asset creation with a view to meet the needs

that may arise in the immediate future. For instance, a young man in a Multinational job takes a housing loan and invests in a house.

- **Partner** [on getting marriage at say 28 -30]: this is the stage when one has got married and now has a family of one's own. This stage brings into immediate focus a host of concerns associated with building a family and the liabilities that come in its wake – like having a house of one's own, perhaps a car, consumer durables, planning for children's future etc.

- **Parent** [say 28 to 35] : these are the years when one has become the proud parent of one or more children. These are typcal; years when one has to worry about their health and education - getting them into good schools etc.

- **Provider** [say age 35 to 55] : this is the age when children have grown into teenagers, and includes their crucial high school years and college. One is highly concerned about the high cost of education that is needed today to make the child technically and professionally qualified to face the challenges of life. For insrtance, consider the amount that needs to be set up to finance a medical course that runs for five years. In many Indian homes, the girls also get married by the time they have turned into adults. Provision for marriage and settlement of the girls is one of the most critical areas of concern for Indian families. Indeed, marriage and education of children is the number one motive for savings among most Indian families today.

- **Empty Nester [age 55 to 65] :** the term empty nester implies that the offspring have flown away leaving the nest [the household] empty. This is the period when children have married and sometimes have migrated to other places for work, leaving the parents. Hopefully by this stage, one has liquidated one's liabilities [like housing loan and other mortgages] and has built up a fund for reirement. This is also the period when degenerative ailments like BP and Diabetes begin to manifest and plague one's life. Health care protection becomes paramount as thus the need for financial independence and security of income.

- **Retirement – the twilight years [age 60 and beyond] :** this is the age when one has retired from active work and now draws largely on one's savings to meet the needs of life. Focus here is on addressing living needs till the end of one's life and that of one's spouse. The critical concerns are with health issues, uncertainty

about income and loneliness. This is also the period when one would seek to enhance quality of life and enjoy many of the things that one had dreamt of but could never achieve – like pursuing a hobby or going on a vacation or a pilgrimage. The issue – whether one could age gracefully or in deprivation would depend a great deal on whether one has made adequate provision for these years.

As we can see above, the economic life cycle has three phases.

Student Phase	The first phase is the pre-job phase when one is typically a student. This is a preparatory stage for taking up responsibilities as a productive citizen. The priority is developing one's skillsets and enhancing one's human capital value.
Working Phase	The phase of work begins somewhere between the ages of 18 to 25 or even earlier, and may last for 35 to 40 years. During this period, the individual comes to earn more than he consumes and thus begins to save and invest funds.
Retirement Phase	In the process he accumulates wealth and builds assets which would provide funds for various needs in the future including an income in later years, when one has retired and stopped working.

3. Why does one need to save and purchase various financial assets?

The reason is that each stage in an individual's life, when he or she performs a particular role, brings with it a number of needs for which funds have to be provided.

Example

When a person gets married and starts a family of his own, he may need to have his own house. As children grow older, funds are needed for their higher education. As an individual goes well past middle age, the concern is for having provision to meet health costs and post retirement savings so that one does not need to depend on one's children and become a burden. Living with independence and dignity becomes important.

Savings may be considered as a composite of two decisions.

i. **Postponement of consumption:** an allocation of resources between present and future consumption

ii. **Parting with liquidity** (or ready purchasing power) in exchange for less liquid assets. For instance, purchase of a life insurance policy implies exchanging money for a contract which is less liquid.

Financial planning includes both kinds of decisions. One needs to plan in order to save for the future and also must invest wisely in assets which are appropriate for meeting the various needs that will arise in future.

To understand the needs and appropriate assets, it would be relevant to look more closely at the stages of one's life as are illustrated below

Important

Life Stages

Childhood stage	When one is a student or learner
Young unmarried stage	When one has begun to earn a livelihood but is single
Young married stage	When one has become a partner or spouse
Married with young children stage	When one has become a parent
Married with older children stage	When one has become a provider who has to take care of education and other needs of children who are growing older
Post family/Pre-retirement stage	When the children may have become independent and left the house, just as birds leaving an empty nest behind
Retirement stage	When one passes through the twilight years of one's life. One could live with dignity if one has saved and made sufficient provisions for the needs that arise at this stage or one may be destitute and dependent on another's charity if one has not made such provision

4. Individual needs

If we look at the above life cycle, we would see that three types of needs can arise. These give rise to three types of financial products.

a) Enabling future transactions

The first set of needs arise from funds that are needed to meet a range of anticipated expenditures that are expected to arise at different stages of the life cycle. There are two types of such needs:

i. **Specific transaction needs**: Linked to specific life events which require a commitment of resources. For instance making a provision for higher education / marriage of dependents; or purchase of a house or consumer durables

ii. **General transaction needs:** Amounts set aside from current consumption without being earmarked for any specific purposes – these are popularly termed as 'future provisions'

b) Meeting contingencies

Contingencies are unforeseen life events that may call for a large commitment of funds which are not met from current income and hence needing to be pre-funded. Some of these events, like death and disability or unemployment, lead to a loss of income. Others, like a fire, may result in a loss of wealth. Such needs may be addressed through insurance, if the probability of their occurrence is low but cost impact is high. Alternatively one may need to set aside a large amount of liquid assets as a reserve as provision for such contingencies.

c) Wealth accumulation

All savings and investments indeed lead to creation of some wealth. When we speak of the accumulation motive it refers to an individual's desire to invest primarily with the motive of taking advantage and reap benefits from favourable market opportunities. In other words savings and investments are primarily driven by a desire to accumulate wealth.

This motive has also been termed as the speculative motive because an individual is willing to take some risks while investing, with a view to earn a higher return. Higher return is desired because it enables to multiply one's wealth or net worth more rapidly. Wealth is desired because it is linked with independence, enterprise, power and influence.

5. Financial products

Corresponding to the above sets of needs there are three types of products in the financial market:

Transactional products	Bank deposits and other savings instruments that enable one to have adequate purchasing power (liquidity) at the right time and quantum.
Contingency products like insurance	These provide protection against large losses that may be suffered in the event of sudden unforeseen events.
Wealth accumulation products	Shares and high yielding bonds or real estate are examples of such products. Here the investment is made with a view to committing money for making more money.

An individual would typically have a mix of all of the above needs and thus may need to have all three types of products. In a nutshell one may say there is:

i. A need to save – For cash requirements
ii. A need to insure – Against uncertainties
iii. A need to invest – For wealth creation

6. Risk profile and investments

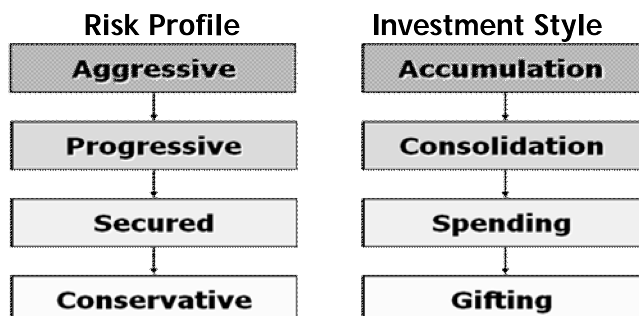
It would also be seen that as an individual moves through various stages in the life cycle, from young earner towards middle ages and then towards the final years of one's work life, the risk profile, or the approach towards taking risks also undergoes a change.

When one is young, one has a lot of years to look forward to and one may tend to be quite aggressive and willing to take risks in order to accumulate as much wealth as possible. As the years pass however, one may become more prudent and careful about investing, the purpose now being to secure and consolidate one's investments.

Finally, as one nears retirement years, one may tend to be quite conservative. The focus is now to have a corpus from which one can spend in the post retirement years. One may also think about making bequests for one's children or gifting to charity etc.

One's investment style also changes to keep pace with the risk profile. This is indicated below

Diagram 3: Risk Profile and Investment Style



Test Yourself 1

Which among the following would you recommend in order to seek protection against unforeseen events?

I. Insurance
II. Transactional products like bank FD's
III. Shares
IV. Debentures

B. Role of financial planning

1. Financial planning

Financial planning is the process in which a client's current and future needs that may arise are carefully considered and evaluated and his individual risk profile and income are assessed, to chart out a road map for meeting various anticipated / unforeseen needs through recommending appropriate financial products.

Elements of financial planning include:

- ✓ Investing - allocating assets based on one's risk taking appetite,
- ✓ Risk management,
- ✓ Retirement planning,
- ✓ Tax and estate planning, and
- ✓ Financing one's needs

To put it in a nutshell financial planning involves 360 degrees planning.

Diagram 4: Elements of Financial Planning

2. Role of Financial planning

Financial planning is not a new discipline. It was practiced in simple form by our fore fathers. There were limited investment options then. A few decades ago equity investment was considered by a large majority to be akin to gambling. Savings were largely channelled in bank deposits, postal savings schemes and other fixed income instruments. The challenges facing our society and our customers are far different today. Some of them are:

i. Disintegration of the joint family

The joint family has given way to the nuclear family, consisting of father, mother and children. The typical head and earning member of the family has to bear the onus of responsibility for taking care of oneself and one's immediate family. This calls for a lot of proper planning and one could benefit from a certain amount of support from a professional financial planner.

ii. Multiple investment choices

We have a large number of investment instruments available today for wealth creation, each of these having varying degrees of risk and return. To ensure accomplishment of financial goals, one has to choose wisely and make the right investment decisions based on one's risk taking appetite. Financial planning can help with one's asset allocation.

iii. Changing lifestyles

Instant gratification seems to be the order of the day. Individuals want to have the latest mobile phones, cars, large homes, memberships of prestigious clubs, etc. To satisfy these desires they invariably end up with large borrowings. The result is that a large chunk of income goes towards paying off loans, reducing the scope to save. Financial planning is a means to bring awareness and self-discipline as well as to help plan one's expenditure so that one can cut down unnecessary expenses and succeed in both: maintaining present standard of living while upgrading it over time.

iv. Inflation

Inflation is a rise in the general level of prices of goods and services in an economy over a period of time. This leads to a fall in the value of money. As a result the purchasing power of one's hard earned money gets eroded. Inflation could play havoc during one's retirement period, when regular income from one's gainful occupation has dried out and the only source of income is from past savings. Financial planning can help to ensure that one is equipped to deal with inflation, especially in later years.

v. Other contingencies and needs

Financial planning is also the means to help individuals meet a number of other needs and challenges. For instance, there are unexpected expenses that crop up during medical emergencies or other contingencies that individuals may have to cope with. Similarly, individuals need to manage their tax liabilities prudently. Individuals also need to ensure that their estate consisting of their wealth and properties, smoothly pass on to their loved ones after their death. There are other needs like the need to do charity or meet certain social and religious obligations during one's lifetime and even thereafter. Financial planning is the means to achieve all this,

3. When is the right time to start financial planning?

Is it meant only for the wealthy? Indeed, planning should ideally start the moment you earn your first salary. There is no trigger as such that says when one should begin to plan.

There is however an important principle that should guide us – the longer the time period of our investments, the more they will multiply.

Hence it is never too early to start. One's investments would then get the maximum benefit of time. Again, planning is not only for the wealthy individuals. It's for everyone. To achieve one's financial goals, one must follow a disciplined approach, beginning with setting financial goals and embarking on dedicated savings in investment vehicles that best suit one's risk taking appetite. An unplanned, impulsive approach to financial planning is one of the prime causes of financial distress that affects individuals.

Test Yourself 2

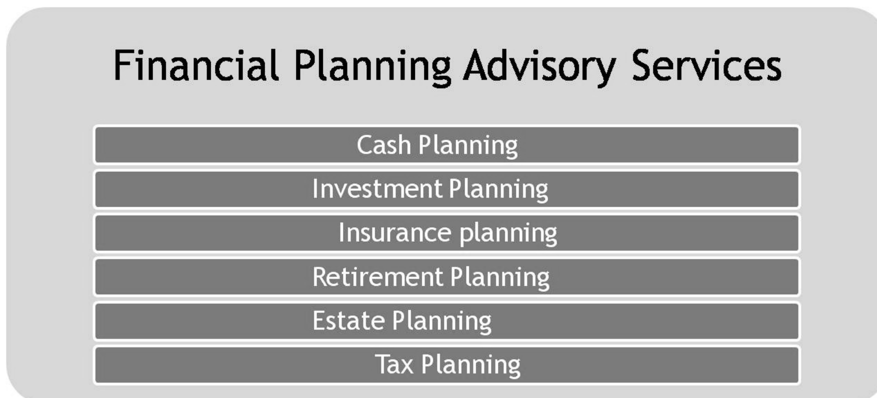
When is the best time to start financial planning?

I. Post retirement
II. As soon as one gets his first salary
III. After marriage
IV. Only after one gets rich

C. Financial planning - Types

Let us now look at the various types of financial planning exercises that an individual may need to do.

Diagram 5: Financial Planning Advisory Services



Consider the various advisory services that may be provided. There are six such areas we shall take up

- ✓ Cash planning
- ✓ Investment planning
- ✓ Insurance planning
- ✓ Retirement planning
- ✓ Estate planning
- ✓ Tax planning

1. Cash planning

Managing cash flows has two purposes.

i. Firstly one needs to manage income and expenditures flow including establishing and maintaining a reserve of liquid assets to meet unanticipated or emergency needs.

ii. Secondly one needs to systematically create and maintain a surplus of cash for capital investment.

The first step here is to **prepare a budget** and perform an analysis of current income and expenditure flows. For this, individuals must first prepare a set of reasonable goals and objectives for the future. This would help to determine whether current spending patterns would get them there.

The next step is to **analyse the expenses and income flows over last six months** to see what regular and lump sum costs have been incurred. Expenses may be categorised into different types and also divided into fixed and variable expenses. While one may not have much control over the fixed expenses, the variable expenses being more discretionary, can often be reduced or postponed.

The third step is to **predict future monthly income and expenses over the whole year**. On the basis of analysis of past and anticipation for the future, one can design a plan for managing these cash flows.

Another part of the cash planning process is to design strategies for maximizing discretionary income.

Example

One can restructure one's outstanding debts.

One can meet outstanding credit card debts through consolidating them and paying them off through a bank loan with lower interest.

One may reallocate one's investments to make them earn more income.

2. Insurance planning

There are certain risks to which individuals are exposed that can keep them from attaining their personal financial goals. Insurance planning involves constructing a plan of action to provide adequate insurance against such risks. The task here is to estimate how much insurance is needed and determining what type of policy is best suited.

i. **Life insurance** may be decided by estimating the income and expense requirements of the dependents in the event of premature death of the bread winner.

ii. **Health insurance** requirements may be assessed in terms of the hospitalisation expenses that are likely to be incurred in any family medical emergency.

iii. Finally **insurance for one's assets** may be considered in terms of the type and quantum of cover required to protect one's home/vehicle / factory etc. from the risk of loss.

3. Investment planning

There is no one right way to invest. What is appropriate would vary from individual to individual. Investment planning is a process of determining the most suitable investment and asset allocation strategies based on an individual's risk taking appetite, financial goals and the time horizon to meet those goals.

a) Investment parameters

Diagram 6: Investment Parameters

The first step here is to define certain investment parameters. These include:

i. **Risk tolerance**: A measure of how much risk someone is willing to take in purchasing an investment.

ii. **Time horizon**: It is the amount of time available to attain a financial objective. The time horizon affects the investment vehicles used to attain the goal. The longer the time horizon, the less concern is there about short term liability. One can then invest in longer term, less liquid assets that earn a higher return.

iii. **Liquidity**: Individuals whose capacity to invest is limited or whose income and expenditure flows are uncertain or who are investing for meeting a particular personal or business expenditure may be concerned with liquidity or the ability to convert investment into cash without loss of value.

iv. **Marketability**: The ease with which an asset can be bought or sold.

v. **Diversification**: The extent to which one seeks to diversify or spread the investments to reduce the risks.

vi. **Tax considerations**: Many investments confer certain income tax benefits and one may like to consider the post-tax returns of various investments.

b) Selection of appropriate investment vehicles

The next step is selection of appropriate investment vehicles based on the above parameters. The actual selection would depend on the individual's expectations about return and risk.
In India there are a variety of products that may be considered for the purpose of investments. These include:

- ✓ Fixed deposits of banks / corporates,
- ✓ Small savings schemes of post office,
- ✓ Public issues of shares,
- ✓ Debentures or other securities,
- ✓ Mutual funds
- ✓ Unit linked policies that are issued by life insurance companies etc.

4. Retirement planning

It is the process of determining the amount of money that an individual needs to meet his needs post retirement and deciding on various retirement options for meeting these needs.

Diagram 7: Phases of retirement

Retirement planning involves three phases

a) **Accumulation:** Accumulation of funds is done through various kinds of strategies to set aside money for investment with this purpose.

b) **Conservation:** Conservation refers to the efforts made to ensure that one's investments are put to hard work and that the principal gets maximised during the individual's working years.

c) **Distribution:** Distribution refers to the optimal method of converting principal (which we may also call the corpus or a nest egg) into withdrawals / annuity payments for meeting income needs after retirement.

5. Estate planning

It is a plan for the devolution and transfer of one's estate after one's demise. There are various processes like nomination and assignment or preparation of a will. The basic idea is to ensure that one's property and assets are smoothly distributed and / or utilised according to one's wishes after one is no more.

6. Tax planning

Finally tax planning is done to determine how to gain maximum tax benefit from existing tax laws and for planning of income, expenses and investments taking full advantage of the tax breaks. It involves making strategies to reduce, time or shift either current or future income tax liabilities. One must note that the purpose here is to minimise and not evade taxes.

By repositioning one's investments and seeking out potential tax savings opportunities to take advantage of, it is possible to increase one's income and savings, which otherwise would have gone to the tax authorities.

Life insurance agents may be often required by their clients and prospective customers to advise them not only about meeting their insurance needs but also for support in meeting their other financial needs as well. A sound knowledge of financial planning and its various types as described above would be of great value to any insurance agent.

Test Yourself 3

Which among the following is not an objective of tax planning?

I. Maximum tax benefit
II. Reduced tax burden as a result of prudent investments
III. Tax evasion
IV. Full advantage of tax breaks

Summary

- Financial planning is a process of:

✓ Identifying one's life's goals,
✓ Translating these identified goals into financial goals and
✓ Managing one's finances in ways that will help one to achieve those goals

- Based on the individual life cycle three types of financial products are needed. These help in:

✓ Enabling future transactions,
✓ Meeting contingencies and
✓ Wealth accumulation

- The need for financial planning is further increased by the changing societal dynamics like disintegration of the joint family, multiple investment choices that are available today and changing lifestyles etc.

- The best time to start financial planning is right after one receives the first salary.

- Financial planning advisory services include:

✓ Cash planning,
✓ Investment planning,
✓ Insurance planning,
✓ Retirement planning,
✓ Estate planning and
✓ Tax planning

Key Terms

1. Financial planning
2. Life stages
3. Risk profile
4. Cash planning
5. Investment planning
6. Insurance planning
7. Retirement planning
8. Estate planning
9. Tax planning

Answers to Test Yourself

Answer 1

The correct option is I.

Insurance provides protection against unforeseen events.

Answer 2

The correct option is II.

As soon as one gets his first salary one should start financial planning.

Answer 3

The correct option is III.

Tax evasion is not an objective of tax planning.

Self-Examination Questions

Question 1

An individual with an aggressive risk profile is likely to follow wealth ________ investment style.

I. Consolidation
II. Gifting
III. Accumulation
IV. Spending

Question 2

Which among the following is a wealth accumulation product?

I. Bank Loans
II. Shares
III. Term Insurance Policy
IV. Savings Bank Account

Question 3

Savings can be considered as a composite of two decisions. Choose them from the list below.

I. Risk retention and reduced consumption
II. Gifting and accumulation
III. Spending and accumulation
IV. Postponement of consumption and parting with liquidity

Question 4

During which stage of life will an individual appreciate past savings the most?

I. Post retirement
II. Earner
III. Learner
IV. Just married

Question 5

What is the relation between investment horizon and returns?

I. Both are not related at all
II. Greater the investment horizon the larger the returns
III. Greater the investment horizon the smaller the returns
IV. Greater the investment horizon more tax on the returns

Question 6

Which among the following can be categorised under transactional products?

I. Bank deposits
II. Life insurance
III. Shares
IV. Bonds

Question 7

Which among the following can be categorised under contingency products?

I. Bank deposits
II. Life insurance
III. Shares
IV. Bonds

Question 8

Which of the below can be categorised under wealth accumulation products?

I. Bank deposits
II. Life insurance
III. General insurance
IV. Shares

Question 9

__________ is a rise in the general level of prices of goods and services in an economy over a period of time.

I. Deflation
II. Inflation
III. Stagflation
IV. Hyperinflation

Question 10

Which of the below is not a strategy to maximise discretionary income?

I. Debt restructuring
II. Loan transfer
III. Investment restructuring
IV. Insurance purchase

Answers to Self-Examination Questions

Answer 1

The correct option is III.

Individual with an aggressive risk profile is likely to follow wealth accumulation investment style.

Answer 2

The correct option is II.

Shares are a wealth accumulation product.

Answer 3

The correct option is IV.

Savings is a combination of postponement of consumption and parting with liquidity.

Answer 4

The correct option is I.

Post retirement an individual appreciate past savings the most.

Answer 5

The correct option is II.

Greater the investment horizon larger will be the returns.

Answer 6

The correct option is I.

Bank deposits can be categorised under transactional products.

Answer 7

The correct option is II.

Life insurance can be categorised under contingency product.

Answer 8

The correct option is IV.

Shares can be categorised under wealth accumulation products.

Answer 9

The correct option is II.

Inflation is a rise in the general level of prices of goods and services in an economy over a period of time.

Answer 10

The correct option is IV.

Insurance purchase cannot maximise discretionary income.

CHAPTER 5

LIFE INSURANCE PRODUCTS – I

Chapter Introduction

The chapter introduces you to the world of life insurance products. It begins by talking about products in general and then proceeds to discussing the need for life insurance products and the role they play in achieving various life goals. Finally we look at some traditional life insurance products.

Learning Outcomes

A. Overview of life insurance products
B. Traditional life insurance products

A. Overview of life insurance products

1. What is a product?

To begin with let us understand what is meant by a product. In popular terms a product is considered same as a commodity– a good brought and sold in the marketplace. The term 'product' comes from the term 'reproduce' which means 'to bring forth' or 'to create'. In other words, a product is the output or result of certain labour or efforts.

However a good's usefulness or utility derives not from the good itself but from its features. This brings us to the marketing perspective. From a marketing standpoint, a **product is a bundle of attributes**. Firms differentiate their product offerings in the marketplace by packing together different types of attributes or different bundles of the same attributes.

The difference between a product (as used in a marketing sense) and a commodity is thus that a product can be differentiated. A commodity cannot. This means that the products sold by different companies, though they may belong to the same category, may be quite different from one another in terms of their features.

Example

Colgate, Close up and Promise are all different brands of the same category of toothpastes. But the features of each of these brands are different from the other.

A product is not an end in itself but a means to satisfy other ends. In this sense products are problem solving tools. They serve as need or want satisfiers. How appropriate a product is for the purpose would depend on the features of the product.

Products may be:

i. **Tangible**: refers to physical objects that can be directly perceived by touch (for instance a car or a television set)
ii. **Intangible:** refers to products that can only be perceived indirectly.

Life insurance is a product that is intangible. A life insurance agent has the responsibility to enable the customer to understand the features of a particular life insurance product, what it can do and how it can serve the customer's unique needs.

2. Purpose of life insurance products and needs covered

Wherever there is risk it is a cause for anxiety. However, we humans have sought to master or at least understand risk, to anticipate and be prepared for it. The instinct and desire to create security against risk has been a key reason for the creation of insurance.

We human beings are social beings who share our lives with others like us – our loved ones. We also possess an immensely valuable asset - **our human capital - which is the source of our productive earning capacity.** However, there is an uncertainty about life and human well-being. Events like death and disease can destroy our productive capabilities and thus cut down or erode the value of our human capital.

Life insurance products offer protection against the loss of economic value of an individual's productive abilities, which is available to his dependents or to the self. The very word 'insurance' in 'life insurance' signifies the need to protect both oneself and one's loved ones against financial loss upon death or permanent disability.

There are other functions, such as savings and investment, but death or dread disease coverage is the most common reason for taking out life insurance. In specific terms, the potential estate value or the wealth expected to be created by the insured individual during his/her remaining earning span of work life, is sought to be replaced or compensated to one's loved ones or to self, should the income generating ability of the insured person be damaged or destroyed during the period of the contract. This is done by creating an **immediate estate** in the name of the insured life, the moment the first premium is paid by him.

So, a life insurance policy, at its core, **provides peace of mind and protection to the near and dear ones of the individual** in case something unfortunate happens to him. The other role of life insurance has been as a vehicle for saving and wealth accumulation. In this sense, it offers safety and security of investment and also a certain rate of return.

Life insurance is more than an instrument for protecting against death and disease. It is also a financial product and may be seen as one among many constituents of a portfolio of financial assets rather than as a unique stand-alone product. In the emerging financial marketplace, customers have multiple choices, not only among alternative types of life insurance products but also with numerous substitutes to life insurance that have come up, like deposits, bonds, stocks and mutual funds.

In this context, one needs to understand what the value proposition of life insurance is. **Customer value** would depend on how life insurance is perceived as a solution to a set of customer needs.

- ✓ Does it offer the right solution? or "Is it effective?"
- ✓ What does it cost? or "is it efficient?"

Life insurance industry has seen enormous innovations in product offerings over the last two centuries. The journey had begun with death benefit products but over the period, multiple living benefits like endowment, disability benefits, dread disease cover and so on were added.

Similarly from a '**participating in profit**' traditional product, the innovations created '**market linked**' policies where the insured was invited to participate in choosing and managing his investment assets. Another dimension was added, where life insurance products evolved from being a fixed bundle (of defined benefits) to highly flexible unbundled products, wherein different benefits as well as cost components could be varied by the policy holder as per changing needs, affordability and life-stages.

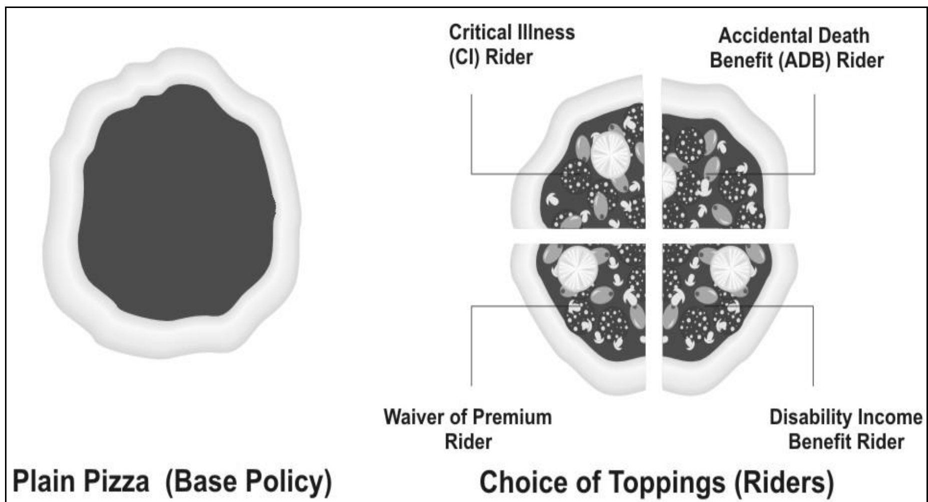
3. Riders in Life Insurance Products

We have seen above, how life insurance contracts offer various benefits which serve as solutions to a host of needs of their customers. Life insurance companies have also offered a number of riders through which the value of their offerings can get enhanced.

A rider is a provision typically added through an endorsement, which then becomes part of the contract. Riders are commonly used to provide some sort of supplementary benefit or to increase the amount of death benefit provided by a policy.

Riders can be compared to choice of different toppings in a pizza. A base policy is like a pizza base and choice of riders is like choice of different pizza toppings available to customise the pizza as per an individual's requirement. Riders help to customise different requirements of a person into a single plan

Diagram 1: Choice of Riders



Riders can be the way through which benefits like Disability cover, accident cover and Critical Illness cover can be provided as additional benefits in a standard life insurance contract. These riders may be availed of by the policyholder by opting for them and paying an additional premium for the purpose.

Test Yourself 1 +

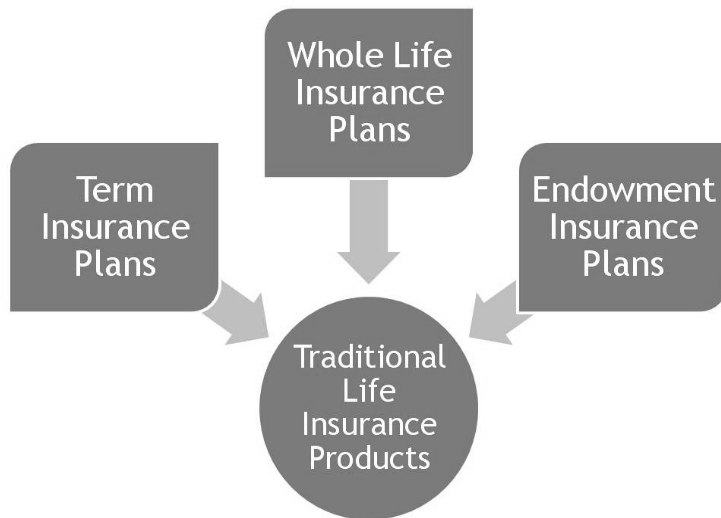
Which among the following is an intangible product?

I. Car
II. House
III. Life insurance
IV. Soap

B. Traditional life insurance products

In this chapter we shall now learn about some of the traditional types of life insurance products.

Diagram 2: Traditional Life Insurance Products



1. Term insurance plans

Term insurance is valid only during a certain time period that has been specified in the contract. The term can range from as short as it takes to complete an airplane trip to as long as forty years.

Protection may extend up to age 65 or 70. One-year term policies are quite similar to property and casualty insurance contracts. All premiums received under such a policy may be treated as earned towards the cost of mortality risk by the company. There is no savings or cash value element accruing to the insured.

a) Purpose

A term life insurance fulfills the main and basic idea behind life insurance, that is, if the life insured dies prematurely there will be a sum of money available to take care of his/her family. This lump sum money represents the insured's human life value for his loved ones: either chosen arbitrarily by self or calculated scientifically.

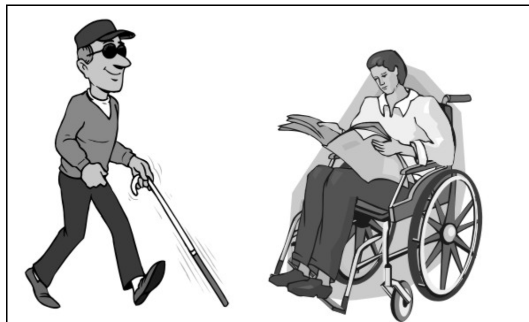
A term insurance policy also comes handy as an income replacement plan. Here in place of payment of a lump-sum amount to the dependents, on the happening of an unfortunate death during the term of the policy, a series of monthly, quarterly or similar periodical pay outs for a pre-defined duration may be provided to the dependent beneficiaries.

b) Disability

Normally a term insurance policy covers only death. However, when it is purchased with a disability protection rider on the main policy and if someone were to suffer such a catastrophe during the period of term

insurance, the insurance company will provide a payout to the beneficiaries/insured person. If the insured dies after the term ends, there are no benefits available as the deal is over as soon as the term expires.

Diagram 3: Disability



c) Term insurance as a rider

Protection under term life is usually provided as a stand-alone policy but it could also be provided through a rider in a policy.

Example

A pension plan may contain provision for a death benefit to be payable in case one dies before the date when pension is to start.

d) Renewability

The premiums are generally charged at a fixed annual rate for the whole duration of term insurance. Some plans have an option to renew at the end of the term duration; however, in these products the premium will be recalculated based on one's age and health at that stage and also the new term for which the policy is being renewed.

e) Convertibility

Convertible term insurance policies allow a policyholder to change or convert a term insurance policy into a permanent plan like "Whole Life" without providing fresh evidence of insurability. This privilege helps those who wish to have permanent cash value insurance but are temporarily unable to afford its high premiums. When the term policy is converted into permanent insurance the new premium rate would be higher.

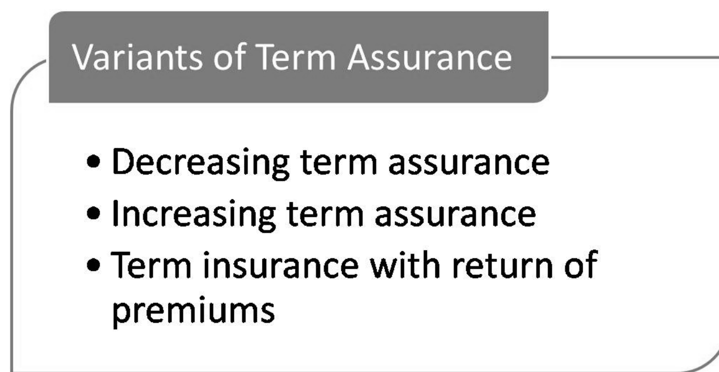
f) USP

The unique selling proposition (USP) of term assurance is its low price, enabling one to buy relatively large amounts of life insurance on a limited budget. It thus makes a good plan for the main income earner, who wishes to protect his/her loved ones from financial insecurity in case of premature death, and who has a limited budget for making insurance premium payments.

g) Variants

A number of variants of term assurance are possible.

Diagram 4: Variants of Term Assurance



i. Decreasing term assurance

These plans provide a death benefit that decreases in amount with term of coverage. A ten year decreasing term policy may thus offer a benefit of Rs. 1,00,000 for death in the first year, with the amount decreasing by Rs. 10,000 on each policy anniversary, to finally come to zero at the end of the tenth year. The premium payable each year however remains level.

Decreasing Term Assurance plans have been marketed as mortgage redemption and credit life insurance.

- ✓ **Mortgage redemption**: is a plan of decreasing term insurance designed to provide a death amount that corresponds to the decreasing amount owed on a mortgage loan. Typically in such loans, each equated monthly instalment (EMI) payment leads to a reduction of the outstanding principal amount. The insurance may be arranged such that the amount of death benefit at any given time equals the balance of principal owed. The term of the policy would correspond to the length of the mortgage. The renewal premiums are generally level throughout the term. Purchase of mortgage redemption is often a condition of the mortgage loan.
- ✓ **Credit life insurance** is a type of term insurance plan designed to pay the balance due on a loan, if the borrower dies before the loan is

repaid. Like mortgage redemption it is usually decreasing term assurance. It is more popularly sold to lending institutions as group insurance to cover the lives of the borrowers of these institutions. It may be also available for automobile and other personal loans. The benefit under these policies is often paid directly to the lender or creditor if the insured borrower dies during the policy term.

ii. Increasing term assurance

As the name suggests, the plan provides a death benefit, which increases along with the term of the policy. The sum may increase by a specified amount or by a percentage at stated intervals over the policy term. Alternatively the face amount may increase according to a rise in the cost of living index. Premium generally increases as the amount of coverage increases.

iii. Term insurance with return of premiums

Yet another type of policy (quite popular in India) has been that of term assurance with return of premiums. The plan leaves the policyholder with the satisfaction that he / she has not lost anything in case he/she survives the term. Obviously the premium paid would be much higher than that applicable for an equivalent term assurance without return of premiums.

h) Relevant scenarios

Term insurance has been perceived to hold much relevance in the following situations:

- ✓ Where the need for insurance protection is purely temporary, as in case of mortgage redemption or for protection of a speculative investment
- ✓ As an additional supplement to a savings plan, for instance a young parent buying decreasing term assurance to provide additional protection for dependents in the growing years. Convertible term assurance may be suggested as an option where a permanent plan is non-affordable.
- ✓ As part of a "buy term and invest the rest" philosophy, where the buyer seeks to buy only cheap term insurance protection from the insurance company and to invest the resultant difference of premiums in a more attractive investment option elsewhere. The policyholder must of course bear the risks involved in such investment.

i) Considerations

Price is in sum the primary basis of competitive advantage in term assurance plans. This is particularly seen in case of yearly renewable term policies that are cheaper than their level premium counterparts.

The problem with such one-year term plans is that mortality costs rise with age. They are thus attractive only for those with a short period insurance planning horizon.

Important

Limitations of term plans

At the same time one must be aware of the limitations of term assurance plans. The major problem arises when the purpose of taking insurance cover is more permanent and the need for life insurance protection extends beyond the policy period. The policy owner may be uninsurable after the term expires and hence unable to obtain a new policy at say age 65 or 70. Individuals would seek more permanent plans for the purpose of preserving their wealth against erosion from terminal illness, or to leave a bequest behind. Term assurance may not work in such situations.

2. Whole life insurance

While term assurance policies are examples of temporary assurance, where protection is available for a temporary period of time, whole life insurance is an example of a permanent life insurance policy. In other words **there is no fixed term of cover but the insurer offers to pay the agreed upon death benefit when the insured dies, no matter whenever the death might occur.** The premiums can be paid throughout one's life or for a specified period of time which is limited and is less than one's lifetime.

Whole life premiums are much higher than term premiums since a whole life policy is designed to remain in force until the death of the insured, and therefore it is designed to always pay the death benefit. After the insurance company takes the amount of money it needs from the premium, to meet the cost of term insurance, the **balance money is invested on behalf of the policyholder. This is called cash-value.** One can withdraw cash in the form of a policy loan should he require emergency funds, or he can redeem by surrendering the policy for its cash value.

In case of outstanding loans the amount of loan and interest gets deducted from the payout that is made to the designated beneficiaries upon death.

A whole life policy is a good plan for one who is the main income earner of the family and wishes to protect the loved ones from any financial insecurity in case of premature death. This person must be able to afford the higher premiums of a whole life insurance policy on a consistent and long-term basis, and wants a life insurance policy which can pay a death benefit, regardless of when he/she dies, while at the same time wanting to be able to use the cash value of the whole life insurance policy for retirement needs, if required.

Whole life insurance plays an important role in household saving and creating wealth to be passed on to the next generation. An important motive which drives its purchase is that of bequest – the desire to leave behind a legacy to one's future generations. A higher ownership of life insurance policies among households with children and a high regard for the family, further confirms this motive.

3. Endowment assurance

An endowment assurance contract is actually a combination of two plans:

- ✓ A term assurance plan which pays the full sum assured in case of death of the insured during the term
- ✓ Apure endowment plan which pays this amount if the insured survives at the end of the term

The product thus has both a death and a survival benefit component. From an economic point of view, the contract is a combination of decreasing term insurance and an increasing investment element. Shorter the policy term, larger the investment element.

The combination of term and investment elements is also present in whole life and other cash value contracts. It is however much more pronounced in the case of endowment assurance contracts. This makes it an effective vehicle to accumulate a specific sum of money over a period of time.

Endowment is primarily a savings programme, which is protected by provision of insurance against the contingency of premature death. Its appeal to customers lies in the fact that it is an instrument that lends certainty to one's personal financial plans by linking insurance to one's savings programme. Endowment also offers a safe and compulsory method of savings accumulation. While prudent investment and asset liability management lends safety, the semi-compulsory nature of premiums provides the incentive to save.

People buy endowment plans as a sure method of providing against old age or for meeting specific purposes like having an education fund at the end of say 15 years or a fund for meeting marriage expenses of one's daughters. There can be no playing around with these objectives. They have to be met with certainty.

It has also served as an ideal way to pay for a mortgage (housing) loan. Not only is the loan protected against the uncertainty of repayment on account of death but the endowment proceeds could suffice to pay the principal.

The policy has also been promoted as a means for thrift savings. Endowment can serve as a worthwhile proposition when one is looking for an avenue to set

aside a surplus from income every month/quarter/year and commit it to the future.

The plan is also made attractive because of the provision for deduction of premiums for tax purposes.

Yet another proposition in the Indian context has been the facility to place the policy in a trust created under the **MWPA (Married Women's Property Act)** - the money can only be paid to the policy beneficiary, who is thus protected against all creditors' claims on the property of the insured.

Finally many endowment policies mature at ages 55-65, when the insured is planning for his/her retirement and such policies may be a useful supplement to other sources of retirement savings.

a) Variants

Endowment assurance has certain variants that are discussed below.

i. Money back plan

A popular variant of endowment plans in India has been the Money Back policy. **It is typically an endowment plan with the provision for return of a part of the sum assured in periodic installments during the term and balance of sum assured at the end of the term.**

Example

A Money Back policy for 20 years may provide for 20% of the sum assured to be paid as a survival benefit at the end of 5, 10 and 15 years and the balance 40% to be paid at the end of the full term of 20 years.

If the life assured dies at the end of say 18 years, the full sum assured and bonuses accrued are paid, regardless of the fact that the insurer has already paid a benefit of 60% of the face value.

These plans have been very popular because of their liquidity (cash back) element, which renders them good vehicles for meeting short and medium term needs. Full death protection is meanwhile available when the individual dies at any point during the term of the policy.

ii. Par and non-par schemes

The term "Par" implies policies which are participating in the profits of the life insurer. "Non – Par" on the other hand represent policies which do not participate in the profits. Both kinds are present in traditional life insurance.

Under all traditional plans, the pooled life funds, which are made up of the proceeds of premium received from policyholders, are invested under tight regulatory supervision, as per prescribed norms, and policyholders are either guaranteed a part of the growth or get a share of the surpluses that are generated by the insurer, under what are termed as "With Profit Plans".

Non-participating products may be offered either under a linked platform or a non-linked platform. In this chapter, we are concerned with policies which are non-linked. Typically without profit plans are those where the benefits are fixed and guaranteed at the time of the contract and the policyholder would be eligible for these benefits and no more.

Example

One may have an endowment policy of twenty years providing a guaranteed addition of 2% of sum assured for each year of term, so that the maturity benefit is sum assured plus a total addition of 40% of the sum assured.

IRDA's new guidelines on traditional non-par policies provide that for these policies, the benefits which are payable on the occurrence of a specific event are to be explicitly stated at the outset and not linked to any index of benchmark.

Similarly additional benefits, if any, which are accrued at regular intervals during the policy term, have to be explicitly stated at the outset and not linked to any index of benchmark. In other words this means that the return on the policies should be disclosed at the beginning of the policy itself. The policyholder could calculate the net return and compare with other avenues to assess the policy costs.

iii. Participating (Par) or with profit plans

Unlike without profit or guaranteed plans, these plans have a provision for participation in profits. With profits policies have a higher premium than others. Profits are payable as bonuses or dividends. Bonuses are normally paid as reversionary bonuses. They are declared as a proportion of the sum assured (e.g. Rs. 70 per thousand sum assured) and are payable as additional benefits on a reversionary basis (at the end of the tenure of the policy, by death or maturity or surrender).

Apart from reversionary bonuses which, once attached, are guaranteed, the life insurer may also declare terminal bonuses. These are contingent upon the life insurer earning some windfall gains and are not guaranteed.

Terminal Bonuses were developed as a means to share with participating policy holders, the large windfall gains that were made through investment in capital markets in United Kingdom. They have also been adopted in India and many other developing markets.

Information

Dividend method of profit participation

There are certain other markets like the USA where profits are shared in the form of dividends. Two approaches have been followed for dividend crediting.

i. The traditional approach was the "**Portfolio Method**". Here the total investment return on the portfolio held by the company was determined and all policyholders were credited their share of the divisible surplus. No attempt was made to distinguish the rate of return earned on monies that had been invested with the company in previous years from that deposited recently. The portfolio method thus homogenised rates of return and made them stable over time. It applied the principle of pooling of risks over time and is quite analogous in this respect to the uniform reversionary bonus mechanism.

ii. The second approach is the "**Current Money Method**". Here the return depends on when the investment was made and the rate that was secured at the time of investment. It has also been called segmented or investment block method as different investment blocks gets different returns.

Traditional with profits (participating) policies thus offer some linkage to the life office's investment performance. The linkage however is not direct. What the policyholder gains by way of bonus depends on the periodic (usually annual) valuation of the fund's assets and liabilities.

The surplus declared in the valuation depends on the assumptions made and factors taken into consideration by the valuation actuary. Even after the surplus is declared, its allocation among policyholders would depend on the decision of the company's management. Because of all this, the bonuses added to policies only follow investment performance in a very cushioned and distant manner.

The basic logic underlying the approach is the smoothing out of investment returns over time. It is true that terminal bonuses and compound bonuses have enabled the policyholder to enjoy a larger slice of the benefits derived from equity investments. Nevertheless they still depend on the discretion of the life office who declares these bonuses.

Finally, bonuses under a valuation are generally only declared once a year. They obviously cannot reflect the daily fluctuations in the value of assets.

Traditional with profit plans thus represent a generation of products in which the life insurance company decides what is the structure of the product or plan, including the benefits (sum assured and bonuses) and premiums. Even when the life insurance company earns high returns in the investment market, it is not necessary that its bonuses or dividends be directly linked with these returns.

The great advantage to the policyholder or insured has been that the certainty of investment makes these plans quite appropriate vehicles for

meeting those needs that may require definite and dedicated funds. They also help to reduce the overall portfolio risk of an individual's investment portfolio.

Important

IRDA's new guidelines for traditional products

According to the guidelines, the product design of traditional plans would remain almost the same.

a) New traditional products will have a higher death cover.

   i. For **single premium policies** it will be 125% of the single premium for those below 45 years and 110% of single premium for those above 45 years.
   ii. For **regular premium policies**, the cover will be 10 times the annualised premium paid for those below 45 and seven times for others.

b) The **minimum death benefit** in case of traditional plan is at least the amount of sum assured and the additional benefits (if any).

c) In addition to the sum assured, the **bonus / additional benefits** as specified in the policy and accrued till date of death shall become payable on death if not paid earlier.

d) These plans would continue to come in **two variants**, participating and non-participating plans.
   i. For **participating polices** the bonus is linked to the performance of the fund and is not declared or guaranteed before. But, the **bonus once announced becomes a guarantee**. It is usually paid in case of death of the policyholder or maturity benefit. This bonus is also called **reversionary bonus**.
   ii. In case of **non-participating policies**, the return on the policy is disclosed in the beginning of the policy itself.

Test Yourself 2

The premium paid for whole life insurance is _____________ than the premium paid for term assurance.

I. Higher
II. Lower
III. Equal
IV. Substantially higher

Summary

- Life insurance products offer protection against the loss of economic value of an individual's productive abilities, which is available to his dependents or to the self.

- A life insurance policy, at its core, provides peace of mind and protection to the near and dear ones of the individual in case something unfortunate happens to him.

- Term insurance provides valid cover only during a certain time period that has been specified in the contract.

- The unique selling proposition (USP) of term assurance is its low price, enabling one to buy relatively large amounts of life insurance on a limited budget.

- While term assurance policies are examples of temporary assurance, where protection is available for a temporary period of time, whole life insurance is an example of a permanent life insurance policy.

- An endowment assurance contract is actually a combination of two plans - a term assurance plan which pays the full sum assured in case of death of the insured during the term and a pure endowment plan which pays this amount if the insured survives at the end of the term.

Key Terms

1. Term insurance
2. Whole life insurance
3. Endowment assurance
4. Money back policy
5. Par and non-par schemes
6. Reversionary bonus

Answers to Test Yourself

Answer 1

The correct option is III.

Life insurance is an intangible product.

Answer 2

The correct option is I.

The premium paid for whole life insurance is higher than the premium paid for term assurance.

Self-Examination Questions

Question 1

___________ life insurance pays off a policyholder's mortgage in the event of the person's death.

I. Term
II. Mortgage
III. Whole
IV. Endowment

Question 2

The ________ the premium paid by you towards your life insurance, the ________ will be the compensation paid to the beneficiary in the event of your death.

I. Higher, Higher
II. Lower, Higher
III. Higher, Lower
IV. Faster, Slower

Question 3

Which of the below option is correct with regards to a term insurance plan?

I. Term insurance plans come with life-long renewability option
II. All term insurance plans come with a built-in disability rider
III. Term insurance can be bought as a stand-alone policy as well as a rider with another policy
IV. There is no provision in a term insurance plans to convert it into a whole life insurance plan

Question 4

In decreasing-term insurance, the premiums paid ____________ over time.

I. Increase
II. Decrease
III. Remain constant
IV. Are returned

Question 5

Using the conversion option present in a term policy you can convert the same to __________.

I. Whole life policy
II. Mortgage policy
III. Bank FD
IV. Decreasing term policy

Question 6

What is the primary purpose of a life insurance product?

I. Tax rebates
II. Safe investment avenue
III. Protection against the loss of economic value of an individual's productive abilities
IV. Wealth accumulation

Question 7

Who among the following is best advised to purchase a term plan?

I. An individual who needs money at the end of insurance term
II. An individual who needs insurance and has a high budget
III. An individual who needs insurance but has a low budget
IV. An individual who needs an insurance product that gives high returns

Question 8

Which of the below statement is incorrect with regards to decreasing term assurance?

I. Death benefit amount decreases with the term of coverage
II. Premium amount decreases with the term of coverage
III. Premium remains level throughout the term
IV. Mortgage redemption plans are an example of decreasing term assurance plans

Question 9

Which of the below statement is correct with regards to endowment assurance plan?

I. It has a death benefit component only
II. It has a survival benefit component only
III. It has both a death benefit as well as a survival component
IV. It is similar to a term plan

Question 10

Which of the below is an example of an endowment assurance plan?

I. Mortgage Redemption Plan
II. Credit Life Insurance Plan
III. Money Back Plan
IV. Whole Life Plan

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Mortgage life insurance pays off a policyholder's mortgage in the event of the person's death.

Answer 2

The correct option is I.

The higher the premium paid by you towards your life insurance, the higher will be the compensation paid to the beneficiary in the event of your death.

Answer 3

The correct option is III.

Term insurance can be bought as a stand-alone policy as well as a rider with another policy

Answer 4

The correct option is III.

In decreasing-term insurance, the premiums paid remain constant over time.

Answer 5

The correct option is I.

Using the conversion option present in a term policy you can convert the same to whole life policy.

Answer 6

The correct option is III.

Protection against the loss of economic value of an individual's productive abilities is the primary purpose behind a life insurance product.

Answer 7

The correct option is III.

Term plan is a good choice for an individual who needs insurance and has a low budget.

Answer 8

The correct option is II.

Premium remains level throughout the term for decreasing term assurance plans.

Answer 9

The correct option is III.

Endowment assurance plan has both a death benefit as well as a survival component.

Answer 10

The correct option is III.

Money Back Plan is an example of an endowment assurance plan.

CHAPTER 6

LIFE INSURANCE PRODUCTS – II

Chapter Introduction

The chapter introduces you to the world of non-traditional life insurance products. We start by examining the limitations of traditional life insurance products and then have a look at the appeal of non-traditional life insurance products. Finally we look at some of the different types of non-traditional life insurance products available in the market.

Learning Outcomes

A. Overview of non-traditional life insurance products
B. Non-traditional life insurance products

A. Overview of non-traditional life insurance products

1. Non-traditional life insurance products - Purpose and need

In the previous chapters we have considered some of the traditional life insurance products which have insurance as well as a savings element in them. These products have often been considered as being part of the financial market and compared with other instruments of capital accumulation.

One of the principal purposes of saving and investing, we must note, is to **achieve inter-temporal allocation of resources, which is both efficient and effective**.

i. **Inter-temporal allocation** means allocation across time. The term **effective** here implies that sufficient funds are available to successfully satisfy various needs as they arise in different stages of the life cycle.
ii. **Efficient allocation** on the other hand implies a faster rate of accumulation and more funds available in future. Higher the return for a given level of risk, the more efficient would the investment be.

A critical point of concern with respect to life insurance policies has been the issue of giving a competitive rate of return which is comparable to that of other assets in the financial market place. It would be useful to examine some of the features of the traditional cash value plans of life insurance that we discussed in the previous chapter. These have been called bundled plans because of the way their structure is bundled and presented as a single package of benefits and premium.

2. Limitations of traditional products

A critical examination would reveal the following areas of concern:

a) **Cash value component:** Firstly, the savings or cash value component in such policies is not well defined. It depends on the amount of actuarial reserve that is set up. This in turn is determined by assumptions about mortality, interest rates, expenses and other parameters that are set by the life insurer. These assumptions can be quite arbitrary.

b) **Rate of return:** Secondly it is not easy to ascertain what would be rate of return on these policies. This is because the value of the benefits under "With Profit policies" would be known for sure, only when the contract comes to an end. Again, the exact costs of the insurer are not disclosed. This lack of clarity about the rate of return makes it difficult to compare them with other alterative instruments of savings. Obviously one cannot know how efficient life insurance is as a savings instrument unless one can make such comparison.

c) **Surrender value:** A third problem is that the cash and surrender values (at any point of time), under these contracts depend on certain values (like the amount of actuarial reserve and the pro-rata asset share of the policy). These values may be determined quite arbitrarily. The method of arriving at surrender value is not visible.

d) **Yield:** Finally there is the issue of the yield on these policies. Both because of prudential norms and tight supervision on investment and because bonuses do not immediately reflect the investment performance of the life insurer, the yields on these policies may not be as high as can be obtained from more risky investments.

3. The shifts

As the limitations of traditional life insurance plans became obvious, a number of shifts occurred in the product profiles of life insurers. These have been summarised below:

a) Unbundling

This trend involved separation of the protection and savings elements and consequently the development of products, which stressed on protection or savings, rather than a vague mix of both.

While in markets like the United States, these led to a rediscovery of term insurance and new products like universal assurance and variable assurance, the United Kingdom and other markets witnessed the rise of unit linked insurance.

b) Investment linkage

The second trend was the shift towards investment linked products, which linked benefits to policyholders with an index of investment performance. There was consequently a shift in the way life insurance was positioned. The new products like unit linked implied that life insurers had a new role to play. They were now efficient fund managers with the mandate of providing a high competitive rate of yield, rather than mere providers of financial security.

c) Transparency

Unbundling also ushered greater visibility in the rate of return and in the charges made by the companies for their services (like expenses etc.). All these were explicitly spelt out and could thus be compared

d) Non-standard products

The fourth major trend has been a shift from rigid to flexible product structures, which is also seen as a move towards non-standard products. When we speak of non-standard, it is with respect to the degree of choice which a customer can exercise with respect to designing the structure and benefits of the policy.

There are two areas where customers may actively participate in this regard

- ✓ While fixing and altering the structure of premiums and benefits
- ✓ While choosing how to invest the premium proceeds

4. The appeal - Needs met

The major sources of appeal of the new genre of products that emerged worldwide are given below:

a) **Direct linkage with the investment gains**: First of all, there was the prospect of direct linkage with the investment gains which life insurance companies could make through investment in a buoyant and promising capital market. One of the most important arguments in support of investment linked insurance policies has been that, even though in the short run, there may be some ups and downs in the equity markets the returns from these markets would, in the longer run, be much higher than that of other secured fixed income instruments. Life insurers who are able to efficiently manage their investment portfolios could generate superior returns for their customers and thus develop high value products.

b) **Inflation beating returns:** The importance of yield also stems from the impact of inflation on savings. As we all know, inflation can erode the purchasing power of one's wealth so that, if a rupee today would be worth only 30 paisa after fifteen years, a principal of Rs. 100 today would need to grow to at least Rs. 300 in fifteen years in order to be worth what it is today. This means that the rate of yield on a life insurance policy must be significantly higher than the rate of inflation. This is where investment linked insurance policies were especially able to score over traditional life insurance policies.

c) **Flexibility:** A third reason for their appeal was their flexibility. Policyholders could now decide within limits, the amount of premium they wanted to pay and vary the amount of death benefits and cash values. In investment linked products, they also had the choice of investments and could also decide the mix of funds in which they wanted to have the proceeds of their premiums invested. This implied that policyholders could have a greater control over their investment in life insurance.

d) **Surrender value:** Finally, the policies also allowed the policyholders to withdraw from the schemes after a specified initial period of years (say three to five), after deduction of a nominal surrender charge. The amount available on such surrender or encashment before the full term of the policy was much higher than the surrender values available under erstwhile traditional policies.

These policies became very popular and even began to replace traditional products in many countries, including India because they were meeting a critical motive of many investors – **the wealth accumulation motive which generated a demand for efficient investment vehicles**. In the United States for example, products like "Universal Life" provided the means to pass on the benefits of high current interest rates returns which life insurers earned in money and capital markets very quickly to policyholders.

Flexibility of premiums and face amount meanwhile enabled the policyholder to adjust the premiums to suit his or her particular situations. The convenience of early withdrawal without undue loss also meant that the policyholder no longer needed to lock his or her money for long periods of time.

Test Yourself 1

Which among the following is a non-traditional life insurance product?

I. Term assurance
II. Universal life insurance
III. Endowment insurance
IV. Whole life insurance

B. Non-traditional life insurance products

1. Some non-traditional products

In the remaining paragraphs of this chapter we shall discuss some of the non-traditional products which have emerged in the Indian market and elsewhere.

a) Universal life

Universal life insurance is a policy that was introduced in the United States in 1979 and quickly grew to become very popular by the first half of the eighties.

As per the IRDA Circular of November 2010, "All Universal Life products shall be known as Variable Insurance Products (VIP)".

Information

About Universal Life

Universal life insurance is a form of permanent life insurance characterised by its **flexible premiums, flexible face amount and death benefit amounts, and the unbundling of its pricing factors**. While traditional cash value policies require a specific gross or office premium to be paid periodically in order to keep the contract in force, universal life policies allow the policyholder within limits, to decide the amount of premiums he or she wants to pay for the coverage. Larger the size of the premium, greater the coverage provided and greater the policy's cash value.

The major innovation of universal life insurance was the introduction of completely flexible premiums after the first policy year. One had only to ensure that premiums as a whole were enough to cover the costs of maintaining the policy. What this implied is that the policy could be deemed to be in force, so long as its cash value was sufficient to pay the mortality charges and expenses.

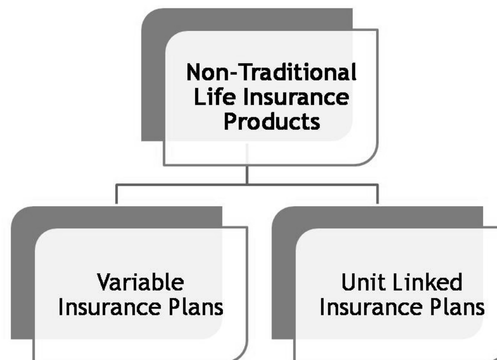
Premium flexibility allowed the policyholder to make additional premiums above the target amount. It also allowed one to skip premium payments or make payments that were lower than the target amount.

Flexibility of structures also enabled the policyholder to make partial withdrawals from the cash value that was available, without the obligation to repay this amount or pay any interest on it. The cash value was simply reduced to that extent.

Flexibility also meant that the death benefits could be adjusted and the face amounts could be varied.

However this kind of policy could be mis-sold. Indeed, in markets like the US, prospective customers were enticed by the proviso that 'one needed to make only a few initial premium payments and then the policy would take care of itself'. What they did not disclose was that cash values could maintain and keep the policy in force only if investment returns were adequate for the purpose. The decline of investment returns during latter half of the eighties led to erosion of cash values. Policyholders who failed to continue premium payments were shocked to find that their policies had lapsed and they no longer had any life insurance protection.

Diagram 1: Non-traditional life insurance products



In India, as per the IRDA norms, there are thus only two kinds of non-traditional savings life insurance products that are permitted:

- ✓ Variable insurance plans
- ✓ Unit linked insurance plans

i. Variable life insurance

To begin with it would be useful to know about variable life insurance as introduced in the United States and other markets.

This policy was first introduced in the United States in 1977. Variable life insurance is a kind of "Whole Life" policy where the death benefit and cash value of the policy fluctuates according to the investment performance of a special investment account into which premiums are credited. The policy thus provides no guarantees with respect to either the interest rate or minimum cash value. **Theoretically the cash value can go down to zero, in which case the policy would terminate.**

The difference with traditional cash value policies is obvious. A traditional cash value policy has a face amount that remains level throughout the policy term. The cash value grows with premiums and interest earnings at a specified rate. Assets backing the policy reserves form part of a **general investment account** in which the insurer maintains the funds of its guaranteed products. These assets are placed in a portfolio of secured investments. The insurer can thus expect to earn a sturdy rate of return on the assets in this account.

In contrast, assets representing the policy reserves of a variable life insurance policy are placed in a **separate fund** that do not form part of its general investment account. In the US this was termed as a separate account while in Canada it was termed as a segregated account. Most variable policies permitted policyholders to select from among several separate accounts and to change their selection at least once a year.

In sum, here is a policy in which the cash values are funded by separate accounts of the life insurance company, and death benefits and cash values vary to reflect investment experience. The policy also provides a minimum death benefit guarantee for which the mortality and expense risks are borne by the insurance company. The premiums are fixed as under traditional whole life. The principal difference with traditional whole life policies is thus in the investment factor.

Variable life policies have become the preferred option for those who wanted to keep their assets invested in an assortment of funds of their choice and also wanted to directly benefit from favourable investment performance of their portfolio. A prime condition for their purchase is that the purchaser must be able and willing to bear the investment risk on the policy. This implies that variable life policies should be typically bought by people who are knowledgeable and quite comfortable with equity / debt investments and market volatility. Obviously, its popularity would depend on investment market conditions – thriving in market booms and declining when stock and bond prices plummet. This volatility has to be kept in mind while marketing variable life.

ii. Unit linked insurance

Unit linked plans, also known as ULIP's emerged as one of the most popular and significant products, displacing traditional plans in many markets. These plans were introduced in UK, in a situation of substantial investments that life insurance companies made in ordinary equity shares and the large capital gains and profits they made as a result. A need was felt for having both greater investment in equities and also passing the benefits to policyholders in a more efficient and equitable manner.

Conventional with profit (participating) policies offer some linkage to the life office's investment performance. The linkage however is not direct. The policyholder's bonus depends on periodic (usually annual) valuation of assets and liabilities and resultant surplus declared, which in turn depends on assumptions and factors considered by the valuation actuary.

Critical to the valuation process is the allowance for guarantees provided under the contract. As a result the bonus does not directly reflect the value of the underlying assets of the insurer. Even after the surplus is declared, the life insurer may still not allocate it to bonus but may decide to build free assets which can be used for growth and expansion.

Because of all this, bonus additions to policies follow investment performance in a very cushioned and distant manner.

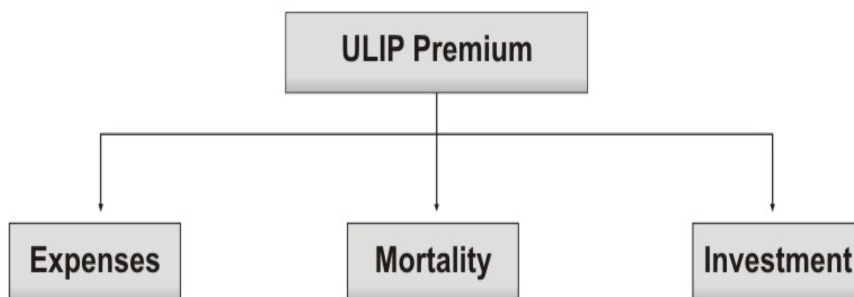
The basic logic that governs conventional policies is to smooth investment returns over time. While terminal bonuses and compound bonuses have enabled policyholders to enjoy a larger slice of benefits of equity and other high yield investments, they are still dependent on the discretion of the life office who declares these bonuses. Again, bonuses are generally only declared once a year since the valuation is done only on annual basis. Returns would thus not reflect the daily fluctuations in the value of assets.

Unit linked policies help to overcome both the above limitations. **The benefits under these contracts are wholly or partially determined by the value of units credited to the policyholder's account at the date when payment is due.**

Unit linked policies thus provide the means for directly and immediately cashing on the benefits of a life insurer's investment performance. The units are usually those of a specified authorised unit trust or a segregated (internal) fund managed by the company. Units may be purchased by payment of a single premium or via regular premium payments.

In the United Kingdom and other markets these policies were developed and positioned as investment vehicles with an attached insurance component. Their structure differs significantly from that of conventional cash value contracts. The latter, as we have said, are bundled. They are opaque with regard to their term, expenses and savings components. Unit linked contracts, in contrast, are unbundled. Their structure is transparent with the charges to pay for the insurance and expenses component being clearly specified.

Diagram 2: Premium break-up



Once these charges are deducted from the premium, the balance of the account and income from it is invested in units. The value of these units is fixed with reference to some pre-determined index of performance.

The key point is that this value is defined by a rule or formula, which is outlined in advance. Typically the value of the units is given by the net asset value (NAV), which reflects the market value of assets in which the fund is invested. Two independent persons could arrive at the same benefits payable by following the formula.

Policyholder benefits thus do not depend on the assumptions and discretion of the life insurance company.

An endearing feature of unit linked policies is its facility of choosing between different kinds of funds, which the unit holder can exercise. Each fund has a different portfolio mix of assets. The investor thus gets to choose between a broad option of debt, balanced and equity funds. A debt fund implies investment of most of one's premiums in debt securities like gilts and bonds. An equity fund would imply that units are predominantly in equity form. Even within these broad categories there may be other types of options.

Equity Fund	Debt Fund	Balanced Fund	Money Market Fund
This fund invests major portion of the money in equity and equity related instruments.	This fund invests major portion of the money in Government Bonds, Corporate Bonds, Fixed Deposits etc.	This fund invests in a mix of equity and debt instruments.	This fund invests money mainly in instruments such as Treasury Bills, Certificates of Deposit, Commercial Paper etc.

One may choose between a growth fund, predominantly invested in growth stocks, or a balanced fund, which balances need for income with capital gain. One may also choose sectoral funds, which invest only in certain sectors and industries. Each option that is selected must reflect one's risk profile and investment need. There is also provision to switch from one kind of fund to another if performance of one or more funds is not perceived to be up to the mark.

All these choices also carry a qualification. The life insurer, while being expected to manage an efficient portfolio, does not give any guarantee about unit values. It is thus relieved here of the greater part of the investment risk. The latter is borne by the unit holder. The life insurer may however bear the mortality and expense risk.

Again, unlike conventional plans, unit linked policies work on a minimum premium basis and not on sum assured. The insured decides on the amount of premium he or she wishes to contribute at regular intervals. **Insurance cover is a multiple of the premiums paid**. The insured has a choice between higher and lower cover. The premium may consist of two components – the term component may be placed in a guaranteed fund (termed as the sterling fund in UK) that would yield a minimum amount of cover on death. The balance of premium is used to purchase units that are invested in the capital market, particularly the stock market, by the insurer. In case of death the death benefit would be the higher of the sum assured or the fund value standing to one’s account. The fund value is simply the unit price multiplied by the number of units in the individual’s account.

Test Yourself 2

Which of the below statement is incorrect?

I. Variable life insurance is a temporary life insurance policy
II. Variable life insurance is a permanent life insurance policy
III. The policy has a cash value account
IV. The policy provides a minimum death benefit guarantee

Summary

- A critical point of concern with respect to life insurance policies has been the issue of giving a competitive rate of return which is comparable to that of other assets in the financial marketplace.

- Some of the trends that led to the upswing in non-traditional life products include unbundling, investment linkage and transparency.

- Universal life insurance is a form of permanent life insurance characterised by its flexible premiums, flexible face amount and death benefit amounts, and the unbundling of its pricing factors.

- Variable life insurance is a kind of "Whole Life" policy where death benefit and cash value of the policy fluctuates according to the investment performance of a special investment account into which premiums are credited.

- Unit linked plans, also known as ULIP's emerged as one of the most popular and significant products, supplanting traditional plans in many markets.

- Unit linked policies provide the means for directly and immediately cashing on the benefits of a life insurer's investment performance.

Key Terms

1. Universal life insurance
2. Variable life insurance
3. Unit linked insurance
4. Net asset value

Answers to Test Yourself

Answer 1

The correct option is II.

Universal life insurance is a non-traditional life insurance product.

Answer 2

The correct option is I.

The statement "Variable life insurance is a temporary life insurance policy" is incorrect.
The correct statement is "Variable life insurance is a permanent life insurance policy".

Self-Examination Questions

Question 1

What does inter-temporal allocation of resources refer to?

I. Postponing allocation of resources until the time is right
II. Allocation of resources over time
III. Temporary allocation of resources
IV. Diversification of resource allocation

Question 2

Which among the following is a limitation of traditional life insurance products?

I. Yields on these policies is high
II. Clear and visible method of arriving at surrender value
III. Well defined cash and savings value component
IV. Rate of return is not easy to ascertain

Question 3

Where was the Universal Life Policy introduced first?

I. USA
II. Great Britain
III. Germany
IV. France

Question 4

Who among the following is most likely to buy variable life insurance?

I. People seeking fixed return
II. People who are risk averse and do not dabble in equity
III. Knowledgeable people comfortable with equity
IV. Young people in general

Question 5

Which of the below statement is true regarding ULIP's?

I. Value of the units is determined by a formula fixed in advance
II. Investment risk is borne by the insurer
III. ULIP's are opaque with regards to their term, expenses and savings components
IV. ULIP's are bundled products

Question 6

All of the following are characteristics of variable life insurance EXCEPT:

I. Flexible premium payments
II. Cash value is not guaranteed
III. Policy owner selects where savings reserve is invested
IV. Minimum Death benefit is guaranteed

Question 7

Which of the below is correct with regards to universal life insurance?

Statement I: It allows policy owner to vary payments
Statement II: Policy owner can earn market based rate of return on cash value

I. I is true
II. II is true
III. I and II are true
IV. I and II are false

Question 8

All of the following is true regarding ULIP's EXCEPT:

I. Unit holder can choose between different kind of funds
II. Life insurer provides guarantee for unit values
III. Units may be purchased by payment of a single premium or via regular premium payments.
IV. ULIP policy structure is transparent with regards to the insurance expenses component

Question 9

As per IRDA norms, an insurance company can provide which of the below non-traditional savings life insurance products are permitted in India?

Choice I: Unit Linked Insurance Plans
Choice II: Variable Insurance Plans

I. I only
II. II only
III. I and II both
IV. Neither I nor II

Question 10

What does unbundling of life insurance products refers to?

I. Correlation of life insurance products with bonds
II. Correlation of life insurance products with equities
III. Amalgamation of protection and savings element
IV. Separation of the protection and savings element

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Inter-temporal allocation of resources refers to allocation of resources over time.

Answer 2

The correct option is IV.

Rate of return is not easy to ascertain in traditional life insurance products.

Answer 3

The correct option is I.

Universal Life Policy was first introduced in the USA.

Answer 4

The correct option is III.

Knowledgeable people comfortable with equity are most likely to buy variable life insurance.

Answer 5

The correct option is III.

ULIP's are transparent with regards to their term, expenses and savings components.

Answer 6

The correct option is I.

Premium payments are fixed and not flexible with variable life insurance.

Answer 7

The correct option is III.

Both statements are true. Premium payment flexibility is a characteristic of universal life insurance. This form of life insurance also permits the policy owner to earn a rate of return tied to some market-based index.

Answer 8

The correct option is II.

Life insurer does not provide guarantee for unit values in case of ULIP's.

Answer 9

The correct option is III.

As per IRDA norms non-traditional savings life insurance products permitted in India include unit linked insurance plans and variable insurance plans.

Answer 10

The correct option is IV.

Separation of the protection and savings element refers to the unbundling of life insurance products.

CHAPTER 7

PENSION AND ANNUITIES

Chapter Introduction

This chapter discusses a product that addresses basic life contingencies but is different from other life insurance products that cover mortality risk. It also takes you briefly into another line of insurance which is different from individual insurance, namely group insurance.

Learning Outcomes

A. Types of pension
B. Classification of annuities
C. Pensions – The value proposition

A. Types of pension

1. Pensions and old age income security

Pensions may be said to represent the flip side of life insurance.

Difference between life insurance products and pension products

Life insurance products	Pension products
Purpose of product: Life insurance products have been designed basically to provide protection against the financial consequences of an individual's early and premature death.	Pension products provide protection against the financial consequences that may arise when the individual lives too long and thus outlives one's financial resources.
Contingency covered: In case of life insurance, the basic contingency covered is that of mortality.	In case of pensions it is post-retirement income discontinuity.
Product structure: In the case of life insurance, a stream of premium payments results in creation of a capital sum, known as the sum assured. This sum is payable to the individual's nominees or beneficiaries in the event of death of the individual, or may be paid as a survival benefit at the end of the term in the case of endowment policies.	In the case of pensions, a capital sum, which we may call a corpus or total consideration gets liquidated in part or whole through its conversion into a stream of regular income payments. These are known as annuities.

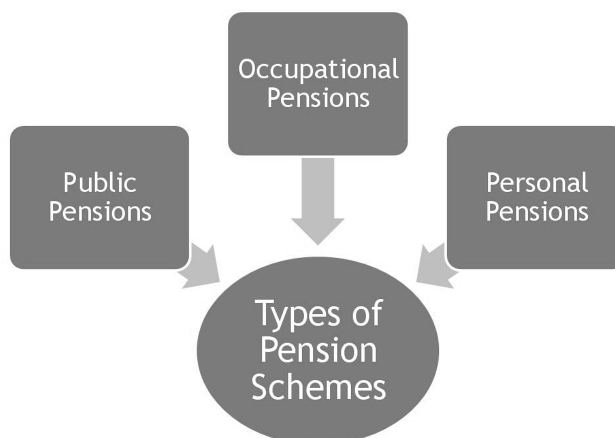
The basic objective of any pension is to provide individuals, who have been working and earning an income during the productive years of their life time, with an income during their old age when they are retired and no longer at work. The need to protect and provide for people when they are old and no longer able to work and earn, has been well recognised by the State and civil society. **Pensions accordingly form a critical part of social security in many countries.**

2. Types of pension schemes

There are three types of pension schemes in existence today

- ✓ Public pensions
- ✓ Occupational pensions
- ✓ Personal pensions

Diagram 1: Types of pension schemes



Let us briefly discuss these.

a) **Public pensions**

This is known as the first pillar of social security and consists of pensions that are provided by the State. The schemes are publicly managed with mandatory membership. They are typically funded on a **'Pay As You Go' (PAYG)** basis. This means that the funding requirements for paying current pension payments are met by drawing on the social security contributions, deducted from current income of the work force. The basic purpose of these pensions is to fulfill the State's responsibility to ensure that all citizens receive a minimum level of income in retirement. It is a kind of safety net.

At the basic level the State may provide what are termed as means – tested benefits. These are paid to people who earn less than a certain amount, or have accumulated less than a certain level of wealth or both. Another more common form of benefit is one in which there is a combination of a flat rate, sufficient to ensure the maintenance of a minimum standard of living, along with an earnings – related component.

i. **Flat rate and means tested pensions** are financed by taxes and contributions which all have to pay regardless of the benefit levels they receive in turn.
ii. **The earnings related supplementary portion**, on the other hand depends on the individual's own contribution which is supplemented, in many cases, by State subsidies.

Many developed countries provide a minimum guaranteed pension, which may alleviate poverty but are not sufficient to maintain even a modest life style. This raises the need for additional layers of provision to supplement the basic State pension.

b) Occupational pensions

This is the second pillar of post-retirement provision. Occupational pensions have been set up by employers for their employees, with contributions from both employers and employees. They are normally sponsored by employers and form part of the employees' benefit package.

Typically, most occupational pension schemes in the past have been of the "Defined Benefit" type. This meant that the benefit payable was defined independently of the contributions made to the scheme or its investment earnings. Such benefit has been normally calculated with reference to the final salary and the number of years in pensionable service, using an accrual rate.

Example

The accrual rate is given by the fraction of pensionable salary earned per year of service by the scheme members.

An employee has put in 38 years of service and has earned a final salary of Rs. 40,000 per month at the time of retirement from service. If the accrual rate was 1/60 for each year of pensionable service, this means that the employee on retirement would be eligible for a pension that is equal to 38 / 60 times of final salary. He or she would get Rs. 25,333 (38/60 x 40000).

The benefits may also be linked to some index in order to reduce the corroding impact of inflation. In this case the employee in the above example would get higher pensions in later years, if price levels were to rise.

Once the benefit to be paid is defined, one needs to then decide how to fund the liability that is created. In occupational schemes the employer typically makes a standard contribution based on a rate that is calculated using actuarial estimates. These estimates are based on assumptions about various events that the scheme may experience in future like:

i. Demographic experience of the members and their dependents
ii. General economic environment
iii. The rate of inflation
iv. Expected long term increases in average earnings
v. Rates of mortality and investment return
vi. Withdrawal or job exit on ill health

Occupational pension schemes may be uninsured or insured.

Uninsured pension scheme	Insured pension scheme
In this case, an employer can decide to manage the fund, typically setting up a trust for the purpose. The trust however can pay the pension only through purchasing an annuity from a life insurance company.	In case of an insured scheme, the insurance company manages the fund. The advantage of this arrangement is that it passes on to the insurer the risks and costs of direct fund management and investment, which the employer would otherwise have had to undertake.

Defined benefit schemes, as described above, were popular during the decades of economic boom that were enjoyed during the latter half of the twentieth century. This was the period when the concept of job for life was dominant. Especially when equity and capital markets were going strong, employers were able to earn large surpluses, which enabled employers to offer generous pensions without too much strain on cash flows of firms.

These schemes have however been faced with serious problems in recent years on account of various reasons.

i. One problem is **erosion in the "Job for life" concept**. Early retirements or retrenchment of workers in the face of economic downturns slashed the period during which contributions could be accrued.

ii. Again, defined benefit schemes placed a set of **open-ended liabilities on the employer**. The latter had to pay the guaranteed benefit regardless of whatever investment, inflation and other market conditions were prevailing. In an environment where business conditions were not stable and profitable, employers found these obligations difficult to meet.

iii. A third critical issue was that defined benefit pensions paid a **benefit that was not linked, to investment performance of the fund**. Many employees found that they could earn large returns by investing their contributions to pension schemes directly in equity markets. These returns were far in excess of the pension the employees would receive under their occupational scheme.

The above factors have prompted many employers worldwide to shift from defined benefit to defined contribution or money purchase schemes. Under these schemes, the contribution to be made is defined. The employer's liability is limited to paying the accrued value that is earned through investing these contributions. Benefits thus depend on performance of the fund in which the contributions are invested.

Again, the pooling and cross-subsidy principles that we would find in defined benefit schemes are absent or much less present in defined contribution schemes. Each member has his or her own individual account in the scheme, is rewarded for whatever is earned by that account, and has to bear the investment risks.

3. Personal pensions

The third type of pensions is known as personal pensions. These are plans that are designed and marketed by market providers, like life insurers and other financial institutions, towards providing an old age income.

A personal pension is typically offered and purchased in the form of an annuity contract between the insurance company or other pension provider and an annuitant. The latter pays either a single premium or a series of premiums – known as annuity considerations. The pension provider pools and invests these contributions, whose principal and investment earnings lead to creation of a **corpus**.

On a specified date, when annuity payments to the annuitant are due to begin, the corpus, and any earnings on it, begins to get converted into a series of payments over a certain time period. The period may be expressed in terms of specified number of years or for duration of life or both.

In sum a personal pension represents the principle of **scientific liquidation of capital**. It may be expressed as follows:

i. A principal sum of money [P] is invested over a specified period of time [T] and earns returns at a certain rate [R].It creates a corpus C
ii. The corpus C is converted into a series of annuity payments [A] over a specified length of time [L].The time may correspond with the remaining lifetime of the annuitant or may be for a specified number of years
iii. We can see that the amount of annuity actually payable [A] would depend on the other four variables (P, T, R, L).It would increase directly with P and T. It would also be more if R is higher. It bears an inverse relationship with the last variable [L]. The longer the period over which the annuity is payable, the smaller its size would be.

Commutation of pension

1/3 rd of the accumulated value can be withdrawn at the time of retirement and is tax-free.

Test Yourself 1

Who provides public pensions?

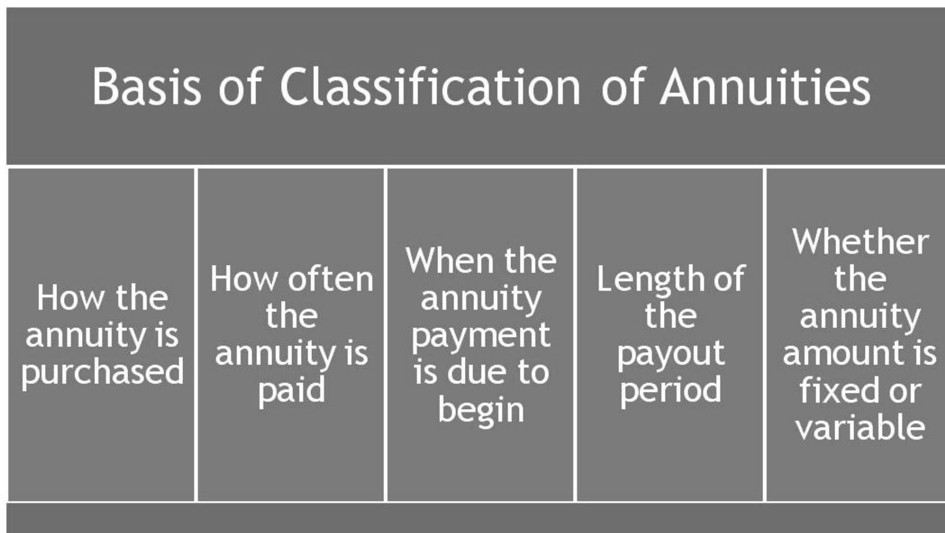
I. State

II. Employers
III. Insurers
IV. NGO's

B. Classification of annuities

Individual annuity plans provided by various life insurance companies are a variant of personal pension plans. It would be useful to know the various ways in which these products are classified.

Diagram 2: Basis of Classification of Annuities



1. Classes of annuities

a) Annuities may firstly be classified on the basis of **how the annuity is purchased**. On this basis they are divided into single premium annuities, which are purchased by paying a single or lump sum premium and periodic premium annuities, which are purchased by paying a series of premiums over a number of years.

b) A second classification could be on the basis of **how often the annuity is paid**. Annuities are typically on monthly basis but other options like fortnightly or quarterly may be possible.

c) The third way is on the basis of **when the annuity payment is due to begin**. On this basis it can be classified as either an immediate or a deferred annuity. An immediate annuity is one where the annuities are scheduled to begin immediately. It is typically purchased with a single premium. A deferred annuity is where periodic benefits are scheduled to begin after a period, say at least 12 months after the date of purchase of the annuity. Every deferred annuity in turn has two periods – an **accumulation period** between when the annuity is purchased and the annuity payments begin, and a payout or **liquidation period** during which the insurer makes the annuity payments.

d) This brings us to the fourth classification basis, given by the **length of the payout period** or when the annuity payments would end. There are various types of options that the annuitant can choose from. The most basic is the life annuity, which provides periodic benefit payments during the lifetime of the annuitant. In the pure life annuity the benefit payment would cease with the death of the annuitant. The second type is known as the annuity certain. Here the periodic payments are unrelated to lifetime of the annuitant. They are payable for a (certain) stated period of time regardless of whether the individual lives or dies meanwhile.

e) Finally, a distinction may be made on the basis of **whether the annuity amount is fixed** (guaranteed) **or variable** (contingent on investment performance). This distinction has been present in some markets like the US for quite some time.

A fixed benefit annuity is where the insurer guarantees a defined amount of monthly annuity benefit for each rupee applied to purchase an annuity. The guarantee implies that the insurer bears the investment risk. A variable annuity is one in which the value of the amount accumulated in the annuitant's name and the monthly benefit payable fluctuates with the performance of the account in which the fund is placed. The annuitant benefits from all gains that arise as a result of profitable investments and suffers from all the losses arising as a result of unprofitable investments.

Payment to annuitants

Annuities are paid to annuitants as long as they live during the guarantee period and thereafter to the nominee. In case of joint-life annuity, upon the death of the annuitant, his annuity ceases and 50% of the annuity is paid to the surviving spouse during her lifetime. If the spouse predeceases the annuitant, the annuity ceases.

Types of Annuities

There are two basic types of annuities :

a) Immediate Annuities
b) Deferred Annuities

Immediate Annuities

A annuitant receives payments after making an initial investment.In an immediate annuity, an individual pays a lump sum and begins to receive income one annuity period later.If it is a monthly annuity, payment commences one month after premium payment, if quarterly after three months, if half-yearly after six months and if annually after one year.

Immediate annuity can be purchased by those approaching retirement to ensure regular cash flow to help cover basic living expenses.

Deferred Annuities

With a deferred annuity, money is invested for a period of time until the annuitant is ready to receive annuities.The deferred annuity accumulates money for the term chosen by the individual.The time period between the date of purchase of the deferred annuity and the date the annuity payments begin is called the accumulation period or deferment period.

A deferred annuity has two phases – accumulation phase during which the annuitant contributes to the annuity for a set time period,and distribution or payout phase during which annuity payments are made.

Test Yourself 2

Who bears the investment risk in a fixed benefit annuity?

I. Insurer
II. Insured
III. State
IV. Risk pool

C. Pensions – The value proposition

1. What really is a pension and how does it differ from other similar products?

Example

Consider a fixed deposit with a bank for Rs. Ten lakhs, which gives interest @ 12% per annum, payable monthly which yields a periodic payment of Rs. 10, 000 per month. In what respect does it differ from a pension, which also provides a periodic payment?

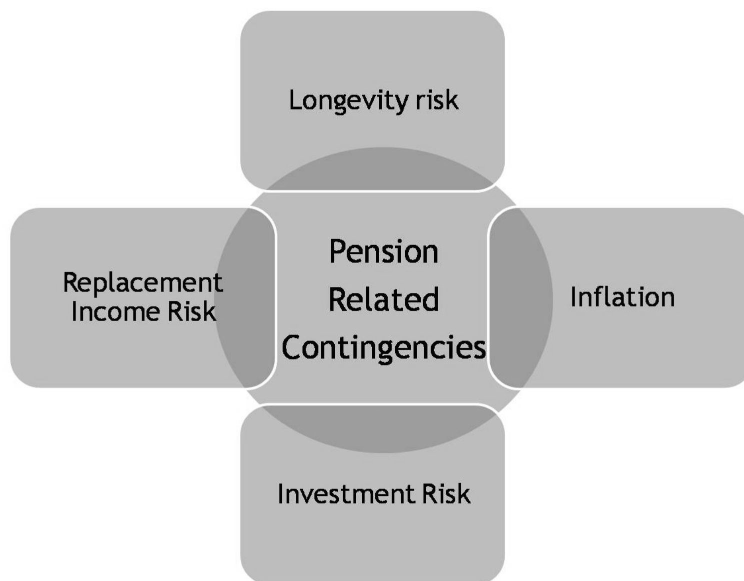
The above case is an instance of an **annuity payment**, which provides a monthly income. Pensions have a similar feature. **Every pension is an annuity** in the sense that it involves a regular stream of income payments but **every annuity is not a pension.**

When we speak of a pension it is as an insurance product. As stated earlier, insurance involves the transfer of risk through pooling it.

The defining characteristic of a pension lies in how the mutuality or pooling principle is applied for addressing contingencies associated with longevity in the

post retirement phase of one's life. Let us take a look at these contingencies and the role of pensions in meeting them

Diagram 3: Pension related contingencies



a) Longevity risk

This is the chance that one may live too long after retirement and outlive one's resources. The dilemma of the old age retiree is twofold – how much old age provision one must make and where the fund must be invested.

Old age provision and Investment vehicle

Ideally a person should have been able to enjoy the fruits of his or her savings in full while one is alive and leave a bequest as one desires. The problem is that one does not know when one will die and for how long one must provide. If one has saved too much by restricting one's living standards, there is the chance of dying too soon without having enjoyed one's resources. On the other hand if one lives too long there is the chance that savings may prove to be inadequate.
The solution lies in having a vehicle that provides both an annuity income, which fully utilises one's savings and also has a term to maturity exactly corresponding to one's lifetime. The pension annuity solves both kinds of problems. A life annuity for example pays a regular payment exactly as long as one's life time. The insurer assumes the risk that the pension may be inadequately funded if the [pensioner] annuitant lives too long. Again, the pension annuity enables the most optimal conversion of capital into income.

Example

Take the above case for example, where a fixed deposit of Rs. 10 lakhs pays an interest of Rs 10,000 @ 12%. The principal is repayable at a certain point but is of no use after the individual's death.

On the other hand the pension annuity provides for scientific liquidation of corpus such that both principal plus interest is timed so as to be exhausted during one's estimated lifetime. A corpus of Rs. 10 lakhs can thus yield a pension that includes two components – an interest, as earned in case of a fixed deposit, and also a portion of the principal. While longevity is the problem that pensions were traditionally designed to address, there are others which are important.

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b) Inflation

The second contingency is inflation. It can reduce post-retirement living standards in real terms. Real incomes are normally protected when one is in active service through suitable wage indexing. What about after retirement? Once again, pension payments may have provisions for indexing which can address the risk of erosion through inflation.

c) Investment risk

A third contingency is that posed by investment risk — the possibility of one's retirement savings being rendered inadequate or even wiped out because the underlying investments performed badly vis-à-vis expectations. This can be on account of default by debtors and / or a fall in the market value of investments. Fixed guaranteed pensions are a way to ward off such contingencies. The insurer assumes the investment risk.

d) Replacement income risk

Yet another challenge is to secure post retirement incomes which are in some measure linked to final salary levels. We must remember that people's standard of living depends on what they earn and they cannot automatically change these standards when income falls. An occupational pension which offers a defined benefit that bears a decent proportion of final salary could be a viable solution to the problem.

Example

Mr. Santosh aged 40 earns a salary of Rs. 50,000 a month. Given that his income and expenditure are expected to rise @ 5% per year, he expects his final salary at age 60 to be around Rs. 1,32,665 (50000 x $(1.05)^{20}$). The replacement income he needs after retirement at age 60 would thus amount to more than two and half times what he earns at age 40. Mr. Santosh is worried whether he would have savings coming anywhere close to this amount. He wishes he had an occupational pension scheme in his company which could have solved his problem at least in part.

As pension markets evolve, they are facing newer and newer challenges of providing income security. With aging of populations and a significant proportion of people facing the spectre of living long years after retirement, pensions are already set to emerge as one of the principal products in the financial marketplace. However the industry would have to also measure up to the expectations of the pensioners and address their concerns.

Test Yourself 3

Which among the below statements is true?
Statement I: Every pension is an annuity
Statement II: Every annuity is a pension

I. I and II are true
II. I and II are false
III. I is true and II is false
IV. I is false and II is true

Summary

- Pensions may be said to represent the flip side of life insurance. They provide protection against the financial consequences that may arise when the individual lives too long and thus outlives one's financial resources.

- There are three types of pension schemes in existence today i.e. public pensions, occupational pensions and personal pensions.

- Public pension schemes are publicly managed with mandatory membership and are typically funded on a 'Pay As You Go' (PAYG) basis.

- Occupational pensions have been set up by employers for their employees, with contributions from both employers and employees.

- A personal pension is typically offered and purchased in the form of an annuity contract between the insurance company or other pension provider and an annuitant.

- Annuities can be classified on the basis of how the annuity is purchased, how often the annuity is paid, when the annuity payment is due or length of the payout period and whether the annuity amount is fixed or variable.

- The contingencies that can be met using pension include longevity risk, inflation, investment risk and replacement income risk.

Key Terms

1. Corpus
2. Public pensions
3. Occupational pensions
4. Personal pensions
5. Annuities
6. Life annuity
7. Fixed benefit annuity
8. Variable annuity

Answers to Test Yourself

Answer 1

The correct option is I.

Public pension is provided by the State.

Answer 2

The correct option is I.

Insurer bears the investment risk in a fixed benefit annuity.

Answer 3

The correct option is III.

Statement I is true and II is false.

Self-Examination Questions

Question 1

Which of the below risk cannot be addressed through pensions?

I. Life longevity
II. Inflation
III. Investment risk
IV. Early death

Question 2

With relation to annuities, explain what does “Liquidation period” refer to?

I. Period between the purchase of annuity and commencement of payments
II. Period during which insurer makes annuity payments
III. Time taken to build up the corpus
IV. Insolvency period

Question 3

Amount of annuity payable depends on which of the following:

1. Principal sum of money
2. Investment period
3. Rate of return
4. Duration of annuity payments

I. 1 and 2
II. 1,2 and 3
III. 1,3 and 4
IV. 1,2,3 and 4

Question 4

Amount of annuity payable is inversely related to which of the following:

1. Principal sum of money
2. Investment period
3. Rate of return
4. Duration of annuity payments

I. 1 only
II. 2 only
III. 3 only
IV. 4 only

Question 5

What is the basic contingency associated with pensions?

I. Mortality
II. Morbidity
III. Post-retirement income security
IV. Disability

Question 6

Which of the below best describes an ordinary annuity?

I. Equal cash flows at equal time intervals forever
II. Equal cash flows at equal time intervals for a specific time period
III. Lumpy cash flows at equal time intervals forever
IV. Lumpy cash flows at equal time intervals for a specific time period

Question 7

From the choices mentioned below, select the one that cannot be categorised as an annuity.

I. Rs. 2000 received today, Rs. 2000 received next year and Rs. 2000 received in 2 years
II. Electricity Bill
III. Car payments
IV. Mortgage payments

Question 8

In an ordinary annuity, payments are made or received ___________ of each period.

I. At the beginning
II. At the end
III. On maturity
IV. 6 months before expiry

Question 9

___________ is an annuity with an infinite life and making continuous annual payments.

I. APR
II. Amortised loan
III. Perpetuity
IV. Principal

Question 10

_____________ is a term used to refer pensions that have some level of Government administration.

I. Insurance Pension Fund
II. Public Pension Fund
III. Private Pension Fund
IV. Market Pension Fund

Answers to Self-Examination Questions

Answer 1

The correct option is IV.

Early death risk cannot be addressed through pensions.

Answer 2

The correct option is II.

The period during which the insurer makes annuity payments, is referred to as liquidation period.

Answer 3

The correct option is IV.

Amount of annuity payable depends on principal sum of money, investment period, rate of return and duration of annuity payments.

Answer 4

The correct option is IV.

Amount of annuity payable is inversely related to duration of annuity payments.

Answer 5

The correct option is III.

The basic contingency associated with pensions is that of post-retirement income security.

Answer 6

The correct option is II.

Equal cash flows at equal time intervals for a specific time period best describe an ordinary annuity.

Answer 7

The correct option is II.

An electricity bill cannot be categorised as an annuity.

Answer 8

The correct option is II.

In an ordinary annuity payments are made or received at the end of each period.

Answer 9

The correct option is III.

Perpetuity is an annuity with an infinite life and making continuous annual payments.

Answer 10

The correct option is II.

Public pension fund is a term used to refer pensions that have some level of Government administration.

CHAPTER 8

HEALTH INSURANCE

Chapter Introduction

The chapter introduces you to health insurance concepts in general and the various health insurance policies available in the market. The chapter explains domiciliary hospitalisation, family floater policies and group health insurance policies.

Learning Outcomes

A. Concepts related to health insurance
B. Benefits and expenses under health policies
C. Terminology connected with health insurance
D. Processes involved in an health insurance claim settlement.

A. Health insurance policies

1. Health insurance

Definition

Health insurance can simply be defined as a contract between the insurer and the insured wherein the insurer agrees to pay hospitalisation expenses to the extent of an agreed sum insured in the event of any medical treatment arising out of an illness or an injury.

Good healthcare is a human right. Everyone is interested in ensuring accessibility and affordability of healthcare. Healthcare in India has assumed great importance in recent times. Increased income, health consciousness, price liberalisation and the introduction of private healthcare financing is bringing the change.

With the rise in lifestyle diseases, especially in urban India, the need for an effective health insurance is increasingly becoming important as being sick or meeting with an accident can cause considerable financial setback. Though hospitals are providing latest medical facilities and state-of-the-art infrastructure, patients are also charged high amounts, accordingly.

While the well-to-do segment of the population may have more accessibility and affordability towards good health care, the rising costs of medical treatment are beyond the reach of the common man.

Heath insurance is the tool that can help in such circumstances. Health insurance is fast emerging as an alternate source for financing health care costs. Absence of health insurance can result in high medical bills in the event of hospitalisation due to illness or injury. Therefore, it has become an important financial tool. After all, health is wealth!

2. Understanding health insurance policies

Insurance companies offer a wide variety of policies under health insurance. These range from policies that cover the cost of doctors and hospitals to those that meet a specific need, such as paying for long term care or specific illness like cancer or critical illness.

Several life insurance companies have of late entered into the health segment, which till recently was dominated by general insurance companies. Some stand-alone health insurance companies have also been set up to tap the vast potential of the health insurance in India.

a) What does a health insurance policy cover?

A health insurance policy generally covers the basic costs in case of hospitalisation due to any accidents/diseases/ illnesses which do not form a part of the permanent exclusions of the policy.

Information

Standalone health insurance companies

i. Standalone companies came into existence in India as they saw tremendous growth in health insurance business.
ii. IRDA lowered the capital requirements for opening standalone health companies, so that more health insurance companies could be established.
iii. Expectations included designing innovative products for different customer segments.
iv. These companies brought in a lot of specialised expertise and research into the country.
v. Hospital chains entered into insurance business.
vi. Standalone companies got involved in special schemes of the Government for covering rural masses.

The expenses covered under health insurance usually include:

- ✓ Cost of room / bed
- ✓ Boarding expenses
- ✓ Nursing expenses
- ✓ Doctor's fees
- ✓ Diagnostic tests
- ✓ Operation theatre charges and
- ✓ Expenses related to surgical appliances and the like

As a part of the standard plan, coverage for pre and post-hospitalisation expenses and specified day-care procedures, are also listed in the specific policies.

Health insurance coverage may vary from insurer to insurer. Some insurers have introduced covers for outpatient (OP) treatment covering expenses like OP consultations, pharmacy bills, diagnostic tests, dental treatment, optical services and annual health check-up costs along with in-patient treatment. Some insurers allow add-ons like critical illness.

Cover for diseases such as cancer, stroke, kidney failure and heart attacks are also given subject to certain conditions and additional premium.

Definition

Some common definitions in health insurance are:

Inpatient: Insured who undergoes treatment after getting admitted in the hospital

Outpatient: Insured who undergoes treatment without getting admission/staying in the hospital

Day care centre: With the advancement of technology and medical science many complicated surgical procedures have been simplified and do not require more than a day's stay in the hospital or less than 24 hours at times; for e.g., lithotripsy, cataract etc. The Centre where such procedures are carried out is known as day care centre.

b) Terms in health insurance

i. Third Party Administrators (TPA)

It means any person who is licensed under the IRDA (Third Party Administrators - Health Services) Regulations, 2001 by the Authority, and is engaged, for a fee or remuneration by an insurance company, for the purposes of providing health services.

ii. Network provider

It means hospitals or health care providers enlisted by an insurer or by a TPA and insurer together to provide medical services to an insured on payment by a cashless facility.

iii. Portability

It is the right accorded to an individual health insurance policyholder (including family cover), to transfer the credit gained for pre-existing conditions and time bound exclusions, from one insurer to another insurer or from one plan to another plan of the same insurer, provided the previous policy has been maintained without any break. Moving between policies of the same company itself has been excluded.

iv. Pre-existing conditions

These refer to manifestation or occurrence of illness/injury for which treatment was required during a pre-determined time. These can be covered after a certain waiting period.

v. Senior citizen

It means any person who has completed sixty or more years of age as on the date of commencement or renewal of a health insurance policy.

vi. Health plus Life Combo Products

They mean products which offer the combination of a life insurance cover from a life insurance company and a health insurance cover offered by non-life and/or standalone health insurance company.

Information

Public sector general insurance companies coined the name 'Mediclaim' for their health insurance policy which was introduced in the market in the late 1980's, to cover hospitalisation. In course of time, 'Mediclaim' got synonymous with health insurance in the Indian market.

Today, though, there are many health insurance products of different types that address different customer needs, much different from the original Mediclaim policy. Though these are sold under different names, many consumers still refer to their health insurances as 'Mediclaim'.

Health insurance policies in India normally provide a comprehensive health cover, covering nearly all illnesses and injuries requiring minimum 24 hours of hospitalisation, subject to a few exclusions namely AIDS, STDs, mental disorders and congenital defects. Typical health insurance policy does not cover medical expenses that are routine in nature or incurred for routine health check-ups, cosmetic surgery, plastic surgery, dental treatment, aesthetic treatment, etc.

Important

There are certain waiting periods (usually 48 months) with regard to pre-existing diseases (PEDs), some specific illnesses like cataract, some procedures like hysterectomy etc., for a defined period which usually range from one year to four years.

However, exclusions and the waiting period may differ from insurer to insurer. Maternity expenses are excluded by many insurers. Lately there are a few products that offer coverage against maternity expenses after certain waiting period. A few plans may also incorporate the ambulance charges, a free medical check-up at the end of every 4 to 5 claim free years.No-claim bonus is offered to the insured in case of claim-free years.

There are insurers, who cover HIV positive persons. A few also offer non-allopathic treatment up to a percentage of sum insured. Most of the insurers offer a wide variety of products.

3. Domiciliary hospitalisation

Certain insurance products offer domiciliary hospitalisation benefits. This generally refers to medical treatment for a period exceeding three days for such illness/ injury which in the normal course would require treatment at the hospital/ nursing home, but was actually taken whilst confined at home in India under any of the following circumstances namely:

- ✓ The condition of the patient is such that he/ she cannot be removed to the hospital / nursing home
- ✓ The patient cannot be removed to hospital/ nursing home for lack of accommodation therein

It excludes certain chronic diseases like asthma, diabetes, hypertension, or common diseases like cough, cold, flu, dysentery etc. Many companies feel that domiciliary hospitalisation covers are not of much practical use and have withdrawn this cover. Domiciliary hospitalisation limit is fixed at a certain percentage of the total sum insured. This amount is within the overall limit of sum insured.

The premium is related to the age of the person and the sum insured selected. It is based on assessment of risk status of the consumer (or of the group of employees) and the level of benefits provided, rather than as a proportion of consumer's income.

4. Family floater policies

Family floater policy is another version of a health insurance policy. Here, the sum insured floats among the family members. Family floaters usually cover husband, wife and two children. Some policies cover more than two children, parents and parents in law as well. The coverage for the entire family is limited to the sum insured opted for. The total premium payable for family floater policies is less than the total premium payable for non-floater policies where separate sums insured are applicable for each family member.

Example

An insured takes a policy for himself, his spouse and the dependent children with individual health insurance plans with a sum assured of Rs. 2 lakhs each. He would have to pay premium ranging between Rs. 2000 - Rs. 4000 for each family member.

However, if the insured opts for a family floater plan with a sum insured of Rs. 5 lakhs, the total premium would be less than the separate premium payments for individual sums insured. While the separate health plan would cover only Rs. 2 lakhs per person, in case of the floater plan, the cover would go up to Rs. 5 lakhs which would help the family in case the medical treatment costs are high for any one family member.

Health Insurance policy can be obtained by an individual for himself, his/her family, or by a group. **The eligibility as per the age factor varies from insurer to insurer, from as young as 3 months to 80 years and above.**

The sum insured is available within a certain range. It depends on the age bracket too. Let us say for age group of 25 -40 years the insurer may offer a sum insured of 10 lakhs or higher and for age group of 3 months to 5 years it could be 2 lakhs.

The rules keep changing from time to time and would apply differently for different policies and insured groups. Agents need to be clear about the tax incentives available for the policies they sell and be familiar with the tax incentives available for other products in the market.

Important

In order to promote health insurance, the Government gives certain tax incentives to policyholders. These benefits could be in the form of a tax rebate or by allowing the premium paid to be deducted from the income for tax calculations. An important incentive is that the premium paid for health insurance policy qualifies for tax benefit under Section 80D of Income Tax Act.

Definition

Hospital

A hospital means any institution established for in-patient care and day care treatment of illness and/or injuries and which has been registered as a hospital with the local authorities under the Clinical Establishments (Registration and Regulation) Act, 2010 or under the enactments specified under the Schedule of Section 56(1) of the said Act OR complies with all minimum criteria as under:

i. Has qualified nursing staff under its employment round the clock
ii. Has at least 10 in-patient beds in towns having a population of less than 10,00,000 and at least 15 in-patient beds in all other places
iii. Has qualified medical practitioner(s) in charge round the clock
iv. Has a fully equipped operation theatre of its own where surgical procedures are carried out
v. Maintains daily records of patients and makes these accessible to the insurance company's authorised personnel

5. Steps to be taken when an insured person gets hospitalised

"Cashless facility" means a facility extended by the insurer to the insured where the payments, of the costs of treatment undergone by the insured in accordance with the policy terms and conditions, are directly made to the network provider by the insurer to the extent pre-authorisation approved. In 'Cashless' hospitalisation, the hospitals identify the insured based on the identity cards/ smart cards issued to them by the insurer. They may also get a pre-authorisation from the insurer. Cashless would mean that no payment need to be made by the insured at the time of admission and that hospital bills will be paid directly by the insurer to the hospital.

Scenario 1: Cashless facility

i. The insured has to approach a network hospital and get the treatment done
ii. The card issued either by the insurer or by a third party administrator has to be presented to the network hospital
iii. Either based on the smart card or after getting pre-authorisation from the insurer or from the TPA, the hospital would give admission
iv. Some insurance companies are required to be notified 48 hours before hospitalisation.
v. The insurer / TPA will process the cashless settlement after verification of policy details

Scenario 2: Claims reimbursement

If the insured does not opt for cashless settlement, he has to pay directly to the hospital. The bills have then to be submitted to the insurer/ TPA and the claims will be reimbursed.

Information

Pre-authorisation

Except in emergencies a cashless facility may require a pre-authorisation to be issued by the insurer or an appointed TPA to the network provider where the treatment is to be undergone. IRDA may prescribe a standard pre-authorisation form and standard reimbursement claims forms which shall be used for this purpose, as applicable.

Where a policyholder has been issued a pre-authorisation for the conduct of a given procedure in a given hospital or if the policyholder is already undergoing such treatment at a hospital, and such hospital is proposed to be removed from the list of network providers, then the insurer shall provide the benefits of cashless facility to such a policyholder as if such hospital continues to be on the network provider list.

Information

As per IRDA regulations issued in February 2013, all health insurance policies are required to have the features/ benefits given in information box below:

i. The network provider list

ii. Free look period of 15 days from the date the documents are received by the customer. During this period, the customer can decide whether or not to continue with the policy. In case she decides not to continue with it, the premium, after making some deductions for expenses, may be refunded in full.

iii. 30 days grace period is allowed beyond the expiry date of the policy, for renewal.

iv. Life time coverage on all policies made mandatory. Wherever a product has a maximum age limit for a certain category of insured, the insurer will offer to migrate the member to another suitable product, by providing credits for the number of all the continuous years of coverage.

v. All health policies are to have a provision for nomination.

vi. There has to be standardisation of customer information summary.

vii. A one page summary of benefits, terms and conditions has to be issued for each product.

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6. Group health insurance policy

Group health insurance policy is available to groups/ associations/ institutions/ corporate bodies, provided they have a central administration point and are subject to a minimum number of persons to be covered. The group must belong to a category that is approved.

The group policy is issued in the name of the group/ association/ institution/ corporate body (called insured) with a schedule of names of the members and their eligible family members (called insured persons) forming part of the policy.

Group includes family floaters and any policy with more than one insured person. The coverage under the policy is generally the same as under Individual health insurance policies with some conditions. However, some insurers allow certain relaxations

For example: A bank may take a group insurance policy for all its customers to whom it has given loans.

Diagram 1: Group insurance policy for bank customers

Information

Identity card and Smart card

i. To avail the benefit of cashless facility, insurers issue an identification card to the insured within 15 days from the date of issue of a policy, either through a TPA or directly.
ii. The identification card normally, carries details of the policyholder and the logo of the insurer.
iii. The validity of the card coincides with the term of the policy and would be renewed from time to time. Insurers may issue a smart card instead of an identity card.

Test Yourself 1

Health insurance is designed to handle which of the following risks?

I. Mortality
II. Morbidity
III. Infinity
IV. Serendipity

Summary

- Health insurance can simply be defined as a contract between the insurer & the insured wherein the insurer agrees to pay hospitalisation expenses to the extent of an agreed sum assured in the event of any medical treatment arising out of an illness or an injury.

- A health insurance policy generally covers the basic costs in case of hospitalisation due to any accidents/diseases/ illnesses which do not form a part of the permanent exclusions of the policy.

- Family floater policy is another version of a health insurance policy. Here, the sum insured floats among the family members.

- Cashless facility means a facility extended by the insurer to the insured where the payments, of the costs of treatment undergone by the insured in accordance with the policy terms and conditions, are directly made to the network provider by the insurer to the extent pre-authorisation approved.

- Group health insurance policy is available to groups/ associations/ institutions/ corporate bodies, provided they have a central administration point and are subject to a minimum number of persons to be covered.

Key Terms

1. Standalone health insurance companies
2. Domiciliary hospitalisation
3. Third party administrators (TPA's)
4. Pre-existing diseases (PED's)
5. Family floater policy
6. Cashless facility

Answers to Test Yourself

Answer 1

The correct option is II.

Health insurance can be used to address the risk of morbidity.

Self-Examination Questions

Question 1

IRDA stands for __________.

I. International Regulatory & Development Authority
II. Indian Regulatory & Development Authority
III. Insurance Regulatory & Development Authority
IV. Income Regulatory & Development Authority

Question 2

The term TPA refers to ________.
(Answer with regards to health insurance)

I. The Primary Associate
II. To Provide Assistance
III. Third Party Administrator
IV. Third Party Assistance

Question 3

Which of the below group would not be eligible for a group health insurance policy?

I. Employees of a company
II. Credit card holders of an organisation
III. Professional association members
IV. Group of unrelated individuals formed for the purpose of availing group health insurance

Question 4

Who cannot be covered under a family floater policy?

I. Children
II. Spouse
III. Parents-in-law
IV. Maternal uncle

Question 5

As per IRDA regulations issued in February 2013, what is the grace period allowed beyond the expiry date of the policy, for renewal?

I. 15 days
II. 30 days
III. 45 days
IV. 60 days

Question 6

Identify the form of insurance that is depicted in the following scenario.

Scenario: Patient pays the health provider and is subsequently reimbursed by the health insurance company.

I. Service Benefit
II. Direct contracting
III. Indemnity
IV. Casualty

Question 7

Moral hazard by health insurance companies can result in __________.

I. Community rating
II. Adverse selection
III. Abuse of health insurance
IV. Risk pooling

Question 8

Primary care can be described as _____________.

I. Care provided to patient in an acute setting
II. Care provided in hospitals
III. First point of contact for people seeking healthcare
IV. Care provided by Doctors

Question 9

__________________ is an insured who undergoes treatment after getting admitted in a hospital.

I. Inpatient
II. Outpatient
III. Day patient
IV. House patient

Question 10

_________ refers to a hospital/health care provider enlisted by an insurer to provide medical services to an insured on payment by a cashless facility.

I. Day care centre
II. Network provider
III. Third Party Administrator
IV. Domiciliary

Answers to Self-Examination Questions

Answer 1

The correct option is III.

IRDA stands for Insurance Regulatory & Development Authority.

Answer 2

The correct option is III.

The term TPA refers to "Third Party Administrator".

Answer 3

The correct option is IV.

Group of unrelated individuals formed for the purpose of availing group health insurance are not eligible for group health insurance.

Answer 4

The correct option is IV.

Maternal uncle cannot be covered under a family floater policy.

Answer 5

The correct option is II.

As per IRDA regulations issued in February 2013, 30 days grace period is allowed beyond the expiry date of the policy, for renewal.

Answer 6

The correct option is III.

The scenario refers to indemnity form of insurance.

Answer 7

The correct option is II.

Moral hazard by health insurance companies can result in adverse selection.

Answer 8

The correct option is III.

Primary care can be described as the first point of contact for people seeking healthcare.

Answer 9

The correct option is I.

Inpatient is an insured who undergoes treatment after getting admitted in a hospital.

Answer 10

The correct option is II.

Network provider refers to a hospital/health care provider enlisted by an insurer to provide medical services to an insured on payment by a cashless facility.

CHAPTER 9

APPLICATIONS OF LIFE INSURANCE

Chapter Introduction

Life insurance does not merely seek to protect individuals from premature death. It has other applications as well. It can be applied to the creation of trusts with resultant insurance benefits; it can be applied for creating a policy covering key personnel of industries and also for redeeming mortgages. We shall briefly describe these various applications of life insurance.

Learning Outcomes

A. Applications of life insurance

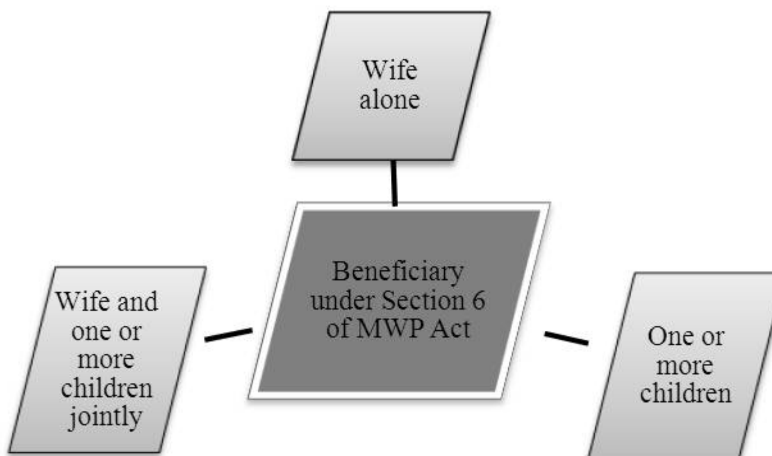
A. Applications of life insurance

1. Married Women's Property Act

The concept of Trusts in a life policy is necessitated by the applicability of estate duty on transfer/inheritance of benefits under a life insurance policy, including annuities. While with the abolition of estate duty in India, the concept of Trusts may no longer be preferred, it is beneficial to understand the subject in detail.

Section 6 of the Married Women's Property Act, 1874 provides for security of benefits under a life insurance policy to the wife and children. Section 6 of the Married Women's Property Act, 1874 also provides for creation of a Trust.

Diagram 1: Beneficiaries under MWP Act



It lays down that 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 of his wife and children, or any of them, shall ensure and be deemed to be a trust for the benefit of his wife, or of his wife and children, or any of them, according to the interest so expressed, and shall not, so long any object of the trust remains, be subject to the control of the husband, or to his creditors, or form part of his estate.

a) Features of a policy under the MWP Act

i. Each policy will remain a separate Trust. Either the wife or child (over 18 years of age) can be a trustee.

ii. The policy shall be beyond the control of court attachments, creditors and even the life assured.

iii. The claim money shall be paid to the trustees.

iv. The policy cannot be surrendered and neither nomination nor assignment is allowed.

v. If the policyholder does not appoint a special trustee to receive and administer the benefits under the policy, the sum secured under the policy becomes payable to the official trustee of the State in which the office at which the insurance was effected is situated.

b) Benefits

The Trust is set-up under an irrevocable, non-amendable Trust Deed and can hold one or more insurance policies. It is important to appoint a trustee for administration of the Trust property, being the benefits under the life policy. By creating a Trust to hold the insurance policies, the policyholder gives up his rights under the policy and upon the death of the life insured. The trustee invests the insurance proceeds and administers the Trust for one or more beneficiaries.

While it is a practice to create the Trust for the benefit of the spouse and children, the beneficiaries can be any other legal person. Creating a Trust ensures that the policy proceeds are invested wisely during the minority of the beneficiary and also secures the benefits against future creditors.

2. Key man Insurance

Keyman insurance is an important form of business insurance.

Definition

Keyman Insurance can be described as an insurance policy taken out by a business to compensate that business for financial losses that would arise from the death or extended incapacity of an important member of the business.

To put it simply, key man insurance is a life insurance that is used for business protection purposes. The policy's term does not extend beyond the period of the key person's usefulness to the business. Key man insurance policies are usually owned by the business and the aim is to compensate the business for losses incurred with the loss of a key income generator and facilitate business continuity. Keyman insurance does not indemnify the actual losses incurred but compensates with a fixed monetary sum as specified on the insurance policy.

Many businesses have a key person who is responsible for the majority of profits, or has a unique and hard to replace skill set such as intellectual property that is vital to the organisation. An employer may take out a key person insurance policy on the life or health of any employee whose knowledge, work, or overall contribution is considered uniquely valuable to the company.

The employer does this to offset the costs (such as hiring temporary help or recruiting a successor) and losses (such as a decreased ability to transact business until successors are trained) which the employer is likely to suffer in the event of the loss of a key person.

Keyman is a term insurance policy where the sum assured is linked to the profitability of the company rather than the key person's own income. The premium is paid by the company. This is tax efficient as the entire premium is treated as business expense. In case the key person dies, the benefit is paid to the company. Unlike individual insurance policies, the death benefit in keyman insurance is taxed as income.

The insurer will look at the business' audited financial statements and filed IT returns in assessing the sum assured. Generally, the company must be profitable to be eligible for keyman insurance. In a few cases, insurers make exceptions for loss making but well-funded start-up companies.

a) Who can be a keyman?

A key person can be anyone directly associated with the business whose loss can cause financial strain to the business. For example, the person could be a director of the company, a partner, a key sales person, key project manager, or someone with specific skills or knowledge which is especially valuable to the company.

b) Insurable losses

The following losses are those for which key person insurance can provide compensation:

i. Losses related to the extended period when a key person is unable to work, to provide temporary personnel and, if necessary to finance the recruitment and training of a replacement

ii. Insurance to protect profits. For example, offsetting lost income from lost sales, losses resulting from the delay or cancellation of any business project that the key person was involved in, loss of opportunity to expand, loss of specialised skills or knowledge

3. Mortgage Redemption Insurance (MRI)

Suppose you are taking a loan to buy a property. You may be required to pay for mortgage redemption insurance by the bank as part of the loan arrangement.

a) What is MRI?

It is an insurance policy that provides financial protection for home loan borrowers. It is basically a decreasing term life insurance policy taken by a mortgagor to repay the balance on a mortgage loan if he/she dies before its full repayment. It can be called a loan protector policy. This plan is suitable for elderly people whose dependents may need assistance in clearing their debts in case of the unexpected demise of the policyholder.

b) Features

The policy bears on surrender value or maturity benefits. The insurance cover under this policy decreases each year unlike a term insurance policy where insurance cover is constant during the policy period.

Test Yourself 1

What is the objective behind Mortgage Redemption Insurance?

I. Facilitate cheaper mortgage rates
II. Provide financial protection for home loan borrowers
III. Protect value of the mortgaged property
IV. Evade eviction in case of default

Summary

- Section 6 of the Married Women's Property Act, 1874 provides for security of benefits under a life insurance policy to the wife and children.

- The policy effected under MWP Act shall be beyond the control of court attachments, creditors and even the life assured.

- Keyman insurance is an important form of business insurance. It can be described as an insurance policy taken out by a business to compensate at for financial losses that would arise from the death or extended capacity of an important member of the business.

- Mortgage redemption insurance is basically a decreasing term life insurance policy taken by a mortgagor to repay the balance on a mortgage loan if he/she dies before its full repayment.

Key Terms

1. Married Women's Property Act
2. Keyman insurance
3. Mortgage Redemption Insurance

Answers to Test Yourself

Answer 1

The correct option is II.

MRI provides financial protection for home loan borrowers.

Self-Examination Questions

Question 1

The sum assured under keyman insurance policy is generally linked to which of the following?

I. Keyman income
II. Business profitability
III. Business history
IV. Inflation index

Question 2

Mortgage redemption insurance (MRI) can be categorised under ________.

I. Increasing term life assurance
II. Decreasing term life assurance
III. Variable life assurance
IV. Universal life assurance

Question 3

Which of the below losses are covered under keyman insurance?

I. Property theft
II. Losses related to the extended period when a key person is unable to work
III. General liability
IV. Losses caused due to errors and omission

Question 4

A policy is effected under the MWP Act. If the policyholder does not appoint a special trustee to receive and administer the benefits under the policy, the sum secured under the policy becomes payable to the ____________.

I. Next of kin
II. Official Trustee of the State
III. Insurer
IV. Insured

Question 5

Mahesh ran a business on borrowed capital. After his sudden demise, all the creditors are doing their best to go after Mahesh's assets. Which of the below assets is beyond the reach of the creditors?

I. Property under Mahesh's name
II. Mahesh's bank accounts
III. Term life insurance policy purchased under Section 6 of MWP Act
IV. Mutual funds owned by Mahesh

Question 6

Which of the below option is true with regards to MWP Act cases?

Statement I: Maturity claims cheques are paid to policyholders
Statement II: Maturity claims cheques are paid to trustees

I. I is true
II. II is true
III. Both I and II are true
IV. Neither I nor II is true

Question 7

Which of the below option is true with regards to MWP act cases?

Statement I: Death claims are settled in favour of nominees
Statement II: Death claims are settled in favour of trustees

I. I is true
II. II is true
III. Both I and II are true
IV. Neither I nor II is true

Question 8

Ajay pays insurance premium for his employees. Which of the below insurance premium will not be treated deductible as compensation paid to employee?

Choice I: Health insurance with benefits payable to employee
Choice II: Keyman life insurance with benefits payable to Ajay

I. I only
II. II only
III. Both I and II
IV. Neither I nor II

Question 9

The practice of charging interest to borrowers who pledge their property as collateral but leaving them in possession of the property is called ______________.

I. Security
II. Mortgage
III. Usury
IV. Hypothecation

Question 10

Which of the below policy can provide protection to home loan borrowers?

I. Life Insurance
II. Disability Insurance
III. Mortgage Redemption Insurance
IV. General Insurance

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Sum assured under keyman insurance policy is generally linked to business profitability.

Answer 2

The correct option is II.

Mortgage redemption insurance (MRI) can be categorised under decreasing term life assurance.

Answer 3

The correct option is II.

Losses related to the extended period when a key person is unable to work are covered under keyman insurance.

Answer 4

The correct option is II.

If the policyholder does not appoint a special trustee to receive and administer the benefits under the policy, the sum secured under the policy becomes payable to the Official Trustee of the State.

Answer 5

The correct option is III.

Term life insurance policy purchased under Section 6 of MWP Act is beyond the reach of court attachments and creditors.

Answer 6

The correct option is II.

Maturity claims cheques are paid to trustees.

Answer 7

The correct option is II.

Death claims are settled in favour of trustees.

Answer 8

The correct option is II.

Keyman life insurance with benefits payable to Ajay will not be treated deductible as compensation paid to employee.

Answer 9

The correct option is II.

The practice of charging interest to borrowers who pledge their property as collateral but leaving them in possession of the property is called mortgage.

Answer 10

The correct option is III.

Mortgage Redemption Insurance can provide protection to home loan borrowers.

CHAPTER 10

PRICING AND VALUATION IN LIFE INSURANCE

Chapter Introduction

The objective of this chapter is to introduce to the learner the basic elements that are involved in the pricing and benefits of life insurance contracts. We shall first discuss the elements that constitute the premium and then discuss the concept of surplus and bonus.

Learning Outcomes

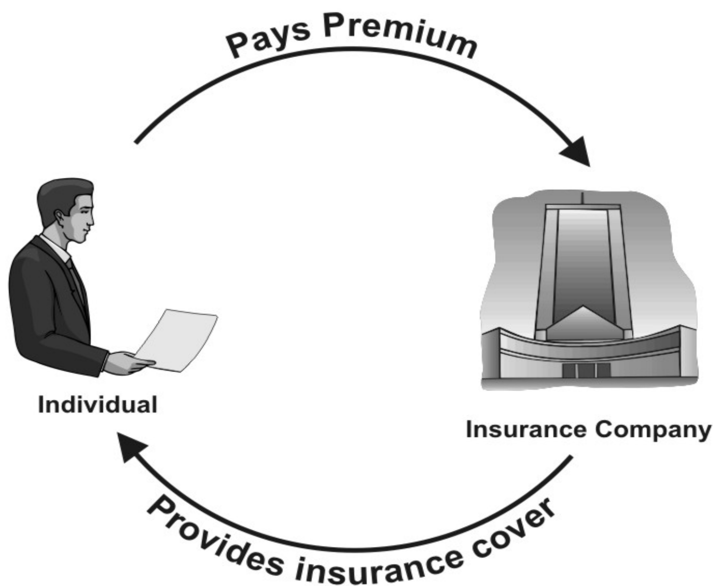
A. Insurance pricing – basic elements
B. Surplus and bonus

A. Insurance pricing - Basic elements

1. Premium

In ordinary language, the term premium denotes the price that is paid by an insured for purchasing an insurance policy. It is normally expressed as a rate of premium per thousand rupees of sum assured. These premium rates are available in the form of tables of rates that are available with insurance companies.

Diagram 1: Premium



The rates that are printed in these tables are known as "Office Premiums". They are typically level annual premiums which need to be paid every year. They are in most cases the same throughout the term and are expressed as an annual rate.

Example

If the premium for a twenty year endowment policy for a given age is Rs. 4,800, it means that Rs. 4,800 has to be paid each year for twenty years.

However it is possible to have some policies in which the premiums are payable only in the first few years. Companies also have single premium contracts in which only one premium is payable at the beginning of the contract. These policies are usually investment oriented.

2. Rebates

Life insurance companies may also offer certain types of rebates on the premium that is payable. Two such rebates are:

- ✓ For sum assured
- ✓ For mode of premium

a) Rebate for sum assured

The rebate **for sum assured** is offered to those who buy policies with higher amounts of sum assured. It is offered as a way of passing on to the customer, the gains that the insurer may make when servicing higher value policies. The reason for this is simple. Whether an insurer services a policy for Rs.50,000 or Rs.5,00,000, the amount of effort required for both, and consequently, the cost of processing these policies remain the same. But higher sum assured policies yield more premium and so more profits.

b) Rebate for mode of premium

Similarly a rebate may be offered **for the mode of premium**. Life insurance companies may allow premiums to be paid on annual, half yearly, quarterly or monthly basis. More frequent the mode, more the cost of service. Yearly and half yearly modes involve collection and accounting only once a year while quarterly and monthly modes would mean the process is more frequent. Half-yearly or yearly premiums thus enable a saving in administrative costs as compared to quarterly or monthly modes. Moreover, in the yearly mode, the insurer can utilise this amount during the entire year and earn interest on it. Insurers would hence encourage payment via yearly and half yearly modes by allowing a rebate on these. They may also charge a little extra for monthly mode of payments, to cover additional administrative expenses involved.

3. Extra charges

The tabular premium is charged for a group of insured individuals who are not subject to any significant factors that would pose an extra risk. Such individual lives are known as **standard lives** and the rates charged are known as ordinary rates.

If a person proposing for insurance suffers from certain health problems like heart ailments or diabetes, which can pose a hazard to his life, such a life is considered to be sub-standard, in relation to other standard lives, the insurer may decide to impose an extra premium by way of a health extra. Similarly an occupational extra may be imposed on those engaged in a hazardous occupation, like a circus acrobat. These extras would result in the premium being more than the tabular premium.

Again, an insurer may offer certain extra benefits under a policy, which are available on payment of an extra premium.

Example

A life insurer may offer a double accident benefit or DAB (where double the sum assured is payable as a claim if death is a result of accident). For this it may charge an extra premium of one rupee per thousand sum assured.

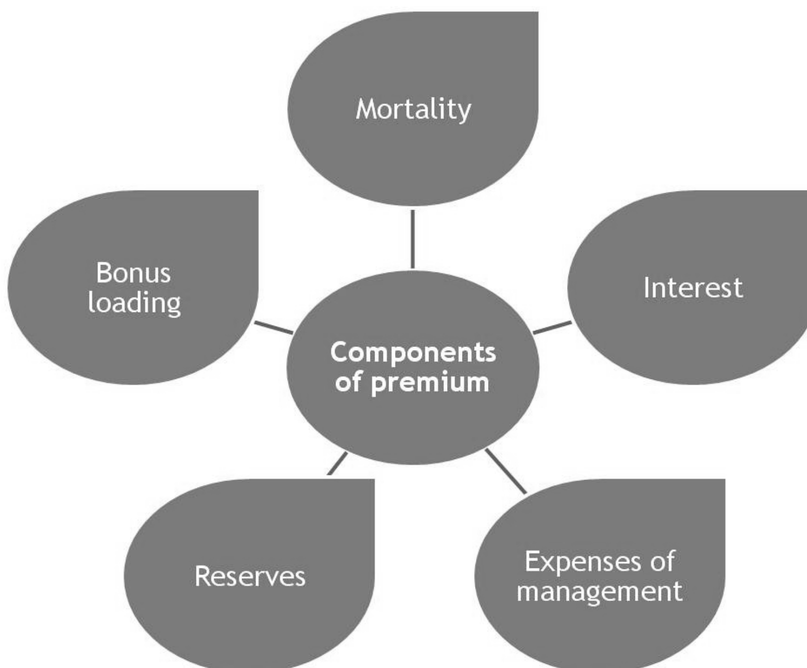
Similarly a benefit known as Permanent Disability Benefit (PDB) may be availed by paying an extra per thousand sum assured.

4. Determining the premium

Let us now examine how life insurers arrive at the rates that are presented in the premium tables. This task is performed by an actuary. The process of setting the premium in case of traditional life insurance policies like term insurance, whole life and endowment considers following elements:

- ✓ Mortality
- ✓ Interest
- ✓ Expenses of management
- ✓ Reserves
- ✓ Bonus loading

Diagram 2: Components of Premium



The first two elements constitute the net premium while the other elements are loaded onto the net premium to yield the gross or office premium

a) Mortality and Interest

Mortality is the first element in premiums. It is determined by using a "Mortality Table", which gives us an estimate of the rate of mortality for different ages.

Example

If the mortality rate for age 35 is 0.0035 it implies that out of every 1000 people who are alive as on age 35, 3.5 (or 35 out of 10,000) are expected to die between age 35 and 36.

The table may be used to calculate mortality cost for different ages. For example the rate of 0.0035 for age 35 implies a cost of insurance of 0.0035 x 1000 (sum assured) = Rs. 3.50 per thousand sum assured.

The above cost may be also called the "Risk Premium". For higher ages the risk premium would be higher.

By summing up the individual risk premiums for different ages we can get the cost of claims that are expected to be payable for an entire period or term, say from age 35 to 55.The total cost of these claims would give us the future liabilities under a policy, in other words it tells us how much money is needed by us to pay claims that may arise in future.

To arrive at "Net Premium" the first step is to estimate the present value of future claim costs. The reason for estimating present value is that we are trying to find out how much we need at hand today to meet claims that may arise in the future. This process of estimating present value brings us to the next element in premium determination, namely "Interest".

Interest is simply the discount rate we assume for arriving at the present value of future claim payments that have to be made.

Example

If we need to have Rs. 5 per thousand to meet the cost of insurance after five years and if we assume a rate of interest of 6%, the present value of Rs. 5 payable after five years would be $5 \times 1/(1.06)^5 = 3.74$.

If instead of 6% we were to assume 10%, the present value would be only 3.10. In other words the higher the rate of interest assumed, the lower the present value.

From our study of mortality and interest there are two major conclusions we can derive

- ✓ Higher the mortality rate in the mortality table, higher the premiums would be
- ✓ Higher the interest rate assumed, lower the premium

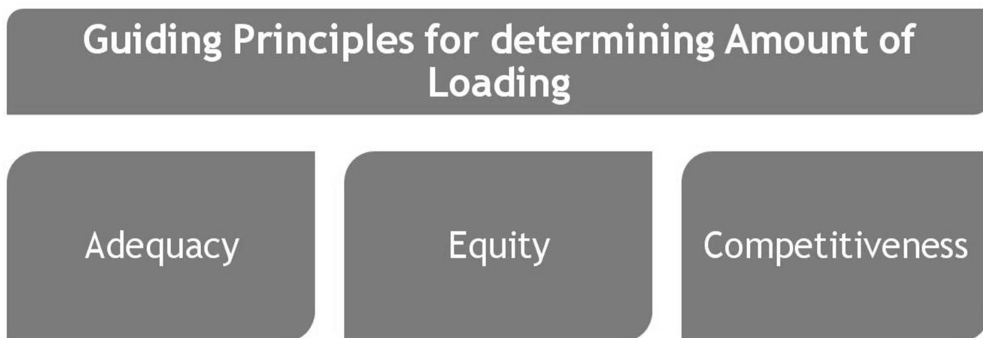
Actuaries tend to be prudent and a little conservative and would typically assume mortality rates that are higher than what they expect to be the actual experience. They would also assume a lower interest rate than what they expect to earn from their investments.

Net premium

The discounted present value of all future claim liabilities gives the "Net Single Premium". From the net single premium, we can get the "Net Level Annual Premium". It is the net single premium which is levelled out so as to be payable over the premium paying term.

Gross premium

Diagram 3: Guiding Principles for determining Amount of Loading



Gross premium is the net premium plus an amount called loading. There are three considerations or guiding principles that needs to be borne in mind when determining the amount of loading:

i. Adequacy

The total loading from all policies must be sufficient to cover the company's total operating expenses. It should also provide a margin of safety and finally it should contribute to the profits or surplus of the company.

ii. Equity

Expenses and safety margins etc. should be equitably apportioned among various kinds of policies, depending on type of plan, age and term etc. The idea is that each class of policy should pay for its own costs, so that to the extent possible, one class of policy does not subsidise the other.

iii. Competitiveness

The resulting gross premiums should enable the company to improve its competitive position. If the loading is too high, it would make the policies very costly and people would not buy.

b) Expenses and reserves

Life insurers have to incur various types of operating expenses including:

- ✓ Agents training and recruitment,
- ✓ Commissions of agents,
- ✓ Staff salaries,
- ✓ Office accommodation,
- ✓ Office stationery,
- ✓ Electricity charges,
- ✓ Other miscellaneous etc.

All these have to be paid from premiums that are collected by insurers. These expenses are loaded to the net premium.

A life insurer incurs two types of expenses:

i. The first, known as "**New Business Expenses**", are incurred at the beginning stage of the contract

ii. The second type of expenses, known as "**Renewal Expenses,**" is incurred during subsequent years.

Initial or new business expenses can be substantial. Life insurers are also required by law to hold certain margins as reserves to ensure they can meet their obligations, even when their actual experience is worse than assumed. The initial expenses along with the margins required to be maintained as reserves are typically higher than the initial premiums received.

The company thus faces a strain, known as new business strain. The initial outflow is only recovered from subsequent annual premiums. An implication is that life insurers cannot afford to have large number of their policies cancelled or lapsing in initial years, before the expenses are recouped. Another implication of new business strain is that life insurance companies would need a gestation period of some years before they can make profits.

Expenses are also determined in different ways, depending on the type of expense.

i. For instance, commissions and incentives for agency managers / development officers are typically decided as a percentage of the premiums earned.

ii. On the other hand, expenses like medical examiners' fees and policy stamps vary depending on the amount of sum assured or face value of the policy and are considered in relation to the sum assured.

iii. A third category of expenses is overheads like salaries and rents which generally vary with the amount of activities that in turn depend on the number of policies being serviced. The larger the volume of business in terms of number of policies, higher the overhead expenses.

Based on the above classification, the typical loading to a net premium would have three parts

i. A percentage of premiums
ii. A constant amount for each '1000 sum assured' (or face amount) which is added to net premium
iii. A constant amount per policy

Lapses and contingencies

The net premium and loading for expenses is designed to cover the estimated cost of benefits and expense charges that the life insurer expects to incur during the term of the policy. The insurer also constantly faces the risk that actual experience may be different from the assumptions made at the stage of designing the contract.

One source of risk is that of lapses and withdrawals. A lapse means that the policyholder discontinues payment of premiums. In case of withdrawals, the policyholder surrenders the policy and receives an amount from the policy's acquired cash value.

Lapses can pose a serious problem because they typically happen within the first three years with highest incidence being typically in the very first year of the contract. Life insurers incorporate a loading in anticipation of leakages that may arise as a result.

Life insurers must also be prepared for the eventuality that the assumptions on basis of which they set their premiums differs from actual experience. Such a contingency can arise from two reasons.

i. Firstly the assumptions themselves may have been inappropriate. For example the life insurer may use a mortality table that does not reflect the current mortality or has not adequately factored for inflation

ii. Secondly there are random fluctuations that may belie the assumptions.

There are three ways in which the above kind of risks can be addressed.

i. They can be passed on to the customer, for instance, in the case of investment-linked products like ULIP's, the risk of lower returns has to be borne by the customer.

ii. A second way is to reinsure the policy with a reinsurer. In this case the mortality risk is borne by the reinsurer.

iii. The third and more commonly used way is to incorporate a loading margin in the premium, which could help to absorb the divergence between expected and actual experience.

c) With Profit policies and Bonus loading

Let us listen to what the actuary Brian Corby had to say about how With Profit policies emerged.

"Some two hundred years ago, at the beginning of life insurance, the major uncertainty was the rate of mortality. The solution adopted was to charge excessive premiums. Of course they did not know that they were excessive in advance so that solvency was assumed, and then, when sufficient experience was accumulated to assess what the premiums should have been, to return the excess or some of it to policyholders by way of bonus additions. This was the origin of the traditional with profit policies we issue today…"

Participation in profits also ushered an element called "**Bonus Loading**" into premiums. The idea was to provide a margin for profits within the premium, such that it served as an added cushion against unforeseen contingencies and also paid for the policy's share of surplus distributed (as bonus).The bonus loading feature is one reason why life insurers have been confident about their long term solvency and capital adequacy.

In sum we can say that:

Gross premium = Net premium + Loading for expenses + Loading for contingencies + Bonus loading

If we assume that the above loadings together comprise a total of K percent of gross premium (GP), we can find out the gross premium, given the net premium (NP) as

GP = NP + K (GP)

For instance if the net single premium for an endowment policy is Rs. 380 and the loading factor, K is 50% then the gross premium would be Rs. 760.

Test Yourself 1

What does a policy lapse mean?

I. Policyholder completes premium payment for a policy
II. Policyholder discontinues premium payment for a policy
III. Policy attains maturity
IV. Policy is withdrawn from the market

B. Surplus and bonus

1. Determination of surplus and bonus

Every life insurance company is expected to undertake a periodic valuation of its assets and liabilities. Such a valuation has two purposes:

i. To assess the financial state of the life insurer, in other words to determine if it is solvent or insolvent
ii. To determine the surplus available for distribution among policyholders / share holders

Definition

Surplus is the excess of value of assets over value of liabilities. If it is negative, it is known as a strain.

Let us now see how the concept of surplus in life insurance is different from that of profit of a firm.

Firms in general have two concepts of profit. In the accounting sense, profit is defined as the **excess of income over outgo** for a given accounting period, it forms part of the profit and loss account. Profit also forms part of the balance sheet of a firm - it may be defined as the **excess of assets over liabilities**. The balance sheet also reflects the profits in the P&L account. In both instances, an ex-post approach is adopted for recognition of profits.

Example

The profits of XYZ firm as on 31stMarch 2013, is given as its income less expenses or its assets less liabilities as on that date.

In both instances, the profit is clearly defined and is known.

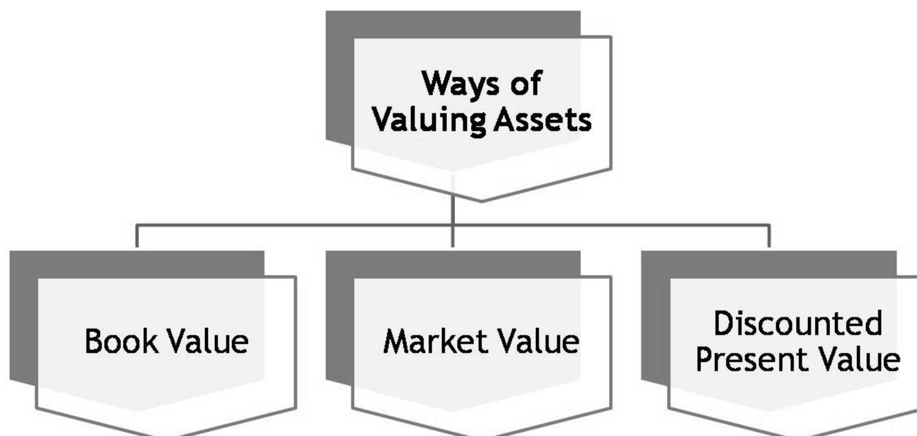
Can we apply a similar argument and specify the liabilities and assets in case of a life insurance valuation?

In such a case, the surplus would be defined as

Surplus = Assets - Liabilities

Where liabilities expected to arise for a block of policies are determined as present value of future claims, expenses and other expected payouts less the present value of premiums expected to be received on these policies

Diagram 4: Ways of Valuing Assets



Assets are valued in one of three ways

i. **At Book Value**

This is the value at which the life insurer has purchased or acquired its assets

ii. **At Market Value**

The worth of the life insurer's assets in the market place

iii. **Discounted Present Value**

Estimating the future income stream from various assets and discounting them to the present

The problem is that one cannot place an exact value on liabilities because one cannot precisely predict what will happen in the future. The value of liabilities depends on assumptions about factors like mortality, interest, expenses and persistency which are made while estimating the present value of future liabilities. It is for this reason that in life insurance we use the term surplus instead of profits.

Surplus is thus a function of how assets and liabilities are valued.

i. When a life insurer is very conservative in its valuation, it would result in liabilities being overvalued than otherwise while assets are undervalued. As a result the surplus that is declared would be reduced. This means lesser bonuses would be available for distribution among current policyholders. But it would also contribute to financial soundness of the insurer. This is because the actual amount of surplus is higher than the declared surplus and so higher provisions can be retained for the future. This would benefit future policyholders.

ii. On the other hand, if assets and liabilities are valued liberally, it has the opposite result. Current policyholders would be benefited at the expense of future ones.

The life insurance company has to strike the right balance between current and future policyholders.

2. Allocating the surplus

Surplus arises as a result of the life insurer's actual experience being better than what it had assumed. Under with profit contracts, the life insurer is obliged to pass on the benefits of such a favourable gap (between the actual and expected results) to policyholders who have agreed to participate in the profits and have purchased these with profit policies.

At the same time, surplus is also the source from which the company's basic capital (its equity or net worth) can be increased from within. In this sense, surplus of a life insurer is similar to an ordinary company's profits which have not been distributed but have been retained. These are known as 'retained earnings'. They contribute to its financial soundness.

Let us now see how the surplus that is determined would be allocated

a) Solvency requirements

Firstly, a part of the excess of assets over liabilities needs to be kept to protect policyholders in the event of unforeseen adversities in future. The solvency margin may be defined as that portion of surplus assets over liabilities specifically set aside as a cushion for addressing any unforeseen deviations between expected and actual experience.

b) Free assets

Another purpose for having surplus that is unallocated (for distribution) is to increase the level of free assets. Free assets are unencumbered. In other words they are not required for meeting any liabilities. The life insurer is thus free to use them. Life insurers need to maintain such free assets for two reasons.

i. Firstly companies need capital to finance the new business. We have already seen how they need to finance their new business strain.

ii. Free assets also offer the life insurer with greater leverage and freedom in choosing its investment strategies. This becomes vital for companies who need to generate and provide higher and more competitive returns.

Once the divisible surplus is declared, the next issue is to determine their distribution among the life insurer's policyholders (after leaving a portion for distribution among shareholders if any). In India, the popular method for the purpose has been through the "Bonus Mechanism" where surplus is distributed in the form of a bonus. This system is popular in the United Kingdom, India and many other countries.

3. Bonus

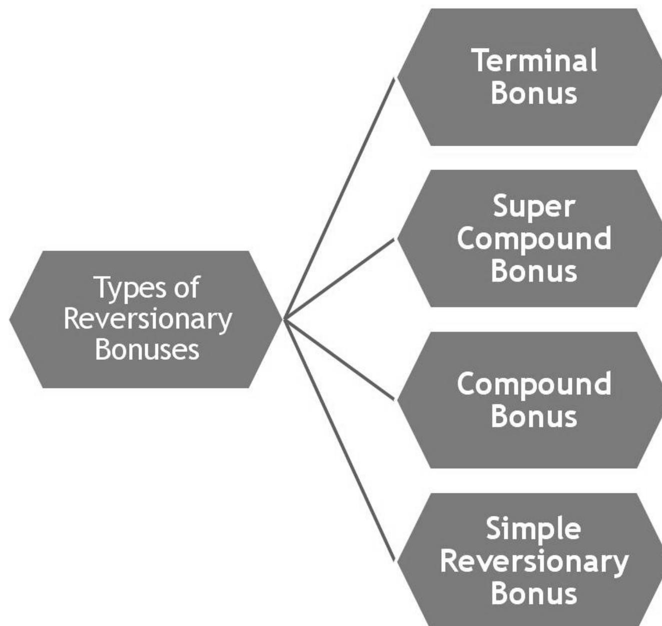
Bonus is paid as an addition to the basic benefit payable under a contract. Typically it may appear as an addition to basic sum assured or basic pension per annum. It is expressed, for example, as Rs. 60 per thousand sum assured (or 60% of SA).

The most common form of bonus is the **reversionary bonus**. The company is expected to declare such bonus additions each year, throughout the lifetime of the contract. Once declared, they get attached and cannot be taken away. They form part of the liabilities of the company. They are called 'Reversionary' bonuses because the policyholder only receives them when the contract becomes a claim by death or maturity.

Bonuses may also be payable on surrender. In such cases it is often stipulated that the contract should have run for a certain term (say 5 years) to become eligible.

Types of reversionary bonuses

Diagram 5: Types of Reversionary Bonuses



i. Simple Reversionary Bonus

This is a bonus expressed as a percentage of the basic cash benefit under the contract. In India for example, it is declared as amount per thousand sum assured.

ii. Compound Bonus

Here the company expresses a bonus as a percentage of basic benefit and already attached bonuses. It is thus a bonus on a bonus. A way to express it may be as @ 8% of basic sum assured plus attached bonus.

iii. Terminal Bonus

As the name suggests, this bonus attaches to the contract only on its contractual termination (by death or maturity). The bonus is declared only for claims of the ensuing year without any commitment about subsequent years (as in case of reversionary bonuses). Thus the terminal bonus declared for 2013 would only apply to claims that have arisen during 2013-14 and not for subsequent years.

Finally, terminal bonuses depend on the time duration of the contract, and increases as the duration increases. Thus the terminal bonus for a contract that has run for 25 years would be higher than one which has run for 15 years.

Terminal bonuses emerged (in UK) as a solution to the problem of how to treat large unrealised gains that were earned as a result of increased investment in shares and property. By giving these as one off payments and also relating them to time, the life insurance companies solved the problems of how to sustain these bonuses. They also became a way to achieve equity among policy holders

4. The Contribution Method

Another method of distribution of surplus which has been adopted in North America is the "Contribution" method. Under this method, consideration is given to three sources of surplus - excess interest, mortality savings and savings arising with respect to expense and other loadings.

The surplus is thus given by the difference between what was expected to happen and what actually happened over the year with respect to mortality, interest and expenses

The dividends that are declared may be used in one of the following four ways

i. It may be paid in the form of dividends in cash

ii. In the form of adjustment to, and reduction in future premiums

iii. A third method is to allow purchase of non-forfeitable paid up additions to the policy

iv. Finally dividends may be allowed to accumulate, with interest, to the credit of the policy. It may be either withdrawn at the option of policyholder or only at the end of the contract

5. Unit Linked Policies

Traditional "With Profit" policies, as discussed above, contain a linkage between the bonuses they pay and the investment performance of the life insurer. The linkage however is not direct. The policyholder's bonus is determined by the surplus that is declared during the periodic valuation of the insurer's assets and liabilities. As a result, the bonus structure does not directly reflect the value of the underlying assets of the insurer.

Again, bonuses under a valuation are generally only declared once a year. They obviously cannot reflect the daily fluctuations in the value of assets. Unit linked policies have been designed precisely to overcome some of the limitations spelt out above.

They involve a different approach to the design of products and follow a different set of principles.

a) Unitising

The distinctive feature of these policies is that their benefits are wholly or partially determined by the value of units credited to the policyholder's account at the date when the claim payment is due to be made. A unit is created through the division of an investment fund into a number of equal parts.

b) Transparent structure

The charges for insurance protection and expenses component of a unit linked product are clearly specified. Once these charges are deducted from the premium the balance of the account and income from it is invested in units. The value of these units is fixed with reference to a pre-determined index of performance.

It is defined by a rule or formula, which is outlined in advance. Two independent persons, by following this formula, would arrive at the same estimate of benefits. Policy holder benefits, in other words, do not depend on the assumptions and discretions of the life insurance company

c) Pricing

In traditional plans like endowment, the insured decides the amount of sum assured to be purchased. This sum assured is guaranteed and the premium is set such that, under given assumptions of mortality, interest and expenses, it would be adequate to pay this amount. If the actual experience is better than the assumptions made while setting the premiums, the benefit is passed on in the form of a bonus.

Under unit linked policies, the insured decides what amount of premium he / she can contribute at regular intervals. The premium may vary, subject to a minimum that may need to be paid. The insurance cover is a multiple of the premiums paid – for example it may be ten times the annual premium.

The premium is divided into three parts

i. Firstly there is a policy allocation charge (PAC) which is comprised of agents' commission, policy setup costs, administrative costs and statutory levies.

ii. The second component is the mortality charge which is the cost of providing risk cover.

iii. The balance of premiums after meeting the above two, are allocated for the purchase of units.

The PAC as a proportion of the premiums is high in the initial years, both under traditional and ULIP plans. Under the former, these charges are apportioned and spread out throughout the policy term. In the case of ULIPs however they are deducted from the initial premiums itself. This implies that in the initial stages, the charges would significantly reduce the amount allocated for investment. This is why the value of the benefits, vis-à-vis the premiums paid, would be very low. It would in fact be less than the premiums paid in the early years of the contract.

d) The bearing of investment risk

Finally, since the value of the units depends on the value of the life insurer's investments, there is a risk that these unit values may be lower than expected and result in the returns being low and even negative. The life insurer, while being expected to manage these investments in an efficient and prudent manner, does not give any guarantee about the unit values. The investment risk, in other words, is borne by the policyholder/unit holder. The life insurer may however bear the mortality and expense risk.

Test Yourself 2

Who bears the investment risk in case of ULIPs?

I. Insurer
II. Insured
III. State
IV. IRDA

Summary

- In ordinary language, the term premium denotes the price that is paid by an insured for purchasing an insurance policy.
- The process of setting the premium for life insurance policies involves consideration of mortality, interests, expense management and reserves.
- Gross premium is the net premium plus an amount called loading.
- A lapse means that the policyholder discontinues payment of premiums. In case of withdrawals, the policyholder surrenders the policy and receives an amount from the policy's acquired cash value.
- Surplus arises as a result of the life insurer's actual experience being better than what it had assumed.
- Surplus allocation could be towards maintaining solvency requirements, increasing free assets etc.
- The most common form of bonus is the reversionary bonus.

Key Terms

1. Premium
2. Rebate
3. Bonus
4. Surplus
5. Reserve
6. Loading
7. Reversionary bonus

Answers to Test Yourself

Answer 1

The correct option is II.

Policyholder discontinuing premium payment for a policy is termed as policy lapse.

Answer 2

The correct option is II.

Insured bears the investment risk in case of ULIP.

Self-Examination Questions

Question 1

What does the term "premium" denote in relation to an insurance policy?

I. Profit earned by the insurer
II. Price paid by an insured for purchasing the policy
III. Margins of an insurer on a policy
IV. Expenses incurred by an insurer on a policy

Question 2

Which of the below is not a factor in determining life insurance premium?

I. Mortality
II. Rebate
III. Reserves
IV. Management expenses

Question 3

What is a policy withdrawal?

I. Discontinuation of premium payment by policyholder
II. Surrender of policy in return for acquired surrender value
III. Policy upgrade
IV. Policy downgrade

Question 4

Which of the below is one of the ways of defining surplus?

I. Excessive liabilities
II. Excessive turnover
III. Excess value of liabilities over assets
IV. Excess value of assets over liabilities

Question 5

Which of the below is not a component of ULIP premiums?

I. Policy allocation charge
II. Investment risk premium
III. Mortality charge
IV. Social security charge

Question 6

Life insurance companies may offer rebate to the buyer on the premium that is payable on the basis of ___________.

I. Sum assured chosen by the buyer
II. Type of policy chosen by the buyer
III. Term of the plan chosen by the buyer
IV. Mode of payment (cash, cheque, card) chosen by the buyer

Question 7

Interest rates are one of the important components used while determining the premium. Which of the below statement is correct with regards to interest rates?

I. Lower the interest rate assumed, lower the premium
II. Higher the interest rate assumed, higher the premium
III. Higher the interest rate assumed, lower the premium
IV. The interest rates don't affect premiums

Question 8

Which of the below statement is correct?

I. The typical loading to a net premium would have 3 parts: a) a constant amount for premiums b) a constant amount for each '1000 sum assured' and c) a constant amount per policy
II. The typical loading to a net premium would have 3 parts: a) a percentage of premiums b) a constant amount for each '1000 sum assured' and c) a constant amount per policy

III. The typical loading to a net premium would have 3 parts: a) a percentage of premiums b) a constant percentage for each '1000 sum assured' and c) a constant amount per policy
IV. The typical loading to a net premium would have 3 parts: a) a percentage of premiums b) a constant amount for each '1000 sum assured' and c) a percentage amount per policy

Question 9

With regards to valuation of assets by insurance companies, __________ is the value at which the life insurer has purchased or acquired its assets.

I. Discounted future value
II. Discounted present value
III. Market value
IV. Book value

Question 10

In case of __________, a company expresses the bonus as a percentage of basic benefit and already attached bonuses.

I. Reversionary bonus
II. Compound bonus
III. Terminal bonus
IV. Persistency bonus

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Price paid by an insured for purchasing the policy is termed as premium.

Answer 2

The correct option is II.

Rebate is not a factor in determining life insurance premium.

Answer 3

The correct option is II.

Surrender of policy in return for acquired surrender value is termed as policy withdrawal.

Answer 4

The correct option is IV.

Excess value of assets over liabilities is one way of defining surplus.

Answer 5

The correct option is IV.

ULIP premium comprises of policy allocation charge, investment risk premium and mortality charge.

Answer 6

The correct option is I.

Life insurance companies may offer rebate to the buyer on the premium that is payable on the basis of sum assured chosen by the buyer.

Answer 7

The correct option is III.

Higher the interest rate assumed, lower the premium

Answer 8

The correct option is II.

The typical loading to a net premium would have 3 parts: a) a percentage of premiums b) a constant amount for each '1000 sum assured' and c) a constant amount per policy.

Answer 9

The correct option is IV.

With regards to valuation of assets by insurance companies, book value is the value at which the life insurer has purchased or acquired its assets.

Answer 10

The correct option is II.

In case of compound bonus, a company expresses the bonus as a percentage of basic benefit and already attached bonuses.

CHAPTER 11

DOCUMENTATION – PROPOSAL STAGE

Chapter Introduction

In the life insurance industry we deal with a large number of forms and documents. These are required for the purpose of bringing clarity in the relationship between the insured and the insurer. In this chapter, we shall deal with the various documents that are involved at the proposal stage and their significance. The documents we shall consider include

i. Prospectus
ii. Proposal form
iii. Agent's report
iv. Medical examiner's report
v. Moral hazard report
vi. Age proof
vii. Know Your Customer (KYC) documents

Learning Outcomes

A. Life insurance – Proposal stage documentation

A. Life insurance – Proposal stage documentation

1. Prospectus

Definition

A prospectus is a formal legal document used by insurance companies that provides details about the product.

A prospectus should contain all facts that are necessary for a prospective policyholder to make an informed decision regarding purchase of a policy.

The prospectus used by a life insurance company should state the following, under each of its plans of insurance:

i. The terms and conditions

ii. Scope of benefits – guaranteed and non-guaranteed

iii. The entitlements

iv. The exceptions

v. Whether the plan is participative or non-participative

The prospectus is like an introductory document which helps the prospective policyholder to get familiar with the company's products.

2. Proposal form

The insurance policy is a legal contract between insurer and the policyholder. As is required for any contract, it has a proposal and its acceptance. The application document used for making the proposal is commonly known as the 'proposal form'. All the facts stated in the proposal form become binding on both the parties and failure to appreciate its contents can lead to adverse consequences in the event of claim settlement.

Definition

The proposal form has been defined under IRDA (Protection of Policyholders' Interests) Regulations, 2002 as:

"It means a form to be filled in by the proposer for insurance for furnishing all material information required by the insurer in respect of a risk, in order to enable the insurer to decide whether to accept or decline, to undertake the risk, and in the event of acceptance of the risk, to determine the rates, terms and conditions of a cover to be granted."

"Material" for the purpose of these regulations shall mean and include all important, essential and relevant information in the context of underwriting the risk to be covered by the insurer.

Important

While the IRDA defined the proposal form, the design and content of the form was left open to the discretion of the insurance company. However based on the feedback received from policyholders, intermediaries, ombudsmen and insurance companies, the IRDA felt it necessary to standardise the form and content of the proposal form.

The IRDA has issued the IRDA (Standard Proposal Form for Life Insurance) Regulations, 2013. While the IRDA has prescribed the design and content, it has provided flexibility to the insurance companies for seeking additional information. The proposal form carries detailed instructions not only for the proposer and the proposed life insured but also to the intermediary who solicits the policy and assists in filling up the form.

3. Agent's report

The agent is the primary underwriter. All material facts and particulars about the policyholder, relevant to risk assessment, need to be revealed by the agent in his / her report. Matters of health, habits, occupation, income and family details need to be mentioned in the report.

4. Medical examiner's report

In many cases, the life to be insured has to be medically examined by a doctor who is empaneled by the insurance company. Details pertaining to physical features like height, weight, blood pressure, cardiac status etc. are recorded and mentioned by the doctor in his report called the medical examiner's report.

We must note that many proposals are underwritten and accepted for insurance without calling for a medical examination. They are known as non-medical cases. The medical examiner's report is required typically when the proposal cannot be considered under non-medical underwriting because the sum proposed or the age of the proposed life is high or there are certain characteristics which are revealed in the proposal, which call for examination and report by a medical examiner.

The underwriter of the insurance company thereby gets an account of the current health position of the life to be insured.

5. Moral hazard report

Life insurance is a contract between an individual and an insurance company that pays a stated amount of money if the covered person passes away during the term of the policy. When you purchase life insurance, you must go through several underwriting procedures including filling out an application and submitting to a physical exam. One factor impacting the risk, which underwriters look out for, is termed as moral hazard.

Definition

Moral hazard is the likelihood that a client's behaviour might change as a result of purchasing a life insurance policy and such a change would increase the chance of a loss.

Example

John Doe recently purchased a life insurance policy. He then decided to go on a skiing expedition at a site which was touted to be one of the most dangerous skiing places on earth. In the past he had refused to undertake such expeditions.

Life insurance companies seek to guard against the possibility of individuals seeking to make a profit from the purchase of life insurance through actions like ending one's own life or the life of another. Life insurance underwriters would thus look for any factors which might suggest such hazard.

For this purpose, the company may require that a moral hazard report has to be submitted by an official of the insurance company. Before completion of the report the reporting official should satisfy himself regarding the identity of the proposer. He should meet him preferably at his residence before completing the report. The reporting official should make independent enquiries about the life to be assureds' health and habits, occupation, income, social background and financial position etc.

6. Age Proof

We have already seen that the risk of mortality in life insurance increases with age. Hence age is a factor that insurance companies use to determine the risk profile of the life to be insured. Accordingly a premium is charged for each age group. Verification of correct age by examination of an appropriate document of evidence of age thus assumes significance in life insurance.

Valid age proofs may be standard or non-standard.

a) Standard age proofs

Some documents considered as standard age proofs are:

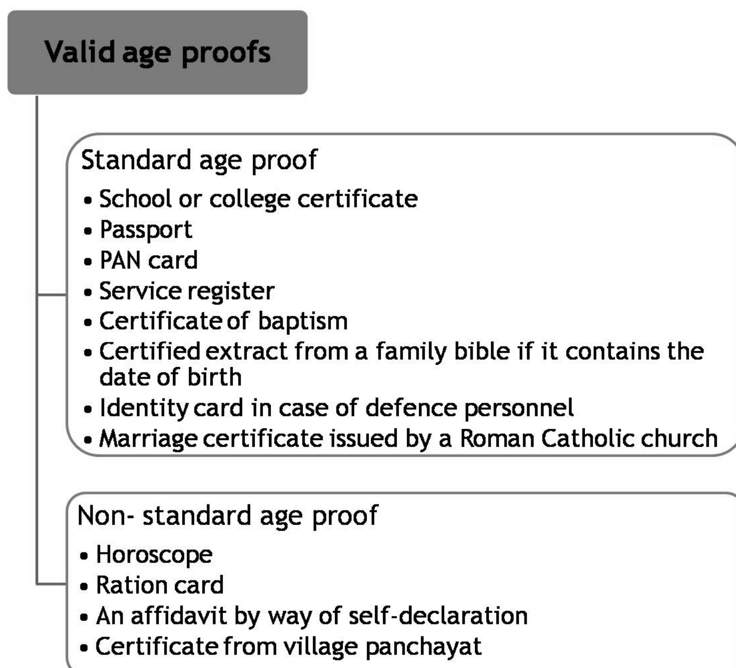
- ✓ School or college certificate
- ✓ Birth certificate extracted from municipal records
- ✓ Passport
- ✓ PAN card
- ✓ Service register
- ✓ Certificate of baptism
- ✓ Certified extract from a family bible if it contains the date of birth
- ✓ Identity card in case of defence personnel
- ✓ Marriage certificate issued by a Roman Catholic church

b) Non-standard age proofs

When standard age proofs like the above are not available, the life insurer may allow submission of a non-standard age proof. Some documents considered as non-standard age proofs are:

- ✓ Horoscope
- ✓ Ration card
- ✓ An affidavit by way of self-declaration
- ✓ Certificate from village panchayat

Diagram 1: Valid age proof



7. Anti-Money Laundering (AML)

Definition

Money laundering is the process of bringing illegal money into an economy by hiding its illegal origin so that it appears to be legally acquired. The Government of India launched the PMLA ,2002 to rein in money-laundering activities.

The Prevention of Money Laundering Act (PMLA), 2002 came into effect from 2005 to control money laundering activities and to provide for confiscation of property derived from money-laundering.It mentions money laundering as an offense which is punishable by rigorous imprisonment from three to seven years and fine upto Rs 5 lakhs.

Each insurer is required to have an AML policy and accordingly file a copy with IRDA. The AML program should include:

i. Internal policies, procedures and controls

ii. Appointment of a principal compliance officer

iii. Recruitment and training of agents on AML measures

iv. Internal audit/control

8. Know Your Customer (KYC)

Know your customer is the process used by a business to verify the identity of their clients.Banks and insurers are increasingly demanding their customers provide detailed information to prevent identity theft, financial fraud and money laundering.
The objective of KYC guidelines is to prevent financial institutions from being used by criminal elements for money laundering activities.

Insurers, hence, need to determine the true identity of their customers. Agents should ensure that proposers submit the proposal form along with the following as part of the KYC procedure:

i. Photographs

ii. Age proof

iii. Proof of address – driving license, passport, telephone bill, electricity bill, bank passbook etc.

iv. Proof of identity – driving license, passport, voter ID card, PAN card, etc.

v. Income proof documents in case of high-value transactions

9. Free-look period

Suppose a person has purchased a new life insurance policy and received the policy document and, on examining the same, finds that the terms and conditions are not what he/she wanted.

What can he/she do?

IRDA has built into its regulations a consumer-friendly provision that takes care of this problem. It has provided for what is termed as a "free look period' or as "cooling period."

During this period, if the policyholder has bought a policy and does not want it, he/she can return it and get a refund subject to the following conditions:

i. He/she can exercise this option within 15 days of receiving the policy document

ii. He/she has to communicate to the company in writing

iii. The premium refund will be adjusted for proportionate risk premium for the period on cover, expenses incurred by the insurer on medical examination and stamp duty charges

This free look period is available to life insurance policy holders as a privilege. They can exercise this choice during a period of fifteen days from the date of receipt of the policy document by the policyholder.

Test Yourself 1

During the __________ period, if the policyholder has bought a policy and does not want it, he / she can return it and get a refund.

I. Free evaluation
II. Free look
III. Cancellation
IV. Free trial

Summary

- Prospectus is a formal legal document used by insurance companies that provides details about the product.
- The application document used for making the proposal is commonly known as the 'proposal form'.
- Matters of health, habits and occupation, income and family details need to be mentioned by the agent in the agent's report.
- Details pertaining to physical features like height, weight, blood pressure, cardiac status etc. are recorded and mentioned by the doctor in his/ her report called the medical examiner's report.
- Moral hazard is the likelihood that a client's behaviour might change as a result of purchasing a life insurance policy and such a change would increase the chance of a loss.
- Some documents considered as standard age proofs include school or college certificate, birth certificate extracted from municipal records etc.
- Each insurer is required to have an AML policy and accordingly file a copy with IRDA. The AML program should include internal policies, procedures and controls and appointment of a principal compliance officer.
- Insurers need to determine the true identity of their customers. KYC documents like address proof, PAN card and photographs etc. need to be collected as a part of the KYC procedure.

Key Terms

1. Prospectus
2. Proposal form
3. Moral hazard
4. Standard and non-standard age proofs
5. Anti-money laundering
6. Know Your Customer (KYC)
7. Free-look period

Answers to Test Yourself

Answer 1

The correct option is II.

During the free look period, if the policyholder has bought a policy and does not want it, he / she can return it and get a refund.

Self-Examination Questions

Question 1

Which of the below is an example of standard age proof?

I. Ration card
II. Horoscope
III. Passport
IV. Village Panchayat certificate

Question 2

Which of the below can be attributed to moral hazard?

I. Increased risky behaviour following the purchase of insurance
II. Increased risky behaviour prior to the purchase of insurance
III. Decreased risky behaviour following the purchase of insurance
IV. Engaging in criminal acts post being insured

Question 3

Which of the below features will be checked in a medical examiner's report?

I. Emotional behaviour of the proposer
II. Height, weight and blood pressure
III. Social status
IV. Truthfulness

Question 4

A ___________ is a formal legal document used by insurance companies that provides details about the product.

I. Proposal form
II. Proposal quote
III. Information docket
IV. Prospectus

Question 5

The application document used for making the proposal is commonly known as the __________.

I. Application form
II. Proposal form
III. Registration form
IV. Subscription form

Question 6

From the below given age proof documents, identify the one which is classified as non-standard by insurance companies.

I. School certificate
II. Identity card in case of defence personnel
III. Ration card
IV. Certificate of baptism

Question 7

Money laundering is the process of bringing _______ money into an economy by hiding its _______ origin so that it appears to be legally acquired.

I. Illegal, illegal
II. Legal, legal
III. Illegal, legal
IV. Legal, illegal

Question 8

In case the policyholder is not satisfied with the policy, he / she can return the policy within the free-look period i.e. within ________of receiving the policy document.

I. 60 days
II. 45 days
III. 30 days
IV. 15 days

Question 9

Which of the below statement is correct with regards to a policy returned by a policyholder during the free look period?

I. The insurance company will refund 100% of the premium
II. The insurance company will refund 50% of the premium
III. The insurance company will refund the premium after adjusting for proportionate risk premium for the period on cover, medical examination expenses and stamp duty charges
IV. The insurance company will forfeit the entire premium

Question 10

Which of the below is not a valid address proof?

I. PAN Card
II. Voter ID Card
III. Bank passbook
IV. Driving licence

Answers to Self-Examination Questions

Answer 1

The correct option is III.

Passport is an example of a standard age proof.

Answer 2

The correct option is I.

Increased risky behaviour following the purchase of insurance can be attributed to moral hazard.

Answer 3

The correct option is II.

Height, weight and blood pressure are among the few items that will be checked in a medical examiner's report.

Answer 4

The correct option is IV.

A prospectus is a formal legal document used by insurance companies that provides details about the product.

Answer 5

The correct option is II.

The application document used for making the proposal is commonly known as the proposal form.

Answer 6

The correct option is III.

Ration card is classified as a non-standard age proof.

Answer 7

The correct option is I.

Money laundering is the process of bringing illegal money into an economy by hiding its illegal origin so that it appears to be legally acquired.

Answer 8

The correct option is IV.

In case the policyholder is not satisfied with the policy, he / she can return the policy within the free-look period i.e. within 15 days of receiving the policy document.

Answer 9

The correct option is III.

With regards to a policy returned by a policyholder during the free look period, the insurance company will refund the premium after adjusting for proportionate risk premium for the period on cover, medical examination expenses and stamp duty charges.

Answer 10

The correct option is II.

PAN Card is not a valid address proof

CHAPTER 12

DOCUMENTATION – POLICY STAGE

Chapter Introduction

In this chapter we discuss the various documents involved when a proposal becomes a life insurance policy.

Learning Outcomes

A. Policy stage documentation

A. Policy stage documentation

1. First Premium Receipt

An insurance contract commences when the life insurance company issues a first premium receipt (FPR). **The FPR is the evidence that the policy contract has begun.**

The first premium receipt contains the following information:

i. Name and address of the life assured
ii. Policy number
iii. Premium amount paid
iv. Method and frequency of premium payment
v. Next due date of premium payment
vi. Date of commencement of the risk
vii. Date of final maturity of the policy
viii. Date of payment of the last premium
ix. Sum assured

After the issue of the FPR, the insurance company will issue subsequent premium receipts when it receives further premiums from the proposer. These receipts are known as renewal premium receipts (RPR). The RPRs act as proof of payment in the event of any disputes related to premium payment.

2. Policy Document

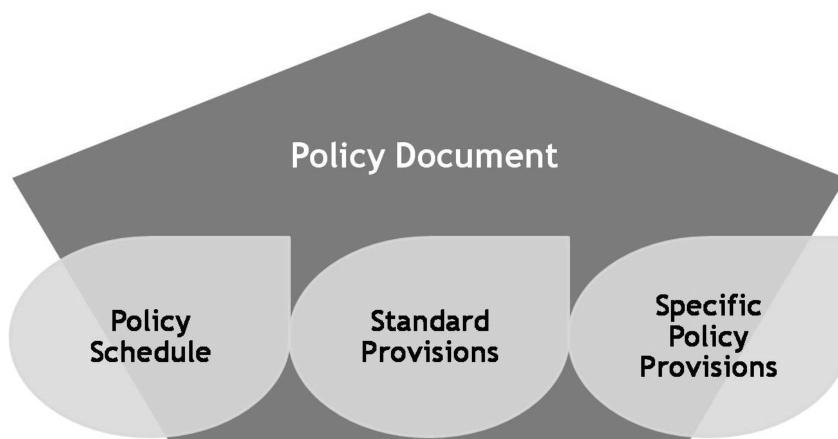
The policy document is the most important document associated with insurance. **It is evidence of the contract between the assured and the insurance company.** It is not the contract itself. If the policy document is lost by the policy holder, it does not affect the insurance contract. The insurance company will issue a duplicate policy without making any changes to the contract. The policy document has to be signed by a competent authority and should be stamped according to the Indian Stamp Act.

The standard policy document typically has three parts:

a) Policy Schedule

The policy schedule forms the first part. It is usually found on the face page of the policy. The schedules of life insurance contracts would be generally similar. They would normally contain the following information:

Diagram 1: Policy document components



i. Name of the insurance company

ii. Some specific details for the particular policy like:

- ✓ Policy owner's name and address
- ✓ Date of birth and age last birthday
- ✓ Plan and term of policy contract
- ✓ Sum assured
- ✓ Amount of premium
- ✓ Premium paying term
- ✓ Date of commencement, date of maturity and due date of last premium
- ✓ Whether policy is with or without profits
- ✓ Name of nominee
- ✓ Mode of premium payment – yearly; half yearly; quarterly; monthly; via deduction from salary
- ✓ The policy number – which is the unique identity number of the policy contract

iii. The insurer's promise to pay. This forms the heart of the insurance contract

iv. The signature of the authorised signatory and policy stamp

v. The address of the local Insurance Ombudsman.

b) Standard Provisions

The second component of the policy document is made up of standard policy provisions, which are normally present in all life insurance contracts, unless specifically excluded. Some of these provisions may not be applicable in the case of certain kinds of contracts, like term, single premium or non-participating (in profits) policies. These standard provisions define the rights

and privileges and other conditions, which are applicable under the contract.

c) Specific Policy Provisions

The third part of the policy document consists of specific policy provisions that are specific to the individual policy contract. These may be printed on the face of the document or inserted separately in the form of an attachment.

While standard policy provisions, like days of grace or non-forfeiture in case of lapse, are often statutorily provided under the contract, specific provisions generally are linked to the particular contract between the insurer and insured.

Example

A clause precluding death due to pregnancy for a lady who is expecting at the time of writing the contract

The detailed provisions are mentioned in chapter 13.

Test Yourself 1

What does a first premium receipt (FPR) signify? Choose the most appropriate option.

I. Free look period has ended
II. It is evidence that the policy contract has begun
III. Policy cannot be cancelled now
IV. Policy has acquired a certain cash value

Summary

- An insurance contract commences when the life insurance company issues a first premium receipt (FPR). The FPR is the evidence that the policy contract has begun.

- The policy document is the most important document associated with insurance. It is the evidence of the contract between the assured and the insurance company.

- The standard policy document typically has three parts which are the policy schedule, standard provisions and the policy's specific provisions.

Key Terms

1. First Premium Receipt (FPR)
2. Policy document
3. Policy schedule
4. Standard provisions
5. Special Provisions

Answers to Test Yourself

Answer 1

The correct option is II.

FPR is evidence that policy contract has begun.

Self-Examination Questions

Question 1

Which of the following documents is an evidence of the contract between insurer and insured?

I. Proposal form
II. Policy document
III. Prospectus
IV. Claim form

Question 2

If complex language is used to word a certain policy document and it has given rise to an ambiguity, how will it generally be construed?

I. In favour of insured
II. In favour of insurer
III. The policy will be declared as void and the insurer will be asked to return the premium with interest to the insured
IV. The policy will be declared as void and the insurer will be asked to return the premium to the insured without any interest

Question 3

Select the option that best describes a policy document.

I. It is evidence of the insurance contract
II. It is evidence of the interest expressed by the insured in buying an insurance policy from the company
III. It is evidence of the policy (procedures) followed by an insurance company when dealing with channel partners like banks, brokers and other entities
IV. It is an acknowledgement slip issued by the insurance company on payment of the first premium

Question 4

Which of the below statement is correct?

I. The proposal form acceptance is the evidence that the policy contract has begun
II. The acceptance of premium is evidence that the policy has begun
III. The First Premium Receipt is the evidence that the policy contract has begun
IV. The premium quote is evidence that the policy contract has begun

Question 5

For the subsequent premiums received by the insurance company after the first premium, the company will issue __________.

I. Revival premium receipt
II. Restoration premium receipt
III. Reinstatement premium receipt
IV. Renewal premium receipt

Question 6

What will happen if the insured person loses the original life insurance policy document?

I. The insurance company will issue a duplicate policy without making any changes to the contract
II. The insurance contract will come to an end
III. The insurance company will issue a duplicate policy with renewed terms and conditions based on the current health declarations of the life insured
IV. The insurance company will issue a duplicate policy without making any changes to the contract, but only after a Court order.

Question 7

Which of the below statement is correct?

I. The policy document has to be signed by a competent authority but need not be compulsorily stamped according to the Indian Stamp Act.
II. The policy document has to be signed by a competent authority and should be stamped according to the Indian Stamp Act.
III. The policy document need not be signed by a competent authority but should be stamped according to the Indian Stamp Act.
IV. The policy document neither needs to be signed by a competent authority nor it needs to be compulsorily stamped according to the Indian Stamp Act.

Question 8

Which of the below forms the first part of a standard insurance policy document?

I. Policy schedule
II. Standard provisions
III. Specific policy provisions
IV. Claim procedure

Question 9

In a standard insurance policy document, the standard provisions section will have information on which of the below?

I. Date of commencement, date of maturity and due date of last premium
II. Name of nominee
III. The rights and privileges and other conditions, which are applicable under the contract
IV. The signature of the authorised signatory and policy stamp

Question 10

"A clause precluding death due to pregnancy for a lady who is expecting at the time of writing the contract" will be included in which section of a standard policy document?

I. Policy schedule
II. General provisions
III. Standard provisions
IV. Specific policy provisions

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Policy document is an evidence of the contract between insurer and insured.

Answer 2

The correct option is I.

If there is complex language used to word a certain policy document and it has given rise to an ambiguity, it generally will be construed in favour of the insured.

Answer 3

The correct option is I.

Policy document is an evidence of the insurance contract.

Answer 4

The correct option is III.

The First Premium Receipt is the evidence that the policy contract has begun.

Answer 5

The correct option is IV.

For the subsequent premiums received by the insurance company after the first premium, the company will issue renewal premium receipt.

Answer 6

The correct option is I.

If the insured person loses the original life insurance policy document, the insurance company will issue a duplicate policy without making any changes to the contract.

Answer 7

The correct option is II.

The policy document has to be signed by a competent authority and should be stamped according to the Indian Stamp Act.

Answer 8

The correct option is I.

Policy schedule forms the first part of a standard insurance policy document.

Answer 9

The correct option is III.

The standard provisions section of an insurance policy document will have information on the rights and privileges and other conditions, which are applicable under the contract.

Answer 10

The correct option is IV.

"A clause precluding death due to pregnancy for a lady who is expecting at the time of writing the contract" will be included in specific policy provisions section of a standard policy document.

CHAPTER 13

DOCUMENTATION - POLICY CONDITION

Chapter Introduction

In this chapter we discuss the provisions incorporated in a policy document. The provisions discussed in the chapter include some important provisions related to grace period, policy lapse and non-forfeiture etc.

Learning Outcomes

A. Policy conditions and privileges

A. Policy conditions and privileges

1. Grace period

Every life insurance contract undertakes to pay the death benefit on the condition that the premiums have been paid up to date and the policy is in force. The "Grace Period" clause grants the policyholder an additional period of time to pay the premium after it has become due.

Important

The standard length of the grace period is one month or 31 days. The days of grace may be computed from the next day after the due date fixed for payment of the premium. The provision enables a policy that would otherwise have lapsed for non-payment of premium, to continue in force during the grace period.

The premium however remains due and if the policyholder dies during this period, the insurer may deduct the premium from the death benefit. If premiums remain unpaid even after the grace period is over, the policy would then be considered lapsed and the company is not under obligation to pay the death benefit. The only amount payable would be whatever is applicable under the non-forfeiture provisions. In a sense the insured may thus be said to have received free insurance during the grace period.

2. Lapse and Reinstatement / Revival

We have already seen that a policy may be said to be in lapse condition if premium has not been paid even during the days of grace. The good news is that practically all the permanent life insurance contracts permit reinstatement (revival) of a lapsed policy.

Definition

Reinstatement is the process by which a life insurance company puts back into force a policy that has either been terminated because of non-payment of premiums or has been continued under one of the non-forfeiture provisions.

A revival of the policy cannot however be an unconditional right of the insured. It can be accomplished only under certain conditions:

i. **No increase in risk for insurer:** Revival of a policy cannot result in an increase in risk for the insurance company

ii. **Creation of reserve:** The policyholder must pay such amount of premiums with interest, as would lead to creation of the same reserve it would have accumulated if the policy had not lapsed.

iii. **Revival application within specific time period:** The policy owner must complete the revival application within the time frame stated in the provision for such reinstatement. In India revival must be affected within a specific time period, say five years, from the date of lapse.

iv. **Satisfactory evidence of continued insurability:** The insured must present to the insurance company satisfactory evidence of continued insurability of the insured. Not only must her health be satisfactory but other factors such as financial income and morals must not have deteriorated substantially.

v. **Payment of overdue premiums with interest:** The policy owner is required to make payment of all overdue premiums with interest from due date of each premium.

vi. **Payment of outstanding loan:** The insured must also pay any outstanding policy loan or reinstate any indebtedness that may have existed.

Perhaps the most significant of the above conditions is that which requires evidence of insurability at revival. The type of evidence called for would depend on the circumstances of each individual policy. If the policy has been in a lapsed state for a very short period of time, the insurer may reinstate the policy without any evidence of insurability or may only require a simple statement from the insured certifying that he is in good health.

The company may however require a medical examination or other evidence of insurability under certain circumstances:

i. One is where the grace period has expired since long and the policy is in a lapsed condition for say, nearly a year.

ii. Another situation is where the insurer has reason to suspect that a health or other problem may be present. Fresh medical examination may also be required if the sum assured or face amount of the policy is large.

Since a revival may require the policyholder to pay a sizeable sum of money (past arrears of premium and interest) for the purpose, each policyholder must decide whether it would be more advantageous to revive the original policy or purchase a new policy. **Revival is often more advantageous because buying a new policy would call for a higher premium rate based on the age the insured has attained on date of revival.**

a) Policy revival measures

Let us now look at some of the ways through which policy revival can be accomplished. In general one can revive a lapsed policy if the revival is within a certain period (say 5 years) from the date of first unpaid premium.

i. Ordinary revival

The simplest form of revival is one that involves payment of arrears of premium with interest. This has been termed as ordinary revival and is affected when the policy has acquired surrender value. The insurer would also call for a declaration of good health or some other evidence of insurability like a medical examination.

ii. Special revival

What do we do when the policy has run for less than three years and has not acquired minimum surrender value (i.e. the accumulated reserves or cash value is insignificant) but the period of lapse is large?, say the policy is coming up for revival after a period of one year or more since the date of first unpaid premium.

One way to revive it is through a scheme known as special revival (which is for instance prevalent in LIC of India). Here it is as though a new policy has been written, whose date of commencement is within two years of the original date of commencement of the lapsed policy. The maturity date shall not exceed the original stipulated period as applicable to certain lives at the time of taking the policy.

Example

If the original policy was taken at age 40 and the new date of commencement is at age 42, the term of the policy may now be reduced from twenty to eighteen for those policies that require that the term should end at age 60. Difference between old and new premium with interest thereon has to be paid.

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iii. Loan cum revival

Yet a third approach to revival also available with LIC and other companies is that of loan cum revival. This is not a revival alone but involves two transactions:

- ✓ the simultaneous granting of a loan and
- ✓ revival of the policy

Arrears of premium and interest are calculated as under ordinary revival. The loan that one is eligible to get under the policy as on date of revival is also determined. This loan may be utilised as consideration amount for revival purposes. If there is any balance amount subsisting after loan adjustment towards arrears of premium and interest, it is payable to the policyholder. Obviously, the facility of loan cum revival would be allowed only for policies that have acquired surrender value as on date of revival.

iv. Instalment revival

Finally we have instalment revival which is allowed when the policyholder is not in a position to pay arrears of premium in a lump sum and neither can the policy be revived under special revival scheme. The arrears of premium in such case would be calculated in the usual manner as under an ordinary revival scheme.

Depending on the mode of payment (quarterly or half yearly) the life assured may be required to pay one half yearly or two quarterly premiums. The balance of arrears to be paid would then be spread so as to be paid with future premiums on premium due dates, during a period of two years or more, including the current policy anniversary yearand two full policy anniversaries thereafter. A condition may be imposed that there should be no outstanding loan under the policy at the time of revival.

Important

Revival of lapsed policies is an important service function that life insurers seek to actively encourage since policies in lapsed state may do little good to either insurer or policyholder.

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3. Non-forfeiture provisions

One of the important provisions under the Indian Insurance Act (Section 113) is that which allows for accrual of certain benefits to policyholders even when they are unable to keep their policies in full force by payment of further premiums. The logic, which applies here, is that the policyholder has a claim to the cash value accumulated under the policy.

The law in India thus provides that if premiums have been paid for at least three consecutive years there shall be a guaranteed surrender value. If the policy has not been surrendered it shall subsist as a policy with a reduced paid up value. The policy provisions usually provide for a more liberal surrender value than that required by law.

a) Surrender values

Life insurers normally have a chart that lists the surrender values at various times and also the method that will be used for calculating the surrender values. The formula takes into account the type and plan of insurance, age of the policy and the length of the policy premium-paying period. The actual amount of cash one gets in hand on surrender may be different from the surrender value amount prescribed in the policy.

This is because paid up additions, bonuses or dividend accumulations, advance premium payments or gaps in premiums, policy loans etc. may result in additions or subtractions from the cash surrender value accrued. What the policyholder ultimately receives is a net surrender value.Surrender Value is a percentage of paid-up value.

Surrender Value arrived as a percentage of premiums paid is called Guaranteed Surrender Value.

b) Policy loans

Life insurance policies that accumulate a cash value also have a provision to grant the policyholder the right to borrow money from the insurer by using the cash value of the policy as a security for the loan. The policy loan is usually limited to a percentage of the policy's surrender value (say 90%). Note that the policyholder borrows from his own account. He or she would have been eligible to get the amount if the policy had been surrendered.

In that case however the insurance would also have been terminated. By instead taking a loan on the policy, a policyholder is able to keep the cake and eat it too. A loan provides access to liquid funds while keeping the insurance alive. A loan is what you would recommend to a client in need of urgent funds but you would like to keep him or her as your client.

A policy loan is different from an ordinary commercial loan in two respects:

Policy loan	Commercial loan
No legal obligation to repay the loan: The policy owner is not legally obligated to repay the loan. She can repay all or part of the loan at any time she chooses. If the loan has not been repaid, the insurer deducts the amount of outstanding (unpaid) loan and interest from the policy benefit that is payable.	A commercial loan creates a debtor – creditor relationship in which the borrower is legally obligated to repay the lender.
No credit check is required: Since the insurer does not really lend its own funds to the policyholder, it is not necessary to perform a credit check on the debtor when the latter applies for the loan. The insurer needs to only	The creditor does a thorough credit check on the debtor

ensure that the loan does not exceed the eligible amount (90% of SV as suggested above).	

The insurer off course reserves the right to decide on terms and conditions of such loans from time to time as a matter of policy. Since the loan is granted on the policy being kept as security, the policy has to be assigned in favour of the insurer. Where the policyholder has nominated someone to receive the money in the event of death of the insured, this nomination shall not be cancelled by the subsequent assignment of the policy.

The nominee's right will affected to the extent of the insurer's interest in the policy.

Example

Arjun bought a life insurance policy wherein the total death claim payable under the policy was Rs. 2.5 lakhs. Arjun's total outstanding loan and interest under the policy amounts to Rs. 1.5 lakhs

Hence in the event of Arjun's death, the nominee will be eligible to get the balance of Rs. 1 lakh

Insurers usually charge interest on policy loans, which are payable semi-annually or annually. If the interest charges are not paid they become part of the policy loan and are included in the loan outstanding.

So long as the premiums are paid in time and the policy is in force, the accumulated cash value will generally be more than sufficient to pay for the loan and interest charges. But if the policy is in a lapsed condition and no new premiums are forthcoming a situation can arise where the amount of outstanding loan plus unpaid interest (the total debt) becomes greater than the amount of policy's cash value.

The insurer obviously cannot allow such a situation. Well before such an eventuality, insurers generally take what is termed as foreclosure action. Notice is to be given to the policyholder before the insurance company resorts to foreclosure. The policy is terminated and subsisting cash value is adjusted to loan and interest that is outstanding. Any excess amount may be paid to the policyholder.

4. Special policy provisions and endorsements

a) Nomination

i. **Nomination** is where the life assured proposes the name of the person(s) to whom the sum assured should be paid by the insurance company after their death.

ii. The life assured can **nominate one or more than one person** as nominees.
iii. Nominees are entitled for **valid discharge** and have to **hold the money as a trustee** on behalf of those entitled to it.
iv. Nomination can be done either **at the time the policy is bought or later**.
v. Under Section39 of the Insurance Act 1938, the holder of a policy on their own life may nominate the person or persons to whom the money secured by the policy shall be paid in the event of their death.

Nomination can be changed by making another endorsement in the policy.

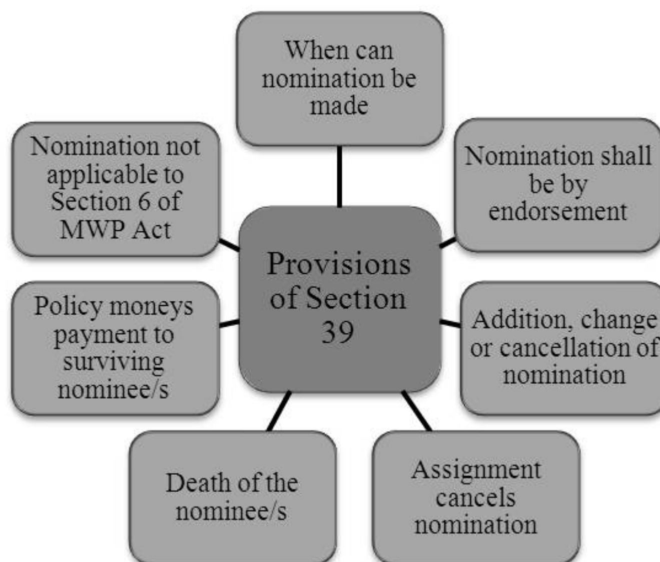
Important

Nomination only gives the nominee the right to receive the policy monies in the event of the death of the life assured. **A nominee does not have any right to the whole (or part) of the claim.**

Where the nominee is a minor, the policy holder needs to appoint an appointee. The appointee needs to sign the policy document to show his or her consent to acting as an appointee. The appointees lose their status when the nominee reaches majority age. The life assured can change the appointee at any time. If no appointee is given, and the nominee is a minor, then on the death of the life assured, the death claim is paid to the legal heirs of the policyholder.

Where more than one nominee is appointed, the death claim will be payable to them jointly, or to the survivor or survivors. **No specific share for each nominee can be made.** Nominations made after the commencement of the policy have to be intimated to the insurers to be effective.

Diagram 1: Provisions related to nomination



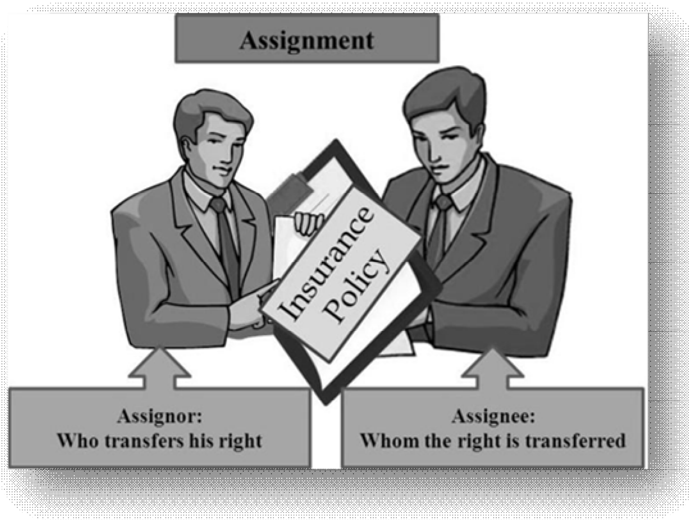
b) Assignment

The term assignment ordinarily refers to transfer of property by writing as distinguished from transfer by delivery. The ownership of property consists of various rights in respect of such property, which are vested in one or more persons.

On assignment, nomination is cancelled, except when assignment is made to insurance company for a policy loan.

The assignment of a life insurance policy implies the act of transferring the rights right, title and interest in the policy (as property) from one person to another. The person who transfers the rights is called **assignor** and the person to whom property is transferred is called **assignee.**

Diagram 2: Assignment

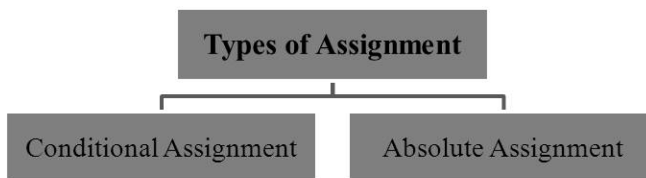


In India assignment is governed by Section 38 of Insurance Act. On execution of the assignment the assignee gets all rights title and interest in respect of property assigned and becomes the owner of the policy, subject to the provision that the assignee cannot have a better title than the assignor.

This last provision is very important. It means simply that the assignee would not be eligible to get a claim that for some reason is rejected to the assured. Assignment requires that the parties be competent to contract and is not subject to legal disqualifications.

There are two types of assignments.

Diagram 3: Types of Assignment



Conditional Assignment	Absolute Assignment
Conditional assignment provides that the policy shall revert back to the life assured on his or her surviving the date of maturity or on death of the assignee.	Absolute assignment provides that all rights, title and interest which the assignor has in the policy are transferred to the assignee without reversion to the former or his/her estate in any event. The policy thus vests absolutely with the assignee. The latter can deal with the policy in whatever manner he or she likes without the consent of the assignor.

Absolute assignment is more commonly seen in many commercial situations where the policy is typically mortgaged against a debt assumed by the policyholder, like a housing loan.

Conditions for valid assignment

Let us now look at the conditions that are necessary for a valid assignment.

i. First of all the person executing it (the assignor) must have **absolute right and title or assignable interest** to the policy being assigned.

ii. Secondly it is necessary that the assignment be **supported by valuable consideration**, which may include love and affection.

iii. Thirdly it is imperative that the assignment is **not opposed to any law in force**. For example the assignment of a policy to a foreign national residing in another country may contravene exchange control regulations.

iv. Assignee can do another assignment, but cannot do nomination because assignee is not the life assured.

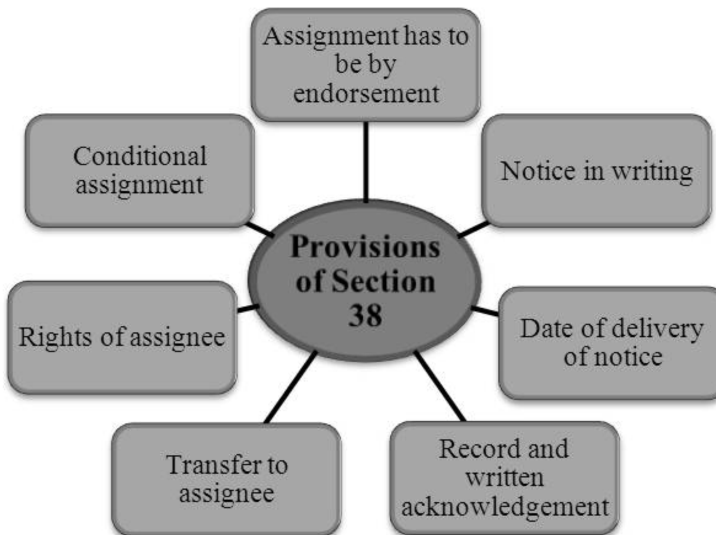
The assignment has to be in writing and must be signed and attested by at least one witness. The fact of transfer of title has to be specifically set forth in the form of an endorsement on the policy. It is also necessary that the policyholder must give notice of the assignment to the insurer. **Unless such**

notice in writing is received by the insurer, the assignee would not have any right of title to the policy.

On receipt of the policy document for endorsement and notice the life insurance may affect and register the assignment. It must be noted that while registering the assignment the company does not take any responsibility or express any opinion about its validity or legal effect. The date of the assignment as recorded in the books of the life insurance company would be the date on which the assignment and notice thereof has been received by its concerned office. If the notice and the assignment were to be received on separate dates, the date of the one received later will be deemed as the date of registration.

An assignee may reassign interest in the policy to the policyholder /life assured during the currency of the policy. On such reassignment the latter may be advised to execute a fresh nomination or assignment for expeditious settlement of the claim. Again, **in the case of conditional assignment the title to the policy would revert to the life assured in the event of death of the assignee.** On the other hand if the assignment were absolute, the title would pass to the estate of the deceased assignee.

Diagram 4: Provisions related to assignment of insurance policies



Nomination Vs. Assignment

Basis of Difference	Nomination	Assignment
What is Nomination or Assignment?	Nomination is the process of appointment of a person to receive the death claim	Assignment is the process of transferring the title of the insurance policy to another person or institution.
When can the nomination or assignment be done?	Nomination can be done either at the time of proposal or after the commencement of the policy.	Assignment can be done only after commencement of the policy.
Who can make the nomination or assignment?	Nomination can be made only by the life-assured on the policy of his own life.	Assignment can be done by owner of the policy either by the life assured if he is the policyholder or the assignee
Where is it applicable?	It is applicable only where the Insurance Act, 1938 is applicable.	It is applicable all over the world, according to the law of the respective country relating to transfer of property.
Does the policyholder retain control over the policy?	The policyholder retains title and control over the policy and the nominee has no right to sue under the policy	The policyholder loses the right, title and interest under the policy until a re-assignment is executed and the assignee has a right to sue under the policy.
Is a witness required?	Witness is not required.	Witness is mandatory.
Do they get any rights?	Nominee has no rights over the policy.	Assignee gets full rights over the policy, and can even sue under the policy.
Can it be revoked?	Nomination can be revoked or cancelled at any time during the policy term.	The assignment once done cannot be cancelled, but can be re-assigned.
In case of minor:	In case the nominee is a minor, appointee has to be appointed.	In case the assignee is a minor, a guardian has to be appointed.
What happens in	In case of nominee's	In case of conditional

case of the nominee's or assignee's death?	death, the rights of the policy revert to the policyholder or to his legal heirs.	assignee's death, the rights on the policy revert back to the life assured, based on the terms of assignment. In case of the absolute assignee's death, his legal heirs are entitled to the policy.
What happens in case of death of the nominee or assignee after the death of the life-assured and before the payment of the death claim	In case the nominee dies before the settlement of death claim, the death claim will be payable to the legal heirs of the life assured.	In case the assignee dies before the settlement, the policy money is payable to the legal heirs of the assignee and not the life-assured who is the assignor.
Can creditors attach the policy?	Creditors can attach the insurance policy which has a nomination in it.	Creditors cannot attach the policy unless the assignment is shown to have been made to defraud the creditors.

c) Duplicate Policy

A life insurance policy document is only an evidence of a promise. Loss or destruction of the policy document and does not in any way absolve the company of its liability under the contract. Life insurance companies generally have standard procedures to be followed in case of loss of the policy document.

Normally the office would examine the case to see if there is any reason to doubt the alleged loss. Satisfactory proof may require to be produced that the policy has been lost and not been dealt with in any manner. Generally the claim may be settled on the claimant furnishing an indemnity bond with or without surety.

If payment is shortly due and the amount to be paid is high, the office may also insist that an advertisement be placed in a national paper with wide circulation, reporting the loss. A duplicate policy may be issued on being sure that there is no objection from anyone else.

d) Alteration

Policyholders may seek to effect alterations in policy terms and conditions. There is provision to make such changes subject to consent of both the insurer and assured. Normally alterations may not be permitted during the first year of the policy, except for change in the mode of premium or alterations which are of a compulsory nature – like

- ✓ change in name or / address;
- ✓ readmission of age in case it is proved higher or lower;
- ✓ request for grant of double accident benefit or permanent disability benefit etc.

Alterations may be permitted in subsequent years. Some of these alterations may be affected by placing a suitable endorsement on the policy or on a separate paper. Other alterations, which require a material change in policy conditions, may require the cancellation of existing policies and issue of new policies.

Some of the main types of alterations that are permitted are

i. Change in certain classes of insurance or term [where risk is not increased]
ii. Reduction in the sum assured
iii. Change in the mode of payment of premium
iv. Change in the date of commencement of the policy
v. Splitting up of the policy into two or more policies
vi. Removal of an extra premium or restrictive clause
vii. Change from without profits to with profits plan
viii. Correction in name
ix. Settlement option for payment of claim and grant of double accident benefit

These alterations generally do not involve an increase in the risk. There are other alterations in policies that are not allowed. These may be alterations that have the effect of lowering the premium. Examples are extension of the premium paying term; change from with profit to without profit plans; change from one class of insurance to another, where it increases the risk: and increase in the sum assured.

Insurance companies everywhere are generally allowed to select the actual wording of their policy documents, but these may need to be submitted to the regulator for approval.

Test Yourself 1

Under what circumstances would the policyholder need to appoint an appointee?

I. Insured is minor
II. Nominee is a minor
III. Policyholder is not of sound mind
IV. Policyholder is not married

Summary

- The grace period clause grants the policyholder an additional period of time to pay the premium after it has become due.

- Reinstatement is the process by which a life insurance company puts back into force a policy that has either been terminated because of non-payment of premiums or has been continued under one of the non-forfeiture provisions.

- A policy loan is different from an ordinary commercial loan in two respects, firstly the policy owner is not legally obligated to repay the loan and the insurer need not perform a credit check on the insured.

- Nomination is where the life assured proposes the name of the person(s) to which the sum assured should be paid by the insurance company after their death.

- The assignment of a life insurance policy implies the act of transferring the rights right, title and interest in the policy (as property) from one person to another. The person who transfers the rights is called assignor and the person to whom property is transferred is called assignee.

- Alteration is subject to consent of both the insurer and assured. Normally alterations may not be permitted during the first year of the policy, except for some simple ones.

Key Terms

1. Grace period
2. Policy lapse
3. Policy revival
4. Surrender value
5. Nomination
6. Assignment

Answers to Test Yourself

Answer 1

The correct option is II.

Where the nominee is a minor, the policyholder needs to appoint an appointee.

Self-Examination Questions

Question 1

Which of the below statement is false with regards to nomination?

I. Policy nomination is not cancelled if the policy is assigned to the insurer in return for a loan
II. Nomination can be done at the time of policy purchase or subsequently
III. Nomination can be changed by making an endorsement in the policy
IV. A nominee has full rights on the whole of the claim

Question 2

In order for the policy to acquire a guaranteed surrender value, for how long must the premiums be paid as per law?

I. Premiums must be paid for at least 2 consecutive years
II. Premiums must be paid for at least 3 consecutive years
III. Premiums must be paid for at least 4 consecutive years
IV. Premiums must be paid for at least 5 consecutive years

Question 3

When is a policy deemed to be lapsed?

I. If the premiums are not paid on due date
II. If the premiums are not paid before the due date
III. If the premium has not been paid even during days of grace
IV. If the policy is surrendered

Question 4

Which of the below statement is correct with regards to grace period of an insurance policy?

I. The standard length of the grace period is one month.
II. The standard length of the grace period is 30 days.
III. The standard length of the grace period is one month or 30 days.
IV. The standard length of the grace period is one month or 31 days.

Question 5

What will happen if the policyholder does not pay the premium by the due date and dies during the grace period?

I. The insurer will consider the policy void due to non-payment of premium by the due date and hence reject the claim
II. The insurer will pay the claim and waive off the last unpaid premium
III. The insurer will pay the claim after deducting the unpaid premium
IV. The insurer will pay the claim after deducting the unpaid premium along with interest which will be taken as 2% above the bank savings interest rate

Question 6

During the revival of a lapsed policy, which of the below aspect is considered most significant by the insurance company? Choose the most appropriate option.

I. Evidence of insurability at revival
II. Revival of the policy leading to increase in risk for the insurance company
III. Payment of unpaid premiums with interest
IV. Insured submitting the revival application within a specified time frame

Question 7

For an insurance policy nomination is allowed under _________ of the Insurance Act, 1938.

I. Section 10
II. Section 38
III. Section 39
IV. Section 45

Question 8

Which of the below statement is incorrect with regards to a policy against which a loan has been taken from the insurance company?

I. The policy will have to be assigned in favour of the insurance company
II. The nomination of such policy will get cancelled due to assignment of the policy in favour of the insurance company
III. The nominee's right will affected to the extent of the insurer's interest in the policy
IV. The policy loan is usually limited to a percentage of the policy's surrender value

Question 9

Which of the below statement is incorrect with regards to assignment of an insurance policy?

I. In case of Absolute Assignment, in the event of death of the assignee, the title of the policy would pass to the estate of the deceased assignee.
II. The assignment of a life insurance policy implies the act of transferring the rights right, title and interest in the policy (as property) from one person to another.
III. It is necessary that the policyholder must give notice of assignment to the insurer.
IV. In case of Absolute Assignment, the policy vests absolutely with the assignee till maturity, except in case of death of the insured during the policy tenure, wherein the policy reverts back to the beneficiaries of the insured.

Question 10

Which of the below alteration will be permitted by an insurance company?

I. Splitting up of the policy into two or more policies
II. Extension of the premium paying term
III. Change of the policy from with profit policy to without profit policy
IV. Increase in the sum assured

Answers to Self-Examination Questions

Answer 1

The correct option is IV.

A nominee does not have any right to whole (or part) of the claim.

Answer 2

The correct option is II.

In order for the policy to acquire a guaranteed surrender value, premiums must be paid for at least 3 consecutive years.

Answer 3

The correct option is III.

If the premium has not been paid even during days of grace, the policy is deemed to be lapsed.

Answer 4

The correct option is IV.

The standard length of the grace period is one month or 31 days.

Answer 5

The correct option is II.

If the policyholder does not pay the premium by the due date and dies during the grace period, the insurer will pay the claim after deducting the unpaid premium.

Answer 6

The correct option is I.

During the revival of a lapsed policy, evidence of insurability at revival is considered as the most significant aspect by the insurance company.

Answer 7

The correct option is III.

For an insurance policy nomination is allowed under Section 39 of the Insurance Act, 1938.

Answer 8

The correct option is II.

Option II is incorrect.
With regards to a policy against which a loan has been taken from the insurance company, the nomination will NOT get cancelled due to assignment of the policy in favour of the insurance company.

Answer 9

The correct option is IV.

Option 4 is incorrect.
In case of Absolute Assignment, the policy vests absolutely with the assignee till maturity. In the event of death of the insured during the policy tenure, the policy will **NOT** revert back to the beneficiaries of the insured. The assignee will be entitled to policy benefits.

Answer 10

The correct option is I.

An alteration that involves splitting up of the policy into two or more policies is permitted.

CHAPTER 14

UNDERWRITING

Chapter Introduction

A life insurance agent's work does not stop once a proposal is secured from a prospective customer. The proposal must also be accepted by the insurance company and result in a policy.

Every life insurance proposal indeed has to pass through a gateway where the life insurer decides whether to accept the proposal and if so, on what terms. In this chapter we shall know more about the process of underwriting and the elements involved in the process.

Learning Outcomes

A. Underwriting – Basic concepts
B. Non-medical underwriting
C. Medical underwriting

A. Underwriting - Basic concepts

1. Underwriting purpose

We begin with examining the purpose of underwriting. There are two purposes

i. To prevent anti-selection or selection against the insurer
ii. To classify risks and ensure equity among risks

Definition

The term **selection of risks** refers to the process of evaluating each proposal for life insurance in terms of the degree of risk it represents and then deciding whether or not to grant insurance and on what terms.

Anti-selection is the tendency of people, who suspect or know that their chance of experiencing a loss is high, to seek out insurance eagerly and to gain in the process.

Example

If life insurers were to be not selective about whom they offered insurance, there is a chance that people with serious ailments like heart problems or cancer, who did not expect to live long, would seek to buy insurance.

In other words, if an insurer did not exercise selection it would be selected against and suffer losses in the process.

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2. Equity among risks

Let us now consider equity among risks. The term "Equity" means that applicants who are exposed to similar degrees of risk must be placed in the same premium class. We have already seen how life insurers use a mortality table to determine the premiums to be charged. The table represents the mortality experience of standard lives or average risks. They include the vast majority of individuals who propose to take life insurance.

a) Risk classification

To usher equity, the underwriter engages in a process known as **risk classification** i.e. individual lives are categorised and assigned to different risk classes depending on the degree of risks they pose. There are four such risk classes.

Diagram 1: Risk classification

i. Standard lives

These consist of those whose anticipated mortality corresponds to the standard lives represented by the mortality table.

ii. Preferred risks

These are the ones whose anticipated mortality is significantly lower than standard lives and hence could be charged a lower premium.

iii. Substandard lives

These are the ones whose anticipated mortality is higher than the average or standard lives, but are still considered to be insurable. They may be accepted for insurance with higher (or extra) premiums or subjected to certain restrictions.

iv. Declined lives

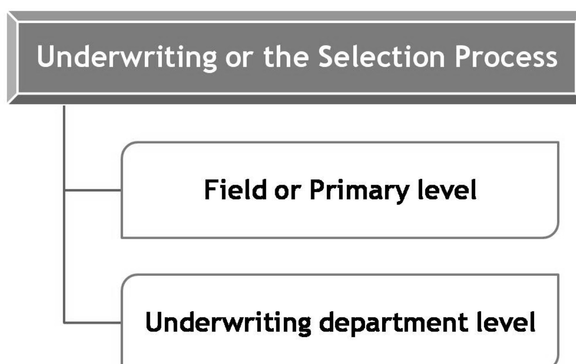
These are the ones whose impairments and anticipated extra mortality are so great that they could not be provided insurance coverage at an affordable cost. Sometimes an individual's proposal may also be temporarily declined if he or she has been exposed to a recent medical event, like an operation.

3. Selection process

Underwriting or the selection process may be said to take place at two levels:

- ✓ At field level
- ✓ At underwriting department level

Diagram 2: Underwriting or the selection process



a) Field or Primary level

Field level underwriting may also be known as **primary underwriting**. It includes information gathering by an agent or company representative to decide whether an applicant is suitable for granting insurance coverage. The agent plays a critical role as primary underwriter. He is in the best position to know the life to be insured.

Many insurance companies may require that agents complete a statement or a confidential report, asking for specific information, opinion and recommendations to be provided by the agent with respect to the proposed life.

A similar kind of report, which has been called as **Moral Hazard report**, may also be sought from an official of the life insurance company. These reports typically cover the occupation, income and financial standing and reputation of the proposed life.

Fraud monitoring and role of agent as primary underwriter

Much of the decision with regard to selection of a risk depends on the facts that have been disclosed by the proposer in the proposal form. It may be difficult for an underwriter who is sitting in the underwriting department to know whether these facts are untrue and have been fraudulently misrepresented with deliberate intent to deceive.

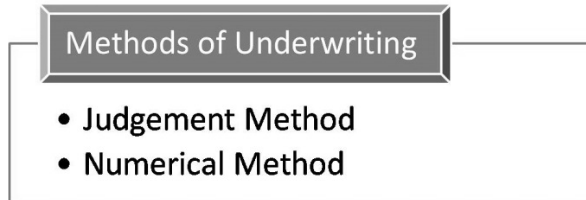
The agent plays a significant role here. He or she is in the best position to ascertain that the facts that have been represented are true, since the agent has direct and personal contact with the proposed life and can thus monitor if any wilful non - disclosure or misrepresentation has been made with an intent to mislead.

b) Underwriting department level

The second level of underwriting is at the department or office level. It involves specialists and persons who are proficient in such work and who consider all the relevant data on the case to decide whether to accept a proposal for life insurance and on what terms.

4. Methods of underwriting

Diagram 3: Methods of Underwriting

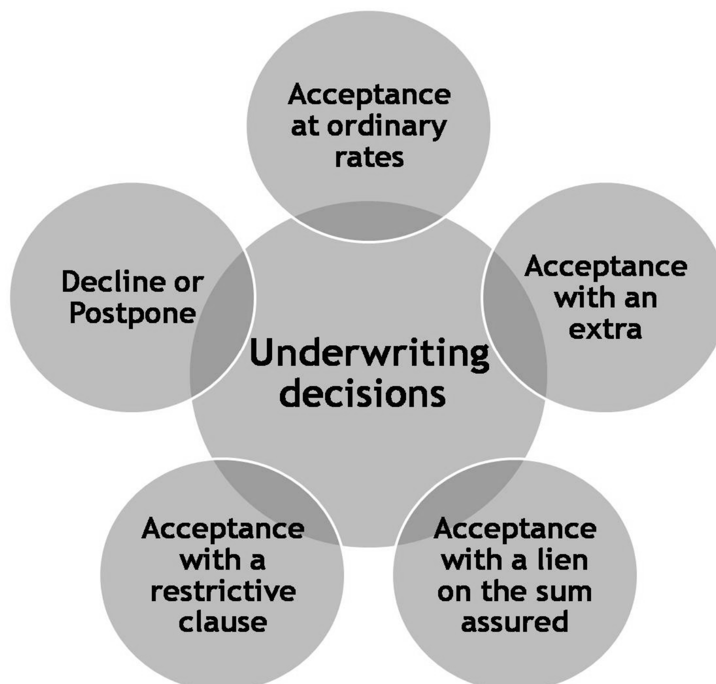


Underwriters may use two types of methods for the purpose:

Judgment Method	Numerical Method
Under this method subjective judgment is used, especially when deciding on a case that is complex.	Under this method underwriters assign positive rating points for all negative or adverse factors (negative points for any positive or favourable factors).
Example: Deciding whether to give insurance to someone who has acute diabetes and on what terms	
In such situations, the department may get the expert opinion of a medical doctor who is also called a medical referee.	The total number of points so assigned will decide how much Extra Mortality Rating (also called EMR) it has been given. Higher the EMR, more substandard the life is. If the EMR is very high, insurance may even be declined.

5. Underwriting decisions

Diagram 4: Underwriting decisions



Let us now consider the various kinds of decisions that underwriters may take with regard to a life proposed for underwriting

a) **Acceptance at ordinary rates (OR)** is the most common decision. This rating indicates that the risk is accepted at the same rate of premium as would apply to an ordinary or standard life.

b) **Acceptance with an extra:** This is the most common way of dealing with the large majority of sub-standard risks. It involves charging an extra over the tabular rate of premium.

c) **Acceptance with a lien on the sum assured:** A lien is a kind of hold which the life insurance company can exercise (in part or whole) on the amount of benefit it has to pay in the event of a claim.
Example: It may be imposed in case the life proposed for insurance has suffered and recovered from certain disease like TB. Lien implies that if the life assured dies from a specified cause (for example relapse of the TB) within a given period, only a decreased amount of death benefit may be payable.

d) **Acceptance with a restrictive clause:** For certain kinds of hazards a restrictive clause may be applied which limits death benefit in the event of death under certain circumstances.
Example is a pregnancy clause imposed on pregnant ladies that limits insurance payable in the event of pregnancy related deaths occurring within say three months of delivery.

e) **Decline or postpone:** Finally, a life insurance underwriter may decide to decline or reject a proposal for insurance. This would happen when there are certain health /other features which are so adverse that they considerably magnify the incidence of the risk.
Example: An individual who suffers from cancer and has little chance of remission, would be a candidate for rejection,

Similarly in some cases it may be prudent to postpone acceptance of the risk until such time as the situation has improved and become more favourable.

Example

A lady who has just had a hysterectomy operation may be asked to wait for a few months before insurance on her life is allowed, to allow any post operation complications that may have arisen to disappear.

Test Yourself 1

Which of the following cases is likely to be declined or postponed by a life insurer?

I. Healthy 18 year old
II. An obese person
III. A person suffering from AIDS
IV. Housewife with no income of her own

B. Non-medical underwriting

1. Non-medical underwriting

A large number of life insurance proposals may typically get selected for insurance without conducting a medical examination to check the insurability of a life to be insured. Such cases are termed as **non-medical proposals.**

The case for non-medical underwriting lies in the finding that medical examinations bring out adverse features only in a small proportion (say one tenth) of the cases. The rest can be found out from the answers given in the proposal or the proposed life's leave records and other documents.

Conducting a medical examination by a qualified doctor would require that fees be paid to the doctor. The cost that can be saved by not conducting such examination is found to be much more than the loss that the life insurer may suffer on account of extra death claims arising as a result of bypassing a medical test. Life insurers have hence adopted the practice of granting insurance without insisting on a medical examination.

2. Conditions for non-medical underwriting

However non-medical underwriting calls for certain conditions to be followed.

i. Firstly **only certain categories** of females, like working women, may be eligible.

ii. **Upper limits on sum insured** may be imposed. For example, any case having a sum assured beyond five lakhs may need to be subjected to a medical examination.

iii. **Age at entry limits** may be imposed – for example, anyone above 40 or 45 years of age has to compulsorily get a medical examination done.

iv. Restriction being imposed with regard to **certain plans of insurance** – term insurance for example may not be allowed under non-medical category.

v. **Maximum term of insurance** may be limited to twenty years /up to age 60.

vi. **Class of lives:** Non-medical insurance may also be allowed to certain specific categories of individuals, for instance, non-medical special is provided to employees of reputed firms – having one year service. These companies have proper leave records and may also have periodic medical examinations so that the employee's medical status can be easily verified.

3. Rating factors in underwriting

Rating factors refer to various aspects related to financial situation, life style, habits, family history, personal history of health and other personal circumstances in the prospective insured's life that may pose a hazard and increase the risk. Underwriting involves identifying these hazards and their likely impact and classifying the risk accordingly.

Let us understand how the characteristics of an individual life have an impact on the risk. Broadly these may be divided into two – those which contribute to moral hazard and those which contribute to physical [medical] hazards. Life insurance companies often divide their underwriting into categories accordingly. Factors like income, occupation, lifestyle and habits, which contribute to moral

hazard, are assessed as part of **financial underwriting**, while medical aspects of health are appraised as part of **medical underwriting**.

a) Female insurance

Women generally have greater longevity than men. However they may face some problems with respect to moral hazard. This is because many women in Indian society are still vulnerable to male domination and social exploitation. Evils like dowry deaths are prevalent even today. Another factor which can affect longevity of women can arise from problems connected with pregnancy.

Insurability of women is governed by need for insurance and capacity to pay premiums. Insurance companies may thus decide to grant full insurance only to those who have earned income of their own and may impose limits on other categories of women. Similarly some conditions may be levied on pregnant women.

b) Minors

Minors have no contracting power of their own. Hence a proposal on the life of a minor has to be submitted by another person who is related to the minor in the capacity of a parent or legal guardian. It would also be necessary to ascertain the need for insurance, since minors usually have no earned income of their own.

Three conditions would generally be sought when considering insurance for minors:

i. **Whether they have a properly developed physique**
Poor growth of physique can arise as a result of malnutrition or other health problems posing grave risks.

ii. **Proper family history and personal history**
If there are adverse indicators here, it may pose risks.

iii. **Whether the family is adequately insured**
Insurance of minors is generally pursued by families having a culture of insurance. One would thus need to be alert when receiving a proposal on a child's life where the parents have not been insured. The underwriter would need to ascertain why such insurance has not been taken. Amount of insurance is also linked to that of parents.

c) Large sums assured

An underwriter needs to be wary when the amount of insurance is very large relative to annual income of the proposed insured. Generally sum assured may be assumed to be around ten to twelve times one's annual income. If the ratio is much higher than this, it raises the possibility of selection against the insurer.

Example

If an individual has an annual income of Rs. 5 lakhs and proposes for a life insurance cover of Rs. 3 crores, it raises a cause for concern.

Typically concerns can arise in such instances because of the possibility that such a large amount of insurance is being proposed in anticipation of suicide or as a result of expected deterioration in health. A third reason for such large sums could be excessive mis-selling by the sales person.

Large sums assured would also imply proportionately large premiums and raise the question whether the payment of such premiums would be continued. In general it would be thus prudent to limit the amount of insurance so that the premium payable is a maximum of say one third of an individual's annual income.

d) Age

As we have seen elsewhere in this course, the mortality risk is closely related to age. The underwriter needs to be careful when considering insurance for people who are of advanced ages.

Example

If the insurance is being proposed for the first time after age 50, there is a need to suspect moral hazard and enquire about why such insurance was not taken earlier.

We must also note that chances of occurrence of degenerative diseases like diseases of the heart and kidney failure increase with age and become high at older ages.

Life insurers may also seek for some special reports when proposals are submitted for high sums assured / advanced ages or a combination of both.

Example

Examples of such reports are the ECG; the EEG; X-Ray of the chest and Blood Sugar test. These tests may reveal deeper insights about the health of the proposed life than the answers given in the proposal or an ordinary medical examination can provide.

An important part of the underwriting process is admission of age, after verifying the proof of age. There are two types of age proofs

- ✓ Standard
- ✓ Non-standard

Standard age proofs are normally issued by a public authority. Instances are

- ✓ the birth certificate which is issued by a municipality or other government body;
- ✓ the school leaving certificate;
- ✓ the passport; and
- ✓ the employers' certificate

Where such proofs are not available, the proposer may be asked to bring a **non-standard age proof**. Examples of the latter are the horoscope; a self-declaration

When a standard age proof is not available, non-standard age proof should not be accepted readily. Often, life insurers would impose certain restrictions with respect to plan of insurance, term of assurance; maximum maturity age and maximum sum assured.

e) Moral hazard

Moral hazard may be said to exist when certain circumstances or characteristics of an individual's financial situation, lifestyle and habits, reputation and mental health indicate that he or she may intentionally engage in actions that increase the risk. There may be a number of factors which may suggest such moral hazard.

Example

When a proposal is submitted at a branch located far away from the place of residence of the proposed insured

A medical examination is done elsewhere even when a qualified medical examiner is available near one's place of residence.

A third case is when a proposal is made on the life of another without having clear insurable interest, or when the nominee is not the near dependent of the life proposed.

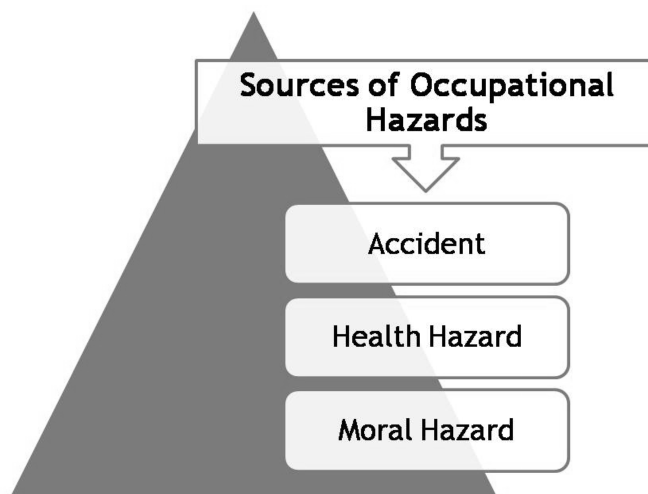
In each such case an enquiry may be made. Finally, when the agent is related to the life assured a moral hazard report may be called from a branch official like the agency manager / development officer.

f) Occupation

Occupational hazards can emanate from any of three sources:

- ✓ Accident
- ✓ Health hazard
- ✓ Moral hazard

Diagram 5: Sources of Occupational Hazards



i. **Accidental hazards** arise because certain kinds of jobs expose one to the risk of accident. There is any number of jobs in this category – like circus artistes, scaffolding workers, demolition experts and film stunt artistes.

ii. **Health hazards** arise when the nature of the job is such as to give rise to possibility of medical impairment. There are various kinds of health hazards.

- ✓ Some jobs like that of **rickshaw pullers** involve tremendous physical strain and impact the respiratory system.
- ✓ The second situation is where one may be exposed to **toxic substances** like mining dust or carcinogenic substances (that cause cancer) like chemicals and nuclear radiation.
- ✓ A third kind of hazard is posed by **high pressure environments** like underground tunnels or deep sea, which can cause acute decompression sickness.
- ✓ Finally, **overexposure** to certain job situations (like sitting cramped and glued to a computer in a KPO or working in a high noise setting) can impair functioning of certain body parts in the longer run.

iii. **Moral hazard** can arise when a job involves proximity or can cause predisposition towards criminal elements or to drugs and alcohol. An

example is that of a dancer in a nightclub or an enforcer in a liquor bar or the 'bodyguard' of a businessman with suspected criminal links. Again the job profiles of certain individuals like superstar entertainers may lead them to heady intoxicating lifestyles, which sometimes come to tragic ends.

Wherever the occupation falls in one of the categories of jobs listed hazardous, the applicant for insurance would normally be required to complete an occupational questionnaire which would ask for specific details of the job, duties involved and risks exposed to. A rating may also be imposed for occupation in the form of a flat extra (for example Rupees two per thousand sums assured.) Such extra may be reduced or removed when the insured's occupation changes.

g) Lifestyle and habits

Lifestyle and habits are terms, which cover a wide range of individual characteristics. Generally the agents' confidential reports and moral hazard reports are expected to mention if any of these characteristics are present in the individual's lifestyles, which suggest exposure to risk. In particular three features are important:

i. **Smoking and tobacco use**: It has now been well recognised that use of tobacco is not only a risk in itself but also contributes to increasing other medical risks. Companies charge differential rates today for smokers and non-smokers with the former having to pay much higher premiums. Other forms of tobacco usage like gutkha and paan masala may also attract adverse mortality ratings.

ii. **Alcohol:** Drinking alcohol in modest quantities and occasionally is not a hazard. It is even an accepted part of social life in many countries. However when it is regularly consumed in excess for a long time it can have a significant impact on mortality risk. Long term heavy drinking can impair liver functioning and affect the digestive system. It can also lead to mental disorders.

    Alcoholism is also linked with accidents, violence and family abuse, depression and suicides. Where the proposal form indicates use of alcohol, the underwriter may call for further details and decide on the case depending on the extent of usage and any complications that are indicated to have been caused as a result.

iii. **Substance abuse**: Substance abuse refers to the use of various kinds of substances like drugs or narcotics, sedatives and other similar stimulants. Some of these are even illegal and their use indicates criminal disposition and moral hazard. Where substance abuse is

suspected, the underwriter may need to call for a number of tests to check the abuse. Insurance is often declined in such cases.

Test Yourself 2

Which of the following is an example of moral hazard?

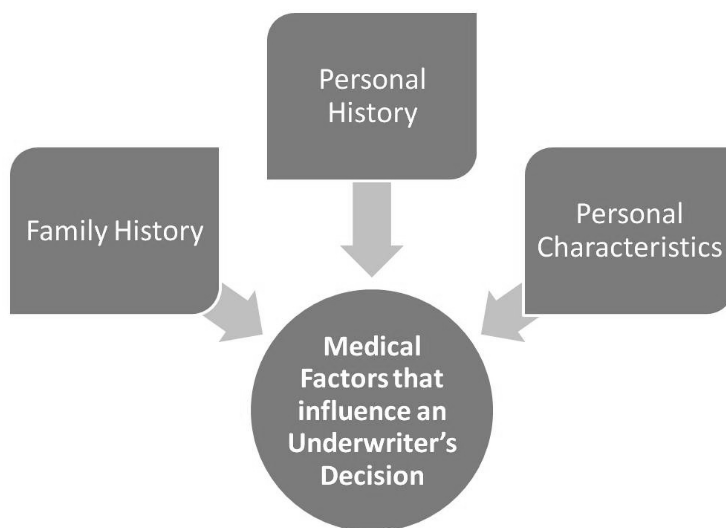
I. Stunt artist dies while performing a stunt
II. A person drinking copious amounts of alcohol because he is inured
III. Insured defaulting on premium payments
IV. Proposer lying on policy document

C. Medical underwriting

1. Medical underwriting

Let us now consider some of the medical factors that would influence an underwriter's decision. These are generally assessed through medical underwriting. They may often call for a medical examiner's report. Let us look at some of the factors that are checked.

Diagram 6: Medical Factors that influence an Underwriter's Decision



a) Family history

The impact of family history on mortality risk has been studied from three angles.

i. **Heredity**: Certain diseases can be transmitted from one generation to another, say from parents to children.
ii. **Average longevity of the family**: When the parents have died early on account of certain diseases like heart trouble or cancer, it may be a pointer that the offspring may also not live long.
iii. **Family environment**: Thirdly, the environment in which the family lives can cause exposure to infection and other risks.

Life insurers have thus to be careful when entertaining cases of individuals with adverse family history. They may call for other reports and may impose an extra mortality rating in such cases.

b) Personal history

Personal history refers to past impairments of various systems of the human body which the life to be insured has suffered from. The proposal form for life insurance typically contains a set of questions which enquire whether the life to be insured has been under treatment for any of these.

Such problems may also be indicated by the medical examiner's reports or any special reports called for. The major kinds of ailments that are killer diseases include

i. **Cardiovascular diseases** which affect the heart and blood system – like heart attack, stroke and haemorrhage

ii. Diseases of the **respiratory system** like Tuberculosis

iii. **Excessive production and reproduction of cells** which leads to malignant tumours, also known as cancer

iv. **Ailments of the renal system**, which includes the kidney and other urinary parts, which can lead to kidney failure and death

v. **Impairments of the endocrine system**, the most well-known of which is Diabetes. It arises from the body's inability to generate sufficient insulin to metabolise the sugar (or glucose) in the blood stream.

vi. Diseases of the **digestive system** like gastric ulcers and cirrhosis of the liver

vii. Diseases of the **nervous system**

c) Personal characteristics

These can also be significant indicators of the tendency to disease.

i. Build

For instance a person's build consists of his height, weight, chest and girth of the abdomen. For given age and height, there is a standard weight that has been defined and if the weight is too high or low in relation to this standard weight, we can say that the person is overweight or underweight.

Similarly, it is expected that the chest should be expanded at least by four centimetres in a normal person and that the abdominal girth should not be more than one's expanded chest.

ii. Blood pressure

Another indicator is a person's blood pressure. There are two measures of this

- ✓ Systolic
- ✓ Diastolic

A thumb rule for arriving at normal blood pressure readings given age is
For Systolic: It is 115 + 2/5 of age.
For Diastolic: It is 75 + 1/5 of age

Thus if age is 40 years, the normal blood pressure should be Systolic 131: and Diastolic 83.

When the actual readings are much higher than the above values, we say that the person has high blood pressure or hypertension. When it is too low, it is termed as hypotension. The former can have serious consequences.

The pressure of blood flowing in the system can also be indicated by the pulse rate. Pulse rates can vary from 50 to 90 beats per minute with an average of 72.

iii. Urine – Specific gravity

Finally, a reading of the specific gravity of one's urine can indicate the balance among various salts in the urinary system. It can indicate any malfunctioning of the system.

Test Yourself 3

Why is heredity history of importance in medical underwriting?

I. Rich parents have healthy kids
II. Certain diseases can be passed on from parents to children
III. Poor parents have malnourished kids
IV. Family environment is a critical factor

Summary

- To usher equity, the underwriter engages in risk classification where individual lives are categorised and assigned to different risk classes depending on the degree of risks they pose.

- Underwriting or the selection process may be said to take place at two levels:

✓ At field level and
✓ At underwriting department level

- Judgment method or numerical method of underwriting is widely used for underwriting insurance proposals.

- Underwriting decisions made by underwriters include acceptance of standard risk at standard rates or charging extra for sub-standard risks. Sometimes there is acceptance with lien on sum assured or acceptance is based on restrictive clauses. Where the risk is large the proposal is declined or postponed.

- A large number of life insurance proposals may typically get selected for insurance without conducting a medical examination to check the insurability of an insurant. Such cases are termed as non-medical proposals.

- Some of the rating factors for non-medical underwriting include

✓ Age
✓ Large sum assured
✓ Moral hazard etc.

- Some of the factors considered in medical underwriting include

✓ Family history,
✓ Heredity and personal history etc.

Key Terms

1. Underwriting
2. Standard life
3. Non-medical underwriting
4. Rating factor
5. Medical underwriting
6. Anti-selection

Answers to Test Yourself

Answer 1

The correct option is III.

A person suffering from AIDS is most likely to be declined life insurance cover.

Answer 2

The correct option is II.

A person drinking copious amounts of alcohol because he is inured is an example of moral hazard.

Answer 3

The correct option is II.

Certain diseases can be passed on from parents to children and hence heredity history needs to be considered in medical underwriting.

Self-Examination Questions

Question 1

Which of the following denotes the underwriter's role in an insurance company?

I. Process claims
II. Decide acceptability of risks
III. Product design architect
IV. Customer relations manager

Question 2

Which of the following is not an underwriting decision?

I. Risk acceptance at standard rates
II. Declinature of risk
III. Postponement of risk
IV. Claim rejection

Question 3

Which of the following is not a standard age proof?

I. Passport
II. School leaving certificate
III. Horoscope
IV. Birth certificate

Question 4

Which of the following condition will affect a person's insurability negatively?

I. Daily jogs
II. Banned substance abuse
III. Lazy nature
IV. Procrastination

Question 5

Under what method of underwriting does an underwriter assign positive rating points for all negative or adverse factors (negative points for any positive or favourable factors)?

I. Judgment
II. Arbitrary
III. Numerical rating
IV. Single step

Question 6

Under risk classification, ____________ consist of those whose anticipated mortality corresponds to the standard lives represented by the mortality table.

I. Standard lives
II. Preferred risks
III. Sub-standard lives
IV. Declined lives

Question 7

Amruta is pregnant. She has applied for a term insurance cover. Which of the below option will be the best option to choose for an underwriter to offer insurance to Amruta? Choose the most likely option.

I. Acceptance at ordinary rates
II. Acceptance with extra premium
III. Decline the proposal
IV. Acceptance with a restrictive clause

Question 8

Which of the below insurance proposal is not likely to qualify under non-medical underwriting?

I. Savita, aged 26 years, working in an IT company as a software engineer
II. Mahesh, aged 50 years, working in a coal mine
III. Satish, aged 28 years, working in a bank and has applied for an insurance cover of Rs. 1 crore
IV. Pravin, aged 30 years, working in a departmental store and has applied for an endowment insurance plan for a tenure of 10 years

Question 9

Sheena is suffering from acute diabetes. She has applied for an insurance plan. In this case the underwriter is most likely to use ____________ for underwriting. Choose the most appropriate option.

I. Judgment method
II. Numerical method
III. Any of the above method since an illness like diabetes does not play a major role in the underwriting process
IV. Neither of the above method as diabetes cases are rejected outright

Question 10

Santosh has applied for a term insurance policy. His anticipated mortality is significantly lower than standard lives and hence could be charged a lower premium. Under risk classification, Santosh will be classified under ___________.

I. Standard lives
II. Preferred risks
III. Substandard lives
IV. Declined lives

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Underwriter decides acceptability of risks.

Answer 2

The correct option is IV.

Claim rejection is not an underwriting decision.

Answer 3

The correct option is III.

Horoscope is not a standard age proof.

Answer 4

The correct option is II.

Banned substance abuse will affect a person’s insurability negatively.

Answer 5

The correct option is III.

Numerical rating method of underwriting assigns positive rating points for all negative or adverse factors (negative points for any positive or favourable factors).

Answer 6

The correct option is I.

Under risk classification, standard lives consist of those whose anticipated mortality corresponds to the standard lives represented by the mortality table.

Answer 7

The correct option is IV.

In Amruta's case, considering her pregnancy, the best option that the underwriter can choose is to offer insurance to Amruta with a restrictive clause. This restrictive clause can be limiting insurance payment in the event of pregnancy related death occurring within say three months of delivery.

Answer 8

The correct option is II.

Mahesh's insurance proposal is not likely to qualify under non-medical underwriting because his age is higher (50 years) and his occupation is more risky as compared to other occupations in software, banking industry etc.

Answer 9

The correct option is I.

When deciding on a complex case like that of Sheena who is suffering from acute diabetes, the underwriter will use the judgment method of underwriting.

Answer 10

The correct option is II.

Under risk classification, Santosh will be classified under preferred risks.

CHAPTER 15

PAYMENTS UNDER A LIFE INSURANCE POLICY

Chapter Introduction

This chapter explains the concept of claim and how claims are ascertained. The chapter then explains the types of claims. In the end you will learn about the forms to be submitted for a death claim and the safeguards (indisputability clause and Protection of Policyholders Interests Regulations) in place to protect beneficiary from claim rejection by the insurer, provided no material information has been suppressed by the insured.

Learning Outcomes

A. Types of claims and claims procedure

A. Types of claims and claims procedure

1. Concept of claims

The real test of an insurance company and an insurance policy comes when a policy results into a claim. The true value of life insurance is judged by the way a claim is settled and benefits are paid.

Definition

A claim is a demand that the insurer should make good the promise specified in the contract.

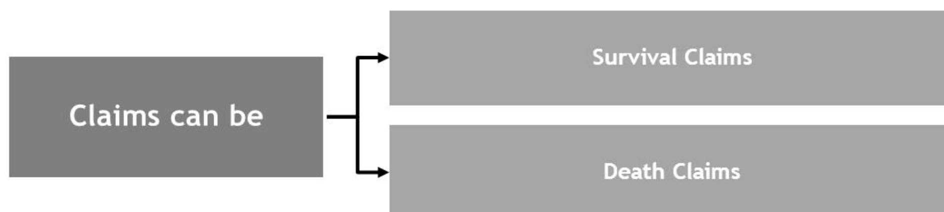
A claim under a life insurance contract is triggered by the happening of one or more of the events covered under the insurance contract. While in some claims, the contract continues, in others, the contract is terminated.

Diagram 1: Risk event and claim

Claims can be of two types:

- **i.** survival claims payable even when the life assured is alive and
- **ii.** death claim

Diagram 2: Types of claims



While a **death claim** arises only upon the death of the life assured, **survival claims** can be caused by one or more events.

Example

Examples of events triggering survival claims are:

i. Maturity of the policy;
ii. An instalment payable upon reaching the milestone under a money-back policy;
iii. Critical illnesses covered under the policy as a rider benefit;
iv. Surrender of the policy either by the policyholder or assignee;

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2. Ascertaining whether a claim event has occurred

i. For payment of a **survival claim**, the insurer has to ascertain that the event has occurred as per the conditions stipulated in the policy.

ii. **Maturity claims and money-back instalment claims** are easily established as they are based on dates which are determined at the beginning of the contract itself.

For instance, the date of maturity and the dates when the instalments of survival benefits may be paid under a money back policy are clearly laid out at the time of preparing the contract.

iii. Surrender value payments are different from other claim payments. Unlike other claims, here the event is triggered by the decision of the policy holder or assignee to cancel the contract and withdraw what is due to him or her under the contract. Surrender payments would typically involve a penalty for premature withdrawal and hence would be less than what would have been due if the full claim were to be paid.

iv. **Critical illness** claims are ascertained based on the medical and other records provided by the policyholder in support of his claim.

The complexity arises in case of a policy that has a critical illness claim rider and such policy has been assigned. The purpose of a critical illness benefit is to enable a policy holder to defray his expenses in the event of such an illness. If this policy where to be assigned, all benefits would be payable to the assignee. Although this is legally correct, it may not meet the intended purpose. In order to avoid such a situation, it is important to educate policyholders about the extent of benefits that they may assign, by way of a **conditional assignment.**

A **maturity or death claim** or a surrender leads to termination of the insurance cover under the contract and no further insurance cover is available. This is irrespective of whether the claim is actually paid or not. Non-payment of a claim does not assure the continuity of insurance cover under the contract.

3. Types of claims

The following payments may occur during the policy term:

a) Survival Benefit Payments

Periodical payments are made by the insurer to the insured at specified times during the term of the policy. The policy bond is returned to the policyholder bearing an endorsement of payments made after each survival benefit instalment.

b) Surrender of Policy

The policyholder opts for a premature closure of his policy. This is a voluntary termination of the policy contract. A policy can be surrendered only if it has acquired paid-up value. The amount payable to the insured is the **surrender value** which is usually a percentage of the premiums paid. There is also a minimum guaranteed surrender value (GSV), but the actual surrender value paid to the insured is more than the GSV.

c) Rider Benefit

A payment under a rider is made by an insurance company on the occurrence of a specified event according to the terms and conditions.

Under a **critical illness rider**, in the event of diagnosis of a critical illness, a specified amount is paid as per terms. The illness should have been covered in the list of critical illnesses specified by the insurance company.

Under **hospital care rider**, the insurer pays the treatment costs in the event of hospitalisation of the insured, subject to terms and conditions.

The policy contract continues even after the rider payments are made.

The following claim payments are made at the end of the policy term specified in the insurance contract.

d) Maturity Claim

In such claims, the insurer promises to pay the insured a specified amount at the end of the term, if the insured survives the plan's entire term. This is known as a **maturity claim.**

i. **Participating Plan:** The amount payable under a maturity claim, if participating, is the sum assured plus accumulated bonuses less dues such as outstanding premium and policy loans and interests thereon.

ii. **Return of Premium (ROP) Plan:** In some cases premiums paid over the term period are returned when the policy matures.

iii. **Unit Linked Insurance Plan (ULIP):** In case of ULIPs, the insurer pays the fund value as the maturity claim.

iv. **Money-back Plan:** In case of money-back policy, the insurer pays the maturity claim minus the survival benefits received during the term of the policy.

The insurance contact terminates after the claim is paid.

e) Death Claim

If the insured expires during the term of his / her policy, accidentally or otherwise, the insurer pays the sum assured plus accumulated bonuses, if participating, less dues like outstanding policy loan and premia plus interest there on respectively. This is the **death claim**, which is paid to the nominee or assignee or legal whatever the situation may be. A death claim marks the end of the contract as a result of death.

A death claim may be:

- ✓ Early (less than three years policy duration) or
- ✓ Non-early (more than three years)

The nominee or assignee or legal heir has to intimate the insurer of the cause, date and place of death.

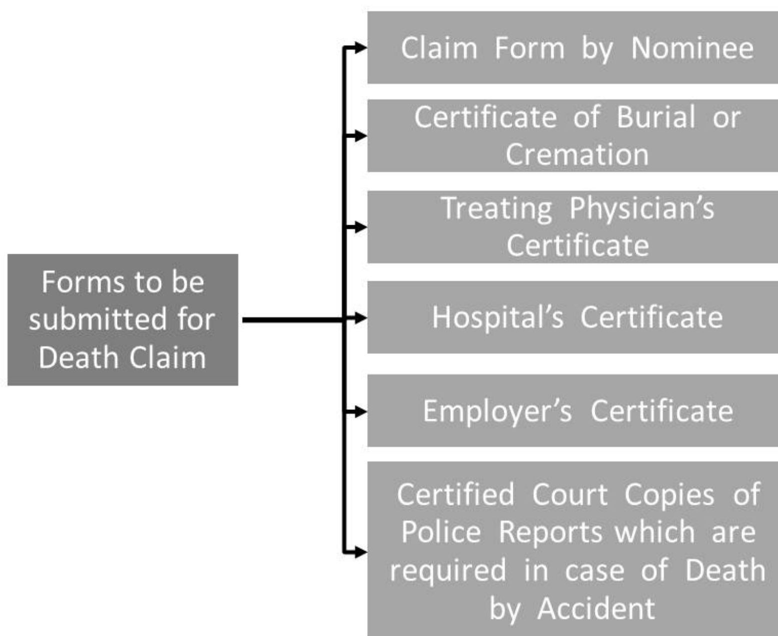
i. Forms to be submitted for death claim

Claim Document

The following forms are to be submitted by the beneficiary with the insurer to facilitate processing of the claim:

- ✓ Claim form by nominee
- ✓ Certificate of burial or cremation
- ✓ Treating physician's certificate
- ✓ Hospital's certificate
- ✓ Employer's certificate
- ✓ Certified court copies of police reports like First Information Report (FIR), Inquest Report, Post-Mortem Report, Final Report which are required in case of death by accident.
- ✓ Death certificate issued by municipal authorities etc as proof of death

Diagram 3: Forms to be submitted for Death Claim



ii. Repudiation of death claim

The death claim may be paid or repudiated. While processing the claim, if it is detected by the insurer that the proposer had made any incorrect statements or had suppressed material facts relevant to the policy, the contract becomes void. All benefits under the policy are forfeited.

iii. Section 45: Indisputability Clause

However this penalty is subject to **Section 45** of the Insurance Act, 1938.

Important

Section 45 states:

No policy of life insurance shall 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 the statement made in the proposal 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 that 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.

Explanation :
If a policyholder suppressed material facts, at any time upto 2 years from issuance of policy, repudiation can be done by insurer if material facts in proposal are false.

The 2 – year period is a wait and watch period for the customer. After this period, an insurer has to prove that that policyholder had made fraudulent statements and suppressed material facts and knew that the statements given were false. Only after obtaining proof can the insurer repudiate a policy after the 2-year period.

iv. Presumption of Death

Sometimes a person is reported missing without any information about his whereabouts.The Indian Evidence Act provides for presumption of death in such cases, if he has not been heard of for seven years.If the nominee or heirs claim that the life insured is missing and must be presumed to be dead, insurers insist on a decree from a competent court.It is necessary that premiums should be paid till the court decrees presumption of death.Insurers may, as a matter of concession, waive the premiums during the seven year period.

4. Claim Procedure for Life Insurance Policy

The IRDA (Protection of Policyholders Interests) Regulations, 2002 provides as follows:

Regulation 8: Claims procedure in respect of a life insurance policy

i. A life insurance policy shall state the **primary documents** which are normally required to be submitted by a claimant in support of a claim.

ii. A life insurance company, upon receiving a claim, shall **process the claim without delay**. Any queries or requirement of additional documents, to the extent possible**,** shall be raised all at once and not in a piece-meal manner, **within a period of 15 days of the receipt of the claim.**

iii. 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. Where in the opinion of the insurance company the circumstances of a claim warrant an investigation, it shall initiate and complete such investigation at the earliest, in any case not later than 6 months from the time of lodging the claim.

iv. 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 insurer 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).

v. 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 (iv), the life insurance company shall pay **interest on the claim amount at a rate which is 2% above the bank rate** prevalent at the beginning of the financial year in which the claim is reviewed by it.

5. Role of an agent

An agent shall render all possible service to the nominee/legal heir or the beneficiary in filling up of claim forms accurately and assisting in submission of these at the insurer’s office.

Apart from discharging obligations, goodwill is generated from such a situation whereby there exists ample opportunity for the agent to procure business or referrals in future from the family of the deceased.

Test Yourself 1

Which of the below statement best describes the concept of claim? Choose the most appropriate option.

I. A claim is a request that the insurer should make good the promise specified in the contract
II. A claim is a demand that the insurer should make good the promise specified in the contract
III. A claim is a demand that the insured should make good the commitment specified in the agreement
IV. A claim is a request that the insured should make good the promise specified in the agreement

Summary

- A claim is a demand that the insurer should make good the promise specified in the contract.

- A claim can be survival claim or death claim. While a death claim arises only upon the death of the life assured, survival claims can be caused by one or more events

- For payment of a survival claim, the insurer has to ascertain that the event has occurred as per the conditions stipulated in the policy.

- The following payments may occur during the policy term:

✓ Survival Benefit Payments
✓ Surrender of Policy
✓ Rider Benefit
✓ Maturity Claim
✓ Death Claim

- Section 45 (Indisputability Clause) of the Insurance Act protects the insured from rejection of claim by the insurer, provided the policy has completed two years and the insured has not suppressed any material information

- Under the IRDA (Protection of Policyholders Interests) Regulations, 2002, the IRDA has laid down regulations to safeguard / protect the insured or beneficiary in case of claims.

Answers to Test Yourself

Answer 1

The correct option is II.

A claim is a demand that the insurer should make good the promise specified in the contract.

Self-Examination Questions

Question 1

Given below is a list of policies. Identify under which type of policy, the claim payment is made in the form of periodic payments?

I. Money-back policy
II. Unit linked insurance policy
III. Return of premium policy
IV. Term insurance policy

Question 2

Mahesh has bought a life insurance policy with a critical illness rider. He has made absolute assignment of the policy in favour of Karan. Mahesh suffers a heart attack and there is a claim of Rs. 50,000 under the critical illness rider. To whom will the payment be made in this case?

I. Mahesh
II. Karan
III. The payment will be shared equally by Mahesh and Karan
IV. Neither of the two because Mahesh has suffered the heart attack but the policy is assigned in favour of Karan.

Question 3

Praveen died in a car accident. The beneficiary submits documents for death claim. Which of the below document is an additional document required to be submitted in case of accidental death as compared to natural death.

I. Certificate of burial or cremation
II. Treating physician's certificate
III. Employer's certificate
IV. Inquest Report

Question 4

Which of the below death claim will be treated as an early death claim?

I. If the insured dies within three years of policy duration
II. If the insured dies within five years of policy duration
III. If the insured dies within seven years of policy duration
IV. If the insured dies within ten years of policy duration

Question 5

Given below are some events that will trigger survival claims. Identify which of the below statement is incorrect?

I. Claim paid on maturity of a term insurance policy
II. An instalment payable upon reaching the milestone under a money-back policy
III. Claim paid for critical illnesses covered under the policy as a rider benefit
IV. Surrender value paid on surrender of an endowment policy by the policyholder

Question 6

A payment made under a money-back policy upon reaching a milestone will be classified under which type of claim?

I. Death claim
II. Maturity claim
III. Periodical survival claim
IV. Surrender claim

Question 7

Shankar bought a 10 year Unit Linked Insurance Plan. If he dies before the maturity of the policy which of the below will be paid?

I. Lower of sum assured or fund value
II. Higher of sum assured or fund value
III. Premiums paid will be returned with 2% higher interest rate as compared to a bank's savings deposit
IV. Surrender value

Question 8

Based on classification of claims (early or non-early), pick the odd one out?

I. Ramya dies after 6 months of buying a term insurance plan
II. Manoj dies after one and half years of buying a term insurance plan
III. David dies after two and half years of buying a term insurance plan
IV. Pravin dies after five and half years of buying a term insurance plan

Question 9

Given below is a list of documents to be submitted for a normal death claim by all beneficiaries in the event of death of life insured. Pick the odd one out which is additionally required to be submitted only in case of death by accident.

I. Inquest report
II. Claim form
III. Certificate of burial or cremation
IV. Hospital's certificate

Question 10

As per IRDA (Protection of Policyholders Interests) Regulations, 2002, a claim under a life policy shall be paid or be disputed, within 30 days from the date of receipt of all relevant papers and clarifications required.

I. 7 days
II. 15 days
III. 30 days
IV. 45 days

Answers to Self-Examination Questions

Answer 1

The correct option is I

In case of a money-back policy the claim payment is made in the form of periodic payments.

Answer 2

The correct option is II

In this case the entire payment of Rs. 50,000 will be made to Karan as the policy has been assigned in favour of Karan on an absolute basis.

Answer 3

The correct option is IV

Documents like claim form by nominee, Certificate of burial or cremation, Treating physician's certificate, Hospital's certificate, Employer's certificate etc. are required to be submitted in case of natural death as well as accidental death.

First Information Report (FIR), Inquest Report, Post-Mortem Report, Final Report etc. are additional documents required to be submitted in case of accidental death as compared to natural death.

Answer 4

The correct option is I

If the insured dies within three years of policy duration, the death claim will be treated as early death claim.

Answer 5

The correct option is I

Option I is incorrect. There is no claim paid on maturity of a term insurance policy.

Answer 6

The correct option is III

A payment made under a money-back policy upon reaching a milestone will be classified under periodic survival claim.

Answer 7

The correct option is II

If Shankar dies before the maturity of the ULIP policy, higher of sum assured or fund value will be paid.

Answer 8

The correct option is IV

Option IV is the odd one out because it will be treated as a non-early claim. Option I, II and III will be treated as early claims.

Answer 9

The correct option is I

Inquest report is additionally required to be submitted in case of death by accident. The other documents like claim form, certificate of burial or cremation, hospital's certificate are required to be submitted by all beneficiaries in the event of death of life insured

Answer 10

The correct option is III

As per IRDA (Protection of Policyholders Interests) Regulations, 2002, a claim under a life policy shall be paid or be disputed, within 30 days from the date of receipt of all relevant papers and clarifications required.

CHAPTER 16

REGULATORY ASPECTS

Chapter Introduction

This chapter aims to provide you with an understanding of the importance of insurance regulations. This chapter also provides you with an understanding of the legal status of an insurance agent. You will also learn the various rules and regulations applicable to agents in general; and to insurance agents in particular.

Learning Outcomes

A. Insurance regulations and regulatory framework
B. Regulations and code of conduct applicable to insurance agents

A. Insurance regulations and regulatory framework

1. Importance of insurance regulations

An insurance agent should always bear in mind that she is selling a promise that the insurance company will pay a certain amount of money if a misfortune occurs. The insured person would undoubtedly have many worries about the insurance that is being purchased.

Some common concerns of an insured would be:

i. Is the insurance legal?

ii. Are insurance agents recognised by law?

iii. Are these insurance companies regulated or supervised?

iv. Is the document given to me by the insurer legally valid?

v. Will the insurance company pay me the money if a loss happens?

vi. Will they pay me the full money that is due to me?

vii. If I do not get a claim, can I go to court based on the documents they have given me?

viii. Are there any hidden provisions in the insurance contract whereby the insurance company can avoid paying me a claim?

ix. Do I have to go through any complicated procedures to get my claim paid?

2. Why are insurance regulations required?

The prime purpose of insurance regulation is to protect the policyholder. The policy holder has paid the money and bought the insurance policy. She should be assured that the insurance policy she bought will be honoured by the insurance company.

i. First and foremost, an insured should understand that **insurance is an absolutely legal contract**, in compliance with the provisions of the Indian Contract Act and other laws of the country

ii. The **Government is duty bound** to protect all its citizens and all entities in the country through its legal and judicial systems.

iii. **Regulations made by IRDA** are to ensure that insurance companies should exist as financially sound organisations to honour the contracts that they have entered into. IRDA regulates companies from their registration onwards and monitors all their major activities like investments, accounting etc.

Information

In specialised sectors of the economy, the Government creates bodies to regulate these sectors. Thus we have bodies like Reserve Bank of India (RBI) to regulate banks and the Securities and Exchange Board of India (SEBI) to regulate the capital market.

Similarly, to regulate the insurance sector, the Government enacted the Insurance Act in 1938, which was amended from time to time to make it relevant to the changes in the industry. Insurance Regulatory and Development Authority (IRDA) Act, 1999, created the IRDA as an independent authority for the purpose of regulating the insurance industry.

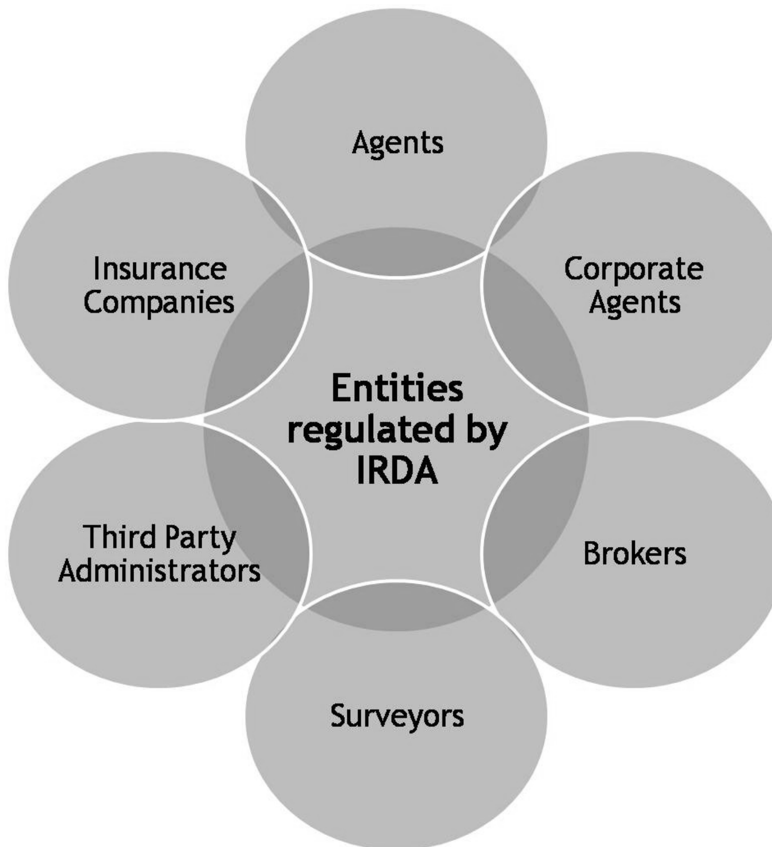
All insurance policy wordings, rates and the documents issued by insurance companies are scrutinised and approved by IRDA. The advertisements issued by insurers are also regulated.

There are guidelines about prompt settlement of claims, grievance handling systems in every company and at IRDA level to address complaints at the company and at IRDA level.

IRDA has issued directions to ensure that the insurance company targets rural areas of the country and weaker sections of the population towards providing significant coverage of these segments.

All people dealing with selling and servicing of insurance policies, viz. agents, corporate agents, brokers, surveyors, third party administrators (TPAs) and insurance companies are licensed as well as regulated by IRDA as per various regulations.

Diagram 1: Entities regulated by IRDA



3. Insurance regulatory framework in India

The Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999 form the basis of insurance regulations in India. There are a few other legislations in the country that are directly or indirectly applicable to insurance business.

a) The Insurance Act, 1938

The Insurance Act, 1938 is the basic insurance legislation of the country, which governs insurance business in India. It was created to protect the interest of insured public, with comprehensive provisions for effective control over the activities of insurers and came into effect on 1st July, 1939. This Act has been amended from time to time to strengthen the legal provisions of the Act.

The Insurance Act 1938 has provisions for monitoring and control of operations of insurance companies. Some important sections of the Act are listed below:

i. Registration of insurance companies and renewal of registrations (Sec. 3 & 70)
ii. Requirement to have sufficient capital for the company and to maintain solvency (Sec. 64 V)
iii. Compulsion that assets of insurance companies should be invested only as per norms prescribed for the same (Sec. 27 & 85)
iv. Requirement to maintain audit and submit returns to the regulator (Sec. 28)
v. Obligations of insurers towards the rural and social sectors (Sec. 32B & 32C)
vi. Rules for assignment and transfer of policies and nominations (Sec. 38 & 39)
vii. Limitations on the expenses of the management (Sec. 40)
viii. Licensing of agents and their remunerations (Sec. 40 to 44)
ix. Prohibition on using rebates as an inducement to any person to take, renew or continue an insurance policy in India (Sec. 41)
x. Solvency (financial strength) of the insurance companies who meet all their commitments to policy holders (64V)
xi. Advance payment of premium (Sec. 64VB)
xii. Need for survey of losses (Sec. 64UM)

b) The Insurance Regulatory & Development Authority Act, 1999

Insurance Regulatory and Development Authority (IRDA) was established in 2000 as an independent authority to regulate and develop the insurance industry by an Act of Parliament (namely Insurance Regulatory & Development Authority Act, 1999).

Important

The preamble of the IRDA Act states:

"An Act to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto."

IRDA has prescribed regulations for protecting the interests of policyholders stipulating obligations on both insurers as well as intermediaries.

These regulations prescribe insurers' obligations:

i. at the point of sale,
ii. towards policy servicing,
iii. claims servicing,
iv. control on expenses, investment and
v. financial strength to meet the commitments to policyholders

c) Other legislations

In addition, insurance business in India is linked to various other Acts / legislations of the country, some of which are listed below:

i. The Workmen's Compensation Act, 1923 (amended and renamed as Employees Compensation Act in 2010)
ii. Employees' State Insurance Act, 1948
iii. Life Insurance Corporation Act, 1956
iv. Deposit Insurance and Credit Guarantee Corporation Act, 1961
v. Marine Insurance Act, 1963
vi. Export Credit Guarantee Corporation Act, 1964
vii. General Insurance Business (Nationalisation) Act, 1972
viii. General Insurance Business (Nationalisation) Amendment Act, 2002
ix. Motor Vehicles Act, 1988
x. Public Liability Insurance Act, 1991

Apart from these general laws, there are many regulations, orders and circulars issued by IRDA from time to time on specific matters relating to the conduct of insurance business and policyholders protection.

Test Yourself 1

Which of the below statements is correct?

I. The prime purpose of insurance regulation is to protect the insurance companies
II. The prime purpose of insurance regulation is to protect the policyholder
III. The prime purpose of insurance regulation is to protect the insurance intermediaries
IV. The prime purpose of insurance regulation is to protect the Government

B. Regulations and code of conduct applicable to insurance agents

1. Regulations applicable to insurance agents

As per the Insurance Act, 1938 (Section 42), to work as an insurance agent, one must have a licence. IRDA deals with issuance of licences and other matters relating to agents recruitment. There are regulations which must be complied with at all stages in the process.

Some of the important provisions relating to agents stated in the Insurance Act, 1938 and the Insurance Regulatory and Development Authority (IRDA) Act, 1999 are discussed below.

a) The Insurance Act, 1938

Important

An insurance agent has to be licensed under Section 42. Under the Section, an insurance agent receives or agrees to receive "payment by way of commission or other remuneration in consideration of his soliciting or procuring insurance business including business relating to the continuance, renewal or revival of policies of insurance".

An agent can be individual agent or a corporate agent. An individual agent is an individual representing an insurance company while a corporate agent is other than an individual, representing an insurance company. IRDA has issued separate regulations for the different type of agents.

An agent can be issued licence for doing 'life' or 'general' insurance or both. Insurance agents who hold licence to act as agent for both a life insurer and a general insurer are called **composite insurance agents.**

b) Agents for standalone health insurance companies

It has been decided by IRDA to waive the mandated IC-34 certification for life insurance agents desiring to distribute products of a standalone health insurance company.

The standalone health insurers desirous of converting life insurance agents into composite agents to sell their products, based on IC-33 certification, can do so after making such agents undergo an internal training programme on health insurance, which shall cover the basics of health insurance, health insurance terminology, and products etc. for a minimum period of 25 hours. However such composite agents shall not be allowed to transfer general part of their licence to other non-life insurance company without completing IC-34 certification.

It has also been decided by IRDA to allow standalone health insurance companies to avail the services of agents, corporate agents of other life and / or non-life insurance companies to distribute their products provided such agents and corporate agents undergo 25 hours training.

However, no agent, corporate agent of life and / or non-life insurance company shall offer his / her services to more than one standalone health insurance company.

IRDA also recognises the fact that the Agriculture Insurance Corporation of India (AIC) is engaged in providing crop insurance with no conflict of interest or competition with the activities of any GIPSA Company in the country. Hence it has decided to permit Agriculture Insurance Company to distribute its own products by utilising the services of agents and corporate agents of other non-life insurance companies. Agents and corporate agents desiring to offer their services, shall submit "No Objection Certificate" obtained from their parent general insurer and enrol themselves with AIC for distributing its products.

A situation could arise wherein an agent or corporate agent works for three non-life insurers. Hence, in all such cases those agents shall achieve in full, the minimum business requirements laid down by their respective parent insurance companies. In case they fail to achieve minimum business requirements laid by their parent insurers, they cannot seek transfer of their licence to any one insurer to whom they are offering services in terms of the circulars and guidelines issued from time to time on transfer of licences of agents from one insurer to other.

The Insurance Act, 1938 mandates that to work as an insurance agent, one must have a licence. Insurance Regulatory and Development Authority (Licensing of Insurance Agents) Regulations, 2000 and Insurance Regulatory and Development Authority (Licensing of Insurance Agents) (Amendment) Regulations, 2002 give detailed provisions relating to licensing of agents. These are available at the website of IRDA www.irdaindia.gov.in.

Important

Adverse selection (Anti-selection)

This denotes the insurance firm's acceptance of applicants who are at a greater than normal risk (or uninsurable), but conceal / falsify information about their actual condition or situation. Acceptance of their application has an 'adverse' effect on insurance companies, because normally insurance premiums are computed on the basis of policyholders being in normal or average circumstances (e.g. enjoying good health / employed in non-hazardous environments).

Agents represent insurance companies and they act as the main link between the insurance company and the insured. Their role is to recommend to clients the right products that address the clients' needs. At the same time, they must act in the interests of the insurance company by understanding the risk insured properly enough so as to avoid any adverse selection against the insurance company.

2. Rules governing licensing of insurance agents

Rules relating to issuance and renewal of licences to insurance agents and the procedures for obtaining the licence are stated in the Insurance Act and regulations, summarised below:

a) Qualifications of the applicant

The applicant must possess the minimum qualification of a pass in **12th Standard or equivalent examination** conducted by any recognised Board / Institution, where the applicant resides in a place with a population of five thousand or more as per the last census, and a pass in **10th Standard or equivalent examination** from a recognised Board / Institution if the applicant resides in any other place.

b) Disqualifications of the applicant

As per Section 42 sub-section (4) of Insurance Act 1938, there are certain conditions that disqualify an applicant.

The applicant for agent licence is disqualified if she:

i. Is a **minor**,

ii. Is of **unsound mind**,

iii. Has been found **guilty of criminal misappropriation** or criminal breach of trust / cheating / forgery / abetment of / attempt to commit any such offence, by a court of competent jurisdiction,

iv. Has been found **guilty of knowingly participating in or has connived at any fraud**, dishonesty or misrepresentation against an insurer or an insured,

v. **(in the case of an individual)** does not possess the requisite qualifications and practical training for a period not exceeding twelve months, as may be specified by the regulations made by the authority,

vi. **(in the case of a company or firm, if a director / partner / the chief executive officers / other designated employees)**does not possess the requisite qualifications and practical training and have not passed the prescribed examination

vii. **Violates the code of conduct** as specified by the regulations made by the IRDA

c) Practical training

i. The first time applicant for agency licence shall have completed from an IRDA approved institution, at least, **fifty hours'** practical training in life **or** general insurance business, which may be spread over two to three weeks.

ii. The first time applicant seeking licence to act as a composite insurance agent shall have completed from an IRDA approved institution, at least, **seventy five hours** practical training in life and general insurance business, which may be spread over two to three weeks.

iii. Where the applicant is:

- ✓ An Associate / Fellow of the Insurance Institute of India,
- ✓ An Associate / Fellow of the Institute of Chartered Accountants of India,
- ✓ An Associate / Fellow of the Institute of Costs and Works Accountants of India,
- ✓ An Associate / Fellow of the Institute of Company Secretaries of India,
- ✓ An Associate / Fellow of the Actuarial Society of India,
- ✓ A Master of Business Administration of any Institution / University recognised by any State Government or the Central Government; or
- ✓ Possessing any professional qualification in marketing from any Institution / University recognised by any State Government or the Central Government and shall have completed, at least, **twenty five hours'** practical training from an approved institution.

d) Examination

The applicant shall have passed the pre-recruitment examination in life or general insurance business, or both, as the case may be, conducted by the **Insurance Institute of India, Mumbai**, or any other 'examination body'.

e) **Fees payable**

The fees payable to the Authority for issue / renewal of licence to act as insurance agent or composite insurance agent shall be Rs. Two Hundred and Fifty or as amended from time to time

f) **Procedure to apply for agent's licence**

i. The licensing process usually starts with the **insurer sponsoring a candidate** for practical training.
ii. On completion of the mandated training, the applicant has to **make an application in specified format** for undergoing a written exam.
iii. On clearing of her written exam, the applicant will make an **application to the "designated person"** of the sponsoring insurer.

"Designated person" means an officer normally in charge of marketing operations, as specified by an insurer, and authorised by the Authority to issue or renew licences under the regulations.

Based on meeting all the above requirements and along with the evidence of payment of the application fees to the Authority, the designated persons will issue the licence, along with identity card. **The licence is valid for a period of 3 years unless terminated or surrendered.**

For any renewal of licence, the agent needs to undergo additional 25 hours of training in life or general as the institution, if the designated person refuses to grant or renew a licence under this regulation, she shall give the reasons therefore to the applicant.

The applications for licence to the 'designated person' should be in prescribed forms.

- ✓ If the **applicant is an individual**, application should be in Form IRDA-Agents-VA
- ✓ If the **applicant is a firm/company**, application should be in Form IRDA-Agents-VC

To become a composite insurance agent, two separate applications have to be submitted. The Licence which is issued entitles the applicant to act as insurance agent for one life insurer or one general insurer or both, as the case may be.

g) **Cancellation of licence**

The designated person may cancel a licence of an insurance agent, if the insurance agent suffers, at any time during the currency of the licence, from any of the disqualifications mentioned in the regulations and recover from her the licence and the identity card issued earlier.

h) Issue of duplicate licence

The Authority may issue a duplicate licence to replace a licence lost, destroyed, or mutilated on payment of a fee of rupees fifty.

3. Agents' Code of Conduct

IRDA Regulations stipulate that every person holding a licence as an insurance agent shall adhere to the code of conduct specified below:

i. Every insurance agent shall

a) Identify himself and the insurance company of whom he is an insurance agent;

b) Disclose his licence to the prospect on demand;

c) Explain carefully the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan;

d) Disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect;

e) Indicate the premium to be charged by the insurer for the insurance product offered for sale;

f) Explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract;

g) Bring to the notice of the insurer any adverse habits or income inconsistency of the prospect, in the form of a report (called "insurance agent's confidential report") along with every proposal submitted to the insurer, and any material fact that may adversely affect the underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect;

h) Inform promptly the prospect about the acceptance or rejection of the proposal by the insurer;

i) Obtain the requisite documents at the time of filing the proposal form with the insurer; and other documents subsequently asked for by the insurer for completion of the proposal;

j) Render necessary assistance to the policyholders or claimants or beneficiaries in complying with the requirements for settlement of claims by the insurer;

k) Advise every individual policyholder to effect nomination or assignment or change of address or exercise of options, as the case may be, and offer necessary assistance in this behalf, wherever necessary

ii. No insurance agent shall

a) solicit or procure insurance business without holding a valid licence;

b) induce the prospect to omit any material information in the proposal form;

c) induce the prospect to submit wrong information in the proposal form or documents submitted to the insurer for acceptance of the proposal;

d) behave in a discourteous manner with the prospect;

e) interfere with any proposal introduced by any other insurance agent;

f) offer different rates, advantages, terms and conditions other than those offered by his insurer;

g) demand or receive a share of proceeds from the beneficiary under an insurance contract;

h) force a policyholder to terminate the existing policy and to effect a new proposal from him within three years from the date of such termination;

i) have, in case of a corporate agent, a portfolio of insurance business under which the premium is in excess of fifty percent of total premium procured, in any year, from one person (who is not an individual) or one organisation or one group of organisations;

j) apply for fresh licence to act as an insurance agent, if his licence was earlier cancelled by the designated person, and a period of five years has not elapsed from the date of such cancellation;

k) become or remain a director of any insurance company;

iii. Every insurance agent shall

With a view to conserve the insurance business already procured through him; make every attempt to ensure remittance of the premiums by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing. It means the agent should ensure that premium is paid well in advance on renewal or else the risk will not be assumed by the insurer.

4. Prohibition of rebates

No intermediary is allowed to induce anyone to take a policy. Section 41 of the Insurance Act, 1938 is hence an important section for an insurance agent. It reads as follows:

Important

Section 41 of the Insurance Act, 1938

"41. (1) No person shall allow or offer to allow, either directly or indirectly, as an inducement to any person to take or renew or continue an insurance in respect of any kind of risk relating to lives or property in India, any rebate of the whole or part of the commission payable or any rebate of the premium shown on the policy, nor shall any person taking out or renewing or continuing a policy accept any rebate, except such rebate as may be allowed in accordance with the published prospectuses or tables of the insurer;

Provided that acceptance by an insurance agent of commission in connection with a policy of life insurance taken out by himself on his own life shall not be deemed to be acceptance of a rebate of premium within the meaning of this sub-section if at the time of such acceptance the insurance agent satisfies the prescribed conditions establishing that he is a bona fide insurance agent employed by the insurer."

"41.(2) Any person making default in complying with the provisions of this section shall be punishable with fine which may extend to five hundred rupees." This states that **an agent cannot offer any rebates on premium as an inducement to the policyholder, except as allowed by the insurer.**

Test Yourself 2

Which of the below statement is correct?

I. If agent loses the licence, then no duplicate licence is issued. The agent has to wait till the time of renewal, when another copy is issued
II. If agent loses the licence, then the Authority may issue a duplicate licence free of cost.
III. If agent loses the licence, then the Authority may issue a duplicate licence only after a FIR is lodged and a waiting period of 30 days.
IV. If the agent loses the licence, then the Authority may issue a duplicate licence on payment of a fee of rupees fifty.

Summary

- An insurance agent should always bear in mind that she is selling a promise that the insurance company will pay a certain amount of money if a misfortune occurs.
- The prime purpose of insurance regulations is to protect the policyholder.
- Insurance Act, 1938, and Insurance Regulatory and Development Authority Act, 1999 form the basic framework of insurance regulation.
- The Insurance Act 1938 has provisions for monitoring and control of operations of insurance companies.
- Insurance Regulatory and Development Authority (IRDA) was established in 2000 as an independent authority to regulate and develop the insurance industry.
- IRDA has prescribed regulations for protecting the interests of policyholders stipulating obligations on both insurers as well as intermediaries.
- An agent can be an individual agent or a corporate agent.
- To become an agent the prospect should possess minimum prescribed educational qualification, should undergo prescribed practical training, pay the prescribed fees and undertake the prescribed examination.
- IRDA regulations stipulate that every person holding a licence as an insurance agent shall adhere to the specified code of conduct.
- No intermediary is allowed to induce anyone to take a policy.

Key Terms

1. Individual agent
2. Corporate agent
3. Composite insurance agent
4. Rebate
5. Intermediaries

Answers to Test Yourself

Answer 1

The correct option is II.

The prime purpose of insurance regulation is to protect the policyholder.

Answer 2

The correct option is IV.

If the agent loses the licence, then the Authority may issue a duplicate licence on payment a fee of rupees fifty.

Self-Examination Questions

Question 1

Applicant shall complete ______ hours training to become an insurance agent.

I. 50
II. 100
III. 30
IV. 25

Question 2

Insurance agent represents the __________.

I. Insurance company
II. Sub-agent
III. Co-agent
IV. Broker

Question 3

Licence to work as an insurance agent is issued by __________.

I. General Insurance Corporation (GIC)
II. Insurance Regulatory & Development Authority (IRDA)
III. State Bank of India (SBI)
IV. Post office

Question 4

Agent's licence is to be renewed __________.

I. Every year
II. After 5 years
III. After 3 years
IV. After 15 years

Question 5

Identify the statement which is not correct. Insurance agent should __________.

I. Indicate the scale of commission if asked by the customer
II. Share the commission by way of rebate
III. Disclose his licence on demand
IV. Indicate the premium to be charged

Question 6

__________ is the fees payable to the Authority for issue / renewal of licence to Act as an insurance agent or composite insurance agent.

I. 250
II. 150
III. 520
IV. 100

Question 7

The Authority may issue duplicate licence in case it is ____________.

I. Lost
II. Destroyed
III. Mutilated
IV. All of the above

Question 8

If an agent is found guilty of criminal misappropriation the designated person will ____________.

I. Cancel the licence
II. Issue a duplicate licence
III. Renew the existing licence
IV. Take some fees from the agent

Question 9

Minimum qualification required for insurance agent is _______ pass.

I. Graduate
II. 10th
III. Post-graduate
IV. 7th

Question 10

___________ may deal with more than one life insurance company or general insurance company or both.

I. Agent
II. Surveyor
III. Composite agent
IV. None of the above

Answers to Self-Examination Questions

Answer 1

The correct option is I.

Applicant shall complete 50 hours training to become an insurance agent.

Answer 2

The correct option is I.

Insurance agent represents the insurance company

Answer 3

The correct option is II.

Licence to work as an insurance agent is issued by Insurance Regulatory and Development Authority

Answer 4

The correct option is III.

Agent's licence is to be renewed after 3 years.

Answer 5

The correct option is II.

An insurance agent should not share the commission by way of rebate

Answer 6

The correct option is I.

Rs. 250 is the fees payable to the Authority for issue / renewal of licence to act as an insurance agent or composite insurance agent.

Answer 7

The correct option is IV.

The Authority may issue duplicate licence in case it is lost, destroyed or mutilated.

Answer 8

The correct option is I.

If an agent is found guilty of criminal misappropriation the designated person will cancel the licence.

Answer 9

The correct option is II.

Minimum qualification required for insurance agent is 10th pass.

Answer 10

The correct option is III.

Composite agent may deal with more than one life insurance company or general insurance company or both.

CHAPTER 17

LIFE INSURANCE AGENCY AS A CAREER

Chapter Introduction

In previous chapters we have covered various aspects of life insurance, including regulations. In this chapter we shall discuss about life insurance agency as a career. We shall consider the prospects in an agency career, the role of an agent and the requirements of being a good agent.

Learning Outcomes

A. Insurance channels
B. Life insurance agency profession
C. Recruitment, training and licensing of agents

A. Insurance channels

1. Who is an agent?

Definition

Agent and principal
As per Section 182 of the Indian Contract Act, an **agent** is a person employed to do any act for another or to represent another in dealing with a third person.

The person for whom such act is done or who is represented is called the **principal**.

Definition

Insurance agent
As per the Insurance Act, an agent is one who is licensed under Section 42 of the Act, authorised to be a salesman for insurance, and is paid commissions for soliciting, procuring and continuance of the business.

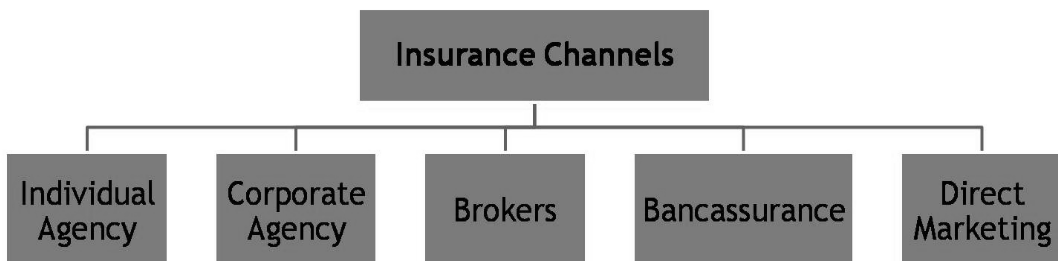
In India, when we speak of agent, we mean a tied agent – one who is allowed by law to represent only one life insurance company and sell its products.

It may be seen that the agent is an intermediary who comes between the life insurer and the customer.

2. Insurance channels

Until a few years ago, the agency channel was the only one that was in vogue. Today there are a range of other channels. It would be useful to know about some of these channels and how they work.

Diagram 1: Insurance channels



a) Corporate agency

It is a variant of the individual agency model. Here a corporate entity, which has its own set of customers, tries to reach out and sell insurance products. IRDA's regulations clearly mandate that the "entity" needs to set up a separate unit with a Principle Officer and trained manpower which has undergone compulsory training from an institute recognised by the regulator.

b) Brokers

Both agents and brokers are intermediaries who interact between the insurance company and the customer. There is however a difference between the two.

Insurance agent	Broker
An insurance agent typically is a representative of the insurance company and is governed by the agent-principal relationship. The agent's primary relationship and responsibility is to the insurance company and not the insurance buyer.	An insurance broker represents the insured and generally does not have any contractual agreement to exclusively serve any one insurance company.
The agent is expected to faithfully represent his company and offer whatever is available in the company's product line to the customer.	Insurance broker is expected to represent the customer's interest when choosing the right product and company that would best fit the customer's particular needs.

c) Bancassurance

The term 'bancassurance' refers to the collaboration between banks and insurers to distribute insurance products to the same customers or customer base. It has emerged as an important distribution channel globally and has risen in a relatively short time due to the benefits it offered over other channels in terms of operational cost and efficiencies. This was due to the wide consumer network that banks had access to. Bancassurance is today the main distributing channel for life insurance products in many of the European nations.

In India there are two broad Bancassurance models

i. One is where a bank becomes a corporate agent of an insurer and taps its customer base to sell insurance products. In this case the employees of the bank take up the task of selling the products of the insurance company

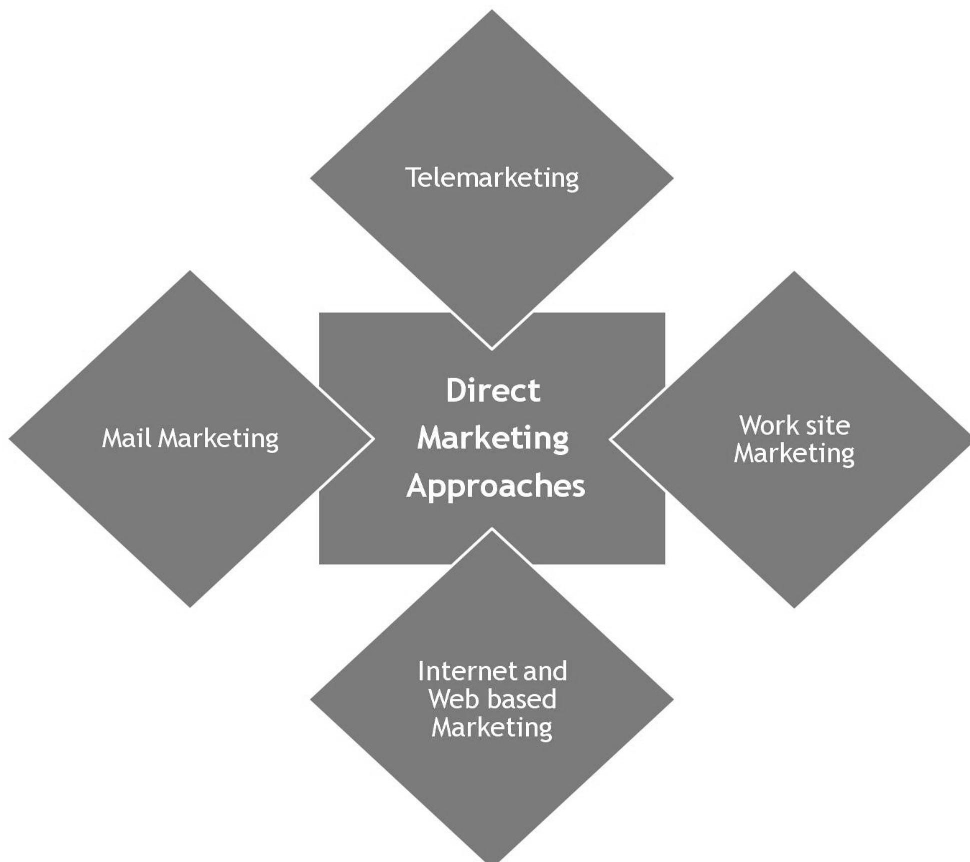
ii. A referral model, where the bank supports the insurance company with its data base, while the sale of insurance products is done by the insurance company.

Bancsassurance has gained much momentum as a preferred channel of marketing for some of the private life insurance companies in India and is a strong alternative to the agency channel.

d) Direct marketing

This is where the company directly markets to customers through its own sales force which is made up of employees of the company. They may get a regular salary and incentives, based on their sales performance.

Diagram 2: Direct marketing approaches



Direct marketing may involve various approaches like

i. Telemarketing (through call centres for instance);
ii. Mail marketing;
iii. Internet and web based marketing and
iv. Work site marketing

Here the life insurer directly communicates and solicits business with the prospective customer without going through an intermediary.

The presence of so many alternative marketing channels has no doubt made the marketplace more competitive and challenging. Nevertheless, life insurance agents who have acquired competence in selling and are able to build great relationships with their customers have continued to thrive and ascend to great heights in their profession.

Test Yourself 1

Which of the below statements is incorrect?

I. An individual insurance agent is a representative of the insurance company and is governed by the agent-principal relationship.
II. An individual insurance agent's primary relationship and responsibility is to the insurance buyer and not the insurance company.
III. Insurance broker, who represents the insured, generally does not have any contractual agreement to exclusively serve any one insurance company
IV. Insurance broker is expected to represent the customer's interest when choosing the right product and company that would best fit the customer's particular needs.

B. Life insurance agency profession

1. Rewards of an agency career in life insurance

The nature of the selling business in life insurance is quite different from others. Unlike other products, life insurance is intangible. One has to often create a need in the prospect's mind and motivate the latter to buy life insurance. This involves a very high level of concept selling and thus life insurance sales persons are generally among the most accomplished of sales professionals. Since they are remunerated through commissions, there is no limit to what an agent can earn. The limit is set by whatever premium revenues the agent generates.

Apart from the scope to earn high incomes, an insurance agent can also attain a tremendous amount of job satisfaction and social respect if one's job is done in an ethical and professional manner. The rewards and recognitions can be listed as:

i. Being **recognised by the society** as a knowledge worker and a professional.

ii. Being **able to provide solutions** to some of the most critical problems of people around is a matter of immense social value that life Insurance agents enjoy. Social prestige comes from being instrumental in financially helping out people who are affected by a misfortune.

    How many jobs are as noble as helping a family which is orphaned by death of its bread winner, or helping to provide for someone in his old age?

iii. Being **able to help people by advising them to take the right policy** to cover their death or old age needs or an accident or an illness or meet other family needs can be a matter of immense personal satisfaction for life insurance agents.

iv. Agents deal with multiple clients and keep learning during their interactions. Over a period of time they **become fairly knowledgeable in many areas** simply by dealing with multiple experts. More significantly, they can **become very skilled in dealing with various kinds of people**, in understanding human emotions and being able to communicate and bring together people of various kinds. They can thus have the potential to be great community builders.

v. Finally, the life insurance agency is one of the few avocations where **one can be an entrepreneur** – it calls for little financial investment. No big educational or technical qualifications are needed to set up the business. One is master of oneself and has the freedom that comes from being one's own employer. Of course with this freedom comes great responsibility and a successful life insurance agent quite often builds a brand around himself / herself by the quality of professional advise they provide; the trust that they inspire and the great friendships and relationships that they build.

2. Unique advantages of insurance agents

Insurance agents have unique advantages of working as per their own career ambitions:

i. If an agent wishes to have a regular commission income, he will meet a fixed number of prospects or a fixed number of existing customers for renewal.

ii. If he wants to earn more commission, he will step up his efforts depending on his appetite for growth. He may even decide to be more active in some months and less active in other months based on his other priorities.

iii. If he has appetite for sales, he may be able to synergise with fields of life insurance, banking etc.

The work – life balance that one can achieve when one is working as per his own career ambitions is a plus point for insurance agents.

3. Requirements for success in the life insurance agency profession

Let us now dwell a little on what kind of qualities or traits would contribute to success in the career as an insurance agent or advisor.

Diagram 3: Requirements for success in the life insurance agency profession

a) Fire in the belly

Perhaps the most important requirement is what we call 'fire in the belly'. It is difficult to sustain in the profession unless one has a massive hunger to excel and significantly better one's financial standing in the process. There are no free lunches in sales. Success has a price and one can pay that price only when there is sufficient fire within.

This hunger within is closely related to an **entrepreneurial spirit** – the ability to look at one's work as an exciting adventure and look forward to a job environment where the only kind of job security comes from the ability to achieve results and the results don't come easily. To some extent the ability to live with uncertainty can come from a background where work and life was challenging and every meal had to be earned the hard way. But this need not always be true.

b) Positive self-image

Unless one feels good inside, it is difficult to attract others to oneself. Take the profile of persons who are considered 'difficult to get along with' – hostile, pompous, negative, always giving excuses, complaining …. the list may be long – at the heart of it all, you would find an individual who feels insecure and inadequate.

This insecurity comes from a number of factors – like

i. the tendency to compare oneself with and consequently feel inferior to others;
ii. the obsession with looking good in others' eyes;
iii. taking oneself too seriously and
iv. getting upset at the slightest attack on one's self-image

One of the principal reasons for all the above is a bloated sense of ego and pre-occupation with oneself and one's concerns. It is difficult for such a person to persist for long and consistently perform in sales.

c) Being a self-starter

How much are you self-driven and independent of others. Stephen Covey in his popular and path breaking work, **"The seven habits of highly effective people"** has put it as the first habit – he terms it the "**inside out approach**" as contrasted with the **"outside in approach"**.

In essence, it is about where the locus of control of one's life and destiny resides - outside of or within oneself. Ineffective people, according to Covey, are typically seeking to fix responsibility on "someone - somewhere - out there" for all that has happened to them. People in this frame of mind may be okay in a work setting where they are led and supervised by others. No agent goes very far with such an approach.

d) Ability to relate with and communicate with people

To be a top producer, one would need to be at home with the persons who are one's prospective customers. These may often be individuals with lots of money and egos, difficult to please and demanding in nature. The ability to relate and connect with people is a great gift. It calls for an ability to feel what other people feel and put oneself in the other's shoes. At the same time one cannot let one's feelings run riot and take charge of one's business sense.

It would also not do to be an introvert. The whole business is after all about reaching out to others, making friends and influencing people. A sales person succeeds only when he or she extends affection and care to as wide a circle as possible. Almost everyone has to be a friend. At the same time one has to learn to take it in stride when others do not reciprocate – when they say no.

Case Study

In 1964, an interesting study on **"What makes a good salesman"** was published in Harvard Business Review. The authors, David Mayer and Herbert M. Greenberg, after seven years of intensive field research, came up with an interesting insight.

They found that a good salesman should have two basic qualities: empathy and ego drive.

i. **Empathy** is the ability to feel as the other person does in order to be able to sell him a product or service. A sales person needs to be more sensitive to what goes on in the customer's mind and adopt one's approach and communicate accordingly.

ii. **Ego drive** refers to the sales person's intense drive and effort to make the sale, not merely for the money to be gained, but because it is a personal need one simply has to fulfil.

In other words great sales people typically have a massive hunger to excel and to improve their financial standing in the process. They also have an entrepreneurial spirit – the ability to see their work as an exciting adventure and look forward to a job environment where security comes from the ability to achieve results. They also have the ability to relate and connect with people. They are comfortable in networking with others, making friends and influencing them.

4. Ethics and market conduct

Ethics is derived from the ancient Greek word ethos, which means customs or habits. In popular language, the term 'Ethics' is used to denote a set of principles for morally correct behaviour. An ethical person is one who has character, who lives by principles and demonstrates morally correct behaviour. It essentially means not just doing what one has a right to do but to ensure that one does the right things. In the work place it implies acting with honesty and integrity in one's all dealings with customers and all other associates.

a) Golden rules

Golden rules of ethics are seen in many religious teachings. To give a few instances:

i. **Hinduism:** "Good people proceed while considering that what is best for others is best for them, too". (Hitopdesha, Hinduism)".

ii. **Judaism:** "Thou shalt regard thy neighbour as thyself. (Leviticus 19:18, Judaism)".

iii. **Christianity:** "All things whatsoever ye would that men should do to you, do ye even so to them. (Matthew 7:12, Christianity)".

iv. **Buddhism:** "Hurt not others with that which pains yourself. (Udanavarga 5:18, Buddhism)".

v. **Confucianism:** "What you do not want done to yourself, do not to others. (Analects 15:23, Confucianism)".

vi. **Islam:** "No one of you is a believer until he loves for his brother what he loves for himself. (Traditions, Islam)".

b) Ethics at work

Some very basic ethical principles to be followed:

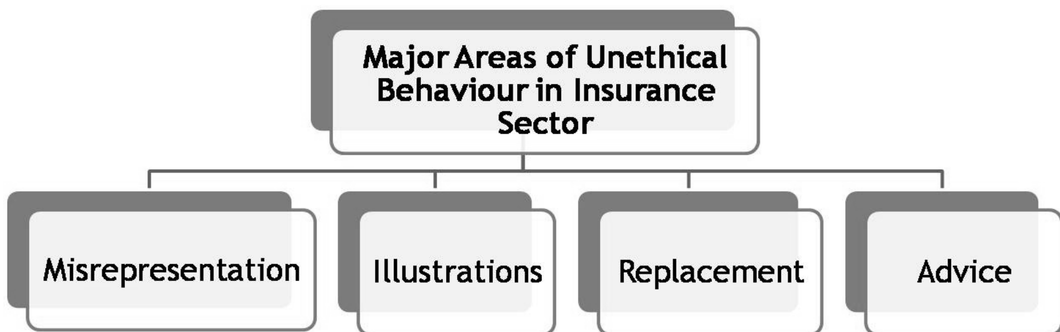
- ✓ Do good and avoid harm
- ✓ Be fair
- ✓ Keep your word
- ✓ Be true to yourself

Remember, every action of ours creates obligations to six constituencies:

- ✓ The prospect
- ✓ The company
- ✓ The profession
- ✓ Allied professionals
- ✓ Oneself and others related to us and
- ✓ Society and its laws

A vital element for the success of any life insurance or other financial service company is a strong commitment to high standards of business practices and market conduct in the insurance and financial marketplace.

Diagram 4: Major areas of unethical behaviour in insurance sector



Four major areas of unethical behaviour have been identified in the insurance sector:

i. Misrepresentation
ii. Illustrations
iii. Replacement and
iv. Advice

Let us look at each of these

i. Misrepresentation: stating one thing as another

Any advertisement for insurance is considered unfair if it fails to identify the product as insurance and this is applicable to advertisements by the company and its agents. The agent has to comply with rules at the point of sale such as explaining the exact benefits and features of the insurance product. The regulation mentions that that the scope of insurance benefits should be clearly stated in the prospectus that is shown to the prospect

ii. Illustrations

All companies follow a standard format for providing sales illustrations. **It is mandatory to provide illustrations with two scenarios, one optimistic and one conservative, in respect to likely returns.** It is considered unethical to present only one scenario and suggest that the illustrated one will be correct. According to 2008 IRDA guidelines on ULIPs, the policy holder must sign the business illustration along with the proposal form.

iii. Replacement

Surrender, reduced in amount, changed to reduced paid-up insurance, changed to extended term insurance, taking a policy loan to buy a new policy, more than 25% withdrawal from an existing plan to buy a new plan or lapse of an existing policy to purchase a new policy is not generally in the best interests of the policy holder.

iv. Advice

Do not give any legal or tax advice if you are not an attorney or a CA.

Mis-selling and its implications

In recent years the issue of mis-selling has acquired much significance and has been the subject of much outcry. This is in part due to the crisis of confidence arising in the industry with respect to problems of market conduct.

Mis-selling may take various forms – like policies being sold without proper reference to the needs of the buyer or his/ her risk appetite; benefits to be received being illustrated without spelling out what is the price / cost the customer actually has to pay; benefits of investment linked policies illustrated, but the customer not told that these benefits are not guaranteed but depends on investment performance of the insurer.

Mis-selling has multiple impacts that are adverse to all participants. The companies and the industry as a whole get a bad name and this is reflected in loss of business and decline of growth. Agents and other sales persons, who

have mis-sold, sooner or later lose all their credibility in the market as customers who have had bitter experiences with these individuals, bad mouth about them to others. Finally the general loss of confidence of customers can result in life insurance no longer being a product people want to buy. This can have serious social consequences because it also results in large sections of people who need the benefits of insurance being denied it.

c) Code of ethical conduct

It would perhaps be relevant to reproduce here some of the Insurance Marketplace Standards Association (IMSA) principles:

Principle 1	To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.
Principle 2	To provide competent and customer-focused sales and service.
Principle 3	To engage in active and fair competition.
Principle 4	To provide advertising and sales material that is clear as to purpose and honest and fair as to content.
Principle 5	To provide for fair and expeditious handling of customer complaints and disputes.
Principle 6	To maintain a system of supervision and review that is reasonably designed to achieve compliance with these principles of ethical market conduct.

d) IRDA code of ethics and market conduct for agents

Let us look at the code of ethics and market conduct for agents prescribed by the IRDA. These are listed below.

Every insurance agent shall

i. Identify himself and the insurance company of whom he is an insurance agent;

ii. Disclose his licence to the prospect on demand;

iii. Disseminate the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan;

iv. Disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect;

v. Indicate the premium to be charged by the insurer for the insurance product offered for sale;

vi. Explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract;

vii. Bring to the notice of the insurer any adverse habits or income inconsistency of the prospect, in the form of a report (called "Insurance Agent's Confidential Report") along with every proposal submitted to the insurer, and any material fact that may adversely affect the underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect;

viii. Inform promptly the prospect about the acceptance or rejection of the proposal by the insurer;

ix. Obtain the requisite documents at the time of filing the proposal form with the insurer; and other documents subsequently asked for by the insurer for completion of the proposal;

x. Render necessary assistance to the policyholders or claimants or beneficiaries in complying with the requirements for settlement of claims by the insurer;

xi. Advise every individual policyholder to effect nomination or assignment or change of address or exercise of options, as the case may be, and offer necessary assistance in this behalf, wherever necessary;

No insurance agent shall

i. Solicit or procure insurance business without holding a valid licence;

ii. Induce the prospect to omit any material information in the proposal form;

iii. Induce the prospect to submit wrong information in the proposal form or documents submitted to the insurer for acceptance of the proposal;

iv. Behave in a discourteous manner with the prospect;

v. Interfere with any proposal introduced by any other insurance agent;

vi. Offer different rates, advantages, terms and conditions other than those offered by his insurer;

vii. Demand or receive a share of proceeds from the beneficiary under an insurance contract;

viii. Force a policyholder to terminate the existing policy and to effect a new proposal from him within three years from the date of such termination;

ix. Apply for fresh licence to act as an insurance agent, if his licence was earlier cancelled by the designated person, and a period of five years has not elapsed from the date of such cancellation;

x. Become or remain a director of any insurance company;

Every insurance agent shall, with a view to conserve the insurance business already procured through him, make every attempt to ensure remittance of the premiums by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing

5. Professionalism

What is meant by 'professional'?

Definition

Webster's dictionary uses the term **professional** in two ways:

i. One is the following of a profession for gain or livelihood
ii. Second sense is in terms of conduct, aims, or qualities that characterise or mark a profession or a professional person.

Let us look at the second definition a little more closely.

a) Characteristics of professionals

If we look at some of the professionals we meet regularly like doctors, lawyers or chartered accountants, we would notice certain distinctive characteristics:

i. Firstly that they have been **qualified through an extensive process of education** and possess a sound amount of knowledge that has been systematically acquired.

ii. Secondly, we would observe that they **bring a high degree of technical skill** to what they do. They adhere to certain accepted rules of practice which has been scientifically derived by the profession over long years of experience. Though doctors and surgeons may have various degrees of skill, they follow a certain tried and tested procedure which is objective.

iii. Thirdly they **adhere to a high degree of ethical standards**. In particular this means putting the customers' interests above self-interest and also adherence to morally correct conduct and behaviour.

iv. A fourth characteristic of professionalism is a **commitment to lifelong learning and continuous professional development**. Many professions typically have professional bodies or associations that have been set up to promote the interests of the profession, including supporting and enabling their members to continually improve their knowledge and enhance their skills.

Test Yourself 2

In 1964, Harvard Business Review published a study on "What makes a good salesman". The authors came up with an interesting insight. They found that a good salesman should have two basic qualities. Which are those two qualities?

I. Affection and zeal to succeed
II. Patience and pro-activeness
III. Empathy and ego drive
IV. Hunger for growth and self-confidence

C. Recruitment, training and licensing of agents

In India, the IRDA regulations with regard to agents have been designed with a view to bring in an element of professionalism into the life agency business. Let us consider some of these.

1. Agent regulations

a) Mandated minimum qualification levels of an agent

The regulator has prescribed that the applicant, willing to be recruited as an individual agent of a life insurance company, must have passed **Standard XII examination** or equivalent by any board or institution. In case of rural areas (having population of less than 5000, as per the last census) the applicant must have passed **Standard X** or equivalent

b) Pre-recruitment practical training

When an application is seeking licence for the first time, he / she is supposed to **undergo 50 hours** (75 hours in case the candidate has applied for composite licence) **of practical training** (from an approved institution) in life insurance. However, if the applicant possesses additional qualification, then the practical training requirement is relaxed.

c) Examination

Post the practical training, the applicant needs to take the examination, conducted by **Insurance Institute of India (III)** or any other approved examination body

d) Issue of Licence

After confirming that the applicant

i. possesses the minimum qualification required;
ii. had undergone the practical training;
iii. had passed the examination;

iv. had the knowledge to seek and gain insurance business and
v. was capable of providing the necessary service to the policyholders,

the designated officer of the insurance company may issue licence to the applicant

e) Ethics and code of conduct

The agent is constantly bound by the ethics and code of conduct.

f) Renewal of Licence

The licence issued to the agent is **valid for three years** and needs to be renewed. Before the licence could be renewed, the applicant needs to undergo renewal training of 25 hours (35 hours in case of composite licence) from an approved institution.

g) Cancellation of Licence

The designated officer of the insurance company may cancel the licence if the agent suffers from any of the disqualifications like:

i. Being of unsound mind;

ii. Has been found guilty of any criminal misappropriation, breach of trust, forgery, cheating etc.;

iii. Has participated in any fraud, dishonesty or misrepresentation against the insured or the insurer;

iv. Has not followed any code of conduct etc. Mentioned in sub-section (4) of Section 42 of the Insurance Act, 1938

2. Guidelines on persistency for individual agents

Definition

Persistency during a period has been defined as "proportion of policies remaining in force at the end of the period out of the total policies in force at the beginning of the period."

In other words, persistency is the percentage of business retained without lapsing or without being surrendered. Low persistency means high lapsation and vice versa. **The persistency scores could be computed premium-wise as well as policy number-wise.**

It has been observed that the quality of sale does impact the persistency rate of the policies. If the quality of sale has been high or good (which means that the solution offered is based on the need(s) of the client, the policyholder would not want to lapse or surrender the policy and eventually, its persistency would be higher and vice versa.

All this while, the agent was not held accountable for low persistency and it was only the insurer, who had to bear the brunt for low persistency. However, effective July 1st, 2014, this would change as soon as the guidelines on persistency get implemented.

3. Standard proposal form

Effective September 2012, a standard proposal form has been adopted by all life insurers, for all individual policies. This is based on the draft exposure guidelines issued by IRDA in June 2012.

This standard proposal form comprises of different sections. The section, pertaining to details of the prospects, needs of the prospects and the agent's recommendation thereto, is compulsory. The insurers are also required to establish a system to measure the adequacy of the analysis of the client's needs done with the appropriateness of recommendations made.

Information

Million Dollar Round Table (MDRT)

Founded in 1927, MDRT is an international, independent association with several thousand members representing hundreds of life insurance companies in 76 countries.

MDRT members are internationally recognised as the standard of sales excellence in the life insurance and financial services industry - they are professionals / advisors who serve their clients by exemplary performance and the highest standards of ethics, knowledge, service and productivity.

How does an agent grow into a professional and then move up the career graph to become a champion sales producer in the agency business?

To answer this question, it is necessary to understand the role that a life insurance agent is expected to play. When we use the term "Role" it implies the distinctive way in which the agent adds value to his or her customer.

Most agents, we must remember, make a sale. Few create a great sales experience for their customer

4. Agency function

The agency function consists of two distinctive tasks:

i. Building a relation with the customer – which inspires trust and confidence.

ii. Providing expert financial advice to the customer – which enables the latter to meet his or her needs for insurance in the most appropriate manner.

Stages in the development of an agent

Let us see how these two functions evolve as an agent advances on a career path towards success and becomes a sales champion. An agent's development could indeed be envisaged as progressing through three stages:

a) As a peddler

This is the stage when an agent has circle of personal contacts where he tries to push one or two products and their benefits. He is largely **'shaking hands'** and getting customers to buy what he has. Sometimes the agent is lucky - the prospect has been looking for a particular product or solution or sometimes insurance may be taken as a personal favour. Many agents drop off here - the rejection, the sense of uncertainty and the loss of self-esteem are just too much to bear.

b) As a respected professional advisor or consultant in the field of insurance, personal finance and life cycle planning

The second stage is set when the agent goes beyond mere **'hand shake' into 'hand holding'**. He no longer just tries to peddle off the products that he has but now is actively interested in the client's needs – asks and seeks to understand the client's needs, displays knowledge of products and services and is skilled at offering financial advice that is unbiased and in the best interests of his or her client.

This is also the stage when the agent begins to cultivate deeper relationships with a larger and larger circle of clients and begins to earn a stream of renewal commissions from the circle of clients that he has built. Productivity mounts as the agent is now able to achieve a higher conversion rate (turning prospects into buyers). Blind groping gives way to working to a plan – he is now engaged more and more in various kinds of personal and community service and other activities, building goodwill and acquiring a reputation for professionalism. He gets continual referrals and is the person to contact when people want to plan their life cycle investments.

c) As social entrepreneur

The third stage is when the agent progresses to become **a sort of social entrepreneur - the CEO of an enterprise**, providing insurance and investment advice and other personal financial services. The enterprise thrives on a 360 degree relationship with a large circle of customers, and may even help the clients to secure services of other enterprises / service providers with which one is networked. The result is to make a range of

service and support systems available at the customer's doorstep – from filing income tax returns, to holiday planning, to making a will, to advice on health or education. The firm thrives on a lifetime partnership with a large network of clients.

When you decide to take up a career in life insurance agency, you must enter with a vision. You must go beyond asking how much you can make and begin to ask 'how you can serve and make a difference to your customers'. If you set out with such purpose, success and satisfaction in the agency career will certainly by yours.

Test Yourself 3

Proportion of policies remaining in force at the end of the period out of the total policies in force at the beginning of the period is referred to as ___________.

I. Persistency
II. Consistency
III. Uniformity
IV. Reliability

Summary

- As per the Insurance Act, an agent is one who is licensed under Section 42 of the Act, authorised to be a salesman for insurance, and is paid commissions for soliciting, procuring and continuance of the business.

- Apart from individual agency, other insurance channels include:

✓ Corporate agency
✓ Brokers
✓ Bancassurance
✓ Direct marketing

- Through an agency career, apart from the scope to earn high incomes, an insurance agent can also attain a tremendous amount of job satisfaction and social respect if one's job is done in an ethical and professional manner.

- Qualities that would contribute to success in the career as an insurance agent or advisor include:

✓ Fire in the belly
✓ Positive self-image
✓ Being a self-starter
✓ Ability to relate and communicate with people

- A good salesman should have two basic qualities: empathy and ego drive

- Four major areas of unethical behaviour have been identified in the insurance sector:

✓ Misrepresentation
✓ Illustrations
✓ Replacement
✓ Advice

- The IRDA has prescribed a code of ethics and market conduct for agents

- IRDA has laid down the regulations for recruitment, training and licensing of insurance agents.

- Effective September 2012, a standard proposal form has been adopted by all life insurers for all individual policies. This is based on the draft exposure guidelines issued by IRDA in June 2012.

- The Agency Function consists of two distinctive tasks:

✓ Building a relation with the customer – which inspires trust and confidence
✓ Providing expert financial advice to the customer – which enables the latter to meet his or her needs for insurance in the most appropriate manner

Key Terms

1. Corporate agency
2. Bancassurance
3. Professionalism
4. Persistency

Answers to Test Yourself

Answer 1

The correct option is II.

The statement "An individual insurance agent's primary relationship and responsibility is to the insurance buyer and not the insurance company" is incorrect.

The correct statement is "An individual insurance agent's primary relationship and responsibility is to the insurance company and not the insurance buyer."

Answer 2

The correct option is III.

Two basic qualities that a good salesman should have are empathy and ego drive.

Answer 3

The correct option is I.

Proportion of policies remaining in force at the end of the period out of the total policies in force at the beginning of the period is referred to as persistency.

Self-Examination Questions

Question 1

An insurance agent is typically a representative of _______________.

I. Customer
II. Insurance company
III. Government
IV. IRDA

Question 2

Direct marketing involves which of the below?

I. Telemarketing
II. Insurance agents
III. Bancassurance
IV. All of the above

Question 3

"Hurt not others with that which pains yourself". This golden rule of ethics is given in the teaching of which religion?

I. Buddhism
II. Christianity
III. Hinduism
IV. Judaism

Question 4

When an applicant is seeking license for the first time, he / she is supposed to undergo ________of practical training (from an approved institution) in life insurance.

I. 25 hours
II. 50 hours
III. 75 hours
IV. 100 hours

Question 5

The license issued to the agent is valid for _________.

I. One year
II. Two years
III. Three years
IV. Five years

Question 6

As per Section 182 of the Indian Contract Act, _____ is a person employed to do any act for another or to represent another in dealing with a third person.

I. Principal Officer
II. Proxy
III. Mediator
IV. Agent

Question 7

An insurance broker represents _______.

I. Insurance company
II. Insured
III. Association of insurance companies
IV. Community of people who have already taken insurance

Question 8

Which of the below reflects Principle 2 of the Insurance Marketplace Standards Association (IMSA) principles?

I. To provide competent and customer-focused sales and service.
II. To engage in active and fair competition.
III. To provide for fair and expeditious handling of customer complaints and disputes.
IV. To maintain a system of supervision and review that is reasonably designed to achieve compliance with these principles of ethical market conduct.

Question 9

Before the composite licence could be renewed, the applicant needs to undergo renewal training of ________ from an approved institution.

I. 25 hours
II. 50 hours
III. 35 hours
IV. 75 hours

Question 10

IRDA has decided to implement guidelines on persistency from _______.

I. 1st July 2011
II. 1st July 2012
III. 1st July 2013
IV. 1st July 2014

Answers to Self-Examination Questions

Answer 1

The correct option is II.

An insurance agent is typically a representative of insurance company.

Answer 2

The correct option is IV.

Direct marketing involves telemarketing, mail marketing, internet and web based marketing and work site marketing

Answer 3

The correct option is I.

"Hurt not others with that which pains yourself". This golden rule of ethics is given in the teaching of Buddhism.

Answer 4

The correct option is II.

When an applicant is seeking license for the first time, he / she is supposed to undergo 50 hours of practical training (from an approved institution) in life insurance.

Answer 5

The correct option is III.

The license issued to the agent is valid for three years.

Answer 6

The correct option is IV.

As per Section 182 of the Indian Contract Act, an agent is a person employed to do any act for another or to represent another in dealing with a third person..

Answer 7

The correct option is II.

An insurance broker represents the insured.

Answer 8

The correct option is I.

Principle 2 of the Insurance Marketplace Standards Association (IMSA) principles reflects: To provide competent and customer-focused sales and service.

Answer 9

The correct option is III.

Before the composite licence could be renewed, the applicant needs to undergo renewal training of 35 hours from an approved institution.

Answer 10

The correct option is IV.

IRDA has decided to implement guidelines on persistency from 1st July 2014.

CHAPTER 18

LIFE INSURANCE SELLING PROCESS

Chapter Introduction

This chapter aims to provide an understanding of the sales process and its various steps.

Learning Outcomes

A. Sales process

A. Sales process

Every one of us is engaged in selling almost from the day we were born. Each day we try to persuade, influence and induce one another to do (or not to do) things in the way we want. However this does not mean that we are all sales professionals.

Definition

Selling as a profession refers to the act of inducing a commercial transaction through inducing the purchase of a product or service, such act being carried out with the intent of earning remuneration.

The salesperson thus seeks to make a livelihood out of selling.

Insurance agents are sales persons who seek to induce members of the community to buy insurance contacts written by the insurance company that they represent. The remuneration they enjoy in return is known as a commission.

Diagram 1: Insurance sales

Types of sales in other industries and life insurance

While all selling involves inducing someone to buy, the nature of the sales process can differ from industry to industry and would depend on the nature of the product and industry. The sales person's role also consequently changes.

Example

i. **Fast Moving Consumer Goods (FMCG):** are typically mass marketed through malls and other retail sales outlets. A product like soap, for example, is promoted through mass media (particularly ads in TV and other visual media) and the customer asks for it at a retail outlet (e.g. a shopkeeper or mall).

ii. **Showroom sales:** A car in a show room costs much more than a bar of soap and the buyer has to be naturally careful when taking a decision to buy. The sales person does not go to the prospect but instead it is the prospect who visits the showroom. The sales person has to win the prospective customer's confidence and make a convincing case for purchase of the car. The role is essentially to convert an enquiry into a sale.

iii. **Medicines and Drugs**: are usually brought from a chemist after being prescribed by a doctor. Medical Representatives of pharmaceutical companies visit doctors' clinics to sell their company's products and their features to the doctor. Here the target of sales efforts is a medical expert who prescribes the brand for the end buyer who buys it from the pharmacy. The salesman's role is basically sharing hard medical information with a professional.

iv. **Business to Business (B2B sales):** Here the customer is another firm. The decision to buy may be taken by multiple individuals and often it is a panel who decides. Purchase is typically through floating a tender and the selection criteria are fixed and measurable. Decisions are taken on the basis of careful consideration and evaluation of alternatives. The sales person's role is to effectively demonstrate how the product and company meets the buying criteria better than the competition. It requires presentation skills, building good relations with multiple players and being sensitive to feedback and information that can help clinch the deal.

There are two points which distinguish life insurance selling from other products and industries:

i. Firstly it is said that **'life insurance is sold, not bought'**. In case of many other products, the prospect has a need for the product and initiates the enquiry. In the case of life insurance, it is typically the sales person who has to go to the prospect and induces the need to buy.

ii. The second major difference is that in life insurance, unlike many other products, one is **not selling any tangible product but only an idea** – a promise that would be realised only in the future.

The role of the insurance salesman is to sell this promise and relate to the prospective customer in such a way as to win trust and confidence about the fulfilment of the promise far into the future. The element of person to person, eye to eye selling is perhaps far more in life insurance than any other business. It is one of the reasons why life insurance is considered difficult to sell. It is also for this reason that some of the world's greatest and best known salesmen won their wings in the life insurance industry.

Sales Process

Selling is both an art and a science. It is an art in the sense that every sales person brings his own distinct style in the way he communicates, builds rapport and relations with prospective customers, engages in fact finding and presents solutions. Does this mean that only a few individuals who have these distinctive skills can succeed?

It is true that sales people may differ much in style and skills and their chances of success may vary. Some of them may be able to quickly make contacts with a lot of prospects and convert them effectively into customers in a short time. Others may be slower to learn and may move more slowly. The truth one needs to know is that **so long as one does not give up or slacken but persists on the path, even when there are failures, the law of averages would come to one's aid.**

What is this law? It means that if a sales person on average is able to convert one out of every twenty or thirty persons contacted into a customer, he or she simply needs to adopt a standard process and keep contacting more and more persons without giving up. The customer base will begin to build over time. Some sales persons may take longer than others but success is sure. Persistence is what pays off in the business.

This brings us to the importance of adhering to a well-defined sales process with clearly sequenced steps. Let us outline the steps:

Diagram 2: Sales Process

Let us look at each of these processes in some detail.

1. Step I: Prospecting (To identify and build up a list of prospects)

Prospects are people to whom we can sell our products. Prospecting is the process of gathering names of people whom one can approach to secure a sales interview. Continuous prospecting is absolutely vital to a successful sales career.
The key to effective prospecting is to target particular markets where we will be calling on people who have one or more characteristics in common. By cultivating strong relationships with these people, we can get them interested in the products we sell immediately, making the process of prospecting much easier. Let us look at some of these markets.

a) Immediate group

The easiest people to approach would be one's family and friends. We know the needs of these people and would be able to approach them on a favourable basis. Also relatively easy to approach are people with whom we do business; people who work in the food stores, clothing stores, banks, etc. Other such people would be those who know us such as friends, acquaintances, people who belong to the same organisations, and so forth. To sum up, these prospects form part of what we call the sales person's natural market. They are people who should at least grant us an interview if we contact them.

b) Natural market

A second source of contacts is the natural market. This consists of people who may not be part of one's immediate circle of relatives, friends and other acquaintances but one is in a position to know and get acquainted with them because of sharing something in common with these people. If we just look around we would see many groups who may form part of our natural markets:

- ✓ members of a caste or community association;
- ✓ members of a church congregation or a Satsang group;
- ✓ members of a parents – teachers association (PTA);
- ✓ members of a cultural association or a temple festival committee or a trade union

c) Centres of influence (COIs)

One way to get to a large number of prospects is by taking help from people who are visible and influential leaders and whose words are valued by others. We are referring to centres of influence – community leaders, social and political workers, professionals like Chartered Accountants or Lawyers or well-known businessmen.

The secret is to secure this person as a satisfied client whom you have served well and then to seek his or her help to find other new prospects. Even if he or she is not yet your client, it is enough he or she should know about your dedication and passion to help other people and should be confident about your knowledge and sense of professionalism. Another important condition is that he or she should like you and be interested in helping you.

d) References, introductions and testimonials

Just as you can tap a centre of influence, you can also seek the help of other satisfied customers as well as prospects who has not yet bought or may not buy from you for some reason, but still has been impressed and favourably disposed to you by your dedication and professionalism.

i. A **reference** is a name of another potential prospect which is provided as a lead, by your client or prospect or centre of influence or any other person, whom you may be able to support with your solutions.

ii. **Introduction**: An even better way may be to ask for an **introduction.** Here the salesperson asks for a small letter of introduction or a note to the person referred. Typically one could ask for a visiting card at the back of which or attached to which, a small note may be added, introducing one to the referred person.

   The best form of introduction would off course be where one's benefactor picks up the phone and calls his or her contact to introduce the agent, intimating that she would be contacting that person shortly. One's chances of success would multiply, especially if the person who refers is one whose word is respected and taken seriously.

iii. A **testimonial** is a kind of statement which one may seek from a satisfied customer, affirming that the latter has done business with the salesperson and has been very satisfied with the services and solutions rendered. It is a kind of vouching for the sales person's credentials. A testimonial would be very relevant when one is dealing with a circle of professionals who want adequate proof about the sales person's professional credentials.

e) Other service providers

There is a whole range of service providers who are not our competitors. They may include laundry men, real estate agents, lawyers, shop keepers, doctors and others whose services are regularly needed and sought by members of the lay public. The basic principle applied here is that of reciprocity. The agent agrees to be the eyes and ears for the other party, and in turn gets them to make her visible and recommended.

Good agents use this source very effectively. Indeed if were to make a visit to our milkman or laundryman, we may see a sign board asking one to contact so and so, with a contact number, for all one's insurance needs.

f) Conducting seminars and events

This is a professional, efficient method of selling, on a group basis. We can use it to attract both new and existing customers alike. Since we're already dealing with existing customers, we can always ask them to invite a friend or partner along with them. Advertisements in the area of the seminar also can increase the numbers.

g) Information pieces, newsletters, blogs and web based networking

It may not be easy or even viable to conduct seminars and events on a regular basis.

i. Email

Another way to get your message and presence registered in the minds of a large number of prospects is to send them information by mail or hand drops on a regular basis. This can be done almost free of charge today in the form of e-mails.

ii. Newsletter

Another way to communicate regularly is through a newsletter. In both cases, the purpose is to inform readers about various subjects in the form of well-informed write ups. In designing newsletters you can involve some of your important customers and prospects, especially if their views are sought by members of their network.

iii. Personal website or blog

Yet another approach is to have a presence on the worldwide web in the form of a personal website. It may be a little expensive to begin with but it is a way for getting across to a wide circle of individuals who today spend a lot of their time in cyber space.

iv. Social networking sites

Finally there is Facebook and other social networking sites where you can access millions of others almost anywhere in the world.

h) Cold calling

This approach is used by many sales people in many different industries, not just financial services. This is where we make approaches to people or companies unannounced. It is tough and we have to able to accept rejection, but it can be a very quick way of gathering names and getting people to see. A good number of top sales people allocate some of their time to cold calling simply because it works.

i) A prospects' file

It is most important that we establish a prospects' file. This is simply a book or register or data base containing all the vital information about each of our prospects with details and date when the prospect should be called on. A prospects' file is an ever-changing tool. New names must be added continuously on a daily basis and old names must be discarded if the individual is not receptive to our sales efforts. We must be sure that we have enough prospects to call on each day.

2. Step II: The pre-interview approach

Qualifying every prospect in the prospects' list and getting appointments is the next step.

Definition

"Qualified" prospects are those people

- ✓ who can pay for insurance,
- ✓ who can pass the company underwriting requirements,
- ✓ who have one or more needs for insurance products, and
- ✓ who can be approached on a favourable basis

We need to gather enough meaningful information on each name in our prospect-list before we can call on them. The process is called qualifying the prospect.

It is important to collect as much relevant information as possible so as to proactively ensure that one's efforts are in the desired direction. This also enables us to convince the prospect that we do possess necessary knowledge and skills to meet his or her particular needs, thus making a favourable impression.

The initial contact can be made through a letter, by telephone, or in a face-to-face meeting. Whatever method is used, the objective is the same: to get the prospect to consent to an interview where we can understand his or needs and in turn get an opportunity to explain the service that we have to offer.

In order to do this our pre-approach communication should include:

- ✓ Something that will arouse the prospect's interest
- ✓ Offering of a valuable service
- ✓ Making it clear that no commitment is being made
- ✓ Use of a third party influence, if possible
- ✓ Use of alternatives in order to get an affirmative response
- ✓ Obtaining a definite appointment

It is important that during our first contact with the client, we introduce ourselves in a manner that can generate rapport and also some trust and comfort feeling.

3. Step III: The sales interview: Conducting a need – gap analysis

After being successful in obtaining an interview, it is vital to do it in a systematic and professional manner. The first step is to make a proper approach which automatically and smoothly leads to the fact finding part of the sales interview. The approach basically consists of an introductory conversation in the course of which we are able to identify one or more needs of the prospect and get the latter to agree that these are significant needs for insurance protection. Once there is mutual agreement on these one can move forward.

In **need gap analysis** we engage in a process of gathering detailed information about the prospect's insurance requirements, to identify and determine the assets and perils for which there is inadequate coverage. The objective here is to collect as much additional information about the prospect as possible. This additional information helps to identify specific needs of the prospect in a more cogent way, to suggest solutions to those needs, and to help the prospect find the money to pay the premiums.

Need Analysis Method

In need analysis method we do the following things:

i. the present and the future needs of the family are analysed;
ii. the monetary value of these needs are then calculated;
iii. the difference between the funds so needed to meet these needs and the available fund with the family as at present is ascertained

This difference is taken to be the required amount of risk cover.

Needs method takes account of the pressing needs of the family, showing how insurance can be added at various stages in the individual's life as needs increase and income also improves. However the estimation of the potential estate of the insured, that we considered earlier when we talked about Human Life Value, is ignored here. The needs approach however makes selling easier.

The needs of the family can be enumerated as under:

i. **Clean-up funds** for medical expenses, funeral expenses, succession/inheritance expenses, outstanding loans etc.
ii. **Readjustment income:** enough income for permitting enough time to smoothly shift to a required adjustment in living conditions;
iii. **Income for family:** till children are self-supporting;
iv. **Life income for spouse:** after children become independent;
v. **Special needs:** mortgage redemption, emergency medical needs, marriage of daughter, and higher education of children etc.

The above broadly covers all the foreseeable needs and substantially defines the ambit that an insurance salesperson can address.

4. Step IV: Designing the solution

After completing the previous steps, we should know enough about the prospect to design and recommend a solution that is best for him or her at this point in time given all of his or her financial circumstances. In many cases, especially if the problems and solutions are of a simple nature, we would be able to recommend a solution and move on to closing the sale in one interview.

In other cases, where the situation is more complicated, we may need to spend some time in our office for developing the proper solution, then return to the prospect and make our recommendation in a second interview.

If we attempt to conduct the fact-finding session and present our solution all in one interview, we must be prepared to build a bridge from the fact-finding phase to the solution and recommendation phase. This requires identifying the prospect's most critical need, pointing out that need and getting an affirmative reaction from the prospect that this is indeed a very important need in his or her mind. We would then be in a position to present our prospect with a solution to the problem.

Typically one should conclude the initial fact finding interview with a promise to return soon with appropriate solutions to the prospect's identified needs. One should then return to one's office where one can analyse the prospect's problems in depth, design one or more solutions to these problems, prepare one's proposals and recommendations which would lead to the sale, then make an appointment with the prospect for the second interview.

There is no specific rule which states the number of interviews one must have with the prospect. It will depend from case to case. There may be situations where you may have to conduct more interviews to develop a satisfactory solution and also win the prospect's consent to listen to the solution and consider it.

5. Step V: Presenting the solution

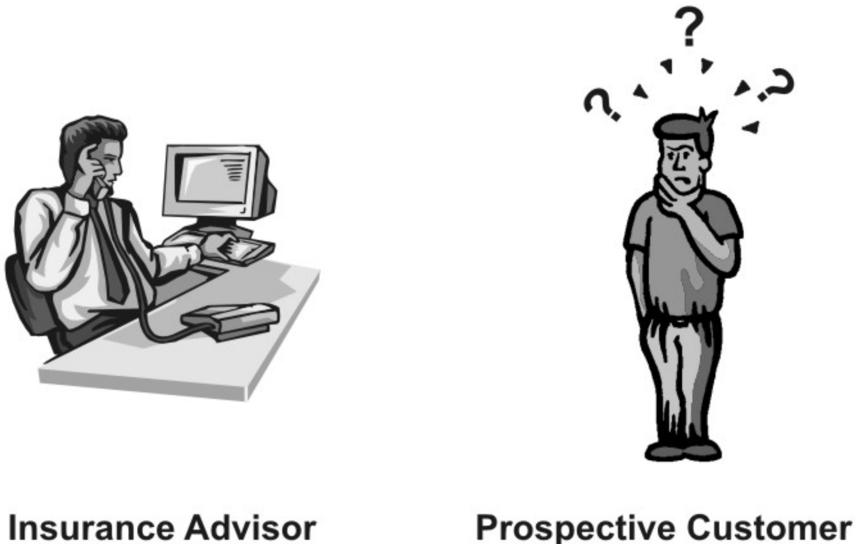
The most important point to remember when presenting our solution is to be thoroughly prepared. Prior to making our proposal we would want to review the prospect's needs in detail, go over our solution one final time, and plan to make our presentation so that it will appeal to our prospect's buying motives. We would also want to anticipate what objections the prospect might raise to our proposal.

It is necessary to arrange for presenting our proposal to the prospect, at a time and place that will be free from interruptions and distractions. As we begin presenting our solution, we must put the prospect at ease while at the same time making sure that he or she understands that this is a decision-making session.

We need to begin by reviewing all the data we obtained in the fact-finding session and stating each of the prospect's problems in an affirmative manner. We must ensure we convey to our prospect that we have spent a lot of time reviewing his / her situation, and that we are quite confident our recommendations are the best possible solutions to these problems. It is very important that we relate each feature of our recommendation to some particular benefit which the prospect will gain from, if he or she buys our proposal. Rather than describing what we have to offer in technical terms, we should explain how the prospect will be getting what he or she wants and needs.

6. Step VI: Handling objections (if any)

Diagram 3: Handling objections



The list of possible objections is a long one. It ranges from prospect being busy, not interested, thinks he has all the insurance he needs, already has an agent he deals with, has no money etc.

Finally there is the prospect who may agree with all that you say and have no objections, but decides to buy the product solutions from someone else. In all instances it means that the prospect does not have sufficient information to help him make the decision to buy from you.

If a prospect is "too busy now," it means you have not provided information that could pique his interest or overcome his wariness of being 'sold to'. Similarly the objection of "no money" can mean that he is not convinced adequately about why and how he can pay for the insurance. If he does not trust you, it is because you have not communicated enough information to overcome his doubts.

The least a salesperson can do is to accept and take responsibility for the fact that one has not adequately done the job of giving prospects the information they want to hear and see if there is anything one can do about it. Whatever the type of objection, we can handle it with this approach. The idea is not to treat it as a battle between us and the prospect where we win and they lose, but a discussion in which our sharing of what we know helps to convince them about the importance of meeting and buying from us.

a) Handling objections through LAPAC

One of the important techniques that one can use for handling objections is known as **LAPAC (Listen, Acknowledge, Probe, Answer and Confirm)**. This method can be used to deal with objections at any stage of the sales process. It respects the prospect's point of view, shows we are listening and persuades rather than attacks the prospect. Let us look at its elements:

i. Listen

Actively pay attention to all statements and gestures. This becomes important especially to know what the underlying concern is. Sometimes the prospect may need to be gently probed with questions to clarify the issue.

Example

What does the term 'no money' mean?

- ✓ Is it that there is no money now or
- ✓ Is it that the price is too high to buy it or
- ✓ Is it that the prospect does not feel that the money is worth spending?

ii. Acknowledge

It is very important to affirm aloud so that both the prospect and the salesperson are on the same page. Acknowledgement is also linked to another very critical act, namely empathising with the prospect. Empathy does not mean that one necessarily agrees with the position taken by the other party. But it certainly means that one respects and tries to see it from the other person's point of view.

Example

Once you are able to see the prospect's reluctance to spend the money, you must express that you can see and understand how he feels. Probably you have faced a similar situation and some sharing on your part could demonstrate your understanding of what the other party is going through.

iii. Probe

This step is intended to seek more information about the prospect's concern area. Remember that if the prospect has a problem in buying, that problem or set of problems have to be sorted out by the prospect himself, either by making a change in his thinking and mind-set or his action.

Example

If the prospect is too busy, he / she must find the time and inclination to meet you. If money is the problem, he / she needs to find ways to generate it.

Probing can do two things. If done in a counselling oriented and friendly manner, a set of gentle questions could guide the prospect towards finding answers to his / her own concerns. Probing can also help to elicit further details of the problem situation which causes the objection. Such information could be important and cannot be overlooked when one is answering the objection.

iv. Answer

The task here is to obviously provide a carefully worded reply that suits the situation and is convincing to the prospect. Answers must be directed at and address the concerns that are raised. They must not be evasive or seek to deflect the concerns.

v. Confirm

The last step is to confirm whether the prospect is satisfied with the answer and if there is anything else needing to be known. If the body language and other signals make you feel that the prospect is not fully convinced, you may need to offer alternative options that he could consider. Getting this confirmation is very important because once a prospect says he / she is satisfied, the ground is laid for moving to the close of the sale.

7. Step VII: Closing the sale

Definition

Closing is the process of persuading the prospect to buy now. The key to successful closing lies in helping the prospect to want to say "yes".

We begin by summarising the presentation, making sure that the prospect understands exactly what the proposal is, and then leading the prospect into an affirmative answer. At this point, when we know that the prospect understands the proposal and is in an affirmative mood, we can conduct a definite close.

a) Closing methods

i. Implied consent

One approach often used is the "implied-consent" method. We simply start filling out the application asking a simple question such as "now, your last name is spelled as ________". If the prospect does not stop us, the sale has probably been made.

ii. Offering alternatives

Another closing method is to offer the prospect an alternative between two minor decisions, either of which would lead to a close. For example, we may ask the prospect if she would prefer to make his payments once a year or twice a year. Here assumed consent is combined with a seemingly minor decision.

While making a close it is important that one should not try high pressured tactics to make a prospect buy something for which there is no real need or where the prospect cannot afford what is being recommended. Such practices of selling are unethical.

In other cases where we are persuading the prospect to take positive action, we must be aware that we are actually rendering an important service to the prospective customer, which the latter would eventually recognise and appreciate.

8. Step VIII: Sales follow-through

Between the time that the application is submitted and the policy is completed and delivered, the four most important responsibilities of the agent are to see that:

i. The application is clear, complete and accurate

ii. Being actively involved in making sure that any further investigations that are required gets completed in a convenient and timely manner

iii. The client's advisors, such as accountants or attorneys, are treated in the same manner that our client is treated and that we do not invade their areas of expertise, and

iv. That all questions and requests are promptly followed up

9. Step IX: Policy delivery

Delivering the policy is an extremely important step in the insurance sales cycle. It provides the agent with the opportunity to perform four important functions:

i. To resell and reaffirm the need

ii. To get the client thinking about the next purchase

iii. To get referrals and

iv. To build prestige

a) Policy delivery procedure

As with the sales process, a proper policy delivery requires a structured, step-by-step procedure such as:

i. Check the entire policy for accuracy

ii. Prepare the policy and the policy wallet, if available

iii. Telephone the client for an appointment

iv. Thoroughly prepare for the delivery interview

v. Congratulate the client for purchasing the insurance

vi. Explain the features, advantages, and benefits of the policy. Relate all benefits to the client's actual situation using names of family members, motivational stories, etc.

vii. Prepare the client for the next sale. Remind the client of the needs that have not yet been covered. Tell him or her of the need to periodically review these

viii. Commit sincerely to the client's service. Tell the client we will contact him / her regularly and that he / she should call us immediately if there are any questions or problems

ix. Ask the client for referred leads

10. Step X: Commitment to service

Service on the part of the agent is an integral element of the sales cycle. Essential to a commitment to service is a structured program for maintaining contact with our clients. Such a program could consist of:

a) Conveying clearly

At the time of the policy delivery, we need to make a service commitment to our client. We should tell the client that at least once a year we will call to carefully review his / her insurance program. Many good agents set the exact date for this service call before leaving the delivery interview.

b) Committing to continuous contact

Throughout the year a good agent should keep in touch with the client in as many ways as possible. The agent may want to send greeting cards on birthdays, wedding anniversaries, etc. A small gift that is personal and useful may be sent from time to time. Newspaper clippings, insurance related items, picture postcards when on trips, are all tokens of the agent's thoughtfulness and may be sent to the client on a random basis.

c) **Annual service review plan**

At least once a year, one must schedule an annual service review with the client. We should schedule this service call well in advance. During the annual service review, one can take the opportunity to remind the client why he / she purchased his / her latest policy, may discuss any needs of the client which are yet unfulfilled, and if appropriate, can suggest to the client that additional insurance be purchased at this time to cover his / her outstanding needs.

Persistency

One of the important reasons for having a proper sales and service follow up is to ensure that the policy holder continues to keep the policy in force through regular payment of premiums.

Definition

Persistency may be defined by the percentage of policies / premiums introduced in a certain year that have been renewed in subsequent years.

It is observed that most policies which lapsed and are not renewed do so within the first three years. When policies lapse the company loses, because the heavy costs that have been incurred at the time of acquiring new business may not have been recovered. More significantly, low persistency is also often a symptom of dissatisfaction and loss of confidence of the insured with the insurer. If the agent does not take care of his or her client, both during the sales and post sales stages, such dissatisfaction can soon lead to loss of credibility of both the agent and the company he or she represents. Hence it is very necessary to carefully monitor persistency rates as it is a sure sign of the health of the company.

The importance of continuous service cannot be overemphasised. It is one of the critical keys to high persistency. We, particularly in insurance sales, always need to remember that while our purpose is to provide a need based solution to the customers we must also sincerely commit to a continuous service that cannot be matched by any other competitor.

Test Yourself 1

Which of the below statement best describes a "testimonial"?

I. An endorsement from a satisfied customer
II. Test result for a product in a benchmarking test
III. List of tests that a product must pass
IV. Money required to test a product

Summary

- Selling as a profession refers to the act of inducing a commercial transaction through inducing the purchase of a product or service, such act being carried out with the intent of earning remuneration.

- Insurance agents are sales persons who seek to induce members of the community to buy insurance contacts written by the insurance company that they represent.

- Prospecting is the process of gathering names of people who can be approached for a sales interview.

- Target markets for prospecting include:

✓ Immediate group
✓ Natural market
✓ Centres of influence
✓ References, introductions and testimonials
✓ Other service providers

- A professional, efficient method of selling on a group basis includes conducting seminars and events.

- An easy and viable means of reaching out to prospects on a mass scale include emails, newsletters, personal website or blog, social networking websites etc.

- "Qualified" prospects are those people:

✓ who can pay for insurance,
✓ who can pass the company underwriting requirements,
✓ who have one or more needs for insurance products, and
✓ who can be approached on a favourable basis

- During a sales interview with the prospect; the agent should do a need – gap analysis

- In need gap analysis we engage in a process of gathering detailed information about the prospect's insurance requirements, to identify and determine the assets and perils for which there is inadequate coverage.

- After completing the sales interview successfully, the agent should design a solution based on the prospect's need and present the solution.

- The agent may handle client objections using the LAPAC (Listen, Acknowledge, Probe, Answer and Confirm) approach.
- Closing a sale involves persuading the prospect to buy now. While closing the agent may use the 'implied consent' method or offer alternatives to the prospect.

- Once the sale is closed, the agent should do a sale follow-through and deliver the policy

- Service on the part of the agent is an integral element of the sales cycle. Essential to a commitment to service is a structured program for maintaining contact with our clients.

Key Terms

1. Selling as a profession
2. Sales process
3. Prospecting
4. Natural market
5. Centres of influence
6. Reference
7. Testimonial
8. Qualified prospects
9. Need-gap analysis
10. LAPAC (Listen, Acknowledge, Probe, Answer and Confirm)
11. Closing
12. Implied consent

Answers to Test Yourself

Answer 1

The correct answer is I.

A testimonial is an endorsement from a satisfied customer.

Self-Examination Questions

Question 1

The key to successful closing lies in helping the prospect to say ________.

I. No
II. Don't know
III. Yes
IV. Maybe

Question 2

Which of the following is not part of sales process?

I. Prospecting
II. Sales interview
III. Loss assessment
IV. Closing

Question 3

Prospecting in an insurance sale is ___________.

I. Gathering the names of people who may be interested in insurance
II. Preparing a list of all the persons in the city
III. Enlisting all the policyholders of the branch office
IV. Preparing list of all the agents in the neighbourhood

Question 4

In insurance, need-gap analysis involves _____________.

I. Identifying the areas where the prospect needs insurance protection
II. Identifying people to work as insurance agents
III. Identifying how much assets a prospect has
IV. Identifying the poverty level of the prospects

Question 5

Cold Calling is ___________.

I. Meeting customers in winter
II. Meeting customers when they are suffering from cold
III. Meeting people unannounced
IV. Meeting customer after fire was extinguished

Question 6

________ as a profession refers to the act of inducing a commercial transaction through inducing the purchase of a product or service, such act being carried out with the intent of earning remuneration.

I. Marketing
II. Selling
III. Advertising
IV. Promotion

Question 7

Which of the below statement is correct?

I. Life insurance is sold, not bought
II. Life insurance is bought, not sold
III. Life insurance is neither bought nor sold; it is a necessity and hence should be bought by every individual.
IV. None of the above

Question 8

Which of the below statement is correct?

I. Selling is an art and not a science
II. Selling is a science and not an art
III. Selling is neither an art or a science
IV. Selling is both an art and a science

Question 9

While prospecting for selling insurance, approaching the members of a caste or community association will be classified under which category?

I. Immediate group
II. Natural market
III. Centres of influence
IV. References and introductions

Question 10

Identify the incorrect statement with regards to a 'qualified' prospect.

I. A qualified prospect is one who can pay for insurance
II. A qualified prospect is one who can be approached on a favourable basis
III. A qualified prospect is one who is academically well qualified to buy insurance
IV. A qualified prospect is one who can pass the company underwriting requirements

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Answers to Self-Examination Questions

Answer 1

The correct option is III.

The key to successful closing lies in helping the prospect to say "Yes".

Answer 2

The correct option is III.

Loss assessment is not a part of the sales process.

Answer 3

The correct option is I.

Prospecting in an insurance sale is gathering the names of people who may be interested in insurance.

Answer 4

The correct option is I.

Need-gap analysis involves identifying the areas where the prospect needs insurance protection.

Answer 5

The correct option is III.

Cold calling involves meeting people unannounced.

Answer 6

The correct option is II.

Selling as a profession refers to the act of inducing a commercial transaction through inducing the purchase of a product or service, such act being carried out with the intent of earning remuneration.

Answer 7

The correct option is I.

The correct statement is "life insurance is sold, not bought".

Answer 8

The correct option is IV.

Selling is both an art and a science.

Answer 9

The correct option is II.

While prospecting for selling insurance, approaching the members of a caste or community association will be classified under natural market category.

Answer 10

The correct option is III.

Option III is incorrect.
In insurance, while qualifying prospects, their academic qualification does not have much role to play with the decision for buying insurance.

CHAPTER 19

CUSTOMER SERVICE

Chapter Introduction

In this chapter you will learn the importance of customer service. You will learn the role of agents in providing service to customers. You will also learn how to communicate and relate with the customer.

Learning Outcomes

A. Importance of customer service
B. Insurance agent's role in providing great customer service
C. Communication skills

A. Importance of customer service

1. Why customer service?

Customers provide the bread and butter of a business and no enterprise can afford to treat them indifferently. The role of customer service and relationships is far more critical in the case of insurance than in other products. This is because insurance is a service and very different from real goods.

Let us examine how buying insurance differs from purchasing a car.

Car	Insurance of the car
It is a tangible good, that can be seen, test driven and experienced.	It is a contract to compensate against loss or damage to the car due to an unforeseen accident in future. One cannot see or touch or experience the insurance benefit till the unfortunate event occurs.
The buyer of the car has an expectation of some pleasure at the time of purchase. The experience is real and easy to understand.	The purchase of insurance is not based on expectation of immediate pleasure, but fear / anxiety about a possible tragedy. It is unlikely that any insurance customer would look forward to a situation where the benefit becomes payable.
A car is produced in a factory assembly line, sold in a showroom and used on the road. The three processes of making, selling and using take place at three different times and places.	In case of insurance it can be seen that production and consumption happen simultaneously. This simultaneity of production and consumption is a distinctive feature of all services.

What the customer really derives is a service experience. If this is less than expected, it causes dissatisfaction. If the service exceeds expectations, the customer would be delighted. The goal of every enterprise should thus be to delight its customers.

2. Quality of service

It is necessary for life insurance companies and their personnel, which includes their agents, to render high quality service and delight the customer.

But what is high quality service? What are its attributes?

A well-known model on service quality (named "**SERVQUAL**") would give us some insights. It highlights five major indicators of service quality:

a) **Reliability**: The ability to perform the promised service dependably and accurately. Most customers regard reliability as being the most important of the five dimensions of service quality. It is the foundation on which trust is built.

b) **Responsiveness**: Refers to the willingness and ability of service personnel to help customers and provide prompt response to the customer's needs. It may be measured by indicators like speed, accuracy and attitude that are displayed while giving the service.

c) **Assurance**: Refers to the knowledge, competence and courtesy of service providers and their ability to convey trust and confidence. It is given by the customer's evaluation of how well the service employee has understood needs and is capable of meeting them.

d) **Empathy**: Is described as the human touch. It is reflected in the caring attitude and individualised attention provided to customers.

e) **Tangibles**: Represent the physical environmental factors that the customer can see, hear and touch. For instance the location, the layout and cleanliness and the sense of order and professionalism that one gets when visiting a life insurance company's office can make a great impression on the customer. The physical ambience becomes especially important because it creates first and lasting impressions, before and after the actual service is experienced.

3. Customer service and insurance

Ask any leading sales producers in the life insurance industry about how they managed to reach the top and stay there. You are likely to get a common answer, that it was the patronage and support of their existing clients that helped them build their business. You would also learn that a large part of their income comes from the commissions for renewal of the contracts. Their clients are also the source for acquiring new customers.

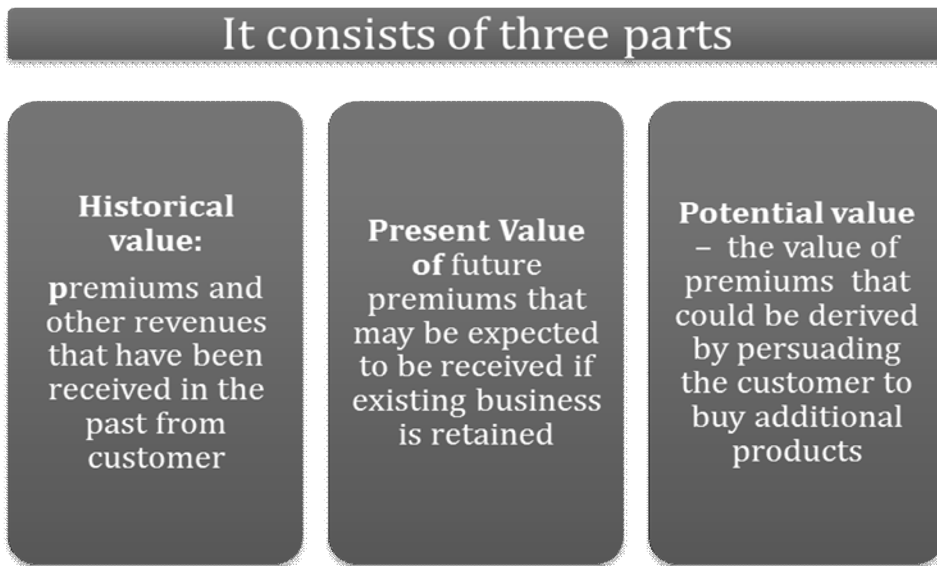
What is the secret of their success? The answer, most likely is, **commitment to serving their customers.**

How does keeping a customer happy benefit the agent and the company? To answer this question, it would be useful to look at customer's lifetime value.

Definition

Customer lifetime value may be defined as the sum of economic benefits that can be derived from building a sound relationship with a customer over a long period of time.

Diagram 1: Customer lifetime value



An agent who renders service and builds close relationships with customers; builds goodwill and brand value, which helps in expanding the business.

Test Yourself 1

What is meant by customer lifetime value?

I. Sum of costs incurred while servicing the customer over his lifetime
II. Rank given to customer based on business generated
III. Sum of economic benefits that can be achieved by building a long term relationship with the customer
IV. Maximum insurance that can be attributed to the customer

B. Insurance agent's role in providing great customer service

Let us now consider how an agent can render great service to the customer. The role begins at the stage of sale and continues through the duration of the contract. Let us look at some of the milestones in a contract and the role played at each step.

1. Point of sale - Best advice

The first point for service is the point of sale. One of the critical issues involved in purchase of life insurance is to determine the **amount of coverage (sum assured) to be bought.**

The agent really begins to earn her commission when she renders best advice on the matter. Life insurance products, as we have seen, are purchased to meet a range of protection and saving needs that arise during an individual's lifetime.

The agent should be able to understand these needs and suggest products whose benefit features are most appropriate for meeting these needs.

The agent's role is to relate to the customer as a coach and partner who would help him to manage his life contingent risk more effectively.

In other words the role of an insurance agent is more than that of a mere sales person. She also **needs to be a personal financial planner and advisor, an underwriter, a designer of customised solutions and a relationship builder who thrives on building trust and long-term relationships,** all rolled into one.

2. Proposal stage

The agent has to support the customer in filling out the proposal for life insurance. The insured is required to take responsibility for the statements made therein.

It is very important that the agent should explain and clarify to the proposer the details to be filled as answer to each of the questions in the proposal form. In the event of a claim, a failure to give proper and complete information can jeopardize the customer's claim.

Sometimes there may be additional information that may be required to complete the policy. In such cases the company may inform the customer directly or through the agent / advisor. In either case, it becomes necessary to help the customer complete all the required formalities and even explain to him or her why these are necessary.

3. Acceptance stage

a) First premium receipt (FPR)

It is the agent's responsibility to ensure that the FPR is issued by the company to the insured. Promptness in this regard communicates to the client that his interests are safe in the hands of the agent and the company.

b) Delivery of the policy document

Delivery of the policy is another major opportunity that an agent gets to make contact with the customer. If company rules permit a policy document being delivered in person, it may be a good idea to collect it and present the document to the customer.

If the policy is being sent directly by mail, one must contact the customer, once it is known that the policy document has been sent. This is an opportunity to visit the customer and explain anything that is unclear in the document received. This is also an occasion to clarify various kinds of policy provisions and the policyholder's rights and privileges that the customer can avail of. This act demonstrates a willingness to provide a level of service beyond the sale.

This meeting is also an occasion to pledge the agent's commitment to serving the customer and communicating full support.

The next logical step would be to ask for the names and particulars of other individuals he knows who can possibly benefit from the agent's services. If the client can himself contact these people and introduce the agent to them, it would mean a great breakthrough in business.

c) Premium payment

The agent has to be in touch with the client to remind him / her of the premium payable so that the policy does not lapse.

The relationship gets strengthened by keeping in touch with the client from time to time, by greeting him on some occasion like a festival or a family event. Similarly when there is a moment of difficulty or sorrow, by offering assistance, one demonstrates that one is available when needs.

4. Claims settlement

The agent has a crucial role to play at the time of claim settlement. It is her /his task to ensure that the details of claim are immediately informed to the insurer and any claim investigation that may be necessary are supported to expedite the process.

5. Other services

The agent, by maintaining regular touch with her / his policyholders, can render other services to the policyholder such as arranging for prompt issue of duplicate policy, policy loan payment, change in nomination, assignment and facilitating revival of lapsed policies.

6. Grievance redressal

The time for high priority action is when the customer has a complaint. Remember that in the case of a complaint, the issue of service failure (it can range from delay in correcting the records of the insurer to a lack of promptness in settling a claim) which has aggrieved the customer is only a part of the story.

Customers get upset and infuriated a lot more because of their interpretations about such failure. There are two types of feelings and related emotions that arise with each service failure:

- ✓ Firstly there is a sense of unfairness, a feeling of being cheated.
- ✓ The second feeling is one of hurt ego – of being made to look and feel small.

A complaint is a crucial "**moment of truth**" in the customer relationship; if the company gets it right there is a potential to actually improve customer loyalty. The human touch is critical in this; customers want to feel that they are valued.

If you are a professional life insurance advisor, you would not allow such a situation to happen in the first place. You would take the matter up with the appropriate officer of the company. **Remember, no one else in the company has ownership of the client's problems as much as you do**.

Complaints / grievances provide us the opportunity to demonstrate how much we care for the customer's interests. They are in fact the solid pillars on which a life insurance agent's goodwill and business is built. At the end of every policy document, the insurance companies have detailed the procedure of grievance, which should be brought to the notice of the customers at the time of explaining the document provisions.

Word of mouth publicity (good / bad) has a significant role in selling and servicing. Remember good service gets rewarded by 5 people being informed, where as bad service is passed on to 20 people.

Test Yourself 2

In a customer's mind, there are two types of feelings and related emotions that arise with each service failure on part of the insurance company. These feelings are

I. Confusion and empathy
II. Dishonesty and revenge
III. Ignorance and sympathy
IV. Sense of unfairness and hurt ego

C. Communication skills

1. Communication skills in customer service

One of the most important set of skills that an agent or service employee needs to possess, for effective performance in the work place, is **soft skills.**

Unlike hard skills – which deal with an individual's ability to perform a certain type of task or activity - **soft skills relate to one's ability to interact effectively with other workers and customers, both at work and outside.**

Communication skills are one of the most important of these soft skills.

2. Communication and customer relationships

Customer service is one of the key elements in creating satisfied and loyal customers. But it is not enough. Customers are human beings with whom the company needs to build a strong relationship.

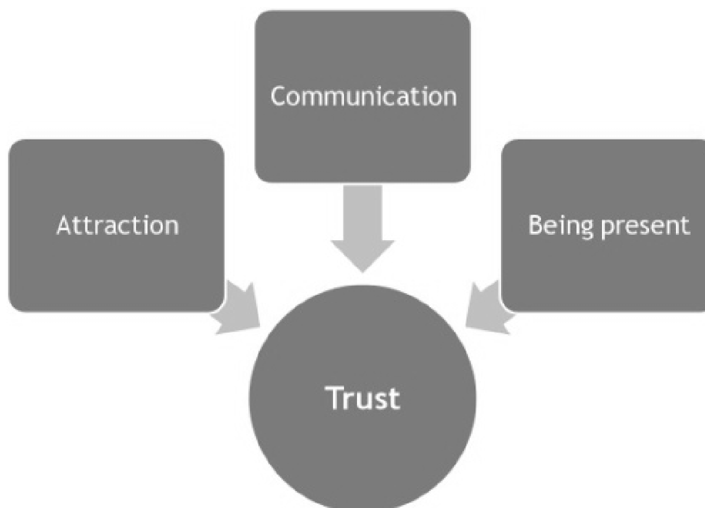
It is both the service and the relationship experience that ultimately shapes how the customer would look at the company.

a) Elements that promote trust

What goes to make a healthy relationship? At its heart, of course, there is trust. At the same time there are other elements, which reinforce and promote that trust.

Let us illustrate

Diagram 1: Trust



i. Every relationship begins with attraction

One needs to be simply liked and must be able to build a rapport with the customer. Attraction is very often the result of first impressions that are derived when a customer comes in touch with the organisation or its representatives. Attraction is the first key to unlocking every heart.

Without attraction, a relationship is hardly possible. Consider a sales person who is not liked. Do you really think he or she will be able to make much headway in the sales career?

ii. The second element of a relationship is one's presence – being there when needed:

The best example is perhaps that of a marriage. Is it important for the husband to be available when the wife needs him? **Similarly in a customer relation, the issue is whether and how the company or its representative is available when needed. Is he or she fully present and listening to the customer's needs?**

iii. Communication

There may be instances when one is not fully present and is unable to do full justice to all the expectations of one's customers. **One can still maintain a strong relationship if one can speak to the customer, in a manner that is assuring, full of empathy and conveys a sense of responsibility.**

All the above - the impression one creates, or the way one is present and listens, or the message one sends across to another – are dimensions of communication and call for discipline and skills. In a sense what one communicates is ultimately a function of how one thinks and sees.

Companies today emphasise a lot on customer relationship management since the cost of retaining a customer is far lower than that of acquiring a new customer. The customer relation occurs across many touch points e.g. while understanding a customer's insurance needs, explaining policy cover, handing over forms. So, there are many opportunities for the agent to strengthen the relation at each of these points.

3. Process of communication

All communications require a sender, who transmits a message, and a recipient of that message. The process is complete once the receiver has understood the message of the sender.

Communication may take place in several forms:

- ✓ Oral,
- ✓ Written,
- ✓ Non-verbal and
- ✓ Using body language

It may be face to face, over the phone, or by mail or internet. It may be formal or informal. Whatever the content or form of the message or the media used, the essence of communication is given by what the recipient has understood as being communicated.

It is important for a business to choose how and when it will send messages to intended receivers.

4. Non-verbal communication

Let us now look at some **concepts** that the agent needs to understand.

a) Making a great first impression

We have already seen that attraction is the first pillar of any relationship. You can hardly expect to get business from a customer who does not like you. In fact many individuals need just a quick glance, of maybe a few seconds, to judge and evaluate you when you meet for the first time. Their opinion about you gets based on your appearance, your body language, your mannerisms, and how you are dressed and speak. Remember, **first impressions last** for long. Some useful tips for making a good first impression are:

i. **Be on time always.** Plan to arrive a few minutes early, allowing flexibility for all kinds of possible delays

ii. **Present yourself appropriately**. Your prospect, whom you are meeting for the first time, does not know you and your appearance is usually the first clue he or she has to go on.

- ✓ Is your appearance helping to create the right first impression?
- ✓ Is the way you dress appropriate for the meeting or occasion?
- ✓ Is your grooming clean and tidy – with good haircut and shave, clean and tidy clothes, neat and tidy make up.

iii. **A warm, confident and winning smile** puts you and your audience immediately at ease with one another

iv. **Being open, confident and positive**

- ✓ Does your body language project confidence and self-assurance?
- ✓ Do you stand tall, smile, make eye contact, greet with a firm handshake?
- ✓ Do you remain positive even in the face of some criticism or when the meeting is not going as well as expected?

v. **Interest in the other person** -The most important thing is about being genuinely interested in the other person.

- ✓ Do you take some time to find out about the customer as a person?
- ✓ Are you caring and attentive to what he or she says?
- ✓ Are you totally present and available to your customer or is your mobile phone engaging you during half your interview?

b) Body Language

Body language refers to movements, gestures, facial expressions. The way we talk, walk, sit and stand, all say something about us, and what is happening inside us. It is often said that people listen to only a small percentage of what is actually said. What we don't say speaks a lot more and a lot louder. Obviously, one needs to be very careful about one's body language.

i. Confidence

Here are a few tips about how to appear confident and self-assured – giving the impression of someone to be seriously listened to:

- ✓ Posture – standing tall with shoulders held back
- ✓ Solid eye contact - with a "smiling" face
- ✓ Purposeful and deliberate gestures

ii. Trust

Quite often, a sales person's words fall on deaf ears because her audience does not trust her, her body language does not give the assurance that she is sincere about what she says. It is very important to be aware of some of the typical signs that may indicate when one is not honest and believable and be on guard against them as listed below:

- ✓ Eyes maintaining little or no eye contact, or rapid eye movements
- ✓ Hand or the fingers are in front of one's mouth when speaking
- ✓ One's body is physically turned away from the other
- ✓ One's breathing rate increases
- ✓ Complexion changes colour; red in face or neck area
- ✓ Perspiration increases
- ✓ Voice changes such as change in pitch, stammering, throat clearing
- ✓ Speech – slow and clear with tone of voice kept moderate to low

Some body movements that indicate defensiveness and non-receptivity include:

- ✓ Hand / arm gestures are small and close to one's body
- ✓ Facial expressions are minimal
- ✓ Body is physically turned away from you.
- ✓ Arms are crossed in front of body
- ✓ Eyes maintain little contact, or are downcast

If your customer expresses any of these, perhaps it is time you checked yourself and paid more attention to what is going on in the customer's mind.

5. Listening skills

The third set of communication skills that one needs to be aware about and cultivate are listening skills. These follow from a well-known principle of personal effectiveness – **'first to understand before being understood'**. How well you listen has a major impact on your job effectiveness, and on the quality of your relationships with others. Let us look at some listening tips.

a) **Active Listening**: is where we consciously try to hear not only the words but also, more importantly, try to understand the complete message being sent by another.

Let us look at some of the elements of active listening. They are:

i. Paying Attention

We need to give the speaker our undivided attention, and acknowledge the message. Note, non-verbal communication also "speaks" loudly. Some aspects of attention are as follows:

- ✓ Look at the speaker directly
- ✓ Put aside distracting thoughts
- ✓ Don't mentally prepare a rebuttal!
- ✓ Avoid all external distractions (for instance, keep your mobile on silent mode)
- ✓ "Listen" to the speaker's body language

ii. Demonstrating that you are listening

Use of body language plays an important role here. For instance one may:

- ✓ Give an occasional nod and smile
- ✓ Adopt a posture that is open and draws out the other to speak freely
- ✓ Have small verbal comments like yes and uh huh that encourage the speaker

iii. Provide feedback

A lot of what we hear may get distorted by our personal filters, like the assumptions, judgments, and beliefs we carry. As a listener, we need to be aware of these filters and try to understand what really is being said.

- ✓ This may require you to reflect on the message and ask questions to clarify what was said
- ✓ Another important way to provide feedback is to paraphrase the speaker's words
- ✓ Yet a third way is to periodically stop the speaker and make a summary of what the speaker has said and repeat it back to him or her

Example

Asking for clarity: From what I have heard, am I right in assuming, that you have issues about the benefits of some of our saving plans, could you be more specific?

Paraphrasing the speaker's exact words: So you are saying that 'our saving plans are not providing benefits that are attractive enough' – have I understood you correctly?

iv. Not being Judgmental

One of the biggest hurdles to active listening is our **tendency to be judgmental and biased about the speaker.** The result is that the listener may hear, what the speaker says but listens according to her own biased interpretation of what the speaker might be saying.

Such judgmental approach can result in the listener being unwilling to allow the speaker to continue speaking, considering it a waste of time.
It can also result in interrupting the speaker and rebutting the speaker with counter arguments, even before he or she has been able to convey the message in full.

This will only frustrate the speaker and limits full understanding of the message. Active listening calls for:

- ✓ Allowing the speaker to finish each point before asking questions
- ✓ Not interrupting the speaker with any counter arguments

v. Responding appropriately

Active listening implies much more than just hearing what a speaker says. The communication can be completed only when the listener responds in some way, through word or action.

Certain rules need to be followed for ensuring that the speaker is not put down but treated with respect and deference. These include:

- ✓ Being candid, open, and honest in your response
- ✓ Asserting one's opinions respectfully
- ✓ Treating another person in a way you would like to be treated yourself

vi. Empathetic listening

Being empathetic literally means putting yourself in the other person's shoes and feeling his or her experience as he or she would feel it.

Listening with empathy is an important aspect of all great customer service. It becomes especially critical when the other person is a customer with a grievance and in a lot of pain.

Empathy implies hearing and listening patiently, and with full attention, to what the other person has to say, even when you do not agree with it. It is important to show the speaker acceptance, not necessarily agreement. One can do so by simply nodding or injecting phrases such as "I understand" or "I see."

Test Yourself 3

Which among the following is not an element of active listening?

I. Paying good attention
II. Being extremely judgmental
III. Empathetic listening
IV. Responding appropriately

Summary

- The role of customer service and relationships is far more critical in the case of insurance than in other products.

- A well-known model on service quality (named "SERVQUAL") would give us some insights. It highlights five major indicators of service quality:

  - ✓ Reliability,
  - ✓ Responsiveness
  - ✓ Assurance,
  - ✓ Empathy and
  - ✓ Tangibles

- The secret to the success of leading sales producers in the life insurance industry is their commitment to serving their customers

- Customer lifetime value may be defined as the sum of economic benefits that can be derived from building a sound relationship with a customer over a long period of time.

- The insurance agent needs to be a personal financial planner and advisor, an underwriter, a designer of customised solutions and a relationship builder who thrives on building trust and long-term relationships, all rolled into one.

- The agent has a crucial role to play at the time of claim settlement. It is her task to ensure that the details of claim are immediately informed to the insurer and any claim investigation that may be necessary are supported to expedite the process.

- Soft skills relate to one's ability to interact effectively with other workers and customers, both at work and outside.

- The elements that promote trust include:

  - ✓ Attraction
  - ✓ Being present
  - ✓ Communication

- Communication may take place in several forms:

  - ✓ Oral,
  - ✓ Written,
  - ✓ Non-verbal and
  - ✓ Using body language

- The agent can make a great first impression on the client by:

✓ Being on time always
✓ Presenting himself or herself appropriately
✓ Always having a warm, confident and winning smile
✓ Being open, confident and positive
✓ Being genuinely interested in the other person

- Active listening involves:

✓ Paying attention,
✓ Demonstrating that you are listening
✓ Providing feedback
✓ Not being judgmental
✓ Responding appropriately

Key Terms

1. Customer service
2. Quality of service
3. SERVQUAL
4. Customer lifetime value
5. Soft skills
6. Communication
7. Body language
8. Active listening
9. Empathetic listening

Answers to Test Yourself

Answer 1

The correct option is III.

Sum of economic benefits that can be achieved by building a long term relationship with the customer is referred to as customer lifetime value.

Answer 2

The correct option is IV.

In a customer's mind, there are two types of feelings and related emotions that arise with each service failure on part of the insurance company. These feelings are: sense of unfairness and hurt ego

Answer 3

The correct option is II.

Being extremely judgmental is not an element of active listening.

Self-Examination Questions

Question 1

_____________ is not a tangible good.

I. House
II. Insurance
III. Mobile Phone
IV. A pair of jeans

Question 2

_____________ is not an indicator of service quality.

I. Cleverness
II. Reliability
III. Empathy
IV. Responsiveness

Question 3

In customer relationship the first impression is created:

I. By being confident
II. By being on time
III. By showing interest
IV. By being on time, showing interest and being confident

Question 4

Select the correct statement:

I. Ethical behaviour is impossible while selling insurance
II. Ethical behaviour is not necessary for insurance agents
III. Ethical behaviour helps in developing trust between the agent and the insurer
IV. Ethical behaviour is expected from the top management only

Question 5

Active listening involves:

I. Paying attention to the speaker
II. Giving an occasional nod and smile
III. Providing feedback
IV. Paying attention to the speaker, giving an occasional nod and smile and providing feedback

Question 6

__________ refers to the ability to perform the promised service dependably and accurately.

I. Reliability
II. Responsiveness
III. Assurance
IV. Empathy

Question 7

____________ relate to one's ability to interact effectively with other workers and customers, both at work and outside.

I. Hard skills
II. Soft skills
III. Negotiating skills
IV. Questioning skills

Question 8

Which of the below elements promote trust?

I. Communication, assertiveness and being present
II. Politeness, affirmation and communication
III. Attraction, communication and being present
IV. Affirmation, assertiveness and attraction

Question 9

Which of the below tips are useful for making a good first impression?

I. Being on time always
II. Presenting yourself appropriately
III. Being open, confident and positive
IV. All of the above

Question 10

___________ is reflected in the caring attitude and individualised attention provided to customers.

I. Assurance
II. Empathy
III. Reliability
IV. Responsiveness

Answers to Self-Examination Questions

Answer 1

The correct option is II.

Insurance is not a tangible good.

Answer 2

The correct option is I.

Cleverness is not an indicator of service quality.

Answer 3

The correct option is IV.

In customer relationship the first impression is created by being confident, on time and by showing interest.

Answer 4

The correct option is III.

Ethical behaviour helps in developing trust in the agent and the insurer.

Answer 5

The correct option is IV.

Active Listening involves paying attention to the speaker, giving an occasional nod and smile and providing feedback.

Answer 6

The correct option is I.

Reliability refers to the ability to perform the promised service dependably and accurately.

Answer 7

The correct option is II.

Soft skills relate to one's ability to interact effectively with other workers and customers, both at work and outside.

Answer 8

The correct option is III.

Attraction, communication and being present are the three elements that promote trust.

Answer 9

The correct option is IV.

Some useful tips for making a good first impression include: Being on time always, presenting yourself appropriately, being open, confident and positive etc.

Answer 10

The correct option is II.

Empathy is reflected in the caring attitude and individualised attention provided to customers.

CHAPTER 20

GRIEVANCE REDRESSAL MECHANISM

Chapter Introduction

Insurance industry is essentially a service industry where, in the present context, customer expectations are constantly rising and dissatisfaction with the standard of services rendered is ever present. Despite there being continuous product innovation and significant improvement in the level of customer service aided by use of modern technology, the industry suffers badly in terms of customer dissatisfaction and poor image. Alive to this situation the Government and the regulator have taken a number of initiatives.

IRDA's regulations stipulate the turnaround times (TAT) for various services that an insurance company has to render the consumer. These are part of the IRDA (Protection of Policyholders' Interests Regulations), 2002.Insurance companies are also required to have an effective grievance redressal mechanism and IRDA has created the guidelines for that too.

Learning Outcomes

A. Grievance redressal mechanism- consumer courts, ombudsman

A. Grievance redressal mechanism

1. Integrated Grievance Management System (IGMS)

IRDA has launched an Integrated Grievance Management System (IGMS) which acts as a central repository of insurance grievance data and as a tool for monitoring grievance redress in the industry.

Policyholders can register on this system with their policy details and lodge their complaints. Complaints are then forwarded to the respective insurance companies.

Grievance redressal mechanism

IGMS tracks complaints and the time taken for their redressal. The complaints can be registered at the following URL:

http://www.policyholder.gov.in/Integrated_Grievance_Management.aspx

2. The Consumer Protection Act, 1986

Important

This Act was passed "to provide for better protection of the interest of consumers and to make provision for the establishment of consumer councils and other authorities for the settlement of consumer's disputes". The Act has been amended by the Consumer Protection (Amendment) Act, 2002.

Some definitions provided in the Act are as follows:

Definition

"**Service**" means service of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance, transport, processing, supply of electrical or other energy, board or lodging or both, housing construction, entertainment, amusement or the purveying of news or other information. But it does not include the rendering of any service free of charge or under a contract of personal service.
Insurance is included as a service

"**Consumer**" means any person who

- ✓ Buys any goods for a consideration and includes any user of such goods. But it does not include a person who obtains such goods for resale or for any commercial purpose or

- ✓ Hires or avails of any services for a consideration and includes beneficiary of such services.

"**Defect**" means any fault, imperfection, shortcoming inadequacy in the quality, nature and manner of performance which is required to be maintained by or under any law or has been undertaken to be performed by a person in pursuance of a contract or otherwise in relation to any service.

"**Complaint**" means any allegation in writing made by a complainant that:

- ✓ an unfair trade practice or restrictive trade practice has been adopted
- ✓ the goods bought by him suffer from one or more defects
- ✓ the services hired or availed of by him suffer from deficiency in any respect
- ✓ price charged is in excess of that fixed by law or displayed on package
- ✓ goods which will be hazardous to life and safety when used are being offered for sale to the public in contravention of the provisions of any law requiring trader to display information in regard to the contents, manner and effect of use of such goods

"**Consumer dispute**" means a dispute where the person against whom a complaint has been made, denies and disputes the allegations contained in the complaint.

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a) Consumer disputes redressal agencies

"Consumer disputes redressal agencies" are established in each district and state and at national level.

i. District Forum

- ✓ The forum has jurisdiction to entertain complaints, where value of the goods or services and the compensation claimed is up to Rs.20 lakhs.
- ✓ The District Forum is empowered to send its order/decree for execution to appropriate civil court.

ii. State Commission

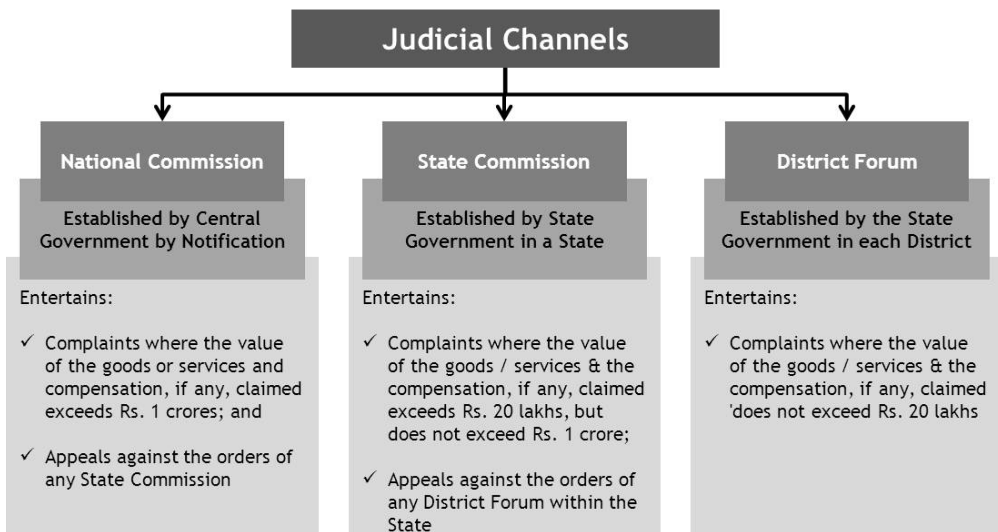
- ✓ This redressal authority has original, appellate and supervisory jurisdiction.
- ✓ It entertains appeals from the District Forum.
- ✓ It also has original jurisdiction to entertain complaints where the value of goods/service and compensation, if any claimed exceeds Rs. 20 lakhs but does not exceed Rs. 100 lakhs.
- ✓ Other powers and authority are similar to those of the District Forum.

iii. National Commission

- ✓ The final authority established under the Act is the National Commission.
- ✓ It has original, appellate as well as supervisory jurisdiction.
- ✓ It can hear the appeals from the order passed by the State Commission and in its original jurisdiction it will entertain disputes, where goods/services and the compensation claimed exceeds Rs.100 lakhs.
- ✓ It has supervisory jurisdiction over State Commission.

All the three agencies have powers of a civil court.

Diagram 2: Channels for grievance redressal



b) Procedure for filing a complaint

The procedure for filing a complaint is very simple in all above three redressal agencies. There is no fee for filing a complaint or filing an appeal whether before the State Commission or National Commission. The complaint can be filed by the complainant himself or by his authorised agent. It can be filed personally or can even be sent by post. It may be noted that no advocate is necessary for the purpose of filing a complaint.

c) Consumer Forum Orders

If the forum is satisfied that the goods complained against suffer from any of the defects specified in the complaint or that any of the allegations contained in the complaint about the services are proved, the forum can issue an order directing the opposite party to do one or more of the following namely,

i. To **return** to the complainant the **price**, (or premium in case of insurance), the charges paid by the complainant
ii. To award such amount as **compensation** to the consumers for any loss or injury suffered by the consumer due to negligence of the opposite party
iii. To remove the defects or **deficiencies** in the services in question
iv. To **discontinue the unfair trade practice** or the restrictive trade practice or not to repeat them
v. To provide for **adequate costs** to parties

d) Nature of complaints

The **majority of consumer disputes** with the three forums fall in the following main categories as far as insurance business are concerned

i. Delay in settlement of claims
ii. Non-settlement of claims
iii. Repudiation of claims
iv. Quantum of loss
v. Policy terms, conditions etc.

3. The Insurance Ombudsman

The Central Government under the powers of the Insurance Act, 1938 made **Redressal of Public Grievances Rules, 1998** by a notification published in the official gazette on November 11, 1998. These rules apply to life and non-life insurance, for all personal lines of insurances, that is, insurances taken in an individual capacity.

The objective of these rules is to resolve all complaints relating to settlement of claim on the part of the insurance companies in a cost effective, efficient and impartial manner.

The Ombudsman, by mutual agreement of the insured and the insurer can act as a mediator and counsellor within the terms of reference.

The decision of the Ombudsman, whether to accept or reject the complaint, is final.

a) Complaint to the Ombudsman

Any complaint made to the Ombudsman should be in writing, signed by the insured or his legal heirs, addressed to an Ombudsman within whose jurisdiction, the insurer has a branch/ office, supported by documents, if any, along with an estimate of the nature and extent of loss to the complainant and the relief sought.

Complaints can be made to the Ombudsman if:

i. The complainant had made a previous written representation to the insurance company and the insurance company had:

   - ✓ Rejected the complaint or
   - ✓ The complainant had not received any reply within one month after receipt of the complaint by the insurer

ii. The complainant is not satisfied with the reply given by the insurer
iii. The complaint is made within one year from the date of rejection by the insurance company
iv. The complaint is not pending in any court or consumer forum or in arbitration

b) Recommendations by the Ombudsman

There are certain duties/protocols that the Ombudsman is expected to follow:

i. Recommendations should be made within one month of the receipt of such a complaint
ii. The copies should be sent to both the complainant and the insurance company
iii. Recommendations have to be accepted in writing by the complainant within 15 days of receipt of such recommendation
iv. A copy of acceptance letter by the insured should be sent to the insurer and his written confirmation sought within 15 days of his receiving such acceptance letter

c) Award

If the dispute is not settled by intermediation, the Ombudsman will pass an award to the insured which he thinks is fair, and is not more than what is necessary to cover the loss of the insured.

The awards by Ombudsman are governed by the following rules:

i. The award should not be more than Rs.20 lakh (inclusive of ex-gratia payment and other expenses)
ii. The award should be made within a period of 3 months from the date of receipt of such a complaint, and the insured should acknowledge the receipt of the award in full as a final settlement within one month of the receipt of such award
iii. The insurer shall comply with the award and send a written intimation to the Ombudsman within 15 days of the receipt of such acceptance letter
iv. If the insured does not intimate in writing the acceptance of such award, the insurer may not implement the award

Test Yourself 1

The _______________ has jurisdiction to entertain complaints, where value of the goods or services and the compensation claimed is up to Rs.20 lakhs.

I. District Forum
II. State Commission
III. Zilla Parishad
IV. National Commission

Summary

- IRDA has launched an Integrated Grievance Management System (IGMS) which acts as a central repository of insurance grievance data and as a tool for monitoring grievance redress in the industry.

- Consumer disputes redressal agencies are established in each district and state and at national level.

- As far as insurance business is concerned, the majority of consumer disputes fall in categories such as delay in settlement of claims, non-settlement of claims, repudiation of claims, quantum of loss and policy terms, conditions etc.

- The Ombudsman, by mutual agreement of the insured and the insurer can act as a mediator and counsellor within the terms of reference.

- If the dispute is not settled by intermediation, the Ombudsman will pass award to the insured which he thinks is fair, and is not more than what is necessary to cover the loss of the insured.

Key Terms

1. Integrated Grievance Management System (IGMS)
2. The Consumer Protection Act, 1986
3. District Forum
4. State Commission
5. National Commission
6. Insurance Ombudsman

Answers to Test Yourself

Answer 1

The correct answer is I.

The District Forum has jurisdiction to entertain complaints, where value of the goods or services and the compensation claimed is up to Rs. 20 lakhs.

Self-Examination Questions

Question 1

Expand the term IGMS.

I. Insurance General Management System
II. Indian General Management System
III. Integrated Grievance Management System
IV. Intelligent Grievance Management System

Question 2

Which of the below consumer grievance redressal agencies would handle consumer disputes amounting between Rs. 20 lakhs and Rs. 100 lakhs?

I. District Forum
II. State Commission
III. National Commission
IV. Zilla Parishad

Question 3

Which among the following cannot form the basis for a valid consumer complaint?

I. Shopkeeper charging a price above the MRP for a product
II. Shopkeeper not advising the customer on the best product in a category
III. Allergy warning not provided on a drug bottle
IV. Faulty products

Question 4

Which of the below will be the most appropriate option for a customer to lodge an insurance policy related complaint?

I. Police
II. Supreme Court
III. Insurance Ombudsman
IV. District Court

Question 5

Which of the below statement is correct with regards to the territorial jurisdiction of the Insurance Ombudsman?

I. Insurance Ombudsman has National jurisdiction
II. Insurance Ombudsman has State jurisdiction
III. Insurance Ombudsman has District jurisdiction
IV. Insurance Ombudsman operates only within the specified territorial limits

Question 6

How is the complaint to be launched with an insurance ombudsman?

I. The complaint is to be made in writing
II. The complaint is to be made orally over the phone
III. The complaint is to be made orally in a face to face manner
IV. The complaint is to be made through newspaper advertisement

Question 7

What is the time limit for approaching an Insurance Ombudsman?

I. Within two years of rejection of the complaint by the insurer
II. Within three years of rejection of the complaint by the insurer
III. Within one year of rejection of the complaint by the insurer
IV. Within one month of rejection of the complaint by the insurer

Question 8

Which among the following is not a pre-requisite for launching a complaint with the Ombudsman?

I. The complaint must be by an individual on a 'Personal Lines' insurance
II. The complaint must be lodged within 1 year of the insurer rejecting the complaint
III. Complainant has to approach a consumer forum prior to the Ombudsman
IV. The total relief sought must be within an amount of Rs.20 lakhs.

Question 9

Are there any fee / charges that need to be paid for lodging the complaint with the Ombudsman?

I. A fee of Rs 100 needs to be paid
II. No fee or charges need to be paid
III. 20% of the relief sought must be paid as fee
IV. 10% of the relief sought must be paid as fee

Question 10

Can a complaint be launched against a private insurer?

I. Complaints can be launched against public insurers only
II. Yes, complaint can be launched against private insurers
III. Complaint can be launched against private insurers only in the Life Sector
IV. Complaint can be launched against private insurers only in the Non-Life Sector

Answers to Self-Examination Questions

Answer 1

The correct option is III.

IGMS stands for Integrated Grievance Management System.

Answer 2

The correct option is II.

State Commission would handle consumer disputes amounting between Rs. 20 lakhs and Rs. 100 lakhs.

Answer 3

The correct option is II.

Shopkeeper not advising the customer on the best product in a category cannot form the basis of a valid consumer complaint.

Answer 4

The correct option is III.

Complaint is to be lodged with the Insurance Ombudsman under whose territorial jurisdiction the insurer's office falls.

Answer 5

The correct option is IV.

Insurance Ombudsman operates only within the specified territorial limits.

Answer 6

The correct option is I.

The complaint to the ombudsman is to be made in writing.

Answer 7

The correct option is III.

The complainant must approach the ombudsman within one year of rejection of the complaint by the insurer.

Answer 8

The correct option is III.

Complainant need not approach a consumer forum prior to the Ombudsman.

Answer 9

The correct option is II.

No fee / charges need to be paid for lodging the complaint with the Ombudsman.

Answer 10

The correct option is II.

Yes, a complaint can be launched against private insurers.

ANNEXURE

List of life insurance companies currently operating in India

Bajaj Allianz Life Insurance
Birla Sun Life Insurance
HDFC Standard Life Insurance
ICICI Prudential Life Insurance
ING Vysya Life Insurance
Life Insurance Corporation of India
Max Life Insurance
PNB Metlife India Insurance
Kotak Mahindra Old Mutual Life Insurance
SBI Life Insurance
Tata AIA Life Insurance
Reliance Life Insurance
Aviva Life Insurance
Sahara India Life Insurance
Shriram Life Insurance
BhartiAxa Life Insurance
Future Generalli India Life Insurance
IDBI Federal Life Insurance
Canara HSBC Oriental Bank of Commerce Life Insurance
AegonReligare Life Insurance
DLF Pramerica Life Insurance
Star Union Dai-ichi Life Insurance
India First Life Insurance
Edelweiss Tokio Life Insurance