UNIT 20 LIFE INSURANCE

Objectives

After going through this unit, you should be able to:

- define pure risk and various types of risks;
- define insurance and explain the basic characteristics of insurance;
- describe various terms used in insurance contract;
- understand the design of life insurance product on the basis of contingencies involved, premium payment patterns and benefits;
- outline the different products of life insurance and their features; and
- understand unit-linked products and the products available in developed countries.

Structure

20.1 Origin of Insurance
20.2 Risk, Peril and Hazard
20.3 Classification of Risks
20.4 Insurable Risks
20.5 Definition of Insurance and Basic Characteristics
20.6 Basic Principles of Insurance
20.7 Classification of Insurance
20.8 Features of Property Insurance
20.9 Features of Liability Insurance
20.10 Insurance Market in India
20.11 Life Insurance: An Introduction
20.12 Product Design
20.13 Principal contingencies
20.14 Other Contingencies
20.15 Supplementary Benefits or Embedded options
20.16 Riders
20.17 Premium Payment Patterns
20.18 Various Products available in the Market
20.19 Income Tax Benefits on Life Insurance and Pension and Mediclaim Insurance
20.20 Life Insurance Industry in India
20.21 Summary
20.22 Self Assessment Questions

20.1 ORIGIN OF INSURANCE

Insurance is a technique involving collection of small amounts of premium from many individuals and companies out of which losses suffered by a few are reimbursed. In this method the individual insured who is exposed to uncertain and accidental loss is able to get protection through payment of a small but definite cost, namely premium.

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In other words the risk is transferred from the insured to the insurer.

Insurance is a contract between two parties i.e. insurer and insured, where by in consideration of payment of premium by the insured, the insurer agrees to reimburse a financial loss which the insured may incur due to an insured peril. The contract is again subject to the Indian Contract Act coupled with special principles evolved by common law. The policy which is the document issued by insurer is an evidence of the contract.

Early insurance goes back to the Egyptian times. Around 3000 BC, Chinese merchants dispersed their shipments among several vessels to avoid the possibility of damage or loss. Insurance understood as a technique providing protection against the fortuitous events for a consideration had its origin in the bottomry bonds which were issued by the Mediterranean merchants as early as the fourth century B.C. This loan was an advance of money on a ship during the period of voyage and the loan was repayable with the agreed rate of interest on arrival of the ship safely at the destination. During the voyage if ship was lost, the obligation to repay the loan was extinguished. The interest payable constituted a sort of premium for the risk of total loss. Now, there is insurance for many aspects of daily living Business, Auto, Health, Life, Travel. Each of those categories include sub-categories, branching off into numerous divisions.

20.2 RISK, PERIL AND HAZARD

What exactly is the meaning of the word risk? To most of us risk is uncertainty of occurrence of a loss. We hear about motorist dying in the accident or severely injured or people losing their houses due to flood, etc. We talk about risk of losing job, risk of accident causing disability, risk of burglary, etc. Risk implies some doubts about future outcome that leave us in worse position.

There are many definitions of risk, risk may be defined as possibility of loss, uncertainty of loss or risk is a combination of hazards.

Generally we use word peril to mean the event that causes loss and the factors which have an effect on the outcome of loss. e.g. A house is constructed on a beach and there is a risk of cyclone. ‘Peril’ is a prime cause of loss which is often beyond the control of human e.g. fire, lightening, flood, earthquake, theft, accident, explosion, etc. Therefore Cyclone is a cause of loss and the houses are constructed on beach influences the outcome. Hazard is a condition that increases the chance and size of loss. Thus the proximity of the house to sea is a hazard. Factors that have an effect on the outcome are called hazards. They increase intensity of perils resulting into loss.

Hazards are of two types viz. Physical Hazard and Moral Hazard.

Physical Hazard

It is a condition that arises from the physical characteristics of an object that increases the probability / severity of loss from given perils. Physical hazards include such fact as icebergs (hazard for ships), earth faults (hazard for earthquake), dense forests (hazard for fire), etc.

Moral Hazard

Moral hazards arise from the attitude of the insured. Insured intentionally does things to bring about loss or make a dishonest claim. Moral hazards are acts of dishonest individuals.

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Proximate Cause

Proximate cause means the effect of the cause is active and which sets in motion a chain of events between the occurrence of covered perils and damage or destruction of the property. e.g fire starts in the house due to LPG explosion in the kitchen and spreads to the bedroom and firefighting team spray the water that causes considerable damage to the furniture, curtains and fabric. The entire loss is covered including damage due to water because fire is proximate cause of loss. In this case fire is the proximate cause of loss even though the forceful use of water has also caused losses.

20.3 CLASSIFICATION OF RISKS

Risk can be classified into various categories viz. Objective risk and Subjective risk; Financial risks and Non financial risks; Pure risk and Speculative risk; Fundamental risk and Particular risk, etc.

Objective Risk and Subjective Risk

Objective risk is mainly related to groups of objects exposed to loss. Objective risk is defined as the relative variation of actual from probable or expected loss. Subjective risk on the other hand refers to the mental state of individual who experiences doubt or worry as to the outcome of a given event. Both definitions of risks concerned with events that may or may not produce financial loss.

Financial Risk and Non-Financial Risks

The loss measurable in terms of money or financial terms is called as financial risk. e.g. in case of damage to the business property due to fire or flood whereby the owner suffers financial losses due to damage to the property is a financial risk.

In situations where the loss cannot be counted in financial terms e.g. choosing life partner, selection of career, etc. are known as non financial risk. In other words we cannot measure sorrow, grief, despair, embarrassment in terms of money. That is called non-financial loss.

Pure Risk and Speculative Risk

Pure Risk is a situation where the outcome can either be a loss or no loss, e.g. a person will die or survive; fire catches the house or does not catch a fire, motor meets an accident or does not, theft from shop or no theft, etc. No one can gain from this situation.

Speculative risk is a situation that involves loss or gain., e.g. suppose you have purchased stocks of infotech; when market will be in boom you will book profit; if it is sluggish you will lose. Insurance cover is not available for speculative risks. Generally, only pure risks are insurable as they create financial insecurity to individual, family, business concerns, industries, etc.

Fundamental Risks and Particular Risks

This classification is connected with cause and effect of risks.

Fundamental risks usually arise from causes outside the control of human. e.g. Flood, volcanos, famine and other natural disasters. It is not proper to limit fundamental risk to naturally happening perils only. War, political intervention, social change, etc. are also fundamental. Fundamental risk affect large number of individuals at a time.

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Particular risks are the risks which are of impersonal origin and widespread in effect. e.g. fire, flood, theft, etc. These are insurable risks whereas fundamental risks which are of personal origin are uninsurable.

20.4 INSURABLE RISKS

Insurable risks include Personal risk, Property risk and Liability risks.

a) Personal Risks

These risks have direct impact on individual. Personal risks relate to the loss of ability to earn income and include premature death, dependent old age, sickness or disability and unemployment losses. These risks are of greatest potential severity. The risk with greatest severity is loss of income for the individual or family unit because the most valuable asset of individual is his income earning ability. Therefore the first and foremost risk is risk of dying early. Second is the risk of living too long. Third is risk of unemployment and fourth risk of illness/disability.

Risk of Premature Death: In any life insurance product naturally the first and foremost contingency covered is contingency of death. Death is certain but when it will occur is always uncertain. Untimely death creates substantial financial problems to the dependents. In the event of such untimely death of breadwinner, life insurance makes funds available to protect the family.

Risk of Living too long: Second important contingency is contingency of living too long. It is a fact that the mortality rates are decreasing all over the world. Therefore this contingency that one must anticipate to take care of post retirement needs of insured and the spouse.

Risk of Unemployment: The most serious single economic problem faced by industrial employees is risk of unemployment. In United States unemployment insurance is provided under four major programmes. So far such type of coverage is not available in India.

Risk of illness/disability: Another important contingency is the contingency of total disability. Unlike death and retirement becoming disabled is only a possibility. But it is a devastating one because it not only partially or totally eliminates an individual's ability to earn living but also entails additional cost of rehabilitative therapy and purchase of special equipment to cope up with the new limitation. Therefore the need to cover this contingency is very important.

b) Property Risks

Individual owning property is exposed to property risk i.e. the risk of property damaged or lost or destroyed because of fire, lightening, flood, cyclone, earthquake or any other natural disasters. There are normally two types of losses associated with destruction or theft of property i.e. direct loss and consequential loss.

Direct loss: It is a financial loss that results from physical damage, destruction or theft of the property. e.g. If a shop is destroyed by fire, the physical damage to the shop is a direct loss.

Consequential loss: It is a financial loss that results due to occurrence of direct physical damage or theft. In addition to physical damage, the shop would lose profit for some months or rent till the shop is reconstructed.

c) Liability Risks

These risks are of great importance because under the law of the land you can be held legally liable if your act results in serious bodily injury or property damage to someone else. A court of law may order you to pay substantial damages to the

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person/ persons you have injured. e.g. Motorist is legally liable if he meets an accident due to negligent driving. Another example can be of a business firm which can be held liable for defective products that may harm or injure customers. This is known as product liability. Professionals like engineers, brokers, accountants can be sued by clients due to alleged acts of malpractices. This is known as professional liability. In case of liability risk, there is no maximum limit with respect to the amount of the loss. One has a right to sue the motorist for any amount. e.g. Your car has actual cost of Rs. 5,00,000 the maximum physical damage; loss is Rs. 5 lakh but due to negligent driving causing accident resulting to severe bodily injury to someone he may sue you for any amount ranging from Rs. 1,00,000 to Rs. 1 crore. Secondly court of law can order to place lien on your income and financial assets to satisfy legal judgment. Thirdly legal defense costs are very high and without liability risk coverage, bearing substantial legal expenses is very difficult for individuals and business firms.

All the insurable risks are not only faced by individuals but also by the society therefore they may be handled by using four major methods viz. risk avoidance, risk control, risk retention and insurance. Generally preferable and practical method of handling risks is "Insurance".

Activity 1

Talk to four/five people and try to find out their views on:

i) What insurance means to them?

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ii) Whether they feel a need for insurance?

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20.5 DEFINITION OF INSURANCE AND BASIC CHARACTERISTICS

Insurance is a method of risk transfer. In insurance the losses of the unfortunate few are shared by fortunate many. The loss of an individual is shared by all those who are likely to face the same situation of loss. In other words, Insurance is the pooling of future unexpected losses by transfer of such risks to the insurers who agree to indemnify insured for such losses, to provide other preliminary benefits on their occurrence or to render services connected with the risk. This definition indicates the basic characteristics of insurance, viz.

Risk pooling: Insurers pool the risk i.e. the spreading of losses of unfortunate few over the entire group. In process actual loss is substituted by average loss.

Risk Transfer: Risk transfer takes place when an insurer agrees to pay loss that may occur and the uncertainty of financial result has been transferred to insurer from insured. For this insured pays premium to the insurer.

Indemnification: Insured is re-established to his or her approximate financial position prior to the occurrence of the loss.

An individual pays a premium while purchasing a policy and can make a claim if insured event occurs. The main functions of insurance are risk transfer by creation of common pool whereby losses of the few are met by the contributions of many.

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And charging equitable premiums i.e. the premium charged to each risk must reflect the severity of risk brought to the pool. If it is set too low losses will be made and if too high, business will lose competitive edge.

Insurance policies are contracts whereby Insurance companies (Insurers) promise the insureds that they will pay the financial loss suffered by the insured in the event of occurrence of insured event and to get this promise insured pays premium (consideration) to the insured.

20.6 BASIC PRINCIPLES OF INSURANCE

A contract is an agreement. It includes a set of promises that are imposed by law and for breach of promises law provides a remedy. Hence Insurance is under the purview of Contract Act.

Non life insurance policies are contracts of indemnity and involves insurable interest of insured. Basic principles of insurance are utmost good faith, insurable interest, indemnity, subrogation and contribution. Before proceeding to the classification of Insurance, let's review the principles of Insurance.

Utmost Good Faith

Insurance contract is done on utmost good faith i.e. in a contract of insurance, there is an implied condition that each party must disclose every material fact known to him. A representation is a statement made by an applicant (proposer) for insurance before the contract is effected. A misrepresentation of material fact makes the contract voidable at the option of insurer. Like misrepresentation , concealment has also the same legal effect. A concealment is defined as a failure of applicant to reveal the facts when obligated to speak. Applicant should not conceal the facts, even if the disclosure of the same may result into rejection of application. e.g. In case of fire insurance material facts are information regarding construction of the building, nature of goods stored, nature of process carried on, location, etc. To give one more example in case of accident insurance, one should give information regarding type of vehicle, nature of operation, tonnage, etc. in motor and in case of burglary, nature of goods, security arrangements, etc.

Principle of Insurable Interest

Insurable interest exists only if insured would suffer economic loss in the event of damage or destruction of insured object. For e.g. insurance of house or shop; damage to the house will result into financial loss to the owner. It is also necessary that insurable interest must exist at the time of loss. Secured creditors have insurable interest in the property for which they have given loan. To illustrate, Mr. Iyer cannot purchase insurance of Mr. Shah's house and collect the insurance claim if house is damaged. By doing this Mr. Iyer will be profiting from the insurance.

Principle of Indemnity

This principle argues that individual should not be permitted to make profit from the contract but should be re-established to the same financial conditions that existed prior to the occurrence of loss. In other words, insurance company agrees to pay not more than the actual amount of loss suffered by the insured. There are two fundamental purposes involved; first is to prevent the insured from making profits from occurrence of loss and second is to reduce moral hazard.

Subrogation

Another provision under the insurance contract which is preventing insured from making profits is subrogation. Subrogation means substitution of the insurer in place

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of insured for the purpose of claiming indemnity from third party for a loss covered by insured. e.g. a negligent car driver fails to stop at red signal and smashes into the car causing damage worth Rs. 10000. If he has comprehensive car insurance then insurance company will pay physical damage expenses and then make an effort to collect the cost of damage from negligent driver who caused accident.

Contribution

It is the right of insurer who have paid a loss under a policy to recover a proportionate amount from other insurers who have covered the liability for the same loss. e.g. A house is insured against the fire with two insurance companies under two different fire insurance policies with sum insured Rs. 20000. Fire occurs in the house causing loss of Rs. 20000 then in the event of loss the insurer who paid full claim has a right to recover Rs. 10000, the proportionate amount of claim paid, from the other insurer.

Deductibles

Deductible is a provision by which a specified amount is subtracted from the loss payment otherwise payable to the insured. Deductible is used to eliminate small claims and the administrative expense of adjusting these claims. Deductible is the amount of the loss which the insured has to bear in each and every claim and in return substantial premium savings are possible. Insurance company shall be liable only when the amount of loss exceeds the 'deductible', e.g. A policy with Rs.100 deductible would mean that policyholder has to bear Rs.100 of each and every claim under the policy. You may choose a higher deductible to lower your premium. But it is not advisable to opt for a higher deductible to reduce the premium outgo.

One should make an informed decision by giving due consideration to policy coverage, service offered by insurer and such other aspects discussed above rather than basing the decision solely on the premium outgo. And one should know that no decision is an informed decision unless that decision is based on the correct and complete understanding of the policy wordings.

20.7 CLASSIFICATION OF INSURANCE

Insurance may be classified according to the type of coverage. The conventional classification of Insurance is Life Insurance and Non-Life Insurance. Life insurance coverage can be further divided into life and health insurance. Non-life or General insurance is further classified into 2 categories Property Insurance and Liability Insurance. General Insurance is again classified into Commercial Line of Insurance i.e. for industry, small sector industry so also commercial organizations and Personal Line of Insurance for individuals, professionals.

Insurance

- **Life Insurance**
- **Non-Life Insurance**
  - **Commercial Lines**
    - Cottage industry and small sector
    - Traders and shopkeepers
    - Industrial Organizations
  - **Personal Lines**
    - Property Insurance
    - Health Insurance
    - Accident Insurance
    - Liability Insurance

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Life Insurance

Under the purview of this class of insurance, the risks associated with human life in general can be covered up to the limit specified called sum assured. A person can insure his or her life and his health against the contingencies like death, disability, surviving too long. In event of his death, his dependents will be reimbursed to the full amount that he was insured for. Or if the insured person meets with an accident or suffers from an illness that cripples him forever, he will be compensated with the complete sum assured anyway since he may not be able to lead a normal life again. In case, the accident is not that severe, he should be able to recover after medical treatment and rehabilitation. If he has opted for medical cover, then his medical expenses, treatment and medication will be paid for by his insurance policy.

Non-Life Insurance (General Insurance)

The scope of Commercial lines of insurance has been extended to the following categories and offer covers for:

Cottage Industry and Small Sector

Traders and Shopkeepers

- Professionals and specific professions
- Industries and commercial organizations
- Rural industries and rural prospects

Personal Line of Insurance

- Property Insurance
- Health Insurance
- Accident Insurance
- Liability Insurance Covers

Property Insurance business may be classified under three broad heads viz. Fire, marine or Miscellaneous Insurance. General insurance business are generally contracts of indemnity and are totally different from Life insurance contracts. Within the framework of the policy of the general insurance the insured is indemnified or provided with compensation in the event of operation of an insured peril. The essentials of normal contract are equally applicable to general insurance contracts.

Property Insurance covers insurances of building, motor vehicles, marine & aviation, boilers machinery, furniture, fixtures, cash in transit, crop, cattle, etc.; whereas Liability insurance covers public liability (Third Party liability), Product Liability and Professional Indemnity.

Property insurance is designed to indemnify the insured for loss or damage to buildings, furniture or other personal property due to different ways in which property can be damaged. Property may be damaged due to fire, theft, engineering, breaking glasses, etc. The standard cover used by almost all the business and households is of Fire Insurance.

Activity 2

State the basic characteristics of insurance

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20.8 FEATURES OF PROPERTY INSURANCE

In property there is a specific sum insured.
The subject matter insured is described in concrete terms.
The claim in the event of loss occurring is payable to the insured named in the policy and the sum assured is the limit of indemnity under the policy.
A valid claim can arise only during the period of policy.

In Personal and commercial lines of insurance the most important insurance cover to protect buildings, property and other assets is of fire insurance. Second important cover is Marine Insurance that deals with Marine Cargo and Marine Hull. Hull insurance deals with the insurance of ships while cargo deals with goods and merchandise. In Miscellaneous insurance a large number of classes of insurance other than fire and marine are covered. Under miscellaneous insurance cover there are many types of covers viz. Motor Insurance which is major business under this class, Engineering Insurance, Liability Insurance, Burglary Insurance, Accident Insurance, Aviation Insurance, Personal insurance, etc.

This is a specialized branch of insurance and distinct from insurance related to property and persons. One of the most serious financial risks covered by insurance is that of loss through legal liability for harm caused to others. Each person has some legal rights. Violation of person's legal rights is called as legal wrong. A crime, a breach of contract and tort are three broad classes of legal wrong. A criminal is punishable by fine, imprisonment or death and torts is legal injury to another that arises when a person's rights are wrongfully invaded, like right to be free from personal injury, to enjoy personal privacy, etc. For torts the law allows remedy in the form of money damages. Torts are generally classified into intentional torts, absolute liability and negligence. We are mainly interested here with protection against the financial consequences of civil action arising out of only one of these torts i.e. negligence. Negligence can result in substantial liability. Negligence is the failure to exercise the degree of care required by the law.

20.9 FEATURES OF LIABILITY INSURANCE

The salient features of Liability insurance are:

1) There is no specific sum insured in respect of this class of insurance instead there are only limits of liability like limit per accident, limit per individual and limit per period.
2) There is no specific subject matter insured which can be identified for purpose of liability insurance. The insurance is taken only in respect of the liability that may arise out of the insured's business or profession.
3) The claimant invariably happens to be other than the insured.
4) The claim only in respect of the legal liability that has to be established by the litigant/claimant third party against the insured. Such liability should be an enforceable one at law.
5) Claims can arise even after the expiry of the policy so long as the loss causing event has happened during the policy period.

There are numerous types of liability exposures which fall broadly into Public liability, product liability and professional indemnity . These exposures arise out of different functions performed and standards of care required of persons or organizations.

This policy covers the amount which the insured becomes legally liable to pay as damages to third parties as a result of accidental death, bodily injury, loss or damage to the property belonging to a third party.

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20.10 INSURANCE MARKET IN INDIA

The following paragraphs which are extracted from the Annual Report, 2003-04 of the Insurance Regulatory and Development Authority (IRDA) gives the present status of insurance market in India. A copy of the full report of IRDA can be seen from IRDA's website.

"The insurance sector was opened up in the year 1999 facilitating entry of private players into the industry. At the time of opening up, it was visualized that well established industrial houses would take the opportunity to come forward to establish insurance companies both in the life and non-life segments, either on their own or as joint ventures in collaboration with foreign insurance companies. The entry level capital requirements were kept sufficiently high at Rs. 100 crore to deter corporates other than those who had sufficiently long term interests, and which had the capability to continuously raise funds through equity contributions from the promoters till such time as the operations stabilize.

The regulatory framework which was designed for the operation of insurance companies laid down the ground rules for insurers and is equally applicable to both the state owned and the private insurers. The new environment has facilitated competitive conditions, and the industry has exhibited a healthy growth trend, in both the life and non-life segments. (Tables 20.1 and 20.2 give the key market indicators and the number of registered insurers in India). The new players not only succeeded in establishing themselves, but also captured a healthy market share. The existing insurers have also been able to show growth in the premium underwritten by them. From total premium underwritten of Rs. 34,898 crore in the year 2000-01 to Rs. 66,287.93 crore in the year 2003-04, the life insurance industry has seen the new players stabilize their operations, while simultaneously, the State owned life insurer has strengthened its position, with total premium of Rs. 63,167.60 crore. The premium numbers bring out the fact that the size of the life insurance market has grown over the four years of liberalization. During the year 2003-04, the life insurance industry (total premium) grew by 18.91 per cent, with LIC recording a

Table 20.1: Key Market Indicators

Life and non-life Market in India Global insurance market (as on 31st December 2003)	Rs. 83,645.11 crore US $2940.67 billion Nominal growth: 11.71 per cent Inflation adjusted: 2.0 per cent
Growth in premium underwritten in India and abroad in 2003-04	Life : 18.91 per cent Non-life : 11.16 per cent
Geographical restriction for new players	None
Equity restriction	Foreign promoter can hold upto 26 per cent of the equity
Registration restriction	Composite registration not available

Table 20.2: Number of Registered Insurers in India

Type of business	Public Sector	Private Sector	Total
Life Insurance	01	13*	14
General Insurance	06	08	14
Reinsurance	01	0	01
Total	**08**	**21**	**29**

* One has commenced operations in 2004-05

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growth rate of over 15.63 per cent. The share of the new insurers increased to 4.71 per cent from 2 per cent in the previous year. In terms of first year premium, LIC and the private insurers held a market share of 87.44 and 12.56 per cent respectively.

Similarly, in case of non-life sector the industry has grown from Rs. 10,779 crore in 2000-01 to Rs. 17,357.18 crore in 2003-04. The total premium underwritten by the public sector insurers has grown from Rs. 10,771.96 crore to Rs. 15,099.35 crore.

Over the last four years, the premium underwritten by the new insurers has increased to Rs. 2,257.83 crore, taking their market share to 13 per cent. In 2003-04, the non-life insurance industry recorded a growth rate of 11.16 per cent over the previous year.

20.11 LIFE INSURANCE: AN INTRODUCTION

Life insurance is designed to be an effective and efficient means of planning for adverse financial consequences in the event of untimely death of income earner for the average family. During the life span of an individual his needs may vary. At different stages of life cycle his needs are different. Also changes in the economic and social environment greatly influence the needs, choices and expectations of customers. To make a product marketable, it must satisfy needs and expectations of customers. Insurers have launched a varied range of products viz. from traditional highly risk oriented term assurance plan to highly investment oriented plans. These new plans are becoming increasingly popular because they offer living benefits such as long-term care, critical illness covers and investment oriented plans tailored to cater to the ageing population, which helps policyholders to maintain their standard of living. Insurance company's success results from how well its products and services meet the needs of customers. In order to reach the maximum possible customers having diverse needs, products must be differentiated. Product features that are used to differentiate them include, maximum and minimum face values i.e. sum assured, principal and supplementary benefits of the policy, embedded or in built options available under the policy, the possible riders being included to increase death benefits and flexibility, premium paying modes available, policy term, settlement of the policy may be arranged and the other provisions under the policy. All these product features constitute Life insurance product design.

20.12 PRODUCT DESIGN

Life Insurance product designs have 3 broad attributes

1) **Kind of Contingencies Covered :** Various contingencies like death, accident, disability, living too long
2) **Pattern of Premium Payment** : Single, level-annual, half yearly, quarterly, monthly, limited term
3) **Pattern of Benefits Received :** Participating in profits, non-participating, Tax, death/survival benefit, accident benefit, etc.

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Product

- **Contingencies Covered**
  - Principal Contingencies
    - Premature Death
    - Living too Long
    - Disability
  - Subsidiary Contingencies & Benefits
    - Dreaded Diseases/ Critical Illness cover
    - Major Surgical Assistance
    - Accident Benefit
    - Fixed/Variable Term
    - Conversion facility/portability
    - Pledged for loan
    - Guaranteed addition
    - Loyalty addition
    - Premium waiver
    - Surrender/paid up
    - Special Surrender
    - Transferable
- **Embedded Options**
  - Loan
  - With/Without Profits
  - Periodical Payment on Survival
- **Patterns of Premium Payment**
  - Single
  - Level Annual Half Yearly Quarterly
  - Monthly
  - Limited Payment

20.13 PRINCIPAL CONTINGENCIES

Death

In any life insurance product naturally the first and foremost contingency is contingency of death. Death is certain but when it will occur is always uncertain. In the event of untimely death of breadwinner, life insurance makes funds available to protect the family. Such untimely death creates substantial financial problems to the dependents even forcing them to compromise on standard of living. Death benefits can be paid within a few days of the claim and are, therefore, excellent source of immediate cash to the surviving family members.

Surviving Too Long

Second important contingency is contingency of living too long. It is a fact that the mortality rates are decreasing all over the world. Therefore, this contingency that one must anticipate to take care of post retirment needs of insured and the spouse. It is well known that the life span of an average Indian is also increasing. In 1947, at the time of independence, the average life span was 35 years, it increased to 61 in 1991 census and is expected to increase to 80 by 2020. Thus, the present generation of Indians who are in the age group of 30 to 45 would be expected to live for at least 15 years after retirement. Because of unpredictability of human life there would be a danger of surviving more than expected lifetime and finding the assets and income totally consumed prior to death due to the increasing cost of medical expenses with the age and cost of self-maintenance rising due to inflation. Annuity plans help elderly persons by giving them income and some deferral income taxes as long as annuitant lives. There is also an option available that the purchase price will be paid back to the beneficiary in the event of death of the annuitant. This amount can then be used to support the surviving spouse or to make a bequest.

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Disability

Third important contingency is the contingency of total disability. Unlike death and retirement, becoming disabled is only a possibility. But it is a devastating one because it not only partially or totally eliminates an individual's ability to earn living but also entails additional cost of rehabilitative therapy and purchase of special equipment to cope up with the new limitation. Therefore the need to cover this contingency is greater than ever. Though the mortality rates have declined in the recent years the incidence of disability due to accident, chronic diseases, emergence of AIDS and injuries due to rigorous fitness programme activities like jogging, high-impact aerobics, etc. The disability cover not only provides cover to disabled individual for treatment but also dependent family members with the amount of monthly indemnity as per policy conditions and waiver of premium during any period of disability.

These are the three principal contingencies covered in life insurance products for protection against financial consequences associated with early death, living death (disability), living too long (postponed death). In addition to these main contingencies there are some other low priority contingencies. The most prominent among those are Mortgage Redemption, Children's education, Marriages of children.

20.14 OTHER CONTINGENCIES

Mortgage Redemption: Home ownership is prevalent among middle-income families today but are burdened with mortgage sometimes financed by life insurance companies. The mortgages are amortized over a period of 15-30 years but it is highly probable that a large unpaid balance will still be outstanding upon death of a person with dependent children. To cover this contingency in the event of death of insured (loanee) proceeds of the policy are adjusted against the loan; so it will substantially reduce the burden of paying installments of mortgage.

Children's Education: Under present conditions the educational expenses range from about Rs. 5000/- to Rs. 25000/- per year. College or professional education is beyond the means of many children who lose an income-earning parent in childhood. Insurance companies have variety of policies which fund expenses of education of children after certain age or pay annuity for their general maintenance in the event of death of insured parent or otherwise as per the policy conditions.

Marriages of Children: For making gifts to children or anticipating marriage expenses of children after some years, the cover will be purchased. In the event of death/maturity at specified date, the amount will be payable to the beneficiary.

In past these special needs were taken care of by traditional investment products like fixed deposits, mutual fund schemes. Now there are life insurance products also to cater these special needs. Increased consumer awareness about all these products has enhanced product competition not only among life insurers but also competition from other financial services. The net effect of this competition is evolution of better-valued and more flexible products. The competition within the life insurers, between the life insurers and other financial institutions has put pressure on actuaries to design and offer lower cost policies. In an effort to gain competitive advantage insurers have adopted several innovative product design approaches. In these products some benefits are inbuilt and some supplementary benefits are added by endorsements to the contract i.e. riders that permits flexibility in adapting basic plans to individual needs. To obtain these supplementary benefits a small extra payment of premium is required. Let's have a look at supplementary benefits or embedded (in built) options and riders.

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Activity 3

1) Consult two/three people and find their expectations from insurance.

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2) Give the broad attributes of life insurance product design.

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20.15 SUPPLEMENTARY BENEFITS OR EMBEDDED OPTIONS

Participating/Non-participating: In participating policies insured will benefit or suffer from the favourable or unfavourable operating experience of life insurance company. Policies that pay dividends/bonuses are called **participating**. The policies which are sold on guaranteed benefits that do not vary with the experience of the company are known as **non-participating** policies.

Loan: It is the policy provision that permits the company to grant a loan to the policyholder. It is a source of liquidity. **Policy Loan** is usually granted within the surrender value of the policy. Normally insurers grant up to 90% of the Surrender Value as loan. The policyholders, who avail of this loan, have to pay interest on the loan at rates prevailing at the time of granting of the loan and will also have to repay the loan whenever necessary.

Surrender Value: Surrender value may be taken in cash or reduced amount of paid up insurance or extended term assurance for full face amount. After the policy has been in force for long enough, the surrender charges decline. The Surrender value will be paid after deducting initial heavy expenses at the time of issuance. The cash surrender value option is available later than 3 years for most policies issued in India. The company has no future obligation under the policy. This privilege provides a ready source of cash to meet financial emergency or to take advantage of business opportunity.

Reduced Paid up Insurance: The net cash surrender value is used to purchase a reduced amount of paid up insurance of the same type as the original policy exclusive of any riders. All the riders are terminated.

Extended Term Insurance: This option permits policy owner to exchange net Surrender value for paid up term assurance for the full face amount. The length of extended term insurance is determined by applying net surrender value as a single term insurance premium to provide level term insurance for whatever duration the funds will carry the policy.

Automatic Premium Loan: Many companies include this provision to protect against unintentional lapse, when a premium payment is overlooked or due to temporary inability to pay the premium. Such loan bears interest applicable to policy loan.

Conversion Option: This feature permits policyholder to exchange the term policy for whole life policy or endowment insurance contact without evidence of insurability. This serves need of those who want permanent protection but are presently unable to pay the higher premiums for whole life or endowment plans. Conversion must take place within specified number of years after issuance. This facility increases flexibility of term plan.

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Guaranteed Additions: Insurance company agrees to refund the money at a guaranteed amount per Rs. 1000 face value per year for the life of contract. In the event of death of insured, a face value in addition to guaranteed additions will be paid to the beneficiary or otherwise guaranteed additions are compounded until the termination date of contract. Usually guaranteed amount per 1000 sum assured is competitive with other long term fixed deposits.

Loyalty Addition: Insurance companies pay loyalty additions on death after specified number of years from commencement of the policy or at maturity of the policy provided it is in full force. The amount of loyalty addition depends upon the future experience of the company in respect of investment returns, expenses and mortality.

Return of Premiums: Policies sometimes include provisions whereby on death of insured an additional death benefit equal to sum of the premiums paid will be paid to the beneficiary if death occurs within a stipulated time period. Term Insurance policies sometimes include provision whereby if the insured survives after maturity the benefit equal to sum of the premiums will be paid to him. In some policies there will be provision that it will return some portion of the premium/ face value at specified interval. e.g. In a Money Back Policy 25% of sum assured is paid to the insured after every 5 years. It gives liquidity advantage to the policy owner.

From the preceding discussion, it should be clear as to what are the embedded options available under life insurance policies. We shall now discuss some of the common riders which could be purchased along with the basic insurance policy.

20.16 RIDERS

Riders are the add-ons that one may buy and add the benefits to the basic insurance policy. These add-ons or riders are additional benefits that can be purchased along with a basic insurance policy, to make the basic policy to match individual's present and future requirements. Theoretically a rider can be purchased anytime during the lifetime of the policy depending on the need. But as of now, companies do not allow riders to be purchased after the policy is issued, i.e., riders are to be purchased only at the time of commencement of the policy. But as the riders are becoming more popular in the market insurers may think of allowing the purchases of riders any time during the policy period.

There are 2 kinds of effects of riders on Basic Plan. When a claim for benefit under a rider is made, it can either result in payment of the benefit along with the termination of the entire policy contract, whereby the basic policy also will come to an end or the policy may continue to exist till the original date of maturity with only the rider getting turned off. For example, a Critical Illness rider can provide for payment of a lump sum in case of affliction with one of the illnesses covered, with the Basic policy continuing to cover the risk of death or survival or getting terminated. Rider can provide for waiver of premium on basic policy in case of critical illness apart from Paying a lump sum. Hence as financial planner you have to be conversant with the benefits that a rider provides while also knowing the effect it has on the basic policy.

Policy owners normally attach riders to basic policies to acquire additional protection at or close to net rates.

1) **Accidental Death Benefit:** When the death results from accidental or bodily injury or accidental means, accidental death benefit doubles the sum assured payable. In some policies accidental death benefit is some other multiple of sum assured. It generally terminates after insured reaches age 65. This is one of the

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most popular riders because of small premium, coupled with the belief of most persons that if they die, the cause will be an accident.

2) **Accelerated Death Benefit:** It involves the payment of all or portion of life insurance policy's face value prior to the insured's death because of adverse medical condition of insured. It is also referred to as living insurance. It may take three forms as follows

   a) ***Terminal Illness Coverage:*** This coverage provides that a specified maximum percentage typically 25 to 50% of the life policy's death benefits can be paid if the insured has been diagnosed as having a terminal illness. Most provisions require that the insured have a maximum of either six months or one year to live. Many companies make no explicit charge for the coverage because they believe that they can absorb the cost of prepayment of what would be resulting in death claim shortly.

   b) ***Catastrophic Illness Coverage or Dreaded Disease Coverage:*** The provision covers illness typically including stroke, heart attack, cancer, renal failure and similar catastrophic illnesses. In this case insured must be diagnosed as suffering from one of the several catastrophic diseases. Both terminal and catastrophic illness coverage provide that the policy death benefits are reduced on payout basis and cash values are reduced in proportion to death benefit reduction.

   c) ***Long Term Care Coverage:*** It provides benefits of skilled nursing home care, custodial care and home health care. When the insured is unable to perform a certain number of activities such as eating, bathing, dressing, general mobility, toileting or taking medication. When the rider is a dependent rider the death benefit and cash value benefits are reduced by long term care benefits. When they are independent riders their benefits may be paid out without reducing underlying policy benefits.

3) **Waiver of Premium:** The waiver of premium benefit offered by life insurance companies provides that in the event of total disability of insured before age 65 the premiums on the contract will be waived during the continuance of disability beyond the specified waiting period. All the benefits under the contract, viz. bonus, cash value, loan paid. The contract continues as if the insured is paying the premiums. Death benefit remains unaffected.

Following are some more riders available in the developed markets which are currently not available in India.

4) **Guaranteed Insurability Option:** This option permits an insured to purchase additional amount of insurance without providing evidence of insurability at three years interval provided the insured has not reached specified age. In most cases the additional insurance is limited to a multiple of basic policy face amount or for the additional purchase option which ever is smaller. The maximum amount of each option is $ 50,000/-. This rider can prove of value especially to those whose family health history suggests that potentially significant medical problems may develop.

5) **Cost of Living Rider:** It can be added to most forms of life insurance. It can be useful when one's needs for life insurance are expected to change over time in approximately the same proportion as changes in the cost of living.

6) **Disability Income Benefit:** Companies that provide disability income often pay monthly 1% of face value. Many companies limit the maximum monthly income that they will issue. The premiums on both base policy and rider will be waived during a period covered disability. Six months total disability is considered as permanent and they commence payment at the end of sixth month. Dividends/

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Bonuses are paid as usual. Basic contract continues as though no disability had occurred. Death benefit remains intact.

With the help of traditional life products and riders, products can be tailored for all market segments. Instead of one complex product, there should be base products with optional riders to satisfy customers' needs and to achieve greater flexibility. It is necessary to unbundle and re-bundle the products to meet customer's demands.

20.17 PREMIUM PAYMENT PATTERNS

The third component of the product design is the pattern of premium payment. Premium is the price charged by a life insurance company to purchase life insurance contract. For the purchase of life insurance policy various modes are available viz. Single premium, level annual premium, half yearly, quarterly, monthly, limited payment and flexible premium payment. Flexible premium payment facility is not available in the Indian insurance market till date.

Single Premium: It involves the payment of single cash sum which pays for entire risk incurred during the term of the policy. This method of premium payment is not very popular because a relatively large initial outlay is required.

Level Premium: Most of the people do not have resources to purchase life insurance by single premium. The fundamental idea of level premium is that the company can accept the same premium provided that the level premiums are the mathematical equivalents of the corresponding single premium. Level premiums are payable until maturity of the contract. The principle of level premium plan may be applied to a life policy of any duration i.e. from short term policies to whole life policies. The level premium plan may amortize the single premium cost of the insurance over the entire duration of the policy's coverage period or over any shorter period. Level premium may be paid annually, half yearly, quarterly or monthly. Financing life insurance on an installment basis is appropriate because fundamental purpose of life insurance is to provide protection against loss of future earnings. One month's premium purchases as much life insurance as a single premium does, therefore people prefer level premium to single premium.

Limited Payment: The premiums may be paid by using limited payment option. In this option the premium payment is to be made for a period less than contract term and risk is covered for the entire contract term. The limited payment policy's premium is larger than that of level premium where the premium payment continues throughout the period of policy. Theoretically the premiums payable under limited payment options are the actuarial equivalent of the premiums payable for the insured's entire lifetime under an ordinary life plan. The limited payment contracts vary between single premium and level annual premium. Limited payment contracts are suitable for professionals, artists, athletes, etc. whose earnings are very large over a short working life span.

Flexible Premium Plan: This option permits the policy owner the flexibility of deciding the amount of premium that he or she would like to pay. Subject to company rules regarding minimum and maximums, the policy owner may pay whatever premium during a policy year that he or she wishes. From this premium may be subtracted an amount to cover the insurer's expenses and mortality charges. The balance remaining, plus the previous period's fund balance then forms the policy's cash value. Mortality charges are based on the policy's net amount at risk calculated using the cash value. Interest at the company's current rates is then credited to the cash value for the year. This process is repeated on each premium due date with the policy owner paying no premium if desired.

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Activity 4

Choose any one life insurance policy and try to find out the riders that could be attached with it.

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20.18 VARIOUS PRODUCTS AVAILABLE IN THE MARKET

Having discussed the three attributes of life insurance products, next we will examine the different types of life insurance products and how do they meet the needs of the customers. To begin with let us discuss the Term Assurance Plan.

Term Assurance Plan

Term Assurance Plan	**Basic Plan of Insurance**
Contingency covered	**Death cover for a specified term of the policy**
Insured event must occur	**During the term of the policy**
Premium payment patterns	**Single, Annual**
Surrender value	**Nil**
Loan	**Nil**
Variations	**Increasing and decreasing Convertible Renewable**

Term Assurance plan is the basic plan of insurance. All that you get after purchasing the term assurance plan is protection for a specified period for a specific sum assured. It is like insuring a property for a specified period. If life assured does not die during the term of the policy there is no return of premiums and cover just ceases. The period for which cover will be provided may be as short as one year to as long as 25 years. Term assurance policy has no surrender value so also no investment element that generally attracts people. In other words term assurance plan does not pay on survival and hence they are extremely cheap. Secondly, the higher the sum assured, longer the term of cover and the worse the state of life assured then policy attracts higher premium. Generally, people with little disposable income find term assurance plans attractive.

Exclusions: There are very few exclusions in term assurance plan. Suicide is a universal exclusion. Death benefit is not payable where the insured person commits suicide within one year from the date of commencement of policy. Some policies also exclude war, civil commotion, etc.

Increasing Term Assurance Plan: Under this plan the insurance coverage goes on increasing periodically over the term. It can increase at a predetermined rate. To illustrate, suppose individual has purchased 15 years term assurance plan of sum assured Rs. 1,00,000 for the first 3 years then it will increase by 30% for every 3 years, viz. Rs. 1,30,000 at the end of 3rd year and will continue till 6th year. From 7th to 9th year, the coverage will be Rs. 1,60,000 and from 10th to 12th year Rs. 1,90,000 and 13th to 15th year Rs. 2,00,000. Sometimes the insurance coverage can be linked to an external index like consumer price index and can increase with the index.

Decreasing Term Insurance Plan: In the circumstances when extra risk is undergone for a restricted period like mortgage protection where term assurance plan

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will provide money to pay off mortgage in the event of life assured dies within the term. Normally, decreasing term assurance plan is utilized to protect mortgage so that as mortgage amount, i.e. outstanding loan amount decreases with the passage of time so also the sum assured.

Renewable Term Assurance Plan: This feature grants the insured the right to renew the policy for a limited number of additional periods, each usually of the same length as the original length of the policy subject to an age limit. For e.g the insured purchases a 15 year term policy at age 25 and survives this period then he has the option to renew the policy for the next 15 years without proving insurability. The insured may renew the policy at age 40, perhaps a age 55 and hence insurers impose an age limit beyond which renewal is not granted.

Convertible Term Assurance Plan: This feature permits policyholder to exchange the term policy for whole life policy or endowment insurance contact without evidence of insurability. This serves need of those who want permanent protection but are presently unable to pay the higher premiums for whole life or endowment plans. Conversion must take place within specified number of years after issuance. This facility increases flexibility of term plan.

The age of the insured must be generally between 18 and 50. The cover can be renewed until the insured reaches to 65 years of age. Some of the private insurance companies in India allow the age limit between 10 & 50 with the authorization of parent for a minor life assured.

Utility of Term Assurance Plan: Term assurance plan is best utilized by the corporate to protect expected costs like loss of business and profits in the event of death of key person i.e. director or specialized skilled employee of a company whose death will incur substantial losses to the company. This policy will generally run till the employee's normal date of retirement.

Endowment Assurance Plan: Endowment assurance plans are extremely popular plans in India. Term insurance plan is risk oriented plan which pays only in the event of death during the policy period whereas endowment assurance plan is investment oriented plan which pays not only in the event of death during the term of the policy but also in the event of survival at the end of the policy period. Endowment policies are with profits or without profits. In case of without profit policies insurance companies guarantee insured that they will pay a fixed sum assured to the insured in the event of his death or at maturity irrespective of profit or loss the company makes. In case of with profit policies, insured gets bonus every year on the sum assured and if death occurs during the policy period sum assured with accrued bonuses are payable to policyholder and if he survives sum assured with accrued bonuses are paid as a maturity benefit.

Endowment Assurance Plan

Contingency Covered	Death Cover for a Specified Term of the Policy. Maturity Benefit at the end of the Policy Period
Insured Event Must Occur	During the Term of the Policy
Premium Payment Patterns	Single, Annual
Surrender Value	Yes
Loan	Yes
Variations	With Profits and Without Profits Double/Triple Endowment Money Back Anticipated Endowment

Generally the duration of endowment policies vary from 3 years to 40 years. In India endowment policies can be purchased by paying single premium, annual premium, half yearly premium or even monthly premium.

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Money Back Plan: When endowment assurance plan is sold with periodical liquidity advantage, it is called as money back plan. Under this policy a certain proportion of sum assured is returned periodically to the insured in the event of his survival and if death occurs anytime during the policy period a full sum assured along with accrued bonuses are payable to his spouse/legal heir irrespective of the survival benefits received by the insured. For e.g Suppose a money back plan is of 15 years duration and after every 5 years 1/3 sum assured is paid back to the insured in the event of his survival. Then insured will receive 1/3 sum assured at the end of 5 years and 1/3 sum assured at the end of 10^{th} year and if he survives at maturity he will get remaining 1/3 sum assured with accrued bonuses. Alternatively if he dies any time during the policy period he will receive sum assured with accrued bonuses.

Educational Endowment Assurance Plan: These are the policies specially designed to meet the school fees of children at a future time. Generally the policy is purchased when a child is young. If insured parent dies before maturity, the instalments may be paid in lumpsum or commence immediately. Alternatively premium may be ceased and the instalment payment of sum assured may be deferred to the date of original maturity.

Endowment Assurance plan, moneyback plans, whole life policies contain a big investment element in them . Premium consists of mortality element and investment element. Hence their premium is higher than term assurance plan. Endowment assurance plan offers option of loan and surrender value. These options increase liquidity of the endowment assurance plans.

Whole Life Policies: The name itself indicates that these policies provide death protection to the individual throughout his lifetime. It provides protection to those who are very much concerned about the family and dependents rather than earning returns on investments. Under these policies payment of death benefit is certain irrespective of when it occurs. Whole life policies are with profits or without profits. With profits policies are entitled to get a share in the distributable surplus of insurer whereby policy value goes up. Whole life policies are of following types:

1) ***Ordinary Whole Life Policy:*** It is called as continuous premium whole life. Insured has to pay the premium throughout his life. It provides constant protection for permanent needs and can be continued for the entire lifetime of the insured. It performs dual function of protection and savings. The policy offers loan and surrender facilities to the insured.

2) ***Limited Payment Whole Life Policy:*** It is the same contract like whole life policy but differs only in premium payment pattern. Like the whole life contract protection is extended till 85 years of age but premium payments are made for some shorter period of time. For limited payment policy the premiums are sufficiently high to prepay the policy premiums in advance. Thus under 30 years limited payment policy, during the payment period one pays premium that are large enough to permit one to stop payment at the end of 30 years and still enjoy the cover equal to the sum assured of the policy for remaining life or till 85 years of age whichever is earlier.

3) ***Anticipated Whole Life Insurance Policies:*** This is a variation of Whole Life Assurance Contract that provides for payment after periodical intervals for a fixed sum of money on survival of the Life Insured from commencement of the policy. A typical policy provides for payment of say 10% of the original Sum Insured on the Life Insured surviving every 5 years from commencement. On death of the Life Insured any time, the policy provides for payment of full Sum Insured without deduction of the survival benefit instalments. Such type of policies take care of 2 different needs that an individual may face, viz., providing

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for the dependents of the insured in case of death and at the same time taking care of the intermittent financial needs of the client himself. This provides for family protection as well as liquidity for the breadwinner.

Whole Life Assurance Plan

Contingency Covered	Death Cover for Indefinite Period
Insured Event Must Occur	Anytime
Premium Payment Patterns	Single, Limited Payment, Annual
Surrender Value	Yes
Loan	Yes
Variations	With Profits and Without Profits Increasing, Convertible, Limited Payment

Variable Life Insurance

Fixed premium variable life policies introduced in United States in 1976 and flexible premium Variable Life Insurance (VLI) policies in 1985. A fixed premium VLI policy resembles traditional whole life policies. Level premiums are fixed and cash values are developed from which policy loans are available. The main difference between variable life and whole life policies is that VLI policies shifts investment risks and returns to the policy owners. Several investment portfolios are generally available and the policyholder has the option of choosing those in which of the selected funds is favourable then the policyholder receives additional coverage in the form of increased death benefits and if the investment performance of the selected fund is favourable then the policyholder receives additional coverage in the form of increased death benefits and if the investment performance is unfavourable then policy owner receives reduced coverage subject to minimum death benefit guarantee. The idea behind variable life policy is that the additional amounts of coverage resulting from favourable investment returns should keep pace with inflation over the long run. However subject to minimum death benefit the policy owner bears the investment risk. Recently Birla Sunlife Insurance Company has launched Variable Life Insurance plan in the Indian market.

The cash value of a variable policy can be invested in investment accounts managed by the life insurance company. Generally Life insurance company gives a choice of three or more investment portfolios like stock fund, bond fund and a money market fund. Policy owner can put all investment in single fund or they can apportion the investments among the available funds. Generally insurers will not permit policy owners to allocate less than 10% to any one fund. Policy owners are also permitted to change the allocation of investments up to four or five times a year without paying additional fee for the exchange. With VLI policies, the insurance company assumes risk of mortality and expenses will be greater than expected but there are no minimum interest guarantees or minimum cash value guarantees in VLI policies. The policy owner assumes the risk that the investment income will be less than expected.

The lack of interest rate guarantees and cash value guarantees make variable policies inappropriate for people desiring known and predictable cash value levels. VLI might be the most attractive to the potential buyers when common stocks have been increasing steadily in value over an extended period. Conversely when the variable life concepts fall out of favour after stock prices experience significant decreases in value, these are higher risk policies than that of traditional whole life. As higher proportion of VLI policies investment might be directed by policy owner to be invested in common stocks and other relatively volatile instruments.

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Universal Life Insurance

It is a relatively innovative product in life insurance. It is also termed as Flexible Premium Life Insurance product. Under this policy policyholder can change the death benefit from time to time. He also can vary the amount and the timing of premium payments without prior notice or negotiation. Premiums are credited to policy account from which mortality and expense charges are deducted and to which interest is credited at rates that may change from time to time. Policy owner can make partial withdrawals of cash value. Part of mortality risk and part of investment risk is transferred to the policy owner. However the insurer decides how policy assets will be invested; guarantees a minimum rate of return on policy accumulations, calculates existing policy cash values and determines what current interest rates will be credited to the policy. The insurer discloses the internal allocation between expenses, mortality and interest.

These policies include option of either a level death benefit or an increasing death benefit. There is no inherent advantage of one design over the other. A preference might be based on insurance needs whether the policy owner needs level benefits or death benefits that increase to reflect inflationary trends. The policy owners are also permitted to change from one type of death benefit to the other by negotiating the change with insurer.

Level Death Benefit: This is similar to whole life policy comprising of two elements i) Pure Protection, and (ii) Savings.

Death Benefit = Increasing Cash Value + Decreasing Pure Protection

The increasing cash value (savings) reduces the amount of pure protection thereby reducing the insurer's mortality risk and the proportion of death benefit to which the mortality charge is applied.

Increasing Death Benefit: This pays a death benefit equal to the cash value of policy in addition to a stipulated amount of pure protection.

Death Benefit = Increasing Cash Value + Level Pure Protection

Flexibility of changing both the amount and type of coverage allows the policy owner to change the policy based on changes in his/her economic position or family liabilities. Adjustment can be made without purchasing separate contracts to supplement or replace a basic policy.

Flexibility of changing both the amount and type of coverage allows the policy owner to change the policy based on changes in his/her economic position or family liabilities. Adjustment can be made without purchasing separate contracts to supplement or replace a basic policy.

Premium flexibility: Universal life policies require a stipulated minimum premium only during the first year of coverage. After that the premium on universal policy is payable at the discretion of policyholder. A target premium amount might be suggested to keep the policy in force or to accumulate desired cash value at some future date. However, policy owner can skip premiums, delay payments or pay extra or pay whatever premium amounts he or she wants. Upper limit on premiums is established by internal revenue code. This prevents policy owner from accumulating excessively high cash values relative to death benefit. Lower limit on premium payments is merely the minimum premium required to keep the policy in force.

Every premium payment (less deduction for expense, if applicable) goes into the cash value of the policy where it is added to any existing cash value already accumulated from prior payments. Interest is credited to the cash value, usually monthly and deduction is made from cash value account usually each month for the mortality

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charge covering the amount at risk. ULP's make cash available to the policy owners in the same way as traditional life insurance contracts i.e. through policy loans and cash surrender of policy. In addition to this, ULP's allow partial withdrawals of the policy cash value. These partial withdrawals are permitted as long as they are not so large that the remaining cash value balance drops below a specified minimum such as $250 or $500. Most insurers impose a transaction fee of $25 on each partial withdrawal. Unlike policy loans' partial withdrawal merely reduces the cash value account in the policy. The policy owner is under no obligation to repay the insurance company or to pay interest on funds withdrawn. Funds withdrawn in this manner can be restored through additional premium payment.

A ULP contains a guaranteed rate of interest. Insurance companies differ in the guaranteed rate of interest but the rates range between 3.5% to 4.5% and cannot exceed limit set forth in the reserve. However, interest rate applicable to cash value is usually greater than minimum guaranteed rate specified in the policy. ULP is more flexible in premium payment structure, death benefit and availability of partial withdrawals than is traditional whole life. ULP has been referred to as an unbundled contract which means that its cash value in effect is separated from death benefit and that the life insurance cost elements are separated in the policy and illustrations for all to refer and evaluate. The unbundled characteristic of ULP as a practical matter has tended to result in ULP being sold in market place as an investment oriented insurance product. Interest is an important cost element, which helps to build policy value inside life insurance contract.

Variable Universal Life Insurance

This is one of the newer innovations in life insurance. It was introduced in 1984 and sales of this product have been modest. Variable Universal Life Insurance (VULI) combines many flexibility features of universal life with investment flexibility of variable life insurance. The features of Universal life in VULI are:

1) Premium flexibility after the first policy year and policy owner decides it when and how much to pay in premiums. Premiums can be skipped or extra premiums paid so long as limiting conditions are met.

2) The choice of either of standard universal life death benefit configurations – level death or increasing death benefit.

3) Ability to make policy loans and partial withdrawals of the cash value.

VULI contains following features of Variable Life Insurance

1) The policy owner assumes all investment risk, with no intererst rate guarantee or minimum cash value guarantee on variable portion of the policy.

2) The policy owner is permitted to allocate the investment supporting the life insurance policy among a limited number of available separate accounts.

3) The policy owner is permitted to reallocate these investments upto four or five times a year without transaction charge.

Variable Universal Life Insurance policies are appropriate for policy owners desiring both flexibility of universal life policy and the ability to direct the investments supporting the universal policies in conjunction with assuming investment risk. The limitation of this is that stock market prices and other investment conditions can influence the sales volume of VULI. No minimum rate of interest is guranteed. VULI is not appropriate for those individuals who will be uncomfortable with fluctuations in cash value because of capital market fluctuations and some policy owners might not want the available flexibility.

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In either design favourable investment performance directly enhances the cash value in the contract. However, the ways in which death benefits are affected differ.

Level Death Benefit: Death benefit does not increase regardless of investment performance. Instead favourable investment performance results in increase in the cash value of policy which in turn reduces amount at risk and consequently the applicable mortality charges usually decrease but increase at older ages.

Increasing Death Benefit: Death benefit always increases by the same amount that the cash value increases. There is no separate purchase of additional coverage from favourable investment results under Variable Universal Life Insurance.

Expenses: The expenses include front-end expenses applicable to premium payments. It includes the cost of managing policy investments and commission fees for stock and bond transactions made within the investment fund. The loading can be a flat percentage of premium payments. It also includes back end expenses which take several forms; viz. surrender charges or transaction fees or charges for any partial withdrawal of cash value.

Unit Linked Plans

What unit-linked products offer is a long-term investment option where returns are far more real and there is no compromise in the protection that the policy offers. In the guaranteed returns regime, the guaranteed component was met by paying lower interest rates to those who did not have any guarantee on their plans. Compared to this, unit-linked plans offer greater value to the customer. The investment risk is in the hands of the customer. However, the flexibility to opt for funds means that the customer can benefit as well. And finally, the returns that these products offer are bound to be relatively higher than what similar traditional plans offer.

Unit-linked life insurance products are those where the benefits are expressed in terms of number of units and unit price. They can be viewed as a combination of insurance and mutual funds. The number of units, which the customer would get will depend on the unit price when he pays his premium. The daily unit price is based on the market value of the underlying assets (equities, bonds, government securities etc.) and computed from the net asset value.

The unit-linked plans work as under:

The premium paid by the client, less any charges to be deducted, is used to buy units in the fund selected by the client at that day's unit price. So more units are added to the client's account each time he pays a premium. If the unit price on that day is relatively high the client gets less number of units and if the unit price is relatively low then he gets more number of units.

In order to pay the regular monthly costs an equivalent number of units are cancelled and are computed as cost to be deducted divided by unit price on that day.

The value of the fund depends on the unit price, which in turn is determined from the market value of the underlying assets as seen earlier. Thus,

Fund Value = Unit Price × Number of Units

When is the best time to buy unit-linked plans? The ideal time to buy a unit-linked plan is when one can expect long-term growth ahead. This is especially so if one also believes that current market values (stock valuations) are relatively low. BSLI has given superior returns on all its investment funds.

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What are the advantages of unit-linked plans vis-a-vis traditional plans?

Unit-linked plans enjoy several advantages. They are

- Simple, clear and easy to understand
- Tansparent and visible for customers to take decisions
- Flexible and adaptable
- Puts the policyholder in control
- Policyholder gets the entire upside on the performance of his fund

Besides all the advantages they offer to the customers, unit-linked plans also lead to an efficient utilisation of capital.

Illustration

UNIT-linked insurance plans have met with considerable success in the Indian market. This week, we take a look at one of the earliest unit-linked plans to hit the market - LIC's **Bima Plus**

Features

Bima Plus is a unit-linked endowment plan. The plan is available over a duration of 10 years. Premium can be paid either yearly, half-yearly, or at one shot. The premium is used to purchase units in a fund of one's choice, after the necessary deductions.

The value of the unit varies with the investment performance of the assets in the fund. Investments can be made in one of three types of funds Secured fund, which invests predominantly in debt and money market instruments; Risk fund, in which the tilt is towards equities; and a Balanced Fund, a blend of the two. Switching between funds is allowed twice during the policy term, subject to the condition that they are at least two years apart. Charges for switching are 2 per cent of the fund's cash value.

Death benefit

What the beneficiary receives depends on when the death of the policyholder occurs. If death occurs within the first six months of the policy, the payout is 30 per cent of the sum assured plus the cash value of the units.

- Between months seven and 12 of the policy, the payout is 60 per cent of the sum assured plus cash value of units.
- After first year, the sum assured and cash value of the units is paid.
- During the 10th year, 105 per cent of the sum assured and cash value of units is paid out.
- If death occurs due to an accident, a sum equal to the sum assured, over and above the benefit mentioned above is paid.

On survival up to maturity, the policyholder will receive 5 per cent of the sum assured plus the cash value of the units.

Charges

As is the case with unit-linked plans, this plan, too, comes with a set of charges. This includes a level annual mortality charge, the quantum of which is a function of the policyholder's entry age; accident benefit charge at Rs 0.50 per thousand sum assured; annual administrative and commission charges; and a fund management charge.

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Surrender value

On surrendering the policy, the cash value of the units, subject to certain deductions that depend on the year surrendered, is paid out to the policyholder.

20.19 INCOME TAX BENEFITS ON LIFE INSURANCE AND PENSION AND MEDICLAIM INSURANCE

Life insurance plans are effective ways of saving taxes. The premium paid for life insurance policies for self, spouse and children is eligible for rebate under section 88 at the rate ranging from NIL to 30 per cent, depending on your employment status and your income slab. If insurance policy consists of riders like critical illness rider, etc., the premium paid for such riders should be segregated and claimed separately as deduction under section 80D (deduction in respect of medical insurance premia).

An amendment made by the Finance Act of 2003 states that where the premium payable on a life insurance policy *exceeds* 20 per cent of the actual capital sum assured, the premium so paid shall not be eligible for rebate under section 88.

The tax breaks that are available under various insurance and pension policies are described below:

1) life insurance plans are eligible for deduction under Sec. 80C.
2) Pension plans are eligible for a deduction under Sec. 80CCC.
3) health riders are eligible for deduction under Sec. 80D.
4) The proceeds or withdrawals of life insurance policies are exempt under Sec 10(10D), subject to norms prescribed in that section.

Premiums paid for Life insurance - Deduction under Section 80C

1) Category of assesses allowed deduction Individual assessee and Hindu Undivided Family assessee.
2) Eligible Savings Premiums paid or deposited by assessee to effect or to keep in force insurance on the life of following persons.

   In case of individual assessee – Himself/Herself, spouse, children of such individual.

   In case of HUF assessee – any member
3) 20% limit If the amount of premium paid in a financial year for a policy is in excess of 20% of the actual capital sum assured, then deduction will be allowed only for premiums upto 20% of the sum assured.
4) Limit on Amount of Deduction: Deduction will be restricted to investments of upto Rs 1,00,000 in savings specified under Section 80C (including life insurance premiums). If any investments have been made under Section 80CCC and 80CCD, then the qualifying amount under Section 80C will stand reduced to that extent.
5) Deduction Limit: The amount of deduction will be equal to the amount by which the income tax payable on such total income is in excess of the amount by which the total income exceeds 1,00,000.

Benefits Under Insurance Policy - Section 10(10D)

As per Section 10(10D) of Income tax Act, 1961, any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy is exempt from tax. However, this rule does not apply to following amounts

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Sum received under Section 80DD(3), or any sum received under a Keyman Insurance Policy, or any sum received other than as death benefit under an insurance policy which has been issued on or after April 1, 2003 and if the premium paid in any of the years during the term of the policy is more than 20% of the sum assured.

The above information is to give a general overview of the current relevant tax laws, and is not and neither intended to be a tax advice. The above information is based on prevailing tax laws and is subject to change with the change in tax laws.
Income-tax rates and provisions of Section 80C and 80CCE as described above are as per the proposals in the Finance Bill 2005, and have not yet become a law (as of April 21, 2005).

20.20 LIFE INSURANCE INDUSTRY IN INDIA

With the registration of Sahara Life Insurance Company Ltd., the number of players in the life insurance industry has increased to fourteen. However, the insurer is yet to launch its products in the market.

The life insurance industry recorded a premium income of Rs. 66,287.93 crore during the financial year 2003-04, as against Rs. 55,747.55 crore in the previous financial year, recording a growth of 18.91 per cent. The contribution of first year premium, single premium and renewal premium was Rs. 13,804.99 crore (20.83 per cent); Rs. 5,625.01 crore (8.48 per cent); and Rs. 46,857.93 crore (70.69 per cent), respectively. In the year 2000-01, when the industry was opened up to the private players, the life insurance premium was Rs. 34,898.48 crore. Single premium continued to decline steadily from Rs. 9,194.07 crore in the year 2001-02 to Rs. 5,625.01 crore in 2003-04 with the withdrawal of the guranteed return policies (Tables 20.3 and 20.4 give the break of premium underwritten by life insurers and their market share).

Table 20. 3: Premium Underwritten by Life Insurers

(Rs. lakh)

Insurer	**2001-02**	**2002-03**	**2003-04**
	First year including Single Premium		
LIC	1958877.25	1597676.15	1698929.64
		(-18.44)	(6.34)
Private Sector	26850.90	96568.97	244070.58
		(259.65)	(152.74)
Total	**1985728.15**	**1694245.12**	**1943000.22**
		(-14.68)	(14.68)
	Renewal Premium		
LIC	3023313.69	3865172.79	4617830.54
		(27.85)	(19.47)
Private Sector	403.48	15337.18	67962.05
		(3701.22)	(343.12)
Total	**3023717.17**	**3880509.97**	**4685792.59**
		(28.34)	(20.75)
	Total Premium		
LIC	4982190.94	5462848.94	6316760.18
		(9.65)	(15.63)
Private Sector	27254.81	111906.15	312032.63
		(310.59)	(178.83)
Total	**5009445.75**	**5574755.09**	**6628792.81**
		(11.28)	(18.91)

Note: Figures in brackets indicate the growth ratio (in per cent)

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Table 20.4: Market Share of Life Insurers (per cent)

Insurer	2001-02	2002-03	2003-04
	First Year Premium		
LIC	98.65	94.30	87.44
Private Sector	1.35	5.70	12.56
Total	**100.0**	**100.00**	**100.0**
	Renewal Premium		
LIC	99.99	99.60	98.55
Private Sector	0.01	0.40	1.45
Total	**100.00**	**100.0**	**100.00**
	Total Premium		
LIC	99.46	97.99	95.29
Private Sector	0.54	2.01	4.71
Total	**100.00**	**100.00**	**100.00**

The size of the life insurance market increased on the strength of the growth in the economy and concomitant increase in per capita income. This resulted in a favourable growth both for LIC (15.63 per cent) and to the new insurers (178.83 per cent) in 2003-04. The higher growth for the new insurers is to be viewed in the context of a very small base. However, the new insurers have improved their market share from 2.01 per cent in 2002-03 to 4.71 in 2003-04 exhibiting a favourable growth.

Analysis of the first year premium underwritten by the life insurers during the year 2003-04 reveals that 81.68 per cent of the business was underwritten in the life segment, followed by 8.98 per cent in Pensions, 8.62 per cent in Annuity and the remaining in Health at 0.72 per cent. The number of new policies underwritten during the year increased to 286.27 lakh as against 253.70 lakh in the previous year exhibiting an increase of 12.83 per cent over the previous year (Table 20.5).

Table 20.5: No. of New Policies Issured : Life Insurers

Insurer	2002-03	2003-04
Private Sector	825094	1658847
	(3.25)	(5.79)
LIC	24545580	26968069
	(96.75)	(94.21)
Total	**25370674**	**28626916**

Note: Figures in bracakets indicate the ratio (in per cent) of respective insurer.

Innovations in the products

With the demographic changes and changing life styles, the demand for insurance cover has also evolved taking into consideration the needs of prospective policyholder for packaged products. There have been innovations in the types of products developed by the insurers, which are relevant to the people of different age groups, and suit their requirements. A number of new products have been introduced in the life segment with guaranteed additions, which were subsequently withdrawn/toned down; single premium mode has been popularized; unit linked products; and add-on/ riders including accidental death; dismemberment, critical illnes, fixed term assurance risk cover, group hospital and surgical treatment, hospital cash benefits, etc. Comprehensive packaged products have been popularized with features of endowment, money back, whole life, single premium, regular premium, rebate in premium for higher sum assured, premium mode rebate, etc., together with riders to the base products.

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In the case of the new insurers a significant contribution to the life premium was from unit linked policies. While LIC has been a significant player in traditional life insurance products, it is now gearing up to meet the competition and intends to introduce more unit linked products in the market. There is a need to develop products for meeting the post-retirement necessities of senior citizens. Though the senior citizens may not be in the customer horizon of insurers, lack of avenues for investment force them to search for plans to park their savings in various schemes including insurance.

20.21 SUMMARY

Insurance is a risk cover wherein the risk is transferred from the insured to the insurer. Risk is an uncertainity of loss or a combination of hazards. Risks are classified into Objective risk and Subjective risk; Financial risks and Non-financial risks; pure risk and Speculative risk; Fundamental risk and Particular risk. Risks that have a direct impact on an individual, such as loss of ability to earn income, premature death, sickness or disability etc. are called personal risks and are insurable. Insurable risks also include property risk such as property damaged or destroyed because of fire, lightening, flood, cyclone, earthquake or any natural disasters, and liability risks wherein under the law of the land a person can be held legally liable if his/her act results in serious bodily injury or property damage to someone else.

Insurance is the pooling of future unexpected losses by transfer of such risks to the insurers who agree to indemnify insured for such losses, to provide other preliminary benefits on their occurrence or to render services connected with the risks. Classification of insurance according to the type of coverage has also been discussed.

Life insurance is designed to be an effective and efficient means of planning for adverse financial consequences in the event of untimely death of income earner for the average family. During an individual's life span his needs may vary and hence in order to reach maximum number of customers having diverse needs, product differentiation is a must. The features generally used to bring about product differentiation are sum assured, principal and supplementary benefits of the policy, embedded or in-built options available under the policy, policy term, premium paying modes available, etc. All these product design features constitute life insurance product design which have been discussed in detail. We have also given you a brief idea about the insurance market and the life insurance industry in India.

20.22 SELF ASSESSMENT QUESTIONS

1) Distinguish between a pure risk and speculative risk.
2) Discuss the concept of Insurance with illustration.
3) Explain the terms hazard and perils. Distinguish between moral hazard and physical hazard.
4) What are the important functions of insurance?
5) Write a note on broad classification of Insurance.
6) What are the contingencies covered under the life insurance contract?
7) What are the modes available to pay the premiums?
8) What is the difference between an annual premium and instalment premiums?
9) What do you mean by embedded options (other benefits)? Name any five.
10) What do you mean by riders?
11) Name the basic Life insurance plans. Explain those in details.
12) Explain the Universal Variable Life Insurance Plan and what are the additional facilities available to the insured under this plan.
13) "Unit linked plans are becoming more and more popular in the Indian Market" - Explain.

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