IC Value 2016 : 61.33| SJIF Impact Factor(2017) : 7.144| ISI Impact Factor (2013): 1.259(Dubai)|UGC J No :47335

Research Paper | Volume - 6, Issue- 3, March 2018 | e-ISSN : 2347 - 9671| p- ISSN : 2349 - 0187

EPRA International Journal of Economic and Business Review

COST OF LAPSATION TO POLICYHOLDERS IN INDIAN LIFE INSURANCE INDUSTRY

Dr. K. Vidyavathi
Professor, Department of Business Administration, Sahyadri College of Engineering & Management, Mangalore – 575007, Karnataka, India

Avinash B N
Research Scholar, Visvesvaraya Technological University, Sahyadri College of Engineering & Management, Mangalore – 575007, Karnataka, India

KEYWORDS:
Insurance, linked, non linked, premium, Lapsation

ABSTRACT

Life insurance is a long-term contract in which company is committed to paying a specified death or maturity benefit provided that the premiums are paid by the insured. However, a policyholder can terminate the policy either through lapse or surrender at any point in time. When a policy holder voluntarily cancels the contract by not paying the premium within the grace period policy gets lapsed. When a policy lapses before it acquires the surrender value it becomes extremely costly to the policyholder regarding the loss of premiums paid and insurance coverage. An effort is made to calculate the cost of lapsation to policyholders regarding the loss of premiums paid. This loss of premium is estimated and analysed across the broad product category of both private as well public insurers and also in the industry as a whole. The renewal premium method is used to estimate the loss premium taking the data from the annual reports of IRDAI.

INTRODUCTION

Insurance is a contract between two parties which would run to 10-20 years whereby one party undertakes to pay the other party a fixed amount of money on the occurrence of a certain event (death or attaining a certain age in case of human life or to pay the amount of actual loss when it takes place through the risk insured in case of property) in exchange for a fixed sum as a consideration of insurance contract. The party who seeks protection against a particular risk is called the insured, and the party who undertakes to protect the former is called the insurer. Insurers are insurance companies these days. The document of an insurance contract is known as an insurance policy; the amount for which the event/risk is insured is the insured amount of policy, and the fixed sum which is paid by the insured to the insurance company is called premium. Thus insurance is an economic device whereby an individual substitutes a specific small cost (premium) for a significant uncertain financial loss (the contingency insured against) that would exist if it were not for the insurance.

Life insurance is designed to offer protection against two distinct risks: premature death and superannuation (living too long) and also to help to meet the long-term needs and aspirations of its customers. It is a long-term contract in which company is committed to paying a specified death or maturity benefit provided that the premiums are paid by the insured. However, a policyholder can terminate the policy either through lapse or surrender at any point in time. Policy termination adversely affects the insured, insurer and the agent. When a policyholder voluntarily cancels the contract by not paying the premium within the grace period policy gets lapsed. When a policy lapses before it acquires the surrender value it becomes incredibly costly to the policyholder regarding the loss of premiums paid and insurance coverage.(Vidyavathi 2013)

Life Insurance Products:

There are two main types of life insurance products traditional life insurance and non-traditional life insurance. Traditional insurance products are the oldest plans and consists of term assurance, endowment and whole life policies. Most of the traditional products besides covering risk also contain some element of savings. Non-traditional insurance products are like unit-linked products contain strong investment elements besides risk coverage.

Traditional Insurance Products:

Term assurance

Term plans provide death cover during a specified term of policy which may be short (for example one year) to long-term (for example 25 years). Term assurance products are purely life insurance products which cover the life in monetary terms in return for payment of premium. There is no provision for loans or surrender value under term plans.

There are a variety of term assurance policies like necessary term assurance plans, increasing term assurance plans, decreasing term assurance policies, renewable term assured policies, convertible term assurance etc. All these plans are real risk-oriented plans and payment is made only in the event of death during the term of the policy.

Endowment Plans

Endowment plans are investment oriented plans in which payments are made not only in the event of death but also in the event of survival at the end of the term. In case of endowment policies insurance companies pay a sum assured plus accumulated profits that are declared annually. Unlike premium under term assurance which covers only mortality element the premium under an endowment plan has two elements-mortality elements and investment element. In endowment policies bonus is added to the necessary sum assured and bonuses are of three types namely simple revisionary bonus declared annually as cash value, special bonus guaranteed at the discretion of the company and terminal bonus which is an additional bonus paid at the end of the policy term. Various types of endowment policies include basic endowment policy, money back policy and whole life policy.

There are a variety of term endowment and whole life policies which are included in traditional plans. They provide benefits like protection, fixed income return, tax benefit etc., they are simple and better understood by people and also risk-free as they provide a fixed return on death and maturity of the policy.

Non Traditional Insurance Products:

Unit Linked Plans

Unit-linked insurance plans (ULIPs) are non-traditional insurance products which offer long-term investment option plus life coverage. In fact, ULIPs are a combination of both investment and insurance(Vidyavathi 2016). ULIPs are not simple to understand as their cost structure is complicated with several charges such as policy administration charges, premium allocation charges, mortality charges, fund management charges etc. (Vidyavathi 2016)

Premiums received from the customers less the administrative charges are used for investing in assets like bonds, equities, government securities etc. at the prevailing prices by a predetermined option of the customers (Vidyavathi 2016). Several options are available to a customer who can select a debt fund or a balanced fund or an equity fund (Vidyavathi 2016). Policyholders also enjoy the freedom of switching over from one fund to other if they feel that a particular fund is not providing a better return. Sale of ULIPs is closely linked to the stock market movement because insurance companies invest policyholders' money in the stock market. Further investing in ULIPs requires a better understanding of unit-linked product development in capital market and risk-return relationship.

OBJECTIVES

In this paper, an effort is made to calculate the cost of lapsation to policy holders regarding the loss of premiums paid. This loss of premium is estimated and analysed across the broad product category of both private as well public insurers and also in the industry as a whole.

HYPOTHESES

1. The cost of lapsation regarding the loss of premium to policy holders is same in case of linked and non linked policies of LIC.
2. The cost of lapsation regarding the loss of premium to policy holders is same in case of linked and non linked policies of private insurers.
3. The cost of lapsation regarding the loss of premium by investors in Indian life insurance companies is same in case of linked and non linked policies.

MATERIALS AND METHODS

The materials in the form of data and information are gathered from the Annual Reports of Insurance Regulatory and Development Authority of India (IRDAI) from 2008 to 2016. The renewal premium method proposed in one paper (Monika et al.,2013) is used to estimate the cost of lapsation taking the data from the annual reports of IRDAI. The research paper of Monika et al. estimated the loss suffered by investors in the life insurance industry during the period from 2004-05 to 2011-12. Loss of premium in linked and non linked products in case of private and public insurers was not calculated in their paper. Hence in this paper, an attempt is made to capture the loss by investors in traditional versus unit linked products as well as public versus private insurers over the years 2008-09 to 2015-16. This loss is due to lapsation of policies when policyholders fail to renew their policies for reasons other than death maturity or income shock.

Single premium policies are excluded while calculating the loss as the question of paying the premium during the tenure of the policy does not arise as they involve one-time lump sum premium payment to insurers. The same formula used by Monika et al. is adopted in this paper to estimate the cost of lapsation or the loss incurred by the investors in traditional versus unit-linked products as well as public versus private insurers over the years 2008-09 to 2015-16. The new regular premium means the money paid at regular intervals viz. annual, semiannual, quarterly or monthly to buy an insurance policy. Both traditional and nontraditional policies require the policyholder to pay the premium at a particular time interval. The renewal premiums are premiums paid after the initial premium at regular intervals to the insurance company by the insured to keep the policy alive and avail the benefits of the policy.

Following is the formula used to calculate the loss of premium to policyholders:

Loss of premium for a particular year = Previous year's new regular premium + Previous year's renewal premium - Renewal premium for a particular year.

Symbolically

$LP_t = NRP_{t-1} + RP_{t-1} - RP_t$ **means Loss of premium for a period t = new regular premium for a period t-1 + renewal premium for a period t-1 - Renewal premium for a period t**

Further to test the hypotheses Student 't' test is applied using SPSS version 20.

RESULTS AND DISCUSSION

The reform process initiated with the formation of IRDAI has facilitated various kinds of product innovations notably the introduction of unit-linked products (ULIPs). Private companies have procured a big chunk of their new business premium from the ULIPs and increased their market share from 2.01 percent in 2002-03 to 30.23in 2010-11 with the domination of ULIPs (Vidyavathi 2017). The year 2003-04 witnessed a paradigm shift from traditional to non-traditional products in the Indian insurance business. In the next six years, the new business underwritten by life insurers is dominated by linked products especially in the case in private. LIC the public sector insurer which was a leader in a traditional life insurance products too introduced number of unit linked products in the market during these years (Vidyavathi 2017). Slow down in the economic growth and meltdown of the stock market in the aftermath of global financial crisis shifted the preferences away from ULIPs. IRDAI's guidelines on ULIPs in 2010 further impacted the sale of ULIPs. The share of linked products in the total first-year premium started drifting down and fell drastically in the recent years.

Table 1 First Year Premium Collected by Indian Life Insurance Companies from 2003-04 to 2015-16 (Rs in billions)

Year	Premium from Linked Policies (First Year)	Premium from Non Linked Policies ((First Year)	Total Premium (First Year)	Percent of Linked in total Premium	Percent of non Linked in total Premium
2003-04	16.13	181.75.11	197.88	8.15	91.85
2004-05	84.46	177.72	262.18	32.22	67.78
2005-06	218.76	229.09	447.86	48.85	51.15
2006-07	432.49	323.68	756.17	57.19	42.8
2008-09	678.39	258.73	937.13	72.39	27.61
2009-10	446.6	426.71	873.31	51.14	48.86
2010-11	599.25	499.68	1098.94	54.53	45.47
2011-12	535.43	728.38	1263.81	42.37	57.63
2012-13	174.06	965.6	1139.66	15.27	84.73
2013-14	108.69	964.92	1073.61	10.12	89.88
2014-15	132.73	1117.11	1249.84	10.62	89.38
2015-16	175.36	1213.27	1388.62	12.63	87.37

Source: computed from the Annual Reports of IRDAI

Table 2 Estimation of loss of premium in linked and non linked policies at private insurers (Rs in billions)

Year	Linked policies			Non linked policies				
	Regular Premium	Renewal Premium	Loss of Premium	Regular Premium	Renewal Premium	Loss of Premium	Total Loss	Loss of Premium As % of total premium due
2008-09	268.69	264.12		37.94	39.33			
2009-10	289.21	364.2	168.61	56.09	45.78	31.49	200.11	32.80
2010-11	186.79	427.65	225.76	89.85	59.98	41.89	267.65	35.40
2011-12	83.71	414.5	199.94	133.62	106.29	43.54	243.48	31.90
2012-13	82.79	316.22	1811.00	135.98	160.28	79.64	261.64	35.40
2013-14	69.27	262.54	136.47	138.54	215.76	80.49	216.96	31.20
2014-15	105.65	264.69	67.11	133.76	271.44	82.87	149.98	21.90
2015-16	132.2	278.97	91.37	139.3	316.31	88.89	180.25	23.20

Source: computed from the Annual Reports of IRDAI

Table 3 Estimation of loss of premium in linked and non linked policies at LIC of India (Rs in billions)

Year	Linked policies			Non linked policies				
	Regular Premium	Renewal Premium	Loss of Premium	Regular Premium	Renewal Premium	Loss of Premium	Total Loss	Loss of Premium As % of total premium due
2008-09	44.59	195.75		146.81	845.34			
2009-10	48.40	191.76	48.58	213.44	953.80	38.36	86.94	7.10
2010-11	31.04	126.95	113.22	331.62	1037.66	129.57	242.79	17.30
2011-12	4.65	107.94	50.04	397.30	1102.33	266.95	316.99	20.80
2012-13	0.40	63.38	49.20	302.73	1258.54	241.09	290.29	18.00
2013-14	0.09	26.84	36.94	318.95	1434.49	126.78	163.72	10.10
2014-15	0.02	18.75	8.18	231.12	1592.85	160.60	168.78	9.50
2015-16	0.29	14.39	4.37	238.00	1671.14	152.83	157.19	8.50

Source: computed from the Annual Reports of IRDAI

Table 4 Estimation of loss of premium in linked and non linked policies in Indian life insurance industry (Rs in billions)

Year	Linked policies			Non linked policies				
	Regular Premium	Renewal Premium	Loss of Premium	Regular Premium	Renewal Premium	Loss of Premium	Total Loss	Loss of Premium As % of total premium due
2008-09	313.28	459.87		184.76	884.68			
2009-10	337.62	555.96	217.19	269.53	999.58	69.86	287.05	15.58
2010-11	217.83	554.59	338.98	421.46	1097.65	171.46	510.44	23.60
2011-12	88.36	522.44	249.98	530.92	1208.62	310.49	560.47	24.46
2012-13	83.19	379.60	231.20	438.71	1418.81	320.73	551.93	23.48
2013-14	69.36	289.38	173.41	457.49	1650.25	207.27	380.69	16.41
2014-15	105.65	283.44	75.30	364.87	1864.29	243.46	318.76	12.92
2015-16	132.49	293.36	95.74	377.30	1987.45	241.71	337.45	12.89

Source: computed from the Annual Reports of IRDAI

During the period from 2003-04 to 2007-08 the average growth of premium underwritten under linked categories by private insurers was 142.32 percent, and after that, there was a declining trend in the premium collected from ULIPs and the average growth recorded for the period from 2008-09 to 2013-14 was negative at 16.77 percent (Vidyavathi 2017). During the same period, i.e. from 2003-04 to 2007-08, the percentage share of linked premium in the total first-year premium underwritten by the life insurance industry went up from 8.15 to 72.39, and after that, it started falling and fell to 12.63 percent in 2015-16 from 54.53 percent in 2010-11 (Vidyavathi 2017). Indian stock market which was booming during 2003-08 helped this type of enormous growth in the sale of ULIPs. The two main features of ULIPs at the time of their introduction in the Indian Insurance market were (i) they had a three year lock-in period, i.e. policyholder was not allowed to surrender the policy during the lock-in period. (ii)The first year commission paid by companies to sales agents was as high as 40 percent for the year one and 7.5 percent for the second year and the third year and 5 percent for the subsequent years.

The three-year lock-in period and the 40 percent commission on selling a unit-linked product prompted the sales agents to push this product as three-year money doubling policy in the market quickly. As long as the stock market was doing well, there was not a problem in selling (in fact mis selling) ULIPs. However, the problem started with the global economic crisis and the crashing of Indian stock market which made the people who invested in ULIPs to realise that the return from ULIPs is linked to the performance of the stock market and they are duped. As a result of a large scale, people discontinued of paying their premium and lost a considerable amount of money by investing in ULIPs. This loss incurred by the investors at private insurance companies is estimated for the years 2008-09 to 2015-16. The loss incurred on linked is Rs 1071.26 billion while the loss of traditional policies during the same period is Rs.448.80 billion. The total loss to policyholders at private insurance companies is to the tune of about Rs 1520.06 billion.

During the period from 2003-04 to 2007-08 the average growth of premium underwritten under linked categories by LIC of India was 341.87 percent, and after that, there was a declining trend in the premium collected from ULIPs and the average growth recorded for the period from 2008-09 to 2013-14 was negative at 39.41 percent (Vidyavathi 2017). LIC, which was a leader in a traditional life insurance products too introduced number of unit linked products in the market during the years from 2004-05 to 2007-08 (Vidyavathi 2017). During the same period, the average growth of premium underwritten under non linked categories by LIC of India was 11.21 percent and after that, the average growth recorded for the period from 2008-09 to 2013-14 was more than a double at 27.88 per cent (Vidyavathi 2017).

The loss incurred by the investors at LIC is estimated for the years 2008-09 to 2015-16. The loss incurred on linked is Rs 310.54 billion while the loss on traditional policies during the same period is Rs.1116.18 billion. The total loss to policyholders at LIC is to the tune of about Rs 1426.71 billion.

The estimation of loss incurred by investors on investing in life insurance products in India for the years 2008-09 to 2015-16 comes to Rs 2946.77 billion, of which policy holders lost Rs 1381.80 billion by investing on ULIPs and Rs 1564.97 on traditional policies. Insurance companies in India every year lost more than 20 percent of premium due to them as a result of lapsation.

Table 5 Hypotheses testing using Student 't' test

Insurer	Insurance Plans	N	Mean	Std. deviation	Std.error mean	T value	df	P value
Loss of premium by investors in LIC	Linked policies	7	44.36	36	13.61	-3.611	12	0.004
	Non linked policies	7	159.46	76.26	28.82			
Loss of premium by investors in Private insurance companies	Linked policies	7	153.04	57.78	21.84	3.76	8.01	0.006
	Non linked policies	7	64.11	24	9.07			
Loss of premium by investors in Indian life insurance companies	Linked policies	7	197.4	91.44	34.56	-0.552	12	0.591
	Non linked policies	7	223.57	85.95	32.49			

Source: computed from the Annual Reports of IRDAI

Hypotheses testing was done using student 't' test. The result of 't' test indicates that the first two hypotheses viz., i) the cost of lapsation in terms of loss of premium to policyholders is same in case of linked and non linked policies of LIC and ii) the cost of lapsation in terms of loss of premium to policyholders is same in case of linked and non linked policies of private insurers gets rejected as the p values of 0.004 and 0.006 are less than the significance level (α=0.05).

However, the third hypothesis - the cost of lapsation regarding the loss of premium by investors in Indian life insurance companies is same in case of linked and non linked policies get accepted that means investors have lapsed both the ULIPs and traditional policies for various reasons and lost the premium paid.

CONCLUSION

Complicated financial contracts and low level of financial awareness in the financial market always give a room for mis selling of financial products and insurance sector is not an exception to this. Lack of proper understanding of contractual terms, the mismatch between product features and needs of customers, failure of agents to market the need-based products, agents pushing the products which give more commissions and not by customer need etc. , have to lead to a lapsation of insurance policies. According to industry experts' opinion, around 20 percent of premium loss may be attributed to death, maturity and income shock and the remaining 80 percent of premium loss are occurring due above said reasons. The loss estimated for the seven-year period is not a small amount but a massive amount of Rs 2357.42 billion after adjusting 20 percent of premium loss due to death maturity and income shock.

REFERENCE

1. *Arpita Khare, Saumya Dixit, Ruchi Chaudhary, Priyanka Kochhar & Shruti Mishra (2012): "Customer Behavaior toward Online Insurance Services in India" Journal of Database Marketing & Customer Strategy Management. Available at http://search.proquest.com*
2. *Carson, James M and Dumm, Randy E (1999): "Insurance Company-level Determinants of Life Insurance Product Performance", Journal of Insurance Regulation: Winter 1999. Available at http://search.proquest.com*
3. *G. Prabhakara (2010) " The Evolution of Life Insurance Industry in the last decade (2000 – 2010)" The Journal of Insurance Institute of India, Vol 36(2) July-December 2010*
4. *Government of India "Economic Survey" from 2000-01 to 2015-16*
5. *Haridas R (2011): "Life Insurance in India" New Century Publications, New Delhi, India.*
6. *Harpreet Singh Bedi and Preeti Singh (2011) "An Empirical Analysis Of Life Insurance Industry In India" International Journal of Multidisciplinary Research Vol.1 (7), November 2011.*
7. *.01IRDA Annual Reports from 2000-01 to 2015-16*
8. *Monika Halan, Renuka Sane and Susan Thomas(2013): "Estimating losses to customers on account of mis-selling life insurance policies in India" working paper, Indira Gandhi Institute of Development Research, Mumbai. Available at http://www.igidr.ac.in/pdf/publication.*

9. Narayanan H (2006): "Indian Insurance -A Profile" Jaico Publishing House, Mumbai
10. Palande P.S, Shah R.S & Lunawat M.L.(2003): "Insurance in India: Changing Policies and Emerging Opportunities" Sage Publications, India.
11. Sadhak H (2009): "Life Insurance in India, Opportunities, Challenges and Strategic Perspective" Sage Publications, New Delhi.
12. Santosh Anagol,Shawn Cole and Shayak Sarkar(2013) " Understanding the Advice of Commissions-Motivated Agents:Evidence from the Indian Life Insurance Market" Harvard Business School, Working Paper 12-055 March 7, 2013
13. Sinha, Tapen (2005): "An Analysis of Evolution of Insurance in India", CRIS discussion paper, available at www.nottingham.ac.uk/business/cris/papers
14. ýSinha, Tapen (2005): "The Indian Insurance Industry: Challenges and Prospects" available at www.ssrn.com
15. Vidyavathi (2013): "Lapsation of Life Insurance Policies in India" Zenith International Journal of Business Economics and Management Research (ZIJBEMR) Vol 3(2) November 2013.
16. Vidyavathi (2014): "A Brief History of the Indian Life Insurance Industry" Zenith International Journal of Business Economics and Management Research (ZIJBEMR) Vol 4 (2) February 2014
17. Vidyavathi (2015): "Indian Life Insurance in the Post Reform Period" Global Journal for Research Analysis" Vol.4 (9) September 2015
18. Vidyavathi (2017): "Rise and fall of Ulips In Indian Life Insurance Market" European Journal of Economics and Management Vol 4(1) January-June 2017
19. Vineet Kumar and Poonam Kumari(2012): "A Comparative Study On Public Vs Private Sector In Life Insurance In India" VSRD International Journal of Business and Management Research, Vol. 2 (10) October 2012