

## **Unit Linked Insurance Policies [ULIP] and Risk Management.**

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The truth in the present day insurance market in India is that Unit Linked Insurance Policies [ULIP] are selling well. This is evident from the sales figures that are being quoted by various marketing personnel engaged by insurance companies. So far Life Insurance Corporation of India [LIC] has launched seven plans in Unit Linked. LIC's premiums from sales of new unit-linked plans [ULIPs] have grown 293% in the first quarter of 2005-06 to Rs.886.3 crore from Rs.225.42 crore last year. Overall new business premium from individual policies has grown 62% to Rs.1958 crore due to slower growth [7.8%] in premium from traditional plans. Despite the 62% jump in premium from individual assurance, the overall sum insured has fallen to Rs.24, 938.72 crore from Rs.25, 745.9 Crore in Q1 last year. Along with the fall in the sum assured, there has also been a decline in the number of policies sold resulting in a higher average premium per policy. As against 34.5 lakh policies sold last year, the number this year has fallen to 33.84 lakh. LIC's ULIP premium accounted for 45% of new business premium from individual policies. This is a major shift from last year, when unit-linked products accounted for only 18.5% of total premium from sales of individual assurances in Q1 2004-05. And the share of traditional plans is on the decline. As against new premium income of Rs.993 crore [81.5%] of total individual assurance premium last year sales, this year account for Rs. 1071 crore [55%]. Even the Group insurance premium is turning out to be a drag on growth this fiscal. In the first quarter, sales have dipped 32% to Rs. 599.25 crore compared to 886.38 crore in Q1 last year. Incidentally, LIC's tilt towards unit-linked plans is fast turning India into a Unit-linked insurance market. Ulip premium already dominates insurance plans sold by private insurance companies. Like LIC private life insurers also have witnessed a tremendous growth in ULIP sales.

ICICI total premium income is predominantly through ULIPs accounts for 60% of the cumulative premium income for the company.

Birla Sunlife sells only Unit linked plans, recorded 189% growth in its new premium income

Bajaj Allianz life sold 75% of the company's policies only in ULIPs in the beginning of the quarter.

Likewise, HDFC Standard Life, AMP Sanmar Life, Tata AIG Life, have also seen the sale of their ULIPs outgrowing the traditional life insurance products.

In this scenario it is the time to question

- What is risk?
- What is risk management?
- Why is "risk" to be managed?
- What is the Role of life insurance in risk management?

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- What is ULIP?
- What is the role of ULIPs in risk management?
- What is the contrast in the objectives of life insurance and ULIP policies.?

### **What is risk?**

It is a condition in which more than one outcome is possible. People take decisions based on perceptions of risk, not necessarily on the actual risk. Risk is a state of nature, where as uncertainty is a state of mind. This uncertainty arises from risk. If something is certain not to occur or certain to occur, there is no risk. Most activities and events in life, however involve risk – we cannot be certain of their outcomes. Except for some recreational activities, humans generally prefer less risk to more risk. Or we are risk averse. Risk aversion causes us to undertake actions to minimize uncertainty. Insurance is one of the most important tool to reduce uncertainty.

### **What are individual risks?**

Individuals are exposed to **Property, liability and personal losses**. **Personal loss exposures** arise from the possibilities of **death, incapacity, illness or injury, retirement, and unemployment**. These losses are associated with families and businesses.

### **What is risk management?**

Risk management is most often associated with attempts to manage those risks that entail the possibility of economic harm. From a financial viewpoint, “harm” is a reduction in the economic value of an individual. The economic value of an individual is the value today of its expected future cash flows. This value today is derived by taking the present [discounted] value of the difference between expected future inflows and outflows. We discount future cash flows because money has time value; i.e., we prefer a rupee today to the same rupee next year – after all, if we invested the rupee today, we [hopefully] would have more than a rupee next year. Thus the purpose of risk management is to contribute to the maximization of the economic value of an individual where value is defined as the discounted value of expected future cash flows. Risk management contributes to economic value by reducing economic harm. The risk management process follows the classical three-step approach to problem solving and involves

### **Problem Specification → Problem Analysis → Problem Decision-making**

Once exposures have been identified and measured, the various means of managing risk should be considered and decisions should be made about the optimum strategy in light of individual objectives. The two fundamental ways of dealing with these losses are

- Risk control
- Risk finance

**Risk Control tools** include avoidance, reduction and prevention of risk, which may not be possible always.

**Risk Finance tools** include risk retention, risk transfer, and risk sharing.

**Risk management decision** has to be taken on the basis of evaluation of risk management alternatives in the light of cost benefit analysis.

### **Why is “risk” to be managed?**

This risk management is a revolutionary idea that defines the boundary between modern times and the past. Because we are vulnerable to more risks than our ancestors risk management is more important today than in the past. The physical and economic security formerly provided by the tribe or extended family diminishes with industrialization. Our income-dependent, wealth-acquiring lifestyles render us and our families more vulnerable to environmental and societal changes over which we have no control. Now more formalized means are required for mitigating the adverse consequences of untimely death, unemployment, loss of health, old age, law suits and destruction of our property.

### **Essence of risk management**

The Essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome.

### **Role of life insurance in risk management.**

- Life Insurance is a **contingent claim contract** on the pool's assets.
- Life insurance is a contract for payment of a sum of money to the person **assured** [or failing him/her, to the person entitled to receive the same] on the happening of the event insured against
- Life Insurance comes to the timely aid of the family in the unfortunate event of the death or total permanent disability of the bread winner. By and large, life insurance is civilization's partial solution to financial uncertainties caused by untimely death.
- **Life Insurance substitutes certainty for uncertainty**
- Life Insurance involves activities and services that are intimately connected with all divisions of economics referred to. The outstanding and distinctive mission of life insurance is **'risk-bearing' and 'risk elimination'** in our economic affairs.
- Life insurance is an attractive financial instrument in an individual's portfolio that provides an **assurance of security**

### **What is ULIP?**

Unit Linked Insurance Policies [ULIP] was first offered in the United States in 1976, [after being developed and sold successfully in The Netherlands, England, and Canada] in the name of Variable Life Insurance. Basically it was a type of whole life insurance whose values may vary directly with the performance of a set of earmarked investments. Now many markets are offering these ULIPs in children plans [ICICI Smart Kid policy] endowment and retirement plans [LIC'S Forty Plus policy] also. These plans give an option to the investor to choose between three fund options – debt, equity, and balanced. In these products, premiums can be paid quarterly, half yearly or yearly. Out of the premium amounts, deductions will be made towards

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

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

In case of death during the premium paying term or the term of the policy, the sum assured [Rs.1 Lakh in example] or value of policy fund, whichever is higher, is paid to the beneficiaries. In case of survival up to maturity, the value of the fund is paid out. **The returns on that day [maturity or death] on the plan depend upon the performance of the market, be it equity or debt.** So if the fund value falls below amount invested on that day, the policyholder will receive a lesser amount. **Hence one can see that the risk here is transferred to the policyholder as nothing is guaranteed.**

Unit-linked plans are essentially similar to mutual fund products wherein the premium is invested in various funds in keeping with **policyholders' risk appetite.**

However, the difference in a mutual fund investment is that the money is virtually at call by the customer. **In case of unit-linked insurance plans, it is impossible to predict whether the market will be in an upswing on the day of the policyholder's death or on maturity.** The Net Asset Value [NAV] will reflect the underlying value of assets, which in turn is dependent on the movement of the Sensex.

### **An Evaluation of ULIP Policies**

Market-linked returns have become the norm today. This is the reason why insurance companies launch unit-linked plans in different avatars. Important segments of the consumer market no longer consider life insurers as competing only with other life insurers. In an effort to gain market power and thereby to protect or enhance profitability the issue of product development and innovation, including pricing and marketing innovation, is all the more important with the continued convergence among financial service competitors.

If we observe the trend of ULIPS in insurance market, after the insurance sector is opened, private players, came up with aggressive marketing strategies to establish their presence. And the public sector has, in its turn, redrawn its priorities. It is quietly being carried out at LIC. "Till last year, we used to do our budgeting for individual plans. But from the beginning of this year we are doing it at the cumulative level," says Ashok Shah, Zonal Manager [North Zone], LIC in a Ficci-organized insurance seminar in October last year. "This new exercise has helped us in prioritizing the sales of individual plans

according to the market needs,” he adds. Accordingly, as already discussed the **Buoyant growth in these plans may be due to**

- Rising stock market – Enticed by the Bull Run, policyholders are putting in more than the actual yearly premium as they top up the investment portion of their risk policies.
- Falling interest rates [The last five years saw interest rates fall dramatically by 400 basis points.]
- Wider product offerings by the insurers [ex. Endowment plan, pension plans etc.]

**Benefits:**

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

But when we think the **risk management part of ULIP Policies** the following questions will arise.

**Linking the market to the death benefit one’s family gets:** Linking death benefits to the market returns may end up in ambiguity which is in the negation of Life insurance purpose. The purpose of Life insurance is to substitute certainty for uncertainty. For Ex. If an individual aged 35, middle class employee who purchased ULIP Policy were to die when the index is at 5,000, his family stands to get Rs.5 lakh. But if were to die when the index is at 8,000, his family will get Rs.8 lakhs.

A very sharp rise in the sensdex is not a common phenomenon and since 1992, a rise of more than 250 points has happened only 13 times. A list prepared by ET [Economic Times] based on the difference between the current close and the previous close reveals that out of these 13 times rise in sensdex, seven rises in the sensdex of more than 250 points had taken place in 1992 during the Harshad Mehata bull run [that had taken the Sensdex above the 4000 point mark for the first time in history]. Hence in the long run, returns in the stock market are likely to settle in the range of five to six per cent. Even the traditional insurance market offers conservative yearly return of 5-6 per cent year after year for long years or for next 20 years.

In this scenario the **risks in ULIP Policies** may be listed out like this.

- The chances of dying in an index downturn
- Is it possible to **replace** the economic value of an individual to their dependants with these policies?
- Is it appropriate for a 35 year old middle class man to bet his last penny on the direction of the market?
- Is it prudent to link the money an individual want to leave behind for family to the whims and fancies of stock market mechanics?
- What is the position of maturity value if the policy matures at the time of break out of scams like Harshad Mehta and Ketan Parekh.

- Is it appropriate to consider Insurance as a means to make big bucks?
- The possibility of falling equity markets and the effect of it on future sales for insurance companies.
- What is the credibility of banks and insurance companies with their customers when they receive low returns on maturity or death?
- Even if there is guaranteed Sum assured what about the cost of the product and bearish trend in the stock market?

**There is a contrast in the objectives of life insurance and ULIP Policies. They are**

- Life Insurance is a **contingent claim contract** where as ULIP is based on **market return and also contingent claim.**
- Life insurance is a contract for payment of a sum of money to the person **assured** [or failing him/her, to the person entitled to receive the same] on the happening of the event insured against. There is **some assurance at higher cost.**
- Life Insurance comes to the timely aid of the family in the unfortunate event of the death or total permanent disability of the bread winner. By and large, life insurance is civilization's partial solution to financial uncertainties caused by untimely death. Policyholder is **transferring his risk** to the insurance company in life insurance where as **market risk is transferred to the policy holder in ULIP Policies.**
- The purpose of life insurance is providing only appropriate **assurance of security or protection** where as the purpose of ULIP is besides providing lower financial security an opportunity to benefit from changes in the security prices in the market.

And finally, Strategic alliances are the norm of today, as life insurers and other financial institutions are joining forces to target new customers [Ex. Bancassurance], distribute new products and become "one-stop" financial service providers on a national or international scale.

But in the absence of a comprehensive social security system in India, the need for pure life and health insurance is enormous. **Across the world, term policies are used by people to meet their insurance requirements.** Till Kelkar Committee recommendations life insurance is sold as a tax product or a saving product. Now it is sold as an investment product. **Ignorance, complexity, and apathy are the three words that best characterize the life insurance market. In fact, in India insurance is never been considered the way it should be considered.** That is the reason after independence of nearly 60 years, or after nationalization of insurance industry around 50 years or after privatization of insurance industry around five years, only 10 -15% of the insurable population are insured.

We cannot stop this trend. People are demanding this product either in ignorance or to make money in short time. Companies are selling aggressively to increase their market share. All the players in this game namely buyers, sellers, regulator, capital market are actively participating. Hence to get the best out of the game some of the suggestions for these players in this trend to play their role are

### **Buyers Role:**

Insurance should never be considered a means to make big bucks. Play the market separately by all means but only after having sufficient cover for life to your dependents till retirement and after making cost benefit analysis in purchasing ULIP Policies.

- Before buying an ULIP policy you must be educated about the features and benefits of life insurance products and how it meets your protection needs.
- Insurance should not be considered as another form of investment
- If you are looking for the cheapest life insurance without any add-ons, don't go for ULIPs,
- You can buy an ULIP policy after providing adequate cover for life to dependents till retirement
- You can buy an ULIP policy after examining and satisfied with all the charges [Initial administrative charges, Investment management charges switch over option charges, Annual administration charges, and Risk cover charges], which are part of the policy.
- Examine the investment strategy of the scheme
- Check out on special facilities like switching options, account statements, sale\repurchase policy etc.
- While utilizing switching option please remember that ULIP is a long term insurance product and short term blips in markets are of little importance.
- Go for a capital guarantee if you are keen to buy a ULIP policy and apprehensive about the risk the market presents. These plans promise to cushion you from market shocks, and offer the benefit of market returns while protecting the downside. Of course you should remember that guarantees come at a price. It is marginally more expensive than a plain ULIP because a percentage of the premium is allocated towards the guaranteed portion.
- If you want include the total risk cover in ULIPs go for guaranteed sum assured.
- If you are investing in ULIPs because of low interest rates in the market, consider the possibility of interest rate upturn.

### **Regulator Role:**

The regulatory body would issue strict norms for unit-linked insurance plans.

- Regulator should curb the practice of insurance companies deploying all their funds of ULIPs in the capital market.
- It should make it mandatory for life insurance companies to **offer cover worth four to five times the annual premium** for unit linked policies.
- It should insist ULIPs should have a medium-term lock-in period
- It should insist Companies should use standardized terminology for charges
- It should educate the public regarding the importance of pure life insurance and the features of ULIPs.

### **Role of insurance Companies:**

- While concentrating more on selling strategies, they should also think of falling equity markets and the effect of it on trust on them entrusted by customers and future sales.

- Do not forget that the basic function of insurance companies i.e. accepting of risk and providing protection for risk unlike transferring risk to the policyholder.
- They should educate the agent in the beginning and through him they should educate the public regarding features of products.

**Role of others:**

- Need for more NGOs, SHG [Self Help Group], voluntary and non profit organizations for spreading the message of insurance.
- Investor Education and Protection Fund [IEPF] should educate the public

**Financial planners:**

- Financial advisors talk about equities. Insurance agents talk about guarantees. The combination of these two should help the buyer to bridge the gap through an emphasis on comprehensive financial planning.

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**LATEST INFORMATION**

**THE GUIDELINES FOR REVISED PRODUCTS FROM JULY 1.**

LIC has registered a 150% growth in new premium income for the period april to September 15.

The first premium income touched

Rs.12,309 crore, a growth of 150% over the previous year. The corporation raked in first premium of Rs.8,192 crore in the first quarter,buoyed by the rush for ULIPs, a head of the guidelines for revised products from july 1.

THE GUIDELINES SPECIFY THAT ULIPs should have a minimum lock-in period of three years and the death benefit payable or sum assured under the single-premium product has to be at least 125% of the premium paid.

Vijayan said that the unprecedented growth in June was not sustained in July, August and September. Around 50% of the first premium income came from ULIPs, he said.

#### **Difference between Mutual Funds and ULIPS**

- MF investment is subjected to Short Term Capital gains tax, Security transaction tax and Dividend distribution tax while ULIP is free from these taxes.
- IPO of shares is entirely different from the IPO of a mutual fund. It is just churning of existing funds.