

## THE VALUE OF LIFE POLICY IN FORCE

(\*) V. Padmavathi

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Risk bearing and risk elimination is the outstanding and distinctive mission of any **insurance** in our economic affairs. Kenneth Arrow,<sup>1</sup> Noble prizewinner opines, the world would be a better place if we could insure against every kind of risk/uncertainty. Then people would be more willing to engage in risk taking, without which economic progress is impossible.

Life insurance in particular is concerned with the organization and management of the economic value of human lives. Dr. S.S.Huebner<sup>2</sup> proposed the concept of Human Life Value. It is the capitalized value of an individual's future earnings or value of services after subtracting self-maintenance cost such as food, clothing and shelter<sup>3</sup>. In connection with life and health insurance, the economic value of a human life is derived from both its earning capacity and the financial dependence of other lives or organizations on that earning capacity. It means the economic bases of life insurance arise out of family purposes or from business purposes.

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<sup>1</sup>Kenneth Arrow won his Nobel Prize in part as a result of his speculations about an imaginary insurance company or other risk-sharing institution that would insure against any loss of any kind and of any magnitude, in what he describes as a “complete market”.

<sup>2</sup>Huebner, S.S., Economics of Life Insurance, D.Appleton and Company, 1927.

<sup>3</sup>. The Human life can be viewed as having two components: economic and hedonic. The HLV approach focuses on the economic component. The hedonic approach places value on the enjoyment one derives from living.

The economic basis of life insurance for families is the source and preservation of an individual's human capital in the face of an uncertain lifetime. The human life value concept provides the philosophical basis for systematizing the insurance purchase decision. Apart from this Pissarides<sup>4</sup> proved that life insurance was theoretically capable of absorbing all fluctuations in life time income and, thereby, could enable consumption and bequests to be independent of the timing of income. As a result, the same effective consumption pattern could be achieved through the appropriate use of life insurance as could be achieved if the time of death were known with certainty<sup>5</sup>. Without life insurance, the lifetime consumption would be different and involve less enjoyment [utility]. In U.S., Research has established that highly risk –averse individuals will guard against a failure to have sufficient income later in life, so they will save more than individuals who are less risk-averse, and they would be expected to purchase more insurance. Mc Gill<sup>6</sup> segmented the practical value of needs approach for demand for life insurance funds to -- meet clean up expenses [hospital bills, burial expenses, legal fee etc.], for settlement from economic and emotional shock, to provide critical period income for children, to provide life income for dependent spouse, to fulfill special and emergency needs.

The economic basis of life insurance for business purpose is the importance of a human life [as an asset] to the successful operation of a business, and this can be indemnified through **key person insurance**. The problems of business continuation with the death of a partner can be handled through **partnership insurance**. Attracting and retaining talented employees by rewarding them through **executive benefit plans**. These plans provide economic basis of life insurance for business purposes.

Hence life insurance is important to individuals, businesses, society [reduces worry and increases initiative], economic development [creating a source of funds for new businesses, generating employment], economies [substitute for government security programs which reduces social expenditure]

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<sup>4</sup> & <sup>5</sup>. Pissarides introduces the concept of perfect life insurance, by which he means that the insurance is actuarially fair and is instantaneously adjustable to meet changing consumer desires and the transferability of budget constraints. In a more practical world, consumption would be affected.

<sup>6</sup>. Graves Edward E. {ed.} [1994] "Mc Gill's Life Insurance", The American College\Bryn Mawr, Pennsylvania.

The premium to pay for this life insurance to insurance company is only one of many **small certain costs** to avoid the possibility of a **large certain loss**. The premium we require to make us part with money is the measure of our disquietitude. This disquietitude includes our **Objectives and Needs**. Some of these needs are linked to life value and lifetime needs. Life value needs are important to dependents based on breadwinner's earnings, whereas lifetime needs are different in different stages of life and different for different people. This depends upon the present value of projected expenses minus current liquid financial resources. If life policy is taken on this basis they cannot afford to discontinue to pay the premium at any cost. Even by beg, borrow and steal they have to continue the policy.

But it is not happening. First of all insurance density [indicates the average annual per capita premium within a country] and insurance penetration [is the ratio of yearly direct premiums written to gross domestic product (GDP)] is very low in India. Out of this low-tapped insurable population in India, there is further discontinuation of premiums of their policies.

This discontinuation of premium is known as LAPSATION. This lapsation can be termed in 3 ways.

- pure lapse [discontinuation of policy within 3 years]
- lapse [discontinuation of policy after 3 years]
- zero duration lapse [discontinuation of premium after first premium]

LIC of India is following the concept of 'zero duration lapse' for collecting data on lapsation of policies. It is reported to be having 17 to 18% lapsation of life insurance policies. Most of the private players are also facing the same problem. The consequences of this lapsation are very costly. The Government of India appointed various committees on the issue of lapsation of insurance policies in India. The views and recommendations of the Morarka Committee [1969], Era Sezhian committees [1980], Malhotra committee [1994] is very important in regard to the magnitude of lapsation of life insurance policies for a developing country like India.

Considering this importance, A.V.Ganesan Committee [1995] was appointed by the Government of India to study exclusively the magnitude and causes of lapsation of life insurance policies in India. Ganesan committee Report revealed that LIC, immediately after nationalization, experienced lapse rates, which were very high. The rate went down in the late sixties and early seventies; again the rate went up in the late seventies and moved in a narrow range in the eighties and has again started showing a upsurge/rise in nineties. The current experience of the insurance industry all over the world brings out the fact that the

problem of lapsation exists universally, though levels of lapsation in the developed countries is lower than that prevalent in India.

Ganesan committee identified that the early lapsation of insurance policies is the combined result of both external and internal factors with some element of interaction between the two. The committee identified the following factors.

### **EXTERNAL FACTORS :**

1. Economic decision making of the policy holder
2. Economic-social back ground
3. Availability of alternative investment options
4. Client specific Features.
  - a) Wealth and savings
  - b) Education.
  - c) Age [low lapsation during middle age]
  - d) Gender [less in women]
  - e) Location - rural\urban [high lapsation in rural areas]
  - f) financial difficulties
  - g) resource availability [higher lapsation for lower sum assured and lower instalment]
5. Macro economic factors.
  - a) Disposable income
  - a) Inflation.
  - b) Government policies with regard to taxation
  - c) Fiscal incentives
  - d) Development of industrialized areas.

All these factors are beyond the control and influence of an insurance company. But the internal factors are under the control and influence of an insurance company. They are

### **INTERNAL FACTORS:**

1. Product design and choices
  - a. Types of plans
  - b. Mode of premium payment [more in quarterly]
  - c. Policy term [more in long term]
2. Marketing and personal strategies
  - a. Planning of business activities [budgets, time frames]
  - b. Sales personnel agents, development officers, branch marketing supervisors
  - c. Customer education
  - d. Market research

- e. HRD linked to marketing [Recruitment and Training, appraisal, incentives and disincentives].

The consequences of this lapsation are different for policyholders, companies, government and society.

**COST OF LAPSES:**

**I. To Policy holder:**

- a) Loses valuable protection.
- b) Loses initial premiums
- c) Loss of savings

**II. To companies:**

- a) Customer retention is less costly than procurement of new business.
- b) Impediment to deferred revenue
- c) Unproductive efforts
- d) Loss of public image through adverse publicity.

**III. Government and society:**

- a) Burden on Government - disadvantage in the context of public finance.
- b) Dependence on public assistance or welfare
- c) Dependence on financial assistance from relatives and friends.

Observations of my preliminary study for this causes of lapsation of life insurance policies are

- a) Policy mismatch [lack of need based approach]
- b) Absence of insurance awareness \ consciousness
- c) Saving element [no element of risk management]
- d) Tax based
- e) Lack of Agency professionalism
- f) No dignity to agent profession.
- g) No importance of after sales service.
- h) Commission Structure [not much interest after first year premiums]
- i) Knowledge gap among the field personnel
- j) Selling high Premium/expensive policies
- k) No quality consciousness in training programmes to sell insurance
- l) High agent turn over
- m) Deficient training of agents.
- n) Commences in March - Ends in April [Business Target Structure]
- o) Rebating
- p) Poaching \ churning
- q) Disservice in the offices

By understanding consequences and causes of lapsation of life insurance policies steps can be taken to bring down the rate of lapses in India, which is very high by international standards. If reduction of lapsation results in lowering the premium rates, the 'insurance cover' can reach to the poorest of the poor. Those resources can pave the way to economic

progress and economic development. All the Committees, which were appointed by the Government of India, were before the privatization of the insurance sector in the country. After A.V.Ganesan Committee Report in 1995, there is no further study in this area. Considering the magnitude and costs of lapsed policies for a developing country like India, this study is taken up. Some of the **suggestions** to improve the lapsed conditions are

- a) Need for public education
- b) Need for training field personnel
- c) Need for Research in Marketing and public needs.
- d) Highlighting risk factor in competition with other financial instrument.
- e) Professionalism in marketing - at the contact level, a portion of the time spent is to counsel the prospect on the possible economic risks and consequences in his family or business economics, while another portion of that in follow-up contacts are devoted to persuading the prospect to do something about the solutions suggested.
- f) Indiscriminate recruitment of large number of agents should be stopped
- g) Pre recruitment training followed by a test and interview.
- h) Career Agency should be encouraged.
- i) 'Know your Customer' - understand the customer - Insisting on Need based selling.
- j) The Bonus Commission which is now payable to agents on 1st year premium income should be paid on the basis of the average of first year, second year and third year income.
- k) Hereditary Commission should be replaced by payment of an appropriate lumpsum.
- l) After sales service from Agents, Development Officers.
- m) Continuation of Relation with customer after sales and after claim also.

Currently, the five-year old liberalized insurance industry is making attempts to tap the untapped potential of 'insurable population'. For a democratic and developing country like India taking care of the uncertainties of life for the masses and building up of a strong supporting system for the all round development and high growth of the economy are essential. This can be achieved through the strong insurance sector. But currently the life insurance premiums as a percentage of GDP is only 1.3 per cent which is very low compared to 5.2 percent in the U.S., 6.5 percent in the U.K. and 8 percent in South Korea. The sheer

size of the Indian market provides comfortable room for many more players. The U.S. has over 2,200 insurance companies and the U.K. over 500. However, since liberalization only 14 new life companies have started operations. On all these fronts, the Indian insurance industry is at the threshold of witnessing a major revolution that would benefit consumers

immensely. In this competitive scenario, the major challenge ahead for the existing insurers, and new private insurers is **LAPSATION OF INSURANCE POLICIES**. The lapsation of life insurance policies is a hindrance for the growth of insurers, individuals and society and the nation's economic growth and development as a whole. It is hoped that this study throws light on the untapped potential and paves the way for economic development and economic growth.

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The world would be a better place if we could insure every future possibility –  
Kenneth Arrow

Guarding against uncertain outcomes and reducing uncertainty is a costly and  
difficult business.

We often face the possibility that we will make the wrong choice and end up  
regretting it.

We go to great lengths to protect ourselves from the consequences of being wrong.

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The premium to pay the insurance company is only one of many **small certain costs** to avoid the possibility of a **larger certain loss**. The premium we require to make us part with money is the measure of our disquietitude. This disquietitude includes our **Objectives** and **Needs**.

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To achieve objectives and to fulfill needs, financial planning is required. Financial Planning does not start with utilizing a particular financial instrument but it involves selecting a financial instrument to fit into the holistic plan to achieve our objectives and needs. To frame them adequately identifying risk is very important. After identifying definite risks or risks which are obstacles to achieve our objectives and goals and when we know that we cannot avoid and control those risks the option left to us is to accept the risk and try to reduce the economic consequence of that risk by transferring it for a price. The number of risks that can be insured against is far smaller than the number of risks we are forced to take in the course of lifetime. But these risks are definite and crucial. Some of these risks are linked to life value and lifetime needs.

Life value needs are important to dependents based on breadwinner's earnings, whereas lifetime needs are different in different stages of life and different for different people. This depends upon the present value of projected expenses minus current liquid financial resources. If life policy is taken on this basis they cannot afford to discontinue to pay the premium at any cost. Even by beg, borrow and steal they have to continue the policy.

- Why is not happening?
- Why is there a discontinuation of payment of premium?
- Why do customers leave a life insurance company and lapse the policy?

The paper at the outset will throw focus on why there is lapsation in insurance companies? LIC of India is reported to be having 17 to 18% of first premium lapsation. Even the recent private players are also facing the same problem.

- Why is it happening?
- What are the consequences of lapsation?
- Why is there rather a high lapsation of life insurance policies in our country?
- Why do customers leave insurance companies?
- What are the consequences of such lapsation.

This paper provides some suggestions to control the percentage of lapsation, such as those given below.

- Highlighting risk element rather than saving element in products.
- Educating the customer of the importance of the product as a primary need instead of buying an insurance product after meeting all the other expenses including entertainment.
- Methods of keeping Life Insurance policies in force despite hardships.

### **The value of life policy in force**

The world would be a better place if we could insure every future possibility  
- Kenneth Arrow

The home would be a 'financial tension free zone' if we could insure every anticipated risk and need.

The premium to pay for that 'financial risk\tension free zone' to insurance company is only one of many **small certain costs. But the gain is enormous.**

Like meeting other basic needs utmost priority has to be given to pay the premium - even by beg, borrow and steal. But it is not happening.

LIC of India is reported to be having 17 to 18% of lapsation of life insurance policies. Most of the private players also facing this problem.

Why?

Why is there a discontinuation of payment of premium?

What is this discontinuation of payment of premium?

### **LAPSATION**

Pure Lapse - with in three years.  
Lapse - after three years.  
Zero duration lapse - after first premium

**Ganesan** committee listed out number of factors

- I. External
- II Internal

**EXTERNAL FACTORS :**

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4. Client specific Features.
  - h) wealth
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5. Macro economic factors.

- b) Disposable income
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**ALL THESE FACTORS ARE BEYOND THE CONTROL OF AN INSURANCE COMPANY.**

**INTERNAL FACTORS:**

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These factors are under the control and influence of an insurance company.

**WHAT ARE THE CONSEQUENCES OF SUCH LAPSATION?  
COST OF LAPSES:**

To Policy holder:

- d) loses valuable protection.
- e) loses initial premiums
- f) loss of savings

To companies:

- e) customer retention is less costlier than procurement of new business  
impediment to deferred revenue
- f) unproductive efforts
- g) loss of public image through adverse publicity.

Government and society:

- c) Burden on Government - disadvantage in the context of public finance.
- d) Dependence on public assistance or welfare
- e) Dependence on financial assistance from relatives and friends.

**AFTER GANESAN COMMITTEE REPORT, 1995, THERE IS NOT MUCH STUDY  
IN THIS AREA.**

Observations of my preliminary study:

- r) Policy mismatch [lack of need based approach]

- s) Absence of insurance awareness \ consciousness
- t) Saving element [no element of risk management]
- u) Tax based
- v) Lack of Agency professionalism
- w) No dignity to agent profession.
- x) No importance of after sales service.
- y) Commission Structure [not much interest after first year premiums]
- z) Knowledge gap among the field personnel
- aa) Selling high Premium/expensive policies
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- ee) Commences in March - Ends in April [Business Target Structure]  
Rebating
- ff) Poaching \ churning
- gg) Disservice in the offices

### **SUGGESTIONS:**

- n) Need for public education
- o) Need for training field personnel
- p) Highlighting risk factor in competition with other financial instrument.
- q) Indiscriminate recruitment of agents should be stopped
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