

**Costs of lapsation of life insurance policies – A case study of LIC of
India**

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Abstract

Life Insurance is a long-term business depending largely on the theory of probability, law of large numbers, factors of mortality and level of the economy. Lapsation of life insurance policies is an obstacle in keeping up the requirement of large numbers, where the theories of probability and actuarial assumptions work at their best. The number of Insurance policies in the portfolio of every Life Insurance Company is subject to erosion due to natural factors such as maturity claims, death claims, and surrenders for cash values etc. The resultant reduction in the number of policies is therefore naturally very large with natural factors and with lapsation of life insurance policies. The erosion of numbers due to natural reasons and for reasons contracted against is inherently inevitable. However, erosion of numbers due to lapsation of life insurance policies is not inevitable. Lapsation of life insurance policies is the most disturbing feature of Indian life insurance business, which is very high by international standards. Combined experience of all Indian insurers 'First premium lapse rate' prior to Nationalization (1956) was about 27 to 36%. Since nationalization of LIC, it was never be less than 14% except the period 1969-70 where the first premium lapsation was 13.92%. On an average 18% of first premium

lapsation is common for LIC before opening of the insurance sector in the year 2000. After opening of the sector, it is 39.91 % in the year 2005 and 24.61% in the year 2006.

The fact here is that a very high proportion of the new business written every year goes off the books by way of lapses. The above-mentioned figures of lapses are first premium lapses that is, before the policy acquires a paid-up value. If we take into consideration of all lapses including paid-ups and surrenders as wastages, the proportion will be substantially higher.

Historically, the problem of lapsation of life insurance policies in India has been studied purely from a general approach. Different committees were constituted under the auspices of the Parliament of India for studying only the causes of lapsation. But no attempt was really done to study the variable effect of changes in lapse rates on:

- The profitability of an insurance company.*
- The distributable surplus and*
- The price of life insurance protection to the policyholder.*

There may be an impression that Policies, which lapse after payment of full first year's premium but before the policy acquired surrender value, may not cause direct financial loss to the insurance company. However, the fact is that the insurer cannot recover all of the expenses involved in writing the policy if lapse occurs in the earliest years. In addition, the Policies which lapse after acquiring surrender value and which are either surrendered or converted into paid-up policies cause some strain to the insurance companies, as the cost of maintenance of these policies is not fully compensated by the reduction in the benefit available to the policyholder.

It has to be remembered that, in other than fake or bogus policies the insured stands to lose most, if not all, of the money placed into a lapsed policy if lapsation occurs in the early years of the policy.

Hence, Lapsation of life insurance policies in normal circumstances will not be beneficial to any parties in the contract. In addition, it can negatively affect each of the three other major pricing factors of life insurance such as expenses, investments and mortality adverse selection. Surprisingly enough, based on review of literature, no systematic research work has been reportedly done in India in the area costs of lapsation of life insurance policies. The need for this study arises by considering the impact of lapsation on individuals, society and industry especially in the era of liberalized insurance industry with competitive environment. Considering the prevailing Competitive environment where companies can sustain only based on efficient management and retaining of business, which includes the reduction of lapse rates, there is a deep concern about the lapsation of insurance policies in the present day Indian Insurance industry. All the Committees, which were appointed by the Govt. of India, which focused only on the causes of lapsation were before the privatization of the insurance sector in the country.

This paper is focusing on the theoretical base for the costs of lapsation of life insurance policies on Life Insurance Corporation of India. To verify the reduced profitability of LIC due to lapsation, it is studied the amount of loss of premium income, irrecoverable expenses and the amount of lost opportunity to invest and get benefits. To analyze the reduced profitability of LIC, “lost benefit” and “lost opportunity” models were developed by taking information from their Annual Reports for a decade. To analyze the ‘reduced distributable surplus’ the procedure of actuarial valuation of surplus is studied. At the end of this paper latest trends in the insurance industry regarding lapsation such as “Lapse supported policies” and “Viatical settlements” (Tradeable lapsed policies) in the Indian Scenario are discussed.