INTRODUCTION TO LIFE INSURANCE

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1.1: Introduction:

In any activity of life there is a possibility that a desired event may fail to occur and that pecuniary (financial) loss may arise. In adventures by sea the ship may fail to make the port (remember Titanic!); or the cargo may be damaged or lost. In the adventure of life itself, the life may fail and death may occur, causing suffering to dependants. Death comes to all sooner or later, and it is the only truth in this world. The rest as they say is all maya (illusion). So if death is the only truth, then why do we ignore the implications of the event? Because of the nature of its permanence, and all pervasive; death requires understanding the financial implications on the dependents. Life insurance is therefore the most important of all forms of insurance. It’s significance pales the other forms of not just insurance but also all investment instruments. The theory of insurance, in general terms, may be expressed to mean that the good fortune of the many compensates for the misfortune of the few. The consequences of such misfortunes cannot be in many instances borne by the individual, and so the insurance company is prepared to shoulder the burden of these consequences in exchange for an assessed payment for the risk undertaken. Those who avail themselves of this service know that such misfortunes will occur but do not know to whom, and when, and they are willing to make such contributions to a common fund to buy the right to be compensated of misfortunes if they should befall them.

The insurance company is concerned with any factor that may affect normal longevity, and once the contract is entered into, and premiums are regularly paid by the policyholder, the company is at a risk on a permanent contract which it cannot break.

From the collation of a vast amount of data, an assessment can be made of the rate of mortality or the likelihood of death occurring at each age. Numbers can be quoted, but which individuals will die at each age cannot be stated. Consequently, all who pay life insurance premiums to the common fund do so with the same willingness that the fund shall be used to compensate the estates of those contributors at whatever age in life they may die, within their respective contract period. This is the basic theory of life insurance. However increasing emphasis on investment aspects has tended to overshadow the primary purpose of protection against premature death.
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Let’s discuss the following two significant statements relating to life insurance.

1. **Life insurance has no competition from other financial products:**
   - Life insurance relates to protection of the economic values of assets. It is a mechanism that helps to reduce the effect of any adverse situations arising out of loss of the asset. It makes sure that the value or income is not lost.
   - Life insurance helps to compensate the financial losses arising out of death/ accident/ retirement of the bread winner in the family.
   - All other financial products such as bank deposits, PPF, NSC, are savings instruments, and offer you safe returns of 8-10% p.a.
   - Investment vehicles such as mutual funds, stocks; offer better return potential with higher risk potential too.

On the loss of income due to unfortunate death of the bread winner in the family, it is only life insurance that offers a guaranteed sum to the dependants of the deceased. That is, on payment of first premium installment and subsequent issuance of policy, a future estate is created for the benefit of the dependents of the life assured; which is payable to the nominee in case of unfortunate death of the life assured.

Thus, for investment purposes, life insurance may have competition from other financial instruments, but there is no competition as far as risk coverage/ protection of economic value of assets is concerned.

**Example:**

Amount invested: Rs 10000 p.a.; age: 30 yrs

<table>
<thead>
<tr>
<th><strong>Product name</strong></th>
<th>Bank deposits</th>
<th>PPF/NSC</th>
<th>Mutual fund</th>
<th>stocks</th>
<th>Life insurance (pure term plan) risk cover: 25 lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Returns p.a</strong></td>
<td>8%</td>
<td>8%</td>
<td>20%*</td>
<td>40%*</td>
<td>nil</td>
</tr>
<tr>
<td><strong>Total value after 1 yr.</strong></td>
<td>10800</td>
<td>10800</td>
<td>12000</td>
<td>14000</td>
<td>nil</td>
</tr>
</tbody>
</table>

► *returns not guaranteed, depends on share market movements

In the above case, in case of death of the life assured, the nominee would get Rs 10800 through the bank deposit, PPF and NSC. The MF investment would give Rs 12000, and the stock investment would provide 14000.

However, life insurance would provide the entire sum guaranteed. i.e. Rs 25 lacs.

Thus, it is only through life insurance that a future financial or monetary estate can be created during the lifetime of the individual.
In this illustration we had assumed the risk cover was Rs 25 lakhs. How do we decide how much risk cover to buy? Is it possible to buy any amount of cover, and how much is enough. That question is significant since most people who bought life insurance in India, have low risk covers. They live in an illusion that they have purchased a life insurance policy, and therefore need not worry. However, the risk cover being grossly inadequate, their dependents would not be getting a financial estate that compensates the human value of the bread winner, in case of his unfortunate death.

Let’s take a case: Mr A is the policyholder and life insured. He had purchase a pure term insurance policy for Rs 1 lakh sum assured some years back. He, being the sole bread winner in the family and earning a gross income of Rs 30,000 per month i.e Rs 3,60,000 per annum dies unexpectedly when still young, leaving behind dependents in the form of his wife and children. What will the nominee (wife) get from the insurer? Yes, not greater than 1 lakh, that being the sum assured. Will it be adequate to meet the financial obligations of the dependents in the short term and long term, such as immediate bills that will be due, the children’s education needs-present and future; pension needs of the widow…and so on. The picture looks rather grim. Therefore, merely having a life insurance cover for name sake, is not enough. It is like little knowledge. It’s better to have no knowledge so that you are recipient to new ideas and willing to accept and change. Likewise, we witness lots of persons who have purchased some insurance cover, without understanding why, and even among them a significant percentage who stop paying premiums after a period, leading to large lapsations. The agent/ advisor should therefore, change the traditional ways of selling and adopt more scientific and professional approaches while soliciting policies from prospective clients. A need analysis of the client should be carried out, his Human Life Value/ HLV should be ascertained, and after matching his requirements for various future financial obligations and aligning them with his present risk covers purchase; the agent should recommend appropriate insurance plans to meet the shortfalls. This approach will be useful to the proposer since he will know the real objective of buying the risk cover. A need based analysis of the client shall determine the insurance covers he requires and also the net cash available to the proposer to invest. Thus higher outlays can be planned to meet greater fund requirements in the future.

How much insurance to buy?
Concept of Human Life Value:
Beyond all doubt, your life is invaluable. Yet, there is a certain worth that can be attributed to the financial support you offer your parents, spouse or children. This worth is referred to as Human Life Value (HLV). In the future, if your family does not have the protective blanket of your presence, they will no longer be able to enjoy the benefits of the income you earned. Put simply, Human Life Value is the present value of your future earnings.
You should calculate your Human Life Value so you can accordingly invest in insurance plans that provide your family with adequate finances and hence security even in your absence.
Your Human Life Value is determined by 3 factors:
1. Your age
2. Current and future expenses
3. Current and future income

As a thumb rule, if you are 30 years of age, you should insure yourself for an amount approximately 8
times your annual income. At 35, your investment should be close to 6 times your income. Of course, the exact amount of your investment should be determined by the number of people who depend on you, your existing investments and your life stage. For example, if you are 30 years of age and have two children and parents to provide for, the amount you invest should be reflective of your requirements.

The Human Life Value may be defined as the capitalized value of the net future earnings of an individual after deducting appropriate costs for self maintenance. From the point of view of dependents, an individual’s Human life value represents the measure of the value of benefits they can rightfully expect to get from their bread-winner. Likewise, from the standpoint of an organisation, the human life value on one of its key employees is a measure of the value of his or her services to the organisation.

In 1924, S.S Huebner of Wharton School of Finance and Commerce, University of Pennsylvania, U.S.A; suggested that the human life value concept is not just a statement that a human life has an economic value but implies that the five aspects as follows:

- Appraisal and capitalization of human life value
- Recognition of family as an economic unit organized around human life values
- Human life value and its protection as the main link between present generation and the succeeding generation
- Recognition of human life value as creator of property values
- Application of scientific principles of business management to life values

Capitalization of economic value of a human life is possible through life and health insurance. By guaranteeing this capitalized value in the event of death, life insurance tries to perpetuate the earning capacity of an individual life for the benefit of its dependents. With the bread winners death, the whole value will be swept away. Life insurance acts as a hedge against such a loss. It is the only scientific method of capitalizing the economic value of a human life and indemnifying for its loss in case of premature death.

**Thumb rule**: Without going into the mathematical aspects, if a person aged 40 earning Rs 20,000 per month, i.e; Rs 2,40,000 per annum, dies leaving behind dependents in the form of his wife and children; the annual economic loss to the dependents is the loss of his income i.e Rs 240000. However, that will take care of the needs of the family for a couple of years only. What about the rest? Hence, thumb rule of maximum 10 times the annual income to maintain the existing standard of living of dependents, or say a minimum of 5 times the annual income to meet expenses; is used. E.g; if the deceased had a life insurance cover 10 times his income, the sum assured payable to the nominee would have been 24 lakhs. The logic is that, this 24 lakhs if deposited in a bank, would generate interest @10% i.e Rs 2.4 lakhs, exactly the sum the deceased earned before death. That is why life insurance is used to maintain the same standard of living in case of unfortunate death of the life assured.

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**2. Life insurance helps to maintain standard of living of dependents in case of unfortunate death/permanent disability of life assured.**

Friends: let me ask you a simple question.
Imagine you are sitting on a chair in your home/office located at the 3rd floor of the building. You are sitting very comfortably (1st level support) on the chair and reading the latest bestseller book. Suddenly, the chair breaks down. Where do you land? Of course, on the floor.

**The floor is your 2nd level support.**

What would have happened in case there was no floor support? Where would you have landed then?

……….on the ground of the building…

..THINK…AGAIN…

“**What happens if there is no 2nd level support when we fall from our comfortable lives?**”

CHAIR-1st level support/broken/you fall down as a result.

FLOOR-2nd level support-makes sure you don’t fall down further.

GROUND-base level support-you cannot fall further.

What happens if there is no support for the standard of living that would fall, when suddenly the income support on which we depend is lost.

“**Have we created a 2nd level support, like the floor, to hold back the fall and maintain the standard of living of our dependents?**”

If the answer is NO, our family is insecure. We need to offer financial security to our loved ones, and nothing better than the mechanism of life insurance to do so.

A unique feature of the life insurance contract is the immediate monetary estate created at inception out of all proportion to the initial contribution made i.e by payment of the first premium installment itself. This considerably reduces the mental disturbance of worry, and modern psychology establishes beyond doubt that there is a close relationship between mental and physical health. A mind free from worry can therefore by greater concentration, actuate the body to greater output and production of wealth.
The ICICI-Prudential Advertisement that appears on television channels where the wife asks the husband to sign the proposal document, and the husband asking her whether she would be able to live without her, after his death. The wife explains that if he signs, his child’s future and his retirement benefits will be guaranteed, and there will be peace of mind for him and the family. And lack of tension will mean longer life. Hence “Jeetey Raho” or ‘Keep Living Longer’.

The message to the viewers is simple: Buy Life Insurance and Enjoy Living.

Many years ago, this message was outlined in a classic print hoarding released by LIC, which read: “Insurance-A little Price-For a Priceless Security”

The world’s largest insurer, AIG (American International Group), had put up a huge Hoarding at Times Square, New York, in the 1960’s which read…

“Smart Men Do Not Need Insurance………………
……………………Their Widows DO………..”

1.2 Need and Advantages – Life Insurance

Need- Life Insurance

A Human being is an income generating asset.

**Loss of income**

Income can be lost either due to:

- Unexpected/ pre-mature death of the bread winner
- Sickness/ critical illness
- Disability due to accident

All these (excepting death) may or may not happen. Insurance covers 2 basic certainties of Life, namely the Risk of Dying Too Early, and the Risk of Living Too Long.

Death is certain. But we have learnt that a ‘certain event’ cannot be insured. Good logic.

The answer is, though death is certain, the timing is uncertain. In case of pre-mature death of the bread winner in the family, the dependents shall be subjected to hardships.

Adequate life insurance cover can provide the buffer against the shock of early death and relieve the financial stress during the period of adjustment.

Hence, life insurance is necessary to provide financial security to the dependents in case of the bread winner dying early.

**Loss of income after retirement**

After retirement, the regular income is likely to be lost or reduced. Also, there is increased potential of regular and unexpected medical expenses. Children may be living separate, or in other parts of the world. In such cases, if there is inadequate provision for retirement needs, the person may suffer.
Life insurance is a means of independence in old age or, at least, assistance to that end. In nations where the proportion of old people to the total population is increasing, this could well be an important factor.

In the developed nations, the responsibility of supporting the aged has shifted from family to the State. As the proportion of people dependent upon the State grows, the greater will be the obligation on successive governments to provide higher old-age pension benefits with a consequent increasing burden on younger generations. India has a relatively younger population; however the problems are the same as in advanced nations. Old-age issues are increasing and increasing nuclear families or the empty nest stage means more and more old people are going to be under financial insecurities. *Living too long in such a situation may be as risky as dying too early.*

The Risk of Dying too early, i.e in the accumulation phase of wealth, can be covered by adequate term insurance cover, for high sum assureds, after an effective need analysis of the client. The sum assured should be limited to the human life value of the person insured, and not higher. An adequate risk cover equivalent to the HLV of the person insured, would be the foundation component of the Insurance and investment portfolio of the client.

**Advantages of Life insurance:**

Insurance should not be confused with only being a profitable and prudent channel of investment. It is much more than that. It is a financial security a responsible person bestows on his or her family in the event of him/her waiting away from the family scene before fulfilling the various responsibilities and obligations. Life insurance addresses two important contingencies in the life of an individual:

- The financial strain on their family due to unforeseen and premature death.
- The financial strain on an individual as a consequence of retiring from an active working life and living longer.

Unlike in other forms of savings where only the accumulations are made available, in life insurance the entire sum assured is made available to the dependants in the event of death irrespective of the number of premiums paid; the only condition being that the policy should have been kept in the force by regular payment of premium.

A life insurance policy is accepted as collateral security by banks, financial institutions and housing finance companies.

A Mortgage Redemption Policy ensures the financial security of both, the borrower and the housing finance company. The plan covers the outstanding portion of the loan, and the borrower’s liability is automatically extinguished on death without any hassle to the dependants.

The proceeds of the policy can be protected against the creditors through a valid assignment.

Through the purchase of immediate annuity by paying the purchase price in one lump sum, one can buy financial security for one’s old age. And the same can be planned from a young age by contributing to a suitable Deferred Annuity Plan.
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Tax benefits are also available on the premiums paid and also on the claims proceeds according to the tax laws in force from time to time.

Life insurance is called an immediate estate because of the death of the assured, the life insurance proceeds are available to the legal heirs inspite of the fact that no estate was in existence up to the time of the death of the assured. The estate itself comes into being as a result of the death of the insured, which otherwise would not have existed to be passed on to the dependants.

*Insurance – The Backbone of an Economy*

- A well-developed insurance sector contributes to the economic growth by encouraging risk taking by entrepreneurs.
- Insurance is also perceived as a tool of wealth management.
- A well managed insurance industry offers risk-specific and risk-adequate insurance covers at a cost-effective price to the society.
- Many developing economies tap the insurance premium mobilized by the insurance companies as a source of national development and infrastructure financing.
- In an economy, insurance provides for the optimal utilization of capital without any necessity to lock in huge amounts of capital to provide for contingencies arising out of risk events.
- Life insurance encourages thrift and savings among individuals, thereby contributing to the economic growth by encouraging capital formation.
- The introduction of the Deposit Insurance Scheme for bank deposits and Export credit Guarantees in India is aimed at accelerating the economic growth.
- As economic growth and the growth of the insurance sector are mutually complementary, insurance companies develop innovative and user-friendly products to keep pace with and to meet the changing socio-economic demands.

The three major roles of insurance are:

- The significant role insurance plays in rebuilding the economy;
- The role of insurance as a provider and protector, and
- Insurance as a package of solutions for increasing personal and corporate liabilities.

Insurance is a derisking medium, both for individual and institutions. Primary insurers derisk themselves by transferring the risk they had underwritten from different sources to the secondary insurers or reinsurers.

*Insurance--- Socio-Economic Relevance*

Risk managers receive insurance as an economic model for reducing and eliminating risk by a process of bringing together an adequate number of homogenous groups so that the loss arising out of the risk become predictable for the group. In practice, each member of the group substitutes a small part of the certain cost, called premium, to meet any uncertain financial loss that would exist but for the contract of insurance.

The primary function of insurance, be it life, non life or reinsurance, is providing protection by assessing the risk and sharing the same with many by the process of risk sharing and, thus, minimizing
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individual risk and its impact. These basic functions are followed by subsidiary responsibilities like efforts for preventing losses and aiding the economic development through the investment of funds.

The role of insurance goes beyond its primary purpose of spreading the risk and, thereby, minimizing the loss. The huge fund collected by way of premium from millions of policyholders, and the amount retained by them as solvency funds to meet unforeseen contingencies are invariably invested according to the mandatory or prudential norms approved by the regulators.

Insurance pays a significant role in shaping the economy of a nation. The contribution of the insurance sector to the growth of the economy is gauged by the rate of penetration. The rate of penetration means the quantum of premium mobilized by the insurance sector vis-à-vis the growth of the Gross Domestic Product (GDP). The ratio indicates the growth of the insurance market.

The reported average insurance penetration of around 1.5% of GDP of India until the 1990s was considered to be one of the lowest in the world. According to Sigma compilations, as at the end of 2003, the UK, had the highest penetration in India as at 2001 worked out to be 2.71%, and subsequently rose to an impressive 3.26% in 2002. The average global insurance penetration during the period 1995-2001 was around 7.05%; and as against this, the average penetration in India was around 2.2%. This indicates that India’s insurance potential lies dormant and remains to be harnessed.

Insurance has a close link with the economic growth. As the process of economic growth leads to the creation of wealth, both for public bodies like the government and the corporates, and individuals, the need for insurance increases. Insurance is an answer to risk. Insurance neither reduces the uncertainty nor does it alter the probability of the event. But it reduces the possible financial loss connected with the occurrences of the event.

1.3 Life Insurance – A Brief History

The history of life insurance dates back to 3000 BC. Learned scholars are of the view that the expression ‘Yogakshemam’ found in the Rig Veda refers to a sort of social welfare insurance; the ancient Aryans seem to have developed such a concept. Edwin W Kopf in his treatise – ‘Origin, Development and Practices of Livestock Insurance’ credits India with being the mother of insurance practices, and opines that the development started in India and after that spread to ancient Babylon. He refers to the Bridari system of India as the most ancient institution formed for the mutual help of the members during the contingencies of daily life.

Insurance began as a way of reducing the risk of traders, as early as 5000 BC in China and 4500 BC in Babylon. Life insurance dates only to ancient Rome; "burial clubs" covered the cost of members' funeral expenses and helped survivors monetarily. Modern life insurance started in late 17th century England, originally as insurance for traders: merchants, ship owners and underwriters met to discuss deals at Lloyd's Coffee House, predecessor to the famous Lloyd's of London.

The growth of life insurance as a tool of family security, synchronized with the growth of affluent families in England during the industrial revolution. As a result of the economic boom brought in by
the industrial revolution, the merchants and manufacturers of England became a wealthy, important and influenced section of the community. They enjoyed a standard of living which their families would have found difficult to maintain at the event of their death, unless special provisions were made. To such people, life assurance offered a special attraction as a provider and protector of family financial security.

The first life insurance company, The Society for the Assurance of Widows and Orphans, was founded in London in 1699. After the repel of the Royal Charter of 1720 providing monopoly to the London Assurance and the Royal Exchange Assurance in 1824 in the UK, the growth of life insurance companies was phenomenal. Competing companies started launching many new and attractive life insurance plans.

The first life insurance company of the United States of America was the ‘Corporation for the Relief of the Poor and Distressed Presbyterian Ministers and for the Poor and Distressed Widows and children of Presbyterian Ministers’; it was started in 1775 by Benjamin Franklin. This is the oldest life insurance company in the world today, and is now known as the Convent Life Insurance Company. Benjamin Franklin played a significant in forming many life insurance companies in the US. The oldest surviving mutual insurance company is the equitable Life Assurance Society of the UK that was founded in 1756. Equitable was the first life insurance company to issue the insurance cover for varying terms subject to certain age restrictions of the assured.

Insurance as an organizational effort came to India in its present form in 1818, and the first insurance company in India was the Oriental Life Insurance Company, which was started in Calcutta by the Europeans mainly for the benefit of the European Community in India. In the initial years, the Company did not consider Indian lives worthy of underwriting. However, due to the persistent effort of Babu Muttyal Seal, the newly formed Oriental Insurance Company consented to consider lives for underwriting and insurance cover.

This was followed by the incorporation of many more companies like the Bombay Life Assurance in 1823 and Madras Equitable in 1823. These two and the few other companies were taken over by Albert Life Assurance Company in 1860; Albert Life Assurance itself went into liquidation in 1869.

The first fully Indian–owned insurance company, Bombay Mutual Life Assurance Society, was started on December 3, 1870 in Mumbai. This landmark in the history of Indian insurance was commemorated in 1970 as the centenary of India’s life insurance. A mutual insurance company is one that has no equity capital by the stockholders. The capital is owned by the policyholders. An insurance company, which is owned and controlled by stockholders or investors, is called a Capital Stock Insurance Company. Another important Indian insurance venture, the Oriental Government Security Life Assurance Company was established on May 5, 1874 with Sir Pherozshah Mehta as its founder.

The first two decades of the twentieth century saw lot of growth in insurance business. From 44 companies with total business-in-force as Rs.22.44 crore, it rose to 176 companies with total business-in-force as Rs.298 crore in 1938. During the mushrooming of insurance companies many financially unsound concerns were also floated which failed miserably. The Insurance Act 1938 was the first legislation governing not only life insurance but also non-life insurance to provide strict state control over insurance business. The demand for nationalization of life insurance industry was made repeatedly in the past but it gathered momentum in 1944 when a bill to amend the Life Insurance Act
1938 was introduced in the Legislative Assembly. However, it was much later on the 19th of January, 1956, that life insurance in India was nationalized. About 154 Indian insurance companies, 16 non-Indian companies and 75 provident were operating in India at the time of nationalization. Nationalization was accomplished in two stages; initially the management of the companies was taken over by means of an Ordinance, and later, the ownership too by means of a comprehensive bill. The Parliament of India passed the Life Insurance Corporation Act on the 19th of June 1956, and the Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

In creating awareness about the life insurance in the mind of the Indian public, both in the urban and rural areas, the Postal Department, through its life insurance wing, played a significant role before the formation of the LIC. It should be noted that neither in 1956 or thereafter were the Postal Life Insurance (PLI) and the insurance wings of some of the state governments brought into the fold of LIC.

LIC had a monopoly status from inception in 1956 to the end of December 1999. In 1993 the Government of Republic of India appointed RN Malhotra Committee to lay down a road map for privatisation of the life insurance sector.

While the committee submitted its report in 1994, it took another six years before the enabling legislation was passed in the year 1999, legislation amending the Insurance Act of 1938 and legislating the Insurance Regulatory and Development Authority Act of 1999. The same year the newly appointed insurance regulator - Insurance Regulatory and Development Authority (IRDA) started issuing licenses to private life insurers. The Foreign Direct Investment (FDI) share in joint ventures with Indian partners is capped at 26%. i.e the Indian partner(s) shall possess maximum stake at 74%. At present, 22 private life insurance companies operate in India as on 1st April 2009.

**Postal Life Insurance – Exempted Insurer**

The Postal Life Insurance popularly known as the PLI was established in 1884 initially to provide life insurance security to the postal employees. Subsequently the benefits were extended to the telegraph employees and gradually to all government employees. In 1956, when the government nationalized the life insurance business in India, PLI was not taken over and was permitted to transact business with postal employees and government servants. At present the PLI covers central and state government employees, various public undertakings; government aided institutions and nationalized banks.

**Some of the important milestones in the life insurance business in India are:**

1818: Oriental Life Insurance Company, the first life insurance company on Indian soil started functioning.

1870: Bombay Mutual Life Assurance Society, the first Indian life insurance company started its business.

1912: The Indian Life Assurance Companies Act enacted as the first statute to regulate the life insurance business.
1928: The Indian Insurance Companies Act enacted to enable the government to collect statistical information about both life and non-life insurance businesses.

1938: Earlier legislation consolidated and amended to by the Insurance Act with the objective of protecting the interests of the insuring public.

1956: 245 Indian and foreign insurers and provident societies are taken over by the central government and nationalised. LIC formed by an Act of Parliament, viz. LIC Act, 1956, with a capital contribution of Rs. 5 crore from the Government of India.


2000: Private insurance companies begin operations in India

1.4 Concept of Life Insurance:
You may wonder how an insurance company can settle a claim of Rs 25 lakhs on a single person’s death as in the above mentioned example, when all that the company received as premium from the person was Rs 10,000. And what if there are many such small and big claims to be settled. How can the insurer manage all the losses he generates on each of these accounts? That’s right. But then that is where we need to understand the whole concept of life insurance.

Lets take an illustration:

1) Village A:
In a village(A) there are 100 houses. It has been observed over the last 10 years that each year at least 4 houses are gutted by fire. The cost of building a house is Rs. 50,000.

The villagers whose houses get burnt find the cost of rebuilding it unaffordable. Also everyone fears that his house may get burnt next.

What should the villagers do to ensure that no one faces extreme financial difficulty in case fire damages his house?

Logic isn’t it: Pretty simple. The total loss is Rs 200,000. The amount of Rs. 200,000 can be divided among the 100 houses and the contribution for each house would come to Rs.2000.

All the houses at risk will pay Rs. 2000 per year and this accumulated amount (Rs 200,000) will be used to rebuild the 4 houses which are actually gutted.

This will reduce the financial burden of the members whose houses do get gutted any year. Thus losses are shared.

This is the concept of insurance.
The group of 100 houses could be grouped together because they shared the same risk. That is, everyone was at similar risk, and therefore they all were willing to contribute to the common pool.

2) Now imagine a neighbouring village B. The inhabitants of this village are engaged in the occupation of baking. They live in huts. They use fire more often than those at village A. There are 10 houses in all, and every year on an average 4 huts are gutted by fire. The cost of rebuilding each hut is Rs 50000. The total loss is Rs 200000, as in Village A. If the sharing principle is used, the contribution comes to Rs 20000 for each hut. That’s certainly a big sum for the poor villagers. What do they do then? Someone suggested the idea of proposing to the leader of Village A to accommodate the members of Village B, and that they would also pay Rs 2000 every year, as payable by those in Village A. What an Idea? Do you think the leader of the Village A would accommodate those from B, at the same contribution rate as they pay, or do you think they will be asked to pay more?

Logic again!

If he accepts the proposal of Village B at the rates they prescribe that is similar to Village A, who will lose? Naturally all villagers of Village A. HOW?
The total loss now will be Rs 4,00,000(of both villages), and the total villagers are 110. Hence per capita contribution will be 3636, as against Rs 2000 earlier. That’s not much of a bad news for village B, but for village A it is unjust. Why would they assent to paying higher for no fault of theirs?. Then what’s the other option for accommodating Village B? Perhaps charge higher contribution. How much higher is the question. In fact it can be similarly worked out that whatever they charge, if it is less than Rs 20000 per head from Village B, it will be Village A that will suffer. It means that there are some groups that cannot be clubbed with the normal groups, for the sake of effecting insurance, since they fall in the uninsurable category due to their higher nature of risk. Where the risk is normal, it is termed standard and good lives. Where the risk is more than normal, but not very high, it is insurable but considered as sub-standard, and charged higher loadings over the base premium. And where the risk is so high that accepting the same would definitely lead to a claim, the insurer is always cautious and the proposal is rejected. For example, if the above illustration is further applied to life insurance, and the huts are treated as humans suffering from terminally ill diseases such as cancer, AIDS, etc., then the whole group is excluded from the purview of life insurance, as the timing of death can be ascertained and the chances of early death are more common. If lenient view had been taken and such proposals accepted by the insurers, then the claims ought to be settled; resulting in huge claims related losses to the insurers. Thus, insurance cannot be granted on emotional basis and it is vital that proper due diligence of the proposer be done, to avoid future financial losses to the insurer. The underwriting strategy is often decided by the actuarial department and depending on the overall management strategy whether growth is pursued or quality, the underwriting norms may either be conservative or aggressive. Insurers must be prudent and balance the dual objectives of quality and growth through acceptable underwriting standards.
1.5 General Principles of Life Insurance

The general principles on which Life Insurance is based are economic, actuarial and legal.

1) Economic principles:

- The attribute of “thrift” or savings is part of the foundation upon which the prosperity of the individual and the nation is built.

When the number of thrifty people in a society grows, that community is strengthened further. Therefore a system that motivates a person to place himself under an obligation to save for a worthwhile purpose is important especially when motive behind the thrift is family welfare and old-age provisions. Life Insurance provides such encouragement and the psychological effect in forming the continuing habit of future financial provision is probably as beneficial as the monetary benefits enjoyed. *The foresight which compels present self restraint is favour of future requirements (financial goals), is an aid to character building.*

- The immediate creation of a monetary estate on payment of the first premium installment is another unique feature of life insurance. The psychological benefits of the contract to the mental and physical health of the individual are unlimited. A mind free from worry can by greater concentration actuate the body to greater output and production of wealth.

- The full social advantage, however, goes beyond the alleviation of worry. A sound education is the foundation of a civil society. Every parent has a dream and every child has a dream. There cannot be a greater impediment to the attainment of such dreams and the pursuit of educational objectives than the parent’s death that results in many children having to abandon their educational pursuits, or lower the bar as far as the goals are concerned due to obvious financial constraints. The difference between a Harvard educated professional employed in a top-notch investment bank, and his colleague with better IQ levels and better grades at school; may be nothing else but Money. Money that the former had and the latter lacked for future higher education. Most of us have been through this, and yet we allow a free access to these uncertainties that bogged us to affect our children’s hope and future. But for a family that has foreseen such eventualities, and covered them through life insurance policies, the full education of the children is guaranteed. Creating better social benefits for self and family is the alternative to government and social security benefits, especially in a country like India where such social security benefits are lacking.

- Capital investment aspect: In the economic and financial spheres, the national value of life insurance is incalculable, and the aggregate sums continuously made available for investment are considerable and have dual effect. They afford a continuous stream of capital into industry which will be difficult to stimulate from other source. Large-scale operations require funding, and borrowing of money is recognized as essential to business and to finance new and existing business operations. By means of life insurance, a central pool is created into which flow the countless comparatively small
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premiums of the vast number of policyholders. Out of the central pool flow the substantial funds, under expert guidance, along investment channels into the economic structure of the nation. There are restrictions as a result of regulations made by the regulators on investments made by the insurers. In India, in case of traditional plans, there is higher percentage of premium outlay that is required to be invested in Government securities. However, in case of Unit Linked plans; the asset allocation is a choice of the investor, and he can decide the funds of the insurer where the premium should be channelised. Whether the premiums are allocated to secured government financial instruments, or to the stock markets in specific sectors; in both cases the effect on the economy is direct.

- In 1774, the Life Insurance Act of England further elucidated the economic principle. There had been much gaming and wagering, disguised as insurance, on the lives of prominent men, statesmen, and criminals, in the hope of making money on early claim. The practice became widespread and it became a public scandal. The person proposing for such policies had no interest to cover. The purpose of life insurance was to protect individuals from economic losses due to death, but this Act went further. *It made legal an economic principle that there should be no insurance unless there was an economic loss which would be sustained through the death of the life assured.*

Thus, *the economic principles are those which relate its service to the needs of the public.*

2) Actuarial Principles:

- If an actuary or a mathematician has at his disposal a mortality table i.e a table of the survivors from age of say, 1,00,000 infant at birth, he can calculate all the probabilities of death and survival which can be put to him. These figures are based on the assumption that the mortality rates are applicable to each age similarly. That assumption is only true approximately. With advances in medical and social conditions, there has been a continual improvement in mortality, so that a mortality table becomes out of date in the course of a generation. In addition to the calculations of the pure probability of an event dependent upon human life, the actuary, by assuming a future rate of interest, can express it in a present monetary value. This enables him to calculate all the complicated figures required for reserves under various types of life insurance policies which should be held by the insurer against their future liabilities. All such calculations are based on unchanging mathematical principles. The question for the actuary is whether his premises in the particular case, as to the mortality and rate of interest, are applicable. The chance of a fire occurring in one particular building in a state of good repair is very much the same one year as the next. In consequence, the premium for the fire insurance is usually the same every year. However, the chance that death will occur in a particular year is greater among elderly persons than young men and women. Therefore, for the same sum assured, a person aged 60 must pay a higher premium than a person aged 25 when both seek life insurance cover. That is, premium is directly proportional to the risk involved.

- Mortality rate: If the risk of death within one year can be ascertained and multiplied by the sum assured, the *net or pure premium* applicable is obtained i.e; the premiums required only to meet claims in respect of those who die. Expenses and many other
items called loadings, are ignored; as they appear in the calculations of the premiums payable at a later stage.

- Table of mortality: It is the result of a study of mortality of the past and is used to give guidance to the probable mortality of the future. The first table gives the ages at which mortality has been studied. The second column gives the number of persons living at each age. The third column shows the number of persons dying at each age. If the number dying is divided by the number living, the rate of mortality i.e. the chances of dying at each age is ascertained. Life insurance is concerned mainly with mortality tables based on the experience of assured lives. Such tables are not frequently prepared, and therefore used for 2 decades without changes. However, a continuous mortality investigation is made by the insurers so that mortality trends are always known.

3) Legal Principles:

- The Indian law is a product of the English law, and therefore a systematic entity. It is not a body of unrelated rules and definitions. Each part is consistent with another. There are fundamental principles that govern the acts. Life insurance is similarly governed by some of the Acts, that is those principles applicable to the law of contract.
- These principles include the Indian Contract Act 1872, the principles of utmost good faith (uberimma fides), and the principle of insurable interest. The principle of indemnity are applicable to non-life or general insurance and not to life insurance.

1.6 Fundamental Principles of Life Insurance:

A) Principle Of Utmost Good Faith: Fundamental Considerations

The principle of Utmost Good Faith (uberimma fides) is fundamental. In life insurance, one party (the proposer) is considered to be in possession of all the facts on which the liability of the insured will be based. The insurer must generally rely on the proposer for a knowledge of these facts, which will include family history, personal medical history, occupation and habits.

As a rule, life insurance is not a yearly contract. It is entered into for a term of years, with an option to renew or terminate at each premium due date. This option is available only to the policyholder. This creates an unequal position, that has to addressed in any form of contract. Thus, the principle of uberimma fides on the part of the proposer is of the utmost importance to the negotiations in life insurance. Utmost good faith likewise alos applies to the insurers.

This principle applies also to the duty of disclosure regarding its duration to life insurance, and material facts which must be disclosed and those which need not be disclosed.

In general, failure to exercise the utmost good faith enables the aggrieved party (the party which shall suffer an unjust financial loss), to repudiate (cancel) the contract or to treat it as null and void ab initio (right from the beginning). Although the contract is binding on both parties alike, it usually arises out of the conduct of the proposer, or insured. An insurer must disclose the precise terms and conditions of the contract that he offers, and must not take advantage of the ignorance of the proposer.
**Duty of Disclosure:**

It is the duty of the proposer to disclose, clearly and accurately, all material facts related to the proposed insurance. It is a positive, not a negative duty. It is confined, however, to matters of fact. It does not include matters of opinion.

A **material fact**, as defined in case of Rivaz v. Gerussi (18880), is a fact which would affect the judgment of a prudent underwriter in considering whether he would enter into a contract at all or enter into it at one rate of premium or another. A material fact includes any communication made to, or any information received by, the proposer.

The proposer must disclose all material facts which he knows, or ought to know; before the contract is concluded. Failure to make such disclosure renders the contract voidable at the insurer’s option. This may happen even if the failure to disclose is inadvertent, or the proposer honestly regarded the fact as immaterial. Whether or not a fact is material cannot rest on the opinion of the proposer. What is material is a matter of fact, and the final judgment can only be given by a court of law. Expert evidence may be called for to prove or disprove the materiality of a fact which has not been disclosed.

Material facts include the following:

- Facts which tend to render a risk proposed greater than the normal. Examples are: physical defects, habits, and family history.
- Facts necessary to explain the exceptional nature of a risk proposed for insurance where, without them, the insurer would justifiably believe the risk to be normal e.g. hazardous occupation.
- Facts which appear to suggest some special motive for insurance e.g. gross over-insurance.

**B) PRINCIPLE OF INSURABLE INTEREST**

Normally it is believed that everything can be insured but **all risks are not insurable** until they have certain characteristics such as:

i. They must be capable of financial measurement.
ii. There must be sufficient number of similar risks.
iii. There must be pure and particular risks.
iv. The occurrences of the event insured must not be against public policy.
v. The premium payable must be reasonable.
vi. There must be insurable interest of the person insuring the risk.

For any insurance contract, the existence of insurable interest is an essential ingredient. This is an important and fundamental principle of insurance.

**Meaning of Insurable Interest:**

In every contract of insurance, it is essential that the insured must have a monetary interest in subject matter of insurance. This is called Insurable Interest. The insured must own part or whole of the subject matter of insurance or he must be in such a position that the injury to it would affect him adversely.

Insurable interest means that the proposer could suffer a financial loss if the subject insured is physically harmed in any way. Only financial interest can be insured.
The proposer must be in a relationship with the subject of insurance whereby he/she benefits from it’s safety and well being.

Insurable interest is the legal right of the insured to effect insurance. It is pecuniary interest of the insured in the property insured. In absence of any pecuniary interest, he is said to have no insurable interest. It is this pecuniary interest of the insured in the property which is actually insured and not the property itself.

A **mere moral claim does not create an insurable interest**. In the same way, mere hope or expectation which may be frustrated in the future by the happening of some event, does not contribute to insurable interest. **A contract of insurance effected without insurable interest is void.**

To illustrate this point, we may take the **following example:**

The owner of the factory has a pecuniary interest in the safety of his factory and he runs a risk of loss in case, the fire breaks out in its premises. If he wants to take a fire insurance policy to cover the risk of his factory, he will be considered to have an insurable interest in the subject matter of insurance because he runs a risk and he has something at stake, something to lose by the happening of the insured peril.

The Insurance Act 1938 does not define “Insurable Interest”. However, its nature and extent was determined by subsequent case laws established by the courts. Mere effecting of a policy of insurance carries with it no right to recover there-under simply because of the happening of an insured event. The insured must have an insurable interest to be able to recover.

It is this feature that differentiates life insurance contracts from wagering agreements.

**The following principles have to be established:**

- A person effecting the policy (proposer) must have an insurable interest in the life to be assured.
- The proposer should be in such a relationship with the life assured, that he should suffer a financial loss in case the life assured dies. i.e the proposer should; even though he has effected the policy, not wish the event to happen, and to gain from it. He should wish for the well being and safety of the life insured at all times.
- The policy must expressly state on whose behalf it has been effected
- The sum assured cannot exceed the extent of the interest when the policy is effected
- Interest must exist at the time of inception i.e when the contract is entered into.
- It is not necessary to prove insurable interest at death.
1.7 Peril And Risk

*Perils* are Events that cause damage to the asset. Assets are likely to be destroyed through accidental occurrences. Perils are such possible occurrences. Example: Fire can destroy a building, so can earthquakes and other natural disasters.

If a house is destroyed by fire, the peril (event) is the fire.
If the house is destroyed by an earthquake, the peril (event) is the earthquake.

*Risks* are the consequential losses or damages.

If a person owns a motor car and keeps it in his garage, there is a possibility of loss by theft. In case he uses the same, there is a possibility of damage through accident.

In both cases, there is a *possibility of loss* of the asset.

The risk to the owner is the market value of the car, if there is a loss.

Insurance is a mechanism to compensate for the financial/economic loss of the asset, so that the impact of the loss on the owner and on those who depend on it is reduced.

*It is like ensuring a 2nd level support.*

Can we insure loss of love and affection?.

No. Only financial losses can be insured.

Insurance can be relevant only if there are uncertainties about the event happening. If the event is certain, it cannot be insured. In case of a terminally ill person, death is certain. The time of death may be uncertain.

Insurance does not protect the asset. It does not prevent the loss due to the peril. It only compensates the financial loss due to destruction of the asset.

**Hazard and Peril**

As insurance is all about risk and indemnity, an understanding of the distinction between a hazard and a peril is inevitable.

The word ‘hazard’, which is commonly used in insurance circles, made its entry into English from Spanish and French. These languages borrowed it from the Arabic word ‘Az-zahar’, meaning chance or luck. In the context of insurance, a hazard means a condition that may create or accelerate the chances of a loss-generating event arising out of a given peril. Perils like fire, water, windstorms or theft are the causes of loss, whereas hazards like physical and moral hazards are external factors that trigger the peril.

It should be noted that many a time, the words peril, hazard and risk are interchanged. Technically, it is necessary to draw a distinction between the usage of the words hazard and peril.
A peril is not a risk. A peril is the cause of the loss, e.g., fire is a peril that causes damage and consequent loss; whereas a hazard is a condition that may create or enhance the chance the chance of a loss that may arise out of a particular peril e.g., dangerous occupations.

Majors Types of Hazards

- **Moral Hazard:** This term is commonly used in insurance underwriting and refers to a certain undesirable predisposition on the part of the insured or the party to be insured, which adds to the chance of the risk and increases the liability of the insurer.
- **Morale Hazard:** This means a careless attitude on the part of the insured in his conduct, a dishonest tendency, which adds to loss and increases the liability of the insurer. In short, a morale hazard is a tendency to be careless because there exist an insurance cover.
- **Occupational Hazard:** Refers to the hazard in relation to an occupation.
- **Physical Hazard:** These hazards are those physical conditions that add or contribute to the enhancement of risk.

1. **8 Life Insurance-The Contract:**

Definition of the Life Insurance Contract:

There are various definitions of the Life Insurance Contract, as there can be wordings intrinsic to the contract. Some of these are as under:

- As defined by Bunyon (UK), in his legal textbook, Law of Life Assurance: “A Contract of Life Insurance is one in which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another.
- According to the Indian Contract Act 1872, “A contract is an agreement between two or more parties to do or to abstain from doing an act. It is intended to create a legally binding relationship”.

A contract is an agreement but an agreement cannot be called a contract. It is the legal binding intention that raises an agreement to the level of a contract.

**Essentials of a valid contract are as follows:**
1. Offer and acceptance
2. Consideration
3. Capacity to contract
4. Consensus ad idem (genuine meeting of the minds)
5. Legality of purpose
6. Possibility of performance
7. Intention to create legally binding relationship

In a contract to life insurance there are two parties, viz., the Insurer and the Insured. The insured is generally called the ‘life assured’. In a life insurance contract the life assured undertakes to pay an agreed sum as premium to the insurer at stipulated intervals called the ‘Mode’ during the selected
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term. According to the nature of the contract and the type of life insurance cover purchased by the assured, the insurer is required to pay the contracted sum to the legal heirs or to the nominee of the assured if death occurs during the currency of the contract or to the assured on the expiry of the selected term if the contract so provides. Normally, the premium remains uniform, but according to the nature of the plan, there could be variations.

The method of paying the premium is called the ‘Mode of Premium Payment’. The assured is required to pay the premium on the date of the policy anniversary covering the ensuing one year. In practice, to facilitate policyholders in the payment of premium, and also to ensure the retention of the business in their books, companies offer half yearly, quarterly and monthly payment modes or frequencies.

In India, a contract of life insurance draws its legal authority from the Indian Contract Act 1872. It should be noted that each policy is a separate contract and is treated accordingly. Though the contract of life insurance is governed by the Indian contract Act, it has certain peculiarities that set it apart from the other legally enforceable contracts. Some of the distinguishing features are:-

- Life insurance is a contract of utmost good faith or *Uberrima fides*. This means that both parties to the contract have to disclose all information for the fruition of the contract.
- The proponent has to complete a questionnaire designed by the insurer called the ‘Proposal form’ to enable the insurer to evaluate the risk and decide whether to accept the risk or decline it or accept the same subject to certain conditions.
- The proposer for the life insurance has to disclose all the material information, which has relevance to his/her health and longevity, and also about his/her habits, however insignificant the proposer may consider them to be.
- In the event of any suppression of the information material to the contract, the insurer will be within his rights to declare the contract null and void, and forfeit all the premiums paid or decline to settle the claim in the event of death.

Similarly the insurer is also required to disclose:-

- All the product features of the plan presented to the proponent for consideration without distorting the product attributes.
- If a plan for insurance is sold by any misrepresentation or if a different package is offered to the proponent without his/her consent in lieu of the one asked for by the proponent, the proponent will be well within his rights to terminate the contract and demand for the repayment of the premium paid by him.
1.9 GLOSSARY/ KEY WORDS

Insurer: The party who agrees to pay money to another party on the happening of a stated contingency. i.e the insurance company
Life Assured: The person on whose life the insurance contract is effected.
Nominee/ Asignee: The party entitled to receive the money under an insurance contract on the happening of a stated contingency or event
Policy: Evidence of insurance contract
Sum Assured: The amount payable on the happening of the event assured against
Premium: The consideration paid to the insurer to secure the payment of the sum assured on the happening of the event insured against.
Policyholder: The owner of the policy i.e in whom the rights are vested. In case of maturity of the policy, he has the right to receive maturity benefits
Proposer: The person who offers to buy the insurance cover, stating all material facts and either stands himself as the life assured, or effects the insurance on someone’s else’s name; subject to insurable interest.
e.g when the husband proposes risk cover for his non-earning wife, he is the proposer and the payor, and she is the life assured.
Agent/ advisor: An insurance company representative licensed by the IRDA who solicits, negotiates or effects contracts of insurance, and provides service to the policyholder for the insurer.
Beneficiary: The person(s) or entity (ies) (e.g. corporation, trust, etc.) named in the policy as the recipient of insurance proceeds upon the death of the insured.
Indemnity: Legal principle that specifies an insured should not collect more than the actual cash value of a loss but should be restored to approximately the same financial position as existed before the loss.
Lapsed policy: A policy which has terminated and is no longer in force due to non-payment of the premium due.
Maturity benefit: The Payment to the policy holder at the end of the stipulated term of the policy is called maturity claim.
Nomination: An act by which the policy holders authorises another person to receive the policy moneys.
Sub-standard/ sub-prime risk: Person who is considered an under-average or impaired insurance risk because of physical condition, family or personal history of disease, occupation, residence in unhealthy climate or dangerous habits.
Life fund: This is a fund set up by an insurance company to which life insurance premiums of certain designated category of life policies issued are paid into. Claims and expenses occurring on these life polices are paid out of these funds. The company actuary does a valuation of the funds periodically before any profits or the company distributes dividends. The insurance company has a responsibility to exercise fairness in the way it manages the fund and the actuary will ensure that the fund is solvent at all times.
Moral hazard: Underwriting the risk affecting an application based on factors such as the personal reputation and character of the applicant, business ethics or the existence of a criminal record. It concerns the intention or motivation behind the buying of a life insurance policy.
Mortality: The probability of death of a life or group of lives.
Collateral: A temporary assignment of the monetary value of a life insurance policy as security for a loan. In the event of default, the creditor would receive proceeds or values only to the extent of his interest.
Commission: A fee paid by the investor to a broker or other sales agent for investment advice and assistance.

Date of commencement: The date on which cover begins, following acceptance of the risk by the insurer.

Declaration: This is the statement or section of the form where the person is required to declare that the statements or answers are given fully and truthfully and that if it were not so, there would be legal consequences.

Repudiation of a claim: This process takes place when the claims examiner looks at the policy document and the evidence submitted to him or her and makes a decision to reject it.