CHAPTER 8

LIFE INSURANCE PRODUCTS - I

Chapter Introduction

The chapter introduces you to the world of life insurance products. It begins by talking about products in general and then proceeds to discussing the need for life insurance products and the role they play in achieving various life goals. Finally we look at some traditional life insurance products.

Learning Outcomes

A. Overview of life insurance products
B. Traditional life insurance products

A. Overview of life insurance products

1. What is a product?

To begin with let us understand what is meant by a product. In popular terms a product is considered same as a commodity– a good brought and sold in the marketplace. The term 'product' comes from the term 'reproduce' which means 'to bring forth' or 'to create'. In other words, a product is the output or result of certain labour or efforts.

However a good's usefulness or utility derives not from the good itself but from its features. This brings us to the marketing perspective. From a marketing standpoint, a **product is a bundle of attributes**. Firms differentiate their product offerings in the marketplace by packing together different types of attributes or different bundles of the same attributes.

The difference between a product (as used in a marketing sense) and a commodity is thus that a product can be differentiated. A commodity cannot. This means that the products sold by different companies, though they may belong to the same category, may be quite different from one another in terms of their features.

Example

Colgate, Close up and Promise are all different brands of the same category of toothpastes. But the features of each of these brands are different from the other.

A product is not an end in itself but a means to satisfy other ends. In this sense products are problem solving tools. They serve as need or want satisfiers. How appropriate a product is for the purpose would depend on the features of the product.

Products may be:

i. **Tangible**: refers to physical objects that can be directly perceived by touch (for instance a car or a television set)
ii. **Intangible:** refers to products that can only be perceived indirectly.

Life insurance is a product that is intangible. A life insurance agent has the responsibility to enable the customer to understand the features of a particular life insurance product, what it can do and how it can serve the customer's unique needs.

2. Purpose of life insurance products and needs covered

Wherever there is risk it is a cause for anxiety. However, we humans have sought to master or at least understand risk, to anticipate and be prepared for it. The instinct and desire to create security against risk has been a key reason for the creation of insurance.

We human beings are social beings who share our lives with others like us – our loved ones. We also possess an immensely valuable asset - **our human capital - which is the source of our productive earning capacity.** However, there is an uncertainty about life and human well-being. Events like death and disease can destroy our productive capabilities and thus cut down or erode the value of our human capital.

Life insurance products offer protection against the loss of economic value of an individual's productive abilities, which is available to his dependents or to the self. The very word 'insurance' in 'life insurance' signifies the need to protect both oneself and one's loved ones against financial loss upon death or permanent disability.

There are other functions, such as savings and investment, but death or dread disease coverage is the most common reason for taking out life insurance. In specific terms, the potential estate value or the wealth expected to be created by the insured individual during his/her remaining earning span of work life, is sought to be replaced or compensated to one's loved ones or to self, should the income generating ability of the insured person be damaged or destroyed during the period of the contract. This is done by creating an **immediate estate** in the name of the insured life, the moment the first premium is paid by him.

So, a life insurance policy, at its core, **provides peace of mind and protection to the near and dear ones of the individual** in case something unfortunate happens to him. The other role of life insurance has been as a vehicle for saving and wealth accumulation. In this sense, it offers safety and security of investment and also a certain rate of return.

Life insurance is more than an instrument for protecting against death and disease. It is also a financial product and may be seen as one among many constituents of a portfolio of financial assets rather than as a unique stand-alone product. In the emerging financial marketplace, customers have multiple choices, not only among alternative types of life insurance products but also with numerous substitutes to life insurance that have come up, like deposits, bonds, stocks and mutual funds.

In this context, one needs to understand what the value proposition of life insurance is. **Customer value** would depend on how life insurance is perceived as a solution to a set of customer needs.

- ✓ Does it offer the right solution? or "Is it effective?"
- ✓ What does it cost? or "is it efficient?"

Life insurance industry has seen enormous innovations in product offerings over the last two centuries. The journey had begun with death benefit products but over the period, multiple living benefits like endowment, disability benefits, dread disease cover and so on were added.

Similarly from a '**participating in profit**' traditional product, the innovations created '**market linked**' policies where the insured was invited to participate in choosing and managing his investment assets. Another dimension was added, where life insurance products evolved from being a fixed bundle (of defined benefits) to highly flexible unbundled products, wherein different benefits as well as cost components could be varied by the policy holder as per changing needs, affordability and life-stages.

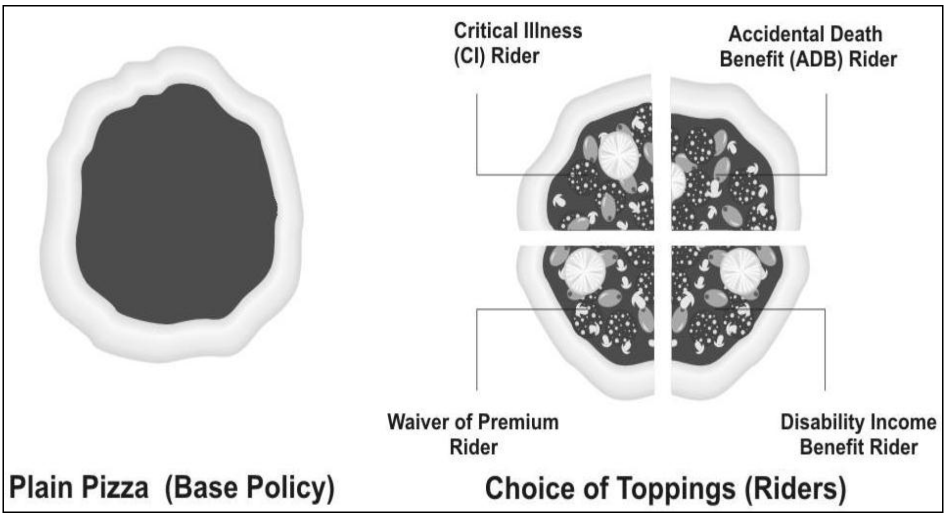
3. Riders in Life Insurance Products

We have seen above, how life insurance contracts offer various benefits which serve as solutions to a host of needs of their customers. Life insurance companies have also offered a number of riders through which the value of their offerings can get enhanced.

A rider is a provision typically added through an endorsement, which then becomes part of the contract. Riders are commonly used to provide some sort of supplementary benefit or to increase the amount of death benefit provided by a policy.

Riders can be compared to choice of different toppings in a pizza. A base policy is like a pizza base and choice of riders is like choice of different pizza toppings available to customise the pizza as per an individual's requirement. Riders help to customise different requirements of a person into a single plan.

Diagram 1: Choice of Riders



Riders can be the way through which benefits like Disability cover, accident cover and Critical Illness cover can be provided as additional benefits in a standard life insurance contract. These riders may be availed of by the policyholder by opting for them and paying an additional premium for the purpose.

Test Yourself 1

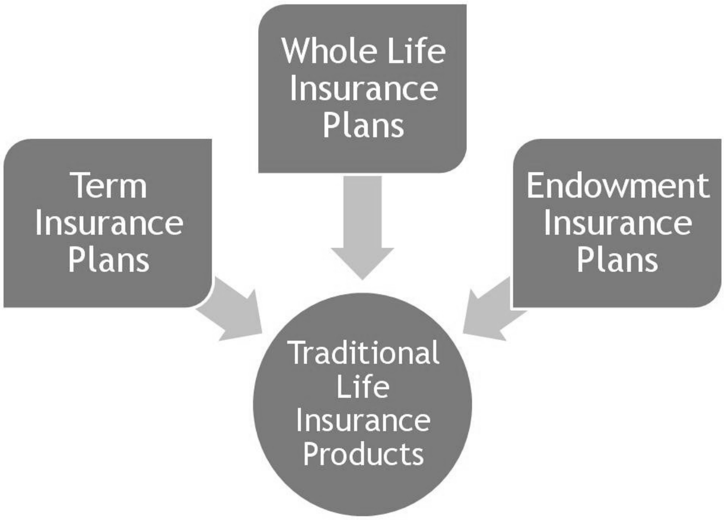
Which among the following is an intangible product?

I. Car
II. House
III. Life insurance
IV. Soap

B. Traditional life insurance products

In this chapter we shall now learn about some of the traditional types of life insurance products.

Diagram 2: Traditional Life Insurance Products



1. Term insurance plans

Term insurance is valid only during a certain time period that has been specified in the contract. The term can range from as short as it takes to complete an airplane trip to as long as forty years.

Protection may extend up to age 65 or 70. One-year term policies are quite similar to property and casualty insurance contracts. All premiums received under such a policy may be treated as earned towards the cost of mortality risk by the company. There is no savings or cash value element accruing to the insured.

a) Purpose

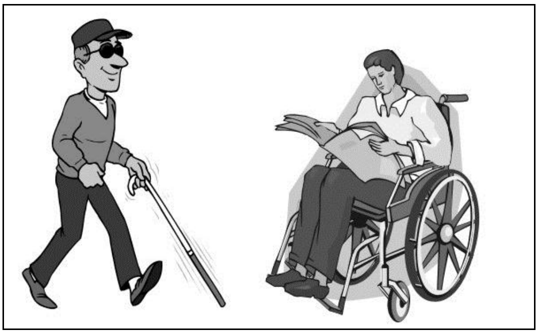
A term life insurance fulfills the main and basic idea behind life insurance, that is, if the life insured dies prematurely there will be a sum of money available to take care of his/her family. This lump sum money represents the insured's human life value for his loved ones: either chosen arbitrarily by self or calculated scientifically.

A term insurance policy also comes handy as an income replacement plan. Here in place of payment of a lump-sum amount to the dependents, on the happening of an unfortunate death during the term of the policy, a series of monthly, quarterly or similar periodical pay outs for a pre-defined duration may be provided to the dependent beneficiaries.

b) Disability

Normally a term insurance policy covers only death. However, when it is purchased with a disability protection rider on the main policy and if someone were to suffer such a catastrophe during the period of term insurance, the insurance company will provide a payout to the beneficiaries/insured person. If the insured dies after the term ends, there are no benefits available as the deal is over as soon as the term expires.

Diagram 3: Disability



c) Term insurance as a rider

Protection under term life is usually provided as a stand-alone policy but it could also be provided through a rider in a policy.

Example

A pension plan may contain provision for a death benefit to be payable in case one dies before the date when pension is to start.

d) Renewability

The premiums are generally charged at a fixed annual rate for the whole duration of term insurance. Some plans have an option to renew at the end of the term duration; however, in these products the premium will be recalculated based on one’s age and health at that stage and also the new term for which the policy is being renewed.

e) Convertibility

Convertible term insurance policies allow a policyholder to change or convert a term insurance policy into a permanent plan like “Whole Life” without providing fresh evidence of insurability. This privilege helps those who wish to have permanent cash value insurance but are temporarily unable to afford its high premiums. When the term policy is converted into permanent insurance the new premium rate would be higher.

f) USP

The unique selling proposition (USP) of term assurance is its low price, enabling one to buy relatively large amounts of life insurance on a limited budget. It thus makes a good plan for the main income earner, who wishes to protect his/her loved ones from financial insecurity in case of premature death, and who has a limited budget for making insurance premium payments.

g) Variants

A number of variants of term assurance are possible.

Diagram 4: Variants of Term Assurance

Variants of Term Assurance

- Decreasing term assurance
- Increasing term assurance
- Term insurance with return of premiums

i. Decreasing term assurance

These plans provide a death benefit that decreases in amount with term of coverage. A ten year decreasing term policy may thus offer a benefit of Rs. 1,00,000 for death in the first year, with the amount decreasing by Rs. 10,000 on each policy anniversary, to finally come to zero at the end of the tenth year. The premium payable each year however remains level.

Decreasing Term Assurance plans have been marketed as mortgage redemption and credit life insurance.

- ✓ **Mortgage redemption**: is a plan of decreasing term insurance designed to provide a death amount that corresponds to the decreasing amount owed on a mortgage loan. Typically in such loans, each equated monthly instalment (EMI) payment leads to a reduction of the outstanding principal amount. The insurance may be arranged such that the amount of death benefit at any given time equals the balance of principal owed. The term of the policy would correspond to the length of the mortgage. The renewal premiums are generally level throughout the term. Purchase of mortgage redemption is often a condition of the mortgage loan.

- ✓ **Credit life insurance** is a type of term insurance plan designed to pay the balance due on a loan, if the borrower dies before the loan is repaid. Like mortgage redemption it is usually decreasing term assurance. It is more popularly sold to lending institutions as group insurance to cover the lives of the borrowers of these institutions. It may be also available for automobile and other personal loans. The benefit under these policies is often paid directly to the lender or creditor if the insured borrower dies during the policy term.

ii. Increasing term assurance

As the name suggests, the plan provides a death benefit, which increases along with the term of the policy. The sum may increase by a specified amount or by a percentage at stated intervals over the policy term. Alternatively the face amount may increase according to a rise in the cost of living index. Premium generally increases as the amount of coverage increases.

iii. Term insurance with return of premiums

Yet another type of policy (quite popular in India) has been that of term assurance with return of premiums. The plan leaves the policyholder with the satisfaction that he / she has not lost anything in case he/she survives the term. Obviously the premium paid would be much higher than that applicable for an equivalent term assurance without return of premiums.

h) Relevant scenarios

Term insurance has been perceived to hold much relevance in the following situations:

i. Where the need for insurance protection is purely temporary, as in case of mortgage redemption or for protection of a speculative investment

ii. As an additional supplement to a savings plan, for instance a young parent buying decreasing term assurance to provide additional protection for dependents in the growing years. Convertible term assurance may be suggested as an option where a permanent plan is non-affordable.

iii. As part of a "buy term and invest the rest" philosophy, where the buyer seeks to buy only cheap term insurance protection from the insurance company and to invest the resultant difference of premiums in a more attractive investment option elsewhere. The policyholder must of course bear the risks involved in such investment.

i) Considerations

Price is in sum the primary basis of competitive advantage in term assurance plans. This is particularly seen in case of yearly renewable term policies that are cheaper than their level premium counterparts.

The problem with such one-year term plans is that mortality costs rise with age. They are thus attractive only for those with a short period insurance planning horizon.

Important

Limitations of term plans

At the same time one must be aware of the limitations of term assurance plans. The major problem arises when the purpose of taking insurance cover is more permanent and the need for life insurance protection extends beyond the policy period. The policy owner may be uninsurable after the term expires and hence unable to obtain a new policy at say age 65 or 70. Individuals would seek more permanent plans for the purpose of preserving their wealth against erosion from terminal illness, or to leave a bequest behind. Term assurance may not work in such situations.

2. Whole life insurance

While term assurance policies are examples of temporary assurance, where protection is available for a temporary period of time, whole life insurance is an example of a permanent life insurance policy. In other words **there is no fixed term of cover but the insurer offers to pay the agreed upon death benefit when the insured dies, no matter whenever the death might occur.** The premiums can be paid throughout one's life or for a specified period of time which is limited and is less than one's lifetime.

Whole life premiums are much higher than term premiums since a whole life policy is designed to remain in force until the death of the insured, and therefore it is designed to always pay the death benefit. After the insurance company takes the amount of money it needs from the premium, to meet the cost of term insurance, the **balance money is invested on behalf of the policyholder. This is called cash-value.** One can withdraw cash in the form of a policy loan should he require emergency funds, or he can redeem by surrendering the policy for its cash value.

In case of outstanding loans the amount of loan and interest gets deducted from the payout that is made to the designated beneficiaries upon death.

A whole life policy is a good plan for one who is the main income earner of the family and wishes to protect the loved ones from any financial insecurity in case of premature death. This person must be able to afford the higher premiums of a whole life insurance policy on a consistent and long-term basis, and wants a life insurance policy which can pay a death benefit, regardless of when he/she dies, while at the same time wanting to be able to use the cash value of the whole life insurance policy for retirement needs, if required.

Whole life insurance plays an important role in household saving and creating wealth to be passed on to the next generation. An important motive which drives its purchase is that of bequest – the desire to leave behind a legacy to one's future generations. A higher ownership of life insurance policies among households with children and a high regard for the family, further confirms this motive.

3. Endowment assurance

An endowment assurance contract is actually a combination of two plans:

- ✓ A term assurance plan which pays the full sum assured in case of death of the insured during the term
- ✓ A pure endowment plan which pays this amount if the insured survives at the end of the term

The product thus has both a death and a survival benefit component. From an economic point of view, the contract is a combination of decreasing term insurance and an increasing investment element. Shorter the policy term, larger the investment element.

The combination of term and investment elements is also present in whole life and other cash value contracts. It is however much more pronounced in the case of endowment assurance contracts. This makes it an effective vehicle to accumulate a specific sum of money over a period of time.

Endowment is primarily a savings programme, which is protected by provision of insurance against the contingency of premature death. Its appeal to customers lies in the fact that it is an instrument that lends certainty to one's personal financial plans by linking insurance to one's savings programme. Endowment also offers a safe and compulsory method of savings accumulation. While prudent investment and asset liability management lends safety, the semi-compulsory nature of premiums provides the incentive to save.

People buy endowment plans as a sure method of providing against old age or for meeting specific purposes like having an education fund at the end of say 15 years or a fund for meeting marriage expenses of one's daughters. There can be no playing around with these objectives. They have to be met with certainty.

It has also served as an ideal way to pay for a mortgage (housing) loan. Not only is the loan protected against the uncertainty of repayment on account of death but the endowment proceeds could suffice to pay the principal.

The policy has also been promoted as a means for thrift savings. Endowment can serve as a worthwhile proposition when one is looking for an avenue to set aside a surplus from income every month/quarter/year and commit it to the future.

The plan is also made attractive because of the provision for deduction of premiums for tax purposes.

Yet another proposition in the Indian context has been the facility to place the policy in a trust created under the **MWPA (Married Women's Property Act), 1874** the money can only be paid to the policy beneficiary, who is thus protected against all creditors' claims on the property of the insured.

Finally many endowment policies mature at ages 55-65, when the insured is planning for his/her retirement and such policies may be a useful supplement to other sources of retirement savings.

a) Variants

Endowment assurance has certain variants that are discussed below.

i. Money back plan

A popular variant of endowment plans in India has been the Money Back policy. **It is typically an endowment plan with the provision for return of a part of the sum assured in periodic installments during the term and balance of sum assured at the end of the term.**

Example

A Money Back policy for 20 years may provide for 20% of the sum assured to be paid as a survival benefit at the end of 5, 10 and 15 years and the balance 40% to be paid at the end of the full term of 20 years.

If the life assured dies at the end of say 18 years, the full sum assured and bonuses accrued are paid, regardless of the fact that the insurer has already paid a benefit of 60% of the face value.

These plans have been very popular because of their liquidity (cash back) element, which renders them good vehicles for meeting short and medium term needs. Full death protection is meanwhile available when the individual dies at any point during the term of the policy.

ii. Par and non-par schemes

The term "Par" implies policies which are participating in the profits of the life insurer. "Non – Par" on the other hand represent policies which do not participate in the profits. Both kinds are present in traditional life insurance.

Under all traditional plans, the pooled life funds, which are made up of the proceeds of premium received from policyholders, are invested under tight regulatory supervision, as per prescribed norms, and policyholders are either guaranteed a part of the growth or get a share of the surpluses that are generated by the insurer, under what are termed as “With Profit Plans”.

Non-participating products may be offered either under a linked platform or a non-linked platform. In this chapter, we are concerned with policies which are non-linked. Typically without profit plans are those where the benefits are fixed and guaranteed at the time of the contract and the policyholder would be eligible for these benefits and no more.

Example

One may have an endowment policy of twenty years providing a guaranteed addition of 2% of sum assured for each year of term, so that the maturity benefit is sum assured plus a total addition of 40% of the sum assured.

IRDAI’s new guidelines on traditional non-par policies provide that for these policies, the benefits which are payable on the occurrence of a specific event are to be explicitly stated at the outset and not linked to any index of benchmark.

Similarly additional benefits, if any, which are accrued at regular intervals during the policy term, have to be explicitly stated at the outset and not linked to any index of benchmark. In other words this means that the return on the policies should be disclosed at the beginning of the policy itself. The policyholder could calculate the net return and compare with other avenues to assess the policy costs.

iii. Participating (Par) or with profit plans

Unlike without profit or guaranteed plans, these plans have a provision for participation in profits. With profits policies have a higher premium than others. Profits are payable as bonuses or dividends. Bonuses are normally paid as reversionary bonuses. They are declared as a proportion of the sum assured (e.g. Rs. 70 per thousand sum assured) and are payable as additional benefits on a reversionary basis (at the end of the tenure of the policy, by death or maturity or surrender).

Apart from reversionary bonuses which, once attached, are guaranteed, the life insurer may also declare terminal bonuses. These are contingent upon the life insurer earning some windfall gains and are not guaranteed.

Terminal Bonuses were developed as a means to share with participating policy holders, the large windfall gains that were made through investment in capital markets in United Kingdom. They have also been adopted in India and many other developing markets.

Information

Dividend method of profit participation

There are certain other markets like the USA where profits are shared in the form of dividends. Two approaches have been followed for dividend crediting.

i. The traditional approach was the "**Portfolio Method**". Here the total investment return on the portfolio held by the company was determined and all policyholders were credited their share of the divisible surplus. No attempt was made to distinguish the rate of return earned on monies that had been invested with the company in previous years from that deposited recently. The portfolio method thus homogenised rates of return and made them stable over time. It applied the principle of pooling of risks over time and is quite analogous in this respect to the uniform reversionary bonus mechanism.

ii. The second approach is the "**Current Money Method**". Here the return depends on when the investment was made and the rate that was secured at the time of investment. It has also been called segmented or investment block method as different investment blocks gets different returns.

Traditional with profits (participating) policies thus offer some linkage to the life office's investment performance. The linkage however is not direct. What the policyholder gains by way of bonus depends on the periodic (usually annual) valuation of the fund's assets and liabilities.

The surplus declared in the valuation depends on the assumptions made and factors taken into consideration by the valuation actuary. Even after the surplus is declared, its allocation among policyholders would depend on the decision of the company's management. Because of all this, the bonuses added to policies only follow investment performance in a very cushioned and distant manner.

The basic logic underlying the approach is the smoothing out of investment returns over time. It is true that terminal bonuses and compound bonuses have enabled the policyholder to enjoy a larger slice of the benefits derived from equity investments. Nevertheless they still depend on the discretion of the life office who declares these bonuses.

Finally, bonuses under a valuation are generally only declared once a year. They obviously cannot reflect the daily fluctuations in the value of assets.
Traditional with profit plans thus represent a generation of products in which the life insurance company decides what is the structure of the product or plan, including the benefits (sum assured and bonuses) and premiums. Even when the

life insurance company earns high returns in the investment market, it is not necessary that its bonuses or dividends be directly linked with these returns.

The great advantage to the policyholder or insured has been that the certainty of investment makes these plans quite appropriate vehicles for meeting those needs that may require definite and dedicated funds. They also help to reduce the overall portfolio risk of an individual's investment portfolio.

Important

IRDAI's new guidelines for traditional products

According to the guidelines, the product design of traditional plans would remain almost the same.

a) New traditional products will have a higher death cover.

   i. For **single premium policies** it will be 125% of the single premium for those below 45 years and 110% of single premium for those above 45 years.
   ii. For **regular premium policies**, the cover will be 10 times the annualised premium paid for those below 45 and seven times for others.

b) The **minimum death benefit** in case of traditional plan is at least the amount of sum assured and the additional benefits (if any).

c) In addition to the sum assured, the **bonus / additional benefits** as specified in the policy and accrued till date of death shall become payable on death if not paid earlier.

d) These plans would continue to come in **two variants**, participating and non-participating plans.

   i. For **participating polices** the bonus is linked to the performance of the fund and is not declared or guaranteed before. But, the **bonus once announced becomes a guarantee**. It is usually paid in case of death of the policyholder or maturity benefit. This bonus is also called **reversionary bonus**.
   ii. In case of **non-participating policies**, the return on the policy is disclosed in the beginning of the policy itself.

Test Yourself 2

The premium paid for whole life insurance is _____________ than the premium paid for term assurance.

I. Higher
II. Lower

III. Equal
IV. Substantially higher

Summary

- Life insurance products offer protection against the loss of economic value of an individual's productive abilities, which is available to his dependents or to the self.

- A life insurance policy, at its core, provides peace of mind and protection to the near and dear ones of the individual in case something unfortunate happens to him.

- Term insurance provides valid cover only during a certain time period that has been specified in the contract.

- The unique selling proposition (USP) of term assurance is its low price, enabling one to buy relatively large amounts of life insurance on a limited budget.

- While term assurance policies are examples of temporary assurance, where protection is available for a temporary period of time, whole life insurance is an example of a permanent life insurance policy.

- An endowment assurance contract is actually a combination of two plans - a term assurance plan which pays the full sum assured in case of death of the insured during the term and a pure endowment plan which pays this amount if the insured survives at the end of the term.

Key Terms

1. Term insurance
2. Whole life insurance
3. Endowment assurance
4. Money back policy
5. Par and non-par schemes
6. Reversionary bonus