3
Part 2: Insurance practices

Contents	Syllabus learning outcomes
Learning objectives	
Introduction	
Key terms	
F How insurance policies are bought and written	3.9, 3.11, 3.15
G Key documents	3.8, 3.12, 3.13, 3.14, 3.17
H Key insurance terms	3.8, 3.15, 3.16
I Relevance of premium payment and valid cover	3.10
Key points	
Question answers	
Self-test questions	

Learning objectives

After studying this chapter, you should be able to:

- describe the main features of how insurance is bought and written;
- analyse the key documents used in insurance and their importance;
- define the key terms used in insurance;
- discuss the relevance of premium payment to valid cover.

Introduction

In the first part of this chapter we looked at the principles behind all insurance. In this second part we are going to build on this by looking at how insurance, and life insurance in particular, is bought. We will do this in two ways.

We will firstly look at the key documents that anyone who has insurance will become familiar with, and discuss their importance. These documents will be exchanged between the insurance company and the policyholder during the policy term. Secondly, we will look at some of the important terms used in life insurance that you will need to be able to explain to your clients.

To put these topics into their proper context we will begin by giving a brief overview of how insurance is bought and written.

Key terms

This chapter features explanations of the following terms and concepts:

Assignment	Cancellation	Lapse	Premium receipts
Assignor	Cooling-off period	Nomination	Policy document
Assignee	Conditional assignment	Notices	Prospectus
Absolute assignment	Exclusions	Paid up value	Revival
Appointee	Endorsements	Proposal form	Surrender value

F How insurance policies are bought and written

We have already established in earlier chapters why an individual should have insurance, what insurance is and the principles behind it. So, how does an individual go about buying an insurance policy? Well, first of all they will need to have heard that insurance is available.

F1 Source of preliminary information

Insurance companies spread awareness of, and generate interest in, their products through mass media advertisements. As we will see later (section G5C), the IRDA has issued specific guidelines on what prospectuses and advertisements issued by insurance companies should say. An individual may conclude from this information that they need insurance and approach the company or one of its agents. We will look at prospectuses in more detail in section G5C.

Alternatively, an individual may be approached by a life insurance agent who will introduce them to the products of the life company they represent.

F2 Purpose of buying insurance

Insurance should be bought by a person based on their needs. There are many insurance products available in the market, and which to buy should be decided after careful consideration. Based on their requirements, an individual may choose to purchase a whole life insurance policy, an endowment policy, a money-back policy, a child plan or a retirement plan etc. We shall look at these products in detail in later chapters.

F3 How life insurance is written

Most policies are written on what is known as a **single life** basis, with only one life insured. Usually, but not always, the person taking out the policy and the life insured are one and the same person. This is known as an **own life policy**. Policies can also be taken out jointly by two insureds – for example a husband and wife can take out one policy, with both being the policyholder and the life insured. This is known as a **joint life policy**.

F4 Proposal form

Advertisements and the prospectus are the means by which insurance companies invite proposals. The person seeking insurance is called the **proposer** – they are proposing themselves for life (or indeed any kind of) insurance. The proposer will complete the proposal form and submit it to the insurance company. The information in the proposal form is evaluated by underwriters who will then choose to accept or reject the proposal, or to accept it on modified terms. We will look at what the proposal form looks like and its importance in section G1.

F5 Quotations

A quotation is simply that – a quotation as to how much the policy will cost and on what terms. It will often be held open for a set period, during which the proposer can choose to take the policy or decide that it is not for them. If the proposer accepts the quotation, then the insurance company is bound to the terms and price that were offered in it. However, if a material fact relating to the proposer changes during the period of the quotation, then the insurance company is not bound to it.

F6 Insurance contract

An insurance contract commences from the date on which the insurance company issues the first premium receipt (see section G3A). The policy document can be sent later (see section G4). If a person dies before the issue of the policy document, but after the issue of first premium receipt, the insurance company is liable to pay the death claim.

F7 Renewals

Life insurance policies are long-term policies, running for a set period of often many years. Health insurance policies on the other hand, issued by non-life companies, are short-term policies that run for only one year. At the end of the year the policyholder is advised to renew the policy so that they do not lose the benefit of the protection that the insurance provides, and also because the insurance company will not want to lose the customer. The insurance company will therefore invite the policyholder to **renew** their policy. We will look at renewal in a little more detail later in the chapter.

F8 Summary

Now that we have set the scene by giving an overview of how insurance is bought, we can build on this knowledge by looking at the documents that are necessary in insurance and at some of the technical terms used in them. To put all this into a practical context we will follow the case study of Nitish Sharma and his life insurance agent, Mr Kumar.

Case study

Nitish Sharma has just been appointed to the position of lecturer in a degree college. He is 28 years old and is married to Sumedha who is a housewife. One day he is approached by an insurance agent, Mr Kumar. During their conversation, Mr Kumar demonstrates to Nitish his need for life insurance. Nitish says that he has already been thinking about this as he recently saw a prospectus issued by a life insurance company and so he agrees to purchase an insurance plan.

G Key documents

There are many important documents associated with insurance – we have already been introduced to some of them in the previous section. These documents provide information on the insured and on the insurance itself and sometimes provide proof that the insurance exists and, when it comes to making a claim, that a loss has occurred. We will look at what these documents are in this section.

G1 Proposal form

The first thing that Mr Kumar does on hearing that Nitish has seen the advantages of having life insurance and is willing to buy a policy, is to give Nitish a **proposal form** to complete.

Case study

When Nitish looks at the proposal form, he is perplexed at the amount of information that it asks for. He wonders why he needs to fill in a proposal form when he is already prepared to pay the price to purchase the insurance plan. He also makes the comment that this is all very well for him, as an educated man, but what if he had been illiterate – could he still buy an insurance plan?

Let us look at how Mr Kumar would answer Nitish's questions.

The proposal form or application form is the first document that the proposer needs to fill in and submit to the insurance company. In our case study Nitish is the proposer. The proposer should fill in the proposal form themselves in their own handwriting. However, there can be a few exceptions to this, for example where the proposer is illiterate or does not understand the language used in the form. Care therefore needs to be taken to ensure that the proposer is fully aware of and is in agreement with the purchase of the insurance plan.

The proposal form is the main source of the information the underwriter will use to assess the risk the person presents to the pool. Therefore it is important that the information provided by the proposer is correct. You should think back to the importance of utmost good faith and the relevance of material facts in the first part of chapter 3.

The insurance company collects the following information through the proposal form:

- information on the life insured, including details regarding their name, age, address, marital status, weight, height, medical history etc.;
- information on the proposer. If the proposer and the life insured are different people then information about the proposer such as name, age, occupation and relationship to the life insured (i.e. the reason they need to take out a policy on the life insured) are also to be given in the form;
- details of the type of insurance plan being requested;
- nomination details (see section H4A);
- details of the riders (if any) being requested (we will look what riders are when we come to look at the individual products available in the market); and
- details about any earlier insurance plans the proposer has taken out.

G1A Declaration in the proposal form

At the end of the proposal form there is a declaration for the proposer to sign. By signing this declaration the proposer states that the information they have provided in the form is correct and that they have fully understood the questions before answering them.

The signing of this declaration is important. By agreeing to this declaration the proposer is recognising that:

- the insurance company can cancel the contract and keep the premiums if it finds out that any of the information provided is not true; and
- by stating that they have understood the questions, they cannot claim that they were given wrong information or misled in any way, if a dispute happens in the future.

What about Nitish's question about illiterate proposers – how can they complete a proposal form and sign the declaration? If the proposer is illiterate, then an impression of the left thumb is taken and a third party has to attest the thumb impression. The person (third party) attesting the thumb impression has to declare that they have fully explained the questions to the proposer, in their language, and that they have correctly entered the answers after consulting the proposer. In this case the address of the declaring person may also be taken.

Sometimes the proposer's language will be different to that of the proposal form. In these cases, where the proposer completes the proposal form and also signs the declaration in their own language, then the proposer has to declare, in their own handwriting above their signature, that all the questions were explained to them and that they answered them only after fully understanding them.

This proposal form and the proposer's signature of the declaration will form the basis of the insurance contract and so are very important documents legally. This is why it is so important that the proposer understands the questions and answers them truthfully.

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Example

Rakesh Chawla is an illiterate person. He is 48 years old and only speaks and understands the Hindi language. He has decided to purchase a life insurance policy, for which he contacts a life insurance agent. The agent provides Rakesh Chawla with the form which he needs to fill in. The form is in English and Rakesh is not well versed in this language. So the insurance agent advises him to ask his friend Nilesh Tandon, who is a school teacher and well versed in both Hindi and English, for help with filling in the form.

Nilesh Tandon agrees to fill in the form on behalf of Rakesh. He explains each question one by one to Rakesh in Hindi and duly records the answers provided by Rakesh on the form.

Once the form is complete, Rakesh Chawla needs to put his thumb impression on the form, declaring that he has understood all the questions and given the answers accordingly.

Nilesh Tandon also signs a declaration provided in the form to confirm that the questions in the proposal form have been explained to the proposer, in a language that he fully understands, and the answers have been recorded accordingly.

G2 Age proof

Case study

Nitish Sharma completes the proposal form and hands it to Mr Kumar who asks Nitish for his High School Mark Sheet as proof to certify his age. Nitish says that he will have to look for this – are there any other documents that he can submit as proof of age – and why does he need to prove his age anyway?

Age is one of the factors that insurance companies use to determine the risk profile of the proposer and thus the premium amount to be charged. This is why it is important that insurance companies verify the correct age of the proposer.

Documents that can be accepted as valid age proofs can be classified as **standard age proof documents** and **non-standard age proof documents**. Some of the documents that can be taken as standard age proofs are:

- a certificate from school or college records;
- a certified extract from registrar of births and deaths or from municipal records made at the time of birth;
- a passport;
- a Permanent Account Number (PAN) Card;
- the service register of the employer;
- a certificate of baptism;
- a certified extract from a family Bible, if it contains the date of birth;
- the identity card of defence personnel, issued by the defence department;
- a marriage certificate issued by a Roman Catholic Church.

Some of the non-standard age proof documents that can be accepted as a valid age proof are:

- a horoscope prepared at the time of birth;
- a ration card;
- an affidavit by way of self-declaration, elder's declaration; and
- a certificate from the village *panchayat.*

Along with proof of their date of birth an individual is required to submit proof of their address, a photograph and a deposit towards the premium. The insurance company may also ask the individual to submit bank statements for six months to a year. Apart from cash or cheque, the premium deposit payment can also be made by credit card, a direct debit from the proposer's bank account or through online payment gateways, electronic clearing system (ECS) etc.

In order to curb money laundering in the insurance sector the IRDA, in recent years, has tightened Anti-Money Laundering (AML)/Combating Financing of Terrorism (CFT) guidelines for insurance companies so that extreme care must be exercised during the Know Your Customer (KYC) process. To prove their identity in accordance with the KYC process, the customer needs to submit:

- an age proof;
- an identity proof;
- an address proof; and
- income proof documents (if required by the insurance company, depending on the insurance amount asked for).

The above documents are to be obtained to establish clearly the identity of the customer and their source of income for the premium being paid. More details about anti-money laundering will be discussed in chapter 12.

G3 Premium receipts

Case study

Nitish Sharma submits his valid age proof, address proof and photograph to Mr Kumar. He also gives him a cheque, in favour of the insurance company, for the premium. He asks Mr Kumar how and when he will hear whether or not his proposal has been accepted.

Mr Kumar tells Nitish that IRDA regulations state that the insurance company has to tell him of its decision within 15 days. He also tells Nitish that the insurance company will show its acceptance by issuing him with a first premium receipt and, maybe at the same time or later, the policy document.

In this section we will discuss the two premiums receipts – the first premium receipt and the renewal premium receipt. We will look at the policy document in the next section G4.

G3A First premium receipt (FPR)

As we have just seen in Mr Kumar's response to Nitish, the insurance company will inform the proposer that their proposal has been accepted and that it has received the premium through issuing the **first premium receipt** (**FPR**). The FPR is important as it is the evidence that the insurance contract has begun. The policy document, which is the evidence of the contract, may be issued some time later.

The first premium receipt contains the following information:

- name and address of the life insured;
- policy number;
- premium amount paid;
- method and frequency of premium payment;
- next date that premium payment is due;
- date of commencement of the risk (i.e. when the cover begins);
- date the policy matures;
- date the last premium will be paid; and
- sum insured.

G3B Renewal premium receipt (RPR)

After the issue of the FPR the insurance company will issue subsequent premium receipts when it receives further premiums from the proposer. These receipts are known as **renewal premium receipts** (**RPRs**). The RPRs act as proof of payment in the event of any disputes related to premium payment, and so are important. The RPRs should be kept in a safe place along with the FPR and the policy document so that they can be produced easily when required.

Be aware

The decision to accept or reject a proposal is taken by the underwriter. If the underwriter accepts the proposal with modified terms and conditions, then the FPR is issued only after the proposer has agreed to the modified terms and conditions and paid the additional premium (if any). IRDA regulations require that the decision on the proposal has to be passed to the proposer within 15 days. We will be looking at the role of the underwriter in more detail in the next chapter.

Question 3.3

Which documents can be accepted as valid proof of age?

G3C What is the 'free look-in period' or the 'cooling-off period'?

Case study

Before Mr Kumar sends Nitish Sharma's proposal, premium and proofs to the insurance company, Nitish has one last question: 'What happens if I change my mind after taking out the insurance policy?'

The issuing of the FPR signifies the conclusion of the contract and is binding on both the parties. However, IRDA regulations provide the proposer with the option to withdraw from the contract within a period of 15 days from the date of receipt of the policy document if they disagree with the terms and conditions of the policy. This period is known as the 'free look-in period' or 'cooling-off period'. If the proposer withdraws from the contract, then the insurance company will have to return the premium paid minus some deductions, such as the cost of covering the risk for the short period during which cover was provided, medical examination expenses and stamp duty.

We will return to the relevance of premium payment and valid cover in section I at the end of this chapter.

G4 Policy document

Shortly after Nitish Sharma receives the first premium receipt, he receives a copy of the policy document. What can Nitish expect from this document? What will it look like?

The policy document is the most important document associated with insurance. It is the **evidence** of the contract between the insured and the insurance company. It is not the contract itself: if the policy document is lost by the policyholder, it does not affect the insurance contract. The insurance company will simply issue a duplicate policy without making any changes to the contract. The policy document has to be signed by a competent authority and should be stamped according to the **Indian Stamp Act.**

A standard policy has the following sections:

Heading	**Preamble**
Operative clause	**Proviso**
Schedule	**Attestation**
Terms and conditions/Privileges and conditions	**Endorsements**

The **heading** of the policy document contains the name and address of the company and its logo.

The **preamble** of the policy states that the proposal and declaration signed by the proposer form the basis of the contract.

The **operative clause** lays down the mutual obligations of the parties regarding:

- the payment of premiums by the insured; and
- the payment of the sum insured by the insurance company on the happening of the insured event, subject to the production of age proof and title by the claimant.

The **proviso** of the policy states the general provisions relating to guaranteed surrender value, nomination, assignment and loans on security of the policy etc.

The **schedule** gives all the essential particulars of the policy, such as:

• the date of commencement of policy;
• the date the policy matures;
• the sum insured (when and how much the policy will pay);
• the premiums to be paid and their due dates;
• the nominee (if stated in the proposal form);
• any special clauses;
• details of riders;
• exclusions; and
• liens.

Insurers also include a printed copy of the proposal form completed by the policyholder in the policy document to remove any ambiguity.

The **attestation** confirms that the insurers have authenticated the policy document by signature. The attestation can be done by authorised officials of the insurance company.

The **terms and conditions** will refer to the:

- days of grace for payment of premium;
- consequences of failing to pay the premium; and
- availability of loans.

It is also in this section that information will be given on how to assign the policy, how to surrender the policy or make it paid up (we will look at what these mean in section H) and how to make a claim. This section will also detail any exclusion(s) under the policy.

An **exclusion** is a statement that a certain risk is not covered by the policy. If the loss is caused by the risk that is excluded from cover, the sum insured will not be paid by the insurance company. An exclusion may be one that is common to all life policies (even those issued by another insurance company). An example of this would be that the policy will not pay out if the life insured commits suicide within one year of purchasing the insurance policy. Other exclusions may be included in the policy by the underwriter because of the risk presented by that particular individual. For example, the underwriter may decide to exclude death resulting from adventure activities like trekking, water rafting or various other water sports etc. which are considered risky or dangerous by the insurer. We will look at why an underwriter might do this in chapter 4, when we consider how an underwriter will sometimes accept a poor risk on modified terms.

In order to make certain changes in the terms and conditions of the original life insurance policy, **endorsements** can be made on a blank sheet of paper and attached to the original policy document. A life insurance policy can be easily amended by using an endorsement. The endorsement is then part of the policy.

Policy information statement

The IRDA requires that the policy information statement should be issued with every policy. This policy information statement should include the following:

- the facility available for method and frequency of premium payment;
- the person or office to be contacted for any enquiry or service relating to the policy;
- the importance of telling the insurance company of any change of address of the policyholder and nominee;
- what to do in the case of a grievance or complaint; and
- information on the location of the Insurance Ombudsman.

Once the proposal has been accepted by the insurance company and the first premium receipt and policy has been issued to the proposer, the proposer is covered by the insurance. From this point we no longer refer to them as proposers – they are now **policyholders**, i.e. people who hold insurance policies.

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Question 3.4

What information is provided in the first premium receipt (FPR)?

G5 Endorsements, notices and prospectus

Case study

As part of his discussions with Mr Kumar, Nitish Sharma asks if he would be allowed to make any changes to the method and frequency of premium payment etc. in the contract, and if yes, how.

Mr Kumar explains endorsements to Nitish. He also provides an explanation of some other documents, such as notices and the prospectus that first set Nitish thinking about life insurance.

G5A Endorsements

During the term of the policy the insurance company allows alterations to the original policy, through the attaching of endorsements. Using endorsements enables the modification of the sum insured, the policy term, premium payment method and frequency, the nomination and assignment etc.

The endorsement can be made on plain paper and attached to the policy document to indicate modifications in the policy.

In cases where the policyholder wants to change the nominee, the endorsement can be done on the back of the policy. Similarly, assignments can also be made on the back of the policy. (More details on nomination and assignment are discussed later in the chapter in sections H4A and H4B.)

G5B Notices

During the policy term the insurance company issues notices to the policyholder. These are:

- notices to remind the policyholder about the due date of premium payment;
- bonus notices;
- notices about premium defaults and policy lapsation;
- notices to revive the policy;
- notices about a benefit falling due – survival benefit/maturity benefit etc.; and
- an annual statement with respect to unit-linked policies.

It is important to note that these notices are used only for information and to remind the policyholder about the premium due date, payment of benefits, status of the policy etc.

G5C Prospectus

We saw in section F1 that the prospectus is used by insurance companies to give information about the product and generate interest among the public about their products. The **IRDA (Protection of Policyholders' Interests) Regulations**, as amended in October 2002, stipulate that the prospectus issued by the insurance company should explicitly state under each insurance plan:

- the scope of benefits offered;
- the conditions;
- any warranties;
- the terms and conditions;
- the entitlements;
- the exceptions; and
- any right to participate in bonuses.

If the right to participate in bonuses is deferred for some time after the commencement of the policy, then this should be explicitly stated. There should be a clear statement as to what benefits are guaranteed and which ones are not. The prospectus should also mention that non-guaranteed benefits in the future may not be the same as in the past and that they may vary.

G6 Documents required at the time of a claim

When an insured loss happens and it is necessary to make a claim the insurance company will require a number of documents from the claimant. For example, for life insurance the insurance company will require proof that the death has actually happened and so will need to see the death certificate. We will look at the documents required at the time of a claim in chapter 11, when we look at the topic of claims.

Suggested activity

Collect a proposal form of any one insurance company. Analyse the form and prepare a list of the information that is being asked for.

The key documents associated with insurance will contain many terms that have a particular meaning in insurance. To understand how an insurance policy works it is necessary to understand what these terms mean and so we will look at some of the key terms in the next section.

H Key insurance terms

We have already used some of the specialist insurance terms in the previous section and in this section we will explain these and others. We will divide the key terms into categories to help you understand them. These categories are:

- terms associated with the continued existence of the policy: terms such as **lapse, paid up value** and **surrender value**. We will also look at **revival** and **renewal** in this context;
- terms associated with who receives the policy monies: **nomination** and **assignment**; and
- terms associated with borrowing against a policy: **loan** and **foreclosure**.

H1 Lapse, paid up value and surrender value

These three terms describe what can happen should the insured find that they are unable to continue to make the premium payments. How they will operate for any particular policy will be described in the terms and conditions of that policy.

Case study

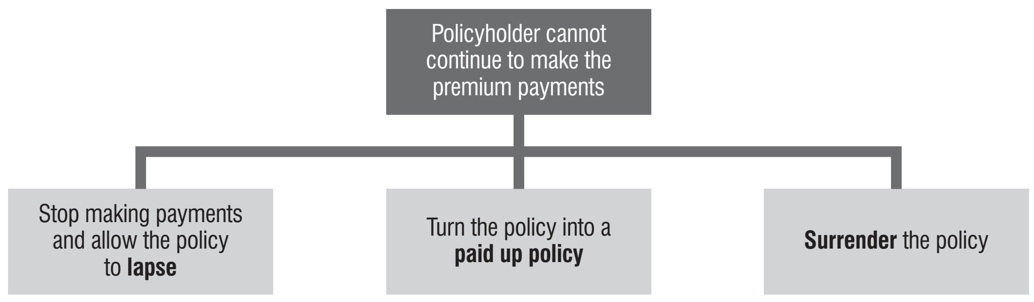
When Nitish Sharma receives the first premium receipt from the insurance company, he is assured that his proposal has been accepted. He then tells his wife about his investment. Sumedha is apprehensive about Nitish's decision and asks him what would happen if he is unable to pay the premium in future. Would he be able to get his invested money back?

Nitish has no idea how to answer her. He visits the agent, Mr Kumar, once again and raises the query with him. Mr Kumar then explains that if Nitish does not pay the premium his policy will lapse. If this happens Nitish can ask the insurer to make the policy paid up. He also informs Nitish that he can voluntarily cancel the policy by surrendering it. In this case the insurance company will pay the surrender value, subject to certain terms and conditions.

Nitish Sharma is confused by the terms (lapse, paid up, surrender value) that Mr Kumar is using and requests Mr Kumar to explain them in detail. So Mr Kumar starts explaining the policy-related terms to Nitish.

A policyholder has three choices if they cannot afford to continue making the premium payments. These are:

Figure 3.3



H1A Lapse

The policyholder is required to pay the regular premiums on the **due dates** agreed with the insurance company. Insurance companies do allow some **days of grace** beyond the due date during which the policyholder can pay the premium and still be considered timely. However, if they do not pay the premium within the 'days of grace' it is considered to be a default.

In the event of a default in the payment of the premium, the insurance company is entitled to terminate the contract. This termination is known as a **'lapse'**. No claims can be made on the policy after a lapse, and all premiums are forfeited.

Be aware

The grace period would normally be one month, but not less than 30 days for yearly, half-yearly or quarterly premium payments, and 15 days for monthly premium payments. However, some insurers allow 30 days even for monthly premium payments.

In practice, the Insurance Act does not allow the insurance company to keep all the premiums paid when a policy lapses. The reason is that every policy acquires a reserve for the following two reasons:

- premiums in the early years of the policy are more than are justified (level premiums); and
- the savings element in the premium.

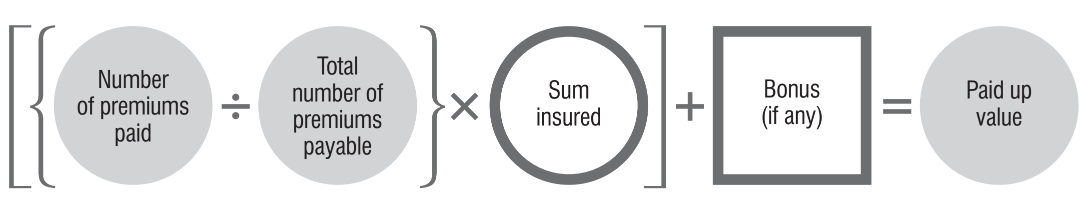
It would not be fair to the policyholder if they were to forfeit this reserve. The policy conditions provide various safeguards to policyholders when there is premium default. These provisions are called non-forfeiture provisions. A policy can be made paid up if sufficient premiums have been paid and there is a savings element to the policy. Whilst the policyholder usually requests this, by the nature of the contract it will be made paid up automatically, based on the number of premiums already paid.

H1B Paid up value

If a policyholder fails to pay a premium on a policy that is capable of having a value (e.g. an endowment or savings plan) and the policy lapses, then the insurance company is not liable to pay the full sum insured. Such a lapsed policy can be made a paid up policy. In a paid up policy the sum insured is reduced to an amount based on the amount of premiums already paid.

The formula for calculating paid up value is:

Figure 3.4



Insurance companies insist on a minimum amount that must be acquired as a paid up value. If the paid up value works out to be lower than this minimum amount, this non-forfeiture benefit would not apply and the policy would lapse. The policyholder may be able to collect the surrender value (which we will discuss in section H1C).

Normally insurance companies will offer the policyholder the right to convert a normal policy into a paid up policy if they have already paid premiums for a minimum of three years. After this period, if the policyholder is unable to pay the remaining premiums then under the paid up option the policy is not cancelled. Instead, the sum insured is reduced in proportion to the number of premiums paid. If other benefits related to the sum insured are payable, the benefits will now be related to the reduced sum insured, which is the paid up value.

What happens to bonuses if a with-profit policy is made paid up?
When calculating the paid up value of a with-profit policy, there is no change in the bonus already vested or granted. Only the sum insured is reduced in proportion to the premiums paid. The accrued bonus is added to the reduced sum insured to arrive at the paid up value. However, a paid up policy is not entitled to receive further bonuses.

Example

Rakesh Singh has a savings policy. The following are the details of the policy:

Policy term	20 years
Date of commencement of policy	4 June 2001
Sum insured	Rs. 5,00,000
Premium payment mode	Annually
Last premium paid	4 June 2008
Number of premiums paid	8
Total number of premiums due	20
Vested bonus	Rs. 50,000

As seen from the data above, Rakesh Singh stopped premium payment after the eighth year. The policy will not be fully cancelled. Instead the sum insured will be reduced in proportion to the premiums paid.

Paid up value = [(number of premiums paid ÷ total premiums payable) × sum insured] + bonus

= [(8/20) × Rs. 5,00,000] + Rs. 50,000

= Rs. 2,00,000 + Rs. 50,000

= Rs. 2,50,000

The paid up value of the policy will be Rs. 2,50,000

H1C Surrender value

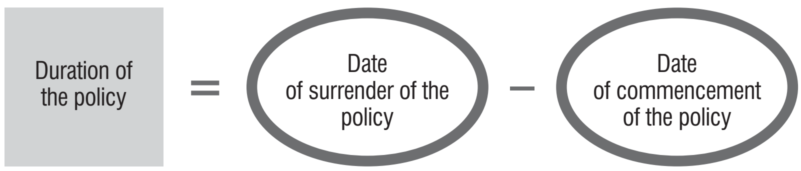
As we have already mentioned, if the policyholder finds that they can no longer meet the premium payments they can cancel the policy by surrendering the policy before it becomes a claim or before it reaches maturity, and have the surrender value paid to them immediately. The policy must be capable of having a value attached to it, e.g. an endowment or savings plan. Policy surrender is the voluntary termination of the contract. Insurance companies stipulate a minimum term of three to seven years before a policy can be surrendered. The 'surrender value' or 'cash value' is the amount that the insurance company is liable to pay once a policy is surrendered. The surrender value is usually a percentage of the premiums paid or a percentage of the paid up value.

The surrender value is calculated based on the amount of premium paid. Hence:

- The surrender value will be low if the duration of the policy has been low.
- If a policy with tenure of 25 years is surrendered after a period of five years, then the amount of premium paid will be less than if the policy was surrendered after, say, ten years. As the surrender value is dependent upon the premiums already paid, it will be high for a policy surrendered after ten years as compared to the same policy if surrendered after five years.
- The surrender value will be lower for a longer-term policy compared to a shorter-term policy if both are surrendered after the same number of years.
- Consider two policies A and B. The term of policy A is 15 years and that of policy B is 20 years. Both the policies are surrendered after ten years and the premiums paid each year are the same. The surrender value for policy A will be higher than for policy B because the premiums in A have been paid for two-thirds of the term, whereas the premiums for B have only been paid for half the term.

The duration of the policy is the difference between the date of surrender of the policy and date of commencement of the policy.

Figure 3.5



The law requires insurance companies to mention in the prospectus or policy document, the minimum guaranteed surrender value, which may be described as a percentage of the premiums paid. However, the actual surrender value paid by insurance companies is more than the guaranteed surrender value.

H2 Revival

Case study

Mr Kumar advises Nitish Sharma against cancelling the insurance policy. There are two reasons for this. The foremost is that as the risk cover is cancelled, Nitish will become highly vulnerable to unfavourable circumstances. Also, if Nitish purchases a new insurance policy later at a higher age, he will have to pay a higher premium.

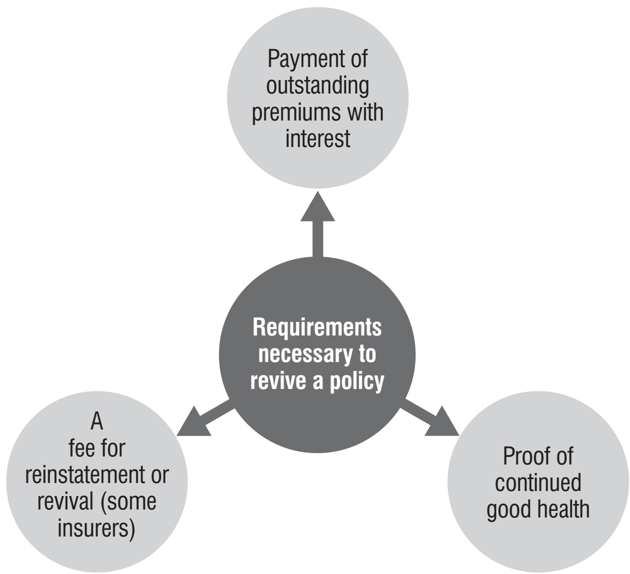
Mr Kumar then informs Nitish Sharma that if he is not able to pay the premiums for any reason and the policy lapses, the insurance company still offers the policyholder a chance to revive the policy on the same terms as the original or modified terms within a certain period.

When a policy lapses it benefits neither the insurer nor the insured. The insured loses the insurance risk cover for the full amount and is exposed to possible adverse circumstances should a claim arise. The insurer also loses. The level premium is based on the assumption that, barring death claims, the policies will run for the full term. The initial expenses incurred on setting up the policy in the first place are high and the insurer can recover them only if the policies remain in force. Generally it is people with bad health who are more likely to keep their policies in force, while some others with good health may lapse or surrender their policies. This will result in adverse selection. This means the insurer's liability is likely to be greater than it assumed that it would be when fixing the cost of insurance.

Because lapsation affects both parties adversely, insurance companies make it possible for lapsed policies to be brought back into full force. This process is called **'revival'**. Insurance companies provide the policyholder with the option of reviving a lapsed policy. Different insurers have different schemes for revival; all with a view to help policyholders revive lapsed policies on easy terms, including instalment revival and loan-cum-revival schemes etc.

To revive a policy, the following will normally be necessary:

Figure 3.6



Some insurers do not allow a policy revival if it has remained in a lapsed condition for more than five years. For a policy to be revived the requirement of proof of good health varies according to the duration of the lapse and also according to the sum insured.

H3 Renewal

We looked briefly at what renewal is in section F7. At the time of maturity of the policy, the insurance company will send a notice to their policyholder inviting them to **renew** their policy.

When issuing the notice to renew, the insurance company may take a fresh look at the risk brought to the pool by that policyholder. Consequently, it may choose to offer renewal on different terms or for a higher premium. It will also remind the policyholder that they will need to tell the insurance company of any material fact that has changed since they first took out the policy. The notice will then explain to the policyholder what they need to do to renew the policy.

It is up to the policyholder to then accept or reject this offer. If they accept the offer, they will follow the instructions and a new policy will start. If they reject the offer then the cover will cease.

H4 Nomination and assignment

Case study

Nitish Sharma has been researching the features and benefits offered under his insurance policy and has come across other terms that he does not understand. He contacts the agent Mr Kumar and asks for help.

He asks why Mr Kumar had insisted on nomination when filling in the proposal form. Nitish also asks: 'what is assignment and how is it done?'

H4A Nomination

Nomination is where the life insured proposes the name of the person(s) to which the sum insured should be paid by the insurance company after their death. The life insured can nominate one or more than one person as nominees. Nominees are entitled for valid discharge and have to hold the money as a trustee on behalf of those entitled to it. Nomination can be done either at the time the policy is bought or later. A person having a policy on the life of another cannot make a nomination. Under section 39 of the Insurance Act 1938, the holder of a policy on their own life may nominate the person or persons to whom the money secured by the policy shall be paid in the event of their death.

Be aware

When an assignment is done (see section H4B below) the nomination is no longer valid. The exception is when the assignment is done in the favour of the insurance company, in consideration for a loan granted against the insurance policy. The nomination remains valid in this case.

Important features of nomination

Nomination can be changed by making another endorsement in the policy. If there is insufficient space, the nomination can be done on a plain piece of paper and attached to the policy document with the signature of the life insured at the edges, where the paper is attached to the policy. Any changes to or cancellation of the nomination can be done by the life insured during the term of the policy.

With a joint life policy, nomination may not be required, as on the death of one of the lives insured the policy monies are payable to the surviving life insured. However, nomination can be made jointly by both the lives insured nominating a person to receive the sum insured, in case both the lives insured die simultaneously.

Nomination only gives the nominee the right to receive the policy monies in the event of the death of the life insured. A nominee does not have any right to the whole (or part) of the claim.

In cases where the nominee is a minor, the policyholder needs to appoint an appointee. The appointee needs to sign the policy document to show their consent to acting as an appointee. The appointee loses their status when the nominee reaches their majority. The life insured can change the appointee at any time. If no appointee is given and the nominee is a minor, then on the death of the life insured, the death claim is paid to the legal heirs of the policyholder.

Where more than one nominee is appointed the death claim will be payable to them jointly, or to the survivor or survivors. No specific share for each nominee can be made. The nomination can also be done in favour of successive nominees such as: 'Payable to Rashmi Gupta, failing him to Pallav Gupta, failing him Madhav Gupta'.

Nominations made after the commencement of the policy have to be intimated to the insurers to be effective.

Should the nominee die after the death of the life insured, but before the payment of the death claim, then the sum insured would form a part of the estate of the life insured and would be paid to their legal heirs.

Example

Vishal Mehta is a senior HR executive. At the age of 28 he purchased an endowment policy. He had nominated his two-year-old son Mohit in the policy. There were no details of the appointee mentioned, and Vishal promised the agent that he would get the signature of an appointee later on. At the age of 35 Vishal dies in a car accident. In the will that was produced, Vishal had appointed his father as the legal heir.

After Vishal's death his wife becomes the natural guardian of the child. Can she claim the policy money being the natural guardian of Mohit?

The answer is **No**. Natural or appointed guardians of minors are not entitled to the policy monies. If Vishal had appointed his wife as the appointee, then only she would have been able to receive the policy money, as Mohit the nominee is a minor.

In this case, the policy money will be given to Vishal's father, the legal heir as stated in the will.

H4B Assignment

Assignment refers to the transfer of title, rights and interest in an insurance policy to another.

Assignor	Assignee
• The person who transfers their title in the insurance policy is known as the **assignor**. • The assignor should be a major (18 or over) and should have a complete title in the policy.	• The person or institution to which the policy is transferred is known as the **assignee**.

Once the policy has been assigned, the assignee has ownership of the policy and does not need the consent of the assignor in matters relating to the policy. An assignment once made cannot be cancelled or altered in any form by the assignor. However, the policy can be 'reassigned' by the assignee in favour of the assignor.

Be aware

Although the assignee becomes the titleholder of the policy following assignment, they cannot make a nomination in the policy as the assignee is not the life insured.

Section 38 of the Insurance Act specifies the legal provisions relating to the assignment of insurance policies. It states that:

- the assignment can be done by an endorsement on the policy or by a separate deed. When assignment is made by an endorsement on the policy itself, no stamp duty is necessary. Separate deeds have to be stamped;
- it must be signed by the assignor or their duly authorized agent;
- the signature must be attested by a witness;
- the assignment becomes effective on execution;
- the insurance company needs to be informed about the assignment along with a notice;
- the insurance company considers the assignment to be effective only when it receives the notice regarding the assignment; and
- when there is more than one instrument of assignment, the priority of the claims shall be determined by the order in which the notices are delivered to the insurer.

Types of assignment
There are two kinds of assignment:

Conditional assignment	Absolute assignment
• The interest in the policy automatically reverts to the assignor on the occurrence of the specified condition.	• The assignee becomes the titleholder in the policy and can deal with the policy in any manner they choose.

Example

A conditional assignment can provide for reversion when:

- the assignee predeceases the assignor; or
- the assignor survives until the date of maturity.

H5 Loans and foreclosure

Case study

In the same conversation with Mr Kumar, Nitish Sharma says to Mr Kumar that he has heard that it is possible to raise a loan against a life insurance policy. Is this true?

Let us look at how Mr Kumar would answer such a question.

H5A Loans against a policy

The policyholder has the option to raise a loan against their insurance policy if the terms and conditions provide for such a facility. Loans are not granted for all policies.

The main features of loans against an insurance policy are as follows:

- In loans against insurance policies, the loan amount is a certain percentage of the surrender value of the policy.
- A loan can be taken by a policyholder against endowment policies, whole life policies and other policies, as allowed by the insurer. These types of policies will have a savings element to them. A loan cannot be taken against policies in which a part of the sum insured needs to be repaid (money-back) during the policy term. Term insurance policies do not acquire any surrender value and hence cannot be used to raise loans.
- The insurance policy needs to be assigned absolutely in favour of the insurance company at the time of raising the loan. The assignment in favour of the insurer for getting the loan under the policy does not invalidate an existing nomination.
- The repayment of the loan can be done by the borrower wholly or in parts during the term of the policy. The borrower also has the option to postpone the repayment until a claim arises.
- If the policyholder continues to pay the premium regularly, then the surrender value goes on increasing and would be more than the outstanding loan and interest at any point of time.

Be aware

Banks also provide loans of up to 75% to 90% of the total surrender value of the policy.

H5B Foreclosure

There are two ways in which an insurance policy can be surrendered:

- surrender by the policyholder; or
- surrender by the insurer (foreclosure).

If the borrower is not paying the interest or interest and principal, the outstanding loan with the interest thereon will be appropriated (deducted) from the claim payable (on maturity or death).

When a policy is surrendered (cancelled) by an insurer, it is known as foreclosure. The policy will be foreclosed by the insurer only in the case of lapsed policies. The policy may have been in force at the time the loan was granted, but subsequently the policy becomes lapsed, and the policyholder is neither paying the premiums, nor loan interest, nor principal.

There can be two major reasons for foreclosure:

- the borrower has chosen to repay the loan during the policy term and is unable to do so; or
- the debt (loan) has accumulated over the policy term until the claim arises, and the accumulated debt (loan) has exceeded the surrender value of the policy.

In the case of paid up policies, the surrender value will not grow as fast as the accumulated interest. The principal and interest could become more than the surrender value at some time. In that case foreclosure becomes necessary.

The borrower is issued a notice of foreclosure, requesting them to repay the interest arrears on the loan. If the borrower fails to repay the interest, then the policy is foreclosed, i.e. surrendered to loan. The balance surrender value (if any) is paid to the policyholder after settling the loan and the outstanding interest. The policyholder has to submit a discharge voucher for the same amount.

Can a foreclosed policy be reinstated?
The foreclosed policy can be reinstated before the discharge voucher is submitted by the policyholder for collecting the balance surrender value. To reinstate the policy, the policyholder will have to pay the arrears of interest and submit a 'Declaration of good health'.

What happens to the nomination in case of foreclosure?
On foreclosure, the nomination ceases to be operative. If a death claim arises before the payment of the surrender value, the payment is made to the legal heirs of the deceased insured.

This concludes our consideration of the key terms used in insurance. However, before we finish this chapter, let us return once more to the topic of the premium. You should have already understood as a result of studying this chapter that the payment of the premium is of great importance in ensuring that insurance cover remains in place. This is so important that it is worth looking at in more detail.

I Relevance of premium payment and valid cover

When an insurance policy is purchased, the risk gets transferred from the insured to the insurance company. In consideration for this transfer of risk, the policyholder has to pay a premium to the insurance company. If a proposer never pays any premium, the policy will never come into force. This is because, as we saw in the first part of chapter 3, consideration is needed if a contract is to be valid. If the proposer does not pay the premium, there is no consideration and so no contract. This is why, as we saw in section G3A, the first premium receipt is the evidence that the insurance contract has begun.

As soon as the proposal is accepted and the first premium is paid, the insurance company becomes liable to pay a death claim, subject to the terms and conditions of the policy. However, if the policyholder fails to make subsequent premium payments, the policy will become lapsed and they will no longer be entitled to the benefits of the policy should the worst happen. The best they can hope for is the return of some of their premium. We looked at this situation in section H1A.

You will see from this how important the premium is if a valid insurance contract is to be in place and the proposer is to receive the protection they sought in buying insurance.

Case study

Nitish Sharma has been worrying about his policy and contacts Mr Kumar one last time with some more questions. What if, he asks, he is late with a payment because he is ill and then dies before he can make it? What happens if he is killed while walking back from the post office after posting his premium cheque? Will he still be covered or will Sumedha lose all the protection he has worked so hard to give her should he die?

Mr Kumar patiently answers Nitish's questions once more.

What happens if the insured dies and the premium has not been paid?
As long as the delay in payment falls within the days of grace given by the insurance company, then, the insurance company is liable to pay the full claim to the nominee or legal beneficiary. The insurance company will deduct the unpaid premium from the claim amount.

When is the premium deemed to be paid?
The premium is deemed to be paid only when the insurance company receives the funds. If the payment has been made by cheque, demand draft or money order, then the payment is deemed to be paid when the amount has been deposited in the insurance company account. However, in practice, the premium is deemed to be paid when any form of payment is received.

What if the insured dies while the cheque/demand draft/money order is in transit?
If the life insured dies while the cheque/demand draft/money order is in transit, i.e. the cheque/demand draft/money order has already been issued by the policyholder but the insurance company has not received it, then the insurance company will seek 'proof of sending these instruments'. The proof can be provided for instruments such as 'demand drafts' and 'money orders'. The insurance company in these cases deems that the premium has been paid on submission of the proof. However, if a cheque was sent in the post, the insurance company will require evidence of posting.