3

Life insurance principles and practices

Contents

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Part 1: Insurance principles

Learning objectives

After studying this chapter, you should be able to:

- explain the essential features of a valid contract;
- explain the concept of insurable interest and state when insurable interest needs to exist;
- explain the importance of utmost good faith; • outline the insurer's and

insured's duty of disclosure;

.   • explain the importance of material facts;

.   • describe the facts which need not be disclosed;

.   • explain the concept of indemnity and its relevance to life insurance.

Introduction

An insurance policy is a legal contract between the insurance company and the insured person and it must satisfy certain conditions to ensure that it is a valid contract.

In this chapter we will learn what the essential features of a valid contract are, including some unique principles that apply only to contracts of insurance.

Key terms

This chapter features explanations of the following terms and concepts:

Offer and acceptance	Consideration	*Consensus ad idem*	Insurable interest
Key person insurance	Utmost good faith	Duty of disclosure	Material facts
Ab initio	Indisputability clause	Indemnity	Capacity to contract
Contract of indemnity	Value contracts		

A Essentials of a valid contract of insurance

An insurance contract is an agreement, enforceable by law, between the insurance company and the insured person; the insured person agrees to pay a premium to the insurance company and the insurance company agrees to pay a sum of money, on the happening of a specified event, to the insured person.

How do both parties enter into this legally binding agreement and what conditions must be satisfied by both parties to ensure that the contract is a valid one?

To answer these questions, we will first look at the essential features of a valid contract, and then we will move on to see how an insurance contract differs from other contracts.

A1 Features of a valid contract

The following features are essential if a legal contract is to be valid:

Features of a valid contract Offer and acceptance

Consideration

Capacity to contract

Consensus ad idem
(both parties having the same understanding)

Legality of object or purpose

Capability of
performance

The most important features are **offer and acceptance** and **consideration**.

A1A Offer and acceptance

A contract comes into existence when one party makes an offer which the other party accepts unconditionally. It is easier to see how unconditional acceptance works by looking at an example. Let's consider the following conversation:

Example

ABC insurance company: 'On the basis of your proposal form we can offer you cover, with a sum insured of Rs. XXXXX.'

Ganesh, the proposer (the person who wants to take out the insurance): 'I accept.'

In this example, Ganesh's acceptance does not alter any of the terms of ABC's offer and the acceptance is said to be unconditional. A contract is formed, subject to the other essential elements being present.

Now, consider an alternative response by Ganesh:

> **Example**
>
> ABC insurance company: 'On the basis of your proposal form we can offer you cover, with a sum insured of Rs. XXXXX.'
>
> Ganesh, the proposer (the person who wants to take out the insurance): 'I accept, but I would like to increase the sum insured to Rs. YYYYY.'

In this case, a contract has not been formed as Ganesh has not unconditionally accepted the offer. Not until ABC accepts Ganesh's counter-offer, without further conditions, is a contract formed.

A1B Consideration

A contract must be supported by consideration in order to be valid. Consideration may be described as each person's side of the bargain which supports the contract. Consideration in contract law is merely something of value that is provided and which acts as the inducement to enter into the agreement. The payment of money is a common form of consideration, although not the only form. In terms of insurance policies, we refer to the premium as the insured's consideration.

A1C Capacity to contract

Persons entering into contracts should be competent to do so. An individual is said to be competent to enter into a contract if they are:

- of the age of majority (age 18);
- of sound mind; and
- not disqualified, by law, from entering into contracts

According to this provision therefore, minors (those under the age of 18) cannot enter into insurance agreements. In addition, people who are legally considered to be of unsound mind and any person who has been barred by law cannot enter into an insurance contract. Any contracts entered into by the above people will be null and void.

A1D *Consensus ad idem*

In simple terms this means both the parties to the contract must understand and agree upon the same thing, in the same sense. The proposer should have understood the features of the insurance policy in the same sense (manner) in which it was explained to them by the agent.

A1E Legality of object or purpose

The objective of both the parties to the contract should be to create a legal relationship. The purpose of the contract should also be legal.

Example

It is illegal for a husband to insure his wife's life, and then to kill her and present it as a case of accidental death in order to benefit from the claim amount that he will receive as the legal beneficiary. Insurance cannot be used for illegal purposes or to derive monetary benefits from it.

Another example of an illegal act is a person who is heavily in debt, taking out life insurance for a large amount and then committing suicide so that their family can benefit from the claim money. Claims for death due to suicide in the first year are excluded by most life insurance companies.

A1F Capability of performance

The contract must be capable of being performed by both the parties. For example, a person requesting life insurance for a very high amount should be capable of paying the premium required.

The agreement and its term must be certain and capable of performance and in a form that complies with the requirements of the laws of the land.

Consider this…

Jigar makes a proposal to an insurance company for life insurance cover of Rs. 75 lakhs with a premium payment of Rs.12,000. During the medical check-up the company finds out that Jigar is suffering from a disease and considers that he presents a higher than normal risk. The insurance company therefore tells him that the premium chargeable will be Rs.15,000 instead of Rs.12,000.

How will you treat the above scenario in terms of offer and acceptance?

Question 3.1

What are the essential features of a valid contract?

A2 The policy document

In order that both the insured person and the insurance company are clear as to the terms that have been agreed between them, a policy is issued. The policy contains all the details of cover, period of cover, exceptions, conditions, the premium and other relevant information. The policy is not the contract of insurance in itself; rather, it is evidence of the contract.

The contract of insurance comes into effect once the insurance company has accepted the insurance proposal, terms have been agreed and the premium has been paid or agreed to be paid. Thus, the contract exists irrespective of the existence of an actual policy document. The absence or loss of the policy does not invalidate the contract, but the policy is useful as proof in the event of a dispute over the terms agreed. We will examine the structure and contents of the policy in detail in Part 2 of this chapter.

A3 The role of insurance agents in insurance contracts

In the eyes of the law, anyone who acts on behalf of another person is an ‘agent’. If we allow someone to act for us, we probably have to accept responsibility for whatever is done by them on our behalf within the terms of the arrangement. This is true in insurance, and whenever there is the involvement of an intermediary, legal relationships are set up.

We saw in chapter 1 that there are different types of intermediaries involved in the insurance industry and that the term ‘agent’ is applied to a licensed intermediary hired by an insurance company to sell that company's products on its behalf. In doing so the intermediary becomes the legal 'agent' and is deemed to be acting on behalf of the 'principal' (in this case, the insurance company). They are authorised by the principal to bring the principal into a contractual relationship with a third party (in this case the proposer/ person wanting to take out insurance).

Be aware

You will also remember from chapter 1 that certain intermediaries called composite brokers are independant advisers. Their legal status is complicated because they do some things on behalf of their client and some on behalf of the insurer, and so they can be deemed to be both the agent of the insured and the agent of the insurer (depending upon the nature of the function they are performing).

Be aware

Insurance contracts are specialised contracts and are subject to additional principles as well as the essentials of a valid contract described above.

We will now look at these additional principles in the following section.

B Insurable interest

Insurable interest is one of the elements necessary to create a valid insurance contract.

B1 What is insurable interest?

The following case study will help you to understand the meaning of insurable interest:

Case study

Ganesh is a 30-year-old man working for a multinational company (MNC). Ganesh's wife works for a domestic firm and she is a co-applicant in the loan on their home together with Ganesh. Whilst Ganesh has a well-paid job, as well as managing the monthly living expenses he has a running home loan and a car loan to take care of. Ganesh has worked hard to build these assets. So far everything has been going as Ganesh has planned. Imagine, however, the following scenarios:

Scenario 1: Ganesh meets with an accident and is hospitalised for a month.

Scenario 2: Ganesh's wife dies unexpectedly.

Let us have a closer look at the above scenarios and the possible solutions.

Scenario 1: Ganesh will not be able to work for at least a month. He will not receive a salary for that time and will also have to pay his hospital bills which could be very costly. To avoid this situation Ganesh should ensure that he has adequate health insurance to cover him against unexpected medical emergencies and to cover him against loss of pay if he is absent from work due to medical reasons.

Scenario 2: Ganesh's wife, apart from contributing to the family income, also takes care of the family. Following her unexpected death, Ganesh will face financial difficulties in repaying the home loan and meeting other financial commitments. To protect against the above scenario Ganesh can take out life insurance on his wife's life which will pay out in the event of her unexpected death, thus ensuring that the family's finances are not put in jeopardy. Ganesh's wife can also take out life insurance on Ganesh's life which would pay out on his unexpected death.

You will see from these scenarios that if either of the events happen, Ganesh and his family's **financial position will be adversely affected unless he has taken out insurance**.

Consider this…

How do these scenarios help us to understand insurable interest?

Insurable interest is said to exist when an individual stands to gain or benefit from the continued existence or well-being of another individual(s) or property, and at the same time the individual would suffer a financial loss or inconvenience if there is damage to the other individual(s) or property.

We can see from the case study that Ganesh has insurable interest in his own good health and the life of his wife because he benefits from the well-being of them, and he would be **financially adversely affected** should there be damage to either or both of them.

B2 Relevance of insurable interest

Now that you know the meaning of insurable interest, you must be wondering what is the relevance or importance of insurable interest in insurance? **Insurable interest is a very important principle of insurance**. In order to take out any kind of insurance, an individual has to have insurable interest in the subject matter they wish to insure. The subject matter is the item or event insured and can be a person's own life, the life of others or property. Insurable interest forms the legal basis for deciding whether insurance can be taken out or not.

To summarise: Insurable interest is the legal right of the person to insure the subject matter with which they have a legal relationship recognised by law.

B3 Circumstances in which insurable interest exists

Court judgements have established the circumstances in which insurable interest is deemed to exist. By common law, insurance interest is deemed to exist in the following circumstances:

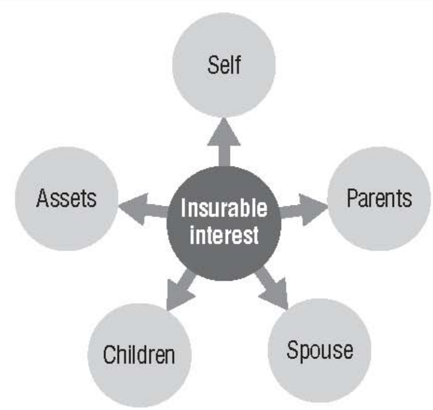
- **Own life:** a person has unlimited insurable interest in their own life.
- **Spouse:** a husband has insurable interest in the life of his wife and, similarly, a wife has insurable interest in the life of her husband. Both benefit from the well-being of each other and each would be adversely affected if something were to happen to the other. So a husband can take out life insurance cover for his wife and vice versa.
- **Children:** parents can take insurance for their children when the children are dependants. Children can also take out insurance for their parents when the parents are dependent upon them. Ganesh can, therefore, take out life insurance for his children. Similarly Ganesh's children can take out health insurance for Ganesh in his old age when he may be dependent on his children.
- **Assets:** a person has insurable interest in the assets they own because they benefit from their use and they would be adversely affected if the assets were to be damaged.

Example

Ganesh can take out life insurance for an amount equal to the present value of his future earnings. Alternatively, he might assess how much would be needed to take care of all his liabilities in his absence – such as the home loan, car loan, his family's living expenses etc.

Another method that can be used to calculate the amount of life insurance needed is to use a multiple of annual income, say, 15 times annual income or even 20 times annual income.

Figure 3.2



Other circumstances where insurable interest is deemed to exist include:

- **Creditor:** a creditor has insurable interest in the life of the debtor to the extent they have lent money to the debtor.
- **Surety:** a surety has insurable interest in the life of the principal debtor and also in the life of the co-surety to the extent of the debt.
- **Employee – employer:** an employee has insurable interest in the life of their employer to the extent of their monthly salary.
- **Employer – employee:** employers have insurable interest in the well-being of all their employees to the extent of the value of their services, for example if an employee falls sick and remains absent from duty for a long time then it can hamper the delivery of the projects that they are working on.
- **Keyman insurance:** a company has insurable interest in the lives of certain important people. The company can take out **keyman insurance** on the lives of such people.
- **Partners:** partners in a business have insurable interests in the lives of each other.

Example

If Ganesh has borrowed Rs.10,000 from Kailash, Kailash will then have insurable interest in the life of Ganesh to the extent of the loan amount lent, i.e. Rs.10,000.

This is because if something happens to Ganesh then Kailash will not be able to recover his Rs.10,000 and he will have incurred a loss. So in this case Kailash can take out life insurance on Ganesh's life for up to the loan amount of Rs.10,000.

Be aware In **life insurance**, insurable interest needs to exist (be proven) at the time of taking out the policy, i.e. at the inception of the policy. In the event of a claim, insurable interest may or may not exist and is not required to be proved. In the case of **general insurance**, insurable interest must exist at the time of inception of the policy **and also** at the time of making a claim. **Different rules apply to marine insurance** where insurable interest need only exist at the time of the claim.

C Utmost good faith

Utmost good faith must also exist for a contract of insurance to be valid.

C1 Importance of utmost good faith

The following scenario will help you to understand the principle of utmost good faith:

Scenario

Rajesh had taken out a term insurance policy of Rs. 50 lakhs for 20 years.

While returning home from the office one day, Rajesh had a road accident and sadly died.

Rajesh’s wife Komal (as the policy nominee) made a claim with the insurance company. To Komal’s surprise the insurance company rejected the insurance claim. Komal was obviously very distressed and asked for an explanation for the rejection of the claim. The insurance company had found out in its investigation that Rajesh had manipulated his proof of age documents and, in order to benefit from a lower premium, declared his age to be five years younger than he actually was. Rajesh had deliberately misled the insurance company to obtain the insurance policy at better terms. Due to this the insurance company declared the policy null and void and rejected the claim made by Rajesh’s wife.

The proposer knows all the facts about themselves and has the moral responsibility to disclose all true information at the time of completing the insurance proposal form and submitting proper documents.

The age of a person is a vital criterion in deciding the premium pricing of a life insurance policy which is what Rajesh manipulated.

In many contracts for the purchase of a tangible product, each party can examine the item. Provided that one party does not mislead the other party and answers questions truthfully, there is no question of the other party avoiding the contract. In the case of buying a refrigerator, its features can be examined and switched on to check that it works properly. The rule governing the sale and purchase of goods and services is *caveat emptor*, or 'let the buyer beware'.

But insurance cannot work like this. We can read the policy but the only point at which we will find out how it works is when a claim is made. There is nothing to touch or see. Equally the insurance company is relying entirely upon the proposer for much of the information that it will use to decide whether it wants to accept the risk, and if it does, on what terms.

The above scenario shows that the intentional suppression of a material fact is not permissible. That is why a different set of rules apply to insurance contracts and a higher duty is required called utmost good faith.

C2 Definition of utmost good faith

We can define 'utmost good faith' as:

> A positive duty voluntarily to disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not.

This means that the parties to a contract must volunteer material information before the contract is concluded. The principle applies equally to both the proposer and the insurer throughout the contract negotiations, but the law sees the proposer as the main supplier of material facts to the contract. We shall be explaining what material facts are in section D.

Breach of the duty of utmost good faith

Breaches of the duty of utmost good faith can be categorised as:

- **Non-disclosure**, or the omission to disclose a material fact, either inadvertently or because the proposer thought it was immaterial.

> For example, Ajay, while applying for life insurance with Company ABC, does not disclose that he had undergone surgery during his childhood. He feels it is immaterial to disclose this information to the insurance company as the surgery was done during his childhood, some 15 years ago, and he had completely recovered from the incident a long time ago.

- **Concealment** of a material fact.

> For example, Ajay consumes alcohol regularly. However, before applying for life insurance he does not consume alcohol for a month, thinking that by doing so it will not be detected during the medical test and he will get insurance at better terms.

. • **Fraudulent misrepresentation** or statements made with the intention of deceiving the insurer.
. • **Innocent misrepresentation** or inaccurate statements which are believed to be true.

For example, Ajay declares his age to be five years less than he actually is. To support this he forges the proof of age documents and submits them to the insurance company to get insurance at better terms.

Question 3.2

List some practical circumstances in which insurable interest is deemed to exist for an individual.

C3 Duty of disclosure

As we have explained, there is a duty to disclose material facts implicit in all insurance negotiations; this is particularly important at the proposal stage, before the contract comes into existence. The duty of disclosure is revived at each renewal date.

Insured's duty of disclosure

It is important that the proposer makes full and complete disclosure of all the material facts relating to the contract since, in the vast majority of cases, the full circumstances of the subject matter are only known to the proposer. The insured should also act towards the insurer in good faith throughout the duration of the insurance contract.

Examples

- The proposer should mention all facts relating to their health. If they are suffering from any illness which may affect the insurer's decision, it must be disclosed at the time of the proposal itself.
- The proposer must declare their correct age and support it with proper proof of age documents.
- If the proposer smokes tobacco or consumes alcohol, then this should be mentioned on the proposal form.
- If the proposer has been denied insurance in the past by any company or a proposal has been accepted at a higher premium than normal, then this should be mentioned along with the reason for it, on the proposal form.

Insurer's duty of disclosure

The insurer also has a duty of disclosure to the insured. In order to fulfil this duty, the insurer must also behave with utmost good faith.

Examples

- The insurer should make sure that it discloses all information related to the insurance product in all its literature, such as pamphlets, brochures, website etc.
- Insurance companies, for example, charge a lower premium for non-smokers compared to those for smokers.
- In the case of health insurance, at the time of renewal some companies offer a discount on the premium or increase the cover by a certain percentage keeping the premium the same, if there has been no claim made by the insured in the entire year.

Suggested activity

We have mentioned above some instances where the insurer has a duty of disclosure to the proposer/insured person. Think about some other instances where there might be a duty of disclosure on the insurer towards the insured.

Or

Search the internet for some cases or examples where the insured has not followed the duty of disclosure and their claims have been rejected by the insurer on the grounds of non-disclosure. Study the reasons for such a rejection of claims.

D Material facts D1 Importance of material facts

Material facts can be defined as those which:

> would influence the judgment of a prudent insurer in fixing the premium or determining whether it will take the risk.

From the above definition we can see that material facts are important because they help the insurance company's underwriter to decide two things:

. • whether to accept the risk proposal or to reject it; and
. • if the proposal is to be accepted, then at what price (premium) it should be accepted.

If the proposer is in any doubt about facts which may be considered material, they should disclose them, regardless of whether there is a specific question on the proposal form. This is because the proposer alone is in possession of the full facts and these must be presented to the insurer when the insurer is underwriting the business.

Any facts which render the risk greater than normal are clearly material, as are those that explain the exceptional nature of a risk, or suggest some special motive for insurance.

D2 Consequences of non-disclosure

If the insured is in material breach of the duty of disclosure, the insurer may avoid the contract entirely, *ab initio* (from the beginning). In other words, no claims are payable. If the non-disclosure is fraudulent (often termed 'concealment') the insurer may keep the premium. The legal rule is that non-disclosure arises and gives grounds for avoidance by the second party to the contract (the insurer) where a fact is:

. • within the **knowledge** of the first party (the insured);
. • **not known** to the second party (insurer); or
. • **calculated**, if disclosed, **to induce** the second party to enter the contract at terms they consider to be better, or not to enter the contract at all.

D3 Indisputability clause (section 45)

As specified in section 45 of the Insurance Act, in the first two years of the policy, if the insurance company comes to know that some material fact has not been disclosed by the proposer, it can declare the policy to be null and void. The insurance company can also keep all the premiums paid. This right can be enforced by the insurance company only during the first two years of the policy. After two years, fraud must be established by the insurance company if it wishes to make the policy void. This clause is referred to as the 'indisputability' clause and applies to life insurance.

D4 Life insurance: duty of disclosure

In the case of life insurance, the duty of disclosure arises at the time of proposal up until the time the risk is accepted by the insurance company and the policy cover has commenced.

Be aware

In the event that a lapsed policy is revived, the insurance company may ask the insured to disclose all material facts along with proof of continued good health. More details about policy lapse and revival are discussed in Part 2 of this chapter.

Example

Scenario 1: Arjun took out a whole of life policy from an insurance company at the age of 30. At the time of completing the proposal form Arjun declared all the material facts. Five years later Arjun is diagnosed with diabetes. Even if Arjun does not disclose this fact to the insurance company it will not affect his policy cover in any way as it happened five years after the policy cover had started. If Arjun's policy lapses and he revives the policy then, at the time of reviving it, the insurance company may ask him to disclose all material facts again.

Scenario 2: At the age of 35 Arjun wants to take out another policy (term insurance) but he is now a diabetic. This time while making the proposal, in accordance with the principle of utmost good faith, Arjun will have to disclose that he is suffering from diabetes.

Based on the disclosures made by Arjun, the insurance company will assess his proposal and may decide to accept or reject the risk. If the company decides to accept the risk it will advise Arjun of the premium it requires.

If Arjun does not disclose that he is suffering from diabetes and the insurance company finds out about this fact 6 months later, it may declare the policy to be null and void and keep all the premiums paid by Arjun to date.

E Indemnity

Indemnity can be defined as:

financial compensation sufficient to place the insured in the same financial position after a loss as they enjoyed immediately before the loss occurred.

In short, this means that in the event of a loss the insurance company indemnifies (compensates) the insured for the loss they incur, under the terms and conditions of the policy.

Example

Suresh has taken out an individual health insurance policy with a sum insured of Rs. 2,00,000. Suresh falls ill and has to be hospitalised, resulting in a hospital bill of Rs. 40,000. So in this case the insurance company will compensate (indemnify) Suresh with Rs. 40,000.

Insurance cannot be used to make a profit

The principle of indemnity makes sure that the insured is compensated only to the extent to which they have suffered a loss. Thus the insured cannot profit from insurance.

Example

Rajesh has taken out an individual health insurance policy with a sum insured of Rs. 1,00,000. Rajesh also has health cover of Rs.1,00,000 from his employer. Rajesh falls ill and has to be hospitalised, resulting in a hospital bill of Rs. 25,000. So in this case Rajesh cannot make a claim of Rs. 25,000 from both insurers. Rajesh will get a total claim of only Rs. 25,000. So the principle of indemnity ensures that insurance cannot be used to make a profit.

To summarise: indemnity makes sure that the insured is neither better nor worse off after the claim is settled by the insurance company. It also makes sure that neither the insured benefits at the cost of the insurer, nor that the insurer benefits at the cost of the insured.

E1 Indemnity and life insurance

General insurance policies and health insurance policies are contracts of indemnity whereby the insured is compensated for the loss incurred in line with the principles explained above.

But the same **does not apply** to life insurance.

Example

If Ajit has taken out an endowment policy of Rs.1,00,000 for 10 years with an annual premium payment of Rs. 10,000 and he dies in the fourth year of the policy, the beneficiary will get the full amount of Rs. 1,00,000 (plus the bonuses accumulated up to that point), even though Ajit has paid premiums for only four years.

Therefore life insurance contracts are also known as **value contracts** and the principle of indemnity does not apply to them. In the case of life insurance, even if a person takes out multiple policies, the insured's death will result in all the insurance companies paying the full sums insured.

So remember that where life insurance is concerned, the concept of sharing claims, as per the principle of indemnity, does not apply; we can see this in the following example:

Example

Manish has taken out a whole of life policy from insurance company ABC for Rs. 15,00,000 and an endowment policy for Rs. 10,00,000 from insurance company XYZ. In the event of his death, within the policy term, both insurance companies will pay Manish's nominee. So Manish's nominee will get a total insurance amount of Rs. 25,00,000 (Rs. 15,00,000 + Rs. 10,00,000) from the two insurance companies.

Key points

The main ideas covered by this chapter can be summarised as follows:

Essential features of a valid contract of insurance
• A contract comes into existence when one party makes an offer which the other party accepts unconditionally.
• In an insurance contract, consideration is the premium paid by the proposer to the insurance company.
• Minors, people deemed to be of unsound mind and persons disqualified by law cannot enter into insurance contracts.
Insurable interest
• Insurable interest is the legal right of a person to insure a subject matter which can be their own life, the lives of family members or their assets.
• When an individual has insurable interest they benefit from the well-being of, and are adversely affected by damage to, the other person or asset.
• Other instances where insurable interest is deemed to exist include creditor-debtor, employer-employee and vice versa, partners in each other's lives, and companies in the lives of key persons.
Utmost good faith
• In an insurance contract both parties to the contract must act in good faith.
• We can define utmost good faith as 'a positive duty voluntarily to disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not'.
• There is a duty to disclose material facts implicit in all insurance negotiations; this is particularly important at the proposal stage, before the contract comes into existence.
• The insurer also has a duty of disclosure to the insured. In order to fulfil this duty, the insurer must also behave with utmost good faith.
Material facts
• Material facts can be defined as those 'which would influence the judgment of a prudent insurer in fixing the premium or determining whether it will take the risk'.
• There are some facts, for example facts of law and of knowledge, that need not be disclosed.
• If the insured is in material breach of the duty of disclosure, the insurer may declare the contract null and void.
Indemnity
• Indemnity means placing the insured in the same financial position after the loss, as they were before the occurrence of the loss.
• Indemnity makes sure that insurance cannot be used by the insured to make a profit through inflated claims.
• Indemnity does not apply to life insurance because life insurance contracts are value contracts.

Question answers

3.1 The essential features of a valid contract are:

- Offer and acceptance.
- Consideration.
- Capacity to contract.
- *Consensus ad idem*.
- Legality of object or purpose.
- Capability of performance.

3.2 Circumstances in which insurable interest is deemed to exist are those where an individual has:

- unlimited interest in their own life;
- interest in their spouse's life and vice versa;
- interest in their children's life and vice versa; and
- interest in their assets.

Self-test questions

a. 1.

Define utmost good faith and explain the meaning of it.

.2.

What is indemnity?

You will find the answers on the next page

1.

Utmost good faith can be defined as:

'a positive duty to voluntarily disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not'.

This means that the parties to a contract must volunteer material information before the contract is concluded. The principle applies equally to both the proposer and the insurer throughout the contract negotiations, but the law sees the proposer as the main supplier of material facts to the contract.

2.

Indemnity can be defined as:

'financial compensation sufficient to place the insured in the same financial position after a loss as they enjoyed immediately before the loss occurred'.

This means that in the event of a loss the insurance company indemnifies (compensates) the insured for the loss they incur, under the terms and conditions of the policy.

3

Part 2: Insurance practices

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:

t_
JOGPSNBUJPO_PO_UIF_MJGF_JOTVSFE_JODMVEJOH_EFUBJMT_SFHBSEJOH_UIFJS_OBNF_BHF_BEESFTT_NBSJUBM_TUBUVT_XFJHIU_IFJHIU_ NFEJDBM_IJTUPSZ_FUD__

t_ EFUBJMT_PG_UIF_UZQF_PG_JOTVSBODF_QMBO_CFJOH_SFRVFTU FE_

t_ EFUBJMT_PG_UIF_SJEFST_ JG_BOZ _CFJOH_SFRVFTUFE_
XF_XJMM_MPPL_XIBU_SJEFST_BSF_XIFO_XF_DPNF_UP_MPPL _BU_UIF_JOEJWJEVBM_ QSPEVDUT_BWBJMBCMF_JO_UIF_NBSLFU __BOE

• 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.

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:

t_ B_DFSUJmDBUF_GSPN_TDIPPM_PS_DPMMFHF_SFDPSET_

t_ B_QBTTQPSU_

t_ UIF_TFSWJDF_SFHJTUFS_PG_UIF_FNQMPZFS_ t_ B_DFSUJmFE_FYUSBDU_GSPN_B_GBNJMZ_#JCMF_JG_JU_DPOUBJOT_UIF_EBUF_PG_CJSUI_

• the identity card of defence personnel, issued by the defence department;

t_ B_NBSSJBHF_DFSUJmDBUF_JTTVFE_CZ_B_3PNBO_$BUIPMJD_$IVSDI__

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

t_ B_IPSPTDPQF_QSFQBSFE_BU_UIF_UJNF_PG_CJSUI_

t_ BO_BGmEBWJU_CZ_XBZ_PG_TFMG_EFDMBSBUJPO_FMEFS_T_EFDMBSBUJPO__BOE

• 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:

t_ OBNF_BOE_BEESFTT_PG_UIF_MJGF_JOTVSFE_

- policy number;

t_ QSFNJVN_BNPVOU_QBJE_

- method and frequency of premium payment;

t_ OFYU_EBUF_UIBU_QSFNJVN_QBZNFOU_JT_EVF_

- date of commencement of the risk (i.e. when the cover begins);

t_ EBUF_UIF_QPMJDZ_NBUVSFT__

- date the last premium will be paid; and

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:

t_ UIF_EBUF_PG_DPNNFODFNFOU_PG_QPMJDZ_

t_ UIF_TVN_JOTVSFE_ XIFO_BOE_IPX_NVDI_UIF_QPMJDZ_XJMM_QBZ _

t_ UIF_OPNJOFF_ JG_TUBUFE_JO_UIF_QSPQPTBM_GPSN _

t_ EFUBJMT_PG_SJEFST_

• exclusions; and

t_ MJFOT_

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.

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:

Stop making payments

Turn the policy into a

Surrender the policy

and allow the policy

paid up policy

to **lapse**

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 nonforfeiture 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:

Total Number Sum Bonus Paid up of premiums ÷ number of

premiums × insured + (if any) = value paid payable

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.

t_
*G_B_QPMJDZ_XJUI_UFOVSF_PG____ZFBST_JT_TVSSFOEFSFE_BG
UFS_B_QFSJPE_PG_mWF_ZFBST_UIFO_UIF_BNPVOU_PG_QSFNJV
N_QBJE_XJMM_CF_
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.

t_
$POTJEFS_UXP_QPMJDJFT_"_BOE_#__5IF_UFSN_PG_QPMJDZ_"_JT
____ZFBST_BOE_UIBU_PG_QPMJDZ_#_JT____ZFBST__#PUI_UIF_QP
MJDJFT_BSF_
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:

A fee for reinstatement or revival (some insurers) Payment of outstanding premiums with interest

Proof of continued good health

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.

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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.

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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.

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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:

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t_
5IF_JOTVSBODF_QPMJDZ_OFFET_UP_CF_BTTJHOFE_BCTPMVUFMZ_JO_GBWPVS_PG_UIF_JOTVSBODF_DPNQBOZ_BU_UIF_UJNF_PG_SBJTJOH_UIF_
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.

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*G_UIF_QPMJDZIPMEFS_DPOUJOVFT_UP_QBZ_UIF_QSFNJVN_SFH

VMBSMZ_UIFO_UIF_TVSSFOEFS_WBMVF_HPFT_PO_JODSFBTJOH_
BOE_XPVME_CF_
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.

Key points

The main ideas covered by this chapter can be summarised as follows:

How insurance policies are bought and written

- Insurance companies generate interest in their products through prospectuses and advertisements.
- A policy should only be purchased by an individual after they have carefully considered how well it meets their needs.
- Life insurance can be written on a single life or a joint life basis and may be on the proposer's own life or on the life of another.

Key documents

- The proposal form is the main source of information through which an underwriter assesses the risk of a proposal.
- Some of the documents that can be taken as valid age proof are a high school mark sheet, passport, birth certificate, driving licence, voter ID card etc.
- The insurance company informs the proposer that their proposal has been accepted and the premium has been received by the company by issuing the first premium receipt (FPR).
- The insurance company issues renewal premium receipts (RPR) when it receives subsequent premiums from the policyholder.
- The policy document is an important document. It is evidence of the contract between the insured and the insurance company.
- The insurance company allows modification/alteration of the original policy documents through endorsements.

Key insurance terms

- Due dates are the dates on which the policyholder needs to pay the premium to the insurance company.
- In the event of default in payment of premium after the days of grace, the policy is said to lapse.
- Paid up value = [(number of premiums paid ÷ number premiums payable) x sum insured] + bonus.
- 'Surrender value' or 'cash value' is the amount that insurance companies are liable to pay once the policy is surrendered.
- When a lapsed policy is reinstated it is known as policy revival.
- Nomination is where the life insured proposes the name of a person(s) to whom the sum insured should be paid by the insurance company after their death.
- Assignment refers to the transfer of the title, rights and interests of the insurance policy, by the assignor, to the assignee.
- If the borrower defaults in loan repayment, the insurance company has the option to cancel the policy. This is known as foreclosure.

Relevance of premium payment and valid cover

- The payment of the premium is the consideration of the insurance contract, and so without its payment the contract cannot exist and there will be no cover.

Question answers

3.3 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;
- an identity card of defence personnel, issued by defence department; and
- a marriage certificate issued by a Roman Catholic Church.

Apart from the above mentioned standard documents, some of the non-standard age proof documents that can be accepted as a valid age proof are:

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

3.4 The FPR contains the following information:

- name and address of the life insured;
- policy number;
- premium amount paid;
- method and frequency of premium payment;
- next due date for premium payment;
- date of commencement of the risk;
- date of maturity;
- date the last premium payment will be made; and
- the sum insured.

Self-test questions

1. 3.

What happens if the nominee is a minor and no appointee has been made?

.4.

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

.5.

What happens if a policy lapses?

You will find the answers on the next page

3.

If the nominee is a minor, an appointee needs to be appointed by the life insured. If no appointee is appointed, then, if the life insured dies, the death claim is paid to their legal heir(s) and not to the natural or appointed guardian of the minor.

4.

The insurance contract starts with the issue of the FPR. However, IRDA regulations require that the proposer be given an option to withdraw from the contract within a period 15 days of the issue of the policy. This period is known as ‘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 for the cost of risk for the short period, medical examination expenses and stamp duty.

5.

Once the policy is ‘lapsed’, the policyholder forfeits all the premiums and no claims arise on the policy. However, insurers do not terminate the contract. They allow the policyholder to revive the policy by offering them various easy options, such as on payment of the premium arrears and on the provision of a signed declaration of continued good health.