Economic Rationale of Trading in Life Insurance Products

By Lalitagauri Kulkarni

Abstract:
Insurance sector in India is undergoing many changes. At present, the secondary market in life insurance exists in most of the developed countries like United Kingdom, United States of America, Canada, European countries, Australia, Japan, and Singapore etc. the ownership rights of the life insurance policy can be legally transferred in the name of a third party in exchange for money value. This means the law approves the selling of insurance rights to a third party. In this situation the paper aims at examining the economic viability of secondary market trading in life insurance products from the point of policyowner, insurer and the third party investor.

Keywords:
Trading in life insurance; Tradable endowment policies.

Introduction:
Trading in Life Insurance product implies the secondary market trading in life insurance products. The secondary market can be defined as the market where the resale and repurchase of the same instrument takes place with a wider variety of players.

Primary market in life insurance includes the transactions between the cedant and the insurer. The cedant pays the premiums and gets the rights to insurance contract benefits in return. If the insured no longer wants to maintain the policy, he can surrender it to the insurer in exchange of a specified surrender value. The contract of life insurance is a long-term contract. Hence, the provision of surrender of the policy exists. This is the arrangement in the primary market itself as the insurance contract is surrendered to the primary insurer it is terminated. This cannot be considered as secondary market trading as no third parties other than primary insurer and the insured are involved and the policy is surrendered and not traded.

This type of market already exists in India in life insurance sector.

Secondary market in life insurance involves third party firms and investors.

The insured transfers the policy ownership in the name of the third party firm in exchange of a prespecified value. The third party firm then makes slots of these policies and transfers them to investors who provide capital to the firm.

This type of market already exists in many countries like UK, USA, Canada, Australia, European countries, etc.

The secondary market trading of the life insurance policies involves many theoretical and empirical issues. But the most important issue is whether there is economic rationale behind the market. Economic rationale implies the need for the market in form of market demand and the profitability for the market players to survive in the market. Market for any product requires economic rationale for existence, survival and growth.

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This paper aims at exploring the economic rationale behind secondary market trading in life insurance products in India.

The data used for analysis of life insurance market in India is mainly the secondary data from Life Insurance Corporation that represents the large sample of the life insurance sector. Especially because the number of policies acquiring surrender value is small in case of other companies as they have entered the field just five years back.

Generic Nature of Life Insurance Contract:
At present life insurance market in India is thriving with high growth rate of business, newly introduced competition, product innovation and revolutionary marketing techniques.

One of the latest examples of newer products is the unit-linked policy, which is a rage in the market. ULIP policies are unique policies because these plans offer hundred percent liquidity to the investor. The unit linked plans are offering higher liquidity to the investors but with higher risk element.

The generic nature of life insurance contract is illiquid. If life insurance is viewed as one of the financial assets in individual's portfolio, it is a long-term financial instrument with good returns low risk and of course the risk cover. Liquidity in economics means the capacity of an asset to transform itself into cash.

The general definition of life insurance business is the business of affecting contracts whereby the insurer agrees for a consideration (that is payment of a sum of money or a periodical payment, called the premium) to pay to insured or his estate, a stated sum on the happening of an event dependent on human life. Life insurance is illiquid instrument because the sum assured or the insured or the heirs receive the claims after insured's death or at a specified period ranging usually fro ten years to twenty-five years. Liquid assets can be transformed into cash without much wastage of time and energy and without financial loss.[1]

Illiquidity in the primary market:
Given the long-term nature of insurance, it is accepted by the insurer that the circumstances may change over the years and the policyholder may want to free himself of the contract. In this case the policy may be surrendered to the insurer, for a specific value. In India, the life insurance policies can be surrendered if minimum of two to three years premiums are paid .For example, in case of Life Insurance Corporation of India, paid up clause is applicable only for the policies for which minimum three years premium is received. If the three years premium is not paid and the policy is discontinued, then the value of the policy is zero. Thus, the provision to get out of the contract exists, but it is with a lock-in period and with a loss of value. For example, in case of an endowment plan the policyholder has paid Rs 1000/- per month for 30 months or 2 and ½ year's i.e.Rs.30000 .If the policyholder wants to discontinue the contract, he gets zero value.

While after three years premium payments the policy assumes paid-up value. That is the value which is payable at the end of the term .For example, for a policy with Rs.1 lakh as sum assured, for 20 years term, discontinued after 5years ,paid up value[2]=100000*5/20=250000/-This value with accrued bonus will be payable after 20 years or at death. If this value is to be paid today (at the end of five years) then surrender value is payable calculated on the basis of surrender value

[1] Insurance Institute of India, Legal Aspects of life insurance, p36, (Aug.2000)
[2] Paid up value = (sum assured * no. of yrs. Paid) /total no. of yrs.

factor. In that case the policyholder gets only 30% to 40 % of the sum of paid value and accrued bonus. In most of the cases the policyholder loses the return as well as the principle.

In case of LIC, for 2002-03,the number of policies forfeited i.e. lapsed without acquiring paid up value is 8599146.Out of these, 1334718 policies were reinstated.

The sum assured of policies those lapsed after acquiring paid up value is Rs.5332 crores in 2002-03. Even if the policies of Life Insurance Corporation of India are taken into account, in 2001-02 surrender value paid is 2291.42 crores. Number of policies surrendered, in this year is 9, 37,624. The number of surrenders in the year 2002-03 is 10; 97,333.The total surrender value paid in the year 2002-03 is 2566.26 crores in the year 2002-03. This is to show the extent of the need for the market and the prospective scope for the market.[3]

In India, even today, life insurance is commonly popular as a tax saving form of investment .The emphasis of the sellers as well as the potential investors is on the financial part of insurance rather than the insurance benefit part. Even though this is unfortunate, it is a fact confirmed by the high pro portion of sales of endowment, money back plans which involve saving features.

In last twenty years, the surrender value factor is downscaled for two times. Rewards in form of loyalty benefits as final additional bonus, loyalty addition on maturity are offered to dissuade the policyholders from discontinuation of the policy.

Theoretically, life insurance is a risk instrument. Hence, illiquid nature is logical and even desirable. But from policyholder's point of view, in-built rigidity in the contract may become burdensome.

The policyholder wants to discontinue the life insurance policy for various reasons. Some of the commonly observed reasons for surrender of life insurance policies are as follows: The insured decides to sell his policy because of the following reasons:

- The premium on the policy is no longer affordable.
- The beneficiary for whom the policy was originally purchased no longer needs the policy.
- The policyholder owns multiple policies and wants to eliminate one.
- Need of liquid cash for urgent expenditure
- Purchase of some other type of insurance product, which better suits the changed needs and interest rates.
- Purchase of some other type of financial instrument.

According to a research project by S. Balachandran and C.d'Mello[4] of National Insurance academy, the first and fourth reason of the above are more relevant in Indian context. The study, throws light on following points,

1. There is incidence of policy surrender in all income groups and all types of income earners salaried as well as businessmen. But in case of flexible income group the incidence is greater than that in case of the fixed income earners.
2. Longer the term to maturity higher the incidence of surrender
3. The surrenders are mainly for economic distress.

[3] Annual reports, Life Insurance Corporation of India, 2002-03.
4 . S.Balachandran and C.D, Mello, A study on Surrenders of Life Insurance Policies, (April 1986), NIA

4. The study observes that basic motivation of the policyholder is to continue the policy as long as possible and not to terminate it until it is very burdensome. In this case it is extremely necessary that policyholder's loss is minimum of the value and he gets urgent money.
5. The study states that the agents do not influence the decision to surrender in fact they are not accessible at the time of surrender. This emphasizes the need for easy availability of information about the policy options to the policyholders.

It is very clear from above discussion that the policyholder wants to exercise his right to transfer the policy in exchange for money value when he is in financial need. At this time the liquidity is preferred by the policyholder than any other benefit. Hence, a system that will cater to this need by providing competitive value for policy, quick delivery of money and transparent easy information will benefit the policyholder. These are the virtues of competitive market.

At present, in India, no organizes market is available for life insurance products. The surrender is to the insurer implies monopoly of the insurer in purchasing the policies. In economics, the market with a single buyer and large number of sellers is a monopsonic market where the seller has to accept the value decided by the purchaser.

Secondary Market in Life Insurance Products:
Secondary market in life insurance will give choice to the policyholder of redemption. The policyholders will have choice as to where to transfer their policies .In this way they can get competitive values for their policies. The competition would also improve the speed of realization of transaction and the market transparency through marketing by various competing firms, increased awareness.

To illustrate how the entry of more firms and competition among these firms can pay higher returns to the policyholder, two empirical examples of product of LIC are elaborated. These are the actual examples of the policies that were traded by a secondary market firm, Insure Policy Plus Services. This firm worked in India from 2000-2002 at organized level.

The examples show how the returns accrue to the investor while the policyholder also receives the due amount .In some cases, even if policyholder is given the full amount which he has paid before discontinuing the policy, the investor gets a return at about 9%.So,this is a win-win situation for both.

The following example shows how the secondary market competition contributes to the policyholders' welfare in case of a well-organized secondary market. This is an example of LICs popular JeevanShree plan 112/10.

- Case 1 shows the surrender value paid to the policyholder as per today's actual primary market conditions.
- Case 2 shows the payment to the policyholder = the sum paid by the policyholder till date.
- Case 3 shows that the IRR is still competitive in comparison with other investments even if the loyalty addition is not calculated and paying the policyholder the amount he has paid for the policy.

	Plan& term-112/10	Case 1	Case2	Case 3
1.	Sum assured Rs.	500000	500000	500000
2.	Premium payment Rs.	180326	180326	180326
3.	Surrender value Rs.	242533	**360652**	**360652**
4.	Guaranteed addition (Rs.75/1000s.a.)	375000	375000	375000
5.	loyalty addition Rs. (Rs.75*500*10)	62500	62500	Not Considered
6.	**Total return** Rs. (1+4+5)	937500	937500	875000
7.	Internal Rate of Return[5]	14.72%	9.87%	8.58%

	Plan 112/25	Case 1	Case2	Case 3
1.	Sum assured Rs.	500000	500000	500000
2.	Premium payment Rs. (Rs.14776*7.5 yrs)	221640	221640	221640
3.	Surrender value Rs.	71921	132985	132985
4.	Guaranteed addition (Rs.75/1000s.a.)	937500	937500	937500
5.	loyalty addition Rs. (Rs.75% of 5 lakh)	375000	375000	
6.	**Total return** Rs. (1+4+5)	1812500	1812500	1437500
7.	Internal Rate of Return	10.6%	9.25%	7.90%

The above examples show that the competition among third party trading firms is likely to benefit the policyholder because he may get higher value for his policy even up to the sum paid which is not offered in monopsony market for obvious reasons.

As proved by Hal Singer and Neil Doherty in their famous Wharton working paper[6]r, the secondary market for any commodity facilitates the primary market as the quality of the product increases due to increased liquidity or flexibility. To quote Singer and Doherty, 'Enhanced liquidity brought about by the secondary market makes life insurance a superior risk management product that enables the policyholder to more effectively protect himself from the financial effects of death or health impairment.'

In other words the entry into the secondary market eliminates the downside risk of receiving less than the market value for the policy.

Profitability for the Investor:

5 Changing bonus trend is reduction in bonus at the rate of 10%, will affect secondary market yield by </=1%

6 Neil Doherty and Hal Singer, The Benefits of a Secondary Market For Life Insurance Policies, Wharton Financial Institutions Working Paper, (2002)

The profit potential or the rate of return is the key factor from point of view of the investor in any market. In secondary market for life insurance the third party firm or the provider and the investors get high rate of return, which is the most attractive feature of this market.

The important point to note is that the source of profit of the third party firms in secondary market is the change in the nature of instrument. The investor does not count on policyholder's loss but his own capacity to pay the lump sum amount and future premiums. In the process the policyholder gains in form of liquidity and investor gains in form of long-term investment by parting with liquidity. The shifting ownership of the instrument delivers liquidity as well as return in bifurcated form.

The trading in life insurance products includes not only viaticals and life settlement but trading in endowment policies also. The corollary to this fact is the profit may not be related to the longevity of the policyholder but to the financial features of the instrument. This may increase the acceptability of this concept in India. The tradable life insurance product may prove to be a dream product for investors with its promise of low risk and high profitability.

The following empirical examples help to prove the above issue. The following are the examples each of money back and endowment plans.

Example 1:
Plan & Term: 88/20 Sum Assured: Rs.50000/-
Date of commencement: 28/03/1990 Date of purchase: 2002
Premium: Rs.2585 p.a. First unpaid premium: 28/03/2003
Surrender value: Rs.41181/- Future premiums: 2585*7yrs.=Rs.18095/-
In this example, the firm has to pay, surrender value to the policyholder + future premiums for remaining years.
Rs.59276= Rs 41181 + Rs.18095.
The firm receives; Sum assured + vested bonus + final additional bonus.
Rs.116700 = Rs.50000+Rs.45200+Rs.17500+ Rs.4000
The Internal Rate of Return is 10.19% per annum

Example 2
Plan & Term 75/20 Sum Assured Rs.1Lakh
Date of commencement-22/10/1991 Date of purchase-2005
Premium –Rs.6443/- First unpaid premium-22/10/2001
Surrender value- Rs.55513/-
Revival amount. -Rs.14413/- Future premium-6443*5=Rs.32215/-
The firm has to pay
Surrender value =Rs.55513 revival amount=rs.14413
Premium till 2005=Rs.6443 future premiums=Rs.32215
Total payments=Rs.108584
Total receipts for this policy are
Money back installment=Rs.20000 Remaining sum assuredRs.40000
Vested bonus=Rs.72300 Future bonus=Rs.40000
Final additional bonus=Rs.4000
Total Receipts=Rs.156300
Internal Rate of Return=11.35%

These examples bring out certain important points about trading in life insurance policies.

1. These policies are fixed term life policies and the return nowhere includes the death claim. The myth that trading in life insurance policies is only based upon the speculation about the policy owner's longevity is proved to be wrong here.
2. Even if operating costs are taken into consideration the rate of return can prove to be very high compared to other options in this time of falling interest rates.
3. For the investors this rate of return is a dream rate considering that the risk associated with this instrument is very low due to the stringent regulation of primary market insurers by regulatory authorities like IRDA.
4. The Unit Linked Products (ULIP) plans have the NAV declared on daily basis. These products are also suitable for secondary market trading.

Issues related to the Insurer:
It is but natural and well proven by theory as well as practice that the existing or incumbent firms in the market feel uncomfortable with the new entrants and competition.
Economic theory proves that the secondary market for any asset facilitates the primary market for that asset. With the development of secondary market the demand for life insurance may increase as the instrument gets more flexibility without changing its original structure only due to an external factor that is secondary market trading. In economics this can be called as positive externality of the secondary market.

There is the issue of lapse –supported pricing and the effect of secondary market on insurer. Lapse-supported pricing means adjustment of premiums on the assumption that some of the policies will be eventually lapsed and will not continue till maturity. It is argued that continuation of more and more policies and lowering down the lapse rate would be problematic for the insurer because the premium calculations and profitability takes into account the lapsation rate.

The eligibility of this issue is questionable as far as Indian insurance sector and LIC is concerned. Life Insurance Corporation of India has actually reduced the surrender value factor over last twenty years. The loyalty additions are paid to the policies continued till maturity. This does not indicate that the insurer would have adopted the lapse-supported pricing.

Theoretically the issue of lapse-supported pricing is very weak because the sale and profitability of any product cannot and should not depend upon the chances of discontinuation of the product

Conclusions:
1. Economic rationale for the secondary market trading in life insurance products is established by existence of the need or demand and also by the profitability to the investor.
2. Competition may bring in benefits to the policyholders in form of higher value and greater liquidity for their policies. This is certainly on the assumption that the secondary market is regulated to safeguard the interests of the policyholders as well as the investors.
3. The trading in life insurance products includes not only viaticals and life settlement but trading in endowment policies also. The corollary to this fact is the profit may not be related to the longevity of the policyholder but to the financial features of the instrument. This may increase the acceptability of this concept in India.
4. The investors get a dream financial instrument that offers a good return at comparatively low risk.
5. Insurer firm's interest is not undermined by the third party firms entering the secondary market.

6. Finally, economic rationale in form of demand and profitability to the players is pre-condition for the existence, survival and growth of any market. On the other hand if market demand and profitability exists, the market invariably comes into existence in some way or the other. If the regulators ignore these facts, the unorganized, indigenous market comes into existence that may result into mal practices and exploitation of the weak. Secondary market for life insurance products in India does not exist in organized sector. But the demand for the market exists which is catered to by either the insurer or the indigenous, unorganized sector traders.

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About the Author

Lalitagauri Kulkarni
Lecturer in Economics at the Department of Economics, University of Pune

Academic Experience:
Lecturer in Economics at graduate and post-graduate levels as well as for Management courses since more than ten years at various prestigious institutions in Pune like Ferguson College, S.P.College, Institute of Management Development and Research

Professional Experience:
Manager in charge of the Pune branch of a pioneering insurance trading firm in India, Insure Policy plus Services.

Educational Qualifications:
Postgraduate in Economics from Gokhale institute of Politics and Economics with a rank and A grade. Specialization in Macroeconomics, Economics of Finance and International Trade.

Current Area of Research:
Working on secondary market trading in life insurance products.

Contact:
Gulmohar,Harshad Society,Kothrud,Pune-411029
Tel: 020 2544 60 13,
e-mail: rkulkarni@unipune.ernet.in