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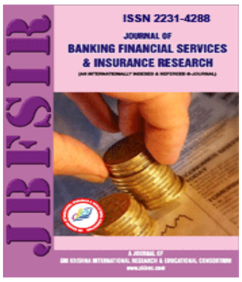

LAPSING OF POLICIES IN LIFE INSURANCE SECTOR – NEED FOR COMPETETIVE STRATEGIES

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ABSTRACT

Emergence of private sector has brought significant improvement in the growth of life insurance sector. The growth of private sector resulted in introduction of many new policies with variety features. The growth in the sector has also resulted in the increasing threat to the growth of life insurance industry. The lapsation which is considered to be one of the critical problems for the growth of life insurance industry is widening especially in the last 10 years. The present paper will focus on analyzing the reasons of lapsation and fund wise lapsing of policies in the life insurance companies. The study will also contribute to the various competitive strategies to be taken to reduce the lapsation and to increase the growth of life insurance sector.

KEYWORDS: *customer retention, IRDA (Insurance Regulatory Development Authority), NP Whole life, WP Non life.*

1.1) INTRODUCTION TO INSURANCE

Insurance is considered to be one of the promising service sectors which is not only providing the benefit to the human beings but also contributing to the growth of economy. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for a premium, and can be thought of a guaranteed small loss to prevent a large, possibly devastating loss. Insurance is the backbone of a country's risk management system. Risk is an inherent part in human's lives. The insurance providers offer a variety of products to businesses and individuals in order to provide protection form risk and to ensure financial security. The insurance is classified into Life and Non –life insurance sectors. The non-life insurance deals with other than the insurance services to the life of human beings. Life insurance or life assurance is a contract between the policy owner and the insurer, where the insurer agrees to pay a designated beneficiary a sum of money upon the occurrence of the insured individual's or individuals' death or other event, such as terminal illness or critical illness. In return, the policy owner agrees to pay a stipulated amount at regular intervals or in lump sums.

1.2). INTRODUCTION TO LAPSATION OF POLICIES IN INSURANCE SECTOR

Lapsation of a life insurance policy is a discontinuation of premium payment by the policy holder during the period of operation of the policy, due to any reason other than the death of the policy holder. The length of life of a lapsed policy can be defined as the period between the month when the last premium installment was paid and the month the policy was issued. Lapse is the discontinuance of the policy by non-payment of premiums due. In pure term product (policy), where there is neither surrender benefit nor maturity benefit the lapse will result in a loss to the company if asset share under the policy is negative at the time of lapse. Especially in India, presently, many private sector companies have less than 6/8 years of their existence and hence lapses would have significant impact on the financial health of the company. Early lapses, therefore, pose a major financial problem to the companies. After privatization significant progress has taken place in Indian insurance sector especially in life insurance business. But, still lot of potential for life insurance consumption is available in India as the India's Life Insurance penetration and density is low when compared to Asian average or world average. In spite of rapid progress the sector is suffering with high rate of lapsation of policies. As, many companies are opened for the customers , the policies lapsation is increasing and are creating hurdles for the development of the private life insurance companies as well as for life insurance corporation of India. The present research study is a modest attempt to analyze the causes for lapsation after privatization on the basis of the experience of the functionaries like branch manager, development officers and insurance agents working for the life insurance companies operating in India. The study will also provide statistical based analysis in order to analyze the lapsation in life insurance sector.

1.4). REVIEW OF LITERATURE

N.V. Subramanian, in his article "Lapsation of life insurance policy – a critical study" discussed the importance of retention of life insurance business, effects of lapsations, and reasons for lapsation of life insurance policies and solutions to reduce lapsation. Reasons for lapsation which were mentioned in the article are wrong selling, forced selling, over selling, bogus selling, effect of competition, introduction of new plans, bad service, awareness levels of customers, non-receipt of notices, no follow-up by agents, requirement of medical check-ups, change of address, inadequate explanation of the product riders, repayment of house finance, malpractice of agents an field force.

Jogindra Kumar in his article titled "Lapsation of a life insurance policy" has made thorough study on impacts of lapsation. He pointed out that from insurers' perspective, the life insurance products especially whole life products, typically entail large underwriting and upfront origination costs, heavily driven by sales costs and commissionsM. Srinivas in his article titled " Cause of lapsation of life insurance policies in LIC of India" has analyzed the impact of lapsation on Life Insurance Corporation of India", he studied that after privatization significant changes has occurred in the sector and also increasing lapsation has made LIC to think about the issue seriously. His article focused on the statistical figures of growth and the impact of privatization and lapsation on the growth rates of the LIC and its business. V. Rajagopalan in his article titled "Lapsation of life insurance polices – some causative factors" focused on the profitability growth, alternative investment options of the life insurance companies. David Chandrasekharan in his article titled "Policy lapsation in life insurance –

role of middle man" studied the need of the middle men in the reduction of lapsation. He studied that agency termination, like lapsation, is a curse of the life insurance industry and two are interrelated. He studied that sale of polices should be done ethically and professionally by the agent and the policy is serviced properly and assistance in given for payment of premium, chances are that the policy sold would remain in the books of the company in order to decrease the lapse rate of policies. Dr. G. Gopalakrishna in his article titled "conservation of life insurance business – role of the parties" has studied the lapse and revival – contractual implications. He pointed out the need for special revival schemes that can decrease the lapsing of policies in insurance sector.

1.5). OBJECTIVES OF THE RESEARCH STUDY

The major objective of this study is to study the lapsation of policies in life insurance sector in India and its impact on the business of life insurance companies. This paper also attempts to study the lapse rates in different life insurance products (policies) and the various consequences of lapsation on the companies. Further the study will also provide various competitive strategies to be done in order to reduce the lapsation in life insurance policies.

1.6). RESEARCH METHODOLOGY

The present research paper is an empirical one which is based on the doctoral thesis work. The statistical figures for the study have been collected from the annual reports of IRDA and the branches of life insurance companies. The primary data has been collected from the policy holders and the representatives of the life insurance companies. F-test was used to analyze the significance of factors. The data in most of the cases comprise of 5 years (decade) from the period 2002-03 to 2006-07. The latest statistics are also considered where ever appropriate. Percentages and averages were used where ever appropriate.

1.7). ANALYSIS AND DISCUSSION

A). Analysis on policy wise lapsation – comparison of traditional & unit linked policies

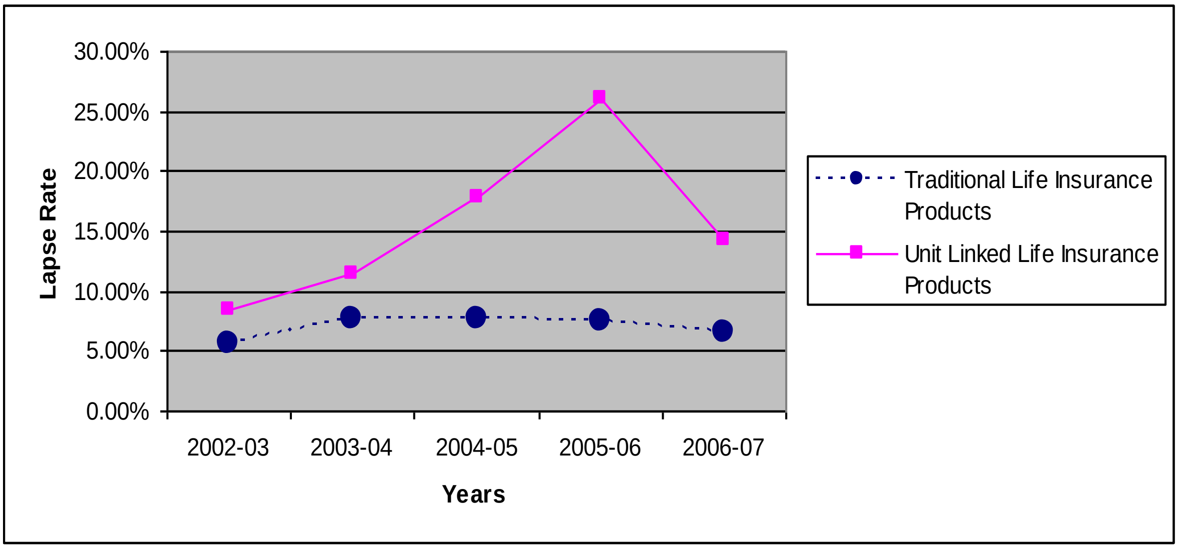
The following table shows the lapse rate of traditional and Unit Linked products of the life insurance companies.

TABLE NO.1

Type of Policy	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**
Traditional Life Insurance Products	5.58%	7.70%	7.69%	7.48%	6.59%
Unit Linked Life Insurance Products	8.43%	11.37%	17.80%	26.09%	14.34%

Source: IRDA Annual Reports

GRAPH NO.1



The above Table & Graph, it is to be concluded that the majority number of policies lapsed in unit linked products category. There is a sharp increase in lapse rate from 17.8% to 26% in 2005-06 but decreased to 14.34% in 2006-07. The lapse rate with respect to the number of polices under Unit Linked Products are observed to be considerably higher than those under conventional products as evident from the above figures.

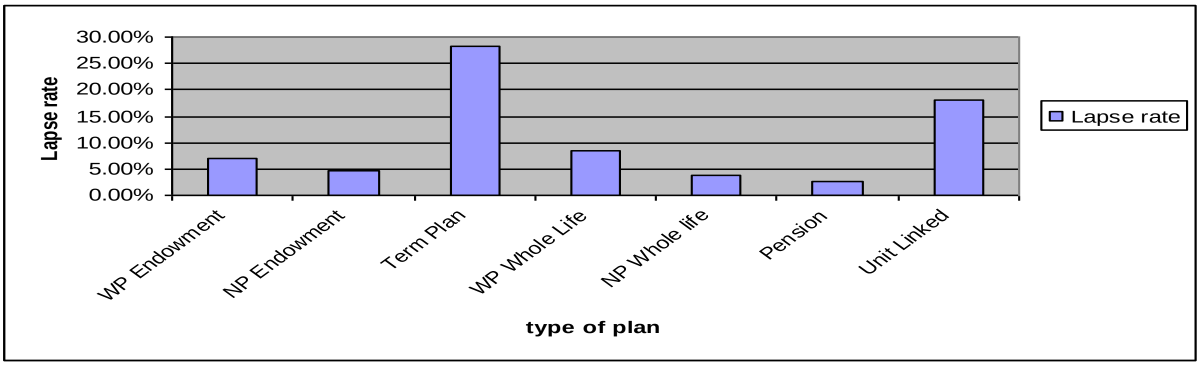
II). ANALYSIS ON LAPSE RATE IN DIFFERENT PRODUCTS OF LIFE INSURANCE COMPANIES

TABLE NO.2

Product Type	WP Endowment	NP Endowment	Term Plan	WP Whole Life	NP Whole life	Pension	Unit Linked
Lapse rate	7.08%	4.55%	28.27%	8.51%	3.80%	2.54%	18.09%

Source: IRDA Annual Reports

GRAPH NO.2



From the above statistics, it is to be concluded that the lapse rate in term plan is very high than the other type of life insurance products. The Unit-linked plan is the next category which has more lapse rate. In NP Endowment, the lapse rate was considerable less than remaining categories.

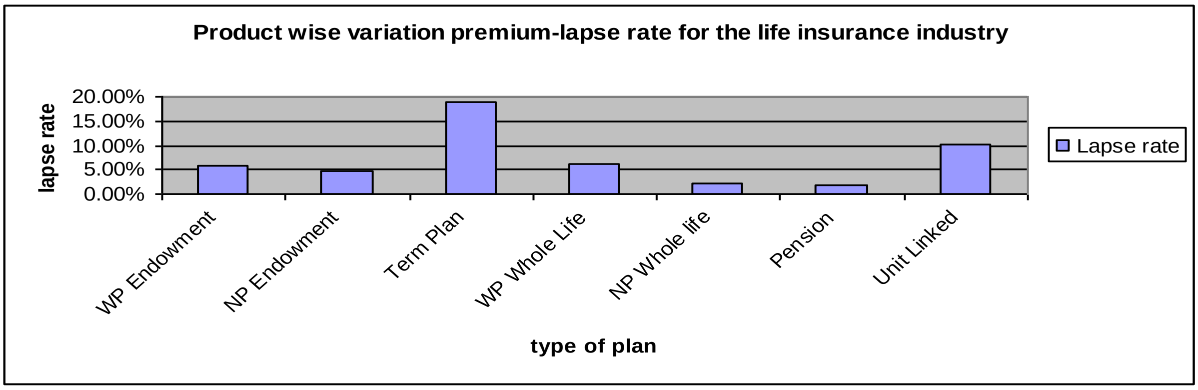
B). STATISTICAL STATEMENT ON THE LAPSE RATE OF DIFFERENT TYPE OF POLICES BASED ON PREMIUM

TABLE NO.3

Product Type	WP Endowment	NP Endowment	Term Plan	WP Whole Life	NP Whole life	Pension	Unit Linked
Lapse rate	5.99%	4.60%	18.95%	6.13%	2.28%	1.79%	10.01%

Source: IRDA Annual reports

GRAPH NO.3



From the above statistics, it is clear that based on premium wise lapse rates, the Term plan recorded highest with a lapse rate of 18.955 %. The Unit linked plan is of second category which has the lapse rate of 10.01%.

C). STATISTICS ON LAPSE RATES OF NON-LINKED PRODUCTS AND LINKED PRODUCTS OVER THE LAST THREE YEARS

TABLE NO.4

Duration elapsed in years	Non-linked plans			Linked plans		
	2004-05	2005-06	2006-07	2004-05	2005-06	2006-07
0-1	22.31%	18.95	6.1	24.19	41.06	13.43
1-2	12.12	12.96	2.5	9.43	17.62	18.1

2-3	4.51	5.94	2.18	8.73	6.1	8.78
3-4	3.5	4.74	5.55	2.23	2.5	3.94
4-5	3.26	3.97	4.42	6.07	2.18	2.08

Source: IRDA report on Lapsation, Occasional Paper:1/2008.

ANALYSIS

From the above statistics, the linked plans are showing maximum lapsation during first two years. The Non-linked plans are also showing the same trend in the initial two years period. And the lapse rate percentages are clearly showing that the linked plans are the effected ones of lapsation more than compared to non-linked plans.

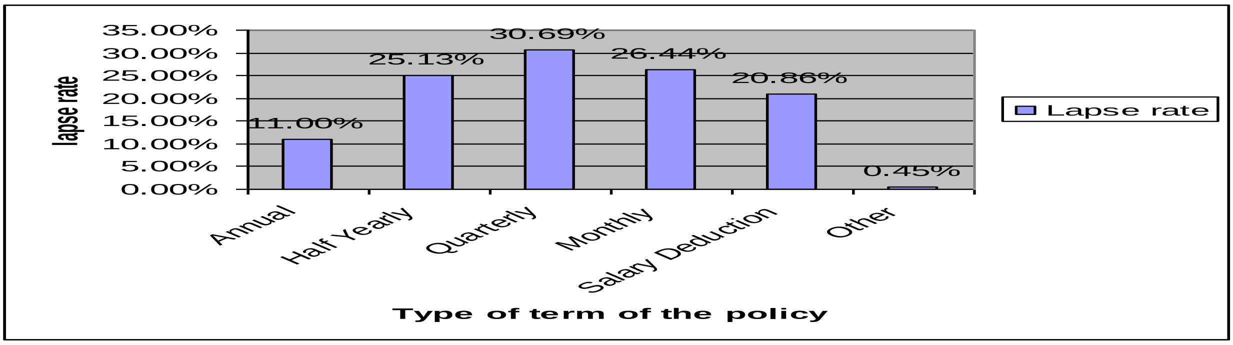
D). STATISTICAL ANALYSIS ON TYPE OF TERM WHICH THE POLICY PREMIUM PAID AND LAPSE RATES

TABLE NO.5

Type of Term which the policy premium paid	Annual	Half Yearly	Quarterly	Monthly	Salary Deduction	Other
Lapse rate	11.00%	25.13%	30.69%	26.44%	20.86%	0.45%

Source: IRDA Occasional Paper, 01/2008.

GRAPH NO.4



From the above statistics, it is to be concluded that the lapse rate is high when the term of policy premium paid is "Quarterly". The Monthly and Half yearly follows next with lapse rates of 26% and 25%. From this it is evident that the annual term is comparatively better when it comes to reducing the lapse rate of policies.

E). ANALYSIS ON PREMIUM TERM AND LAPSE RATES

TABLE NO.6

Premium term	0-10	11-15	16-20	21-25	>25
Lapse rate	8.03%	5.47%	7.81%	7.80%	7.95%

Source: IRDA Occasional Paper, 01/2008.

From the above table, it is to be concluded that, the lapse rate is high in the initial period of first 10 years. The lapse rate is 8.03% for the initial 10 years period of premium paying duration. And again, the lapse rate is increasing steadily from 16-20, 21-25 and more than 25 years periods.

F). COMBINATION OF FACTORS: DURATION AND AGENT TYPE

Data for this combination of factors has not been received for major portion of the industry business. With the available data, the following analysis was made.

TABLE NO.7

Type of Agency	**Duration**					
	0-1	**1-2**	**2-3**	**3-4**	**4-5**	**5-6**
Tied Agent	19.07%	19.09%	10.86%	7.87%	5.80%	3.72%
Corporate Agent	20.36%	27.44%	16.23%	7.04%	5.00%	4.08%
Broker	12.68%	31.14%	14.66%	19.01%	9.70%	7.31%
Bancassurance	11.20%	20.81%	9.76%	9.07%	8.48%	1.03%

Source: IRDA Occasional Paper, 01/2008.

From the statistics, it is clear that, for the duration 1-2 years, the lapse rate is high with 31.14%, when the policies were made with the help of broker. And again, the lapse rate is high with 27.44% when the polices are made through Corporate Agent.

G). F-TEST RESULTS

1. COMBINATION OF FACTORS: AGE GROUP AND DURATION

TABLE NO.8

Source of Variation	**SS**	**df**	**MS**	**F**	**P-value**	**F critical**
Between age groups	0.02883	10	0.002883	8.254539	1.02E-07	2.026
Between durations	0.092989	5	0.018598	53.2492	7.43E-19	2.400
Residual	0.017463	50	0.000349			
Total	0.139282	65				

CALICULATION OF F-CRITICAL VALUE

As test statistic value is greater than the critical value of F-distribution at 5% level of significance the factors Age group and Duration are found to be significant with duration being more significant.

2). COMBINATION OF FACTORS: DURATION OF THE POLICY AND AGENCY

TABLE NO.9

Source of Variation	**SS**	**df**	**MS**	**F**	**P-value**	**F critical**
Between Durations	0.02518	5	0.0503	7.6100	0.00038	2.7108
Between types of agency	0.1287	4	0.032	4.8618	0.0066	2.8660
Residual	0.1323	20	0.0066			
Total	**0.5128**	**29**				

CALICULATION OF F-CRITICAL VALUE

As test statistic value is greater than the critical value of F-distribution at 5% level of significance the factors Duration and Agency are found to be significant with duration being more significant.

3). COMBINATION OF FACTORS: DURATION AND POLICY TYPE

TABLE NO.10

Source of Variation	**SS**	**df**	**MS**	**F**	**P-value**	**F critical**
Between Durations	0.1789	5	0.0357	8.4709	4.33E-05	2.5335
Between policy types	0.1579	6	0.0263	6.2321	0.0002	2.42
Residual	0.126742	30	0.0042			
Total	0.4636	41				

CALICULATION OF F-CRITICAL VALUE

As test statistic value is greater than the critical value of F-distribution at 5% level of significance, the factors Duration and Policy type are found to be significant with duration being more significant.

H). EFFECT OF LAPSATION ON PROFITS OF INSURANCE COMPANIES

1. **FOR AN ENDOWMENT TYPE OF PRODUCT (WITHOUT PROFITS)**

For a typical endowment policy of term 15 years with age at entry of 35 and sum assured of Rs.25000

TABLE NO.11

Duration since inception (years)	**Change in profit**	
	Per unit increase in lapse rate	**Per unit decrease in lapse rate**
0-1	-7.99	4.47
1-6	0.93	1.35
7-10	0.91	0.92
10-15	0.95	0.61

Source: IRDA Occasional Paper, 01/2008.

In this case, higher losses were observed with higher lapses in the fist policy year which might be due to heavy initial expenses for which loading has been spread over the term of the contract and high negative asset share. Profits increased even at later durations due to excess of asset share over the surrender value.

2. FOR A TERM ASSURANCE PRODUCT

For a typical endowment policy of term 20 years with age at entry of 35 years

TABLE NO.12

Duration since inception (years)	**Change in profit**	
	Per unit increase in lapse rate	**Per unit decrease in lapse rate**
0-3	-0.16	0.84
4-8	-0.39	2.01
9-12	-0.23	0.37
13-19	-0.65	0.85
19-20	-0.09	0.13

Source: IRDA Occasional Paper, 01/2008.

For a typical term insurance product, profits decreased with increase in lapses at all most all durations of the term. The rate of decrease was higher in initial years than in the later years. The decrease in profits with increase in lapses could be attributed to i). low premiums charged which do not cover the expenses unless received fully ii). Increase in lapses resulting from selective withdrawals which tend to increase the average mortality of the remaining policyholders exposed to risk and hence mortality cost increases.

3. FOR A UNIT LINKED PRODUCT

(for an age at entry 35 years, sum assured of 2 lacs and term of 15 years)

TABLE NO.13

Duration since inception (years)	**Change in profit**	
	Per unit increase in lapse rate	**Per unit decrease in lapse rate**
0-3	0.16	-0.28
4-10	-0.24	0.67
10-15	-0.71	0.57

Source: IRDA Occasional Paper, 01/2008.

Higher profit/lower loss was observed with higher lapses in the first three years. However, the level of increase in profits decreased as the duration elapsed which could be low initial allocation rates and high surrender penalties. In later years of the policy term, higher lapses resulted in decrease I profits and the level of decrease increased with duration. It is appropriate to mention that other than fake or bogus policies, the increasing magnitude on the lapsation of life insurance policies affect all the concerned viz., policy holders, insurers, intermediaries, economy, society and the government. The impact on every concerned part is mentioned below.

1.8). IMPACT OF LAPSATION OF LIFE INSURANCE POLICIES ON THE INSURERS

To the insurer, lapsation of policy is a curse and is such a serious disease which if not cured could even lead to bankruptcy of the insurance company as a whole. The functioning of insurance companies is based on the concept of risk pooling and risk sharing which means that the losses of the few are spread over the group and average loss is substituted for actual loss. Lapsation of polices is a leakage in their estimates to achieve accuracy. Since for the business of insurance the base is spreading risk over a large number of insured, if policies start lapsing the business is sure to deteriorate. In the context, the lapsation causes impact on the customer retention, product performance, pricing factors, public image, work force planning and ultimately detrimental to the business of the insurer. From the survey on life insurance companies and discussions with the people engaged in the life insurance companies operations and as well as the customers of life insurance policies, the following observations are made.

A). CUSTOMER RETENTION: Lapses may be source of customer unhappiness. Satisfied customer generally wants to continue to do business with the company. Customer retention is a key driver of profit for any business organization especially for an insurance company. Retention of customer is much cheaper and profitable then getting a new customer. From the survey, it was found that the customers are getting negative opinion with the increase in the lapsation especially in Unit Linked Insurance Plans (ULIPs).

B). PRODUCT PERFORMANCE: Product performance and solvency of any organization in the competitive market is entirely dependent on the persistency of the business. The life insurance industry uses, persistency (the measure of how long policy or a block of polices remains in force) to monitor its marketing and service quality. Higher the persistency rate (the number of policies in force at the end of a given year divided by the number of policies in force at the beginning of the year) higher the product performance. Moreover, persistency directly affects profitability because policies that have been in force for a long time are more profitable for insurers than policies that lapse quickly. With the continuation of paying premiums, policies stay on the books longer. The longer a policy remains on the books, the greater the likelihood that it will fill the need it was sold to cover.

C). MANAGEMENT EXPENSES: the insurance companies tend to make profit out of premium received after completion of 3 years of a policy. This is due to that that first year's expense of an insurance company is very high compared to the premium taken in first year. It is known that the insurer has to spend very heavily in the initial years to procure a policy. It is a special problem called "new business strain". It is near universal practice for a life insurance companies to pay a high rate of sales commission to their sales personnel in the first year of the contract. The commission and bonus paid on such polices becomes an undeserving benefit conferred on the agents and offices involved. It leads to a financial burden to industry. Other than this, first year's expenses include stamp duty, postage, fixed costs, administration costs (salaries to administrative employees like underwriters, managers, supporting staff engaged in processing of new business), establishment expenses, and advertising costs

D). LOSS OF PUBLIC IMAGE: The rising lapsation rates in the life insurance policies also create the loss of public image. The image of a life insurance company is certainly based on its performance. As rising lapsation adversely affects its growth, hence it results in loss of public image. Loss of public image also creates disinterest of the public towards choosing a life insurance polices from the life insurance companies.

E). WORK FORCE PLANNING: Lapsation of polices even hampers the ability of the companies to do proper work force planning, as the companies can't accurately force planning, as the companies cannot accurately evaluate the administrative staff needed to process the proposals and for their further processing of the policy servicing. The company needs to have a clear idea of the number of proposals that would be processes to estimate the people needed to complete them into policies. The incidence of lapsation would render such efforts put in by the employees useless. Such lapsation would render such efforts put in by the employees useless. Such lapsation would lead to the feeling that the company is overstaffed since the total cost by way of salaries would be high including the employees needed to process the lapsable polices) while the premiums would not be collected on these. Lapsation is thus is an anti-employee phenomenon.

F). DETRIMENTAL TO THE BUSINESS OF THE INSURER: Apart from the above mentioned direct losses, the un productive efforts involved there is also result in forgoing opportunities to generate genuine business, serving larger number of customers. This way the organization goal and objectives of the company stand defeated leading in the extreme cause, to closure of the insurance company. Closure of an insurance company is a great loss which can be interpreted in the following ways.

- To many policy holders that will not get back their premiums fully, leave a side the sum assured.
- Employees of the insurance company shall be retrenches to reduce costs or in case of closure, all the employees less their respective employment.
- If the company is a nationalized one, large-scale lapsation implies loose of the revenue of central government and ultimately the government shall recover its loss by taxing the citizens carefully.

Hence, lapsation of insurance policies is detrimental to the business of the insurer particularly when the policy is lapsed within one or 2 years of taking the policy. Therefore, it is very imperative that the insurer should control lapsation from the very beginning.

G). IMPACT OF LAPSATION OF THE LIFE INSURANCE POLICY ON INTERMEDIARIES

The negative effect of lapsation is not only for the main parties of the contract but also on the intermediaries. The efforts of the intermediaries' right from agents, branch marketing supervisors, branch managers, assistant branch managers who have toiled to bring in the policy holders to the books of their companies become futile. The unproductive efforts involved there in also result in forgoing opportunities to generate genuine business, serving large number of customers. Moreover, lapsation hits the income of several agents by way of loss of commission on the policies that are lapsed. Now, even the development officers pay a price at first year lapsation hits their incentive bonus calculations also.

H). IMPACT OF LAPSATION OF THE LIFE INSURANCE POLICES ON THE ECONOMY

There can be for reaching losses to the society as a whole. Today, almost every field where investment for building infrastructure is required, the money comes from insurance sector only. Banks, insurance companies and stock markets are the 3 avenues in a country through which people tend to invest, and this money is utilized for nation building and contributes to nation's economy. Due to lapsation of policies, there can be serious miscalculation of investments leading to a dry on the economic policy of a country. Because of lapses, the nation building and progress of the country may be a stake.

I). IMPACT OF LAPSATION OF LIFE INSURANCE POLICES ON THE SOCIETY

The costs of lapsation on society are also high because lapsation reduces the financial security of individuals. The presence of risk as a consequence of lapsation of the life insurance polices may lead to certain undesirable social and economic effects. A severe burden of risk on legislative on society is the worry. This leads to mental rest. Moreover, dependence on public assistance or welfare of financial assistance from relatives and friends would increase in the case of loss occurrence.

1.9). FINDINGS & SUGGESTIONS

The growth in the life insurance sector is especially resulted in the development of many policies. But, at the same time the sector started to face the problems of lapsation. The lapsation of policies in life insurance sector is creating obstacles for the growth of the entire sector. The lapsing is more in the new type of policies like ULIPs compared to the traditional products. The lapse rate is increasing when the policies term taken by the policy holders are quarterly and monthly duration. Hence, it to be understand that the need for the marketers to convey the information about policy dues to the customers must be increased. And from the survey it was also found that the lapse rate for the premium term 0-10 years is heavy than other periods. Hence, the companies must prepare strategies to reduce the lapsing rate in the initial period of first 10 years. Further, the lapsing rate is increasing when the sales of policies are done through brokers and corporate agents. Hence, the companies must understand the problem and must prepare competitive plans to encourage the agencies to lessen the lapsing rate. From the survey, it was also found that there is significant influence of a). age group and duration of the policy, b). Duration of life insurance policy and the type of policy chosen by the policy holders, c). Duration of policy and agency in which the customer chosen. The profitability in different types of products of life insurance companies revealed that higher lapses in the first policy year which might be due to heavy initial expenses for which loading has been spread over the term of the contract and higher negative asset share. Finally, it is to be concluded that the lapsation in the life insurance policy not only creating problems to the growth of life insurance companies but also effecting the growth of the economy also.

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