International Journal of Management Research and Social Science (IJMRSS) ISSN 2394-6407(Print)
Volume 1, Issue 1, October - December 2014 ISSN 2394-6415(Online)

Lapsation- An Impediment to the Growth of Unit Linked Insurance Policies

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Abstract— Early lapse of life insurance policies is one of the serious issues in the pace of Life Insurance market. In recent timesIRDA report witnesses twenty percentages of lapsed policies in the first year of the initiation of the ULIP. After the emergence of private sector in India, Life Insurance Industry had a significant growth that paves the way for competition as well as introduction of innovative policies with varieties of features. Early lapsation costs the Life insurer the major part of the first year's premium, high degree of financial losses for policyholders and general dissatisfaction over Unit Linked Policies. As half million people needs to be covered with insurance in India, lapsation and existing policy holders' dissatisfaction over products will make difficult for the insurance companies to pull the customers towards Life Insurance. This paper aims to suggest new strategies to reduce early lapsation and to enhance the growth of Life Insurance Sector.

Keywords— *ULIP, Lapsation, Private sector, Dissatisfaction*

1. Stakeholder's Varied Perspective on Lapses

1.1 Customers

Customers are the worst affected by lapses. In general, they have a significant financial loss in the form of a surrender charge. Also, there is an opportunity cost as the premium amount could have been deployed productively elsewhere, and the cost of purchasing insurance increases with age.

1.2 Intermediaries

In general intermediaries such as individual agents, corporate agents and brokers are focused on the first year compensation from an insurance sale.

The situation is aggravated because many agents have low productivities and invariably become inactive over time. For all practical purposes they lose interest in soliciting or renewing insurance. In banks and other corporate agents, the issue is different. High attrition levels, frequent transfers and lack of training of the sales staff are an important reason for poor persistency.

2. Reason behind Policies Lapsation

There are multiple factors at play that lead to policy lapsation. All or some of these could be impacting persistency of a life insurer at any given point of time. The spectrum of reasons leading to lapsation range from quality of sales, service, customer's financial literacy level, general outlook of economy, etc.

1. Lack of proper need analysis at time of sale
2. Financial crisis of policyholder or Adverse market performance
3. Customer service & complaints management experience
4. Lack of adequate financial underwriting
5. New product options
6. Ignorance of policyholder
7. Policy Returns (ROI)

The role of the distributor in life insurance business has always remained a very strong point in most emerging markets; and accordingly, it would not be out of place to look at various aspects of business wherein the distributor can play an important part in arresting the discontinuance of policy contracts. One gets to hear very often that a policyholder has discontinued payment of premium in disenchantment as he or she was sold the wrong product different from what was explained at the time of entering into the contract.

For the distributor, the opportunity of bringing new prospects into his business portfolio should be looked at as an opportunity to serve also; and not merely to sell. Identifying the needs of the prospect, suggesting viable alternatives and finally clinching the most suitable product would be the perfect recipe for maintaining long-term relationships. Being driven by short term goals like a higher initial incentive, fulfilling a business target etc would best be avoided to ensure that the policyholder has a motive to fulfill his contractual obligations throughout the contract period.

The good work done by the field force should ably be supplemented by the administrative staff. Completing the formalities associated with the issuance of the policy bond without loss of time.

3. Generally recognized Factors: for Policy Lapse

3.1 Sales process

Any miss selling will create cognitive dissonance leading to early lapse. It could be that matching of customer needs with the product was not properly done, or sustained customer affordability was not taken into account while selling an appropriate product.

3.2 Surrender Charge Structure

If the surrender charge structure causes losses by way of negative returns vis-à-vis premiums paid, this will prevent lapse and hence is a factor. The lifting of surrender charge regime provides some sort of encouragement to surrender.

3.3 Personal circumstances

This is the most important factor in lapsation and the least controllable. in general have a different set of social obligations. As popularly acknowledged, joint family system even if its practice is being widely disregarded has its impact on Indian society. Even nuclear families (which are very different from nuclear families of the developed world) include unmarried adult children. These all translate into unique pressure points which have to be taken care of.

3.4 Present value

The worth of any investment as a factor to lapse or to persist is a largely relative measure. For example, in a falling market, term deposits may be seen as a better investment than insurance and in a rising market direct investments in stock and mutual funds may be seen as better performers than insurance.

4. Extraneous factors: Tax benefits & Collateral credit

Tax benefits are a huge driver in insurance sales. The possible removal or restriction of tax benefits could be a factor to lapse. Also introduction of benefits to other instruments competing with life insurance will also be a factor to lapse. If a life insurance policy is taken as a collateral for availing any credit facility such as housing loan or for any heavy investment, unless the policy face amount is directly linked to the balance credit in which case the policy will normally expire the closure of credit will be a factor to lapse as the specific reason for taking out the policy is no longer there.

4.1 Commission structure

A heaped commission structure is more associated with lapse than a trail commission structure as there is incentive for the sales force to generate more new business than service the old business. This in fact leads to churning which is a headache for the insurers the world over.

4.2 Economy

Life insurance is mostly considered as a discretionary purchase rather than a mandatory one. As premium payments are a form of renewing the purchase decision, a fluctuation in disposable income levels will influence policy lapse. Amount of disposable income increases with increasing income levels. In case of a recessionary economy, where there is negative growth, reallocation of available resources will happen and hence society as a whole will see an increase in policy lapse.

4.3 Product features

Policy owners sometimes need access to their invested funds and instruments which facilitate this will see better persistency than which does not. A good example is term products have higher lapse rates than endowment or whole life products.

5. Impact of policy lapse on various stakeholders

5.1 Customer groups

Policy lapse affects the customers in three ways:

1. On lapse, customers lose the insurance coverage and more often than not, the insurance need is acute at the times of lapse (one example is where the insured is out of work due to illness and hence unable to pay premiums).

2. Customers get a reduced return if any; from the lapsed policy as discount factors tend to get applied to the paid-up value.
3. As a class, customers will be affected by higher lapse rates as the cost gets passed on to them by way of higher premiums (in future product pricing) or lower bonuses.

5.2 Insurer groups

Insurers do provide for policy lapses even while designing the policy. The challenge is to accurately predict the lapse rate for a particular product and for a particular block of policies.

For fixed premium policies, insurer actuaries have to be accurate as possible. If lapse rates are higher than predicted, insurer stands the risk of losing his margins.

5.3 Sales force

Reducing policy lapse and increasing persistency benefits the field force a lot. If a customer lapses a policy, not only does the agent lose his renewal commissions, it also becomes tough to sell another policy to that customer as the losses on his first policy would have created a negative thought in his mind.

Hence it is better for the agent to capture the financial, economic and social profiles of his customer even as he sells a policy to him/her, and use it for lapse prediction and diligent follow-up. Such activities would create trust in the minds of the customers. IRDA too has recognized the importance of distribution channel in decreasing lapse.

In February this year, IRDA, under Section 14(2) of the IRDA Act, 1999 has issued guidelines requiring agents and insurers to enhance persistency of life insurance policies. The new guidelines among other things mandate 50% persistency for agency renewals till the financial year 2014-15 and 75% persistency after that. This alone is bound to play a major role in controlling lapses and it would benefit all the stakeholders including agents themselves and policyholders.

6. Management of Lapse

1. Opines that while there are several reasons for the lapsation of a life insurance contract, insurers must adopt proactive measures to ensure that commitments made by the policyholders are honored.
2. In general, Life insurance is a long term contract. While the insurer has the obligation to provide coverage as long as the policy is in force and does not have an option to foreclose, the customer has the right to stop paying the premiums at will.
3. In the Indian context, a policy is treated as lapsed if the premium is not paid within a period ranging from 15 to 60 days.
4. Number of policies exposed to lapse during the year is arrived from total number of policies at the beginning of the year and deducting the death, term expiry, maturity and conversion policy count from it.

7. Suggestions to bring down lapse

1. Regularizing the sales process and strict monitoring of the field force by the insurer. The field force should be educated of the exact target segment a product is designed for and should be instructed to sell only to them.
2. The surrender charge structure should be designed in such a way that it is a big reason for policy holders not to lapse. Having said the same, one would wish to mention that such an inhibitive regime be tempered with access facility to invested funds such as policy loans.
3. Personal factors should be better predicted through analytics. A typical Indian person's life cycle over time should be drawn out with the money need points mapped. To this any time bound factors which prevent a policy from being renewed – education expenses, marriage expenses, retirement – should be added. This would yield in better prediction of "in-danger-of-lapse" policies and result in sharper focus on renewing them.
4. Perceived Present values of insurance contracts are not controllable after issue. Rather product feature design has to take care of embedding features which get high returns. The popularity of unit linked products is a pointer to this. Better positioning of the product can mitigate the effect of return rates on lapse rates.
5. Any systemic hazard affecting the lapse ratio of an economy as a whole can never be easily modeled. Even past data can only be a rough indicator over the long term. One suggestion which could make the lapsation irrelevant is developing a mandatory term insurance, a la Employees Provident Fund. This will be a low cost insurance whose face value is tied to the basic pay of an employee. Since it is mandatory, coverage lapsation will be out of question. Such a mandatory scheme will also help

the families of employees at unfortunate death of the insured.

6. Ensuring better customer understanding of the product's nature. The better the customer understands a product it would help that much to map the product to the customer's perceived needs. And the realization of the customer of his/her needs that the product is meeting will ensure that the customer keeps the product in force.

8. Strategies towards better lapse Management

The three strategies that the insurers should adopt for accurate lapse rate design are:

1. Aggressive adoption of continuous KYC philosophy: The soliciting of data pertaining to KYC should not stop with New Business. The KYC data acquisition should also be proactive. For example, the field force can be asked to file a quarterly customer profile change report.
2. Focusing on single premium policies is a good idea to control lapse. Another example could be selling ULIP policies where the death benefit is the values of the units at the time of death. This may not directly prevent lapse but will remove the effect of lapse on insurer's reserves.
3. End to end marketing-From product features to servicing features: Marketing should not be confined to the product features. Focused marketing should also be done on the servicing features that are there to be utilized by the customer. The servicing features can range from call center support, multiple premium payment options like online and mobile payment channels. Not only customer friendly servicing features should be introduced but also should be proactively marketed to the customer.

9. Measures to curb lapsation and increase Persistency

1. Professionalize sales force & emphasis on need based selling
2. Understanding and appreciating Persistency
3. Compensation strategies
4. Linking Agent license Renewal norms to persistency
5. Product features & flexibility
6. Prudent Financial Under writing
7. New age and expanded service options
8. Grace Period & reinstatement window
9. Policyholder grievance Management
10. Customers connect & education

10. Conclusion

Persistency improvement is a journey and as we progress further, we will all agree that covering such steps is not the last mile of this journey, these may just be the first few miles that we have traversed so far. Business conservation or retention not only reflects the financial health of the insurer and ensures commission continuity for the advisor but also ensures that the customer interests and returns are safeguarded. If policyholder is disappointed at the sales process, then it is a permanent and irreparable loss to distributors. Further, insurers may also impose penalties due to lapsation, such a denying club membership associated facilities and fringe benefits.

Lapsation adversely impacts the policyholder due to loss of risk cover and more often than not, forfeiture of the premiums remitted thus far. For the sales force, lapsation translates into loss of future renewal commissions. The costs of acquiring new business are high, apart from the fact that the distributor's remuneration is also at its peak during the initial years. All this presupposes that unless the contracts run for their full time, it ends up as a losing proposition for the life insurers.

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