UNIT-1 FINANCIAL PLANNING AND LIFE INSURANCE

Structure:

1.0 LEARNING OBJECTIVES

After studying this unit, you will be able to know

- The importance of Financial Planning
- The Role of Life insurance in Financial Planning

1.1 INTRODUCTION

Financial planning is a step-by-step method to meet one's life goals. A financial plan acts as a guide in your life's journey helping you to be in control of your income, expenses and investments such that you can manage your money most effectively and achieve your goals. It can also be defined as it's a procedure to develop one's road map for financial wellbeing. Here one should know that a financial plan won't assure that one will enjoy his golden years, but it can certainly help to work toward making that happen. So this dreamlike financial plan in simple words is a broad assessment of your current financial status, an overview of your short, mid and long term goals and a strategy that will help one to reach them. During the planning stage information collected is (a) Investor finance such as income, liabilities, assets etc. (b) Risk appetite of the investor (different appetite at different life stages) (c) Goal or financial objectives the investor carries in his mind (d) The period in which the goal or objectives to be achieved. The output of the financial exercise is 'how to use the available income to achieve goals or objectives, keeping the tax structure and inflation in mind'. In other words, financial planning is a procedure of systematic planning of finances to attain short term and long term goals of the investor.

1.2 FINANCIAL PLANNING

Financial Planning offers numerous practical benefits. Financial Planning helps an investor to increase savings, maintain a better living standard, helps to stay prepared for any emergencies and finally leave you in a peaceful state of mind. Apart from all these the financial planning offers lot more in achieving future goals and objectives such as

(a) Wealth Creation

Every one of us faces a price rise on everyday items in our life which means one needs to save for the future it wants to maintain the same lifestyle. In addition, the desire for a new luxury car or a house in a beautiful location or travel to a location for a vacation keeps hitting our minds most of the time. And to fulfil all these one require money. It is possible to achieve these goals and dreams or desires by carefully investing your money in the right avenues.

(b) Child's Education

Education has become very expensive for a couple of decades, not only in India but across the world. And in future, this cost is only going to rise. This is why it is necessary to start planning from the moment a child is born. One needs to calculate how much to earn and invest in long-term investment avenues, so that the corpus can be created and which can be utilised for the education of a child in future.

(c) Retirement Planning

It's quite common sense that a retirement plan cannot be made at the time of retirement. To enjoy a happy and comfortable retired life, one needs to start building a retirement corpus as early as possible. Planning at an early stage in life can help secure the future against financial uncertainties. Also, if planned early, one needs to invest lesser amounts and gain from the power of compounding which helps to build a large enough corpus over 25-30 years.

(d) Saving Tax

Every year, millions of people in our country are paying a substantial amount as tax. But if one plans properly then one can land up paying lower tax legally. The Indian Income Tax Act provides various provisions for people to reduce their tax outgo. By planning taxes, one can identify the best avenues to invest money and reduce taxable income.

Crucial Factors of Financial Planning

Inflation

All of us must have heard from our parents or grandparents that everything was so cheap back in their days. Today, whether it is chocolate, coffee, clothes, petrol or diesel, edible oil everything, has become expensive. This phenomenon of prices rising over the years is known as inflation. It is the steady increase in the price of goods and services over some time. And if you are not careful, it can eat into your savings within no time.

Example: Assume a chocolate bar costs Rs. 10 today and with Rs. 100 one can buy only 10 chocolate bars. Now, one keeps Rs. 100 over the next one year, in a bank that offers an annual interest rate of 5.5%. At the end of the year, the maturity value of the investment would be Rs. Rs.105.50. But over one year, let's assume that the price of the chocolate bar increases by 10% (Rs. 11). This means one has to pay Rs. 110 to purchase the same 10 number of chocolate bars next year. But the bank has grown the investment to Rs. 105.50. Since only Rs. 105.50 is available, one is short by Rs. 4.50. This shortfall of Rs. 4.50 has to be managed by using personal savings. This is how inflation eats into one's savings. It reduces purchasing power over time, and one has to pay more money to buy the same amount of goods.

Contingency fund

The future is uncertain and anything may happen at any point in time. Below mentioned a scenario for better understanding. Imagine a father who has taken an education loan to finance his daughter's college education. At the same time, he is also saving money to fund his retirement and the marriage of his daughter that is a couple of years away. But suddenly, a medical emergency occurs in the family and because of lack of medical insurance coverage he has to pay for medical expenses out of his savings. This reduces his retirement and marriage corpus and increases his financial burden. Many of us face such situations in our life. A sudden job loss or an unexpected medical emergency can shake up your finances considerably. This is why one needs to have an emergency fund to deal with such issues. So it is necessary to plan for such difficult times.

Retirement Corpus

Significant advances in the medical technology field and the availability of effective newer medicines mean that people are now living longer lives post-retirement. This is undoubtedly good news for every retired person which means one can enjoy more time with family, may get more chances to explore one's passions and travel to dream destinations around the world. But there's one crucial question one needs to consider and that is how to fund all these expenses because one needs to have an ample amount of money to fulfil all these and ensure enjoyment in one's retired life to the fullest. This is possible by having a financial plan that provides regular income post-retirement. Having said that it's not easy to manage money because one has to take care of family needs, the educational requirement of children, personal expenses and saving for the future etc. So balancing all these together is quite a difficult task for most of us. Keeping this in mind if one designs his savings and investment using different financial tools, may achieve better results and achieve one's goal or objective.

Famous writer, politician, scientist, statesman, and diplomat of the United States of America Benjamin Franklin has rightly said, "If you fail to plan, you are planning to fail." One may have several different financial goals and wish to achieve in his life but to reach them at the right point in life; one need to plan at a very young age. To create effective financial planning to achieve one's goal and objective either in short term or long term requires step by step approach and a deeper understanding of the following:

1. Understanding of current financial situation of a person is the beginning stage of Financial Planning because if the understanding of financial source is correctly understood then it would be easy to draw a perfect financial plan and execute the same. In this stage the status of current finances is assessed, viz., income, expenses, debt, savings and investments etc.
2. Identifying and freezing financial goals one need to achieve, considering various stages of life. However, make sure that your goals are specific and realistic
3. Once goals and objectives are fixed, one should consider different investment options available in front of him. For example, in mutual funds alone more than a thousand options are available to invest offering different investment avenues to investors. One should invest in equity-based funds to achieve long term goals like child's marriage and retirement plans at the same time invest in debt funds if you want a steady income and does not want to take any risk on investment. ELSS option can be opted out if one is interested in saving tax. Generally, many financial experts highlight investment in mutual funds as Investing in these funds helps to achieve good growth consistently over a longer period can help you achieve your dreams and goals.
4. One need to select the right kind of investment option based on few factors such as his financial goals and objectives over a short term and long term scenario, current age, risk appetite and available investment amount. If unsure of the funds he may need to select to invest in his portfolio, they may take the assistance of a financial advisor. Financial Advisors are certified professionals who help investors make the right investment choices and help to create a complete investment portfolio, which may include areas like insurance, retirement planning, estate planning, education & marriage planning and taxation etc.
5. The process of financial planning does not end once the fund is invested. The regular monitoring of how the funds are performing is vital. If they don't perform according to one's plan or expectation, then one may need to replace them with better performing funds at the earliest. Everyone's life changes during various life stages, hence investment plans and options need to be changed or altered. For instance, financial priorities may change in one's life after the birth of a child in his family because the child brings in some expenses and objectives along with him to your family.

Now we have understood the importance of financial planning and one should do it at a young age to get the best result. So the next step towards the same is to create a best suited financial portfolio for self. This can be done either by self or by taking help from a certified financial advisor. Moving forward let's try to understand what is a portfolio all about. A portfolio is a collection of financial investments such as stocks, bonds, commodities, cash, and cash equivalents, insurance, PPF etc. Although many people generally believe that stocks, bonds, and cash are the core of a portfolio but there is no such rule exists. A portfolio may contain a wide range of assets including real estate, art and private investments etc. But one concept that remains to plan a successful portfolio is the diversified investment which means not to put all your eggs into the same basket. Diversification helps to reduce the investment risks by distributing investments among various financial instruments. Finally, one's goals for the future, appetite for risk and personality are all factors in deciding how to build the most suited portfolio.

Types of Portfolio

There are many different types of portfolios and portfolio strategies are there. One may choose to have multiple portfolios, whose contents could reflect a different strategy or investment scenario, structured for a different need. They are:

Hybrid Portfolio

The hybrid portfolio approach diversifies across various asset classes. Building a hybrid portfolio requires taking positions in stocks and bonds, commodities, real estate and even art. Generally, a hybrid portfolio involves moderately fixed proportions of stocks, bonds, and alternative investments.

Portfolio Investment

When a portfolio is used for investment purposes, ideally one expects that the stock, bond or other financial assets will earn a good return or grow in value over time or both. A portfolio investment may be either planned, where one buys financial assets to hold onto those, for a long time or could be strategic, where one actively buy and sell the assets hoping to achieve short-term gains.

Equity Focussed Portfolio

In this portfolio assets are bought assuming greater risks, expecting great returns. Young and aggressive investors mostly seek out companies that are comparatively new and in the early stages of their growth.

Defensive Focussed Equity Portfolio

A defensive portfolio would tend to focus on companies that are resistant to recessions. These defensive stocks do well all the time irrespective of the good economy or slump times maintaining a balanced kind of return on investment. No matter how bad the economy is at a given time, manufacturing companies that make consumer essential products survive well because these are essential in everyday life.

Income Focussed Equity Portfolio

This type of portfolio concentrates on dividend-paying stocks or other types of distributions to stakeholders. Stocks are primarily selected on their high yield capacity and to generate positive cash flow. Real estate investment could be an example of income-producing investments.

Speculative Equity Portfolio

The speculative portfolio is best for investors with a high risk-taking appetite. Speculative as the name suggests includes initial public offerings (IPOs) or stocks that are assumed to overthrow targets in future.

An Investment Portfolio is a collection of assets that includes investments like stocks, bonds, mutual funds and exchange-traded funds. While creating a portfolio one should very seriously consider the risk-taking capacity of the investor. This ability of the investor creates scope to invest in volatile stocks which may return very high but may lose out as well. Basically tolerance of upward and downward movement of the market.

Once the portfolio is planned the next step is to choose the right kind of financial tools and invest in those. Few common types of investment options are given below:

Stocks

Investors buy a stock thinking that they will be the owner of the company and expect the stock price to go up and give them a good return on their investment over some time. Stocks are a small piece of ownership in a company. But the risk is that the stock might not go up at all or it might even lose value. To help ease that risk, many investors invest in stocks through funds such as index funds, mutual funds or Exchange Trade Funds (ETF) that hold a collection of stocks from a wide variety of companies. Then If one opts for individual stocks, it’s usually wise to invest only 5% to 10% of your portfolio in it.

Bond

Bonds are loans to companies or governments that get paid back after a stipulated period (bond term) with interest. Bonds are considered to be safer investments than stocks, but they generally give lower returns. Since one knows from the beginning of investment how much interest he will receive so, they’re referred to as fixed-income investments. This fixed rate of return in bonds helps to balance out the riskier investments, such as stocks, within an investor’s portfolio.

Mutual Fund

There are many kinds of mutual funds available in the market in which one can invest. The advantage of investing in mutual funds over buying individual stocks is that they allow you to add immediate diversification to your portfolio. Mutual funds allow to invest in a basket of securities, made up of investments such as stocks or bonds. Mutual funds do have some degree of risk, but they are at any timeless risky than investing in individual stocks. Passively managed mutual funds are commonly known as index funds. Index funds and ETFs try to match the performance of a certain market index, such as the S&P 500. Because they don't require a fund manager to actively choose the fund's investments, these investment tools tend to have lower fees than actively managed funds.

The main difference between ETFs and index funds is that ETFs can be actively traded on an exchange throughout the trading day like individual stocks, while index funds can only be bought and sold for the price set at the end of the trading day. Now it's clear that investment can be done by one or in all these investment tools such as stock, mutual funds and some bonds.

But the crucial question here is how one decides exactly how much investment one should do in one or all investment tools. The way one distribute one's portfolio among different types of assets is known as asset allocation, and it's solely dependent on one's risk tolerance. Generally, investors follow a thumb rule which suggests subtracting your age from 100 or 110 to determine what portion of the portfolio should be dedicated to stock investments. For example, if you're 30, these rules suggest 70% to 80% of your portfolio allocated to stocks, leaving 20% to 30% of your portfolio for bond investments. In your 60s, that mix shifts to 50% to 60% allocated to stocks and 40% to 50% allocated to bonds.

At times after investment is done one's chosen asset allocation may get distorted because of stocks rises in value, it may disrupt the proportions of the invested portfolio. So, rebalancing from time to time is required to restore one's investment portfolio to its original percentage. Sometimes rebalancing is done in set intervals such as every 6 or 12 months or when the allocation of one of your asset classes (such as stocks) shifts by more than a predetermined percentage, such as 5%. For example, if one had an investment portfolio with 60% stocks and it increased to 65%, then one may sell some of the possessed stocks or invest in other asset classes until the stock allocation is back at 60%.

1.3 ROLE OF INSURANCE IN FINANCIAL PLANNING

Insurance is considered an essential part of any sound financial plan because for the sole reason that being prepared for the unexpected will guarantee that you can still reach your goals after facing a financial crisis at any point of time in your life journey. And an insurance policy will keep you from draining your emergency fund, protect your loved ones if you're become sick or disabled or die. Without coverage to tackle certain situations can be tough as those are expensive and may exhaust your savings, so it's important to purchase some policy most suited and need-based depending on one's financial status. Generally, experts recommend getting insured before even one gets serious about investing.

Even though most of us aware that having insurance is important, but buying a policy usually isn't a top priority. So, most of us do not feel getting insured is important. It is observed that most of us tend to focus on the 'wealth creation aspect of financial planning more and the 'protection' element often gets compromised or neglected. Life Insurance is still a budding idea in our country and most of us do not think about it until a major life change causes them to realise what might happen to their loved ones in case of any unforeseen circumstances. One should understand the very idea of buying a life insurance policy is to protect oneself from unforeseen circumstances, which in turn would help in wealth accumulation, preservation, and give access to liquidity at the right time if added as a component of financial planning. Most of us usually get confused on how much to invest and where to invest – stocks, bonds, real estate and many others. Life insurance is a good investment tool, which is comparatively simpler, more affordable and most importantly caters to the different stages of the individual's lifecycle. So, someone serious about proper financial planning and looking forward to sizeable wealth creation over a planned period should protect himself to achieve the same because if something untimely unfortunate happens to him then all his efforts go wasted.

In general, every one of us needs a few or all of these below mentioned insurance in various stages of our life. They are (a) Auto Insurance (b) Home/House Insurance (c) Health Insurance (d) Disability Insurance (e) Term Life Insurance etc.

(a) **Auto Insurance:** It is mandatory to take a policy once one owns a bike, auto, car or a bigger vehicle for personal or commercial purposes. The policy should not be purchased just because driving on-road without vehicle insurance is illegal but imagine paying compensation out of your pocket in case of any accidental loss of life. Auto insurance comes in many variances. Those are:
    - Liability coverage: If one is responsible for an accident, then liability coverage will cover the costs of any injuries or property damage caused in the collision.
    - Collision coverage: This covers the cost to repair or replace one's car if it's damaged or destroyed in an accident.
    - Comprehensive coverage: This level of insurance covers one's losses that aren't caused by an accident such as theft, vandalism, flood, fire and storm.

(b) **Home/House Insurance:** This policy generally includes *extended dwelling coverage* which adds an extra level of protection above policy limits. Having extended dwelling coverage, the insurance company will replace or rebuild one's property over and above policy coverage. There is a limit for extended dwelling coverage, generally, it is around 20–25% above the insured amount.

(c) **Health Insurance:** In past few years' medical expenses have gone up by more than 300%. There are thousands of cases we see, read in media that people have gone bankrupt treating a critical medical issue or has created a big basket of debt for themselves and family. In today's world, if one is uninsured, you're leaving yourself vulnerable to potential financial catastrophe. One unexpected major medical emergency could amount to hundreds of thousands of rupees of expenses. Health Insurance premiums are exempted u/s 80(D).

(d) **Disability Insurance:** Disability insurance protects one from loss of income if one is unable to work for a long period due to an illness or injury. If you're in your prime earning years, a permanent disability could upset one's dreams of homeownership or pay for a child's school/college fees.

(e) **Term Life Insurance:** Most of us take life insurance too lightly. If one passes away unexpectedly and untimely, how would one's spouse pay for monthly expenses without income coming in? In the gloomy moments of grief, the last thing any spouse should worry about is surviving financially in absence of the bread earner. With a term life insurance policy for at least 10–12 times, one's yearly income, the family won't have to worry about making ends meet, losing their home or changing their college plans.

1.4 LET'S SUM UP

Financial Planning is a very important aspect of everyone's life. Each one of us should plan to create wealth over 20-30 years to take care of responsibilities in various stages of life. This can be done either by an individual or by taking help from experts. But in both the case the objective remains same to create wealth to take mitigate responsibilities in future. While planning one should remember that no financial planning is complete without covering the life of the bread earner adequately because if something unfortunate happens then there is a very high chance that the wealth creation will be disrupted and in the worst scenario may be the family need to change the lifestyle.

1.5 KEYWORDS

- **Financial Planning:** Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.
- **Wealth Creation:** Wealth creation is the process of investing in different asset classes where the investments will help in fulfilling key needs. Wealth creation process always starts with setting financial goals.
- **Tax Savings:** Tax Savings means the decrease in Tax paid or payable to the relevant Tax Authority (or, without duplication, the increase in any Refund) attributable to a Tax Benefit.
- **Inflation:** Inflation can be defined as a persistent rise in the general price of goods and services of common or daily use. Inflation is the measure of change in average price of services and commodities, done at regular intervals.
- **Equity Portfolio:** An equity portfolio is a collection of investments in the stock market.
- **Term Insurance:** Term life insurance or term assurance is life insurance that provides coverage at a fixed rate of payments for a limited period of time, the relevant term
- **Mutual Fund:** A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt.

1.6 FURTHER READINGS

- M.N. Mishra: Insurance Principles and Practice, S. Chand & Company Ltd, Delhi.

- Indian Institute of Bankers (Pub) Commercial Banking Vol-I/Vol-II (part I&II) Vol- III.
- Hota P.K., and Das S.K. Financial Literacy and Banking, Kalyani Publishers
- Dr P. Periasamy: Principles and Practice of Insurance, Himalaya Publishing House, Delhi.
- Mishra S. Banking Law and Practice – S Chand
- Prasad – Banking Insurance – Vikash Publication
- Inderjit Singh, Rakesh Katyal& Sanjay Arora: Insurance Principles and Practices, Kalyani Publishers, Chennai.
- G. Krishnaswamy: Principles & Practice of Life Insurance
- Kothari &Bahl: Principles and Practices of Insurance.

1.7 MODEL QUESTIONS

Q1: Explain the role of insurance in financial planning.
Q2: What are the crucial factors in financial planning?
Q3: Discuss about the financial planning in the context of life insurance.
Q4: Write short notes on the followings:

- Wealth Creation
- Tax Savings
- Contingency Fund
- Hybrid Portfolio

UNIT-2 LIFE INSURANCE PLANNING

Structure:

2.0 LEARNING OBJECTIVES

After studying this unit, you will be able to know

- The importance of Life Insurance Planning
- How to choose the right types of Life insurance for oneself

2.1 INTRODUCTION

Life insurance not only provides peace of mind to you and your loved ones but can be an essential part of a sound financial plan. As you grow in life, you could realise and appreciate many benefits of it. By now we have understood that financial planning is the process of meeting one's life goals through the proper management of finances. It includes elements of protection, wealth creation, planning for contingencies and emergencies, as well as planning for specific milestones in life such as a child's professional education, marriage at a particular age, owning a house at a posh locality etc. But the question comes to mind that where does life insurance fit in all these.

The fact is, life insurance is very much an essential part of a sound financial plan. Because, as you age, get married, buy a home, build a family, and plan for retirement, life insurance becomes more important. The following are few common areas observed in which life insurance can play an integral part in your financial plan:

Security/Mortgage

For most people, payment towards a mortgage is one of their largest share of expenses. For this reason, most couples in this era shoulder this long-term financial liability jointly. But if something unfortunate happens to one of the partners tomorrow, can the family afford such a large commitment without the other partner's income? In such a situation a life insurance policy can help and provide one's family with a lump sum of money to clear off mortgage liability, eliminating this large financial stress, as well as the stress of a loan default or subsequent foreclosure.

Funding for college Education

These days the average cost to pursue studies in a professional college is very high and can be estimated between 3 – 7 Lakhs per annum. And most of the professional college studies are either 3 or 4 years. Hence, a moderate budget required would be anything between 12 – 30 Lakhs at a private college. If one finds that he is struggling to set aside money for his child's education while he is alive, how would his spouse manage if one is suddenly gone? One can leave his child the gift of education by factoring educational expenses into his life insurance policy's death benefit. This can help relieve the burden of growing college costs, ensuring the necessary funds for college.

Child Marriage and Care of Aging parents

Every parent dream about their child's marriage since the day they are born. They plan to organise the same with their best financial capacity in dream style. At the same time if ageing parents are with someone at home then a lot of expenses goes in to provide them with comfort. If anything unfortunate happens to the sole bread earner of the family, then surely the family will be under great stress to meet the financial expenses. There is a very high possibility that the family after the demise of the bread earner may have to compromise with their living style, bring it down to curtail expenses and compromise with all the dreams that were seen earlier. Life insurance proceeds can provide the financial support needed for these special events and individuals in one's life.

According to Economic Times and their observation, they write in their column saying that, "In the wake of increasing inflation, shift to nuclear families and change in lifestyle patterns, life insurance assumes vital importance. It is paramount for every individual to first adequately insure his life for the financial security of his dependants and then proceed to address other aspects of financial planning. Financial planning is a dynamic process that involves charting an individual's financial goals and long term objectives.

2.2 LIFE INSURANCE PLANNING

A financial plan without adequate life insurance is no financial plan at all. If anyone else is relying on one's income and would be unable to pay their bills without his support, then one needs to have life insurance. That means parents of minor children, anyone financially supporting their parents, spouse or any other family members should consider taking up life insurance seriously. Then having an adequate amount of life insurance is a critical part of everyone's financial planning. Having an adequate amount of life insurance make sure that one does not create a burden on the family in the event of an untimely death. Life insurance benefits are generally received income tax-free and can be used to compensate lost income for family members, pay for children's education, pay off debts, taxes and other expenses. But the most difficult question which needs to be answered by everyone while financial planning is "how much insurance do I need?"

To resolve the issue one should consider the future probable income of the family because it allows one to meet the future living expenses and needs of one's family. In other words, If the bread earner of the family passes away then the family's living expenses should not go away and those who are financially dependent upon the bread earner will still be able to meet those financial obligations. One's need for life insurance and the amount required will depend on his personal and financial circumstances. If one has any or few or all of the following, then one should seriously cover himself with an adequate amount of insurance at the earliest.

- Married having a spouse
- Having dependents
- Created a mortgage or other having outstanding debts
- Retirement pension and savings are not enough to ensure one's spouse's future against a rising cost of living
- Having a large net worth/estate
- Owning a business or are a partner in a business
- Having an ageing parent or disabled family member who depends on one's support

Life insurance is still an emerging idea in our country and most people do not think about it until a major life change causes them to consider what might happen to their loved ones in case of any unforeseen circumstances. While the main objective of buying a life insurance policy is to protect oneself from unforeseen circumstances, it can also help in wealth accumulation, preservation and give access to liquidity at the right time, if added as a component of financial planning. Life insurance is a good investment tool, which is comparatively simpler, more affordable and most importantly caters to the different stages of the individual's lifecycle.

- One can buy a Term Plan (pure protection plan) at an early stage which is most affordable or a unit-linked plan at a later stage which gives you the opportunity of earning higher returns but involves market risk. There are specific education plans which ensure that your child's education is not compromised in case of an unfortunate situation and there are annuity plans available for retirement.
- The bitter truth in practice across the globe is that often people avoid purchasing life insurance as either they find it is too complex to understand or carry a mindset that they have enough time to buy it later. Both these types of thoughts may put the family into a stressful situation in case of any unfortunate event.
- Insurance is not only a protection tool also helps a consumer save in a disciplined manner which leads to wealth creation over some time. While other financial instruments may give you exciting returns but there is hardly any other financial instrument available that provides a good return without having much attention, involvement or expertise of the investor.
- Insurance's main objective is to secure your family's financial needs in one's absence. These needs should be critically assessed depending on the life stage at which the individual is along with current liabilities, the expectation of

future liabilities, number of dependents, financial goals, lifestyle etc. A need in mind makes the decision process simpler; be it child’s education or daughter’s marriage or planning for one’s retirement or loan repayment.

- Insurance helps to avail various tax benefits on premium and maturity amount or death payment which makes it an even more attractive proposition.
- To estimate the quantum of how much insurance an individual needs there are some simple thumb rules followed. The most common way is to calculate life insurance as about 20 times the individual's annual income.

Many product categories can cater to the ‘Investment and Wealth creation needs of the customers, but none can offer the advantage of protection along with the benefit of sustained and disciplined savings as insurance products do. A financial plan would not be complete without the key element of life insurance so chart out your goals and objectives and make an informed decision.

2.3 SELECTION OF RIGHT TYPE OF LIFE INSURANCE

The most herculean task is to select the best suited and right type of insurance for someone. In general, one can opt for a term policy that can keep his life covered for 20 or 30 years till all his responsibilities are over or no one is financially dependent on him or a large amount of corpus is built up to take care of the family needs in one’s absence. Other than term insurance one can choose whole life insurance where the life insurance cover continues for the entire life.

Once the question of which type of insurance one needs are answered the next difficult question that comes in front is that how much insurance one should take. It is equally difficult because there is no one concrete answer to this question as the need for insurance depends on many different aspects during financial planning. Those are broadly the age of a person, Loan or Debt of a person, Family situation, Occupation/ earnings etc.

Age: Generally, one needs a greater amount of insurance in his early life stage and less as you grow by age. For example, If someone is 30 years old and have a young child and a recently created mortgage, he likely needs a larger amount of life insurance on his life today than in a couple of decades when he around 50 years old and he is a child is older and a substantial portion of your loan or debt has been paid off. Then this cannot be a rule for everyone.

Loan/ Debt: The insurance need of someone is directly proportionate to his liabilities. The life cover should be much more than the liabilities one has created in his name because the idea is not only to cover all the liabilities but also leave enough after all the payments for the family to manage their remaining life without compromising their lifestyle, in case something unfortunate happens to him.

Family Situation: During life insurance calculation how many family members one has, how many children one have, what future one has planned for his children, how many dependents at home etc. is considered very carefully. For example, if a person has one child who is 10 years old and another person having three children all below 10 years then the person having three children need more insurance. The interesting aspect here is both the persons may be earning the same amount but the need varies because of their family situation.

Occupation/ Earnings: If a person is the sole bread earner of his family or his earning share is 75% of the total family income then it is quite obvious that the male earning person of the family requires more insurance on his life. At the same time, if a person is employed in the defence sector, mines or works with the electricity department where he is exposed to the maintenance of high voltage line or his job involves climbing on to high rise tower then his need of life cover is certainly more.

There are many more situations which we can mention here such as if a person is dreaming high for his child (IAS, IPS, Doctor, Engineer etc.) and another person is planning not so high for his child (technician, teacher etc.) than the person who is planning high for his child needs to take more insurance on his life than the other one.

Again we can take another example where Ram and Shyam are working for the same company in the same designation and earning around 5 Lakhs per annum. While Ram is very calculative and saves around 24% of his earnings in a year, Shyam believes in living a good life and lavishly spends his earnings and manage a meagre 4-5% to save per annum. Here Ram would be needing less insurance because he will be able to create a corpus of his own to pass on to his family in case of any unfortunate event but Shyam needs to take more insurance.

Types of Life Insurance

Life Insurance products are designed to cater to varieties of investment needs of investors. With it, one can secure his family's future and ensure there's a source of replacement income for them in the event of his unfortunate demise. With the death benefits derived from Life Insurance, his family can pay back any significant expenses which may have left behind, like debt repayments. It also helps the family to maintain their lifestyle without any kind of compromise. In plans like endowment policies and ULIPs, one gets to enjoy maturity benefits that can serve as a reliable corpus to cater for any kind of need. Whereas one can opt for pension plans that give the option to receive lump sum pay-outs or steady periodic payments post-retirement. Below mentioned are few broad categories of life insurance.

Term Insurance: A term insurance policy is to secure the immediate needs of nominees or beneficiaries in the event of the sudden or unfortunate demise of the policyholder. The policyholder does not get any monetary benefit at the end of the policy term except for the tax benefits he avails of throughout the tenure of the policy. In the event of the death of the policyholder, the sum assured is paid to his beneficiaries. Term insurance policies are relatively cheaper to acquire as compared to other insurance products. Currently, few insurers are offering a variety of term life insurance where at the end of the term if the insured survives then the insurer pays back the entire premiums paid during the tenure of the term policy.

Money Back Policy: Money back policies are an extension of endowment plans wherein the policyholder receives a fixed amount at specific intervals throughout the policy. In the event of the death of the policyholder, the full sum assured is paid to the beneficiaries. The terms again might slightly vary from one insurance company to another.

Whole Life Policy: A whole life insurance plan covers the insured over his life. Whole Life Insurance offers dual benefits - Death Benefits as well as Savings Benefits. The primary feature of this product is that the validity of the policy is not defined so the policyholder enjoys the life cover throughout his life.

ULIP Policy: Unit-linked insurance policies are insurance-cum-investment policies where one gets to enjoy the benefits of both insurance and investment. While a part of the premium goes towards the insurance cover, the remaining money is invested in various types of funds that invest in debt or equity or both equity and debt instruments. ULIP plans are more or less similar in comparison to mutual funds except for the difference that ULIPs offer the additional benefit of insurance. ULIP policy can help to grow one's money adequately to provide his child with the best education possible. One can also make use of the benefits from this plan to meet the expenses for his child's wedding.

Pension Policy: Pension policies helps to generate a steady assured income post-retirement for an individual. It is a retirement investment plan where the sum assured or the pay-out after retirement entirely depends on the capital invested in the form of premium contributed over a period (longer the term period larger is the corpus) and the age at which one retires. Various kinds of pension plans are offered by insurers to cater to different types of investment needs and regulated by IRDA.

Health Insurance: A financial plan may complete with the inclusion of a health policy. As it is said 'health is wealth' one needs to consider opting for a health plan for himself and his family, so that in case if someone falls sick and gets hospitalised then these unplanned expenses should not jeopardise his investment plans. Considering the rising cost of medical expenses these days one can make his life peaceful by taking a Health Insurance plan. This plan can meet any medical expense which may occur at any point in time without putting any significant financial stress on the insured. Medical insurance generally covers various costs like hospitalisation expenses, home care expenses, daycare procedures and ambulance charges etc. In addition, critical illnesses like cancer, kidney problems, and Alzheimer's disease are also covered. The costs associated with treating these conditions can be extremely expensive. Fortunately, with a good Health Insurance plan, one can rest assured that these expenses will be covered, at least to a certain extent.

Hope by now it's understood clearly why Life Insurance and Health Insurance are both important types of insurance to include in a financial plan. To experience these benefits, one needs to identify the best Life Insurance plan and the ideal Health Insurance plan according to one's requirements and include them in his financial plan. This way, it can be assured that the financial future of someone as well as the future of your family is secure.

An investor mostly finds himself in a dilemma when it comes to finding the right investment strategy. Financial planning is tricky if one is not aware of the elements that one can opt for making investments. Available options are:

Mutual Funds

Mutual funds are excellent options to consider for investors. One can opt for either equity-based or debt-based mutual funds according to one's risk appetite. Investors with a high-risk appetite usually go for equity funds since they offer higher returns. Whereas, debt funds are for those who are looking for highly liquid investments. Mutual funds are market-linked investments that invest your money in various instruments including, stocks, money market funds and more. Mutual funds can prove to be a great addition to your financial planning.

Public Provident Fund (PPF)

Financial planning requires one to expand his investment portfolio. A public provident fund is a good investment option if someone is looking for a guaranteed return along with tax rebates u/s 80 C of IT Act, 1961 on the principal amount, interest earned and maturity amount. It is a Government-backed investment scheme that allows one to enjoy risk-free returns. The maturity period under the plan is 15 years, but one can make partial withdrawals after 6 years.

2.4 LET'S SUM UP

Financial Planning cannot be completed without including Life insurance and Health insurance. These not only provide peace of mind to the investor but also ensures one continue with the plan without much hindrance. With stages of life, one could realise and appreciate many benefits of it which, includes elements of protection, wealth creation, planning for contingencies and emergencies, as well as planning for specific milestones in life such as child's professional education, marriage at a particular age, owning a house at a posh locality etc. The fact is, life insurance is very much an essential part of a sound financial plan. Because, as one age, get married, buy a home, build a family, and plan for retirement, life insurance becomes more and more important.

2.5 KEYWORDS

- **Mortgage:** A legal agreement by which a bank, building society, etc. lends money at interest in exchange for taking title of the debtor's property, with the condition that the conveyance of title becomes void upon the payment of the debt.

- **ULIP:** A Unit Linked Insurance Plan is a product offered by insurance companies that, unlike a pure insurance policy, gives investors both insurance and investment under a single integrated plan
- **Pension Plan:** A pension plan is the retirement amount, which an individual gets from their insurance companies on a regular basis or in the form of a lump sum.
- **Public Provident Fund:** It is a long-term saving schemes which focuses on inducing small savings like investments and accrue returns on the same. As a saving scheme by the government, PPF gives an agreeable rate of interest and returns on investments.
- **Money Back Policy:** It provides life coverage during the term of the policy and the maturity benefits are paid in instalments by way of survival benefits in every 5 years. The plan is available with 20 years and 25 years term.

2.6 FURTHER READINGS

- M.N. Mishra: Insurance Principles and Practice, S. Chand & Company Ltd, Delhi.
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- G. Krishnaswamy: Principles & Practice of Life Insurance
- Kothari &Bahl: Principles and Practices of Insurance.

2.7 MODEL QUESTIONS

Q 01: Write a note on importance of Life Insurance Planning

Q 02: How to choose the right types of Life insurance for oneself.

Q 03: Discuss about various types of life insurance.

Q 04: Write short notes on the following:

- Mutual Fund
- Whole Life Policy
- ULIP Policy
- Term Insurance

UNIT-3 HEALTH POLICIES, PENSIONS AND ANNUITIES

Structure:

3.0 LEARNING OBJECTIVES

After studying this unit, you will be able to know

- The importance of Health Policies
- The role of Pension Plans post-retirement

3.1 INTRODUCTION

In the past few years, we are witnessing a little change in the mind-set of the people for opting out of medical policies. This behaviour change is because the government is trying its best to aware more and more people about the benefits of this policy and also has floated many schemes for the masses. Medical policies provide coverage of medical services during hospitalisation but it is far from satisfactory level because still, the policies do not put many outpatient costs in the policies. Retirement plans are investment plans which help to accumulate a portion of savings over a long period so, that a corpus can be build and available to the investor post-retirement when all his income is stopped. It also allows financial independence to the investor and takes away all his unnecessary worries, as this plan offers a steady income over the long term. In few policies, the plan continues paying the spouse as well after the demise of the investor.

3.2 HEALTH POLICIES

Health insurance is insurance that covers the whole or a part of the medical expenses of a person who has taken medical insurance. Health insurance in India in the current scenario pays only for inpatient hospitalization and for treatment in Indian hospitals. Health policies do not cover outpatient services in India. The first health policies in India were Mediclaim Policies. In the Year 2000, the Government of India allowed private players into the health insurance sector. The beginning of private insurers in

India saw the introduction of many innovative products like family floater plans, top-up plans, critical illness plans, hospital cash and top up policies.

Health Insurance is growing fast in India. As per statistics in the year 2011, 3.9% of India's gross domestic product was spent in the health sector. According to the World Health Organisation (WHO), this is the lowest spending among the BRICS (Brazil, Russia, India, China, and South Africa) economies. In the year 2016, the NSSO released the report “Key Indicators of Social Consumption in India: Health” based on its 71st round of surveys. The survey carried out in the year 2014 found out that, more than 80% of Indians are not covered under any health insurance plan, and only 18% (government-funded 12%) of the urban population and 14% (government-funded 13%) of the rural population was covered under any form of health insurance. Launched in 1986, the health insurance industry has grown significantly mainly due to the liberalization of the economy and general awareness. According to the World Bank, by 2010, more than 25%of India’s population had access to some form of health insurance.

Hospitalization plans are indemnity plans that pay the cost of hospitalization and medical costs of the insured subject to the sum insured. These policies do not normally pay any cash benefit. In addition to hospitalization benefits, specific policies may offer several additional benefits like maternity and new born coverage, day care procedures for specific procedures, pre-and post-hospitalization care, domiciliary benefits where patients cannot be moved to a hospital, daily cash, and convalescence. Types of Health policies are Family Floater Health Insurance, Senior Citizen Health Insurance, Maternity Health Insurance, Hospital Daily Cash Benefit Plans, and Critical Illness Plans etc.

The expected increase in the healthcare market to three-fold around 8.6 trillion (US$ 133.44 billion) by 2022. India is experiencing 22-25 per cent growth in medical tourism and the industry is expected to double its size from US$ 3 billion in April 2017 to US$ 6 billion by 2018. Medical tourist arrivals in India increased to 1.07 million in January 2018 from 0.98 million in January 2017. There is significant scope for enhancing healthcare services considering that healthcare spending as a percentage of Gross Domestic Product (GDP) is rising. Rural India, which accounts for over 70 per cent of the population, is set to emerge as a potential demand source. In 2017, the Government of India has provided a grant-in-aid for the setting up of AYUSH educational institutions in States and Union Territories.

Government Initiatives

Few major initiatives taken by the Government of India to promote the Indian healthcare industry are as follows:

- Mission Indra Dhanush (IMI) has been launched by the Government of India to improve coverage of immunisation in the country and reaches every child under two years of age and all the pregnant women who have not been part of the routine immunisation programme.

- National Nutrition Mission (NNM) with a three-year budget of Rs 9,046.17 crore (US$ 1.40 billion) to monitor, supervise, fix targets and guide the nutrition-related interventions across the Ministries.
- The Government of India aims to increase the total health expenditure to 2.5 per cent of Gross Domestic Product (GDP) by 2025 from the current 1.15 per cent.
- Mr J P Nadda, Union Minister of Health and Family Welfare, Government of India, launched initiatives such as LaQshya, for Labour Room Quality Improvement, a mobile application for safe delivery, and operational guidelines for obstetric high dependency units (HDUs) and intensive care units (ICUs).
- In March 2018, National Health Mission was set up with a budget of Rs 85,217 crore (US$ 13.16 billion) from 1st April 2017 to 31st March 2020.
- In April 2018, the Government of India apprised the signing of the Memorandum of Agreement (MoA) between India and the World Health Organisation to facilitate improving public health in India.
- In May 2018, the Government of India approved `1,103 crores (US$ 170.14 million) for setting up the All India Institute of Medical Sciences (AIIMS) in Deoghar, Jharkhand.
- In June 2018, the Ministry of Health and Family Welfare signed a Memorandum of Understanding (MoU) with the Norwegian Ministry of Foreign Affairs through the Norway India Partnership Initiative
- (NIPI) from 2018-2020, the cooperation is aligned with National Health Policy 2017.

Government-Sponsored Health Insurance Schemes

Rashtriya Swasthya Bima Yojana ('RSBY')

This is a Health insurance scheme launched by the Ministry of Labour and Employment, Government of India for Below the Poverty Line ('BPL') families. The family included as BPL family in the District BPL List prepared by State Governments are the beneficiaries. Such BPL family needs to enrol by identifying before the authorised official. Under this Scheme, hospitalisation expenses up to 30,000 for a family comprising of up to 5 members is provided on a floater basis. Under a floater cover, any one or more of the members is eligible to claim the hospitalisation expenses.

Employees State Insurance ('ESI')

Employees State Insurance Act, 1948 is the governing Act in this regard. Under Section 2(12) the Act applies to non-seasonal factories employing 10 or more persons. Under Section 1(5) of the Act, the Scheme has been extended to shops, hotels, and restaurants, cinemas including preview theatres, road-motor transport undertakings and newspaper establishments employing 10 or more persons. Further, under section 1(5) of the Act, the Scheme has been extended to Private Medical and Educational institutions employing 10 or more persons in certain States/Union Territories. Employees' State Insurance Scheme of India is a multi-dimensional Social Security Scheme tailored to provide Socio-economic protection to the 'employees' in the organised sector against the events of sickness, maternity, disablement and death due to employment injury and to provide medical care to the insured employees and their families.

Varnish Mediclaim Policy (Senior Citizens Health Insurance Scheme)

Varnish Mediclaim policy by the government is made specifically for senior citizens between the age of 60 and 80 years to meet the requirements of a senior citizen health insurance scheme. The policy period is only a year but the renewal of the plan can be made up to the age of 90 years. One lakh of sum assured is provided for hospitalisation and up to 2 lakhs for critical illnesses coverage. This scheme is especially for the employees of the central government, both newly recruited and retired one.

Prime Minister's Aayushman Bharath Health Scheme

Prime Minister Narendra Modi rolled out the Pradhan Mantri Jan Arogya Yojana-Ayushman Bharat Health Scheme in September 2018. Termed as a "game-changer initiative to serve the poor "PMJAY-Ayushman Bharat" is the biggest government-sponsored healthcare scheme in the world. The magnitude of the scheme could be gauged from the fact that more than 1,300 ailments are covered under it, including heart diseases, kidney and liver disorders and diabetes. A health card would be provided to the beneficiaries for availing of the benefits. A total of 13,000 hospitals have become a part of the Ayushman Bharat scheme. Billed as the world's largest government healthcare programme, it will be funded with 60 per cent contribution coming from the Centre and remaining from the states.

Privately Administered Health Insurance Schemes

Besides there are many privately administered Health insurance schemes administered by General Insurance companies or Stand-alone Health insurance companies that are regulated by IRDAI. Besides Critical illness covers are provided by Life insurance companies. Any individual can purchase health insurance cover directly by purchasing a Health insurance policy from any of the above insurance companies. But while purchasing health policy one should consider riders available, Coverage, Benefits offered, Network Hospitals in areas etc. There are few health policies listed below that are falling within the Top 10 health plans in our country. They are:

- Aditya Birla Active Assure Diamond Plan allows anyone aged about 5 years and above to enter into the policy and opt for coverage between 2 Lakhs – 2 Crores having a Network Hospital of 7100+
- Bajaj Allianz Health Guard Plan allows anyone aged about 18 years till 65 years to enter into the policy and opt for coverage between 1.50 Lakhs – 50 Lakhs having a Network Hospital of 6500+
- Bharti AXA Smart Super Health Plan allows anyone aged about 91 days till 65 years' entry into the policy and opts for coverage between 5 Lakhs – 1 Crore having a Network Hospital of 4500+
- Care Health Care Plan allows anyone aged about 91 days and above to enter into the policy and opts for coverage between 4 Lakhs – 6 Crores having a Network Hospital of 7800+

- Cholamandalam Chola Healthline Plan allows anyone aged about 18 years till 65 years to enter into the policy and opt for coverage between 2 Lakhs – 25 Lakhs having a Network Hospital of 7250+
- Edelweiss Health Plan allows anyone aged about 90 days till 65 years to enter into the policy and opt for coverage between 1 Lakh – 1 Crore having a Network Hospital of 2578+
- Future Generali Criticare Plan allows anyone aged about 18 years till 65 years to enter into the policy and opts for coverage between 1 Lakh – 50 Lakhs having a Network Hospital of 5100+

3.3 PENSION & ANNUITIES

An Annuity is a financial product that pays a periodical payment to an individual post-retirement. This product is primarily used as an income solution after retirement. An annuity is a contract between the individual and an insurance company in which the individual makes a lump-sum payment or regular payments for a specified period prefixed in the plan, and in return receive regular pay-outs, beginning either immediately or in the future periodically, up to death or expiry of the term. In other words, annuities are contracts sourced and issued by insurers and invest collected funds from individuals in government-guaranteed bonds and securities, mostly debt instruments. Insurance companies selling annuity plans, help individuals address the risk of outliving their savings, especially during post-retirement days.

Key Points

- Annuities are insurance contracts that promise to pay regular income either immediately or in the future to the pension purchaser
- One can buy an annuity with a lump sum or regular payments
- Annuities come in three main varieties—fixed, variable, and indexed—each with its level of risk and pay-out probable
- The income received from an annuity was taxed at regular income tax rates but recently the government has decided not to tax it anymore. So it’s completely tax-free u/s 10(10D)
- Annuities are financial products that offer a guaranteed income stream, to be used primarily after retirement
- The first phase of Annuities is an accumulation phase. During this phase, the fund collected from policyholders either by lump-sum or periodic payments is invested in guaranteed, secured bonds and securities, mainly in debt instruments
- Once the annuitization phase has been reached, the product begins paying out to the annuitant for either a fixed period or for the annuitant's remaining lifetime
- Annuities can be structured into different kinds of instruments—fixed, variable, immediate, and deferred income—which gives investors lots of flexibility to receive the pay-outs

Annuity Objectives

The goal of an annuity is to provide a steady stream of income, typically after retirement. Funds accrue on a tax-deferred basis, can only be withdrawn without penalty after age 60. Many aspects of an annuity can be tailored to the specific needs of the buyer. In addition to choosing between a lump-sum payment and a series of payments to the insurer, you can choose when you want to annuitize your contributions or start receiving payments. An annuity that begins paying out immediately is referred to as an immediate annuity, while one that starts at a predetermined date in the future is called a deferred annuity.

The duration of the disbursements can also vary. You can choose to receive payments for a specific period, such as 15/20/25 years, or the rest of your life. Of course, securing a lifetime of payments can lower the amount of each check, but it helps ensure that you don't outlive your assets, which is one of the main selling points of annuities.

Types of Annuities

Immediate Annuity is an annuity plan which provides consistent income to the annuitant immediately after the ending of the first income period which can be either annually or half-yearly or quarterly or monthly as allowed in the annuity plan. In this annuity plan, the person has to pay a single premium amount to the insurer. In this plan, the annuitant receives more annuity than the regular premium plan immediately till a specified period or lifetime.

Deferred Annuity is an annuity plan in which the annuity is received by the annuitant at a later stage or only after attaining a specified age. In this plan, the purchaser invests his money either through a single premium or a regular premium over a fixed period.

Annuities can be classified into the following categories of annuity and those are (a) number of lives covered (b) mode of payment of premium (c) disposition of proceeds etc.

- Several lives covered annuity has single life annuity and multiple life annuity schemes under it. A Single Life Annuity is an annuity in which a person pays a lump sum and receives an annuity till his death. Multiple Life Annuity as the name suggests can be a Joint Life Annuity where the annuity is paid till the first death occurs and if it is a Joint Life Last Survivor annuity then the annuity is paid till the death of the last person in the group.
- Mode of Payment annuity has Level premium and Single premium annuities under it. Level Premium Annuity is an annuity where the purchaser deposits contribution over some time to receive the annuity after a pre-decided period (accumulation period) in equal instalments. In case of death of the annuitant during the accumulation period, the nominee receives either the surrender value or premiums paid whichever is higher. In Single-Premium Annuity the purchaser pays a single lump sum amount.

- Disposition of proceeds annuity has Life annuity, Guaranteed premium annuity and Retirement Annuity under it. Life Annuity offers a guaranteed fixed regular payment to the annuitant throughout his life. In this plan, once the annuitant demise happens no further payment is done. Guaranteed Payment Annuity as the name suggests, is guaranteed by the insurer. Under this plan, there are two types of schemes available (a) Immediate annuity with guaranteed payment – in this plan annuity payment for several years is pre fixed and paid to the annuitant if he survives or else the nominee receives the remaining annuities if the annuitant dies. This plan also comes with a little variation where the annuitant is paid annuity regularly for a period of 5 or 10 or 15 or 20 years and thereafter if the annuitant survives then till the end of his life. (b) In Deferred annuity with a guaranteed payment plan, the annuity starts either after a later period or after attaining a specified age for a fixed pre-decided period of 5 or 10 or 15 or 20 years and further life time of the annuitant and after his demise, the insurer pays a lump sum amount to the nominee. Retirement Annuity is mostly opted out by employees and this annuity payment starts between the ages 58 – 68 years of the annuitant. Ordinarily, this annuity plan payment is done till the death of the annuitant.

Currently, there are various kinds of Annuities offered by various Government and Private insurers. They are:

- Life Annuity: Regular (Yearly/Half Yearly, Quarterly, Monthly) annuity payouts are made to the annuitant till his death. The annuity pay-out stops after the demise of the annuitant
- Life Annuity with return of purchase price: Regular (Yearly/Half Yearly, Quarterly, Monthly) annuity pay-outs are made to the annuitant till his death after which, the insurer returns the total premium paid to purchase the annuity to the nominee.
- Annuity payable for a guaranteed period: Regular (Yearly/Half Yearly, Quarterly, Monthly) annuity pay-outs are made for a guaranteed period of 5 or 10 or 15 or 20 years. In such a plan the pay-out is paid for the pre-decided fixed number of years irrespective of whether the annuitant is living or dead. The annuity pay-out stops either on the death of the annuitant or completion of the guaranteed period, whichever is later.
- Inflation-indexed annuity: in such policy every year the annuitant gets a rise in the annuity payable at a certain rate fixed by the insurer to take care of the inflation load on expenses.
- Joint Life Survivor annuity: the annuity pay-out is paid to the annuitant till he survives and later the pay-out I made to the spouse till she survives.
- Joint Life Annuity with the return of purchase price: the annuity pay-out is paid to the annuitant till he survives and later the pay-out I made to the spouse till she survives. In case of demise of both the joint-life annuitant the nominee gets the total premium paid to purchase the annuity.

3.4 LET'S SUM UP

In India mostly people do not pay adequate attention to their health and related areas. It is mainly because people are not well educated and the health awareness programs were not very well driven by the government. Then things have started changing in the past few years because of the increase in literacy and government-sponsored awareness campaigns. The statistics show still a very low percentage but if we compare over past few years' numbers then we can certainly see an upward trend. Around 80% of the population are not covered by any Health policies yet. Despite the government's continuous effort and introducing few subsidised health policies, which can be affordable by anyone irrespective of their earning capacity still all need to go a long way in this area. Health insurance in India in the current scenario pays only for inpatient hospitalization and for treatment in Indian hospitals. Health policies do not cover outpatient services in India. On the other hand, Retirement plans are investment plans which help to accumulate a portion of savings over a long period so, that a corpus can be build and available to the investor post-retirement when his regular income is stopped. It also allows financial independence to the investor and takes away all his unnecessary worries. Annuity plans offer a steady income over the long term.

3.5 KEYWORDS

- **Annuity:** A fixed sum of money paid to someone each year, typically for the rest of their life. A form of insurance or investment entitling the investor to a series of annual sums.
- **WHO:** The World Health Organization is a specialized agency of the United Nations responsible for international public health.
- **Critical Illness:** Critical illness insurance provides additional coverage for medical emergencies like heart attack, stroke, or cancer. Because these emergencies or illnesses often incur greater than average medical costs, these policies pay out cash to help cover those overruns where traditional health insurance may fall short.
- **RSBY:** Rashtriya Swasthya Bima Yojana is a government-run health insurance programme for the Indian poor. The scheme aims to provide health insurance coverage to the unrecognised sector workers belonging to the BPL category and their family members shall be beneficiaries under this scheme.
- **Mediclaim:** Mediclaim, often referred to as Mediclaim insurance, is a form of health cover that mitigates your risk in monetary terms. It covers your hospitalization expenses along with any specific ailments and treatments that you incur during hospitalization.

3.6 FURTHER READINGS

- M.N. Mishra: Insurance Principles and Practice, S. Chand & Company Ltd, Delhi.

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- Kothari &Bahl: Principles and Practices of Insurance.

3.7 MODEL QUESTIONS

Q1: What are the major initiatives taken by the Government of India to promote the Indian Healthcare Industry?

Q2: Explain different types of Annuities offered by various Government and Private Insurers.

Q3: Write short notes of the followings:

- Employees State Insurance
- RSBY
- Critical Illness

Q4: Express your view on Health Insurance Industry in Indian Context.

UNIT-4 TAKAFUL (ISLAMIC INSAURANCE)

Structure:

4.0 LEARNING OBJECTIVES

After studying this unit, you will be able to know

- The meaning of Takaful in Islamic Law
- Takaful principles and practice

4.1 INTRODUCTION

Today, insurance has become an unavoidable instrument for human beings regardless of religion. It is mainly due to the complex nature of our lifestyles and business activities. In addition, the government regulation makes us engage with the insurance policy, for example, buying car insurance to renew the road tax. The main purpose of insurance is to provide coverage for the policy holders in the case of any adversity. This noble objective of insurance practices is acknowledged and appreciated since it helps human beings in an emergency. However, the inherited elements in the insurance practices such as interest, uncertainty and gambling make Muslim scholars think to come out with alternative insurance which is not against the teaching of Islam. In 1972, the Malaysian National Fatwa Council and in 1985, Islamic Fiqh academy under the patronage of the Organization of Islamic Conference (OIC) in its resolution no. 9 (2\9) declared that insurance is prohibited from the Islamic perspective.

Human actions are subject to the risk of loss from unpredicted events. According to history that we can trace, it has been found that to relieve this burden of individuals, insurance has been in practice since 215 BC. This concept has been in practice in various forms for over 1400 years. It originates from the Arabic word *Kafalah*, which means "guaranteeing each other" or "joint guarantee". The concept is in line with the principles of compensation and shared responsibilities among the community members. Takaful in Islam is a form of insurance based on principles of support and co-operation, shared responsibility, joint indemnity, common interest and solidarity.

Takaful originated within the ancient Arab tribes as a pooled liability that obliged those who committed offences against members of a different tribe to pay compensation to the victims or their heirs. This principle later extended to many walks of life, including sea trade, in which participants contributed to a fund to cover anyone in a group who suffered mishaps on sea expeditions. In the modern-day practice of insurance, the insurance company sells policies and invests the proceeds for the profit of its shareholders. The company make pay-outs to policyholders as well but it varies depending on the financial performance of the company but a minimum positive return is always contractually guaranteed.

4.2 TAKAFUL (Islamic Insurance)

Takaful is commonly referred to as Islamic insurance; this is due to the apparent similarity between the contract of kafala (guarantee) and that of insurance. However, Takaful is founded on the cooperative principle and the principle of separation between the funds and operations of shareholders, thus passing the ownership of the Takaful (Insurance) fund and operations to the policyholders. Muslim jurists conclude that insurance in Islam should be based on principles of support and co-operation, shared responsibility, joint indemnity, common interest and solidarity.

In Takaful, the policyholders are joint investors with the Takaful operator, who acts as a mudarib – ‘a manager or an agent’ for the policyholders. The policyholders share in the investment pool's profits as well as its losses among themselves. A positive return on policies is not legally guaranteed, as any fixed profit guarantee would be parallel to receiving interest and offend the prohibition against riba (prohibited in Islam). Today, Takaful complies with the Shari’ah (which outlines the principles of compensation and shared responsibilities among the community) and has been approved by Muslim scholars. There is now general, health and life Takaful plans available for the Muslim communities. According to an Islamic scholar, Yusuf Ali, in his translation of The Holy Qur’an, comments on Sura (chapter) Al-Baqara, ayat (verse) 219, "Insurance is not gambling, when conducted on business principles. The basis for calculation is statistics on a large scale, from which mere chance is eliminated. The insurers charge a premium in proportion to the risks, exactly and scientifically calculated".

According to a report by Research and Markets, the global Takaful market is growing at a rapid pace. The estimated worth was roughly around USD 19 billion by the end of 2017, And the Takaful market is expected to grow to $40 billion by 2023. This estimation was done keeping to a large global Muslim population, especially in the Asia-Pacific region. Young Muslims make up about 60% of the community, making the Takaful market even more likely to grow in the future.

Some of the largest names in the Takaful market, according to the report, were believed to be the following:

- Islamic Insurance Company

- Standard Chartered
- Allianz
- Prudential BSN Takaful Berhad
- Zurich Malaysia
- Takaful Malaysia

4.3 TAKAFUL PRINCIPLES

Principles of Takaful

Islamic insurance requires each participant to contribute into a fund or pool which is used to support each other; each participant contributing a sufficient amount to cover expected claims. Few Takaful principles are mentioned below:

- Cooperation among Policyholders for their common good.
- Contribution is paid by every policyholder as a donation to help those that need assistance.
- Losses are divided and liabilities spread according to the community pooling system.
- Uncertainty is eliminated in respect of subscription and compensation.
- It does not seek to derive advantage at the cost of others.

Takaful is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. The purpose of this system is not to generate profits but to uphold the principle of "bear ye one another's burden."

Modus Operandi of Takaful

All participants in Takaful practice contributes to a mutual fund or a common pool. The pool of collected contributions creates the Takaful fund and it is managed by a Takaful Operator on behalf of the participants, who charge an agreed fee. The amount of contribution that each participant pays is based on the type of cover he requires as in conventional insurance (the policy specifies the nature of the risk and period of cover). Takaful Operator charge (costs) includes the costs of sales and marketing, underwriting and claims management etc. Any claims made by participants are paid out of the Takaful fund. And any remaining surpluses, after making provisions for the probable cost of future claims and other reserves, treated as participant's shares in the fund and may be distributed to the participants in the form of cash dividends or distributions. Alternatively, the same is adjusted against the future outstanding premiums, which means a reduction in the premium amount.

Operating Principles

An Islamic insurance company must have the following operating principles:

- It must operate according to Islamic co-operative principles.
- Insurance commission may be paid to or received from Islamic insurance companies only.

- The insurance company must maintain two funds: a participants’ or ‘policyholders' fund and a shareholders' fund.

Policy Holder’s Fund

1. The assets of the policyholders' fund consist of premiums received, claims received, the proportion of the investment profits allocated to them by the Board of Directors and other receipts.
2. All the claims payable to the policyholders, reinsurance costs, technical reserves, administrative expenses, etc., excluding the expenses of the investment department, shall be met out of the policyholders' fund.
3. The balance available to the credit of the policyholders' fund at the end of the year represents their surplus. The General Assembly may allocate the whole or part of the surplus to the policyholders' special reserves and will be distributed among the policyholders.
4. When the policyholders' funds are insufficient to meet their expenses, the deficit is adjusted from the shareholders' fund.
5. The shareholders undertake to discharge all the contractual liabilities of the policyholders' fund, but this liability should not exceed their equity share in the company.

Shareholder’s Fund

1. The assets of the shareholders' fund consist of:
   a. Paid-up capital and reserves attributable to shareholders
   b. Profit on the investment of capital and shareholders' reserves
   c. Such proportion of the investment profit generated by the investment of the policyholders' fund, technical and other reserves as is attributable to them
   d. Miscellaneous receipts
2. All the administrative expenses of the investment department are deducted from the Shareholders' Fund.
3. The balance of the shareholders' surplus, if any, is distributed among them.

Takaful Models

According to the nature of the relationship between the company and the participants, there are various models of Takaful practised. (a) wakalah (agency) (b) mudarabah (c) combination of the two. In the Sudanese Takaful model, every policyholder is a shareholder. According to Shari'ah experts, a Takaful Operator only runs the business on behalf of the participants and no other entity is allowed to manage the business. Whereas, in other Islamic countries, the legal framework does not allow this arrangement and Takaful companies work as separate entities based on mudarabah (in Malaysia) and wakalah (in the Middle East) model.

In the mudarabah model practised mainly in the Asia Pacific region, the policyholders receive any available profit on their part of the funds only. The Shari'ah committee of a Takaful company approves the sharing ratio for each year in advance, most of the expenses being charged to the shareholders.

In the wakalah model, after adjusting management fees and expenses, the surplus of policyholders' investments goes to the policyholders. The shareholders charge the wakalah fee from participant's contributions and this covers most of the expenses of the business. The fee is fixed annually in advance in consultation with the company's Shari'ah Supervisory Board. The management fee is related to performance.

By now it's clearly understood that Islamic insurance, in agreement with the Islamic Shari'ah, is a form of social solidarity (Takaful), based on the principles of trusteeship and cooperation.

1. Unlike conventional insurance, in Islamic insurance, the participants share all risks mutually and there is no transfer of risk is involved
2. Unlike Conventional Insurance Islamic insurance companies are non-profit making, the shareholders not being entitled to share in the profits of the business. They are entitled to charge fees for their services and share in the investment returns of funds managed by them
3. Unlike conventional insurance in Islamic companies; voting rights are available to all participants who pay a certain stipulated amount of contributions
4. In the Takaful system, if the assured dies before the policy matures, the beneficiary is entitled to the whole amount of the premiums, the bonus and dividend and a share of the profits made over the paid premiums, plus a donation from the company out of the policyholder's contributions given based on tabarru. Such a transaction is seen as a mutual contribution towards the welfare of the helpless in society. Where the insured is still alive on the maturing of the policy, he/she is entitled to the whole amount of the premiums, a share of the profit made over the premiums, a bonus and dividends according to the company policy.
5. Unlike a conventional life insurance policy, in the Islamic model, the agents work for the company and thus are paid by the company
6. Unlike conventional system insurable interest under the Islamic model, goes to the assured or his heirs, according to the principles of Mirth or Wasiyyah

Shari'ah Legitimacy

According to Shaikh Yusuf Talal DeLorenzo, Islamic scholar, the position is that unless a financial product or service can be certified as Shari'ah compliant by a competent Shari'ah supervisory board, that product's authenticity is dubious.

Shari'ah Supervisory Board members review the Takaful / retakaful operations, supervise its development of Islamic insurance products, and determine the Shari'ah compliance of these products and the investments. The Shari'ah Supervisory Board have to carry their independent audit and certify that nothing relating to any of the operations involve any element that is prohibited by Shari'ah.

Reinsurance

When the value of insurance risks underwritten is too large for one insurer to accept, companies go for reinsurance to alleviate their risk exposure. In other words, when insurers ensure a risk again with another company, it is called reinsurance. This technique is used to spread the risks and losses across companies, these are called reinsurance companies. The reinsurance contract, for Islamic companies, must be contracted in conformity with the Shari'ah.

Status of Takaful

In modern society, insurance has become a necessity for trade and industry. Life insurance has become the most effective vehicle for mobilising savings, for capital formation and long-term investment, as well as for making provision for old age and grief moments in the case of individuals. On similar lines, Islamic finance continues to expand, and huge demand for other products such as pensions, education, marriage, health and mortgage Takaful plans are witnessed. In the past few years, increasing demand for a Shari'ah-compliant insurance system is seen.

Realising the potential for Takaful insurance and various products is quite huge and substantial, the following factors need to very seriously consider which will further boost growth in the days to come. They are:

1. Islam is the fastest-growing religion and Muslims constitute the second-largest religious group in the world. It is being realised now that a greater inclination amongst the Muslim population worldwide to go in for religion based solutions to the problems they face, be it social-economic or others.

2. If we observe, we will know that despite great efforts insurance penetration in Muslim countries are still very low. And the same observation applies to the Muslim population in other non-Muslim countries. One reason is that the insurance industry operates on a non-Islamic system. Any alternative system, which can provide religious comfort to Muslims, therefore has tremendous potential.

3. Takaful insurance is seen as more ethical, more balanced for all the stakeholders and less exploitative. It is a fairer and more transparent system. In traditional insurance, the premium paid becomes dead expenditure without any corresponding benefit if there is no claim. Given the uniqueness of the Takaful system, it has the potential to become very popular with the non-Muslim population also. Policyholders under this system know upfront the formula and mechanism for-profits sharing. Profit-sharing is a great attraction.

Takaful business is sustainable and has been operating for more than two decades now in various countries offering Takaful products to meet the needs of all sectors of the economy at the corporate and individual level. Takaful exclusive insurance companies are operating in many countries and many traditional insurance companies are operating with “Takaful Window.” There are companies now operating as Retakaful providers also. Malaysia was the first country to come out with the Takaful Act 1984 modelled after the traditional existing insurance Act. This act provides for the procedure for registration of Takaful providers and establishes the conditions under which they will operate. It requires the operator to establish a Shariah Committee to monitor and certify Shariah Compliance. Countries like Pakistan and Srilanka has introduced certain Takaful products in their country.

As far as India is concerned, takaful insurance and its products are not yet popular even though there is great potential for Takaful given the substantial Muslim population and also keeping in mind the uniqueness of Takaful insurance which makes it attractive to non-Muslims (Takaful). According to the recent news, GIC is thinking of going in for Re-takaful. Realising the great potential Reliance Life has come out with plans where the investment of funds is made in Shariah-compliant mode. Though this is not a Takaful product per se, it is indicative of the shape of the things that come in the future.

To promote Takaful in India IRDA need to focus to develop the required regulatory framework. By introducing the Takaful in India hopefully, the challenge of penetration of Insurance in India can be partly addressed. But responsibility also lies with the Muslim community in India, especially the educated class to take initiative to develop a class of people who are not only well-versed with Islamic teachings, Quranic injunction, sayings and traditions of the prophet of Islam but also have sound knowledge of modern-day economic principle and practices. Unless there are qualified and competent people with proper understanding and insight into the Islamic Shariah and the way the modern economies are run, it will be difficult to constitute the Shariah board to supervise and certify Takaful. This is a basic requirement if Takaful is to take root in India.

4.4 LET'S SUM UP

If the historical development of insurance is carefully studied, it is indisputable that since conception insurance has become a necessity in our daily life. However, due to the involvement of prohibited and unethical elements defined in Shariah such as interest, gambling and uncertainty which are practised in conventional insurance, the Muslim community could not involve themselves much, hence, it is necessary to move a step forward to find a way to overcome this problem. A way out to this is to introduce takaful along with guidelines to conventional insurance companies to open takaful windows. . According to various surveys in India at different times, it has been evident that takaful is accepted regardless of religion. If IRDA and the Indian government takes initiative to offer takaful in India for the benefit of all involved parties, then the people of India and specifically the Muslim community will be benefitted to a large extent in turn. Will promote penetration of insurance deeper in our country.

4.5 KEYWORDS

- **Takaful:** Takaful is a type of Islamic insurance wherein members contribute money into a pool system to guarantee each other against loss or damage. Takafulbranded insurance is based on sharia or Islamic religious law, which explains how individuals are responsible to cooperate and protect one another.

- **Kafalah:** A contract of guarantee or surety that provides assurance in terms of performance and value when the object of the transaction is exposed to adverse.
- **Reinsurance:** Reinsurance is the practice whereby insurers transfer portions of their risk portfolios to other parties by some form of agreement to reduce the likelihood of paying a large obligation resulting from an insurance claim.

4.6 FURTHER READINGS

- M.N. Mishra: Insurance Principles and Practice, S. Chand & Company Ltd, Delhi.
- Indian Institute of Bankers (Pub) Commercial Banking Vol-I/Vol-II (part I&II) Vol- III.
- Hota P.K., and Das S.K. Financial Literacy and Banking, Kalyani Publishers
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- G. Krishnaswamy: Principles & Practice of Life Insurance
- Kothari &Bahl: Principles and Practices of Insurance.

4.7 MODEL QUESTIONS

Q1: Give a brief introduction on Islamic Insurance: Takaful.
Q2: Discuss on the status of Takaful in the Modern Society.
Q3: Explain about various operating principles and models of Takaful.
Q4: Write short notes on the followings:

- Reinsurance
- Takaful
- IRDA
- Shareholder’s Fund

UNIT-5 INSURANCE UNDERWRITTING

Structure:

5.0 LEARNING OBJECTIVES

After studying this unit, you will be able to know

- The meaning of Underwriting
- Usefulness of Underwriting in insurance
- The Process in Life & General insurance

5.1 INTRODUCTION

Insurance is the transfer of risk and Insurance companies are in the business of accepting the risks. Insurance Underwriting is the process by which an insurance company selects the life or non-life cases to be accepted to offer coverage on its terms and conditions and price. In other words, underwriting denotes acceptance of risk on a Proposal. Insurance contracts are based on the principle of (viii) “uberrimaefidei”, meaning “utmost good faith”. The person taking the insurance policy is required to disclose all the facts impacting the assessment of risk truthfully and completely about the subject matter of insurance, to the Insurer to enable the insurer to correctly assess the risk on hand. If the principle of utmost good faith is compromised, the insurer has the right to cancel the contract or deny payment of Policy benefits. A person who does the underwriting for the insurance companies is called an underwriter. They are responsible for assessing the loss potentials of each proposed case using the information provided by the client.

5.2 WHAT IS UNDERWRITING ?

Underwriting is the process by which an insurance company selects or classify the risk exposure of life or non-life cases to be accepted to offer coverage on its terms and conditions and price. Insurance underwriters are professionals who evaluate and analyse the risks involved in insuring people and assets on behalf of the insurance company and fix pricing to accept the same risks. The term underwriting means receiving remuneration for the willingness to pay to accept a potential risk. The insurance underwriter's vital function is to accept the risk involved in a contract with an individual or entity. The essential objective of underwriting is to produce a profitable booking of business hence, constantly endeavours to select sustainable types of insurance proposals and rejects others to obtain a profitable range of insurable risks.

Underwriting is the most important department of an insurance company because if they follow a too-aggressive policy to accept the risks then there is a very high possibility that the company need end up paying too many claims which could compromise on their earnings and if the underwriter follows a very conservative approach in accepting the risk then they will be outpriced by the competitors and may lose out in the market. An underwriter should always remember that his most important objective is to assess the risks accurately of those who submit their proposals and once risk is assessed put them into appropriate classified groups. Broadly underwriting deals with expectations or probabilities rather than certainties.

Conceptually underwriting constitutes of two elements and they are (a) Selection - is a process in which an underwriter (on behalf of insurer) evaluates individual application (proposal) for insurance to determine the degree of risks involved in it and (b) Classification – is the process of assigning a proposed insured to a group of insureds of the same expected loss probabilities as the proposed risk.

5.3 METHOD OF UNDERWRITING

The underwriting process starts with formulating the insurance company's policy. This policy establishes and outlines the framework within which the underwriter should function and make underwriting decisions. The policy clearly states and specify the coverage amount permitted on various types of risk exposure, geographical areas etc.

The first level of underwriting is done by the field force of the insurance company which is otherwise known as field underwriting. The field force or agents are trained regarding the quality of proposals to be accepted and prohibitions etc. Once the proposal is sourced then the actual underwriting takes place to decide whether it can be accepted or rejected.

5.4 UNDERWRITING PROCESS

Life Insurance – Underwriting

By now we understood that Insurance is all about the transfer of risk and Insurance companies are in the business of accepting the risks. Underwriting denotes acceptance of risk on a Proposal. It is the judgement of the insurance company to take the risk based on the assessment of the extent of risk. But underwriting methodology applied for life insurance is quite different from other forms of insurance because in life insurance the risk of the client is assessed in the beginning and then the risk cover continues for a long term.

Insurance contracts are based on the principle of "uberrimae fidei", meaning "utmost good faith". The person taking the insurance policy is required to disclose all the facts impacting the assessment of risk truthfully and completely about the subject matter of insurance, to the Insurer to enable the insurer to correctly assess the risk on hand. If the principle of utmost good faith is violated, the insurer has every right to cancel the contract or deny payment of Policy benefits.

While underwriting proposal forms, the extent of risk assessment is done considering one of the following decisions:

- Acceptance of risk and issuing a Policy
- Whether the normal premiums or extra premiums to be charged bearing in mind the increased risk on the proposal. For example, insuring persons with a history of some illnesses or disorders
- Whether the risk on Proposal should be postponed considering the current state of health
- Whether the risk on Proposal should be declined seeming severity of the risk
- Circumstances when the Proposal may be accepted subject to exclusion of payment of benefits under certain circumstances i.e. no payment of any benefit if death occurs due to suicide within1 year from the date of commencement of the Policy or date of reinstatement of Policy
- Circumstances when Proposal can be accepted subject to co-sharing basis (usually in health claim Policies), i.e. where part of the benefit is not paid. For example, with the co-sharing option, only 80% of the claim amount is paid under the insurance policy.
- Imposing a reducing lien on benefits – i.e. on Policies where the extra risk subsides over a period, imposition of a lien (non-payment or reduction of benefit payments) till such time the risk persists

In life insurance underwriting following steps are practised in sequence. They are:

Quality of Proposal Form

Once the Proposal forms are sourced by the field personnel such as agents or field officers and brought to the insurance office the official underwriting process starts. The application is first gone through to make sure the information provided is complete and correct. These forms generally contain a name, age, date of birth, address, gender, income, occupation, habit, marital status and occupation etc. of the proposer or to be insured. It also contains how much life cover is applied, which plan opted for, nominee details and relationship, family details with age and cause of death if any etc. With all this information in hand, the underwriter assesses the risk and in case of any doubts, the underwriter may further ask for additional information or may ask the, to be insured to undergo medical examination before accepting the proposal.

Medical Examination

While underwriting using the information provided in the proposal form the answers to medical questionnaires and family history details are very critically evaluated by the underwriter. And if required the client may be asked to undergo a medical test at the company's expense. This medical test is a simple check-up with the doctor recommended by the insurance company. After the medical examination, the results are sent to the underwriter for evaluation. This step involves looking at the results of one's paramedical examination very carefully. The information used by the underwriter is mainly (a) basic measurements - regular metrics like height, weight, blood pressure (b) blood test - a blood test can get a lot of information on potential health risks such as heart disease, stroke, diabetes, and blood-borne illnesses etc. and (c) drug test - urine test for a full drug panel will alert the underwriter to the use of drugs, smoking and alcohol consumption.

Underwriting Review

Once all the information on the proposal form are assimilated and the medical examination reports are received on the table then the underwriter decides whether to accept the proposal or reject it. At this stage the underwriter also fix the premium amount as normal or in case the underwriter finds the risk cover is more, then a revised premium may be suggested to the client. At the same time if the underwriter finds the client's risk profile is more than the risk which the insurance company is willing to cover, then the application will be declined.

Policy Writing

After completion of the underwriting process, the instructions from the underwriting department is passed on to the policy writing department to prepare policy document contracts and then verified their correctness.

The tendency on the part of the Proposer (Prospective Customer) to conceal or make misstatements or not making complete disclosures about the subject matter of insurance, to get insurance at favourable terms is called "adverse selection". This is a risk which insurer has to counter by putting effective risk control measures. So, call for medical examination beyond a particular age or where there is suspicion based on disclosures made in the Proposal form (Application form) for Life insurance is initiated.

Standard lives & Sub-standard lives

Standard life exposes the insurer to a normal risk, i.e. falls in line with when compared to the mortality indicated in the mortality table. A mortality table gives the statistics on several persons dying at each age which is used as the basis or benchmark for calculating the base premiums.

However, if the individual life which is considered by the insurer, shows a higher chance of mortality than the standard lives in the mortality table, it would be termed as a Sub-standard life and the insurer takes an extra risk and will have to therefore put additional risk controls like imposing extra premiums etc. Under certain circumstances, the risk under Substandard lives can also be postponed and in extreme cases can also be declined if the risk is adverse.

Factors that are mostly considered while underwriting a proposal form by the insurer are personal health history, family history, occupation history, personal habits & living style, financial status, place of risk etc. Based on the mortality assumptions the underwriter assesses the risk as per the standards laid down by the Company. As per IRDAI guidelines, there has to be a Board-approved Underwriting Policy in place. This Policy gives a broad framework for Underwriting, within which the Company's Chief Underwriter will have to finalise his/her Underwriting manual.

Section 64VB of the Insurance Act, 1938, states that no risk on an insurance proposal can be accepted by the Insurer, unless, among other things, an amount equal to the first premium is received by the Insurer in advance. Therefore, an amount equal to the First premium is usually accepted along with the Proposal Form.

Concept of Human Life Value & Insurable Interest

In the underwriting phase, it's important to calculate the HLV of Life Assured and carefully validate insurable interest in the case of proposed cases. While Human life value determines the extent to which an insurance cover is needed by an individual, Insurable interest is verified to ensure the risk on Life Assured's life is not further increased. Human Life Value is necessary to calculate to avoid moral hazards, a scientific way of placing a limit on the sum assured. Another hand Insurable interest should be established before admitting the proposal because by accepting a proposal on someone's life, we should not increase the lifetime risk on him/her under any circumstances.

Example: Husband can propose insurance in his spouse name because a person has unlimited insurable interest on his/her own life or that of his/her spouse. Whereas, if someone takes a policy in the name of the neighbour or friend then the Underwriter must carefully question the very purpose of insurance as there is no insurable interest present between the parties.

Non-Life Underwriting

Unlike life insurance underwriting, non-life insurance underwriting of commercial establishments, businesses are much more complicated. Because the commercial establishments may be as small as a small shop or as big as a factory or a large corporate. The degree of complexity of the underwriting varies with the size of the business house. While underwriting the underwriter evaluates the hazards associated with the risks and tries to understand the risk profile. The information related to hazards is available to the underwriter from Proposal Form, Agent/Broker Report, Prior Experience based on the history of claims and premium payment records, Physical inspection report etc. In case the underwriter is unable to conclude further physical inspection by company authorised person is called for.

Health Policy Underwriting

Medical underwriting is an evaluation process for health insurance coverage by examining the applicant's medical history. During the medical underwriting process, insurance companies examine the medical history, demographic profile, lifestyle, habits and other factors that may relate to a candidate's current and future medical needs. Through actuarial analysis, an estimate of the risk associated with providing health coverage to that person is determined and priced. The price of coverage is determined by the risk factors of the applicant. Medical underwriting may be undertaken for an individual or a small group, such as a company seeking coverage for its employees. In this case, individual scrutiny would not be feasible when setting rates for a large company. For high-risk applicants, underwriting follows a health insurance company's policies and prevailing state regulations and may exclude coverage for certain conditions or may offer the coverage at a very high premium or may even deny the coverage completely.

5.5 LET'S SUM UP

Underwriting is the process, by which insurers determine and decide the financial risks of insuring either an individual life or an institution. It involves the insurance company determining whether a life risk or risk on business a firm possess if it does, calculating a fair price for the coverage. Underwriting is the most important department and underwriters are the risk control managers of an insurance company. As an insurance company employee, an underwriter represents the insurer, not the customer, in the purchase of plans transaction. They help the organization to keep experience within the mortality assumption used in calculating the premium rates, which helps the company to offer insurance cover at competitive terms and offer cover to as wide a group of lives as possible. Underwriting has an important function in the financial world for a list of reasons and they are (a) Assessing the degree of risk whether it is an individual life or an institution (b) Establish fair rate (c) Fixing the right premium to cover the real cost of insurance (d) Ensuring proper assessment and coverage (e) helping investor in right decision making etc.

5.6 KEYWORDS

- **Underwriting:** Underwriting is the process through which an individual or institution takes on financial risk for a fee. Underwriters assess the degree of risk of insurers' business.

- **Utmost Good Faith:** It is the name of a legal doctrine which governs insurance contracts. This means that all parties to an insurance contract must deal in good faith, making a full declaration of all material facts in the insurance proposal.
- **Insurable Interest:** Insurable interest is a type of investment that protects anything subject to a financial loss. A person or entity has an insurable interest in an item, event or action when the damage or loss of the object would cause a financial loss or other hardships.
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5.7 FURTHER READINGS

- M.N. Mishra: Insurance Principles and Practice, S. Chand & Company Ltd, Delhi.
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- G. Krishnaswamy: Principles & Practice of Life Insurance
- Kothari &Bahl: Principles and Practices of Insurance.

5.8 MODEL QUESTIONS

Q 01: Explain the concept and meaning of underwriting.
Q 02: Write on the method and process of underwriting
Q 03: What is the difference between standard lives and sub standards lives?
Q 04: Write short notes on the followings:

- Policy Writing
- Utmost Good Faith
- Insurable Interest