EXPOSURE DRAFT

July 16, 2010

To

ALL INSURERS/INSURANCE INTERMEDIARIES/CONSUMER BODIES/GENERAL PUBLIC

Persistency of Life Insurance Policiesâ€ ” an exposure draft

Introduction

â€˜ Persistencyâ€ ™during a period may be defined as the proportion of policies remaining in force at the end of the period out of the total policies in force at the beginning of the period. In other words, persistency is the percentage of business retained without lapsing or being surrendered. Low lapsation means high persistency and vice versa.

Insurers as well as Intermediaries have a responsibility of ensuring a high persistency ratio of life insurance policies. The financial impact of lapsation is significant for all stakeholders. It adversely affects the policyholder, the insurer and the agent. For the policyholder it not only means forfeiture of premiums paid but also loss of protection. For the insurer, the cost of acquisition is not fully recovered. For the agent it means loss of renewal commission. Lapsation of policy can be disruptive for the life insurance industry at large.

Impact on insurer

Insurer, as business owner, is better placed to control lapsation and thereby improve persistency. Persistency is a key factor impacting the financials of an insurer. Considering the voluntary element involved, there are constraints in estimating its future value based on the past experience. Insurance companies incur high expenses at the time of sale of a policy. The loading in the premiums to recoup these expenses would be spread over a number of years during the term of the policy. Poor persistency, therefore, would mean to losses to insurers.

Due to selective withdrawals/lapses, the average mortality of the remaining policyholders would make premiums insufficient to cover the risk. Poor persistency also reduces the profits in absolute amounts due to lower volumes of policies in force thus increasing the cost of capital. Further, poor persistency renders the loading for per policy expense in the premium insufficient leaving the extra burden not only on the insurance company but makes insurance costlier for new policyholders. Thus the impact of poor persistency is cyclical in nature.

Early lapses/surrenders result in poor paid-up/surrender values causing damage to the reputation of the company, which in turn results in further lapses or poorer persistency. Thus, persistency being one of the key drivers of profitability in life insurance business, declining persistency levels would mean increased pressure on revenue. The data relating to persistency over the last 5 years clearly shows a declining trend and this is a concern for life insurance business. Please refer **Annexure A** for insurer-wise data.

Product design and persistency

Product design has an impact on lapsation. Insurers have to design products that meet the long terms needs of the customer thereby motivating them to persist with their policies. Also, if product performance is not as good as expected or the product has more flexibility designed into it, people might let their policies lapse by planning contribution breaks. Time and trigger for this action might vary. Some may actually switch to better products and obtain value out of it. Proper product design is therefore crucial to persistency.

Many times it is the gap between the need of the policyholder and how the product meets that need that leads to lapsation . The bonus rates may no longer be attractive, or the policy fund value does not accumulate at the expected rate. It is also possible that policyholder may not be aware of the cost-return trade-off to set proper expectations of returns. For instance, majority of Unit linked policyholders do not know the mortality and expense charges and other such policy charges get deducted periodically from available policy value.

Premium collection methods and practices followed by insurers also have an impact on persistency.

Policyholderâ€™s circumstances

A policy may become unaffordable or unsuitable because of changes in a policyholderâ€™s circumstances that cannot be foreseen at the time of sale. For example, unexpected changes to a policyholderâ€™s income will affect whether they can afford regular premium products. A change in jobs can also affect persistency. If for example, someone moves to an employer offering an occupational pension scheme he or she may discontinue an existing pension policy. Changes in health status may also impact persistency.

Servicing aspects

Policyholders who had repeated unpleasant experience with the services of an insurance company or the agent, most typically, would prefer to end their relationship with the company. One example could be that the sales literature distributed during the sale process may not provide adequate disclosures in an easy to understand way of all the risks and costs associated with the product. If the actual experience turns out to be different, the policyholder is disappointed not only with the product but also with the agent. They feel that loyalty is abused in such instances. Similarly, if the insurance companies do not upgrade their services and are not competitive in using technology, policyholders think they are deprived of the benefits.

Economic environment

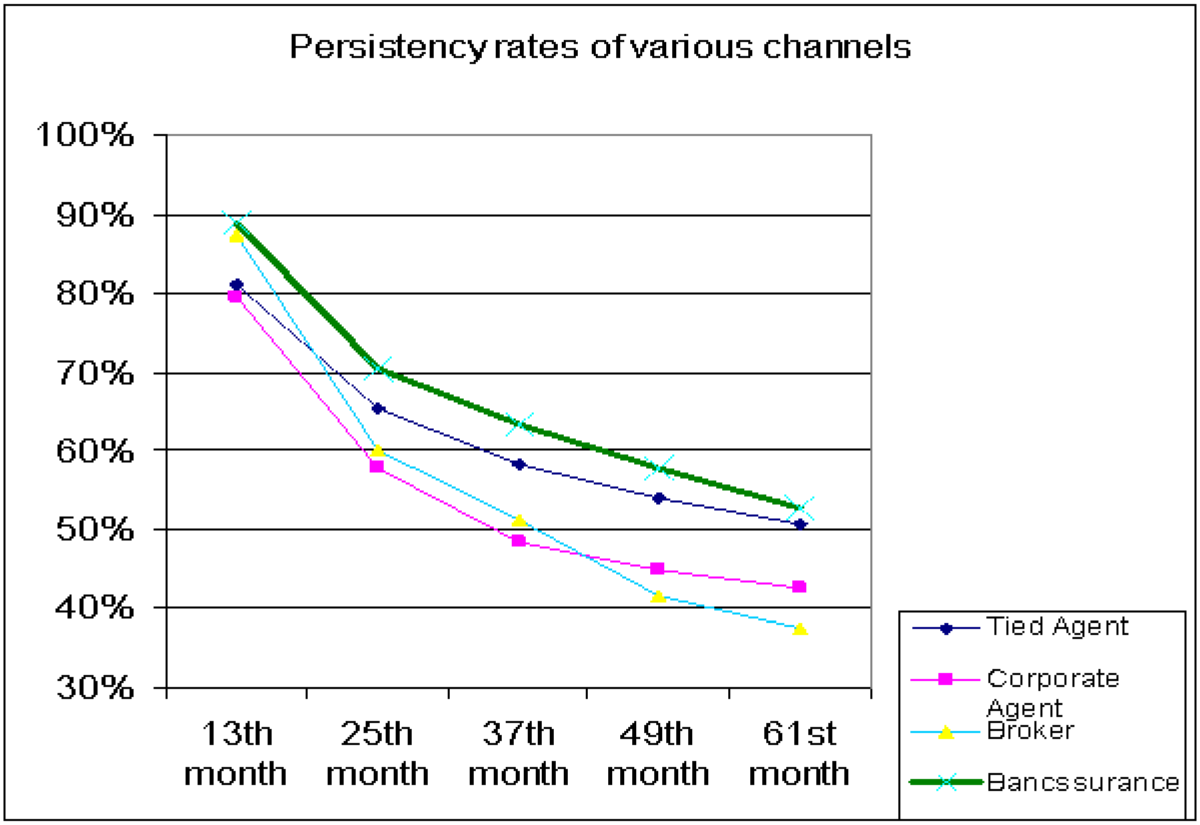
In additional to personal circumstances, persistency may be affected by the overall economic environment. So, where economic growth and employment levels are high, fewer policyholders will be under the kind of financial pressure that would cause them to lapse their policy. Whereas if economic conditions are difficult and unemployment is increasing, more policyholders will be under financial pressure, and savings and protection policies may be lapsed or surrendered to obtain cash or to reduce financial outgo.

Distribution channel

Next we come to what is perhaps the most crucial element in ensuring high persistency levelsâ€ ” the distribution channel. Distribution channels play a crucial role in affecting the persistency of insurance policies. The intermediary has to build a good rapport and credibility with the clients and also build faith in the company. He/She should advise the clients keeping in view of the clientâ€ ™s needs of insurance rather than the levels of remuneration or other incentives he/she receives from the insurer or client.

After designing an insurance product, the insurance company has to choose appropriate mix of distribution channels to reach the customers. In fact the distribution channels influence the pricing as well as designing of the product. Different distribution channels suit the distribution of different types of product. For instance, more complex products are better sold through â€ ˜ Brokersâ€ ™. Some simple Term Assurance products are suitable for sale through internet. Similarly different distribution channels appeal to different socio economic sections of people.The most common distribution channels that exist in the present scenario are Tied individual agents, Corporate agents, Bancassurance, Brokers and Direct marketing

The approximate average persistency rates observed under different distribution channels during the period 2004-05 to 2006-07 (3 years) is as represented
below:



Note: *This approximation is based on the data collected for IRDA study on â€˜ Lapsation and its impact on Indian Life Insurance Industryâ€™. The data excludes PSU.*

***Bancassurance*:**

The brand name, large customer base, capital strength, enormous outreach to the rural population across the length and breadth of the country, trustworthiness, the loyalty factor that the customers have in the banks enable Bancassurance to be a reliable and cost effective way of distributing insurance policies. Banks which act as Bancassurance agents can also determine the capacity and investment psychology of the customer by proper analysis of the transactions he/she has made and hence it can suggest optimum levels of insurance that the customer needs.

Cost in Bancassurance channel would also be lower when compared with other channels. This may be attributed to various reasons . For any distribution channel the first step would be to find a prospective customer and then to go to him personally to persuade him to buy insurance by explaining the need for insurance and how the proposed insurance best suits his needs. The first part of identifying a potential customer is easier with Bancassurance as the bank would have a readily available customer database with it and this is typically a large/substantial one. Also, the bank customer would be expected to have a minimum level of financial sophistication as compared to the general population, on an average. This makes the second part of the marketing easier than other channels. This also saves the cost involved in meeting the customer personally and convincing him about the need for insurance and making him recognize that the proposed product will cater to his needs.

The above factors have probably contributed to the highest persistency in the channel among all channels. However, it may be noted that it may take a few more years for stable trends to emerge under this channel.

Corporate agents excluding Banks:

This channel had shown the poorest persistency rates in the first three policy years. This indicates a scope to improve the quality of sales. However, again, in order to observe stable trends we would need data of a few more years.

Brokers:

It may be expected that the level of mis-selling would be minimal under this channel. This is because the target market would be generally more financially sophisticated than the other channels. Also, some times the sale would be client initiated. As the channel is expected to have thorough familiarity with all the products available in the market, there is more chance that the best fitted product would be suggested to the client. However, surprisingly, barring the 13^{th} month, persistency under this channel was observed to be poorer than under the tied agents and the Bancassurance channels.

Tied Agents:

This is the main traditional channel in the current scenario of Indian market. The primary advantage of this channel is its greater ability to reach the customer resulting from its wider spread across the entire spectrum of the society compared to the other channels. This is possible because an agent living in a locality for many years will have greater acquaintance with the people of that locality and will have better understanding of the needs of the people. He/She can also have credibility built with the customers. This channel best suits to tap the rural markets.

The profile of the agents may not be up to the required standards-- that they are sufficiently knowledgeable regarding various products available and their suitability to particular circumstances. This poses a serious restraint on the persistency of the policies under this channel. Also many of the agents take insurance policy distribution as an auxiliary occupation and lack in professionalism. This is also one of the factors adding to the reduced persistency. The large difference between the initial and renewal commission rates would also affect the persistency in later policy years.

Need to increase professionalism of agents

Insurers would have to ensure that intermediaries are trained adequately to ensure proper servicing of policyholders. Failure of agents has often resulted in high lapsation rates in some of the new and emerging companies. There are several causes of decline in persistency that are linked to agents. The primary one, as we have already seen, is mis-selling. If policyholders have bought policies on the basis of good and proper advice, they would not normally give them up unless there are unforeseen changes in circumstances. But where they have been sold a policy without proper advice, for instance on the actual cost or installments to be paid, they may have no option but to cease or reduce the premiums.

It is therefore not incorrect to conclude that professionalism among the agency force is largely lacking. This prompts the Authority to review the existing Regulations and Guidelines relating to Agents. There is a need to set certain minimum standards and requirements for agents and mandate insurers to review the performance of agents periodically. There are several demands for revamping commission structures in a bid to increase agency income. This would only mean increase in acquisition costs, the burden of which would ultimately fall on the policyholder. On the other hand, persistency would ensure regular inflow of income to agents through renewal commission. It would also mean lesser acquisition costs for the insurer and protection for the policyholder.

Another cause of lapsation linked to agents is high levels of attrition. Where agents are groomed to become true professionals and build a long term career, attrition would be less and persistency would certainly be better. It is necessary to have an environment where agents take their career seriously.

The Authority, therefore, considers it necessary to provide for a framework that would stipulate certain minimum requirements for agents, in terms of performance. Some of the criteria suggested by industry stakeholders are listed below:

(1). Where average annual persistency ratio is less than 50%, the agency licence would not be renewed.

(2). The minimum number of policies per agent shall be 20 per annum.

(3). The minimum First Year Premium Income to be procured by an agent would be Rs.1, 50,000 per annum.

(4). Where an agent falls short of achieving either (2) or (3) listed above, he or she would have to achieve proportionately more in either one to make up for the shortfall in the other.

(5). Spouses and close relatives of employees of insurers shall not be engaged as agents by insurers.

(6). Further, there shall be a disincentive for lapsation in the form of commission claw back by the insurer, on a proportionate basis. Alternatively, a part of the first year commission shall be withheld to be paid based on persistency in later years.

The above proposals would be a step forward in protecting the interests of policyholders, who in the ultimate analysis stand to gain if persistency is high, both in terms of protection of life and profitability of life insurance business which would benefit them in the long run.

The Life Insurance Council, the General Insurance Council, Insurers, Consumer Organisations and the general public are requested to submit their comments to ypriyab@irda.gov.in **on or before 31st July, 2010.**

(A.Giridhar)
Executive Director

Encl**: Annexure A (attached as .xls file)**