Roots Institute of Financial Markets

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Study Notes

Risk Analysis and Insurance Planning

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Forward

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Risk Analysis and Insurance Planning

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CHAPTER

5

THE INSURANCE CONTRACT

A. Requirements of an insurance contract

B. Distinct legal characteristics of an insurance contract

C. Basic parts of an insurance contract

D. Meaning of insured

E. Endorsements/riders

F. Common types of deductibles

G. Co-insurance, Nature, purpose and problems

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Section 2(h) of the Indian Contract Act, 1872 has laid down that “an agreement enforceable by law is a contract”. In order words” a contract consists in an actionable promise or promises”. Agreements of casual nature don’t give rise to contract in the legal sense. When a person invites another to go for a movie or to have dinner together and the invitation is accepted, there is an agreement between them. Neither party to the agreement, however, intends that legal consequences should result from the agreement. Hence a contract is an agreement designed to have legal consequences.

This definition concerns any ordinary contract based on the principle of Caveat Emptor meaning thereby let the buyer be aware. The contract of insurance is based on the principal known as uberrimae fides i.e. of the fullest confidence or of the utmost good faith

A contract is said to be unberrimae fide when the promise is bound to communicate to the promisor every fact and circumstances which may influence him in deciding whether to enter into contract or not. Contracts which require unberrimae fides are those entered into between persons in a particular relationship, e. g. guardian and ward, advocate and clients, insurer and insured param vishwas.

[A] Requirements of an insurance contract

A contract is basically an agreement between two or more parties. All agreements are not contracts but all contracts are agreements.

An agreements is defined under section 2 (e) of the Indian contract act, 1872 as every promise and every promise and every set of promises forming the consideration for each other, is an agreement , Section 2(h) of this Act defines a contract as an agreement enforceable by law is a contract

To be legally enforceable, an insurance contract must meet following requirements:

1. Intention to create legal relationship
2. Offer and acceptance of the terms of the contract
3. Consideration the value that each party exchange
4. Legally competent parties, with legal capacity to enter into a binding contract.
5. The contract must exist for a legal purpose.
6. Consensus ad idem (genuine meeting of mind)
7. Legally of object or purpose
8. Capability of performance

Insurance is a specialized type of contract. Apart from the usual essentials of a valid contract, insurance contracts are subject to two additional principles viz. Principle of utmost Good Faith & Principle of Insurable Interest. These apply to all insurance, both life and non-life.

1. **Intention to create legal relation:**
The intention of the parties entering into the contract has to be legal in nature. In Life Insurance Contract/Policy the intention is to assure families and therefore it is legal in nature. That is how insurance on the life of the stranger is illegal. Or taking insurance on the life of girl friend or a boy friend is not allowed. You cannot make a stranger as a nominee.

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2. Offer & Acceptance

There has to be an offer by one party and acceptance by the other party. The proposed offer and the insurer (underwriter on behalf of the insurer) accept. Therefore there is an offer and an acceptance.

3. Consideration

There has to be a consideration involved in the contract. Premium needs to be paid regularly to keep the contract in force. This premium is the consideration. Although in an ordinary commercial contract, the consideration can be past, present or even future. Definition of consideration is "when at the desire of the promisor, the promise or any other person has done or abstained from doing, or does or abstain from "consideration" for the promise. "but in the contract of insurance the consideration has to be tendered in advance and Section 64 VB laid down that No insurer can assume the risk unless premium is received in advance.

4. Capacity to contract

The parties entering into the contract should be having the capacity to contract. In the contract of life insurance, the insured has to be a major and with a sound mind. The agent has to be a licensed agent who will then work on behalf of the principal.

5. Certainly of terms

The terms of the contract should be clear and definite. The sum assured, premium payments, age and other terms are very clear and definite.

6. Consensus ad idem

The agreement by contracting parties to identical terms that is necessary for the formation of a legally binding contract. In contract of insurance, both the parties i.e. insured and insurers are in agreement to the terms of the policy.

7. Legality of purpose

The purpose of the contract has to be legal in nature. The purpose of the contract of insurance is legal in nature.

8. Possibility of performance

The contract should be one which can be carried out. In contract of insurance both the parties involved have the possibility to perform because the insurer can pay the claims and the capacity to pay the premiums.

[B] Distinct Legal Characteristics of Insurance Contract

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It goes without saying that insurance is a specialized type of contract. Apart from the usual essentials of a valid contract, insurance contracts are subject to two additional principles viz. Principle of Utmost Good Faith & principle of Insurable Interest. These apply to all insurances both life and non-life.

Commercial contracts are normally subject to the principle of caveat emptor i.e. let the buyer beware. It is assumed that each party to the contract can examine the item or service, which is the subject matter of the contract. Each party can verify the correctness of the statements of the other party. There is no need to take the statements on trust. Proof can be asked for.

In the case of insurance contracts especially life insurance, this principle does not apply. Most of the facts relating to health, habits, personal history, family history, etc, which form the basis of the life insurance contract are known only to the proposer does not disclose them. The underwriter can ask for a medical report. Yet there may be certain aspects, which may not be brought out even by the best medical examination. For example a person suffering from Blood Pressure or diabetes can through appropriate medication, hide these facts from the examining doctor. History of past sickness, operations, injuries can be supposed. Some of these may affect the life expectancy of the proposer. Hence, these constitute material information from the underwriter's point of view. Similarly in general insurance, an inspection of the premises may not disclose that the contents of the go down have been temporarily relocated. Non-disclosure of such facts would put the insurer as well as the community of policyholders, at a disadvantage. When a proposer puts an insurer and the community of policyholders at a disadvantage, there is what is called adverse selection. The contract is unfair, because one of the parties to the contract is in more advantageous position. Faith is a key to any transaction, agreement leading to contract. But in insurance contracts it is required to be observed in more onerous way. The proposer has a legal duty to disclose all material information about the subject matter of insurance to the insurers who do not have this information. Material information is that information which enables the insurers to make an underwriting decision that is the decision (1) whether to accept the risk: and (11) the rate of premium and terms and conditions of acceptance. The duty of disclosing material facts ceases when the contract is concluded by the issue of FPR (subject to the above condition) cover note or a policy. The duty arises again at the time of revival or reinvestment of policy in Life Insurance or at the time of renewal of the policy in general insurance. Insurance contract are generally considered contracts of adhesion because the insurer draws up the contract and the insured has little or no ability to make material changes to it. This is interpreted to mean that the insurer bears the burden if there is any ambiguity in any terms of the contract.

Insurance contracts are already in that the amounts exchanged by the insured and insurer are unequal and depend upon uncertain future events. Insurance contracts are unilateral meaning that only the insurer makes legally enforceable promises in the contracts. The insured is not required to pay the premiums, but the insurer is required to pay the benefits under the contract if the insured has paid the premiums and met certain other basic provisions.

[C] Basic Parts of an Insurance Contract

Insurance is a contract. The sakes in the contract are usually large and those interested in the stakes, many. One party, namely, the insurer, contracts with another, the policy holder to perform a particular service. There

could be disputes involving the insurer and the insured or the insurer and the beneficiaries of the policy or between the beneficiaries. The terms and conditions of the policy will provide the grounds to decide the issues in the dispute. These terms will be based on and will relate to statements and action at various times during\g the course of the policy. These will have to be proved through documents.

1. Prospectus proposal Forms

The IRDA (protection of Policyholders Interest) Regulations, as amended in October 2002, stipulate that the Prospectus of brochures issued by the insurer, should explicitly state the scope of benefits, conditions, warranties, entitlements, exceptions, right for participation in bonus, etc., under each plan of insurance. If the right to participate in bonus is deferred for some time after commencements of the policy, that fact should be explicitly stated. There should also be clear statements as to what are guaranteed benefits and what are not guaranteed and also a statement that the non guaranteed benefits in the future may not be the same as in the past. They may vary.

Proposal Forms

*The first document in the insurance file is the proposal or application for insurance. It is used to obtain the proposal in a standardized, printed form. This is to be completed by the proposer in his handwriting and signed in the presence of a witness. Contract, to be deemed valid, require signatures to be authenticated through witness. The proposal forms the basis of the life insurance contract.

* If someone other than the proposer has filled up the proposal form, the person filling up the proposal form has to declare that he wrote the answers as dictated by the proposer, in his language and the answer were written by him only after understanding the questions fully. If the proposer is illiterate, the left thumb impression has to attested by a third party, who has to give a declaration that the questions were explained to him and answer dictated by him were recorded truthfully and were read out to him and were understood by him. These procedures are important to make the proposer responsible for the answer in the proposal, which become the basis of the insurance contract. Otherwise, he may be able to claim at a later date, that he did not know what was written in the proposal, as somebody else had written the answer.

* The proposal form contains a declaration at the end stating that all the statements therein are true in every respect and that if any untrue averment be contained therein, the insurer will be entitled to declare the contract as null and void and forfeit the moneys already paid. The policy documents also make a reference to this declaration. This declaration makes the principle of utmost good faith operational. The agent must draw the attention of the proposer to this declaration and its importance and ensure that there are no untrue statements in the proposal.

* The proposal form will contain information as to (a) the name and address of the proposer, (b) name of the person to be insured, if different (c) details of the person to be insured like his occupation and date of birth (d)

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details about the insurance required like plan, term and sum assured, (ea) riders to be added (f) details about earlier proposals for insurances. These particulars are looked at by the underwriter. If the address is “care of somebody” clarifications may be asked for. There could be suspicions of moral hazard. The occupation of the life to be assured would determine the need for occupation extras. The manner in which the earlier proposals had been accepted do not bind the underwriter, but provide some guidance. If the earlier policies are not continuing, there could be doubt about the purpose of the present proposal.

* Further particulars required along with the proposal, would include (a) preferred mode of premium, (b) whether the policy should be backdated, to get the benefits of a lower age and a lower premium (c) employment particulars enable SSS deductions and (d) nomination. If the policy is to be issued under the Married Women’s Property Act, then the relevant forms have to be filled up, stating the beneficiaries and the trustees. These details have no bearing on the underwriting, but are necessary for preparing the policy and for making the necessary administrative arrangements for servicing. Proof of age is usually called for along with the proposal. Since 2006, proposers are required to furnish, along with the proposal, a photograph and proof of address, in terms of the law to prevent Money Laundering.

2. First Premium Receipt (FPR) & cover note

The underwriter’s decision on the proposal may be to accept at OR or otherwise. If it is accepted at or, the policy can be commenced immediately, provided the full premium had been paid along with the proposal. The FPR will be issued. If the acceptance is not at OR, the proposer has to agree to the modified terms and pay the balance premium if any, before the FPR can be issued. The IRDA regulations require that the decision on the proposal should be made by the insurer within 15 days.

The FPR is the evidence that the insurance contract has begun. The policy document, which is the evidence of the contract, mat be issued only after some time. If the claim arises before the policy is issued, but after the FPR is issued, the insurer is liable. Once the policy document is issued, that becomes the proof that the cover has begun and that the first premium has been paid. The FPR becomes irrelevant.

The FPR will state the proposal for insurance has been accepted and that the premium has been received. It will give the particulars of the policy, such as policy number date of commencement of risk, date of maturity, date of last payments of premium, premium amount, mode, name and address of the life assured. The date on which the next premium becomes due is also stated.

The date of issue of the FPR is the date on which the premium is adjusted in the books of the insurer. Until then, the money remains in deposit. This date is effectively the date on which the liability of the insurer commences.

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The FPR, and later the policy also, may show another date as the date of commencement. This would be an earlier date, chosen for the benefit of a lower premium, corresponding to a lower age, insurers agree to such request for back-dated date. The date of commencement is only national, because there is no-risk cover till the date of issue of the FPR. In the case of a policy which is backdated, the FPR may acknowledge more than one installment premium. This depends on the extent of dating back and the mode of premium.

Strictly, the issue of the FPR signifies the conclusion of the contract and it is binding on both the parties. However, they regulations issued by the IRDA, provide that the policyholder has the option to withdraw from the contract within 15 days of the issue of the policy. He will then, be entitled to refund of the premium paid, less cost of risk for the short period and expense towards medical examination and stamp duty. This period of 15 days is called the 'free look in period' or 'cooling off period'.

In non life kind of policy a cover note issued in advance of the policy. It may be issued in the following circumstances:-

1. When the negotiations are completed it may take some time before the policy is issued. Pending the preparation of the policy the cover note is issued as evidence of protection for a temporary period of time to prove that cover is in force.
2. Cover note is also issued when the negotiations for insurance are in progress and it is necessary to provide cover on a provisional basis or when the premises are being inspected for determining the actual rate applicable.
3. Cover note is issued in Marine Insurance Policy normally when details required for the issue of policy such as name of the steamer number of packages or exact value etc. are not known.
4. A cover note in Motor Insurance is issued in the form prescribed form. Motor Vehicle Act requires a Certificate of Insurance along with in addition to the policy.

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3. Renewal Premium Receipt

When the policyholder pays the premiums due under the policy subsequent to the issue of the FPR, RPRs are issued. These RPRs are important to prove payments, as defaults can lead to termination of the contract. Disputes may arise as to whether a particular payment had been made or not. If such disputes are raised at the time of the claim, the respective RPRs will provide conclusive evidence. The adjustments of subsequent premiums do not conclusive evidence. This is because insurers do adjust later payments leaving gaps for earlier defaults, to be collected at the time of claim.

Renewal receipts are not issued in respect of policies under SSS. The consolidated cheque received from the employer is adjusted as one transaction. Individual policyholders do not get respects. Salary slips would show deduction of premium from salary. That should be sufficient proof of continuance of insurance. A certificate from the employer about the deduction having been made and sent to the insurer should also suffice.

Policyholders tend to argue that the SSS arrangement is between the insurer and employer and that he, the policyholder, is not responsible for any default. This argument is not valid. The employer is not an agent of employer will not have any control if salary is not paid any time because of strike or leave or because of termination of employment. The insurer may not even be informed about it. The employee has to make sure that the deduction are made, and, if not done for any reason, to arrange separately for payment.

Electronic systems are being developed for payment of premium. These include electronic clearing systems, direct debit to the bank account or payment through the interest. Credit and debit cards, may also be accepted. The appropriate documents to prove the transaction, in these new systems have to be understood as they develop.

4. The Policy Document

The policy document is the most important document. It is the evidence of the contract. It is prepared to reflect the terms of the contract. If the original document is lost, it does not affect the insurance contract. A duplicate policy will be issued, on request.

Pre-printed policy forms containing standard policy conditions and schedules are used. Clauses and liens may be separately typed and pasted on the policy document. The policy document is to be signed by the competent authority and stamped, according to the Indian Stamp Act. New technology may enable insurers to avoid pre printed forms and print a policy every time, with appropriate schedule and terms, including clauses and liens.

The preamble to the policy states that the proposal and declaration signed by the party form the basis of the contract. The operative clause lays down the mutual obligations of the parties regarding payment of premiums and payment of SA on the happening of the insured event and on production of age-proof and title of the claimant. The schedule gives all essential particulars of the policy, like dates of commencement and of maturity, SA (when and how much to pay), nominee (if stated in the proposal), premiums (when and how much to pay), special clauses, if any, rides and exclusions or liens, etc. The terms and conditions will refer to the days of grace for payment of premium, consequences of default in payment of premium, availability of loan, etc.

Instruction issued by the IRDA require that the policy information statement should be issued with every policy, stating.

*The facility available for mode and periodicity of payment of premium

*Person or office to be contracted for any enquiry or services relating to the policy.

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* Importance of intimating change of address of [policyholder and nominee.

* Availability of mechanism to address grievances/companies

* Information on location of Insurance Ombudsman

[D] Meaning of Insured

Insured is the person whom benefits would be paid to or on the behalf of, if certain defined events occur. The meaning of the insured is twofold: one as insured person and the other as insured event. The person who has made an agreement with an insurance company and who receive money is the insured person.

A person whose interest are protected by an insurance policy; a person who contract for an insurance policy that indemnifies him against loss of property or life or heath etc. it is an event covered by insurance; an insured risk.

Who can be insured? The answer is any person who is competent to contract can be insured person. As per the Indian Contract Act 1872 the definition of the person who is competent to contract has been given as under:-

Section 11 who competent to contract

Every person is competent to contract and who is of sound mind, and is not qualified from contracting by any law to which he is subject, who is of the age of majority according to the law to which he is subject.

1. 18 years or 21 years of age
2. Of sound Mind
3. Not debarred by any law to which he is subject.]

Sec 3 of Indian Majority Act.1875

1) 18
2) 21

Section 12 of Indian Contract Act deals with the term 'sound mind'. What is a sound mind for the purposes of contracting? A person is said to be of sound mind for the purpose of making a contract if, at the time when he makes it, he is capable of understanding it and of formatting a rational judgment as to its effect upon his interests. He has not been found to be of unsound mind by a court of competent justifications. A person, who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind.

Illustrations:

a) A patient in a lunatic asylum, who is at intervals of sound mind, may contract during those intervals.
b) A sane man, who is delirious from fever, or who is so drunk that he cannot understand the terms of a contract, or form a rational judgment as to its effect in his interests, cannot contract whilst such delirium or drunkenness lasts.

Married and Pardanashin Lady

The Indian contract act 1872 does not impose any restrictions on married women to enter into contracts. However Insurance Companied have been cautious about granting insurance on female lives. The practices have changed during the last fifty years. Working women and educated women are treated on par with men. Some women who do not have any earned income are considered, provided their husbands are adequately insured.

Because of customs by certain communities a lady may be obliged to be under complete seclusion, such as a Pardanashin lady. Women in purdah are not considered for insurance. These are not rigid rules or principles. Every insurer will have its own experiences and practices. Some insurance allow lower premium rates for working women.

[E] Endorsements

In a pre-printed policy form, the standard policy conditions and privileges are printed. If any of them need modifications, in keeping with the terms of acceptance, endorsements are attached to the policy. If a condition in the pre-printed policy is not applicable, the same will be cancelled by rubber stamping the clause accordingly. If individual polices are printed by computers, such endorsements and cancellations may be avoided.

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During the currency of the policy, alterations may be effected in age, plan or term S.A, mode of premium payment, etc. Separate endorsements will be placed on and kept attached to the policy document, to indicate such changes

Nominations made subsequent to the issue of the policy are to be made on the back of the policy itself as endorsements. Assignments can also be made on the back of the policy. If made on separate stamped deeds, then these deeds as well as the notices issued to the insurer become important documents.

Endorsements may also be issued during the currency of the policy to record alterations. The alterations normally required under a policy relate to:

1. Variations in sum insured
2. Change of insurable interest by way of sale, mortgage, etc.
3. Extension of insurance to cover additional perils
4. Change in risk e.g. change of construction, or occupancy of the building in fire insurance
5. Transfer of property to another location

6. Cancellation of insurance
7. Change in name or address etc.

Riders

What is rider?

A rider is a clause or condition that is added on to a basic policy providing an additional benefit, at the choice of the proposer. For example, a provision that in the event of death of the life assured by accident, the SA would be double can be a rider on an endowment policy. This rider can be added on to a policy under any plan. the option to participate in valuation surplus can also be offered as a rider. Riders can be with regard to additional payments on disability or sickness, or waiver of future premiums, partly or fully, under certain conditions. Riders add variety and attractiveness to the nature of the policy.

Insurance find it convenient to have a small number of basic plans, with riders being offered as options, so that effectively the prospect has a number of options to choose from. Each plan can be taken with anyone or more of the riders. 5 basic plans and 7 riders, effectively provide 300 or more options. Many riders can be added or removed at the well of the policyholder, thus allowing him a lot of flexibility. Such options enable customization of the product.

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Some of the riders being offered by insurers in India are mentioned below

*Increased death benefit, being twice or even bigger multiple of the survival benefit

*Accident benefit allowing double the SA if death happens due to accident

* Permanent disability benefits, covering loss of limbs, eyesight, hearing, speech, etc.

* premium waiver which would be useful in the case of children's assurances, if the parent dies before vesting date or in the case of permanent disability and sickness.

* Dreaded disease or Critical illness cover, providing additional payments (in lump or in installments), if the life insured requires medical attention because of specified ailments like cancer, cardiac or cardiovascular surgeries, stroke, kidney, failure, major organ transplants major burns, total blindness caused by illness or accident, etc.

* Cover to meet major surgical expenses

* Guaranteed increase in cover at specified periods or annually

* Cover to continue beyond maturity age for same SA or higher SA

* Option to increase cover within specified limits or dates

* Option to cover spouse without medical examination

As per the regulations made by the IRDA in April 2002 and amended in October 2002

- The premium on all the riders relating to health or critical illness, in case of term or group products shall not exceed 100% of the premium of the main policy.
- The premium on all the other riders put together should not exceed 30% of the premium on the main policy and
- The benefits arising under each of the riders shall not exceed the SA under the basic product

This virtually puts a limit on the number of riders that can be offered with any policy. It is possible that these limits may be amended from time to time.

The premium for providing accident benefit does not depend on the age of the life to be insured. That is not so in the case of the other riders. Also, the benefit of the other riders may not be taken into account for grant of loans or non forfeiture clauses, referred to in a later chapter. The practice of insurance may vary.

[F] Common types of deductible

A deductible is the amount of money subtracted from the value of a loss, which is not covered by insurance. For instance, if you are in an auto accident and you suffer collision damage of 10,000 and have a deductible for collision of 500, then your insurance company will pay you 9,500 for your loss. If the collision damage is 450, then you collect nothing, because it is lower than your deductible.

The reasons for deductibles are to eliminate small claims, which keep premiums affordable, and to reduce moral and moral hazard.

Coinsurance is another method commonly used to keep premiums affordable by having the insured pay part of the cost.

Since processing claims requires a minimum cost that is mostly independent of the amount of the claim, the expense of processing a small claim would constitute a large percentage of the claim itself. Thus, deductibles are an effective way to keep premiums affordable. Furthermore, most people or business can easily afford to pay for small losses with earned income. The primary purpose of insurance is to cover large, catastrophic losses-what is sometimes called the large-loss principle-that could financially ruin an individual or business.

Deductibles also reduce premiums by lowering the payouts for the losses by the insurance company. However, the size of the deductible and the amount of the saving is not linear. By increasing the size of the deductible, saving will be much greater at first, but decline dramatically with larger deductibles. For instance, the standard deductibles for collision in car insurance are 500. If this insurance costs you 1,000 per year, increasing the deductibles to 1,000 may reduce the premium to 800 per year. So in this scenario, by taking the lower deductibles of 500, you are paying $200 per year for 500 worth of coverage-not a very good cost-benefit

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ratio. If you increase the deductible to 2,000, then your premium may only drop another $20. Thus, when buying insurance, it pays to compare various deductibles and the association premiums.

Deductibles also help to reduce moral hazard which is causing losses to collect the insurance money, because the insured will suffer the loss of the deductible for any losses. Losing the deductible also helps to reduce morale hazard, which exists because the insured may otherwise be nonchalant about losses, and do little to prevent losses because of insurance.

Some types of insurance do not have deductibles. For instance, life insurance policies do not have a deduction has no benefit. A deductible in life insurance would not be a moral or moral hazard, and there are no small claims-death occurs or it doesn't. Liability insurance also has no deductible, because almost all liability claims will be for fairly substantial sums of money and because the insurer will want to handle the case from the beginning to minimize legal mistake that could be more costly later on.

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Deductibles in Property Insurance

Property insurance has 2 types of deductibles: straight deductibles and aggregate deductibles.

A straight deductible is a deductible that applies to each separate loss, and is the type of deductible in most personal lines of insurance. For instance, if during the course of a year, you are involved in 2 separate auto accidents, then the deductible will be subtracted for each accident.

Commercial insurance often has an aggregate deductible, which is the total deductible for a given policy period. For instance, if a business has property insurance with an aggregate deductible of 10,000, then the business will have to cover the 1st 10,000 worth of losses for each policy period usually a year. So if business will have to cover 10,000 of its losses, but will receive 2,000 from its insurance company for the last loss. Any more losses that occur within the same policy period will be fully covered. So if the business has another loss of 3,000, it will receive the full amount from its insurer.

An aggregate deductible makes more sense in commercial insurance, since business can have many separate losses during the course of a year, but would be unusual for an individual to experience multiple losses within a year.

Deductibles in Health Insurance

Deductibles for health insurance can be in the form of dollars or time. Most medical insurance policies have a dollar deductible, while disability insurance has a time deductible, where the insured must wait a specific amount of time after a disability to collect any insurance.

The most common type of deductible for basic medical expense and major medical contracts is the calendar year deductible, which is the amount that must be paid by the insured in a calendar year before the insurance company pays anything. After the insured has paid the deductible for the year, then the insurance company pays everything for the rest of the year. This is basically the same as the aggregate deductible in commercial insurance policies.

Often, employers provide employees with a basic medical expense plan that is supplemented with a major medical plan. a corridor deductible is the deductible that applies to the major medical plan that only pays what the basic plan does not, plus a specific dollar amount: it bridges the 2 policies (hence, the name)

Most disability insurance policies have an elimination period deductible of 1 or more months, which requires the insured to be disabled for a time greater than the waiting period, and for which payments will be paid only for the time after the waiting period when the insured is disabled. To collect social security disability benefits, for instance, require a waiting period of 1 year. Like the dollar deductible, shorter waiting periods command higher premiums.

Elimination period deductibles are common for any type of insurance that pays a specified amount over a period of time, because it is more effective as a deductible than the dollar amount deductible. Like dollar deductibles, elimination period deductibles reduce premiums by eliminating small claims of disability of short duration which should be paid with saving or other liquid assets. Also, dollar amount deductibles make no sense when the insurance providers a regular stream of payments, because the amount of the regular payments is specified in the contract, in contrast to other types of insurance that cover only losses and their associated expenses, and for which the amount of pavements is determined by the amount of the loss.

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[G] Co-Insurance

As the name suggests, it is sharing of risk between two or more insurance companies in predetermined ratio. This is mostly done in cases of large insurance risks, wherein either the insured feels comfortable in getting the risk underwritten by different insurance companies in a fixed proportion or when the insurance companies are not comfortable in insuring the risk alone and would like to share the same with other insurance companies. In case of underinsurance, the insured becomes a co insurer in the policy to the tune of under insurance.

Example: A risk is insured by 2 companies in the ratio of 40% & 60% and the premium is shared in the same proportion, then in case of loss the loss will also be payable in the ratio of 40% & 60% by the respective companies.

If the property is underinsured by 40% then the company will pay only 60% of the actual claim and rest 40% is to be borne by the insured, that is why it is said that in case of underinsurance, insured becomes a co insurance in the policy.

In co-insurance all participating companies can issue separate policies mentioning their share of risk or the company leading the pool can issue a master policy mentioning the share of all companies, which is signed by all insurance companies and is called collective policy. One more way of doing it is that the leading insurance company signs the policy on behalf of all other insurance companies and a clause called “Collective insurance clause” is incorporated in the policy.

[H] Other Insurance Provision

Multiple Insurance Coverage: Pro Rata Liability. Contribution of Equal Shares, and Primary and Excess Insurance.

Some losses may be covered by more than 1 insurance policy. However, insurance policies are written to prevent people from profiting from insurance the principle of indemnity-because otherwise potential profits from insurance can create a moral hazard by motivating people to file claims for profit rather to cover losses, which would increase premiums substantially.

Insurance companies have developed various solutions to prevent the insured from profiting from multiple insurance polices: pro rata liability, contribution of equal shares, and primary and excess insurance.

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Exercise

1. Besides meeting the essential requirement of a valid contract (offer and acceptance, consideration etc) the following must be there for a contract to be present.

A. Duty of care
B. Consensus ad idem
C. Waiver and Estoppel
D. None of these

2. In a life insurance contract, offer refers to

A. Proposer paying the first premium
B. Proposer's application form for insurance
C. Original policy bond
D. Company brochure duly authenticated

3. In life insurance
(A) Consideration is the payment of premium by the insured
(B) Consideration is the payment of premium or the promise to pay future premiums

A. Statement A alone is correct
B. Statement B alone is contract
C. Statements A and B are both correct
D. None of the above

4. (A) Payment of the first premium is legal consideration
(B) Payment of the first year's premium as also the subsequent two years' premium constitutes legal consideration.

A. Statement A is correct
B. Statement B is correct
C. Statement A and B are both incorrect
D. None of these

5. When it is said that insurance contracts, generally speaking are contracts of indemnity, the reference is to

A. Life insurance
B. Group insurance
C. Reinsurance
D. **Non-life or general insurance**

6. What is a proposal?

A. A request for an insurance cover
B. An offer to enter into a contract
C. Both statements are correct
D. Both statements are wrong

7. Policy document is …

A. Evidence of the contract
B. Evidence of risk

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C. Evidence of the company having accepted premiums
D. None of the above

8. Of the following which is the basis of the contract?

A. Proposal form
B. Agent's confidential report
C. Occupational query form
D. Medical report

9. Parties to a contract must have intention to create ………………. relationship.

A. Social
B. Legal
C. Political
D. Emotional

10. Offer in life insurance contract refers to :
A. Proposer paying first premium
B. Proposer's filling up application form for taking insurance
C. Original policy document
D. Company's brochure duly authenticated

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CHAPTER

12

ANNUITIES

A. ***Difference between annuity and life insurance***
B. ***Type of annuities***
C. ***Taxation of individual annuities***
D. ***Individual Retirement Accounts (IRAs) in the international context***

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Life insurance business has been defined under section 2(11) of the Insurance Act, 1938. In accordance with the definition, granting of annuities and superannuation schemes constitute the life insurance business.

Annuities are practically the same as pensions. Annuities are called the 'reverse' of life insurance. In annuity contracts a person agrees to pay to the insurer a specified capital sum in return for a promise from the insurer to make a series of payments to him so long as he lives, while in insurance, the insured pays a series of payments in return for a promise to pay a lump sum on his death. Theoretically, under a life insurance contract, the insurer starts paying upon the death of the insured but under an annuity contract, the insurer scopes paying upon the death of the annuitant.

In actual practice, however, there are many variations. The insured does not have to pay in lump sum. He can pay in installments. The annuity does not have to stop on death. It can continue beyond.

Practically no underwriting is done in annuities. In fact annuitants are supposed to exercise self-selection. Therefore, medical examination of annuitants is not insisted upon. The risk, that is to be covered, under annuities is of living too long.

Annuities are paid by insurers in monthly, quarterly, half yearly or annual installments as may preferred by the annuitant. An annuity can be made payable during the life time of the annuitant, in which case it ceases on his death. This is called a 'life annuity' during the life time of the annuitant or his spouse, which ever is longer.

The annuity may commence immediately after the contract is concluded. Such an annuity is called an immediate annuity. The purchaser of an immediate annuity pays the purchase price in a lump sum. The first installment will start at the end of the month, quarter, half year or the year, as the case may be.

The alternative to an immediate annuity is a Deferred Annuity. In this case the annuity payment will start after the lapse of a specified period, called the deferment period. The purchase price can be paid as a single premium at the commencement or may be paid in installments during the deferment period. If the annuitant dies during the deferment period, the premiums paid are returned to the nominee or heirs.

Like life insurance policies, annuities can be purchased on the lives of two or more persons. The annuity will be paid till the death of the last survivor, subject to certain minimum periods, if so arranged.

There are annuity plans on offer, which, after the death of the annuitant (s), pay the purchase price (single premium paid) to the heirs.

This contract is governed by Indian Contract Act, 1872.

An immediate annuity begins at once and a deferred annuity after a fixed period. An annuity certain is for a specific number of years. A life annuity is paid from a certain age until death. Perpetuity continues indefinitely.

Annuities start where life insurance ends. A specified capital sum is paid by a person, in return for a promise from the insurer to make a series of payments as long as the person lives. Annuity stops on death of the person, whereas theoretically life insurance starts on death of the assured.

Immediate and Deferred Annuities

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Annuities fall into one of the two general categories, based on when the annuity's payments are scheduled to begin. These categories are immediate-and deferred annuities. A contract is designated as an immediate annuity if income payments to the annuitant are scheduled to begin one payout interval (for instance, one month or one year) after the purchase date of the annuity. The contract is called a deferred annuity if income payments are to begin at some further point in the future-perhaps as much as several years from the date of purchase.

In the case of immediate annuities, the naming has often caused confusion. It should therefore be remembered that although the contract is called an immediate annuity, payments don't begin on the very next day after the contract is purchased. Instead, payments begin after one full payment period has elapsed following the date of purchase. For example, if the contract calls for monthly installments payment will begin one month after the date of purchase. If the contract stipulates that annual payments will be made, the annuitant will receive the first payment one year after the purchase date of the annuity.

Annuity benefit payments are made on either a monthly, quarterly, semiannual or annual basis. Since the longest period between benefit payments is one year, it naturally follows that payments from an immediate annuity will begin no later than one year from the date of purchase. By the same token, payments could also begin as soon as one month from the annuity's purchase date. Therefore, the point to remember is this : an immediate annuity is " immediate" only in relation to a deferred annuity, in which the first payment is deferred by as much as several years.

Additionally, it must be mentioned that if the insurance company is to begin paying the annuitant shortly after the purchase of the contract, the purchaser must pay for the entire contract all at once. An immediate annuity, then, must be paid for with a single premium and is commonly known as a single premium immediate annuity (SPIA). (Well-to-do individuals with high incomes often purchase his type of contract while their means allow them to do so.) A deferred annuity, on the other hand, may be either a single premium contract or a single premium deferred annuity (SPDA).

On some occasions annuity payments will not begin until many after the first premium is paid (or only premium, in the case of single premium annuities). These contracts are known as deferred annuities , because the benefits are not rendered immediate but are delayed until some specified future time. This deferral period not only allows a deferred annuity to be used as an accumulation vehicle during the annuitant's working years but also as well as a source of lifetime income after retirement. Deferred annuity premiums are usually paid in monthly, quarterly, semiannual, or annual installments over a number of years. The start of income payments is delayed for a specified period of time- for instance, until the annuitant reaches age 55, 60, or 70.

[A] Difference between Annuity and life insurance

Annuity is called the 'reverse' of life insurance. In annuity contracts, a person agrees to pay to the insurer a specified capital sum in return for a promise from the insurer to make a series of payments to him so long as he lives, while in insurance, the insured pays a series of payments in return for a promise to pay a lump sum on his death. Theoretically, under a life insurance contract, the insurer starts paying upon the death of the insured but under an annuity contract, the insurer stops paying upon the death of the annuitant.

Under annuity contracts, the insurer stops paying upon the death of the annuitant.

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Under life insurance, the risk that is sought to be covered is of dying too young. Under annuity contracts, the risk that is sought to be covered is of living too long.

Annuitants are supposed to exercise self-selection (as against adverse selection in life insurance). Therefore, medical examination of annuitants is not insisted upon. However the rate of annuity is according to the age of the Annuitant. Higher the age higher the amount of annuity. As such the age proof is insisted upon.

Annuity and Pension

Annuities are practically the same as pensions. The difference between both is captured as under:-

1. Pension signifies that the recipient was an employee;
2. Pension is part of salary. Standard deductions used to be allowed from the amount of salary.
3. Pension is always monthly.
4. Pension is commutable as 1/3rd or ½ where as the annuity is generally commuted to 1/4th of the NCO.

[B] Types of Annuities

Immediate Annuity or Deferred Annuity is two types of annuities. However there are different types of payment which one can opt for.

Immediate Annuity- Here the purchaser of an annuity pays a lump sum called “Purchase Price”, in return for a promise to receive monthly, quarterly, half-yearly, or yearly annuity.

First installment starts at the end of month, quarter, half year or one year, as the case may be.

Deferred Annuity- Purchase price payable either in lump sum or in installments during the deferment period accumulates to the required capital (or cash option) and then the annuity contract starts.

It suits the employees to give their employees a provision of regular income after a selected deferment period.

Types of Annuity Payments- Literal meaning is annual payments. Annuity contracts provide for periodical payments depending upon status, time and life.

If payments are for a certain number of years, it is called “annuity certain”

Annuity contracts providing for periodical payments throughout life are known as “life annuities

Payments cease absolutely on death of policyholder or annuitant.

Annuity with return of Corpus.

Under such annuity contracts, the purchase price is returned to the legal heirs (no nominee) after death of the annuitant.

Joint Life Annuity

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In case of a 'joint life annuity' annuity payments are made to the annuitant during his/her life time and thereafter to the spouse, if the spouse is alive.

Retirement Annuity

1. Designed primarily to meet the needs of the partner in a firm (CA, Architect, Solicitor, lawyer, etc)
Premiums paid by the assessee are entitled to tax relief.

2. Proposer and the annuitant should be the same.
3. Primarily for the entire life of annuitant but provision for certain capital return before death, after a specified term.

[C] Taxation of Individual Annuities

Policy of Annuity is not taken as maturity of the policy. The payment of annuity is taxable as salary.

There has been change in income tax laws that now the payment is covered under Section 80 C instead of 80CC or 80CCC.

The amount eligible is Rs. 100000 as payment of premium as under any other policy of Insurance. It may be expected that the proceeds of any annuity plan is covered under section 10(10D)

There has been a huge cry from Senior Citizens that annuity payments should not be taxed. May be Pension or Life annuity is exempted with certain conditions.

[D] Individual retirement Accounts (IRAs) in the international context

Most of the developed countries like the USA have a strong social security system under which the citizens will be provided with a retirement income by the Governments. For this the governments levy a social security tax, which has to be contributed by all the earning members of the country. In the case employee's wishes to opt of the social security pension arrangement, they can do so by having their own personal pension plan, which can be built up by opening IRAs with the Govt. authorized financial institutions. The benefit assured by such an individuals can do this, they will be eligible to stop their social security contributions but have to make the necessary contributions to the IRAs. Though this kind of a system does not exist in India as of now, this has been proposed to be introduced under the pension sector reforms that are being debated now.

In the most general terms, an annuity is a series of periodic payments. Most of us make and receive such periodic payments. For example, your monthly rent or mortgage payments constitute an annuity, and salaries paid on a regular, periodic basis are annuities. In the financial services industry, the term annuity means a contract under which one party- the insurer- promises to make a series of periodic payments in exchange for a premium or series of premiums. Historically, annuities have been considered to be an insurance product, thus, by law, only insurance companies could issue annuities. Other providers of financial services- for examples, stock brokers, banks and savings and loan institutions-now market annuity products issued by insurers, and some these providers would like to begin issuing annuities.

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In western countries, although advertised as insurance, annuities are an investment product sold by life insurance companies, brokerage firms, mutual funds, banks and financial planners. It promises to Pay a specific sum periodically for a specified number of years. For example, you could purchase an annuity that promise to pay you $2000 a month for 30 years. Or you might be interested in buying an annuity for retirement income which will begin 15 years from now. The cost of annuities varies depending upon your age, sex ,the number of lives that will be covered, the date that payments are to begin, and the method used to distribute the benefits.

Insurance companies offer annuities that can make annual or monthly payments which begin immediately, or at a specified date in the future. If you're near retirement, an immediate annuity., which begins making monthly immediately, may be of interest to you. Purchasing this type of annuity requires that you pay the full cost of the annuity in a single up-front lump sum. For example, a $150,000 payment may purchase a $1,400 per month annuity for as long as you live. A larger up front payment will purchase an annuity that pays a larger monthly income. An immediate annuity may be an attractive choice for someone who has accumulated a large reserve of funds that he or she would like to convert into a lifetime income.

Deferred annuities begin making payments on a specified date in the future. Let's say that you want to receive monthly payments of $1,200 beginning in 25years, when you expect to reduce at age 65. A deferred annuity can be purchased by making either a large one time upfront payment to the insurance company (say, $50,000, for example), or by making either a large one time upfront payments. The insurance company, in turn, promises to provide you with monthly income payments of $1,200 for the rest of your life, beginning at age 65.

Variable annuities offer the advantages of investing in mutual funds (potentially high returns, diversification, protection from inflation, etc.) along with the added advantage of deferring taxes on investment income. Variable annuities make periodic payments that can vary in size depending on the performance of the assets in which the funds are invested. Typically, payments into a variable annuity are invested in common stocks or a combination of common stocks and bonds. The performance of those markets determines the return that's earned by the annuity's invested funds. The higher the return the more rapidly the annuity's pool of saving grows, and the greater the size of the payments that will eventually be received by the annuitant. However, variable annuities also have the possibility of reduced payments to the annuitant if the value of the investments that the annuity's funds are in declines. Financial experts, therefore, advise that when considering the purchase of a variable annuity, you check the investment history over a period of ten to twenty years or more.

Annuities generally should investment income from taxation until funds are paid out to the annuitant. Thus, annuities provide tax deferral rather than tax savings. However, early withdrawals are treated in the same manner as those of an IRA, which means that they could be subject to a ten percent penalty.

Examining Annuity Premiums

There are different types of annuities available, and various ways to pay for them. Let's take a look at how a purchaser may pay for an annuity and how the premiums are determined.

An annuity purchased with a single lump sum payment is known as a single premium annuity. For the single premium, the company promises to pay the annuitant an amount each payment period (monthly, quarterly, semiannually, or annually).

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A second way of buying is with the level premium annuity. Under this agreement the premiums are paid in periodic installments over the years prior to the date that the annuity income begins. Level premiums are, in essence, a method of “forced saving.” A common level premium arrangement is the annual premium annuity, in which the premiums are paid in yearly installments up to the time that the annuity and the benefit begins. However, premium can also be paid monthly, quarterly, or semiannually.

Like the level premium annuity, a flexible premium annuity’s premiums are paid over a period of time (usually years) until the annuity benefits are scheduled to begin. The flexible premium annuity differs, however, in that the purchaser has the option to vary the size of each premium payment, as long as it falls between a set minimum and maximum amount- for instance, between $200 and $10000 (if an annuity is used to fund an IRA, it must provide for flexible premiums.)

There are five factors used to determine annuity premium: the annuitant’s age and sex, the assumed interest rate, the periodic income amount and any payment guarantees, and company expenses (or load). The annuitant’s age is important because the company must determine for how long it’s likely to be obligated to make income payments to the annuitant. For example, if Mr. smith wants to receive $300 a month for life beginning at age 60 and Mr. Jones wants to receive $300 a month for life beginning at age 65, with all other variables being equal, the company will charge Mr. Smith a higher premium than Mr. Jones.

The annuitant’s sex is also a factor used in most states to determine premiums. Most statistics show that women live longer than men. As such, it follows that if the annuitant is a woman, the premium will be higher because she’s likely to live longer-and will therefore receive more income payments- than a man of the same age. However, some states have adopted unisex provisions that disregard gender in determining annuity premiums. In these states, the premium charged will not differ based on the annuitant’s sex.

The third factor used in determining annuity premiums is the assumed rate of interest. Life insurance companies invest premium dollars and earn a certain rate of interest on these investments. When determining premiums for annuities, the companies estimate, or assume, that their invested premium dollars will earn a specified interest rate.

The fourth factor in annuity premium computation consists of the amount of the periodic income (monthly, annually,etc.) and any payment guarantees that the company has made concerning that total amount (or total number of payments) to be paid. For instance, the company may guarantee that no less than 120 monthly payments will be made even if the original annuitant dies before 120 months elapse. Needless to say the higher the amount of the periodic income payment and the longer the guarantee of the payment, the higher the annuity premium the company will charge.

Finally as with virtually all other business transaction, annuity premium contain an amount (called a load) to help offset the company’s operating expenses.

The earnings in the account are tax deferred; no taxes are due on earnings during the accumulation phase, but during the annuity period, earning, but not principal, are taxed as ordinary income.

A fixed annuity guarantee a specific payment starting at an agreed date and continuing every pay period, which can be monthly, quarterly, semi-annually or annually. It does not stop on the expiry of the fixed

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(commonly known as guaranteed period). After the fixed period is over the payment of annuity shall continue till life of the annuitant.

Rate of annuity is just interest on the accumulated amount

No; to say that is wrong. The amount of annuity will depend upon the actuarial working of the scheme.

How can an insurance company guarantee payments to an individual without knowing beforehand how long that person will live?

By spreading the risk of the living long over a large number of people as we in pure risk covering living too short. A payment for a fixed annuity is dependent, among other factors, on the life expectancy of the annuitant when payments begin. Some will live longer than expected, but others will die sooner. If the annuitant dies sooner, the insurance company keeps the rest of the principal; this will help pay for others who live longer.

Inflation and annuity

The main risk with a fixed annuity is inflation risk. Inflation will continually lessen the amount of goods and services the fixed payment can buy. Although there are periods of economic deflation, most of the time, prices for goods and services continually increases, so this risk will increase the longer the annuitant lives.

Variable Annuity

A variable annuity has a variable payout that is contingent on the profitability of the investment portfolio on which the annuity is based, and thus it can be a hudge against inflation.

The premiums for a variable annuity are placed in a account that is separate from the general account of an insurance company, because the account is managed more aggressively for more income, but also with the attendant risk.

Variable annuities are an investment because the payout depends on the performance of a specific portfolio, and are therefore classified as securities by the SEC. if the account doesn ‘t perform well, the annuitant will receive reduced payments, or none at all.

Combination Annuity

The combination annuity combines fixed and variable annuities, guaranteeing the annuitant a specific amount, but also allowing the potential for more money from the variable annuity.

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Because an annuity is paid for the annuitant's lifetime, life expectancy is an obvious factor to consider when calculating premiums, which in turn, will depend on the annuitant's age at the start of the annuity period and sex, because women generally live longer than men.

When are the Settlement Options decided in an Annuity Plan?

1. At the time of taking policy
2. At the time payment of annuity of annuity begins
3. Any time

Longevity Insurance/If You Outlive Your Saving

As people live longer, there is a danger that they will outlive their income. At least 20% of people aged 65 will live at least another 30 years. Longevity insurance is like a single-payment deferred annuity that is typically purchased by the annuitant around retirement age to receive guaranteed monthly payments for the rest of the annuitant's life, starting at around age 80-85. It differs from a deferred annuity are determined when the payments start, and will vary depending on how will the invested annuity are determined when the payments start, and will vary depending on how will the invested money performed. Thus, one advantage of longevity insurance is that the annuitant knows exactly how much she'll be getting, but the disadvantages is that the payout remains the sme even if the markets do will over the years.

The main advantage of longevity insurance is the much larger payout of longevity insurance over a deferred annuity for the same investment- more than 4 times greater- which is possible because most people will die before receiving any payout, leaving more for those who survive. If the annuitant dies before receiving any payments, then the insurance company keeps the money. Another advantage is that since the payout is known, estate planning is easier.

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Exercise

1. An annuity that makes lifetime payments with the first payment made after one period from issue is called a(an):

- **A. Life annuity immediate.**
- B. Life annuity due.
- C. Annuity certain.
- D. Annuity due.

2. Under a deferred annuity, the purchaser can pay the purchase premium as

- A. Single premium only
- B. By installments only
- **C. In any way as stated in (a) and (b) above**
- D. None of the above

3. Medical examination is not at all required under_____ policy.

A. Partnership insurance
B. Group insurance
C. Individual Insurance
D. Annuity

4. Tony buys an annuity from an insurance company, under which the insurer will pay him a certain sum periodically as long as he is alive. Billy buys an annuity from an insurance company under which the insurer will pay annuities to him (or his heirs) for a definite number of years, whether he is alive or not.
1. Tony has purchased a life annuity and Billy has purchased an annuity certain.
2. Tony has annuity certain and Billy has variable annuity.

A. 1 is correct
B. 2 is correct
C. Both 1 and 2 are correct
D. None is correct

5. Manish and Sheela, a retired couple, opted for a joint life survivor annuity. Under this annuity;

A. The annuity is payable as long as both of them are alive
B. The annuity will cease on the death of the eldest of the annuities
C. The annuity is payable as long as either one of them is alive
D. The annuity payment will cease on the death of any one of the annuitants

6. What risk is covered by an annuity?

A. Sickness
B. Accident
C. Living too long
D. Death

7. Rahul and Priya (husband and wife) were born in 1950 and 1958 respectively. Rahul's life expectancy at birth is 75 years while Priya's life expectancy at birth is 72 years. Rahul is planning to buy an annuity that will be paid to him or his wife till any one of them is alive. For how long should he purchase this annuity if he is buying the same in the year 2008?

A. 10 years
B. 12 years
C. 17 years
D. **22 years**

8. Which of the following are types of annuity?

A. Immediate
B. Deferred
C. Flexible
D. All of the above

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