CAUSE AND EFFECT ANALYSIS OF LAPSATION OF LIFE INSURANCE POLICIES

INTRODUCTION

High lapse of life insurance policies is one of the most serious issues in the Indian market place. On average about 20 percent of policies lapse in the first year\(^1\). In some companies and in some product lines, lapses are much higher. When applied to the large base of policyholders this is a big number. It implies a high degree of financial losses for policyholders and general dissatisfaction with the products they had purchased.

When a life insurance contract gets crystallized, the insurer envisages that the contract would run to its full length which could often go to a few decades. Accordingly, the insurer makes commitments to deploy the funds prudently so that there is a balance between the assets and liabilities. When the inflows of anticipated premiums get adversely affected, it impedes the steady progress of fund management—eventually leading to disarray in the insurer’s financial management.

Looking at it from the policyholder’s angle, the stoppage of premium payment brings along an equally detrimental proposition. The protection that life insurance affords to the policyholder suddenly gets

\(^1\) Annual Report, IRDA, Mumbai, 2010-11, 136.
interrupted; and the safety net that is provided to come to the rescue of the dependent family members in case of the policyholder’s untimely demise, ceases to exist. Even otherwise, it could bring in a few financial disadvantages like the possibility of the loss of entire premium paid, an adverse rating with regard to future life insurance needs etc. among others. Despite this being a no-win situation, lapsation in life insurance continues to be in high volumes and calls for a close scrutiny of the possible causative factors.  

Financial awareness among the general masses continues to be below par in the Indian domain; and in this regard, the role of the distribution channels for a successful completion of the contractual obligations needs no emphasis. A proper identification of the needs of the prospect, properly supplemented by providing the most suitable solution to the needs, would go a long way in ensuring the long term sustenance of business. Further, a proper assessment of the financial strengths of the applicant – not only at the time of application but also for the period of commitment – would necessarily bring down the levels of business attrition.

It has often been commented that the evil practice of rebating in whatever form is a major reason for several of the discontinued policies. While it is termed as a punishable offence, it should be appreciated that

only a voluntary abandoning of the practice could bring in the desired effect rather than an enforced diktat.

Further, mis-selling has also been proclaimed as a strong reason for the policyholder not sticking to his/her commitment in keeping the policy in force at all times. The role of the distributor in ensuring that the policyholder is not disillusioned for reasons of being sold the wrong product, needs no special mention. In any case, there is need to ensure that there is drastic improvement in the levels of business retention so that the real purpose of life insurance is served; and that life insurance business is successful in the long run.

**Decoding the Term - Lapsation**

In order to understand the impact of lapses, it is necessary to understand the different types of lapses. The term “lapse” is not directly defined in the insurance legislation, except to the extent that “a policy which has acquired a surrender value shall not lapse by reason of non-payment of further premiums but shall be kept alive to the extent of the paid up sum assured…”(Section 113(2) of the Insurance Act, 1938).

Also, Regulation 2(1) (vi) of IRDA (Treatment of Discontinued Linked Insurance Policies) Regulations, 2010, defines discontinuance as the state of the policy that could arise on account of non-payment of

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premiums by a policyholder within the period allowed under the Regulations (which is typically 75 days from the due date for non-monthly modes).\textsuperscript{5} Lapse is defined in different ways in insurance literature. Lapse definition also varies with type of product and its features. Overall, a policy lapses if the premium is not paid or cannot be supported by the policyholder/policy fund value at the end of grace period.

There can be cancellation or termination of policies from inception for reasons such as the policyholder exercising the free look option, cancellation due to non-disclosure, cheque dishonour action etc. These are not considered as lapse. In general, Life insurance is a long term contract. While the insurer has the obligation to provide coverage as along as the policy is in force and does not have an option to foreclose, the customer has the right to stop paying the premiums at will. So any insurer would like to have an accurate understanding of the lapse rate for any particular block of policies.

High lapse of life insurance policies is one of the most serious issues in the Indian market place. On average about 20 percent of policies lapse in the first year. In some companies and in some product lines, lapses are much higher. When applied to the large base of policyholders this is a big number. It implies a high degree of financial losses for

\textsuperscript{5} The IRDA (Treatment of Discontinued Linked Insurance Policies) Regulations, 2010.
policyholders and general dissatisfaction with the products they had purchased.

This chapter dwells on the individual economic and financial factors that cause lapse. Then the impact of lapse on various stakeholders is discussed. Also suggestions have been given to avoid lapsation. The study also proposes the strategies for the insurers to handle policy lapse and the operational tactics that can be deployed to hold the lapse rate to the assumed levels.

**Measure of lapse**

There are small differences in the way lapse is defined across various countries. In the Indian context, a policy is treated as lapsed if the premium is not paid within a period ranging from 15 to 60 days. Lapse Ratio during the year = Lapses (including forfeitures) during the year/Arithmetic Mean of the business in force at the beginning and at the end of the year.

A LIMRA/SOA⁶ sponsored study defines as, Annualized Policy Lapse Rate = [Number of policies lapsed during the year/Number of policies exposed to lapse during the year] x 100 Number of policies exposed to lapse during the year is arrived from total number of policies at the beginning of the year and deducting the death, term expiry, maturity and conversion policy count from it.

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GENERALLY RECOGNIZED FACTORS OF LAPSATION\textsuperscript{7}

Surrender Charge Structure

If the surrender charge structure causes losses by way of negative returns vis-à-vis premiums paid, this will prevent lapse and hence is a factor. It should be noted that this feature has also caused a secondary market for life insurance policies. Therefore, the fact that the effect on surrender charge structure on policy lapse rates gets artificially accentuated due to the arbitrage opportunities available, should be considered while modelling the product design assumptions. Also, the lifting of surrender charge regime provides some sort of encouragement to surrender.

Personal Circumstances

This is the most important factor in lapsation and the least controllable. It is suggested that better analytics be used in predicting this factor. This is geography specific as well and goes to show that the Indian scenario has its own set of reasons which trigger lapse.

Indian people in general have a different set of social obligations. As popularly acknowledged, joint family system even if its practice is being widely disregarded has its impact on Indian society. Even nuclear families (which are very different from nuclear families of the developed world) include unmarried adult children. These all translate into unique

pressure points which have to be taken care of.

**Extraneous factors: Tax benefits and Collateral credit**

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

**Commission structure**

A heaped commission structure is more associated with lapse than a levelized or trail commission structure as there is incentive for the sales force to generate more new business than to serve the old business. This in fact leads to churning which is a headache for insurers the world over.\(^8\)

**Economy**

Life insurance is mostly considered as a discretionary purchase rather than a mandatory one. As premium payments are a form of renewing the purchase decision, a fluctuation in disposable income levels will influence policy lapse. Amount of disposable income increases with

increasing income levels. In case of a recessionary economy, where there is negative growth, reallocation of available resources will happen and hence society as a whole will see an increase in policy lapse. This is a systemic risk as it affects the whole of society. It is also possible that a particular section of the society is affected like when a single industry like aviation is seeing a downturn. This is rarely the case as the after-shocks of a collapse of any industry would reverberate across all sections\textsuperscript{9} of the society.

**Product Features**

Policy owners sometimes need access to their invested funds and instruments which facilitate this will see better persistency than which does not. A good example is the term products which have higher lapse rates than endowment or whole life products. Apart from the factors described above the life settlement market too causes a variation in assumed lapse rates. A life settlement is a financial contract where the insured assigns the policy to a third party institution which pays the policy holder more than the cash value payable by the insurer. After assuming ownership the third party continues to pay the premiums and is the beneficiary for all claim payments on the policy. The life settlement market exploits the undervalued (by the insurer) policy contracts which are in danger of lapse due to the inability of the policy owners to pay the

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premiums. The typical targets are the policy owners whose increased mortality makes the present value of the contract much more than the cash surrender value offered by the insurance companies.

**Sales Process**

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

- **Lack of proper need analysis at time of sale**: Understanding the customer’s financial requirements is one of the most critical factors impacting policy continuity. At times, this step is completely missed out or covered inadequately by the distributor. This results into customers buying a policy (product or ticket size or both) that doesn’t adequately meet their financial objectives (tax benefit, protection or investment). In most cases the policyholders lose interest in the product over a period of time and the policy lapses. Policies not taken according to the financial capacity of the policyholder may not continue as he/she will find it difficult to pay for it.

- **Distribution Factor**: The quality of sales made by the distribution channel is one of the biggest factors impacting the

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11. Ibid., 16.
persistency levels. Factors like rebating and churning are leading causes of lapsation. Levels of distributor’s product understanding, selling skills, professionalism, commitment to business and overall attitude can be linked to quality of sale.12

• Advisor’s offering some part of their commission as discounts on initial premiums is termed as rebating13. This could lead to the policyholder being enticed to buy a premium size that he/she would not be able to afford later, thus leading to policy lapsation.

• Advisor’s inducing the policyholders to lapse an existing policy to take a new policy is termed as churning. Advisor’s objective could be earning high initial commission from new policy or meeting criterion for rewards and recognition. Policyholders are usually misled by such advisors on features and charges of new products while not explaining the opportunity loss of existing policies.

• Orphan policies: Rising attrition of distributors and increasing orphan portfolio are new challenges for insurers. When an advisor leaves or is terminated, the policies sourced by him / her become orphaned. At times, such terminated advisors misguide policyholders to discontinue their existing policies14. Some policyholders also find it difficult to

manage their policies through new assigned advisors; such policies pose higher risk of lapsation.

- **Lack of adequate financial underwriting:** If the premium paying capacity is not established at the time of underwriting by referring to proper income documents, it may result in policyholder contracting to pay premiums higher than his capacity.

- **New Product Options**\(^\text{15}\): Availability of upgraded products with better features and returns can also be a motive to lapse the existing policy and go for the new one. This could result into replacement with newer products offered by the same insurer or with the products of another insurer. Further, if the original need for taking the policy has changed, policyholder could prefer discontinuing the policy.

- **Policy Returns:** Product returns in terms of cash / fund value, bonus rates, etc. may not meet policyholder expectations and the policyholder may find the product unattractive to continue. There is a possibility that some policyholders may not keep various policy and mortality charges in mind while calculating their return on premiums paid. It becomes more lopsided, if such returns are calculated in initial

years of the policy. In high interest rate regimes, products offering lower fixed returns become unattractive. This leads to high lapsation rates.¹⁶

- **Financial crisis of Policyholder or Adverse Market Performance:** At times, due to general economic outlook, unexpected business constraints or priorities, the policyholder may decide not to pay or may not be able to continue paying premium for the policy.

- **Lack of premium payment channels (Reach):** As life insurers have expanded their operations to the interior most and remote parts of the country, choice of premium payment options / modes has got limited in such topographies. This poses challenge for policyholders to pay their renewal premiums and can lead to high lapsation rates for such policies.

- **Customer service and complaints management experience:** Policyholders getting repeated unpleasant experience with services of the insurer or the advisor may prefer to lapse or surrender their policies. Mis-selling complaints like selling regular premium policy as single premium policy or logging customer intended annual premium as semi-annual, etc. are frequently reported. Any delay or no corrective action of such complaints may lead to lapsation.¹⁷

- **Ignorance of policyholder** (Unintentional lapsation): Many a time, the policyholders forget to pay their renewal premiums despite


¹⁷. Ibid., 27.
reminders from the insurer. Sometimes the premium reminders and other important insurer communication do not reach the policy holders due to low contactability. Common reasons for low policyholder contactability include incomplete contact details provided by the policyholder at proposal stage, data capture errors, wrong/self-contact details provided by advisor, contact details not updated with insurer in case of address change by policyholder, etc.¹⁸

The Supreme Court has held that agent has no express authority to receive the premium on behalf of the corporation¹⁹ he has no implied authority to collect the premium. As per regulation 8(4) of IRDA an agent has been expressly prohibited to collect premium from the insured. In a law suit²⁰ the insured (deceased) took out four life policies with double accident benefits premiums payable half-yearly. When the third premium fell due, the general agent of the Corporation met the person and took a bearer cheque towards the premium payable by him in respect of the policies. Although, the cheque was encashed immediately thereafter, it was not deposited with the Corporation for another three months. In the meantime the insured met a fatal accident and died. The corporation rejected the widow’s claim for payment of the sum assured on the ground that the policies had lapsed for non-payment of premium within the grace

²⁰. Ibid.
period.\textsuperscript{21}

But now keeping pace with increasing customer expectation for more conveniences in policy servicing, the LIC has empowered select Agents to collect renewal premium. As on 31 March, 2012 there were more than 23378 authorized Agents across the country, which can collect the premium (including ULIP but excluding HI Policies) in cash or cheque and issue a valid receipt instantly.\textsuperscript{22}

If we analyse the data and trends on lapsation, certain factors like demographics, financial and socio-economic, etc. exhibit differential policyholder continuity patterns. Like the decision to buy an insurance policy, the decision to continue renewal premium is influenced by a number of personal factors like age, gender, socio-economic background, marital status, education level, income level, etc.

- Lapse rates vary significantly between rural and urban customers. This can also be related to lack of communication, service reach, etc. in rural areas.\textsuperscript{23}

- Lower premium ticket size policies tend to have higher lapsation rates. While a small proportion of the same can be attributed to


\textsuperscript{22} Annual Report 2011-12, IRDA, Mumbai, 86.

malpractices, policies purchased by people having limited resources are more prone to lapses.

- Quarterly and monthly modes of payment tend to have higher lapse ratios.
- Lapse rate is higher for younger policyholders most probably due to lower and uncertain income levels, greater job mobility and lack of appreciation of concepts like risk cover, family protection, old age provision etc.\(^\text{24}\)
- Lapse rate of female policyholders has been observed to be lower than that of their male counterparts.

**Why do customers lapse policies?**\(^\text{25}\)

Understanding the root causes of lapses is the first step to addressing the issue. There are several reasons why policyholders lapse policies:

(a) A surprisingly large number of people do not even realize that the policy has lapsed. This is because most individuals are notoriously poor in systematically keeping track of their finances. It is common to have individuals pay their premiums for years and then suddenly slip up on payment in a particular year.


\(^{25}\) Ibid., 34.
(b) Many a time, the reminder notices or calls by an insurer are the call for action for a consumer to renew their policies. If for some reason the company fails to remind customers of their obligations then the policy is very likely to lapse. Failure on the part of the insurance company is not deliberate. Often enough, policyholders change homes or phones and do not provide updated information to the insurance companies.

(c) In many instances, policyholders terminate a policy deliberately. Here too, quite often, termination is instigated by the advisor and driven by his desire to earn first year commissions once again. This is called replacement of policies and is illegal\textsuperscript{26} in many countries including India. The main challenge in curbing replacement is to systemically track it. If a company has thousands of agents it is hard to determine when replacement has occurred.

(d) Then there are cases where the customer was mis-sold a policy.\textsuperscript{27} On becoming aware of this, he decides to terminate the policy. This is a serious breakdown of the solicitation process. It is not enough to say that all policy details were provided in the terms and conditions of the policy. Insurers and intermediaries have a responsibility to make sure that customers understand all conditions clearly.

(e) Finally, customers may lapse a product if their needs change or new, much improved products enter the market. Both these situations are market realities in India. The lapses on term products tend to be the highest and one of the reasons is that policyholders feel that they no longer need death protection. An improvement in prosperity; changed financial circumstances can lead to this. Many a time customers realise that significantly cheaper term products have become available.

A structural change in ULIPs driven by the regulatory changes last year could also result in higher than normal lapses. The new ULIP products are much more attractive for customers as there are restrictions on how much insurers can charge customers. Many policyholders may be tempted to replace their products with the new ULIPs – particularly if their old policies have been active for a long time and surrender charges are minimal.

(f) Lapses due to financial shocks or a liquidity cash crunch. During a liquidity crunch some policyholders seek to cash out their policies. The immediate cash requirement in their mind supersedes the long term benefits of keeping the policy active

Stakeholders’ Varied Perspective on Lapses

Customers’ Perspective on Lapses

Customers are the worst affected by lapses. In general, they have a

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significant financial loss in the form of a surrender charge. Also, there is an opportunity cost as the premium amount could have been deployed productively elsewhere, and the cost of purchasing insurance increases with age.

**Intermediaries**

In general intermediaries such as individual agents, corporate agents and brokers are focussed on the first year compensation from an insurance sale. Renewal commissions are small (typically 5 per cent of premium in traditional policies) and it may not be profitable for the intermediary if there is considerable follow-up work required for renewal. The situation is aggravated because many agents have low productivities and invariably become inactive over time. For all practical purposes they lose interest in soliciting or renewing insurance. In banks and other corporate agents, the issue is different. High attrition levels, frequent transfers and lack of training of the sales staff are an important reason for poor persistency. The intermediary’s role is very crucial in keeping the contracts in life insurance in force. While it is very important to identify the prospect’s needs upfront, it is equally important to render efficient service throughout the contract period.

**Insurers**

The impact of lapses on insurers is more complicated. Good, long-term oriented insurers understand that a lapse results in loss of a long
term cash flow and the resultant profits. There is also loss of reputation each time a company’s insurance policy lapses. However, sometimes, lapses may actually increase an insurer’s profits in the short term. Several products are lapse-supported. This means that, because of the high surrender charges, lapses may actually increase short-term profits. This creates a tension as, often enough, meeting short term objectives is important for the insurers. Further, in some markets, even the long term impact of lapses can be positive for the insurer. Taiwan is one such example. Policies that were sold there a decade ago were embedded with high guarantees as interest rates were at a peak at that time. Over the years interest rates in Taiwan have reduced considerably and to such an extent that many of the policies are unprofitable for the insurer. In such a situation, insurers can actually create significant long term value by lapsing policies. Customers have realized this and therefore persistency in these markets is high. Several insurers have now exited this market because of the unfavourable insurance economics. There is a lesson here about the risks of offering high guarantees.

**Impact of policy lapse on various stakeholders:**

Most vintage items have high value and it is said that ‘Old is Gold’. This applies to life insurance policies as well. With vintage, life insurance policies become more beneficial and profitable to the

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policyholder and the incremental ROI is also high. Despite this fact, many insurance policies lapse due to varied reasons like ignorance, misguidance, relative lower appreciation in early years, etc.

With significant changes brought in by the regulator in terms of permissible charges in new products (Effective September 2010), persistency has become a big word for insurers now. Now persistency is synonymous with the financial health of the company. At a broader level, insurance products are priced using the four basic factors; MIXP – Mortality, Interest, Expenses and Persistency.

Persistency can be one differentiator for an insurer to price its products more competitively in the market. Persistency becomes one of the major deciding factors as the acquisition costs involved which include the expenses incurred to market, sell, underwrite and issue a life insurance policy. The initial expenses thus incurred must be amortized through the collection of renewal premiums. Needless to say, if the acquisition costs are not recovered, the same would affect the financial interest of the company adversely.

Improved persistency is not only in the interest of the company but also of the policyholder and the sales force. Lapsation adversely impacts the policyholder due to loss of risk cover and more often than not,

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forfeiture of the premiums remitted thus far. For the sales force, lapsation translates into loss of future renewal commissions. From the industry perspective, it may hamper the growth of business.

**Customer Groups**

A lapsed policy ceases to provide insurance protection to the insured. It forfeits benefits under the policy and possible favourable terms later in the contract. A new policy would cost more, considering the current higher age and other related factors. Some insurers consider previous lapses as adverse factor while underwriting a new proposal. The pay back, which is part of the premium paid that cannot be forfeited, will never meet the expectations of policyholders. Certain products do not carry cash values, so they will not compensate any value on lapsation.

Unit linked policies\(^{32}\) yield good returns only in the long run. If there is an early lapsation, policyholders receive the blow, in that they may not have received any gains, not recovered the front end costs and also get deprived of the advantage of lower costs in the long run. Unit linked policies are priced such that the cost of insurance reduces with increasing accumulation value. So, lapsing of these policies prematurely deprives policyholder of these benefits. Even for the traditional policies, the policyholder will be at a huge loss as there would be higher surrender charges and possible loss of bonuses.

Policy lapse affects the customers in three ways:

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

2. Customers get a reduced return if any; from the lapsed policy as discount factors tend to get applied to the paid-up value.

3. As a class, customers will be affected by higher lapse rates as the cost gets passed on to them by way of higher premiums (in future product pricing) or lower bonuses.

Insurer Groups:

A life insurer would incur losses if a significant portion of its policies lapse in initial years before the expenses can be recovered. Persistently high Lapsation, surrenders and cancellations will affect the growth of company’s portfolio of business and its reputation in the market.

Pricing of products and valuation models make assumptions on year-wise lapse rates thereby projecting the profits / losses arising from such transactions. In the event of higher Lapsation in early years, when the initial expenses and commissions have not been fully covered; the life
insurer can have higher overruns or losses. Normally the life insurer obtains the bulk of its profit in later years of the policy and its profit forecast will be defeated if higher proportion than expected take up the surrender values. Such gap on achieving assumed returns can lead to re-forecasting of capital requirements and strategy thereon.

Lapsation can also mean loss of goodwill, which can result in market share decline in the current competitive environment. Low persistency suggests a review of the quality of underwriting, new business origination process, degree of distributor professionalism and customer service, to name a few. Impact of lapsation is high since persistency is an evaluation factor used by rating agencies while arriving at overall rating of the insurer. Probably, life insurer bears the maximum brunt of Lapsation.

Insurers do provide for policy lapses even while designing the policy. The challenge is to accurately predict the lapse rate for a particular product and for a particular block of policies. For fixed premium policies, insurer actuaries have to be accurate as possible. If lapse rates are higher than predicted, insurer stands the risk of losing his margins.

In case of level premiums, in the initial years, the premium paid is more than what is required. So if the policy lapses, the life insurance company pockets the so-called lapsation profits, which is factored into the pricing of the life insurance policy to start with. Life insurers have to contend with pricing for lapses as well as pricing for the possibility of policy not lapping due to settlement contracts which artificially extends the term of the contract.

**Sales force:**

Distributors do not get renewal commissions if the policy is lapsed. In this case, it is possible that they may be losing client which is more disastrous than losing commission. If policyholder is disappointed at the sales process, then it is a permanent and irreparable loss to distributors. Further, insurers may also impose penalties due to lapsation, such as denying club membership associated facilities and fringe benefits.

It is ironical that an incentive of renewal commission is not a sufficient incentive for an agent to pursue his policyholders to pay. In fact, no other industry offers continuous regular payouts to distributors which a life insurance policy offers. A highly persistent policy brings a regular income to the agent – if he serves the insurance company for 5 years, even after his termination the renewal commission is guaranteed –

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even after the agent’s death after 5 years, hereditary commission is guaranteed to his family – clearly no other product can offer.36

Reducing policy lapse and increasing persistency benefits the field force a lot. If a customer lapses a policy, not only does the agent lose his renewal commissions, it also becomes tough to sell another policy to that customer as the losses on his first policy would have created a negative thought in his mind. Hence it is better for the agent to capture the financial, economic and social profiles of his customer even as he sells a policy to him/her, and use it for lapse prediction and diligent follow-up. Such activities would create trust in the minds of the customers.

IRDA too has recognized the importance of distribution channel in decreasing lapse.37 In February this year, IRDA, under Section 14(2) of the IRDA Act, 1999 has issued guidelines requiring agents and insurers to enhance persistency of life insurance policies. The new guidelines among other things mandate 50% persistency for agency renewals till the financial year 2014-15 and 75% persistency after that. This alone is bound to play a major role in controlling lapses and it would benefit all the stakeholders including agents themselves and policyholders.

**Strategies towards better lapse management:**

The three strategies that the insurers should adopt for accurate

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36. Monika Halan, Renuka Sane and Susan Thomas, “Estimating losses to customers on account of mis-selling life insurance policies in India”, Indira Gandhi Institute of Development Research, Mumbai, April 2013, 12.
37. Ibid., 13.
lapse rate design are:

1. **Aggressive adoption of continuous KYC Philosophy**

   The soliciting of data pertaining to KYC should not stop with new business. The KYC data acquisition should also be proactive. For example, the field force can be asked to file a quarterly customer profile change report. All customer interaction touch-points should query the customer on the known economic factors affecting lapse. Also financial need analysis can be proactively be carried out to provide a status check to the customer whether he or she is sufficiently insured on increasing age as well as income levels.

2. **Product Design Involving Lapse Moderators**:  

   The product design should encompass lapse moderators. These features can range from simple riders such as No-Lapse Guarantees (NLG) to identifying the pressure point timelines on the targeted customer demographic and designing for providing/introducing benefits on them. The products benefit deliverable should not only be need based but also based on the timing of the needs. For example a traditional policy can be introduced with commutation features with the commutation option at either pre-defined or customer opted intervals. Customizing benefit delivery timelines within design constraints addresses not only the

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39. Ibid. 17.
insurance need but also the need to pay the premiums. Automatic premium loans where premiums are loaned against the collateral of the cash value are also an example. Focusing on single premium policies is a good idea to control lapse. Another example could be selling ULIP policies where the death benefit is the value of the units at the time of death. This may not directly prevent lapse but will remove the effect of lapse on insurer’s reserves.

3. **End to end marketing-From product features to servicing features:**

   Marketing should not be confined to the product features. Focussed marketing should also be done on the servicing features that are there to be utilized by the customer. The servicing features can range from call centre support, multiple premium payment options like online and mobile payment channels. Not only customer friendly servicing features should be introduced but also should be proactively marketed to the customer.

4. **Operational tactics to govern lapse rates**

   Successful deployment of the strategies to manage lapse rates needs suitable vehicles of delivering them. This involves analyzing the strategy and identifying action items which would enable implementation of the strategy and aligning the organization dynamics along the stated

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goals. For example, among the below proposed operational action items, the first three map into the strategy of aggressive adoption of continuous KYC philosophy. Such alignment of evolution of strategy / tactics into activities would yield better overall results. Provided below are some of the operational initiatives towards better persistency management.

(i) Ensuring integrity in customer ID creation and capture
(ii) Periodical dispatch (online and offline) of customer detail update forms
(iii) Proactive update of customer details (including changes in the family structure) by the field force
(iv) Fine-tuning the lapse control measures that are already in place like follow-up on non-receipt of premiums
(v) Informing the customer of policy no lapse features in case premiums are delayed
(vi) Systematic sharing of the analytics data with the field force for accurate targeting of potential defaulters
(vii) Partnering with bill aggregators which for a fee offer a single window to the customer for all his/her bills

Reaction of Indian Insurers to Lapse rates:

However small the body of work on policy lapses may be, Indian insurers are pro-active in controlling lapses. For example many insurers send out short messaging service (sms) messages to remind the customers when premium is due.\textsuperscript{42} Multiple premium due notices are also sent out. Further, agents are also given a list of customers whose premiums fall due in the next 30 to 90 days. This is done for the agents to follow-up aggressively and to ensure policies stay in force. Premium default letters are also sent after the due date.

Stakeholders’ Role towards Reduction of Lapses Insurers

To address the issue insurers must:

1. Design products that minimize the risk of inadvertent lapses. Single premium products are one such example. These are once-and-done products and can often be very cost effective for customers. Another product feature that is common in the US and Japan is the no-lapse guarantee.\textsuperscript{43} The product feature ensures that even in traditional products, once a minimum premium has been paid the death benefits on the products are guaranteed not to lapse even if the remaining premiums are not paid in a timely manner.

2. Automate premium collection : Cash collection in the country is

complex. There are several areas where bank penetration is low. Even if a customer wants to make a payment it may be administratively difficult. Insurers can address this issue by increasing ECS (Electronic Clearing Services) mandates or, in the urban areas, ensuring automated credit card payments. These are not fool proof methodologies but do go a long way in improving persistency because people tend to keep their bank accounts and credit cards unchanged over the years.

3. Build an effective technology system to identify replacements. As mentioned earlier, replacement is when an agent encourages a customer to lapse an existing policy of theirs and replace with a new policy. This seldom benefits the customer but helps the agent earn a higher commission through the new sale. This process is not allowed by the regulator. However, effectively monitoring replacement in the market place is difficult and requires effective technology. Insurers must also actively discourage replacements by taking strict action on defaulting agents, even if they are high performers.

4. Finally, insurers have to keep strengthening their ability to deliver renewal notices or reminder calls to customers. Contactability of customers is another big issue in the industry and can only be
addressed by ensuring that the information collected while selling the product is accurate and reliable.

**Intermediaries**

For intermediaries the priority is to develop a long term orientation on the business. Key initiatives would be to:

1. Build a stronger community to share best practices. There is a small but growing segment of agents who embody the best practices of life insurance solicitation. Their renewal performance would be second to none in the world. These high performing agents need to be showcased within the agent community.

2. Build stronger cross-selling capabilities. Intermediaries may find that cross-selling can get them very good results, perhaps more attractive than searching for new clients. Cross selling results in an individual customer becoming more valuable for the intermediary. This forces the intermediary to move towards a more comprehensive key account management and relationship based approach. Such approaches do tend to increase customer’s satisfaction levels and enhance renewals.

**Regulators**

In order to reduce lapses, regulators must:

1. Discourage lapse-supported products. Insurers need to have their products approved by the regulator prior to launch. The Authority
must take a hard look at products where profitability increases with an increase in lapses.

2. Publish a consolidated list of renewal persistency each quarter – similar to the new business sales that are published. This will help bring about customer (and media) focus on the issue. The Authority’s initiative to link the renewal of an agent’s license to persistency is an excellent move. This must be defined in a manner that is practical to implement.

3. Encourage a compensation system for an agent that rewards renewals. Insurers need more flexibility in renewal commissions. Currently, the absolute amount of renewal compensation is low and many agents or intermediaries do not focus on this aspect.

**Measures to curb lapsation and increase persistency:**

Lapsation can be controlled by an insightful mix of proactive and reactive measures. The proactive measures can help reduce instances of lapsation whereas the reactive measures can help reinstate the lapsed policies.

- **Professionalize sales force and emphasis on need based selling:**

  A well trained, passionate and professional sales force can bring in right selling to the customer and increase the life duration of the policies. Investment in training the resources (sales force) on

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professional conduct, selling skills, product features along with competition product benchmarking, service appreciation/understanding and relationship management goes a long way in building a professional sales force and healthy portfolio. Tools and measures like financial need analysis or life-stage mapping of customers can help decide the right product, right premium ticket, right sequence of plans etc. to match customer’s present and future requirements. Such services can also come as an additional benefit to the customers for their overall financial planning. Life insurers effectively doing the financial planning for the customer can gain his/her confidence and loyalty in the long term.

• **Understanding and appreciating Persistency:** Life insurance industry is evolving and direct channels of distribution are surfacing. The alternate channels of distribution evolved post liberalization in life insurance in last decade but still most of the insurance policies are purchased (or rather sold) through non direct channels where the policyholder’s preferred touch point is the distributor. So the insurer needs to ensure that the distribution and servicing work force understands persistency and the ways in which it can be improved. Insurer needs to send updates on due

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dates and lapsed policies to the distributor in time so that they can impact the continuity of the policy.

- **Compensation strategies:** From an earlier focus of insurers on levelised compensation structure, of late the focus of insurers has been on heaped compensation structure. Both compensation structures have their pros and cons for insurers depending upon their current priorities and business life stage. Life insurance being long tail business, levelised compensation structure resonates more with the overall architecture and can support persistency in a better way. The heaped structure provides incentive to procuring business with high first year commission and gradually reduced renewal commissions. The levelised structure reduces the gap between first and renewal commissions.

- **Linking Agent License Renewal Norms to Persistency:** The regulator has laid directions on agent license renewals and the same is linked to defined minimum persistency levels. Such criterion along with compensation linkages to persistency can drive agents to focus on persistency. Similar norms can be looked at for other distribution channels to encourage and enforce persistency.

- **Product features and flexibility:** Combination of product charge structure and features impacts not only the sale but the continuity of a policy. IRDA keeps a close watch on this and ensures that
norms are in place to safeguard the customer interest. Product features like premium mode switching, premium amount changes (reduction/ increase/holiday), portability between life cover and investment portion, product upgrade option (option of converting to newly launched variant more applicable for reduced price term plans) etc. can help the policyholder to modify the life insurance policy to his current financial state and match his financial goals in long term.

Creativity and innovation of product and pricing teams at the insurer coupled with marketing teams getting voice of customer to match their requirements and preferences can go a long way to ensure continued customer patronage and loyalty.

- **Prudent Financial Underwriting:**\(^46\) The underwriting process should include assessment of customer’s current and future financial capabilities and base the decision on policy and premium size on this as well.

- **New age and expanded service options:**\(^47\) All customers are not the same and have varying needs and preferences. Handling this diversity becomes more important and critical when managing your existing set of customers. Premium payment options and


customer request handling needs to be supported at multiple communication levels like website, contact centre, SMS, e-mail, branch, advisor etc. so that the customers can choose their preferred mode. Communication language also plays a big role in customer experience and can impact persistency. Multilingual communication can ease understanding of customers and can help address customer issues.

- **Grace Period and reinstatement window:** Regulations provide for a grace period of 15 / 30 days depending upon policy payment mode, and the policyholder enjoys the complete benefits of the policy during this grace period. Reinstatement window or period is the period post lapsation in which the policyholder can reinstate the policy with more documents and checks if required as per product terms. Under the new pricing regulations for unit linked policies (effective September 2010), a notice of intimation of lapse must go to the policyholders within 15 days from the expiry of grace period if premiums were still not paid. If within 30 days of receipt of this notice, the customer does not still pay the premiums, the policy would irretrievably lapse.

There can be genuine reasons wherein the policyholder is not able to reinstate his policy like temporary financial constraint, long

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duration out of station travel, non-receipt of communication from insurer, etc. Reinstatement period/window comes as a big respite to the policyholders. Earlier non-standard reinstatement period (of 2 years) may not be justifiable but an acceptable longer period than the current norms will benefit both policyholders and insurers.

- **Policyholder grievance Management:** Having a satisfied customer goes a long way in shaping the overall health of any business and it applies more so in long tail business like life insurance. While an insurer can put in place measures to have good sales, service, product options, etc. but customer satisfaction also depends on how they are treated when they come up with their grievances. Understanding customer grievance, providing a resolution and closing process gaps, if any, can build the insurer’s reputation with customer and overall in industry as well. A satisfied and happy customer not only continues with his policy but also influences many more to continue and buy more. Managing a positive publicity on being customer centric is tough but not impossible.

- **Customers connect and education:**49 Only if a company (in service industry) is accountable and responsible to the customer and available for the customer, it can expect to get its rewards i.e. growth by the customer. Being customer centric can be of limited

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use, if customer’s needs, priorities and experiences are not captured and acted upon. Engagement marketing encourages policyholder’s involvement in shaping the marketing strategy of a company. In contrast to traditional and direct marketing strategies, it accounts for policyholder’s feedback shaping the brand’s marketing strategy. Policyholder’s feedback on experience and expectations should be captured by top and middle management meeting up with them on a regular basis. Such initiatives coupled with financial literacy programs create policyholder’s connect to the brand / insurer. This not only helps persistency but also makes the customer its brand ambassador on ground over a period of time.

- Regularizing the sales process and strict monitoring of the field force by the insurer. The field force should be educated of the exact target segment a product is designed for and should be instructed to sell only to them. Rigorous control over the sale process may even result in loss in quantity, but quality will be ensured and hence valuation will more closely follow product design assumptions. Also documentation of financial need analysis of the client done at the time of sale should be made mandatory.

- The surrender charge structure should be designed in such a way that it is a big reason for policy holders not to lapse. Having said the same, one would wish to mention that such an inhibitive regime
be tempered with access facility to invested funds such as policy loans. Of course there is very little leeway in designing the surrender charge structure as it has to comply with regulator norms. In this context, this is to point out that an unidentified insurer has notified Kansas State insurance department that it intends to implement a policy loan program that would allow in force policy owners who meet certain underwriting criteria to avail policy loans as a percentage of death benefit rather than surrender value. This is to pre-empt artificial manipulation of lapse rates through secondary markets.

- Personal factors should be better predicted through analytics. A typical Indian person’s life cycle over time should be drawn out with the money need points mapped. To this any time bound factors which prevent a policy from being renewed – education expenses, marriage expenses, retirement – should be added. This would yield in better prediction of “in-danger-of-lapse” policies and result in sharper focus on renewing them. This would also help in accurate product design.

- Perceived Present values of insurance contracts are not controllable after issue. Rather product feature design has to take care of embedding features which get high returns. The popularity of unit
linked products is a pointer to this. Better positioning of the product can mitigate the effect of return rates on lapse rates.

- Extraneous factors like tax benefits even while used for attracting the customers to an insurance product should not be used for selling the product. This is easier said than done as more than often insurance contracts are sold as tax benefit instruments rather than insurance products as such. Only proper education of sales force can reduce, if not completely remove this effect.

- Unique ID for agents: The prevalent commission structure is an unintended factor in causing lapsation. The straightforward way to resolve this would be to levelize the structure or provide more incentives for persistency. This might involve additional expenditure. While this would not have been taken into account during design of existing products, for new products too a thinner spread of commissions may make the product to be perceived as non-remunerative.

A nationwide database of agents, very similar to National Skills Registry of NASSCOM can be created. Just as every new employee of an affiliate of National Skills Registry is required to provide a unique NSR ID number, agents may also be given a unique ID. This unique ID should be used to verify past persistency.

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levels of the agent while he moves from one insurer to another. Any data available in the database should be scrubbed of company specific information.\textsuperscript{51}

If such a database can be created agents’ performance can be linked to an incentive concept very similar to “No-Claim” bonus of auto insurance. The persistency ratio of any particular agent should be matched against the persistency ratio of the company and only the relative measure should be used to increase or decrease the commissions paid. Since setting up of this central repository and maintaining it is a huge effort, no single organization can achieve on its own. All the insurers need to come together and set up such an initiative.

- Any systemic hazard affecting the lapse ratio of an economy as a whole can never be easily modelled. Even past data can only be a rough indicator over the long term. One suggestion which could make the lapsation irrelevant is developing a mandatory term insurance, a la Employees Provident Fund. This will be a low cost insurance whose face value is tied to the basic pay of an employee. Since it is mandatory, coverage lapsation will be out of question.

Such a mandatory scheme will also help the families of employees at unfortunate death of the insured.\textsuperscript{52}

- Though it is impossible to design products solely on the basis to ensure persistency as market needs drive product design, care can be taken for better selection of lives for a particular product line. The match between a life’s current profile in terms of his/her socio-economic characteristics and the purchased product should be as intended by the actuaries.\textsuperscript{53}

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

**Conclusion:**

IRDA annual reports show that lapse rates vary greatly among the Indian insurers. If insurers are forthcoming in sharing their data to an organization agnostic and Indian industry specific study, then the lapse factors common to all the insurers and lapse factors specific to organizations can be recognized. This would help all the organizations involved.


\textsuperscript{53} Ibid., 22.
Also, adoption of organization independent unique IDs such as the Aadhar can be used for across industry identification of propensity to lapse. Such an initiative would no doubt, be very welcome in the Indian context, where the year on year growth is very healthy.

Persistency clearly comes out as the 5th ‘P of marketing’ for life insurers. The traditional 4 P’s may be important at the customer acquisition stage but this 5th P is of vital significance in customer and product lifecycle. Policies in force are not only a source of income but also can help price products competitively. Persistency improvement is a journey and as we progress further, we will all agree that covering such steps is not the last mile of this journey, these may just be the first few miles that we have traversed so far.

In this testing times for the insurers, where break even period is extending every year, persistency and related pro-active measures are of and will continue to be of prime importance. Else the business drain through lapsation will act as a double edged sword taking away profits from insurer and reducing the earning of the distributors and the customers.

The term insurance is the purest and cheapest form of insurance. Typically, the proportion of term insurance steadily increases as a market matures. Therefore, it is disturbing that term insurance has the highest lapse rates in the country. This clearly points to the need for educating
customers about protection oriented insurance and ensuring that they have done a proper comparison of products and prices before making a purchase.

In summary, the impact of lapses on insurers is not always clear and there can be several conflicting outcomes. This makes it critical for regulators to take the right steps and for consumers to be more aware about insurance. The insurers must understand why policyholders lapse their policies, the costs involved and the options available.

It is obvious that if sale of policies is done ethically and professionally by the agent and the policy is serviced properly and assistance is given for payment of premium, chances are that the policy sold would remain in the books of the company. The agent would reap the full benefits of the sale made by getting the full renewal commission due to him. There will be other rewards for him in the form of opportunities to sell further insurance to his existing policyholders; and a flood of referrals will come his way to help him earn more commission.