Chapter 4

Economics of Life Insurance: Need for the Secondary Market Trading

4.0 Introduction:

Secondary market is defined as the market for resale and repurchase of a commodity, service, or financial instrument with different market participants than those involved in the primary market. The existence of the Secondary market is necessitated by the need for certain attributes, which are not available in the primary market. The secondary markets for life insurance policies (viaticals and life settlements) evolved in other countries because there was an opportunity and a need. Chapter 5 discusses the opportunity for secondary market trading characterized by the demand at a price, which assures profitability to the provider firms. The secondary market comes into existence when the primary market fails to cater to certain requirements. In life insurance, the secondary market trading emerges due to peculiar characteristics of the life insurance business.

The present chapter aims at analyzing the need for secondary market trading in life insurance. This discussion is based upon the literature survey, life insurance regulations in
India and interviews with the legal experts, actuaries, and the life insurance professionals.

4.1 The Generic nature of life insurance:

As already discussed Primary market in life insurance includes the transactions between the cedant and the insurer. The cedant pays the premiums and gets the rights to insurance contract benefits in return. If the insured no longer wants to maintain the policy, he can surrender it to the insurer in exchange of a specified surrender value. The contract of life insurance is a long-term contract.

Broad Types of Life Insurance Contracts:

Term Assurance: Term policies provide for the payment of the full policy amount if the insured dies during the policy term. Term life insurance furnishes protection for limited number of years at the end of which the policy expires, meaning that it terminates with no maturity value. The face amount of the policy is payable only if the insured’s death occurs during the stipulated time/ the term of the policy. It is the purest form of life insurance in the sense that it only provides the risk cover for the term of the policy and no financial returns. In India, the term insurance is not very popular.

Endowment Assurance: Pure endowment insurance promises to pay the maturity amount only if the insured is living at the end of the term. This is not very common form of insurance. It
is more often combined with term insurance to form endowment insurance.

Endowment policies promise not only to pay the policy face amount on the death of the insured during a fixed term of years but also to pay the full face amount at the end of the term, if the insured survives the policy term. Thus, the endowment insurance not only provides for the heirs but also pays the insured. This type of insurance is extremely popular in India. It covers approximately 80 percent of the life insurance market.

Endowment insurance does not exist in USA. Apart from India, it is widely sold in many countries like Germany, Japan, Korea, Taiwan, and Thailand.

**Whole Life Assurance**: Whole life insurance pays for the death of the insured regardless of when the death occurs. It is insurance for the whole of life. The whole life policies are not very popular in India because these policies are not conceived to be flexible. The trading in whole life would imply a viatical or life settlement type of trading.

**Unit Linked Products**: ULIP is the life insurance product that provides for the protection as well as flexibility in investment. The premium paid, less the charges (administrative, fund management, insurance cover charges, allocation charges), is used to buy units in the fund. This fund can be equity, bonds, debt and money market, according to the ULIP holder’s choice. The investment is at the price of the
fund units on the day of investment. The ULIP holder gets more units if the price on the day of investment is lower and vice versa. More units are added to the fund as the client pays premiums. In order to pay the monthly costs equivalent number of units is cancelled and is computed as cost to be deducted divided by unit price of the day. The ULIP holder has the choice to sell the units (to the insurer) any time after the lock in period, generally after three years’ premium payment. The ULIP holder can sell the units when the fund value is high. The value of the fund depends upon the unit price, which in turn is determined by the market value of the underlying assets. Fund value = Unit price * number of units.

(The implications of ULIPs for trading are discussed in Appendix 5.1, Chapter 5)

Implications change according to the conditions mentioned on the policy contract subject to policyholders’ profile, policy conditions, and company policy.

**Reasons for Discontinuing Life Insurance Contract:**

What if the preferences of the policyholder change due to changed circumstances and he needs liquidity rather than the policy rights?

The policyholder wants to discontinue the life insurance policy for various reasons. Some of the commonly observed reasons for surrender of life insurance policies are as follows:

1. The premium on the policy is no longer affordable.
2. The beneficiary for whom the policy was originally purchased no longer needs the policy.

3. The policyholder owns multiple policies and wants to eliminate one.


5. Purchase of some other type of insurance product, which better suits the changed needs and interest rates.

6. Purchase of some other type of financial instrument.

According to a research project by Balachandran and d’Mello (1985) of National Insurance Academy, the first and fourth reason of the above are more relevant in Indian context.

The study brings into light the following points on policyholder behavior,

- The incidence of policy surrender is observed in all income groups and all types of income earners salaried as well as businesspersons. However, in case of flexible income group the incidence is greater than that in case of the fixed income earners.

- Longer the term to maturity higher the incidence of surrender

- The surrenders are mainly due to financial distress.

- The study observes that basic motivation of the policyholder is to continue the policy as long as possible
and not to terminate it until it is very burdensome. In this case, it is extremely necessary that policyholder’s loss of the value is minimized and he gets urgent money.

- The study states that the agents do not influence the decision to surrender in fact they are not accessible at the time of surrender. This emphasizes the need for easy availability of information about the policy options to the policyholders.

It is very clear from the above discussion that the policyholder wants to exercise his right to transfer the policy in exchange for money value when there is a financial exigency. At this time, the policyholder prefers the liquidity to any other benefit. Hence, a system that will cater to this need by providing competitive value for policy, quick delivery of money, easy information, and transparent services will benefit the policyholder. These are the virtues of a competitive market.

4.2 Stance of the life insurance firm:

Since the life insurance is a long term, financial contract, the insurer recognizes the possibility of changed preferences. Hence, there is the option of surrender of the policy to the insurer in return for the surrender value.
Surrender value is in a way the secondary market benchmark price for the policies. The insurer sets these in the primary market. In the absence of secondary market trading, the transaction is between the insurer and the insured. The insurer is the sole re-purchaser of the policies and the policyholder has to take the price quoted by the insurer i.e. the surrender value. This type of market is the monopsony market where there is single purchaser and large number of sellers. Therefore, the purchaser has the power to decide the price while the seller has to accept the price.

**Insurer and Withdrawing policyholder:**

The existence of surrender value does not make it obligatory for the policyholder to resell his policy to the insurer. The policyholder has the legal right to assign his policy in the name of an individual or an entity other than the primary insurer\(^\text{14}\). This fact gives rise to the potential for the secondary market in life insurance.

The need to withdraw from the contract of life insurance arises under various conditions but the underlying cause is the long-term nature of the life insurance contract.

In this case, the policy may be surrendered to the insurer, for a specific value. In India, the life insurance policies can be surrendered, if minimum of three years premiums are paid.

\(^{14}\) The legal provisions are already discussed in Chapter 3 on Legal aspects of Life Insurance Trading.
4.3 Non-Forfeiture Regulations:

Sec.113 of the Insurance Act, 1938, provides for accrual of certain benefits to policyholders even if they are unable to keep their policies in full force by payment of further premiums. According to the Life Insurance Corporation of India, if the policy has run for at least 3 full years since commencement and subsequent premiums have not been paid the policy shall not be void but the sum assured will be reduced to a sum which will bear the same ratio as to the number of premiums paid bear to the total number of premiums payable.

Paid-up value and Surrender value:

This implies that if premiums are paid for at least three years then the policy has a paid up value (Sum assured * the ratio of number of premiums paid to the total number of premiums). If the policy is not surrendered, it shall subsist as a paid up policy. If the premiums for at least three years are not paid then the policy does not have any value. A grace period of six months is allowed to revive the policy. After the grace period if the policy is not revived then it is regarded as a forfeited policy in case of the nonpayment of three years premiums.

After payment of premiums for at least three years, the Surrender Value allowed under the policy is equal to 30% of
the total premiums paid excluding premiums for the 1st year and all extra premiums.

The policy conditions usually provide for a more liberal surrender value and paid up value than those secured by the statutory provisions. While grace period is meant to be for convenience, non-forfeiture regulations provide relief to policyholders who are unable to pay premiums due to temporary financial difficulties. Insurers’ non-forfeiture regulations allow additional time of, say, six months or a year for payment of premiums on a policy, even as the risk under the policy continues to be covered. Insurers offer this privilege after the policy has been in force for a few years and it is not offered on term assurance and some of the 'high risk cover' policies.

If the three years premium is not paid and the policy is discontinued, then the amount paid by the insurer is zero. Thus, the provision to get out of the contract exists, but it is with a lock-in period and with a loss of value.

For example, in case of an endowment plan the policyholder has paid Rs. 1000/- per month for 30 months or 2 and ½ year’s i.e. Rs.30,000/- .If the policyholder wants to discontinue the contract, he does not receive anything. While after three years premium payments the policy assumes a paid-up value. That is the value which is payable at the end of the term.

Paid up value = (sum assured * number of years Paid) /Total number of years
For example, a policy with Rs.1 lacs as sum assured, for 20 years term, if discontinued after 5 years,

Paid up value = Rs.1, 00,000*5/20=Rs.25, 000/- This value with accrued bonus will be payable after twenty years or at death. If this value is to be paid today (at the end of five years) then surrender value is payable calculated based on surrender value factor. In that case, the policyholder gets only 30% to 40% of the sum of paid value and accrued bonus.

**Lapse Policies and Revival clause:**

Subject to the terms and conditions of the policy, when the premium is not paid within the days of grace the policy is considered as the lapsed policy. This means the benefits will not accrue to the policy owner. A lapse policy may be revived during the lifetime of the life assured. The terms and conditions for revival are subject to change by the insurer from time to time. The revival terms and conditions also are specific to the insurance firm.

**Policy Loans:**

Policy loan is a ready source of borrowing to a policyholder, in a financial contingency. It is paid by insurers against the surrender value accrued to a policy. Policy loans lend liquidity to contracts, which are otherwise 'frozen' during the term of the policy. From the insurers' point of view, they add to the marketability of the insurance products.
The insurer can grant loan to the policyholders on the security of the policies up to the surrender value of the policy. The insurer reserves the right to decide the terms and conditions of loans. These are subject to change from time to time.

Even though policy loan provides a certain amount of liquidity to the policyholder, there are two hitches,

1. The loan amount paid is less than the surrender value of the policy. About 85% to 90% of the surrender value is paid as loan. If the policyholder defaults to repay the loan, and the interest and if this amount crosses the surrender value the policy is written off.

2. Loans on policies are approximately 85-90% of the surrender value. The experience of the insurers and providers shows that 90% of the loans are never repaid resulting into the forfeiture of the policy at much lesser (loan) amount than surrender value. The data shows that out of the total loan policies, 90% of the policies are ultimately written off.(Annual Reports L.I.C. of India)

The above provisions reveal that there are certain provisions in the primary market itself to render liquidity to the life insurance contract however, these provisions are inadequate as the policyholder loses 60 to 70 % of the premium amount paid.
4.4 Why the insurer pays only thirty to forty percent of the paid-up value to the withdrawing policyholders?

Low surrender value paid by the primary insurer does not imply that the primary insurer exploits the insured. The calculation of the surrender value is based on the economics of the insurance firm.

The insurer is concerned about the problem of adequately pricing the product to meet the claim liabilities in future. Rate adequacy means that for a given block of policies\textsuperscript{15} total payment collected now and in the future by the insurer plus the investment earnings, should be sufficient to fund the current and future benefit payments promised by the insurer to the policyholders plus related expenses.

<table>
<thead>
<tr>
<th>Present &amp; future Premium collection + Return on investment</th>
<th>Promised benefit payments + Claim payments + Total Expenses</th>
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Due to the long-term nature of investment, life insurance leads to certain issues of concern for both policyholders as

\textsuperscript{15} A block of policies constitutes all policies issued by the insurer under the same schedule of rates and values, on the same policy form. For example, in case of LIC of India the endowment plan under table no 14; sum assured 100000 lakh, age 35 is one block.
well as the insurers. The policyholder worries about the premium payments for a long period and the certainty of future returns. The insurer is anxious about maintaining the balance between sufficient liquidity for early claims and cash surrenders on one hand and earning enough surpluses to meet the future liabilities on the other hand.

4.4.1 Factors determining premium:

Since the future benefits and claims promised by the insurer depend on the probabilistic factor of life expectancy, the rate calculation becomes complicated. It involves the following factors:

1. The probability of life (Mortality): Since the insurance is based upon the concept of loss sharing, it involves collection of funds from all the insured to provide for the few who suffer loss. Therefore, the insurer starts with the idea of likelihood of the loss for the group. Every insurance organization is a mechanism of sharing losses. The Law of Large Numbers is the backbone of the insurance operations. According to this principle the greater the number of similar exposures (lives insured) to a peril, (death), the less the observed loss experience will deviate from the expected loss experience. The law of large numbers does not suggest that the losses to a particular individual become predictable. It suggests that the larger the group insured the more predictable the loss experience of the group as a whole, other things being the
same. To insure a single life against death for Rs. 1, 00,000 is clearly a gamble.\textsuperscript{16} If 5, 00,000 similar lives are insured, the actual death rates vary from the expected death rates (Shown in mortality tables) by less than 1%. Thus, insurer can manage the expected death claims with a reasonable accuracy. Unlike non-life insurance, in life insurance the probability of death is one. Only the timing varies. Hence, the insurer must accumulate an adequate fund to meet a claim that is certain to occur. Life tables show yearly probabilities of death.\textsuperscript{17} These tables showing probabilities of death for a group of insured from birth to death are the foundations upon which the expected cost of life insurance are based.

2. The time value of money: Life insurance companies collect premiums in advance of providing the insurance coverage. The amount collected but not immediately needed is invested and produces earnings that are used to support the premium income to cover expenses and payment of claims. Insurers discount premiums in advance in recognition of the fact that they will earn interest on the accumulated funds.

3. The benefits promised: insurers must take in account the period of coverage and the benefits, which are promised to the policyholders.

\textsuperscript{16} Many a times it is difficult for a layperson to differentiate between gamble and insurance. Insurance deals with the already existing risk and does not create risk unlike in the case of gamble. Moreover, insurance is based on a rate structure in which inevitable losses are planned for.

\textsuperscript{17} The probability of death and so mortality changes according to change in the living standard in a country. LIC has published the mortality table for 1994-96 showing lower mortality for each age than the earlier ones.
Rates calculated based on these three factors are called the net rates.

In addition to this net rate, following two factors are also added to the premium to calculate the gross premium charged to the policyholder.

4. Expenses: Administrative and operating expense of the insurance firm.

5. Profits and contingencies: are also loaded on the premiums these rates are called as gross rates actually charged to the policyholders.

In India, IRDA controls the floor premium rate to avoid competitive rate cutting on behalf of the private life insurance firms.

The insurer tests a gross premium rate structure for insurance at various ages. Because the asset share accumulated through the premium collection must be sufficiently high to provide the surrender values, death claims, and other benefits to the policyholders, to meet the legal requirements.

4.4.2 The asset –share calculation:

Asset share is the fund accumulated for each policy block through premiums and the returns on investments for each year of the policy block. As soon as the insurer underwrites the policy a liability is created to pay the benefits
promised at the stipulated period. This liability per policy block per year is the ‘policy reserve’\textsuperscript{18}.

In addition, the surrender values are to be paid to the withdrawing policyholders. As the premiums charged are level premiums (equal for each year) or a single premium; the insurer has to ascertain that the rate of the premium is sufficient to meet the liabilities of the insurer. The asset share in initial period is less than the policy reserve. As the accumulated premium and returns on its investment increases the asset share surpasses the policy reserve and a surplus fund for the insurer is created.

The following Figure 4.1, shows a whole life insurance policy, of sum assured Rs. 1 lac which is payable on the death of the insured and may be purchased by a male aged 30 with a net level of premium payable at the rate Rs.1800 per year till death or the age 80. The figure shows the increasing reserves and the declining net amount at risk. Policy Reserve (when stated on per policy basis instead of a policy block) can be considered vanishing with the insured’s death. So, the insurer can be considered to have a less than face amount of the policy at risk. The actual amount of pure life insurance protection at any point can be considered as the difference between the policy reserve at that point and the face amount of the contract. This difference is called Net Amount at Risk. For example at age 40 the reserve is 20000 and the net amount at risk is

\textsuperscript{18} The term Policy Reserve might be confusing as conventionally reserve implies a surplus amount accumulated but here it means a liability.
At the age 60 the net amount at risk is 40000 and the policy reserve is 60000.

**Figure 4.1**

The testing of the gross premium rate is performed by the asset-share calculation. It is a simulation of the anticipated cost of a block of policies using the best estimates of what the individual factors will be for each future policy year. (Skipper, 1994, p39) This calculation is done for determining whether the profit and other objectives of the insurer can be met for that block of policies. It is in other words the feasibility study for the policy block.
The Relation of Lapse /surrender with the profits:

The matter of surrender and lapsation is of utmost importance for the insurer, because he has to estimate the payment of cash surrender values in the outgo calculations and the accumulated fund is divided by the persisting policyholders. The asset share of each policy block is created by the premium payments by the policy owners in that block, when one of them decides to withdraw, the amount given to him should represent an equitable share of the amount accumulated on behalf of that block of policies.

Asset–share calculations are made before the fact. This equitable distribution is more complicated than can be apparently thought of, because asset share accumulates to meet the total outgo of the insurer only over several years. While the liability starts as soon as the first premium is paid. Due to this, the asset share is typically less in early years than the policy reserve. Policy reserve is the measure of company’s liability for a given block of policies. The insurer decides the minimum amount of time taken by the asset share to exceed the policy reserve. This length of time required for the asset share to equal the policy reserve is called the validation time. Once asset share equals the policy reserve, the asset share usually rises at a slightly higher rate creating a valuation surplus for the insurer.
The sale of policies is expected to make some permanent contribution to the surplus. The actual contribution depends on the relationship between asset share and the surrender value of the policy. When the policyholder terminates the policy, surrender reserves are released, because obviously the company is not required to maintain a liability on its balance sheet, as the policy is no longer in force. Surrender values roughly coincide the surplus value that builds up in the policies over time.

The insurer gains if the asset share exceeds the surrender value. This typically occurs after the first few years of the policy, when the initial costs are already covered by the premium payments. That is why the insurer usually pays the surrender value after a lock in period of 3-5 years. The asset share calculations and hence the premium calculations involve the underlying assumptions about termination rate for the block of policies. (Along with the assumptions about mortality -to estimate the claim payments at each point of time and about interest rates- to estimate the returns on investments, and operating expenses).

The asset share is less than the policy reserve in the early years. Depending upon the decision of the company the asset share would exceed the reserve at some point. This decision depends on how soon the company wants to recover the initial costs. (In the diagram panel (a) it is around 7\textsuperscript{th} year.)
Note that the cash surrender values shown by the bold line lie somewhere between the asset share and the policy reserve in the initial years.

More importantly, the policy reserve includes the surrender payment. Hence, in case the surrender values are increased, the reserves curve would rotate upwards and the intersection of the reserves curve with the asset-share curve will be delayed. The gap between the two curves representing the insurer surplus for the policy block also decreases. (Diagram Panel (b) surplus is shown after 12 years) This is the economic logic for the insurer not being able to pay higher surrender value.

**Diagram 4.2**

![Diagram 4.2](image)

(b) Several important facts are shown by the asset-share study
1. The asset-share is negative at the end of the first policy year, due to high policy expenses, on underwriting procuring and handling the policy.

2. For the first policy year, the company faces loss on each terminating policy (Cost > Premium collection). This is the reason why the policy is forfeited if first few premiums are not paid. From the second year on, the company actually would experience a net gain on policies that are surrendered each year.

Predicting future lapse rates is a difficult task. The lapse rate fluctuates because of many exogenous as well as endogenous factors. Though these rates change for each individual insurer, generally they are highest during the first two years. These rates depend upon the age at which the policy is purchased, the mode of premium payment, and the appropriate selling of the policies to suit the needs of the policyholder. Generally, the higher the lapse rate, the lower the insurer’s profit. In some cases, insurers try to devise the policies in such a way that higher the lapse rate higher is the profit. The product is designed in such a way that the surrender values are less than the corresponding asset share. The insurer assumes that the lapse rate would be sufficiently high so that there would be gain from reduced future liability in case of surrender. Policies so constructed that their future values are in part dependent on the assumption of incurring gains from high early lapses and surrenders are called Lapse supported policies.
Lapse–supported–pricing$^{19}$ creates problems if lapse rates are lower than expected then future asset shares would be low and potentially low product value.

**Effect of early withdrawals:**

The premium calculation and economics of life insurance shows the effect on the insurance company when the policyholder terminates or surrenders the policy before maturity.

Early surrenders imply two forces working in opposite directions on the insurer’s profit:

1. Lower future claim liability. The expected amount of benefits to be paid in future is less.
2. Lower investment earnings as the collection goes down to that extent. The present and future premium collection is lower and the cash value has to be paid now.

The net effect of these on the insurer is difficult to ascertain.

So, most of the insurers have surrender value payment loaded on the premium. Usually in case of LIC in India, the extra surplus generated due to lapse or early termination of policies is distributed among the policyholders as the final additional bonus.

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$^{19}$ Interviews with the experts show that LIC of India does not have the lapse-supported–pricing. The surplus is distributed to the policyholders as the final additional bonus.
The important issue is whether the policyholder gets reasonable amount back if he terminates or surrenders the policy before the maturity.

4.5 The treatment to the withdrawing policyholder and the non-forfeiture law:

The payment of surrender value and its fair valuation has been an issue of controversy in the life insurance literature. The treatment of the withdrawing policyholder can be based on various approaches. One approach is that the policy owner should receive nothing. Because the life insurance contracts are supposed to provide certain pre-specified benefits in the event of the insured’s death or survival to the maturity date of an endowment policy. Instead of paying the surrender value, the premiums could be discounted or the dividends could be increased from the released policy reserve. Earlier in the history of life insurance this view was applied, (in many cases without reducing the premiums the insurers enjoyed the increased surplus.) These practices led to the non-forfeiture legislation. The law made it mandatory for the insurer to ‘buy back ‘the life insurance policy at certain stipulated value, commonly known as the cash surrender value\(^\text{20}\).

\(^{20}\) In 1844, Wright Reforms and non-forfeiture law made the cash value payment to the withdrawing policyholders mandatory for the insurer.
Another approach states that the policy owner is entitled to all the premiums paid, less the dividend as well as the interest, less the pro-rata share of assumed death claims, i.e. the full reserve under the policy. The proponents of this view argue that major amount of policies are terminated in the initial years. These are mostly due to ‘miss-selling’ resulting into selling the policy, which is not suitable for the policyholder. This view insists that the policy owner should receive the full amount of policy reserve and the selling agent or the insurer should be held accountable for discontinuation of the contract, by way of reduction in the surplus or reduction against the agents’ commission.

This view was supported by the report of the committee on Consumer Policy of the Organization for Economic Cooperation and Development (OECD). If the initial acquisition expenses of the terminated policies are borne by the insurer, the agent and the policy owners, and then the surrender value may reach the full reserve.

As Skipper (2000) points out “Key to any discussion about who ultimately bears the cost burden associated with early policy terminations is an understanding of the elasticity of demand and supply of the each of the stakeholders”. It is worth noting however that because of elasticity differences, the cost may not be borne ultimately by the apparent person or entity. For example, if we want the insurer surplus to absorb the costs of early termination, the insurer may transfer the burden. Hence, it would be unclear whether those costs were
ultimately borne by the insurer stockholders in form of a reduction in dividends, by the policy owners in the form of higher premiums, or by the insurer’s employees or agents in the form of lower wages and commissions.

The third approach commonly applied, is that the withdrawing policy owners should receive a surrender value that is as nearly as possible equivalent to their contribution to the funds of the insurer, less the cost of protection received (till termination), handling expenses, a contribution to insurer surplus. This view tries to ensure that the withdrawing policy owner neither benefits nor harms the interests of the persisting policy owners.

4.6 The raison d’etre of third party trading firms:

Reasons for existence of the trading in life insurance in other countries and the informal sector trading in India are, the inability of the life insurer to cater to the policyholders’ requirements of liquidity and higher surrender value. This inability is built into the financial structure of life insurance firm.

How the insurer paying less surrender value than the asset share is justified?

The asset share value equals the pro-rata share of the assets accumulated by the insurer on behalf of the block of policies to which a particular policy belongs. This value reflects the incidence of expense and its relationship to policy duration.
The actual cash surrender value may be less because of the following reasons.

1. If the full asset share is paid, there is higher incentive for the policy owners to terminate the policy. This is to induce him indirectly to make the adverse financial decision. This may affect the insurer in the financially troubled times like depressions. In normal times, with reasonable returns on investments life insurance companies have reasonable surplus to cover expenses and surrender payments. In depressions if surrenders increase due to high surrender values, the insurer’s financial standing may be weakened.

2. The option provided to the policy owner to demand the cash surrender value at anytime also necessitates a more liquid investment policy leading to loss of investment earnings.

3. The unilateral nature of life insurance contract makes it obligatory for the insurer to adhere to it, but the policy owner can terminate it anytime. Therefore, whenever the premium payment seems a hardship, the policyholder is inclined to terminate the contract.

4. Policyholders with ill health value the policy more and try to retain it. According to this argument, the policy on the good risk is likely to lapse on a larger scale. If surrender values were liberal, people with good health would be inclined to terminate their policies. This would
affect severely the policy reserve of the insurer raising the mortality and claim liability for each age.

4.7 Summary:

The surrender value paid by the primary insurer is perfectly justified due to following points.
1. Surrender of the policy is in fact a breach of long-term contract.
2. Surrender value comes from the reserve value of the policy. This reserve comes from the need to put money invested in the early years of the policy. These asset reserves provide for amount of claims in later years when the mortality rate is higher.
3. By paying out surrender values, the insurer loses opportunity to invest that amount. Funds kept aside for surrender demands are not available for investment. Insurer has to consider the interest of the policyholders who maintain their policies.
4. It is assumed that generally the surrenders are more of a good risk than a bad risk. This has adverse effect on the policy reserve, so to discourage the surrenders the insurer should not raise the surrender value.

The producer himself cannot and should not give full market value for the resale of the product that he himself has produced. However, a good resale value by a dealer benefits the consumer as well as the producer because a good resale
market leads to increased demand for primary market products. The provider is a ‘third party’ that is not accountable for selling insurance or settling death claims. Hence, provider can give higher cash value for the traded policy. This discussion about the economics of the life insurance firm brings out the inability of the primary insurer to give reasonable surrender value. Primary insurer providing the high surrender value is neither actuarially, neither economically, nor principally justified. This is the root cause of the need of existence of a third party provider and a secondary market for life insurance.