Life Insurance Assignment

Ch-1,2,3,4,5,6

Q1. Do you agree with the view that a bachelor without dependents needs no insurance? If you feel that he needs insurance, state the reasons in support of your view.

A) A bachelor with no dependants should buy a life insurance policy for the following reasons:

- **Uncertainty of the Future:** The bachelor may have dependants in the future due to the uncertainty of life. He may decide to get married and have kids. His parents will also retire after a certain age. Thus he can have many upcoming dependants even though he has none right now. To provide financial protection to the family he should buy a life insurance policy.
- **Tax Savings:** Life insurance policies also act as an effective tax saving tool. The premiums paid for life insurance policies are exempted under section 80(C) and 10(10D) of the income tax act of 1961. This allows the bachelor to save some money on taxes.
- **Cheaper premiums:** The bachelor enjoys the benefit of cheaper premiums as he has no dependants right now. Since he starts paying premiums at a young age he would be paying less than what he would have had to pay if he started at a later time. Also paying premiums would be easy for him right now as no one is financially dependant on him right now. Since he has all the

income to himself he can easily manage his money to pay premiums.

Q4.Life insurance in short is concerned with two hazards that stand across the life path of every person 'that of dying prematurely leaving the dependent family to fend for itself' and 'that of living too long without visible means of support'. Of the two hazards which is more serious and difficult to manage? Give your views with reasons

- **A)** In my opinion the risk of dying too young and living too long are almost equivalent risks. However, the risk of dying prematurely leaving the dependent family to fend for itself is more serious and difficult to manage. When the sole earner of the family dies suddenly then the family faces both emotional as well as financial loss. In the phase of mourning the family has to make a number of difficult decisions regarding their lives which include the financial decisions as well. It becomes very difficult for the family members to do proper financial planning and management. They have to repay all the debts and dues of the dead person as well. They have to make sure to use their resources wisely and make them last longer.
- However in the case of living too long, the person can at least plan his next moves and can make certain arrangements like joining old age homes, retirement homes etc. He may also become dependant on his children for financial support. Thus the risk of living too long is not as sudden

and surprising as dying young. The person can plan his future suitably and make arrangements so that he can face this adversity of life.

- Thus even though the risk of living too long is very important and concerning it is not as serious as dying too young as with proper planning the person may be able to face this contingency of life. The adversities faced by the family of a person who dies prematurely are very severe and serious.

Q6. What is adverse selection & moral hazard with respect to life insurance?

- **A) Adverse selection:** Adverse selection occurs when one party in a transaction possesses more accurate information compared to the other party. The other party, with less accurate information, is usually at a disadvantage since the party with more information stands to gain more from that transaction. Suppose that a diabetic person wants to buy a life insurance policy for himself. Since the diabetic person is aware that disclosing his condition will attract high premiums, he may conceal the information in order to get similar treatment as the other client with no health condition. Concealing such vital information leads to adverse selection. The insurance company will be at a disadvantage since it will enter into an agreement with a diabetic patient without knowing the health condition that the policyholder has. If an individual poses a greater risk to the insurance company than they disclosed on their application and are more likely to die before the date that the insurance company determined, there will be a gap between the amount the policyholder paid in premiums and their death benefit. The insurance company will have to cover this difference with its financial reserves. If this miscalculation occurs too frequently, insurance companies may deplete their reserves and have a harder time paying out claims.

- **Moral Hazard:** Moral hazard means the likelihood that a client's behaviour will change as a result of purchasing a life insurance policy and that change will increase the chance of a loss. Life insurance companies look to ensure that the act of purchasing life insurance does not make it more likely for someone to end their own life or the life of another. A moral hazard is a situation where someone has limited responsibility for the risks they take. Consequently, that person or organization may have an incentive to take on more risks than they otherwise would because they don’t need to pay for them. The concept of a moral hazard is essential for insurance because people may be inclined towards taking more significant risks if they are insured than if they are not.
- In both moral hazard and adverse selection, there is information asymmetry between the two parties. The main difference is when it occurs. In a moral hazard situation, the change in the behaviour of one party occurs after the agreement has been made. However, in adverse selection, there is a

lack of symmetric information prior to when the contract or deal is agreed upon.

Q12. Bob is a 25-year-old carpenter who is a subcontractor to various builders. He is married and has one 3 year old daughter. He earns Rs. 700,000/- gross but pays Rs 200,000/- in expenses, most which are fixed expenses i.e. a leased car and leased equipment. Bob rents an apartment and spends his earnings of Rs. 300,000/- on living and entertainment expenses. Bob saves and invests all the other money.

A. Describe briefly the features of insurances Bob could have taken out. These insurance cover may not necessarily exist in India

B. Why would anyone buy insurance policy?

A) A. The features of insurance bob could have taken out are:

1. Income Protection: Bob could have taken out income protection for 75% of his net income of Rs. 300,000 which would provide him with a monthly benefit of Rs. 18750. As he had no sick leave or savings to fall back on ideally Bob should take out the shortest waiting period of 14 days but this is also the most expensive. Other alternatives would be to take out a longer 30 day waiting period but include an accident option which would begin payments from day one if he suffered an accident. Due to his youth Bob should ideally take out an age 65 benefit period as if his injury proved to be permanent and he could not work again in his own occupation he would be paid a benefit for the remaining 40 years of his income earning capacity.

2. Business Expenses cover: As his income protection will not cover his Rs. 200,000 of fixed expenses Bob could have taken out 12 months cover for this so that he did not have to meet these expenses out of the Rs. 18750 he received from his income protection.

3. Total and Permanent Disability (TPD) / Life insurance: Bob could have taken out an amount of Rs. 30,00,000 of TPD cover so that if he was totally and permanently disabled and unable to work again he would receive a lump sum to supplement his income protection payments. This could be used to pay medical expenses, home modifications and even to purchase a house of his own.

4. Trauma Insurance: Bob and his wife could have taken out trauma insurance of say Rs. 12,00,000 to be paid in the event of serious illness.

5. Life insurance: Bob can also purchase a life insurance policy making his wife the beneficiary. He should choose a suitable amount which is able to meet various expenses like :

- Funds to cover immediate expenses after death. This includes medical expenses for terminal illness, expenses for the performance of last rites and religious ceremonies connected with death.
- Funds for meeting expenses for education and marriage of dependent children.

- Regular income fund for meeting the day-to-day expenses of dependant spouse and children.
- Fund for paying off debts. This includes outstanding house mortgage loan dues, car loan and credit card dues and other miscellaneous dues.

B. One should buy an insurance policy for the following reasons:

- **Financial Security:** No matter how much you are earning or how much you have saved; your financial position can be dented by an unexpected event in a moment. So, the best way to become financially secure is to cover yourself, your family, and your assets with insurance.
- **Transfer of Risk:** The contract of insurance works on the ‘principle of transfer of financial risk from the insured to the insurer’. As an insured, you pay premiums to receive compensation from the insurer, in case of occurrence of an unforeseen event. So, having insurance reduces the financial burden on your shoulders.
- **Complete Protection for You and Your Family:** Family is the most important asset that you have and your family also depends on you for financial support. This is why it is important to make sure that you and your family are completely secure to face any emergency.
- **No More Stress or Tension During Difficult Times:** Any unforeseen tragedy can leave you physically, mentally, and financially strained. So, if you have insurance to take care of the outcomes

of such tragedies such as illness, injury or permanent disability, even death- you save yourself and your family from tension and stress. With insurance in place, any financial stress will be taken care of, and you can focus on your recovery.

- **Peace of Mind:** Having insurance offers you financial security and also peace of mind. No amount of money can replace your peace of mind. So, when you have insurance you know that you are secured against any unforeseen events in life, and this gives you complete peace of mind.

Q15. What undesirable consequences might follow if underwriting were not permitted in the private, voluntary markets for life and health insurance?

- **A)** Underwriting is how an insurance company evaluates and analyses the risks involved in insuring a person or an asset. This may be in regard to insuring a home, car, driver, or a person's health or life. It helps an insurance company decide whether taking a chance on providing coverage to a person or business would be profitable. That is why it’s so important for underwriters to make the right decisions. It is up to them, and nobody else, to ensure that a correct level of risk is entering the industry and that this risk is matched by the right premium.
- If underwriting were not permitted in the private, voluntary markets for life and health insurance then the companies won’t be able to evaluate the risks associated with a person. The companies

won’t be able to charge suitable premiums to balance those risks. If underwriting is not done then the people who are bad risks or have very high risks associated with their lives might get insurance which will result in huge losses for the insurance companies. If medical underwriting is not done in health and life insurance then the health conditions of the person are unknown and the people who are unhealthy and are suffering from a no. of diseases or a terminal illness will be able to get insurance at cheaper premiums, leading to losses for the insurance company. Absence of underwriting will also be unfair for the customers as people who lead a healthy lifestyle may be charged equivalent premiums with respect to those who are unhealthy and are suffering from some disease or terminal illness. This might result in insurance companies depleting their reserves and having a harder time paying out claims.

Q18. Describe various type of life insurance a person can buy. State which reason on level of premiums (highest to lowest) charged in each case.

A) There are various types of life insurance policies depending of the criteria for receiving the sum assured:

1. Whole life insurance - Whole life insurance is a type of life insurance that provides you coverage throughout your lifetime provided the policy is in force. You receive the death benefit whenever you die(up to 100 years). You receive tax benefits for whole life.

2. Term life insurance - Term life insurance is a type of life insurance that provides a death benefit to the beneficiary only if the insured dies during a specified period. If the insured survives until the end of the period, the coverage ceases without value and death claim cannot be made. The premiums paid towards the term insurance plans are eligible for tax exemption under section 80C of Income Tax Act 1961.

3. Endowment policy - An endowment policy is defined as a type of life insurance that is payable to the insured if he/she is still living on the policy's maturity date, or to a beneficiary if the policyholder dies. An endowment policy provides you with a dual combination of protection and savings. Tax benefit can be availed under section 80C and 10(10D) of Income Tax Act 1961.

4. Pure endowment - An insurance contract promises to pay the insured a stated sum if he survives a specified period with nothing payable in case of prior death. It is frequently used when a policyholder intends to save up money towards some specific financial goals.

5. Annuity - An annuity is a financial product that pays out a fixed stream of payments to an individual who has paid a huge lumpsum at the outset. These financial products are primarily used as an income stream for retirees. Upon annuitization, the holding institution will issue a stream of payments at a later point in time.

6. Joint life policy - A Joint Life Policy is the insurance cover that you get on a first – death basis. It is a pay out which an insurer receives in case of death of his other insured partner during the period. Usually, when you apply for a life insurance policy, you mention a nominee or beneficiary. In Joint Life Insurance, both you and your partner will be the owner as well as the beneficiary. So, in case something happens to one of you, the other will receive the benefit of the life cover.

7. Unit Linked Contracts: In these policies the sum assured is dependant on an index like NIFTY, SENSEX etc. Each policyholder receives the value of the units allocated to the policy. As each premium is paid, a specified proportion (the "allocation percentage") is invested in an investment fund chosen by the policyholder. When each investment allocation is made, the number of units purchased by the policyholder is recorded. The value at the date of death or survival (i.e. at the time of the claim) of the cumulative number of units purchased is the sum assured under the policy.

Premiums charged for the same sum assured:

- Unit linked endowment product will have the highest premium because the sum assured you receive is dependant on an index fund which provides you higher returns on investment. Also it is a participating policy and receive a share of the company's profits in the form of dividends and bonuses. Also since it is endowment you receive the maturity as well as death benefit which guarantees the payment of the sum assured.

- Next will be unit linked whole life product as in this you receive the coverage for your entire life. It's also a participating policy and the sum assured is dependant on an investment fund.
- Next is an Endowment plan. In an endowment plan you receive the death as well as the maturity benefit which increases the guarantee of the payment of the sum assured.
- Next will be the Whole life plan. In the whole life plan you receive the death benefit for your entire life (up to 100 years). There is no maturity benefit. The claim may also be denied if you die after the age of 100 years. Thus the guarantee of the payment of the sum assured is a bit less than that of endowment plan.
- Joint life will be next in line as the partner receives the sum assured whenever the other partner dies.
- Next will be pure endowment plan as you only receive the maturity benefit. If you die within the term you won't be receiving any money.
- Next is annuity which provides a regular stream of payments of the sum assured to the individual. However if the individual dies then the annuity payments are discontinued.
- The cheapest will be the term life policy as you only receive the death benefit for a specific term. If you die after the term you won't receive any money.