Trading of Life Insurance Policies – A Critical Study

** Dr. K.S. Jaiswal*
*** Mrs. Dipti Saha*

Life Insurance is a contract for the payment of a sum of money to the person assured (or nominee) on the happening of the event insured against. Usually the contract provides for the payment of an amount of money on the date of maturity or at specific dates at periodic intervals or an unfortunate death, if it occurs earlier. It is said to be superior to other forms of savings because of protection, aid to thrift, liquidity, tax relief etc. Any person who has attended majority is eligible to enter into a valid contract, can take out a life insurance policy for himself/herself and for those in whom he or she has insurable interest. In India, Life Insurance Corporation of India Ltd. (LIC) is the biggest company dealing in life insurance business. LIC was established as a statutory corporation under the Life Insurance Corporation Act of the Parliament which received the consent of the Government on 18th June 1956. The Act came into force on 1st July 1956 and the Corporation began to function w.e.f. 1st September 1956, since then carrying on life insurance business in India. LIC, which was the sole life insurer till a few years ago, prohibited free trading of insurance policies. LIC insisted on the presence of the principle of insurable interest and policyholders could assign a policy only to entities that had an insurable interest in them. When a policyholder sells a policy, his rights in the policy get transferred to the buyer. So, if the policyholder dies, his death benefit goes to the buyer, instead of the beneficiary. Free trading goes against the principle of insurable interest, and that's why LIC didn't allow policy trading. Though LIC allowed a policyholder to assign (transfer of rights) his policy to a bank or financial institution for mortgage or to a family member or a friend, it is against assigning the policy to an organization for trading purposes. When the life insurance sector was opened to private players, the same norm was followed by the private players also.

But of late, the number of lapsed policies has increased, and policyholders are the losers — they paid premiums for some part of the policy tenure, but they forfeited the entire gains due to them. Trading will help such policyholders get some money for their policies. When a policyholder can't afford to pay premiums, he either accepts the surrender value being offered by the insurer or the policy lapses. The policy has acquired some value. If the policy can be sold and a higher amount realized, it is good for the policyholder. Even the buyer can manage higher returns.

If the policyholder is facing a severe cash crunch and can no longer service his policy, trading will be helpful to him, as it helps him to get some value for his policy and it will be fair to him. If anyone took a policy that one now thinks is inappropriate for one, a secondary market offers an exit route. Typically, trading is done on lapsed policies where investors pay the policyholder an amount which is higher than the surrender value paid by the insurer. This enables the policyholder to raise funds at a short notice and is a profitable business in the US and UK.

Assignment or transfer is a method by which a policyholder can transfer his rights to another entity. The entity pays the premium and enjoys the bonuses, benefits in the form of tax exempted returns and enjoys the survival benefits on maturity of the policy. The assignee entity can be a family member, relative, friend, a bank, financial institution or a private entity. Assignment under valuable consideration is done when the policyholder mortgages his policy with a bank or an institution. Assignment under love and affection is done for a family member, relative or a friend. The policyholder can opt for an absolute assignment, which involves transferring the total rights to the bank or relative or a conditional assignment that is about placing a condition that in case the holder is able to repay the loan amount, the policy rights are transferred back to him. Keeping all this in view and paving the way for free trading in Insurance policies, the Bombay High Court has, in a landmark judgment on 24th March 2007, ruled that Life Insurance policies are very much tradable and transferable. The ruling came in response to a petition filed by 'Insure Policy Plus Services', a Mumbai-based insurance policy trading company, challenging the refusal by Life Insurance Corporation (LIC) to register assignments of life insurance policies. As already mentioned 'Assignment' is a method by which policyholder can transfer his interest in policy to another person/institution.

A Division Bench of Justice F.I. Rebello and Justice Anoop Mohata, held that assigning of Life Insurance policies was permissible under section 38 of the LIC Act. They held that such policies were "movable property" and they can be traded in by the policyholder. The Petitioner had sought declaration that insurance policies issued by LIC were tradable and assignable in accordance with the LIC Act, as it had issued two circulars refusing to register assignments in favour of companies trading only insurance policies, though assignments in favour of Banks and other Financial

* *Senior Faculty Member,* Mahatma Gandhi Kashi Vidyapith, Varanasi-221002 (U.P.) E-mail : kjaiswal_2001@yahoo.co.in
** *Research Scholar,* Mahatma Gandhi Kashi Vidyapith, Varanasi-221002 (U.P.) E-mail : saha_dipti8@sify.com

Institutions were continued to be allowed. The LIC had taken stand that such companies having only wagering contracts had no insurable interests in the continuance of life insured and section 38 of the LIC Act was only a procedural provision. It was also contended that the LIC Act has been enacted for public interest and as a measure of social security and such a trading cannot be permitted under the Act. As an example, LIC had put forth that in some states of Canada, it was not only prohibited but also punishable under the law. The court refused to accept contention of the LIC, making it clear that the legislature when it provided for assigning or transferring has not treated the policy as protection for a widow or security for family of life insured. On the contrary, Life Insurance has become one of the best forms of investments worldwide. Worldwide, acquisition and trade in life insurance policies is a profitable business - its size in the US is about $143 billion. In India, the business is growing and the Insurance Plus Services – the company which dragged LIC to court – claims to have spent Rs. 3.58 crores on marketing and software development in the last four years. It purchases insurance policies from policyholders and then sells it to banks and financial institutions. Now the Life Insurance Corporation of India (LIC) has decided to file a special leave petition (SLP) in the Supreme Court against the trading of life insurance policies. LIC maintains that transfer of policy rights should be done for mortgage purposes or within the family. Making it a commercial business would defy the very principle of insurance. But free market trading is typically done on lapsed policies where a person's lapsed policies are bought over by someone else, paying them more than the surrender value as paid by the insurer. In turn, the buyer revives the policy and he earns the maturity benefits. This enables the policyholder to raise funds at a short notice and is a profitable business in the developed countries. Thus, after the decision of the court, now one can assign or sell one's policy to another entity, regardless of whether it has an insurable interest or not. It means development of a secondary market to buy and sell policies, both running and lapsed. For intermediaries, it means another line of business: valuing policies. For insurers, if this leads to a revival of lapsed policies, it means meeting more maturity or claim commitments. But in this regards, two very important questions arise – first **When to sell?** and second – **When to buy?** The answer of the first that is when to sell, it can be said that there can be some instances when assigning or selling life insurance policy makes sense like when it's a burden and one is finding it difficult to pay premiums. Another instance can be that the policy has lapsed or if the premium is not paid on time it will lapse. Yet another reason can be that the policyholder is happy, as he gets some or more money for something he had written off. In case of a medical emergency also, one can sell a life insurance policy, but only as a measure of last resort.

In answer of the second question that is when to buy, it can be said that once trading begins, policies bought from the secondary market will be another investment option. As a buyer, one doesn't get insurance protection; one only gets the maturity value or the death benefit if the policyholder dies. The incentive to buy a second-hand policy is the prospect of an above-market return. A number of eminent persons both from industry and academics have given their views in favour as well as against this decision of the Mumbai High Court. After going through the above discussion, let us see the benefits as well as hazards of free trading of insurance policies.

BENEFITS OF FREE TRADING OF LIFE INSURANCE POLICIES

Free trading of life insurance policies will have some favourable impact on the parties related with it like the insurer (insurance company), the policyholder, the buyer and the society as a whole.

BENEFITS TO THE INSURER

For insurers, the development of a secondary market means servicing lapsed policies, translating into lower profits. But it is profitable for them if premiums come to their books and a policy stays alive for its entire tenure. Any lapse is seen as bad. They will not have to pay the surrender value to the policyholder which they had to if the policyholder would have surrendered his policy. LIC was in favour of assigning policies to Banks and other Financial Institutions because it saw some advantage in it.

BENEFITS TO THE POLICYHOLDER

The policyholder is the biggest gainer from the free trading of life insurance policies. For those who have paid premiums for some part of their policy tenure, will not have to forfeit the entire gains due to them. Trading will help such policyholders get some money for their policies. For those who can't afford to pay premiums due to which either they accept the surrender value being offered by the insurer or the policy lapses though the policy has acquired some value, they can sell the policy and realize a higher amount than what the insurer would had given.

If the policyholder is facing financial crisis in his life and can no longer service his policy, trading will be helpful to him, as it helps him to get some value for his policy. In case of an emergency, the policy can become a sort of liquidity, as the policyholder can sell a life insurance policy and get something more for lapsed policies than what insurers offer or due to any reason he thinks that the policy is inappropriate for him now, he can dispose it off through the secondary market. It will enable the policyholder to raise funds at a short notice.

BENEFITS TO THE BUYER

For the buyer, policies bought from the secondary market will be a form of investment. The purchasing entity pays the premium and enjoys the bonuses, benefits in the form of tax exempted returns and enjoys the survival benefits on maturity of the policy. The buyer gets the maturity value or the death benefit if the policyholder dies. The incentive to buy a second-hand policy is the prospect of an above-market return. As a buyer, he can manage higher returns.

BENEFITS TO THE SOCIETY

The greatest benefit to the society is that the investments in the secondary market will increase. In other words, there will be development of a secondary market to buy and sell policies, both running and lapsed. The number of lapsed policies which are of no worth will decrease. Free trading will lead to greater flow of investment in the society which will lead to capital formation. A person as a policyholder will get a higher value for his policy on selling it to another party. The purchasing entity will enjoy the maturity benefits and can manage a higher return as well.

HAZARDS OF FREE TRADING OF LIFE INSURANCE POLICY

Inspite of a number of benefits, the problem with policy trading is that it could lead to moral hazards. Since the policy benefits get transferred to the buyer, the unscrupulous could buy a policy and then kill the seller to get the sum assured, though the chances of such incidents are rare. The other problem for insurers is that, in the absence of an insurable interest, it is difficult to keep a track of the policy once it reaches the secondary market. Right now there are no guidelines regarding trading of insurance policies in the secondary market. Such rules and regulations will have to be formulated which can regulate free trading of life insurance policies in India. There should be guidelines in place for brokers and policyholders. A pricing mechanism is needed that ensures fairness to both policyholders and buyers. Intermediaries will do the pricing. But how that pricing will be done, what conditions will enable selling, what will be the commissions of the intermediaries need to be decided. Right now, there is nothing in the regulations that can ensure fairness. Once the secondary market picks up, the regulator will introduce guidelines on selling.

SUGGESTIONS

In the light of the above discussion some suggestions may be given for fair and smooth trading of life insurance policy in the secondary market. These are as follows: 1. Sound guidelines should be made by the Government authorities to direct and supervise the process of free trading of insurance policies. 2. Adequate measures should be made to ensure that no unfair game is played in buying and selling of insurance policies, particularly from the buyer's side. 3. Such a price mechanism should be made which is fair to both the seller and the buyer. 4. Provisions governing working of intermediaries in the secondary market should be made. 5. Provisions of IDRA, SEBI and Insurance Act should be amended and made more transparent and easy to implement in this regard.

By following these suggestions, free transfer of life insurance policies can be made smoother and defect-free.

CONCLUSION

As already stated, in developed countries, there's a flourishing secondary market for insurance policies. Says K.C. Mishra, Director, National Insurance Academy: "In the US, trading makes up 30 per cent of the entire market; in the UK, it is 40 per cent." However, insurers in India are circumspect. Says Bimal Balasingham, Deputy Chief Executive Officer, Tata AIG Life Insurance: "I feel this will lead to a lot of mis-selling. Sellers beware!" Adds IRDA chairman C.S. Rao: "In order to ensure that trading is done in a controlled fashion, we will have to amend the present Insurance Act to bring in guidelines." Thus, trading of insurance policies with entities not having insurable interest is now freely permissible in India and the Life Insurance Corporation of India Ltd. cannot prohibit it anymore. But free trading of insurance policies can be fairly done only if there are clear-cut guidelines for it which will benefit both the seller and the buyer.

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