Chapter - I

Introduction

1.1: Concept of Life Insurance

In India, insurance business is classified primarily as **Life Insurance** and **General Insurance.** Life insurance is basically associated with the risk of human lives. Life insurance provides protection to a household against the premature death of its bread winner or the income earning member. Sudden death of the principal earner would lead the family into severe economic crisis. In traditional Indian societies, joint family system itself provided a shield in such eventualities as there were other earning members in every joint family. But in modern days where nucleolus family system has become a part of our society due to some socio-economic conditions, life insurance products provide such an alternative arrangements. Individuals buy life insurance products by paying certain amount of money which is called 'premium' to the life insurance company for such contractual arrangements.

Therefore, **Life insurance** or **life assurance** is a contract between the policy owner and the insurer (the insurance company) where the insurer agrees to pay a sum of money upon the occurrence of the insured individual's or individuals' death. In return, the policyholder/ owner of the policy agree to pay a stipulated amount (premium) at regular intervals for a long term period or in lump sums. If such arrangements did not happen, then the families who faces such an eventuality would forced to face a financial crisis and drag itself to a lower strata of society. People from lower strata cost the society/nation by way of subsidies, poor education and so on. Life insurance helps to reduce such costs by making contractual arrangements with large number of individuals and sharing the risk of uncertainties. Life insurance is the only way to safeguard against any unpredictable risk of the future for the family. Life insurance helps people live financially solvent and maintain same standard of living. This risk sharing capability of the life insurance products makes it (life insurance) unique among all other financial products available in the financial market.

Any Life insurance product typically has two elements first, the risk element and the second one is the savings part. The part of the premiums paid by the policy holder goes toward buying the risk coverage and rest toward savings. Since the life insurance products have the savings elements in it, buying life insurance products has always associated with investment decision which makes the life insurance product comparable with the available investments options (e.g., bank deposits, mutual funds, equities etc.) offered by the other financial institutions. The savings component of the life insurance product and the long term nature of the contract in a life insurance policy make the life insurance an important financial instrument for mobilization of funds which is required for a long gestation period investment projects such as infrastructure projects. In any life insurance contract between insuree and the insurer, insuree agrees to invest funds periodically for a long period of times and can not cancel the insurance contract with out some penalties. Therefore, life insurance contracts provide a long term source of funds for the economy. There are other short term life insurance contracts available which are known as term life insurance products which only covers the risk associated with the human life.

1.2: Life Insurance in India

Life insurance was started in India in 1818 mainly to provide insurance to English widows. Though the periphery of such activities was subsequently extended, Indians were insured only scantly, and that too, at exorbitant premiums. Foreign insurance companies had profound dominance in this market even after the establishment of the first Indian life insurance company, viz. Bombay Mutual Life Assurance Society (BMLAS), in 1870. The main characteristic of such foreign companies was that they invested the proceeds of premium outside India so that Indian economy was not benefited thereby. This development, however, took place in the informal sector. The development of insurance business in the formal sector started with the enactment of twin acts, viz. The life Insurance Companies Act and The Provident Fund Act, both in 1912. A more comprehensive legislation was, however, introduced in India under the Insurance Act of

1938 to ensure strict control over insurance business and an effective check on large scale frauds that had evolved in this business during the 1930's[1].

The definition of life insurance business given in the Section 2(11), of the Insurance Act of 1938 as follows:

"Life Insurance Business" means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) and the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include

(a) the granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance;

(b) the granting of annuities upon human life; and

(c) the granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependent of such persons.

Life insurance business got a boost in India rightly from the eve of the planning era on account of its capacity to mobilize resources from the cross section of population, and to channelise them in productive activities. By 1956 India accommodated as many as 154 Indian life insurance companies, 16 non-Indian companies and 75 provident fund societies issuing life insurance policies[2]. Total assets of these units were about Rs.441 crore on August 31, 1956 with around 57 lakhs policies and an employment level of 27 thousand. Their assured sum stood at more than Rs.1250 crore at that time[3]. The Government of India, however, nationalised these business units, and amalgamated them under Life Insurance Corporation of India (LICI) in 1956 with a view to utilising the then-emerging financial institutions in the successful implementation of Five Year Plans.

The LICI had made tremendous growth after its nationalization. New business that stood at Rs. 336.37 crore in 1957, accelerated to Rs 75606.62 crore in 1998-99. Again, total number of effective policies was around 917 lakhs and the total value of sum assured, Rs. 459201 crore in 1998-99, as against 57 lakh policies and Rs. 441 crore sums assured in 1956. Likewise, LICI's life fund increased from Rs. 410.40 crore in1956 to Rs 127389.06 crore in 1999; its investment in the socially oriented sector escalated from Rs 513.21 crore in 1969 to Rs. 88831 crore in 1999; and its claims settlement went up from 25 crore in 1957 to 7583.18 crore in 1999[4].

Though LICI grew amazingly in terms of business volume prior to 1999, it staggered in terms of geographical spread, especially in the countryside, as well as the number of lives coverage. Evidence indicates that its business had been confined to big cities, and within the cities, only to more affluent sections of the society. The rural sector shared only around 18 per cent of its business in 2000[5]. The Indian insurance market also fell short of the global standard. This is evident in the fact that the penetration level was only 1.39 per cent of GDP in India while it was 2.16 per cent in Malaysia, 2.65 per cent in Chile, 8.39 per cent in South Korea, 13.92 per cent in South Africa, and 10.30 per cent in the UK. India, however, scored ahead of China where the penetration level was 1.02 per cent in 1999. India's share in the global insurance market was also very meager in 1999. It was only 0.36 per cent, and ranked at 23. The scenario was slightly better for the global life insurance market where India's share was 0.43 per cent[6].

1.3: GATS & Life Insurance Industry

The Uruguay Round of GATT *(General Agreement on Trade and Tariffs)* advocated the removal of restrictions and non-tariff barriers of trade so that there will be free flow of international trade and services across countries. GATS *(General Agreement on Trade in Services)* are a part of world's trade agreement in WTO, which has been applied since

January 1995[7]. WTO, as an organization, has a different character from its predecessor, GATT *(General Agreement on Trade and Tariffs)*. GATT only regulated the international trade of goods by decreasing tariff barrier to make the flow of export-import run smoothly, while WTO does not only regulate the traffic of trade of goods, but also establishes the rules for the trade in services (GATS) and the protection of Trade Related Intellectual Property Rights (TRIPs)[8] The ratification of GATS has become the new episode-in the internationalization and institutionalization of service provision which include the insurance and insurance-related services under the head of financial service. Insurance and insurance-related services cover life and non-life insurance, reinsurance, insurance brokerage, agency service, consultancy and actuarial services[9]. Financial services are one of the sectors to be opened under the Agreement on Trade in Services (GATS) along with other WTO Agreements [10]. It is against this backdrop many countries have deregulated its insurance sector, e.g., South Korea and Taiwan in 1987, Argentina and Pakistan in 1990, Philippines in 1992, Japan in 1996 etc. and those countries which have already opened its insurance industry went further to deregulate their insurance market, such as Brazil, Peru, Hong Kong and Singapore[11]. India also opened its insurance sector as a part of the GATS commitments which are unbound except, insurance of freight, reinsurance with foreign re-insurers to the extent of 10 per cent of the premium of the market overall being reinsured abroad. Article VI (1) of GATS made it obligatory to open the sectors where specific commitments have been made by the members. The final commitments made by India in GATS are given in the Annexure 1. (I). The year 1991, however, witnessed a paradigm shift in India's overall development strategy. On the one hand, there has been steady removal of restrictions on the inflow of goods and services, including capital, and, on the other, the public sector has been increasingly privatised [12]. In fact, many provisions of GATT are consonant with the new economic policy adopted by India. The impacts of these new economic policies on LICI have been enormous[13]. Keeping these in view, a Committee on Reforms in the Insurance sector was set up under the Chairmanship of R.N. Malhotra in 1992. The recommendations of the Committee, submitted in 1994, were accepted in principle by the government. The major recommendations of the Committee[14] were as follows:

i. To raise the capital base of LICI from Rs.5 crore to Rs. 200 crore;

ii. To restructure LICI by way of delegating financial, administrative and operational authority to the Zonal Offices, leaving for the Central office the jobs like policy formulation, product development, investments, personal policies and accounts of the corporation:

iii. To allow limited number of private companies in the insurance sector with a restriction that no firm be allowed to operate in both lines of insurance (life and general).

iv. To ensure minimum paid-up capital for a new private company at Rs.100 crore with promoters holding not exceeding 40 per cent and at no time be less than 26 per cent of the paid-up capital.

v. To set up a strong and effective regulatory body with an independent source of fund before allowing private companies into the sector.

vi. To reduce mandatory investment of fresh accretions from the present level of 75 per cent which was considered to be high.

vii. To use modern technology at all levels.

The Government of India started implementing the recommendations of the Malhotra Committee since December 1999, thus heralding an era of liberalization in the country's insurance sector. The setting up of Insurance Regulatory and Development Authority (IRDA) and opening up of Insurance Business (life and general) to foreign capital up to 26 per cent were the initial steps in this direction[15].

It is widely acknowledged that the opening up of the insurance sector has been aimed at ushering in greater efficiency in the insurance business by maximising productivity and minimising transaction cost. Competition is believed to bring a wider choice of products at lower prices to the consumers, larger coverage of population, better customer service, superior information technology, higher returns to the policy holders, and so on[16].

1.4: Objectives

The role of financial sector towards economic development is well established by researchers in their empirical studies [e.g., Levine and Zervos[17] (1998), Levine[18] (1997), King and Levine (1993a[19] and 1993b[20]) Levine et. al[21]. (2000), and Beck et. al[22]. (2000)]. Now the research has been shifted from established link between financial development and economic growth to understand factors that affects the overall financial services, thereby the underlying factors that lead to improve the financial development. Economic literature has been given much of attention to the capital market and banking sector. Insurance is one of the important financial services that can trigger the growth in an economy by channelising the long-term savings for the productive purpose and providing a shield before the risk associated with any activity related to productivity, assets or life. However, literature on relationship between insurance sector and economic growth is very uncommon. Few recent studies showed that the insurance industry can improve the economic growth through financial intermediation, risk aversion and generating employment. For example, we can highlight the studies of Outreville (1990 b), Catalan et. al.[23] (2000), Ward and Zurbruegg[24] (2002). The recent empirical work on insurance market by Browne and Kim[25] (1993), Ward and Zurbruegg[26] (2002), Beck and Webb (2003) and Esho et. al.[27] (2004) have shown that the level of insurance demand can be influenced by the economic, demographic and legal factors.

Despite these studies on the contribution of life insurance sector there are hardly few studies on the individual emerging markets in Asia such as India during the post liberalization period. Though we could find few studies on China such as Hwang and Gao[28] (2003), Hwang and Greenford[29] (2005), Zhang and Zhu[30] (2005). However, there are very few studies on Indian life insurance market available which are worth mentioning like Sinha (2004), Joshi[31] (2003) and Rajagopalan[32] (2004). In his study Rajagopalan (2004) tried to asses the impact on the cost effectiveness of term life insurance products in the post reform era while Joshi (2003) showed the changing customer expectations in insurance sector during the post liberlised period. Sinha (2004) dealt with the overall development of the insurance sector which explains the challenges and opportunities in the years to come before the insurance industry more of theoretically. We do not find any research work on the long run relationship between life insurance reforms and the impacts of those reforms on the development on the life insurance industry in India. In this background, the present study will assess the impact of the insurance sector reforms on the overall development of life insurance in India. The development of this sector will be measured in terms of certain well accepted indices like insurance density, insurance penetration, new policies issued etc. To do this, the present study will formulate and calibrate a theoretical model that will be appropriate to measure the life insurance sector reforms numerically in India as no such study has yet delved into the question of efficacy of these new policies, and their success in terms of their stated objectives.

This present study will also seek to identify the factors that have significant bearings on the overall development of life insurance demand in India in the post-reform era. The determining factors of life insurance demand vary from country to country. The plausible set of such factors have not yet been identified for India in any published study except Sadakh[33] (2006) who have shown certain naive statistical relationship among the potential dependent variables. The present study will investigate into this field and seek to bring out the variables that have been directly or indirectly influencing the development of life insurance business in the post-reform period in India.

In short the broad objectives of this study are:

1. To investigate the implications (positive/negative) of the insurance sector reforms in the Indian life insurance sector;
2. To assess the welfare implications of this reform, and
3. To identify the factors responsible for this development.

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