

**THEORETICAL ANALYSIS OF THE MECHANISM OF UNIT LINKED
INSURANCE POLICIES IN INDIA**

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ABSTRACT

Unit Linked Insurance Policies are policies, which give benefits of insurance as well as investment to the insurer (and in other capacity, investor), all of which is done under one plan. Such policies are distinct from regular insurance policies, which the majority is generally aware of.

With the opening of the insurance sector, Unit Linked Insurance Products (ULIP) have emerged as popular products and the sector has been witnessing significant growth in this line of business in addition to growth of traditional insurance products.¹

This research paper enquires not merely the working of ULIPs in general, but also to generalize the reader with the concept working behind ULIPs and its operation in India. While dealing with the later part, the paper discusses the tax aspect, which intersects with the functioning of ULIPs. In extension, it also delves into the judicial pronouncements by courts, which explained the concept of ULIPs through their interpretation.

¹ Section 2.1, Life Insurance Products – Guidelines for Unit Linked Life Insurance Products, 2005.

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RESEARCH METHODOLOGY

I. OBJECTIVE

To examine, keeping in the mind the operation of Unit Linked Insurance Policies in India, the nature, applicability and functioning of ULIPs and to deal with the open ended questions & grey areas in the field of ULIPs.

II. HYPOTHESIS

Insurance business allows the running of policies including Unit Linked Insurance Policy, which is for the benefit of the public at large.

III. RESEARCH QUESTION

- i. What are the various aspects related to the concept of Unit Linked Insurance Policies.
- ii. How does the functioning of Unit Linked Insurance Policies benefit the insured?

IV. COVERAGE & SCOPE

The scope of this research paper is limited to the law on insurance in India, which includes the IRDA Act, Insurance Act and other allied Acts and Regulations, judicial pronouncements on the issue of ULIPs and the discussion extends to general principles of Insurance.

Chapter I – GENERAL OVERVIEW OF ULIPs

Unit Linked Insurance Plan (hereinafter, 'ULIP') was an initiative taken in result of the fiscal policy in 2001, which opened market gates for foreign direct investment from potential investors. A major role played in the initiative was of the Insurance Regulatory Authority when it issued regulatory guidelines for the functioning of ULIPs (discussed in later part of the research paper).

Subsequently, Unit Trust of India came up with the very first Unit Linked Insurance Plan in 1971 for benefitting the general public by giving a novel way to safely invest capital and get insurance benefits as well. Following the trail, in no time India witnessed floods of ULIPs being offered by insurance companies, giving the inference that such policies were highly advantageous for the potential customers.

As soon as the insurance business capacitated tons of ULIPs with the efflux of time after the launch of the first ULIP, the insurance industry appreciated it for its working mechanism. One intriguing point of its mechanism was that the insured paid the same premium as given in other insurance schemes but here, a part of the amount paid was used to maintain the cover of the insurance and the other part was put into useful investment, after application of expert knowledge of the insurance companies, into equity and debt securities, which bore promising returns.

The other intriguing point of its mechanism is that it not only benefits the insured in this way, it also maintains transparency between the insurer and the insured as the amount collected by the companies is pooled in to form a contributory fund which was invested in securities on a pro rata basis. The working of ULIPs bears similarity to the working of mutual funds otherwise differing in purpose.

I. NATURE OF ULIPs

Unit Linked Insurance Plan is a multi-faceted insurance plan, which includes giving the insured options to switch between varieties of funds as long as the policy exists. The possibility of decreasing or magnifying the level of protection of the insurance is also

guaranteed in a typical ULIP. Other general courses of action like surrendering of the policy after three years of regular premium payment² are available to the policy holder of a ULIP.

Apart from a range of choices available to the holder within one particular ULIP, a potential customer is given the power to choose among different types of ULIPs. Many types of policies offered in the market may be minutely different only, but broadly there are some types of ULIPs which are distinct from the others on the ground of the investment objectives and purposes of the policy holder, while on the other hand some of the policies differ on the point of the customer's risk appetite and the rest on the basis of the horizon of investment offered. Potential investors may also be offered with policies, which attribute a contrasting amount of the investment in debt instruments like Debentures, as compared to equity instruments like Preference Shares, Equity Shares, etc.

II. RISKS INVOLVED IN ULIPS

The underlying mechanism of ULIPs involves direct linkage with the share/debenture market; therefore, an investor faces the same risk, which runs in the securities market. To be in a safe position, the investor needs to be aware of all the risks involved before transacting into something, which might be regretful at a later stage.

In the case of *Virendra Pal Kapoor vs. Union of India*, where the petition was filed against deduction of mortality charges from policyholder's fund, the issue, which arose, was – whether mortality charges were rightly deducted from his fund.³ The Court held that since the Petitioner entered into contract with SBI Life in premises of SBI under its banner and logo and was misled by agent of SBI acting under agreement between SBI and SBI Life, in leading Petitioner to enter into contract which had both investment and insurance aspects, it was therefore an unconscionable contract and was thus arbitrary, illegal and void document and did not bind Petitioner.⁴

III. ULIPS: REBATE ALLOWED IN COMPUTATION OF INCOME-TAX

Firstly, By the coming of the Finance Act 1990, Section 80 C was replaced with effect from 1-4-91 by Sections 87, 88 and 88A for the assessment year 1991-92 and onwards.⁵ Section

² Section 113, Insurance Act, 1938.

³ *Virendra Pal Kapoor vs. Union of India*, 2014 (8) ADJ 602.

⁴ See *Supra* note 3.

⁵ Sections 87, 88 & 88A, Finance Act, 1990.

88 provides for a deduction, to an individual or a HUF, from amount of income tax, of an amount, which is equivalent to twenty percent of the aggregate sums referred in section 88 (2).⁶ Section 88 (2) enumerates the various types of savings for which sums paid or contributed out of income chargeable to tax qualify for deduction from the amount of income tax.⁷ They are life insurance premium, contribution to provident fund, post office Cumulative Time Deposits, National Saving Certificates, *unit linked* insurance plan of the LIC Mutual Fund, Subscription to any deposit scheme of the National Housing Bank, repayment of loans to Banks, Central Govt., State govt., NHB, LIC etc.⁸

Secondly, Section 80 C of the Income Tax Act provides tax exemption on contribution for participation in the Unit-linked Insurance Plan, 1971 made under section 19 (1) (cc) of the Unit Trust of India and for contribution for participation in any such Unit-linked Insurance Plan of the LIC Mutual Fund.⁹ Lastly, Section 88(2) in the Income Tax Act provides to exemption for participation in the Unit linked Insurance Plan, 1971.¹⁰

IV. THE OTHER SIDE OF ULIPS

It was not shocking for the ULIP business to face difficulties in the Indian market, a market, which demands critical analysis of every situation involving even a hint of the subject matter of securities and investment. 'Securities' has always been a sensitive issue for the market, starting from the early manipulation of the securities industry in the 1990s and then especially what followed, the Satyam fiasco. The Mint Newspaper reported a crucial event where it was estimated that Investors lost Rs.1.5 trillion due to insurance mis-selling, and went on further to quote it, as "The ULIP rip-off was an institutional defrauding of the small investors" and covered it in an article ULIP Rips off Consumers.¹¹ Insurance giants like LIC, SBI, Reliance Life, Aviva, HDFC Life, etc, have since been involved in mass awareness regarding the different aspects of ULIPs. A detailed discussion about the mis-selling of ULIPs shall be done in the later chapters of the paper.

⁶ Section 88, Finance Act, 1990.

⁷ Section 88(2), Finance Act, 1990.

⁸ *Ibid.*

⁹ Section 80C, The Income-Tax Act, 1995.

¹⁰ Section 88(2), The Income-Tax Act, 1995.

¹¹ <http://www.livemint.com/Money/Bn8wj4mBbZP3hAI0la0sXL/Investors-lost-15-trillion-due-to-insurance-misselling.html%7C>

Chapter II – REGULATION OF ULIPs: STATUTORY ANALYSIS

I. REGULATIONS ISSUED BY IRDA UNDER SECTION 26, IRDA

A. Regulations for Investment

Since the working of ULIPs intersects with the Securities market, it becomes an imperative matter to re regulated. The Insurance Regulatory and Development Authority of India (hereinafter “IRDA”) is the guardian of the Insurance sector as it protects the interests of holders of insurance policies, regulates, promotes and ensures orderly growth of the insurance industry and for matters connected therewith.¹² Section 26 of the IRDA Act provides for power of the IRDA to make regulations consistent with the Act to carry out the purposes of the Act.¹³

Under the powers so vested, the IRDA made the ‘Insurance Regulatory and Development Authority (Investment) Regulations’ in 2000. Regulation 3 is made for the purpose of regulation of Investments. Para 3 of the Regulation provides a mandate on the insurance companies to keep the fund received as a part of the premium (which is given for the purpose of investment) invested as per the specified arrangement or pattern which was offered, agreed and consented upon.¹⁴ It also provides that the ULIPs offered by insurers may only be offered where the units are linked to categories of assets, which are both marketable and easily realizable.¹⁵

B. Regulations with respect to Life Insurance Policies

By virtue of Section 26 of the IRDA Act, the IRDA also prescribed regulations called the ‘Insurance Regulatory and Development Authority (Protection of Policy-holders’ Interest) Regulations’ in 2002. Regulation 6 of the Regulations deals with the matters, which are to mandatorily be present and stated in life insurance policies. For the purpose of this research paper, Para 2 and Para 3 of the Regulation are important.¹⁶

Para 2 provides that it is the duty of the insurance companies giving life insurance to inform

¹² Insurance Regulatory and Development Authority of India Act, 1999.

¹³ United India Insurance Co. Ltd vs Manubhai Dharmasinhbhai Gajera, (2008) 10 SCC 404.

¹⁴ Abdul Jalil S/O Late Habib Ullah v. Special Judge, 2007 (69) ALR 318.

¹⁵ Regulation 3, Insurance Regulatory and Development Authority (Investment) Regulations, 2000.

¹⁶ Santosh Kanwar vs Life Insurance Corporation, R.P. 2049, 2000, NCR (Raj).

by the letter forwarding the policy that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy and where the Insured disagrees to any of those terms or conditions, he has the option to return the policy stating the reasons for his objection, when he shall be entitled to a refund of the premium paid, subject only to a deduction of a proportionate risk premium for the period on cover and the expenses incurred by the insurer on medical examination of the proposer and stamp duty charges.¹⁷ Para 3 is regarding the tangent of ULIPs in Life Insurance policies as it provides that in respect of a unit linked policy, in addition to the deductions under Para 2 of the regulation, the Insurer shall also be entitled to repurchase the Unit at the price of the units on the date of cancellation.¹⁸

II. GUIDELINES PRESCRIBED BY IRDA FOR ISSUE OF ULIPS

In 2005, the IRDA issued guidelines for issue of ULIPs dealing with Life Insurance. The Guidelines define the nomenclature of various charges and how they are to be levied, so that the customers are clearly aware of various charges under the product and are apprised of the unit prices on a daily basis.¹⁹ These are applicable to all registered insurance companies, which deal in the business of insurance, which are also registered in accordance with the Insurance Act.²⁰ These guidelines were issued with the intention to create more transparency, accountability and awareness of ULIPs for the general public. This is so because in ULIPs, a hint of investment risk is involved.

A. Features and Criteria of ULIPS

The guidelines suggest the minimum features and criteria which ULIP products and business should satisfy, which include reasonable insurance cover with a linkage to the premium payment during the term of the contract; availability of greater part of a targeted sum at the longer end; basic features of life insurance contract including long term nature; avoid technical jargon; remain simple for the public to understand and complete transparency in all aspects of the product terms & conditions; despite the investment risk being borne by the policyholder, the investment strategy is aligned to long term nature of these contracts; adequate disclosure of information pertaining to investment of funds and the elements

¹⁷ Para 2, Regulation 6, Insurance Regulatory and Development Authority (Protection of Policy-holders' Interest) Regulations, 2002.

¹⁸ *Ibid*, Para 3.

¹⁹ Life Insurance Products – Guidelines for Unit Linked Life Insurance Products, 2005.

²⁰ *Ibid*, Section 1.

of risk involved; and a standard method, across the industry, with regard to computation of NAV (Net Asset Value).²¹

B. Disclosure Requirements

Part III of the Annexure to the Guidelines deal with the disclosure requirements, which are to be followed by the insurers providing ULIPs. These requirements are quite peculiar are crucial as the guidelines try to micro supervise every minute detail such as providing details of the ULIPs in the same font size, thereby reducing the chances of fraudulent activities involving fine print conditions. Every insurer should give all vital details, for instance:

1. The minimum and maximum percentage of the Investments in different types (like equities, debt etc.), investment strategy so as to enable the policyholder to make an informed investment decision - "No statement of opinion as to the performance of the fund shall be made any where."²²
2. On top of each document including the proposal form mention, "IN THIS POLICY, THE INVESTMENT RISK IN INVESTMENT PORTFOLIO IS BORNE BY THE POLICYHOLDER".²³
3. The various funds offered along with the details and objective of the fund.

C. Advertisements

The guidelines also declare that there shall be strict adherence to its prescribed rules with respect to the advertisements of ULIP products. General conformation with norms of accuracy, adequacy, lucidity and fair display of information is required by IRDA. Apart from displaying the features, an insurer should also make clear manifestation of all the risks involved in the ULIP product. It should also clearly distinguish the fact that the Unit Linked products are different from the traditional Life Insurance products so that at no point of time the prospective policyholders will be misled while choosing the Unit Linked products.²⁴ For the saving of interests of the policyholders, IRDA also guides that the terminology used in all the advertisements shall be simple, concise and understandable to convey the exact meaning to the policyholders as all of them may not be sophisticated in legal or financial matters and

²¹ *Ibid*, Section 3.

²² Para 1, Part III – Disclosure Norms, Annexure I – Guidelines on Unit Linked Insurance Products, 2005.

²³ Sony India (P) Limited vs Deputy Commissioner Of Income Tax, DCIT 11 ITR 236.

²⁴ Para 1.1.1.1, Part IV – Advertisements, Annexure I – Guidelines on Unit Linked Insurance Products, 2005.

shall avoid the usage of technical jargon and also terms which can have different interpretations or detract the policyholders.²⁵

D. Other guidelines

Further, the Annexures to these Guidelines provide that the minimum term of ULIPs to be provided by any insurer shall be five years and not less than that. It also states that a linked product must have a guaranteed sum assured payable on death and may have a guaranteed maturity value.²⁶ In consonance with the Insurance Act's rule regarding surrender of policy, the guidelines similarly provide that a ULIP will become eligible to be surrendered and to receive the payable surrender value after three years of successful payment of premiums. Any kind of disguised or direct loans provided in the name of ULIPs are strictly prohibited as per the guidelines. The authority also suggests that the Life Insurers should move towards the evaluation of their respective unit linked funds done by an independent rating agency with an objective of providing qualitative information to the policyholder as to the assessment of performance of the various unit linked funds to enable the insuring public to choose the product in an informed manner.²⁷

²⁵ *Ibid*, Para 1.2.

²⁶ Para 3, Part 1 – Product Design, Annexure I – Guidelines on Unit Linked Insurance Products, 2005.

²⁷ Para 1, Part VI – Rating of Unit Linked Funds, Annexure I – Guidelines on Unit Linked Insurance Products, 2005.

Chapter III – MIS-SELLING OF ULIPs IN INDIA

I. INTRODUCTION

There were traditionally three products offered by the Life Insurance Corporation of India (LIC), which was the state owned monopoly till 2001: term policies, annuities and non-linked policies.²⁸ The rationale for such investments in addition to the pure life component is that if the customer is able to put some money aside into an investment along with the insurance product, the investment could be used to fund any changes in the future costs of the insurance product arising out of changes in mortality or fees for other reasons.²⁹

Non-linked policies were popular with investors in the Indian retail market because they gave investors some access to long-term investment opportunities unlike the annuities or the term policies.³⁰ In addition, there were no competing fund management avenues for Indian investors at the time that offered guaranteed returns. Investors funded the policy once or twice a year in the expectation of getting a lump sum in 15-20 years or getting periodic paybacks after 10-15 years of funding the policy.³¹ In addition, there were attractive tax benefits for these insurance products, both as being eligible for tax benefits during investment, and after, with proceeds of the investment and withdrawals being tax free.

After the Insurance Regulatory and Development Authority (IRDA) was set up in 1999, and the privatization of the sector in 2000, two significant changes took place. The first was the entry of the “unit-linked insurance policy” (ULIP), an investment linked insurance policy, where a large fraction of the premium was invested as in a mutual fund product with a small.³²

Although penetration of insurance amongst a wider set of customers did not take place, the commissions paid out by the industry for distribution matched the growth in the AUM of the insurance sector.³³ The industry paid out net commission of Rs.1.13 trillion over the 2004-05

²⁸ Monika Halan, *et. al*, *Estimating losses to customers on account of mis-selling of life insurance policies in India*, WP 2013 – 007, Indira Gandhi Institute of Development Research, Mumbai (2013).

²⁹ F.B. Corby, *Reserves for Maturity Guarantees under Unit-Linked Policies*, Cambridge University Press – Journal of Institute of Acturics, Vol. 104, No. 3 (1997), p. 259.

³⁰ *See Supra* note 26.

³¹ Discussion on the Report of the Committee on Property Bonds and Equity-Linked Life Assurance, Cambridge University Press - Transactions of the Faculty of Acturics Vol. 34, No. 243 (1973-75), p. 24.

³² *Ibid*

³³ Hashempoor, Soghra, *Insurance and History of Its Origin, and Its Surrounding Issues*, Journal of Basic and

to 2011-12 period and in the last few years, there have been many concerns about insurance distribution through agencies such as banks.³⁴

II. REASONS BEHIND MIS-SELLING OF ULIPS

Introduction of ULIPs in the market

The unit-linked insurance plan (ULIP) was born in India in 2002. Reports of mis-selling are invariably connected with this product. Part of the reason is that buyers find the traditional term plan unappealing because when the term ends, the policyholder gets nothing. But ULIPs and other endowment plans promise not only a death benefit (no matter how meager) but investment possibilities as well.³⁵

Motive of agents to get more commission

Unit-linked policies are known to pay higher commissions, which is why in the post-2002 period agents began to sell such plans at the cost of traditional ones. Moreover, now that more players had entered the insurance markets, agents no longer needed to maintain long-term ties with a single insurer they could jump from company to company too.³⁶

Return available within less time

Insurance shoppers conveniently forget that insurance, particularly life insurance, is ideally a long-term product. Lured by the promise of high returns and the ability to grow one's investment in the short-term, many policy buyers treat insurance as a quick investment opportunity, not realizing that unit-linked products are nearly always front-loaded and that exiting early is not beneficial.³⁷

Ignorance of customer with respect to terms of policy

Policy buyers satisfy themselves with the insurance agent's sales pitch, particularly if the agent is a friend or relative. This is a mistake because even if your agent has your interests at heart, he may miss informing you about important clauses.

Expiry of the Free-look Period

Applied Scientific Research 3 (2): 1217–1230.

³⁴ Samuel Marshall, *Treatise on the Law of Insurance* (3rd edition, 1823), Vol 1, p. 23.

³⁵ *Ibid.*

³⁶ See *Supra* note 31.

³⁷ Surinder Kumar Singal vs Aviva Life Insurance Co., SCDR (2014).

The free-look period is a 15-day window following receipt of the policy bond during which the policy buyer can return the policy if the terms and conditions are not to his liking.³⁸ However, many a time, the delivery is rigged such that the mis-sold policy does not reach the customer in time.³⁹

Customers are neither aware nor informed

This represents the main reason why mis-selling is so common in India. Many customers do not understand that insurance is intended primarily for risk protection not for tax savings, not for investment.⁴⁰ Awareness is crucial if the consumer is to receive a policy that truly meets his unique requirements. One available method is that if you want to sell insurance to India, you must sell simple products and must make it absolutely clear to agents and other officers that they should not mis-sell, given that insurance penetration currently represents only about 4 percent of GDP, this is good advice; mis-selling only hampers the sector's growth possibilities.⁴¹

³⁸ M/S Idbi Federal Life Insurance vs Insurance Ombudsman and Anr, 2009 AIR (Raj.) 224.

³⁹ John Varghese, Dagger, *Unit linked insurance products (ULIP) and Regulatory Tangle*, (2011) PL February S-12.

⁴⁰ See *Supra* note 32.

⁴¹ Deepak Yohannan, *Why is mis-selling so prevalent in insurance sector*, available at: http://www.moneycontrol.com/master_your_money/stocks_news_consumption.php?autono=931802 (last visited – 29/03/2015).

CONCLUSION

Fun is like life insurance; the older you get, the more it costs.

- *Kin Hubbard*

Under the aegis of the most imperative regulatory authority in the business of insurance, *i.e.*, the IRDA, the Indian market has been positive side of the insurance industry. The IRDA has to the duty to work in the interest of policyholders and potential policyholders, therefore it helps in bringing out new ways to promote the insurance business. One of the ways crafted with the help of brainstorming in the IRDA was to come out with an insurance scheme which would give the policyholders two capacities, *firstly*, of an investor and *secondly*, of an insured person. It was visioned that such a policy would be much more financially and economically beneficial for the general public. This was so because it had a flavor of the securities market, which made the opportunity risky as well as exciting.

The various regulations and guidelines framed by the IRDA manifest the amount of importance it holds to the authority, or in other words, important enough to require IRDA's expert supervision. Micro-managing of ULIPs has been done, in the field of disclosure requirements, advertisements, etc so that there is absolutely no deviation from what the set statutes say.

With the coming of ULIPs, the policyholders do benefit from the option provided to pay premium, which also includes the amount of investment to be done, but one should never disregard the happenings and the future possibilities of negative activities going on in the field of ULIPs. For instance, mis-selling of ULIPs has always been a matter of great concern for the Indian market ever since ULIPs began to flourish on a commercial scale. Given the fact that such policies have a considerable amount of tax rebates allowed, buying a ULIP does seem very attractive at the first glance.

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