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Indira Gandhi Institute of Development Research, Mumbai
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Monika Halan, Renuka Sane and Susan Thomas
Indira Gandhi Institute of Development Research (IGIDR)
General Arun Kumar Vaidya Marg
Goregaon (E), Mumbai- 400065, INDIA
Email (corresponding author): monikahalan@gmail.com

Abstract

This paper presents two approaches that use publicly available data to estimate the loss to investors from mis-selling of insurance products. The first approach uses the number of lapsed policies from the annual reports of the insurance regulator, IRDA, while the second method uses the persistence of premium payments that are reported
in the annual reports of individual insurance companies. Both these methods arrive at a similar estimate a loss of about Rs.1.5 trillion, or $28 billion, to investors owing to mis-selling over the 2004-05 to 2011-12 period.

Keywords: unit-linked insurance products, lapsed policies, persistence of premium

JEL Code: D14, D18, G22

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*Monika Halan is with *Mint*. Renuka Sane and Susan Thomas are with the Finance Research Group, IGIDR. Corresponding author: Monika Halan, monikahalan@gmail.com.
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Contents

1 Introduction **3**

2 Mis-selling of ULIPs in India **5**
2.1 Factors that assisted the widespread mis-selling of ULIPs . . . 7

3 Methodology: Estimating economic loss **9**
3.1 Renewal premium method 10
3.2 The persistency method 11

4 Results: Estimated economic loss **13**
4.1 Renewal premium method 13
4.2 The persistency method 15

5 Implications **17**
5.1 The response to mis-selling of ULIPs 18
5.2 What remains to be done 21

6 Conclusion **22**

Appendix **26**

A Persistency estimates **26**

1 Introduction

Concerns about consumer protection have come to prominence in financial regulation in recent decades (Campbell, 2006; Inderst, 2009). One specific area is the conflict of interest that exists in distribution of retail financial products which gives rise to various episodes of mis-selling (Mullainathan et. al., 2012; Beyer et. al., 2013). If consumers are naive about understanding complicated financial contracts, they can become victims to mis-selling by distributors and agents, who are incentivised by remuneration structures to push financial products regardless of how suitable the product is for the customer (Inderst and Ottaviani, 2009).

There are several examples that serve as illustrations. The financial sector in the U.K., which is one of the oldest and best established in the world, has recorded various financial sector misdemeanours over the last three decades: The pensions scandal in the 1980s (recognised by regulators only in 1993-94), the endowment mortgage scandal in mid 1990s, and more recently, the Payment Protection Insurance (PPI) mis-selling episode (McConnell and Blacker, 2012). The ponzi scheme engineered by Bernie Madoff in the U.S. is estimated to have defrauded investors of billions of dollars. The collapse of Storm Financial, a financial advisory firm in Australia, left investors with an estimated loss around $3 billion (Barry, 2011).

Relatively little is known in the area of quantification of mis-selling, particularly when it comes to an emerging market such as India. One recent paper (Anagol and Kim, 2012) associates losses of $0.35 billion with shrouding of fees by mutual funds in India.

In this paper, we examine the experience of insurance products in India over a time period when there were important breakdowns of consumer protection, and arrive at a numerical estimate of the magnitude of losses suffered by investors owing to mis-selling.

We propose methods to estimate the losses of investors using two publicly available sources of data. The *renewal premium method* captures the loss in renewal premiums that occurs due to lapsed policies. This is reported in the annual reports of the Insurance Regulatory and Development Authority, (IRDA), as policies that are not renewed by the policyholder. This estimate is cross-validated using the *persistency method*, which tracks the performance of the premium over subsequent time periods to measure the attrition to the business over time, and is reported in the annual reports of the individual insurance companies. This allows for an examination of the life cycle of

policies issued in a particular year.

The underlying assumption in both these methods is that when policies lapse for reasons other than those of death or financial emergencies, it is because the investor discovers that the policy is unsuitable, abandons it from their investment portfolio and treats the lapsed premia as sunk cost. Our methods reveal that investors lost Rs.1.5 trillion (US$28 billion).

The insurance market in India underwent a tremendous growth during the first rise of market linked products called unit linked insurance plans ("ULIPs") between the period of 2004-05 to 2009-10. This period also saw the highest numbers of lapsed policies. The correlation between the growth of ULIPs and the outcomes of these two methods supports the hypothesis that the losses were caused by mis-selling of ULIPs. The causal relationship between loss and mis-selling practices can be strengthened if it can be shown that, after the regulator imposed caps on commissions and other sales practices, the rates at which policies lapsed fell.

Alongside the traditional pillars of financial economics – the analysis of markets, financial intermediaries and corporate finance – a new field that has emerged in recent years is household finance. This paper forms part of an emerging literature that studies household finance in India, that is made possible by large-scale household databases and a series of fascinating natural experiments. An example of this research program is found in Campbell, Ramadorai, and Ranish (2012) which studies home loans in India. The problems of mis-selling by insurance companies and mutual funds in recent years have led to significant academic work (Anagol and Kim, 2012; Anagol, Marisetty, Sane, and Venugopal, 2013; Anagol, Cole, and Sarkar, 2012). Related issues broke out in the microfinance industry in India (Sane and Thomas, 2013). These events have led to substantial responses by policy-makers, including the prominent place of consumer protection issues in the draft Indian Financial Code (Srikrishna, 2013).

The paper proceeds as follows. Section 2 provides the context of the life insurance industry in India, within which we study the economic losses that result from widespread mis-selling of financial products. Section 3 describes the methodology used in estimating investor loss. The estimated value of the loss is presented in Section 4. Section 5 is a discussion of who lost and who gained from the mis-selling, followed by the implications for policy. Section 6 concludes.

2 Mis-selling of ULIPs in India

There were traditionally three products offered by the Life Insurance Corporation of India (LIC), which was the state owned monopoly till 2001: "term policies"[1], "annuities"[2] and "non-linked policies".[3] 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.

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. 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. In addition, there were attractive tax benefits for these insurance products, both as being eligible for tax benefits during investment[4], and after, with proceeds of the investment and final withdrawals being tax free.

After the Insurance Regulatory and Development Authority (IRDA) was set up in 1999[5], and the privatisation 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[6]

[1] A term policy is a stand-alone pure life cover where there is a pay-out on occurance of death. No money is returned if the insured survives the policy term. This kind of insurance gives the maximum life cover per rupee of premium since there is no investment component embedded in the policy.

[2] Annuities are long term investments where a given lump-sum investment resulted in a regular cashflow to the investor till the time of his death.

[3] Non-linked policies have higher premiums than term policies, and accumulate returns from investments that are available both to the fund to adjust for rises in costs of fund management, or to the customer who can withdraw cash from the investments. The typical non-linked insurance product that LIC offered include money-back, endowment, and whole life policies.

[4] Under these tax laws, upto Rs.100,000 of investment in term policies are tax exempt.

[5] `http://www.irda.gov.in`.

[6] The average sum assured was five times the premium. For example, a premium of Rs.100,000 would get a life cover of Rs.500,000. A similar pure life cover, or term cover, would cost around Rs.1000, for a similar age person for a similar number of years. The

Table 1 Total premiums collected from life insurance

	(Rs. trillion)		
	Premium		Linked as % of
Year	Linked	Non-Linked	total premium
2004-2005	0.08	0.17	32
2005-2006	0.16	0.20	45
2006-2007	0.43	0.32	57
2007-2008	0.70	0.23	75
2008-2009	0.91	1.31	41
2009-2010	1.16	1.50	43
2010-2011	1.09	1.83	37
2011-2012	6.97	2.17	24

Source: IRDA annual reports

insurance pay-out in the case of death. The second was that national level corporate agents and banks, which were not regulated for their insurance services, became important distributors of insurance products. For example, 5 percent of the total premium in 2009-10 came from banks as opposed to 3 percent in 2006-07.[7]

The increase in the set of new distributors and the introduction of new products did not really affect the *penetration* of insurance, defined as the ratio of premium to GDP, which increased to 3.4 percent in 2011 from 2.2 percent in 2001.[8] In contrast, the AUM contributed by ULIPs grew at 534.82 percent between 2003 and 2004, and at 92 percent between 2009 and 2010, showing a far higher growth rate than traditional insurance products which grew at 16 percent.[9] Table 1 shows that there was also a steady rise in total premiums from ULIP products, which peaks in 2007-08, with almost 75 percent of the premiums from ULIPs.[10]

Although penetration of insurance amongst a wider set of customers did not take place, the commissions paid out by the industry for distribution matched

size of the cover did not differ across product type, since the regulator mandated that at least five times the premium should be given as a cover. After 2010, that number has been increased to 10 times the premium.

[7]From Table 4, "Channel Wise Individual New Business Performance Of Life Insurers" in the Handbook on Indian Insurance Statistics, 2009-10.

[8]Source: IRDA Annual reports

[9]One record of this remarkable growth is from Table 8, "Assets Under Management of Life Insurers" in the Handbook on Insurance Statistics in India, 2010.

[10]This share has steadily decreased since then, and is as low as 24 percent in the 2011-12 year. This is likely to be a result of the various reforms in the sale and product structure of ULIPs that were undertaken in 2010. These are discussed in more detail in Section 5.1.

the growth in the AUM of the insurance sector. The industry paid out net commission of Rs.1.13 trillion over the 2004-05 to 2011-12 period.[11] In the last few years, there have been many concerns about insurance distribution through agencies such as banks.[12]

A combination of these three factors – lack of penetration, significant growth of the AUM and the fees paid as commissions – makes a case that it is not obvious that end customers were benefitting from the new products, just as is the case that the industry – both the product providers as well as the distributors – clearly were. We present an argument for how certain product structures helped in the mis-sale of life insurance products.

2.1 Factors that assisted the widespread mis-selling of ULIPs

When life insurance products are bundled with investments and the value tends to be realised only over time, the policies need to be funded regularly for a period of at least 10-15 years for the full benefit to accrue to the policyholder. In the Indian market, certain features and incentive structures encouraged the mis-selling of these polices as short-term products, some of which were embedded in the insurance law and regulation. Two key features are:

1. These insurance products typically had a three year lock-in period. Only after the lock-in period got over, was the investor allowed to surrender the policy. For polices that are discontinued within the lock-in period, a lack of regulatory clarity allowed companies to deduct upto 100 percent of the value left in the policy *post costs*.

   All life insurance policies, of which the ULIP was considered one, listed four costs: commissions, administrative costs, mortality and fund management fees. Post these costs, if there was value left in the policy, the insurance company was allowed to appropriate it towards its profits after a two year waiting period.

   In addition to this cost structure, there were very high surrender charges that ensured that investors could get very little money back when they surrendered their policy, even after the lock-in period.

2. The Insurance Act allows life insurance policies to be "front-loaded". This meant that a part of the annual level commissions embedded in the price

[11] Source: IRDA annual reports.
[12] Chapter 8, IRDA (2011).

> of a 15 year product could be pushed to the first year and collected upfront instead of steadily over the life of the product.
>
> First year commissions was money taken from the premium paid by the investor and given by the insurance company to the sales agent as reward for getting the business. These were as high as 40 percent[13] in year one. Commissions then dropped to 7.5 percent in years two and three and then to 5 percent by year four and remain constant thereafter.[14]

This combination offered considerable scope for mis-selling. The regulation on lapsed policies left very little incentive to the insurance companies to promote follow-on premium payments from their customers, as they got to keep the entire proceeds from policy lapses that occur within the first three years. The front-loaded commissions incentivize agents to sell products with the highest pay-off to themselves. The loss in value of accumulated funds also left no incentive for the policy holder to fund the policy.

A recent paper by Anagol, Cole, and Sarkar (2012) uses audit interviews to demonstrate the role of these incentives, especially high commissions, in providing unsuitable advice. In 60-80 percent of visits, agents recommended unsuitable advice i.e. products that ensured the highest commissions for agents. The paper also finds that when disclosure regulations impact only one product, agents switch to alternative products that are similar but have no disclosure.

These incentives were exacerbated in the case of ULIPs, which could be sold as a three-year money doubling policy owing to their market-linked nature. This was helped by a booming stock market that started from 2003. There is strong anecdotal evidence that distributors did not inform investors that the ULIP policies needed to be funded every year for 10-15 years before returns would accrue. Investors bought the equity-linked ULIP as a safe investment in markets that would also result in high returns, assuming that they were buying a three-year guaranteed product that would double their money. The tax benefits made this product more attractive than a mutual fund product which faced both short term and capital gains provisions.[15]

[13] 35 percent for a company that has been in existence for more than 10 years.

[14] In practice, life insurance companies were paying more than this using various heads under which they could pay the agents and other sellers.

[15] Mutual fund products were cheaper than ULIPs and also did not have this lock-in period. Insurance agents however had no incentive to sell, or point their customers to such mutual fund products.

3 Methodology: Estimating economic loss

Performance evaluation and cross-product comparisons of financial products typically involve comparing their cash flows and the risk of these cashflows. In the case of life insurance, this comparison becomes complicated because an investment product is bundled with insurance cover i.e. the investment of an individual has embedded in it an insurance premium for a life cover. There are three measures that are traditionally calculated and reported in an insurance product: the number of policies sold, the sum assured and the premium received. If there is risk or loss to the investor from holding these insurance products, then they must be calculated using one or more of these measures.

Of these measures, investor loss cannot be measured in terms of number of policies sold in a year or the sum that is assured to them by the company. However, premium payments do measure the real outflow from an investor. If the policy has been mis-sold, then the premium outflow reflects the loss to the investor. When a policy lapses, the premium forgone is considered to be the measure of the financial loss.[16] Based on this understanding, we propose two methods to measure investor loss from mis-sold insurance products.

The *renewal premium method* captures the loss in renewal premiums over the years 2004-05 to 2011-12. This loss is adjusted to exclude the premium loss due to reasons including death, maturity and income-shock to provide an adjusted loss number indicating the unexplained losses to the premium. These losses occur due to 'lapsed' policies, or policies that are not renewed by the policyholder. The regulator links this lapsation [17] of policies to mis-selling of policies. These unexplained losses constitute the investor losses.

The *persistency method* tracks the performance of the premium over subsequent time periods to measure the attrition to the business over time to examine the life cycle of policies issued in a particular year. The formula takes into account attrition in premium due to explained losses such as surrender and death benefit pay-outs, leaving the loss in premium as the amount due to mis-selling.

[16] Two issues of the IRDA Journal have focused on the issue of lapsation and persistency (IRDA, 2011b,e)

[17] If premium paying stops within the lock-in period, it is industry practice to call this "lapsation". If the payment stops after the lock-in period, it is termed as "surrender".

3.1 Renewal premium method

The insurance business has several flows of revenue in a year. There are three streams of inflows:

1. Single premium policies: These are a lump-sum one-time investment that provide an insurance cover and returns. There are no regular premium flows from this product.

2. Regular premium policies: Both traditional and unit-linked, regular premium policies have a periodic premium paying tenor. This can be annual, semi-annual, quarterly, or monthly. The premiums are typically paid for a period of 10–15 years, and the pay outs begin thereafter. The investor has a life insurance cover over the life of the policy.

3. Renewal premium. Both traditional and unit linked are long term products and the premium is paid year on year for 10–15 years. For policies that originated in the years before the current year, the premium so collected is called the renewal premium.

The renewal premium is lost as follows: a person buys a 10–15 year product in year one. In year two, he should pay the premium to keep the policy alive and continue to do so for the subsequent years in the life of the policy. An investor may not renew the policy for several reasons. First, in the event of his death there is a pay-out to the beneficiary. Second, the policy completes its premium paying term. Third, the investor wants to terminate this investment due to an income shock. Fourth, the investor may not want to continue with the policy if he has been mis-sold the product and finds it unsuitable. It is reasonable to assume that if a person has bought into a long term product fully understanding his premium commitment for each year, the only reason he would terminate the policy would be due to an income shock or because he discovers that the product is inappropriate for his financial needs.

To calculate the premium lost, the first step is to remove the inflows that should not be counted. Single-premium polices, which by their nature are a one-time investment, are excluded for this reason. The premium flows for linked and non-linked policies are considered. If an insurance company collects Rs.100 of premium in year zero and Rs.110 premium in year one, then the total premium collected in year one should be Rs.100 + Rs.110, or Rs.210. The Rs.100 from year zero becomes the renewal premium for year one. However, if the company collects less than Rs.210 in year one, there has been a loss in the renewal premium income.

The premium lost is estimated using the following formula based on data obtained from IRDA annual reports:

$$\mathrm{RP}_t = \mathrm{NRP}_{t-1} + \mathrm{RP}_{t-1}$$

This states that the renewal premium each year should be equal to the previous year's new regular premium plus renewal premium. Here, RP_t is the renewal premium in a particular year, and NRP_{t-1} is the new regular premium in the previous year. If renewal premium in one year is less than the sum of the new regular premium and renewal premium for the previous year, it means that there has been a drop in the money reinvested in the policies. The formula to obtain the loss is as follows:

$$\mathrm{LP}_t = \mathrm{NRP}_{t-1} + \mathrm{RP}_{t-1} - \mathrm{RP}_t$$

where LP_t is the loss in the renewal premium for year t and NRP and RP are as defined previously. For example:

$$\mathrm{LP}_{2005-06} = \mathrm{NRP}_{2004-05} + \mathrm{RP}_{2004-05} - \mathrm{RP}_{2005-06}$$

3.2 The persistency method

Another way to estimate the lost premium number would be to estimate how much of the premium remains with the company over time (Diacon and Brien, 2002). This is called the persistency number and is disclosed by the regulator[18] as:

> *A policy is said to be persistent at a particular point in time if all the premiums due on the policy at the date of measurement are received. ... Persistency is about understanding how many life insurance policies have been issued to customers and out of these how many customers continue to regularly pay premiums on dates as per the terms set out in the policy contract. The persistency rate measures the percentage of the issued business that remains in force and premium paying after a certain period of time.*

An insurance policy is a recurring renewal product and companies give policyholders a grace period of upto a month to renew the policy. The data on persistence, focusses on how much of the premium collected in a particular

[18]The definition can be found in *Appendix B: Persistency* in (IRDA, 2010a)

year stays with the policy year after year. IRDA estimates the persistence by asking the following question about premium received[19] as follows:

> *How much of the premium issued in a financial year is renewed after 13 months, 25 months, 37 months, 49 months and 61 months?*

The following example illustrates this.

1. In the year 2005-06, Rs.100 worth of polices are issued.
2. The premium is measured again in the 13^{th} month. Suppose this number is Rs.85. The 13^{th} month persistency is said to be 85%.
3. Similarly, a premium of Rs.76 in the 25^{th} month means that persistency is 76%. Rs.68 in the 37^{th} month means a persistency of 68%, Rs.55 in the 49^{th} month means a persistency of 55%, Rs.42 in the 61^{st} month means that persistency is 42%.

It is relatively easy to analyse individual year persistency and determine how much of the business remained with a particular company for policies generated in a particular year, using this approach. However, not all companies use the same approach to report their numbers on persistence, even though it goes against the IRDA rules for calculating persistenc. The alternative method is called the *reducing balance* method and the estimates of the premium are found too to overstate the premium left in the business if taken at face value. This method considers persistency of the premium that returns as a percentage of the previous period's premium and not as a percentage of the original premium. We use the setting of the previous example to illustrate the difference between the IRDA approach and the *reducing balance* approach as follows:

1. In the year 2005-06 Rs.100 worth of polices are issued.
2. The premium is measured again in the 13^{th} month. Suppose this number is Rs.85. The 13^{th} month persistency is said to be 85%.
3. A premium of Rs.76 in the 25^{th} month means that persistency is said to be 76/85 or 89%.

   Similarly, a premium of Rs.68 in the 37^{th} month means that persistency is 68/76 or 89%. Rs.55 in the 49^{th} month means that persistency is 55/68 or 81%. And Rs.42 in the 61^{st} month means that persistency is 42/55 or 76%.

[19] This excludes the premium from single premium products.

From this example, we can see that the reducing balance approach gives persistency values that are much higher than values from the IRDA prescribed method. In our estimation, we use the IRDA prescribed method to calculate persistency.

4 Results: Estimated economic loss

We use the two methods described above, along with publicly available data, some of which are readily available, and others which had to be hand-collected, to assess the loss to the Indian insurance customers during the high ULIP growth period between 2004-05 and 2011-12.

4.1 Renewal premium method

The data used for this estimation has been sourced from annual reports of the IRDA. The reports do not separate the premiums from linked and non-linked products. The estimates therefore reflect lost premiums and persistency ratios of all life-insurance products. However, in the years from 2004 to 2010, a large proportion of the premiums were from unit linked products (See Table 1). To that extent, the estimates may be attributed to the ULIP market.

Table 2 shows the lost premium both in value and as a percentage of premium due in a particular year.

The data shows that the total premium lost over the period is Rs 1.95 trillion. The data also shows that the premium lost as a percentage of the premium due shows a rising trend. In 2005-06, just 7 percent of the premium due was lost, but in 2011-12 this percentage rose to 24 percent.

Policy holders can stop renewing premiums in a regular paying policy for four reasons. First, policies may mature and the maturity benefit is then paid out. Second, the policy holder may die and the death benefit is paid out to the beneficiary. Third, polices may be unfunded due to an income shock suffered by the policy holder. Fourth, polices may lapse because the policy holder chooses to stop funding the policy upon discovering that the product is unsuitable. In this last case, we assume that the policy has been mis-sold. If it can be ascertained which of the four reasons lies behind the lapse of premium renewals, then the cause of the premium lost to the policy holder can be better understood.

Table 2 Estimates of lost premium by year by the renewal premium method

Year	(in Rs. trillion) Regular 1^{st} year premium	Renewal premium	Premium lost	Premium lost as a % of premium due
2004-05	0.16	0.57		
2005-06	0.21	0.67	0.05	7
2006-07	0.45	0.80	0.08	9
2007-08	0.55	1.08	0.18	14
2008-09	0.49	1.35	0.28	17
2009-10	0.61	1.56	0.29	16
2010-11	0.64	1.65	0.51	24
2011-12	0.62	1.73	0.56	24
Total			1.95	

Source: IRDA annual reports

Table 3 Firm specific estimates of premium lost due to lapsed policies

Company	Estimate
Aegon Religare Life Insurance	100%
IndiaFirst Life Insurance	70-80%
Max Life Insurance	80%
Secure Now Insurance Brokers	80%

There is no previous analysis that has been carried out to track the loss in premium due to lapsation, which is linked to mis-selling. For this paper, a survey of life insurance industry experts – including actuaries – was conducted to get their opinion on what fraction of the lapses depended on each of the above four factors. The survey results show that, in the opinion of the industry experts, not more than a sum of 20 percent of the premium lost could be attributed to the first three reasons. Thus, the survey suggests that lapsed polices contributed 80 percent of the premium lost by policy holders on average across firms, with the estimates for specific firms presented in Table 3.

Why would investors lapse their policies, especially when policy rules allow for the insurance companies to appropriate all the residual value in the policy in the lock-in period and the investor stands to lose all his money? The insurance regulator has connected lapsation to mis-selling. The insurance regulator states the following in the annual report 2007-08:

> *In case of lapse of a policy in the first few years, all or most of the premiums paid are usually forfeited by the insurer and the*

> *policy holder ends up losing whatever premiums have already been paid towards the policy. Majority of the lapses occurring in the first few years of the policy are caused by mis-selling – intentional or otherwise, and selling under duress – for instance, in consideration of a loan sanctioned by a bank or any other nature of 'favour' done by the insurance salesman to the policy holder or under 'obligation' to a relative or a friend.*[20]

Using the above survey, it can be assumed that 20 percent of the renewal premium loss can be accounted for by premiums that do not return due to maturing and surrendered policies, polices where the death benefit has been paid out and policies discontinued due to an income shock to the policyholder. Approximately 80 percent of the lost premium can be explained by lapsation due to mis-selling.

The lost premium for the period 2004-05 to 2011-12 is Rs.1.94 trillion. Upon removing 20 percent of the premium lost due to death pay-outs, surrender, policy maturity and income shock, the premium lost due to lapsation is *Rs.1.55 trillion.*

4.2 The persistency method

Data for companies that have been in existence for more than three years were used to examine persistency. The data for companies that report persistency using the reducing balance method is normalised to make it comparable across firms and to bring this data to comply with the IRDA rules.[21]

Table 4 presents the example of one insurance company. It reflects that for policies issued in:

- 2005-06, 31% of premium remained after five years.[22]
- 2006-07, 22% of the premium remained after five years.
- 2007-08, 27% of the premium remained after four years.
- 2008-09, 29% of the premium remained after three years.

[20]IRDA Annual Report 2007-08, page 25.

[21]Tata AIG Life Insurance had to be excluded because their data disclosure was such that it could not be compared with that of the others. The company disclosed data differently for unit linked and non-linked policies while the others provided a consolidated number.

[22]Persistency is calculated upto five years.

Table 4 An illustrative case of persistency calculation for one insurance company

Year that policy originated	Persistency (in %)				
	13th month	25th month	37th month	49th month	61st month
2005-06	82	69	57	37	31
2006-07	75	70	48	33	22
2007-08	66	53	34	27	
2008-09	54	52	29		
2009-10	66	60			
2010-11	68				

- 2009-10, 60% of the premium remained after two years.
- 2010-11, 68% of the premium remained after one year.

This implies that, for example, if the premium collected in 2005-06 was Rs.100, then after 13 months, the premium that returned to the company was Rs.82. After 25 months, it was Rs.69, after 37 months, Rs.57 returned to the company. After 49 months Rs.37 came back and after 61 months, only Rs.31 came back. Similar figures for all companies are presented in the Appendix.

These data were further mapped to the premium data to see how much premium was lost over the years. The new regular premium collected each year was used to investigate how much premium was lost using the persistency ratios for that year. The data for the regular new business come from IRDA annual reports. This method examines the life of the total regular new business premium collected in a particular year over a five-year period.[23]

We calculate the total premium collected and retained for each company to arrive at the total premium lost. Adding across companies yields the following:

Total premium collected	Rs.2.89 trillion
Total premium retained	Rs.1.27 trillion
Total premium lost	Rs.1.62 trillion

The persistency method gives a premium lost number for 2005-06 to 2011-12 of *Rs.1.62 trillion*. This comes closer to the real loss to the investor, because the way that IRDA calculates persistency takes into account premiums that do not return due to death and maturity.

[23]Details of the calculation are available upon request.

5 Implications

The two methods described above reflect the loss recorded by the industry owing to leakages in premium in a particular year. The loss for the individual investor may be higher as the unfunded policy could be *more than a year old and his loss is the sum of premiums paid before he lapsed or surrendered the policy.*

The following examples illustrates the point. Suppose an investor buys a policy in year zero for Rs.100 and does not fund it in year one. The company does not get his second year premium in year one but keeps the entire premium of year zero, post commissions, due to the 100 percent surrender charges allowed. The investor loss in this case is equal to the loss in the premium recorded by the insurer. However, suppose the investor funds the policy again in year one, but stops funding it in year two. The insurance company will show a loss of premium in year three, but for the investor the loss is the premium of year zero plus premium of year one because the company was allowed to keep back the entire premium of a lapsed policy during the three-year lock-in. The investor loss, in this case, will be double the loss recorded by the company.

We have not found a way to record the true investor loss but can only provide a minimum number based on the two methods above. Both the methods count the loss of premium to the insurance company, which becomes the investor's loss multiplied by the premiums he has paid. The investor loss is thus greater than the loss of a Rs.1.5 trillion presented in Section 4.

Some of the gains accrued to the distributors: individual agents, corporate agencies and banks selling life insurance. The rules allowed them to earn 40 percent of the first year premium as commission. Table 5 presents the total commission income for the period 2004-05 to 2011-12. It will not be correct to state that all intermediaries were mis-selling. However, it will also not be incorrect to conclude that pushing expensive products, and not following up on subsequent premiums was a feature of insurance inter-mediation in the last decade, and commission gains of the order of trillion rupees on the back of unfair sales practices is unjustified. The commissions earned drop sharply in 2011-12, perhaps as a result of the regulatory changes in commissions structure, which makes it less lucrative to promote grossly unsuitable products.

The profit and loss accounts of insurance companies point to their gains from lapsed policies. Insurance rules before September 2010 allowed insurance

Table 5 Commission expenses of life insurers

	Rs. trillion	% change over previous year
2004-05	0.07	
2005-06	0.09	22
2006-07	0.12	42
2007-08	0.15	20
2008-09	0.16	6
2009-10	0.18	17
2010-11	0.19	2
2011-12	0.18	-1

Source: IRDA annual reports

companies to levy 100 percent surrender charges on lapsed policies. This means that after paying commissions and accounting for other costs, the company could keep all the residual money left in the policy and account for it under 'surrender charges'. After holding the money in a special reserve, this money becomes part of the profit and loss account after two years. The October 2012 Goldman Sachs Global Investment Research reports that "lapse profits"[24], or profits accruing to insurance companies on account of lapsed policies, for just six companies amount to Rs.32 billion for just two years, ending 2011-12. Table 6, which is sourced from the Goldman Sachs report, shows the contribution of lapsed policies to company profits. This report states that:

> *Now that the charges on lapse policies are minimal and most old policies that had higher lapse charges cross the three year mark, the pool of profit available for booking lapse profit will reduce gradually.*

5.1 The response to mis-selling of ULIPs

Anecdotal evidence shows that by the time of the second or third premium payment, investors realized that almost all of their money had been deducted in costs. The lost premium was often treated as sunk cost by investors, most of whom chose to abandon the product altogether. In some cases, official

[24]Lapse profits is the money identified by the Appointed Actuary from lapsed policies that are entitled to be revived but not likely to be. Companies are required to hold this money in an earmarked reserve for two years, after which it is released to the profit and loss statement.

Table 6 Estimated profits to firms from lapsed policies

(Rs. Million)

	FY11		FY12	
	PAT	Profits from lapsed policies	PAT	Profits from lapsed policies
Bajaj Allianz	10574	3670	13084	4800
HDFC Life	-990	2232	2710	1840
ICICI Life	8076	7377	13841	6722
Kotak Life	1025	1042	2032	1178
Max Life	1941	1847	4598	470
SBI Life	3663	221	5558	525

Source: As presented in the Goldman Sachs Global Investment report, October 2012

complaints by customers started appearing in the public, along with articles in the media.[25] One example is a public interest litigation (PIL) against an insurance company for ULIP fraud filed by an investor with the high court in city of Lucknow.[26]

Matters came to a head when the securities market regulator, the Securities and Exchange Board of India ("SEBI"), took a proactive step by ordering the ban of the sale of ULIP products in early April 2010. Their argument was that they should regulate ULIPs since they were essentially investment products given that the significant fraction of the premium was paid towards the "unit" equity investment (SEBI, 2010). The regulatory turf war went public. An Ordinance signed by the President of India ruled in favour of IRDA, the SEBI order was rescinded, and ULIPs continued to be regulated by the IRDA (IRDA, 2010b).

However, IRDA came out with a set of rules aimed at correcting the overly investment nature of the ULIPs soon after this. With effect from 1 September 2010, the ULIP product rules changed so as to reduce the incentives to mis-sell by introducing an over-all cost cap of 3 percent for a 10-year policy and 2.25 percent for a 10 plus year policy. The loss incurred by an investor who does not fund the policy in the lock-in period has been capped to a maximum of Rs.6,000. The traditional policy rules have also changed and

[25] Halan (2010), PersonalFN.com (2007), Halan (2006)

[26] "PIL against insurance cos for ULIP *fraud*", in the *Times of India*, 22 April 2010, `http://articles.timesofindia.indiatimes.com/2010-04-22/lucknow/28125969_1_irda-order-ulips-insurance`

will come into effect from October 2013. Commissions are now linked to the premium paying term. The longer the term of the policy, the higher are the commissions allowed. First year commissions are still allowed at 40 percent.

There has also been a push towards decreasing the lapsing of policies. In February 2011, IRDA[27] issued guidelines to enhance the persistence of life insurance policies. The new guidelines mandate a persistence of 50 percent for agency renewals till the financial year 2014-15, and 75 percent persistence after that.[28]

IRDA (2011a) lists other rules regarding the sale of products as follows:

1. Insurers must provide the prospect/policyholder all relevant information about amounts deducted towards various charges for each policy year, so that the customer can take an informed decision.

2. Guidelines relating to distance marketing address challenges relating to mis-selling using distance marketing methods.

3. The "IRDA (Sharing of database for distribution of insurance products) Regulations, 2010" aims to significantly reduce the scope for misuse of the system of issue of Referrals.

4. The *Integrated Grievance Management System* (IGMS)[29], has been put in place from April 1, 2011, which allows for faster grievance redressal through an online portal that is connected to all insurance companies. The status of the complaint could also be monitored more regularly: if insurance companies did not fully attend to the investor complaint within fifteen days of lodging it, the IGMS could be used to escalate the complaint to IRDA.

5. IRDA also suggested that companies were required to have a Prospect Product Matrix, which matched a product with the investor requirement that was based on the Needs Analysis (of the investor).

These measures have had an impact on mis-selling of ULIPs, with the growth of ULIPs having dropped sharply from the peak levels seen during the 2004-05 to 2010-11 period. A finer assessment of the impact can only be carried out in the next two to three years when there is more evidence that builds up about insurance sales.

[27]Section 14(2) of the IRDA Act, 1999.
[28]IRDA Journal, August 2011, Page 12.
[29]`http://www.igms.irda.gov.in/`

5.2 What remains to be done

Mis-selling is not new to finance. Regulators have typically responded to such instances through two distinct measures. The first are changes at the level of policy that close the loop-holes that led to the mis-selling episodes, and make the occurrence of similar episodes more difficult.

The second are monetary fines imposed on errant individuals and financial service providers. In 2011-12 the FSA imposed fines of 78.5 million across individuals and firms (Hinton and Patton, 2012). The Australian regulator, the Australian Securities & Investment Commission (ASIC) found that failure to fully compensate investors who lost money can cause severe emotional and financial and have a corrosive effect on trust in the financial system (ASIC, 2011). Financial compensation is seen to be a crucial element in the regime for customer protection.

In India, all the policy interventions in response to the mis-selling during the ULIP period have focussed on changes in regulation by the IRDA. There are also instances of regulators imposing fines or revoking the license of intermediaries. For example, IRDA revoked the license of a broker when found guilty of mis-selling (IRDA, 2011c).

Where there has been little action is in providing *compensation* to those investors who got duped by financial service providers.[30] One counter example is an order passed by the IRDA in May 2011 where financial compensation over and above the policy refund was denied to the complainant because it was found that she had signed a "Declaration by the proposer/Life to be assured" and "Declaration for Unit Linked Products", agreeing to the revelations made therein (IRDA, 2011d).

For consumers to get a fair hearing in such cases, regulators will have to take stronger preconsent steps, such as mandating sellers to read out the provisions of the contract in the language in which solicitation was done, and to do some due diligence on the customer. Such rules are consistent with the suitability standards that require that an intermediary has to ensure that the product is suitable for the customer before signing-off on the contract.

[30]There has been one example where the regulator, and later the courts required a financial firm to pay refund investors more than Rs.174 billion that it had raised from millions of small investors.http://articles.economictimes.indiatimes.com/2012-08-31/news/33521343_1_sahara-group-subrata-roy-sahara-sebi

6 Conclusion

It is possible to envision a world with fully rational consumers, in which conventional contract enforcement would suffice: the State would only need to get involved when financial firms fail to uphold promises they make. The emerging field of household finance has repeatedly uncovered evidence that consumers are often less than effective in understanding financial products, and can get misled by high powered sales campaigns. The ultimate objective of this field would be a body of research that guides us in understanding the mapping from alternative policy strategies to consumer welfare.

In the period under examination, India was an interesting laboratory, where insurance companies vigorously pursued profit in an unregulated environment when it came to consumer protection. The laws and regulations as constructed in that period permitted a variety of egregious practices, which have been documented here and in the related literature.

The contribution of the paper lies in an approximate quantification of the losses to households under this environment. The numerical estimates obtained are fairly large: consumers lost Rs. 1.5 trillion over this seven-year period. This gives us fresh insights into the economic significance of the adverse consequences for consumers when financial law and regulation does not focus upon consumer protection.

While regulation has responded to the mis-selling episode with product disclosure guidelines and commissions caps, what remains is any compensation to investors who were the targets of the mis-selling carried out by insurance companies and their agents. In order for this to be a fair exercise, the first step is to assess the losses that were incurred by the investors. The two approaches discussed in the paper, both of which are based on data that is publicly available, can thus be used by any agency to assess reimbursements for customer redressal.

Our work here connects up to a small emerging literature on the problems of consumer protection with mutual funds and insurance companies in India over this period, and would assist future explorations on these questions. The policy environment has swung from a lack of focus on the consumer interests to one where these interests are the foundation of policy recommendations and regulatory changes. These experiences have helped place consumer protection at the heart of the new legal framework which has now been proposed in India.

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Appendix

A Persistency estimates

Table A.1 Aviva

Year that policy originated	Persistency (in %) 13th month	25th month	37th month	49th month	61st month
2005-06	82	69	57	37	31
2006-07	75	70	48	33	22
2007-08	66	53	34	27	
2008-09	54	52	29		
2009-10	66	60			
2010-11	68				

Table A.2 Aegon Religare

Aegon Religare policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06					
2006-07					
2007-08					
2008-09	44	43	36		
2009-10	63	61			
2010-11	61				

Table A.3 Bajaj Alliance

Bajaj Allianz policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	73	64	17	9	6
2006-07	84	78	11	7	3
2007-08	67	54	10	5	
2008-09	52	42	8		
2009-10	56	48			
2010-11	55				

Data reported reducing balance, has been corrected to fit IRDA format

Table A.4 Bharti Axa

Bharti Axa policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06					
2006-07	76.2	70.3	68	29	39.6
2007-08	60	54	55	52.2	
2008-09	53	49	46.8		
2009-10	60	51.6			
2010-11	58.2				

Table A.5 Birla Sunlife

Birla Sunlife policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	97.3	90.2	82	71	55
2006-07	93.4	83.4	77	64	53
2007-08	87.6	80	72	62	
2008-09	84.0	77	72		
2009-10	83	77			
2010-11	82				

Table A.6 Canara HSBC

Canara HSBC policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06					
2006-07					
2007-08					
2008-09	88.5	91.2	64.7		
2009-10	85	88.9			
2010-11	79.6				

Table A.7 DLF Pramerica

DLF Pramerica policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06					
2006-07					
2007-08			71.76		
2008-09	47	40.12	63.57		
2009-10	55.24	87.15			
2010-11	54.69				

Table A.8 Future Generali

Future Generali policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06					
2006-07					
2007-08					
2008-09	56.17	50.19	51.54		
2009-10	55.46	48.38			
2010-11	47.95				

Table A.9 HDFC Standard

HDFC Standard policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	90.88	86.29	42	30	25.65
2006-07	78.41	72	34	24.64	19.55
2007-08	59	52	29.18	19.52	
2008-09	57	54.26	32.59		
2009-10	81.17	76.24			
2010-11	81.57				

Table A.10 ICICI Prudential

ICICI Pru Life policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	89.30	87	40	22	15
2006-07	87	81.6	30.4	14.1	9.2
2007-08	80.2	69.9	21.1	10.7	
2008-09	72.7	64.5	20.5		
2009-10	75.8	65.7			
2010-11	77				

Data reported reducing balance, has been corrected to fit IRDA format

Table A.11 ING Vysya

ING Vyasa policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	50.76	36.6	28.3	21.6	16.1
2006-07	62.6	52.4	34.9	23.0	38.0
2007-08	65	50.8	26.6	36	
2008-09	57.3	51	38		
2009-10	67.7	55			
2010-11	65				

Table A.12 Kotak Mahindra

Kotak Mahindra Life policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	66	60	42.06	31.67	24.76
2006-07	70	64.51	31.01	21.74	22.17
2007-08	67.29	58.65	23.94	19.70	
2008-09	67.78	61.39	24.28		
2009-10	66.14	61.37			
2010-11	65.78				

Table A.13 Max New York Life

Max New York Life policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	76	68	55	45	39
2006-07	79	70	50	40	31
2007-08	76	67	49	39	
2008-09	68	60	42		
2009-10	70	62			
2010-11	75				

Table A.14 Metlife

Metlife policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	64.09	57.93	59.05	52.98	47.92
2006-07	64.88	64.28	56.16	51.16	44.82
2007-08	71.54	60.09	55.04	47.44	
2008-09	67.29	59.66	50.32		
2009-10	66.18	56.84			
2010-11	63.56				

Table A.15 Reliance

Reliance Life policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	73	48.8	23.8	19.7	16.9
2006-07	77.4	54.7	19.1	14.3	10.9
2007-08	61.20	52.4	18	12.7	
2008-09	51.2	41.7	12.1		
2009-10	52.7	41.2			
2010-11	55.9				

Data reported reducing balance, has been corrected to fit IRDA format

Table A.16 Sahara

Sahara policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	80.57	70.94	67.53	52.41	49.23
2006-07	82.10	72.60	49.53	45.80	41.74
2007-08	86.65	60.96	44.06	39.92	
2008-09	71.92	63.13	43.04		
2009-10	73.55	65.14			
2010-11	73.73				

Table A.17 SBI Life

SBI Life policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	85.28	71.67	48.23	47.72	40.73
2006-07	88.44	51.34	31.41	24.19	23.35
2007-08	58.69	50.49	21.30	16.27	
2008-09	58.89	49.69	20.54		
2009-10	68.81	60.52			
2010-11	71.77				

Table A.18 Shriram

Shriram policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	34.34	18	4.8	1.20	1.1
2006-07	51.3	18.8	4.8	4.3	3.7
2007-08	54.24	24.7	9.8	7.6	
2008-09	54.26	46	16.3		
2009-10	59.8	49.6			
2010-11	54.6				

Data reported reducing balance, has been corrected to fit IRDA format

Table A.19 LIC

LIC policies that originated in	Persistency (%) 13th month	25th month	37th month	49th month	61st month
2005-06	73	72	71	68	59
2006-07	73	71	64	60	58
2007-08	76	60	51	49	
2008-09	76	68	62		
2009-10	73	70			
2010-11	83				