How traditional plans tend to weigh you down

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MUMBAI: "Traditional plans have the largest share in product mix of life insurance industry," said Aalok Bhan, director and chief marketing officer, Max Life Insurance. The life insurance behemoth, Life Insurance Corporation Ltd., has a product portfolio that is tilted towards traditional products. Around 86% of LIC plans are traditional products (excluding riders). "Traditional plans are designed to help build a corpus over a long term for the achievement of a life's goals and suitable for those who have low investment risk appetite," said Bhan. Let's take a look at if such long tenures helpful:

UNSUITED DEMOGRAPHY

The long tenure, combined with strict lock-in periods of traditional products and inadequate cover do not fall in line with the demographics of our country and tend to weigh us down. Traditional products have a lock-in period of at least three years. "You can't withdraw the money in the first three years. After that, the only way you can get some liquidity is by taking a loan on the surrender value or surrendering the policy," said Agrawal. The demographic profile of India in terms of savings and investment is at par across income profiles. "Whether you're from a middle-income category or an HNI, it has been widely observed that Indians feel the need for liquid cash three to five years after parking their corpus in an investment," said Pawan Agrawal, founder of InvestGuru.in. Also, there are multiple other financial instruments you can evaluate it with before investing.

LOAN, SURRENDER VALUE

Say you've already invested a huge corpus in a traditional product and you come across an emergency. Your agent will try to lure you into taking a loan on your surrender value, where the loan amount is capped at 90% of the surrender value. "The interest you receive from the plan is lesser than the interest you end up paying to the insurer on the loan," said Agrawal. If you want to surrender the policy mid-way, you will lose money. The product structure is such that it ends up benefiting the insurer . "After three years of payment, the policy gains a surrender value. If you need the money, the policy can be surrendered, but in the first 7-9 year period, the surrender value is lesser than original capital," he said.

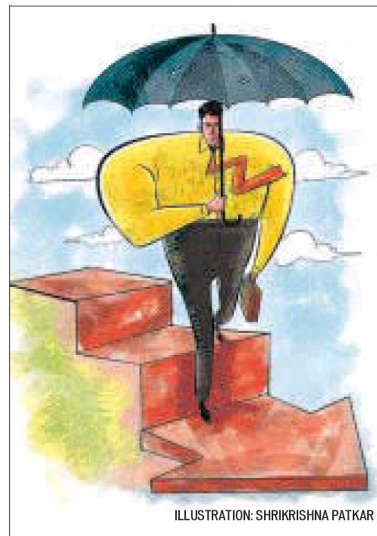

ILLUSTRATION: SHRIKRISHNA PATKAR

PUSH PRODUCTS, PREMIUM DEFAULTS, COMPOUNDING

Time and again, traditional life insurance products have been viewed as a push product. By 'push' product we mean the agents and insurers push the product on you for sale at times, without keeping your financial goals and interests in mind. "Large portion of your premium gets paid out as commission to the agents," said Vishal Dhawan, founder of Plan Ahead Wealth Advisors. "If you don't pay at least three years' premium, your policy lapses and whatever you have paid gets lost. If you pay three years' premium and you do not pay after that, the policy lapses and becomes paid up, meaning the benefits get reduced and you can get that value only when policy term is over. This amount in the first 7-8 years doesn't cover your original capital," said Agrawal. Traditional products that are popular are those which have a money-back guarantee. Money-back plans give you some amount of money annually from the capital. "Due to this, the power of compounding reduces," said Dhawan. The instruments traditional plans invest in don't earn higher returns as well.

WHAT YOU SHOULD DO

Such products are a tad bit beneficial only when you hold the product for at least 15 to 20 years. "If you wait for the whole term to get over, only then will your capital cost get covered and at the end whatever you receive may be higher than the invested capital," said Agrawal. But, does your opportunity cost get covered? It's the cost of the missed opportunity you got had you invested somewhere else. "Over a 20-year period, a traditional life insurance policy gives returns of 4-6%, tax-free. If we compare this with RD returns for higher tax brackets, there may not be much difference. But, if we compare it to balanced or equity based funds, opportunity cost is huge. In a traditional policy, if you pay ₹5,000/year for 20 years, you get around ₹1.8-2 lakh as maturity value; if you invest the same in mutual fund, at 10% return, you get ₹2.86 lakh; at 12% you get ₹3.6 lakh and so on," he said. Make sure you evaluate your cover before buying.