THE ROLES AND FUNCTIONS OF LIFE INSURANCE AS A FINANCIAL INSTRUMENT

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ABSTRACT

Life insurance is important although not a dominant part of the savings industry. There are other competitors for the long term saving dollar, particularly unit and property trusts, and this has grown in recent years at a much faster rate than the life offices. Our government is attempting to deregulate the financial sector in Malaysia. Banks are opening life office and the life offices are setting up banking subsidiaries. With the move made in recent years towards the regulations of the financial sector, the government has made available more bankers license. This represents the first chance for life offices to become involve in the banking sector and a number of offices responded by applying and obtaining bankers' license. This move by the life offices to the banking area is really a further direction they took with the new products they developed and response to the problems in the past. These new products were more investment oriented and in more direct competitions with the product offered by other financial institutions.

Key words: life insurance, uncertainty, and protection

INTRODUCTION

Life insurance is being seen by more and more prospective and existing clients as part of a process of financial planning involving their total savings and investment programme. This has accelerated the trend by the larger financial institutions to offer their clients all saving products. Both bank and life office are offering a range of products which are becoming increasingly similar and leading closer to a situation where people can go to one financial institution and have all their financial needs taken care of.

As a social and economic device, life insurance is a method by which a group pf people may cooperate to ameliorate the loss resulting from the premature death of group members. The insuring organization collects contributions from each member, invests these contributions, guarantees both their safety and a minimum interest return, and distributes benefits to the estates of the members who died. Viewed from the individual standpoint, life insurance is a method of creating an estate. It is a method of seeing to it that plans for accumulating property for the benefits of others, chiefly the family, are realized regardless of whether the breadwinner dies prematurely or lives to a "ripe old age". The word "estate", unfortunately, carries a suggestion of death since the word is often employed to describe the aggregate property belonging to a deceased person. The meaning of estate, however, is much broader and will be used here to mean the aggregate of property, including income-producing property, whether it is to be used before or after the death of the person. In the last analysis, property is accumulated for the living, not the dead, and the various plans for building an estate should recognized this fundamental precept.

PROTECTION AND SAVINGS NEEDS

Because a clear understanding of the purposes of life insurance of such fundamentals importance in appreciating what various contracts of life insurance will accomplish, these purposes warrant special emphasis. Life insurance can accomplish two objectives; to guarantee the existence of an estate out if which one's dependants may meet debts and receive an income in the breadwinner dies; and to save money as a part of one's own living estate, which is created for future income needs. The first objective may be termed the protection need and the latter savings needs.

Life insurance policies may be purchased to reflect each of these needs in varying proportions. Term insurance in its various forms is wholly dedicated to the protection need. Generally, there are no cash value whatever in term insurance and hence no possibility and savings need being met. Thus, the term insurance is designed entirely for death protection and to crate an estate only in the event of premature death. On the other hand, whole life insurance is available in different forms to meet both the savings and protection needs. These contracts may be arranged so that the savings need can receive as much emphasis as desired, within certain limits. All whole life insurance contracts have the element of protection that extends for the whole life of the insured. Endowment and universal life policies emphasis the saving need, with only small element of protection. Ideally, the program of estate building should provide both saving and protection needs.

LIFE VALUES

A human life has value for many reasons. Many of these reasons are philosophical in nature, and would lead us into the realm of religion, esthetics, sociology, psychology and other behavioral sciences. Of greatest interest here are economical values, although it is very difficult to separate the discussion in such a way that an economic analysis would have no implication or overtones for other viewpoints. A human life has economic value to all who depend on the earning capacity of that life, particularly to two central economic groups the family and the employer. To the family, the economic value of human life is probably most easily measured by the value of the earning capacity of each of its members. To the employer, the economic value of a human life is measured by the contribution of an employee to success of the business firm.

If one argues that in a free competitive society a worker is paid according to worth and is not exploited, the worker's contribution again is best measured by earning capacity. It develops that earning capacity is probably the only feasible method of giving measurable economic value to human life. There are four main perils that can destroy, wholly or partially, the economic value of human life. These include premature death, loss of health, old age and unemployment. Therefore, life insurance is created to protect such perils.

FINANCIAL SECURITY

Through the centuries, people have pursued financial security for themselves and those who depend on them. We all have a compelling need for security is a peace of mind and freedom from worry. Insecurity is doubt, fear and apprehension. Most economic actions we take are for purpose of satisfying some need and thus attaining some degree of security. Unfortunately, complete financial security has been elusive, in part because of certain universal problems: death, sickness, accidents and disability. These problems can strike at any time and without any warning. The emotional stress these problems bring is amplified by the financial hardships that are almost certain to follow.

Death may strike anyone prematurely. When death take the life of a family members often suffer if they are left without an adequate income or the means to provide even basic necessities. On the other hand, some people face the unpleasant prospect of outliving their income-retirement may be forced upon them before they have adequately prepared for a non-income-earning existence. Sickness and disability can also leave can easily result in catastrophic medical bills or the inability to work for months or even years.

ECONOMIC UNCERTAINTY

Insurance evolved to produce a practical solution to such economic uncertainties and losses. Life insurance, which is based on actuarial or mathematical principles, guarantees a specified sum of money upon the death of the person who is insured. Health insurance also evolved from scientific principles to provide funds for medical expenses due to sickness or injury and to cover loss of income during a disability. Annuities provide a stream of income, by making series of payments to the annuitant for a specified period of time or for his lifetime. The true significance of life insurance is its promise to substitutes future economic certainty for uncertainty and to replace the unknown with a sense of security.

HEDGE AGAINSTS INFLATION

Saving through life insurance provides a valuable hedge against inflation in direct and indirect ways. Where it applies, saving of income tax of the insured on premium, which are paid within the statutory limit, provides an immediate appreciation of value in the part of policyholder's net income, which he pays in premium. From time to time life insurance is made the target by those who seek to deny its value as a saving medium. It is true that inflation erodes the spreading value of money, adversely affects savings and reduces the living standards of people on fixed income. For this reason, everyone should be concerned about the causes of inflation and should welcome any action to minimize its effects. But to single out life insurance from other forms of saving as being rendered unattractive though inflation is to reveal a lack of appreciation of the true position.

Life insurance is provided by means of a level premium and paid for with money, the spending power of which is related to the year in which it was paid. Thus in the present period of progressive inflation the only premium that represent its proper value on payment is the first. Every subsequent premium is paid with money, more and more closely related to the spending power of the money with which the claim is paid-the last being very closely related to it.

OTHER BENEFITS OF LIFE INSURANCE

Life insurance provides covers not only for future uncertainty on human life but it also helps in creating emergency or instant fund for future planning. There are several needs other than just preparing ones for future economic uncertainty. Life insurance could be considered as a versatile and flexible product, which not only provides financial relief, but as a tool for financial planning. Some of the areas covered under life insurance are:

a. Hospitalization and medical expenses

Besides protecting human values, life insurance also effective in providing hospitalization and medical expenses to the insured especially for life insured that is struggling with disablement and need a medical treatment throughout their life. The benefit is paid in respect of expenses incurred while being hospitalized due to sickness or accident caused by bodily injury or otherwise. The benefits usually provided are hospital daily room and board charges, surgical benefits and other miscellaneous hospital expenses such as x-ray fees, ECG charges etc. It is also payable in respect of number of day(s) hospitalized and hospital expenses subject to a maximum limit. It is a common practice that the hospitalization benefit contract contains a cancellation clause so that the insurer has the right to cancel the benefit. This is to enable the insurer to identify the advance risks and protect the interest of other policyholders from selection against the office. All the supplementary benefits mentioned above provide an age limit beyond which the coverage may not be granted, example 55 years old. Once the benefit is granted, there is also a limit to which the benefits will cease upon reaching certain a certain maximum age. The additional premium charges in respect to the supplementary benefits during the period will also cease to be paid from that age onwards. So, the policyholder will only required to pay the premium in respect of his basic life contract.

b. Policy Loan Value

The loan value provision enables the insured to remove savings from the contract without terminating the contract. If emergency cash is needed but there is no desire to terminate the policy, the cash value may be borrowed from the insurer and interest on the loan applies. Since the insurer has calculated the original premium on the assumption that interest would be earned on reserves, interest is charged to anyone, including the insured, which borrow this reserve. At the time the insured is using the reserve and paying interest on it, the insurer is crediting the insured's account with interest that the company is earning on its assets.

This cost is necessary because policy loans are offered as an accommodation to the insured and are relatively expensive to administer. The above arguments destroy the often expressed fallacy that it is inequitable for an insurer to charge the insured for the loan of the insured's own money. It is actually the insured's money, but that of the policyholders as a group. If the insured dies with an outstanding loan on a policy, the amount of the loan is subtracted from the policy proceeds. Otherwise there is never any obligation to repay the loan. If the entire cash value has been borrowed, it is necessary, of course, for the insured to pay the annual interest in cash in order to avoid a lapse.

c. Education needs

Education is very important, thus expenses for it should be prepared and protected in terms of making the future brighter. It is important to the whole family especially to our child. A protected educational policy is another insurance tools and its issued on the life of the parent. The child is named as the beneficiary and he will only receive the money on attaining a specified age. The object of this type of policy is to provide a sum of money to meet the expenses of higher education of a child. The policy money may be, at maturity, either paid in one lump sum or by installment spread over a number of years. It is also payable upon the death of the parent before the expiry of the policy term. However, such payment can be arranged so that the child can receive some money at the time of his parent's death and the balance upon his reaching the required age at the end of the policy date.

d. Annuities

An annuity is a mathematical concept that is quite simple in its most basic definition. Start with a lump sum of money, pay it out in equal installment over the period of time until the original fund is exhausted, and you have an annuity. An annuity is simply a vehicle for liquidating a sum of money. Of course, in practice the concept is more complex. An important factor not mentioned above is interest. The sum of money that has not yet been paid out is earning interest, and that interest is also passed on to the income recipient.

An annuity is a cash contract with an insurance company. Unlike life insurance products where policy issue and pricing are based largely on mortality risk, annuities are primarily investment products. Individuals' purchase or fund annuities with a single sum amount or through a series of periodic payment; the insurers credits the annuity fund with a certain rate of interest, which is not currently taxable to the annuitant. In this way, the annuity grows. The ultimate amount that will be available for payout is, in part, a reflection of these factors. Most annuities guarantee a death benefit payable in the event the annuitant dies before payout begins; however, it is usually limited to the amount paid into the contract plus interest credited.

e. Estate management

Life insurance is the only investment an individual can make and control, which will immediately create a worthwhile estate for his dependants in the event of his death, without having to lay out cash of equal value course, is the prime purpose of life insurance.
For a person who already has substantial investment in other fields, investment in life insurance provides the ready cash needed for the payment of death and estate duties, or whatever future death tax will replace them, whenever death might occur, thus keeping his other investments intact for his dependants and avoiding the necessity for forced sale with possible resultant loss. This can be particularly important where the estate comprises large investment in shares and death occurs at a time when market values have just reached a peak. Subsequent liquidation of shares to meet death duty liabilities, after the often-lengthy period, which elapses before probate is granted and when values have reduced, will certainly be costly to the estate. Should share values have seriously slumped, the resultant loss could even be disastrous.

f. Funds For Employees

Funds are arranged by employers to provide retirement benefits for employees. This is applied in superannuation plans. It is usual for the rules and terms of the fund to be set out in a trust deed. Usually both employee and employer will contribute to the fund but sometime, particularly in the case of senior employees; the employer will make the total contribution to the fund. In more general terms, superannuation plans provide a mechanism for employer, employees and self-employed persons to build a fund to meet retirement needs. Superannuation helps to provide cash for retirement, for disability or for dependents on the event of untimely death. Superannuation funds may be arranged in many ways. They may be funded through a life office, a bank or other fund manager, or may be arranged by the employer internally. There are some employers who do not set funds aside year to provide retirement benefits for employees, but prefer to meet these payments from income at the time if it is available.

CONCLUSION

Life insurance is important for us today and almost everyone in this world needs insurance for his or her protection. It is a sort of device that protects us against the possibility of economic loss. Economic losses are of many kinds and vary widely as to its severity. There are three types of economic losses when it comes to life insurance, economic loss resulting from death, economic loss resulting from accident or sickness, and economic loss resulting from old age. Such losses would continue to occur as long as we live. As such we have got to minimize the losses or shift the losses. In this instance, insurance is the right tool, which has the financial ability and arrangement to redistribute costs of unexpected losses through its contracts. Insurance contract is the legal contract whereby one party agrees to compensate another for losses.

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