Chapter 11

Risk Management and Life Insurance Planning

Chapter Objectives

Students must be able to:

- Understand the Impact of Risk in Financial Planning
- Define What is Risk Management
- Understand the Character of Risk and Risk Management
- Distinguish Among the Terms Risk, Peril and Hazard and Their Relationship to Loss
- Identify and Explain the Different Types of Hazards
- Differentiate Type of Risks Within Each Class of Risks
- Understand the Risk Management Process
- Identify and Explain the Key Methods of Dealing With Risk
- Define the Concept of Insurance
- Learn the Characteristics of Insurance
- Understand the Legal Principles Governing Insurance
- Understand the Role Insurance Plays in the Economy
- Learn How to Select Right the Insurer for the Client
- Explain the Role of Life and General Insurance in Risk Management
- Describe the Types of Insurance Products
  - Life Insurance
  - Health Insurance
  - Disability Income Insurance
  - General Insurance

Chapter 11

Risk Management and Life Insurance Planning

Fundamentals of Risk Management

Introduction

In financial planning, it is assumed that the path leading to an individual's financial goal is lined with obstacles, constrains and risks. For the financial practitioner, the key concern would be the potential risks in the way of his client's financial goals. These risks are called *financial risks* – risks that everyone has to face in the economic world. Financial risks are risks that involve financial losses if certain events occur. An example would be the medical bills following a serious illness of an individual. Since financial risks are inevitable, the financial practitioner's job would be to identify those potential risks and institute measures to help the client ride towards his goals successfully in spite of these threats. In financial planning, the process of dealing with risks is called *risk management*.

The natural world is full of risk that can affect an individual's financial wellbeing both currently and in the future. This is as true in Malaysia as it is elsewhere. A classification of risk we are concerned with here is *pure risk* as differed from investment risk (which is discussed in another chapter). An example of pure risk would be whether a car owned by an individual may meet with an accident. If the accident did occur, there will be a loss to the owner. If no accident occurs, there will not be any gain on the owner's part. It is either a loss or breakeven for the person – with no chance of any gain.

Hence, we may say pure risks involve only the possibility of financial damage to an individual or a business. In the case of the car's investment risk, its value could appreciate or depreciate depending on the circumstances. For instance, a major increase in tariffs for new imported cars could increase the value of second-hand imported car. Likewise, a reduction in tariffs or natural depreciation could lower the car's value. Pure risk and other classes of risk will be discussed in greater details later in this chapter and in Module 2

The Impact of Risk in Financial Planning

Risk management is needed precisely because risk of various kinds exists. The kind of risk we are concerned with is financial in nature. Needless to say, all individuals face risk of financial losses in some form, practically at all times. With this fact, we can assume that all individuals and businesses

have a need to manage the multiple risks they face in their daily lives. Due to numerous reasons, people often do not, on their own, manage these risks well. Usually the experts that can help them manage these risks professionally are the risk managers and financial practitioners – or those individuals whose profession has a connection with risk management, e.g. life insurance agents.

To handle risk, one first needs to understand the nature of risk. What is the character of risk? There is no single definition of risk for a good reason. Different professionals will define risk differently, usually within the confines of their work. For our purpose, risk may be defined as "**uncertainty about financial loss from an exposure"**. *Loss* is the unpleasant outcome of risk. Losses can be in *two forms* – losses that has **precipitated** or in the form of **loss exposures**, which are losses that might turn out in the future. So long as there exists the uncertainty of financial losses in any exposure, there will be risk.

Terminology Associated with Loss

The terms *peril* and *hazard* are associated with loss, but they are different. **Peril** may be defined as *the source of loss*. If a house is burnt, the peril is fire. On the other hand, **hazard** is *a condition that creates or increases the probability of loss*. Essentially, there are three main types of hazards, namely: *physical hazard, moral hazard* and *morale hazard*.

- A **physical hazard** is a *physical condition that increases the chance of loss*. Example, an oil-spilled road increases the chance of an accident.
- A **moral hazard** is *dishonesty or character defects in an individual that increase the occurrence or grievousness of loss*. Example of moral hazard would be faking an accident to make a PA claim.
- **Morale hazard** is *slackness or indifference to a loss because of the presence of insurance coverage*. Example of morale hazard would be leaving for a holiday without locking the house because all the major household items are well covered with insurance.

Classifications of Risks

Risk could be defined by classifying them as either *pure risk* or *speculative risk*. **Pure risk** is one that there is a possibility of loss and no loss, while **speculative risk** is distinguished by a chance of either loss or gain. Insurance is concerned with pure risks.

Although speculative risks are not insurable, the *pure risk consequences* of speculative risks are insurable. For instance, the marketing of a new line of children's toys has a speculative risk element of either gain or loss. This risk is clearly not insurable. However, the risk that the line will not result in sales gain is not the only risk faced by a business. A flood could damage the machines in the factory where the toys are manufactured or the toys there could be stolen, resulting in the stoppage of the supply of these toys to the marketing office. These are pure risks that are *insurable*. You will also note that these pure risks resulted from the decision to take the speculative risk in the first place. All the above risks can either be in the form of a *financial* or *non-financial* risk. Non-financial risk entails experiences like hurt and torment. In the above instance, the shock of the flood could

cause much distress to the owner of both the factory and the marketing outlets. Unfortunately, non-financial risks are generally not insurable.

Types of Pure Risks

For an individual, the main types of pure risks that are of concern are *personal risks, property risks* and *liability risks*. These pure risks are discussed below.

- **Personal Risks**

  Personal risks are risks that directly relate to an individual, involving the entire loss or decrease of earned income, additional expenses and the devaluation of amassed property when certain events occur.

  The four dominant personal risk factors are as follows:

  i. **Premature Death** – The risk of premature death may be defined as the death of a breadwinner with residual unsatisfied financial obligations. These obligations may be the presence of dependents or an unsettled mortgage with the bank. Since premature death can only cause financial problems when the deceased has dependents to support or dies with any unfulfilled financial obligations, the death of a kid age 8 is not “premature” in our context.

  ii. **Old Age/Retirement** – The main risk associated with growing old is insufficient income at retirement. In Malaysia, the vast majority of people retire at the compulsory retirement age of 55. Once retired, the retiree loses his income and unless there is a reliable source of replacement income, he would be exposed to financial insecurity during that time.

  iii. **Deterioration of Health** – Old age and poor diet also brings about another major personal risk – poor health. Not only is income eroded or completely cut off, poor health also brings about an increase in medical related expenses.

  iv. **Unemployment** – The risk of losing one’s job is another major risk factor to consider. In some countries, the government provides some form of social security benefits to those who are unemployed, but this practice is not available in Malaysia. Unemployment can be financially disconcerting for the unemployed person in three situations. Firstly, the individual will be in financially dire straits without his earned income or is able to draw from reserved cash in the form of past savings. Secondly, even where the individual can find a part-time job, his reduced income may be insufficient to adequately meet his living needs. Lastly, he may have no past savings to draw on.

- **Property Risks**

  Property risks involve the risk of damage to property owned or lost of the property due to some causes. Two major types of loses associated with property losses are direct and indirect losses. A direct loss is defined as a financial loss that results from the physical damage, destruction of

theft of the property. An indirect or consequential loss is a financial loss that results indirectly from the happenings of a direct loss of the property.

- **Liability Risks**

  Liability risks are the other important type of pure risks that are gaining prominence here in recent times. Under the current legal system, a person held legally liable for some wrong doings that resulted in harming a third party bodily or his reputation or his property can be ordered by the court to pay sizable damages. Although, Malaysia is still not considered a very litigious country yet, the number of large lawsuits filed lately may be indicative of a minor paradigm shift in the culture. One of the most frightening aspects of liability risks it that there are no maximum upper limits with respect to the amount of the loss that are known in advance. The maximum amount of loss to a car worth RM 150,000 in an accident is RM150,000, but the injured party can sue for many times more than that amount depending on the circumstances that cause his injury. On top of that, the accused may have to pay an enormous sum in legal fees defending your case.

The Risk Management Concept

Where risk exists, it has to be managed or left alone. Obviously, it is unwise to leave risk alone, hence the need for risk management. The purpose of risk management is to devise methods of handling the risks faced by the client. We may describe **personal risk management** as an organized approach to the problem of handling risks faced by individuals.

The insertion of “management” in risk management would signify that it is a function of management in the similar nature as other management disciplines such as customer relationship management, investment management or marketing management.

Initially, risk management is evolved out of the need to deal with pure risks, e.g. insurance-related risk. However, over the years, the term has been utilized to include the process of managing speculative risks such as investment risks and risk of bad debts. To prevent confusion, some experts have termed the latter as financial risk management.

In the case of financial planning, there is a need to handle issues that involve both the pure risk aspects as well as the speculative risk aspects of the client. He is still exposed to the risk of death, disability and illness. And when he invests for his retirement and thereafter when he retires, he is exposed to investment risks. This session is concerned with **pure risk** aspects of risk management.

The Risk Management Process – Pure Risk

In the wider scope, risk management concerning pure risk involves the **identification**, **measurement, evaluation** and **treatment** of property, liability and other loss exposures of an individual. We shall examine these techniques in the context of personal financial planning.

To serve our purpose, the risk management process tags along a six-step process similar to the financial planning process.

The Six-Step Risk Management Process Table 6-1
1. Setting Risk Management Objectives
2. Gather Information for Risk Identification and Evaluation
3. Analyse Information to Identify and Evaluate Risk
4. Develop Risk Management Plan
5. Implement Risk Management Plan
6. Review, Monitor and Revise Risk Management Plan

1. Establish Risk Management Objectives

The process of managing risk should start with the question, "why are we doing it?" The response to the question can be answered by setting the objectives of the activity. The objectives define the direction and gives meanings to the recommended actions to follow. The risk management objectives should be harmonized with those objectives accepted in relationship with the individual's overall financial goal.

The first aspect to deal with is the personal aspect. Usually, the objectives connected with the personal risk management schedule are developed along with the establishment of the personal financial objectives. For instant, in the case of retirement, some of the objectives in the plan can be stated as evading financial catastrophe as a result of potential loss exposure, such as death, disability and serious illness.

2. Gather Information for Analysis

Gathering of information is the second step. It is to allow the financial practitioner to identify the client's loss exposure during each of his life phases. This step is important because without adequate information, it is impossible to perform an accurate analysis of the personal risk exposures of the individual.

The client, together with his family, is exposed to three classes of risk exposures, i.e. property, liability and personal risk exposures.

Property risk exposures of the client can be *direct* or *indirect*.

- *Direct property exposures* of the client are those that are present because of the possibility of hurt to, destruction of or the disappearance of the property owned by him. For example, the client was involved in a sea accident where his motor boat was totally ruined.

- *Indirect property exposures* refer to the situation where the individual or his family suffers a loss of income due to damage caused to the property or other casualty. Employing the earlier case, the car accident has also gravely injured the client aside from smashing up his car. The indirect losses would be the additional costs of medical expenses incurred and cost of fares when the family needed to travel.

Liability loss exposures exist simply because the client is living in the world. Retired or not, the client can be sued for various reasons in the course of his existence. For instance, he may accidentally knock a bottle of beer off his window on the fifth floor and the bottle hit the head of a teenager in the pavement down below.

Personal loss exposures arise from the possibilities of death, illness or injury of the client. In the case of death, it would be okay if he has no dependent. However, the same cannot be said if the client is ill or injured with no adequate source of income and no insurance to cover the medical cost when he is retired.

In Malaysia, property exposures and liability loss exposure risks are handled by general insurance companies, while personal loss exposure risks are mainly handled by life insurance companies.

For an individual, the information gathering process involved in risk management may include the following:

- A detailed discussion with the client of his financial position and a physical examination of some of his possessions and property.

- The filling of a fact-finding form by the client providing broad-spectrum information on the property owned and his sources of income.

- Getting information of the current general and life insurance coverage owned by the client.

3. Analyse Information to Identify and Evaluate Risk

Once the information is sufficiently gathered, they are used to identify measure and evaluate risks faced by the client. The analysis will also help in determining whether the initial objectives of the risk management plan need to be revised. Identification is simply to make out the risks that could damage the finances of a client. Identification comes before 'solutioning'. Once the risks are identified, they must be measured and evaluated individually to determine the probability or chance the loss will occur and the financial impact it can have on client.

Examples of Risks and Risk Management Strategies
Table 6-2

Personal Risks		Strategies	
Risk Events	***Financial Consequences***	***Planning Measures***	***Defensive Instruments***
♦ **Death**	♦ Income Loss ♦ Final Expenses	♦ Estate Planning ♦ Insurance Planning	♦ Life Insurance ♦ Wills & Trusts
♦ **Disability**	♦ Income Loss ♦ Treatment Costs	♦ Health Programme ♦ Insurance Planning	♦ Disability Insurance ♦ Power of Attorney
♦ **Critical Illness**	♦ Income Loss ♦ Treatment Costs	♦ Health Programme ♦ Insurance Planning	♦ Dread Diseases Insurance ♦ Health Insurance
♦ **Retirement**	♦ Income Reduction ♦ Old-Age Illness Costs	♦ Prudent Investments ♦ Reduce Expenditures	♦ EPF ♦ Approved/Non-Approved Funds ♦ Pensions ♦ Annuities
♦ **Direct/Indirect Property Loss/ Damage**	♦ Income Loss ♦ Replacement Costs ♦ Repair Costs	♦ Proper Upkeep ♦ Safety Measures ♦ Insurance Planning	♦ Direct Property Insurance ♦ Consequential Insurance
♦ **Liability**	♦ Claims & Settlement Costs ♦ Legal Expenses	♦ Safety Measures ♦ Liability Insurance	♦ Liability Insurance

- **Identify the Risks**

The techniques used in identifying the pure risk confronted by the client can vary in intricacy and comprehensiveness. Generally, the more complex the techniques in use to identify risks, the more likely it will wrap in all essential areas as it would have taken into account more factors.

The following are some of the procedures to follow for identifying possible risks faced by client:

1. **Through Discussion with the Client**: For instance, the client may reveal that his retirement income is still needed to support his wife and mother. Even though he is retired, his death or disability will obliterate the only source of income for him and his family.

2. **Through Physical Observation**: For instance, the client is currently living in a house that is three storey high. If he is sick and old on his retirement, the daily need to climb the stairs may be dangerous.

3. **Through Information in the Fact-finding Sheet**: The information provided in the form exposes that the client has an unhealthy debt ratio to the income that runs into his retirement years. He may be severely burdened on his retirement, and on his death and disability, it may burden the estate with debts that have to be paid.

4. **Through Current Insurance Coverage**: An examination of the insurance position reveals that the client has no medical coverage. If he becomes ill or is injured during his retirement, there will be pressure for him to fund the need.

A more organized approach would be to classify loss exposure on the following basis:

1. **Property Losses**:

   - Direct losses associated with the need to replace or repair damaged or missing property. Example: Building burnt down in a fire.

   - Indirect (consequential) losses, such as incurring additional expenses as a result of direct loss. Example: The need to temporarily rent a place to stay because his own house has been destroyed in a fire or in the case of a business, to rent another premises to carry on business.

2. **Liability losses** occurring out of damage to or destruction of others' property or personal injuries to others in the business's premises or elsewhere by the staff who are at the time acting on behalf of the company.

3. **Personal Losses**

   The following are some of the possible personal losses to the client:

   - Loss of income due to death, disability or critical illness.

   - Additional expenses that result from the events.

- **Measuring the Risks**

The second step in risk analysis is **measuring the *monetary size*** of the risks identified.

For risks that are insured with general insurance companies, it is the expert appraiser sent who will inspect and determine the financial value of the risk to be insured. For personal risk of death or

disability of an individual, the assessment is on the loss of income to the family. In the later case, it is the financial practitioner, or a life insurance intermediary who assesses the risk, before it is passed on to the life company underwriter for assessment.

Preferably, this step should involve knowing both the loss seriousness and the chance of the incident taking place. However, in real life, it is usually unfeasible to bring together the statistical data needed to settle on the chance of the happening. There is often insufficient data that can be compiled to provide an acceptable standard of dependability for the financial practitioner.

Hence, the loss significance of the event is given more weight when measuring the risk. The most practical method to adopt when measuring individual risks would be to assume absolute loss and designate this as the worst-case imaginable position. For instance, when a person dies or becomes disabled, we assume his income will be totally wiped out, leaving the family without any income.

- **Measuring Personal Risks**

Every client should be cognizant of the fact that he faces some form of personal risk all the time. We have learnt from the above what are some of these personal risks faced by individuals. For the purpose of showing how personal risk is measured, we shall use the premature death issue for our case.

When a client dies prematurely, he dies at a time when he is still economically productive. This means, on his death, his dependants will be deprived of the usual income.

How is the value loss measured? In this case, the loss associated with the premature death of this client is his whole earnings over the years, but his life value to the dependents is only the total of the monetary amount that would have been provided to the dependants over his economic productive years. This situation provides one basis of measuring the personal risk of the client.

In this case, the ***human-life–value*** method is often used to measure such losses. This calculation requires that the present value of a certain annual sum of money over the period of the person's productive years be determined. The growth of the income over the years is not considered if the growth rate is assumed to be equal to the inflation rate. The present value of the stream of potential income is computed using an assumed interest rate.

There are many other methods used to measure personal risks of premature death. Another common method is the **total needs approach**. This method operates by determining the monetary worth of the financial needs of the dependents when the breadwinner is dead.

In this method, the cash needs of the dependant are determined and added to the capitalized value of the income needed to determine the total financial needs of the dependents. The income replacement value can be capitalized using the **capital liquidation approach** or the **capital conservation approach**. In addition, any special need (legacy need) is added to the value. The total amount less the cash reserves and life insurance of the breadwinner will yield the deficiency or the risk amount.

Table 6-3		
Resources Classification	**Explanation**	**Examples**
Cash Resources	*Those resources that are received in cash form and made available on death within a reasonable time*	
		Cash in Bank
		EPF
		Contractual Death Gratuities
		Life Insurance
Cash Equivalent Resources	*Those resources that are not in cash form, but generally can be converted into cash without much difficulty.*	
		Unit Trust
		Listed Shares
		Others

Table 6-4		
Need Classification	**Explanation**	**Examples**
Cash Need	*These are primarily needs that are usual when an individual dies.*	
Pay Final Expenses		Funeral Expenses
Cancel Liabilities/Debts		Mortgage Loan
Fund Important Events		Child Education
Legal Obligations		Taxes, Estate Duty, Legal Fees
Emergency Fund		Unforeseen Expenses
Religious Obligations		*Zakat (for Muslims)*
Legacy Need	*These are funds created primarily based on desire and not need*	As a Special Gift for Selected Loved Ones
Fund for special purpose		Charity to a School
Income Replacement Need	*These are the funds needed to replace the loss of income to the family*	
Funds needed to replace the individual's income		Daily Expenses

- **Measuring Property Risks**

Retirement notwithstanding, it makes good sense that all valuable property should be protected at all times at their full worth. Determining the correct value is important because property insurance is a *contract of indemnity*. The insured cannot make a profit out of the insurance claim when it is damaged or destroyed. If the property is insured *below* its true value, the claims are subject to the "average clause" and the client will not recover the full value of his losses. *Over-insurance* would result in the client paying far more than it is necessary; a total waste of the client's money that can be used for other purposes.

In measuring the property risks, three basic terms should be clearly understood. They are as follows:

1. **Actual cash value** is defined as replacement cost of assets minus its depreciation amount over the period of cover. The formula for determining the risk amount is:

   "Actual cash value = Replacement cost – Depreciation"

   This term is mentioned in the property insurance policy, which is often used to limit the liability of the insurer issuing the document.

2. **Replacement cost** is the cost required by the client to replace or repair the damaged property. For most personal property, the replacement cost is equivalent to the current market price. The value of replacement cost of real property is often determined by an appraiser appointed by the insurer.

3. **Depreciation** is the reduction of value of the assets due to wear and tear, which depends on the condition at the time of loss and age of the assets. Other factors that may contribute to the deterioration of the assets are also considered in determining the depreciation amount.

- **Measuring Liability Risks**

Possibly the most practical way to measure the liability risk of an individual is to count it as without limit. It would be then up to the court to determine the true amount claimable, when the risk event crystallises.

In today's increasingly litigious society, the amount could range from a few ringgit to millions of ringgit resting on the type of liability incurred and the seriousness of the case. In practical terms, this would mean the maximum amount of possible liability loss is equal to an individual's personal wealth. If the client becomes bankrupt as a result of a lawsuit liability, his potential loss would also include 'goodwill' loss on his ability to work or to do business because of the disrepute attached to the status.

- **Evaluate the Risks**

Evaluation is the process of determining the risk significance for action to be taken after considering the resources available to support action. Once the risks are identified and measured, the next step is to evaluate them to see if there is the need and ability to take defensive action. Not all risks are significant and need handling or to be insured. Size does matter in determining whether the risk should deserve attention. For the smaller ones, it can be ignored even where there is a great chance that it may occur. On the other hand, risks, which have a slight chance of occurrence but carry potentially severe financial impact on the client's family, should be handled. An example would be the client is the sole provider in the family.

There are also times where the resources of the client do not permit full protective action be taken against the risk. In such cases, the level of protective action taken would depend on the client's resources that can be allocated for those purposes. The financial practitioner should also inform the client of the consequences of the balance of the risks that are not treated.

4. Develop Risk Management Plan

Once the practitioner has evaluated of the risks completely, it is time for him to select and apply the different techniques of risk management that are suitable in terms of cost and effectiveness. This is the plan development stage. The techniques employed would usually comprise a mixture of **risk avoidance**, **risk (loss) control**, **risk retention** and **risk transfer** as part of the strategy. These four techniques used in a risk management plan are explained below:

- **Risk avoidance** is essentially an effort by the client to avoid having to deal with the risk at all. In the case of retirement, the client may abstain from drinking alcohol to prevent degenerative diseases from setting in at a later stage of his life.

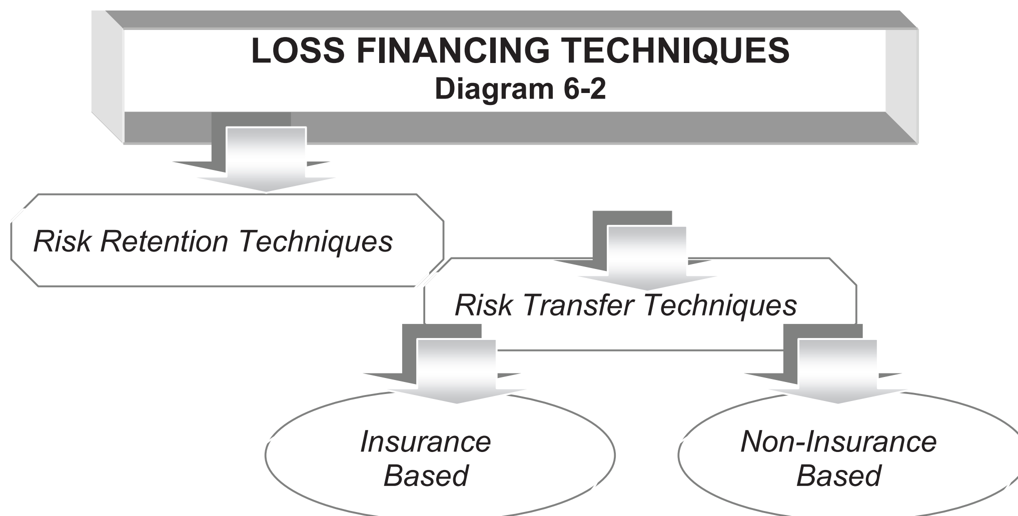
- **Risk (loss) control** is where the client takes steps to reduce the severity of a possible loss or to curb the possibility of the loss occurring. This can be done by using loss prevention and loss reduction techniques.

- **Risk retention** is a process of bearing the risk personally or internally. Usually this is done for a risk that does not severely impact the client financially or used in conjunction with one or more of the other methods.

- **Risk transfer** is the process of shifting (to others) a risk that is neither avoided nor retained through either insurance or non-insurance based contracts.

- **Techniques of Loss Financing**

Both risk retention and risk transfer techniques (insurance and non-insurance) are classified as **loss financing techniques**. As the term suggests, these techniques involve finding ways to finance the loss that may occur, and are not ways to prevent the loss event from occurring. The techniques of loss financing are discussed later on.



5. Implement Risk Management Plan

Once the techniques are matched to the risks identified, the plan is ready for implementation. After the risk management plan is developed, the techniques mentioned in the plan are applied to the area of risk exposures. In performing this step, the financial practitioner should be concerned with prioritising the risks in order of their importance and then matching the actions to be taken (such as insuring the risk) to deal with the risks.

- **Risk avoidance** can be put into place with any or a mixture of the following four techniques, namely: *elimination, substitution, separation* and *rational planning*.
  - **Elimination** concerns the removing of the source of risk in the plan. *For example, avoid taking part in dangerous contact sports like karate.*
  - **Substitution** refers to the replacement of one activity or substance with another, which is less dangerous. *An example would be to replace taking part in a dangerous sport (scuba diving) with another sport like table tennis.*
  - **Separation** refers to the division or placement of items so that potentially dangerous mixtures cannot occur. *An example would be to separate and put in separate rooms two chemicals which can cause an explosion when mixed*.
  - **Rational planning** is to avoid some risks through careful organization to create alternatives or to create contingency sources for critical items. *For example, the business should get more supplier of a critical production raw material so that it will not get caught in an out of stock position on that item.*

- **Risk (loss) control** is a technique of dealing with risks that cannot be avoided and the individual concern does not wish to fully retain or transfer the risk. This technique can exist in two forms, i.e.

  – **Loss prevention** to reduce the chance of loss for any risk that cannot be avoided, *e.g. wearing proper protective attire and sticking to guidelines when working in a hospital with SARS (severe acute respiratory syndrome) patients.*

  – **Loss reduction** to control the severity of the losses when an undesirable event takes place, *e.g. converting a sole proprietorship into a company to limit liabilities in case of insolvency*.

  – **Loss sharing** to reduce the amount of losses by sharing risky ventures with others, *e.g. getting in partners to conduct a business so that losses and liabilities are shared among more people.*

- **Risk retention** is when the client retains the risk instead of passing it out to others. Intentionally or unintentionally, this form of dealing with risks is the most pervasive. In life, the client has to face almost an unlimited assortment of risks, many of which cannot be prevented at all.

  When these risks are not reduced, transferred or avoided, the client retains the possibility of loss. For planning purposes, the risks that should be retained are those that will lead to relatively bearable loss for the client if it occurs. It should be noted that this technique does not affect the frequency or the severity of a loss but provides an indication of how the individual or business will pay for the loss when it occurs.

  Risk retention is sometimes considered a form of **self-insurance**. Technically speaking, however, self-insurance represents an incongruous definition. For the insurance device to operate, there must be a transfer of risk or pooling of exposure units – which no one can do unto himself. However, this term self-insurance has gained unbridled usage to mean the person is taking all the risk within the situation. Most people, those not insured, self-insure by default rather than by choice. There are also situations where a business or organizations (but not individuals) engaged in some form of activities that resemble that of an insurer. An example would be the establishment of a business reserve fund to cover potential losses. Such activities are often also termed "self-insurance".

- **Risk transfer** or *risk shifting* can exist in two forms, i.e. in the form of non-insurance transfer of the risk or the risk transfer could be insurance-based. Essentially, the initiative is to plan how to finance those losses when they arise. An example of non-insurance transfer would be to contractually transfer a risk to another party, forcing that party to either retain or insure the risk. To demonstrate an instance where this has occurred, a property owner could by agreement transfer his property risk to a tenant by laying down in the contract that the tenant must insure the property. Although insurance is used, the owner of the property is not the one insuring the property.

  Insurance-based risk shifting is appropriate where the issue at hand is in a pure risk situation. For instance, a client can transfer the risk of loss of his earnings due to death to the insurer by

insuring himself for an appropriate sum. In the case of a business, the business owner transfers the risk in his business by insuring the subject matter against the financial loss resulting from the insured risk.

6. Review, Monitor and Revise Risk Management Plan

The final step in the risk management process involves periodic reviews, monitoring the implementation of the risk management program and adapting it to changes, as the client sail along in life.

This step is imperative in planning because the circumstances of a person are usually dynamic when it is spread over a period of time. Earnings may rise, debt level may swell or the client's needs for insurance may no longer be present. The financial practitioner and the client should jointly review the changing situation, monitor the implementation of the plan and observe whether there are deficiencies or adjustments needed. The suitability of earlier solutions selected is to be assessed for effectiveness. These can be done according to need or scheduled to be performed periodically whereby the financial practitioner checks the result.

For a person who is also business owner, the owner through his staff could monitor the progress and involve the financial practitioner when the need arises. If there is any deviation from the planned outcome expected, the employees doing the work will report immediately to the owner for adjustment to be made. Monitoring is an important step as it ensures proper execution of the action plans to manage the risks identified. We may assume that the more regularly this is done, the more updated the plan will be in meeting the risk management needs of the client.

Life Insurance Planning

Introduction

In today's world where risk is becoming a norm, it can be said that no trade can carry on to any large extent without the use of insurance. Individuals are just as exposed. New threats such as terrorism have helped bring to the fore the awareness of the need to handle risk with care, be it the business or the individual, or else, to face the unforgiving consequences when a loss event precipitates.

Although not all risks are insurable, most risks can be better managed to eliminate, reduce and hold down the dollar value of the losses when the loss event did occur. And all said and done, there is hardly a better tool than insurance to meet many of the daily risk-related financial losses. It is precisely because of this virtue that insurance is closely associated with risk and risk management. In the last session, we have understood the concept of risk, risk management and its processes. As a natural follow-up, this session will deal with the tools of risk management, specifically, the insurance element.

In Malaysia, insurance is alienated into general and life division. The life side is handled by life insurance companies and the distribution channels specializing in life insurance products marketing. Likewise, the general side is handled by general insurance companies and their intermediaries. Although the two classes of insurance products similar in purpose, i.e. to treat risk of loss, there are a sufficient number of disparity in legal implications, applications and variety that deserves the attention of the financial practitioner. To be able to use and advise on the use of these risk management tools, the financial practitioner must possess sufficient knowledge, both in depth and width, on the principles, concepts, characteristics and the multiple applications potential of this group of unique financial products.

In view of its significance in the practice of financial planning, it is imperative that every financial practitioner should get acquainted well with insurance and the various principles that preside over it. In this chapter, we shall be discussing on the principles of insurance, the use of insurance as a lost treatment tool and insurance planning.

The Concept of 'Insurance'

Insurance Defined

Over the years, different professionals and organizations have defined the word 'insurance' in their own ways. For our purpose, we will focus on the common elements that are typically present on any insurance policy. To proceed on with some basis, we would for our purpose quote two useful definitions.

For our purpose, we have selected two definitions which are useful to us. The first definition here is derived from the ***Commission on Insurance Terminology*** of the **American Risk and Insurance Association**. It defines insurance as follows: "***Insurance*** *is the pooling of fortuitous losses by*

transfer of such risk to the insurers, who agree to indemnify insureds for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk."

The second definition of insurance is stated as, "*The business of transferring pure risks by means of a two-party contract."*

From the two cited definitions, we can see the word "transfer" as a common denominator. What is the significance? Insurance has many purposes, but the transfer of risk is definitely one of the key uses. It is a power device that can be applied to shift risk from one party to another, i.e. from the policyholder to the insurer. Since, both the insured and the insurer have obligations, we may consider insurance as a business transaction with obligations imposed on both parties. The insured or the policyholder has to continue to pay the premiums to enjoy coverage, while the insurer has to hold in reserve at all times the money to make settlement when the insured event occurs. We will learn later in the session that only pure risk is insurable, and this factor is mentioned in the second definition. While the two definitions provide a broad conceptual view of insurance, it is useful for the financial practitioner to analyze and understand deeper the basic characteristics and elements of a true insurance cover.

Fundamental Characteristics of Insurance

In the earlier session, the student is exposed to the various meanings and characteristics of risk, which will provide the necessary background for the understanding of the unique characteristics of insurance. In this section, we shall be discussing the fundamental characteristics of insurance, which is established on the following essential principles:

- Principle of risk transfer
- Principle of indemnity
- Principle of pooling losses
- Payment of fortuitous (unintentional) losses

Principle of Risk Transfer

In its most basic make-up, insurance has two elemental characteristics:

1. Transferring or shifting risk from a financially weaker party e.g. individuals, to one who is financially stronger, e.g. insurers.

2. The sharing of losses among members in the pool on some equitable basis.

Risk transfer is a basic characteristic of insurance, which is why loss-transfer technique in risk management frequently uses insurance as a tool. Unless the case is self-insurance where the individual or organization retains the risk, all insurance devices engage the principle of risk transfer.

In effect*, risk transfer involves the transfer of a pure risk from the insured to the insurer, who is financially well endowed to withstand risk of loss if the insured event occurs*.

From the individual standpoint, pure risks that are frequently transferred to the insurers cover the risk of premature death, deterioration of health, disability, damage and loss to property, and liability lawsuits. For a business, it could be the loss of a keyman due to similar events, causing a loss of profits and the other risks associated with operating a business.

Principle of Indemnity

It is important to note that the purpose of insurance is not for the insured to make a profit when the insured event happens. This is the primary position the principle of indemnity is footed on. In essence, the principle of indemnity asserts that an insured may not be paid an amount in excess of the loss incurred by him in the event the insured peril occurs. **Indemnification** *henceforth is the restoration of an insured person to his or her approximate financial position prior to the occurrence of the loss*. If for instance, the insured's car met with an accident, the insurer will pay a sum approximately equal to the repair bill of the damaged car. In the case of life insurance, the insured is paid on the sum insured stated in the policy when the insured event, say death, occurs, because life insurance is not a contract of indemnity but a **valued contract**. It is a well-established and accepted insurance principle that an individual has unlimited insurable interest in his own life, and henceforth is entitled to insure himself for any sum that the insurer is willing to give cover.

Three auxiliary insurance principles that are applied in the enforcement of the indemnity principle is discussed below:

- Insurable Interest

  The principle of insurable interest is basic to insurance law. The principle essentially states that *an individual with insurable interest on the subject of insurance must stand to lose financially or suffer harm in some ways if the subject of insurance is damaged or destroyed or lost*. Example, you have an insurable interest in your house since you stand to lose financially if it is burnt down or damaged in any way.

  Hence, to be legally enforceable, all insurance contract must be supported by insurable interest. A question may arise as to when must an insurable interest exists. In property insurance, the insurable interest must exist at the *time of loss*. There are two main reasons why this is the case.

  1. The majority of property insurance contracts are contracts of indemnity. The principle of indemnity would be violated if the insured is paid when no loss to him is present at the time of claim. If for instance, Ricky sold his factory to Lim, and a fire occurs before the policy is cancelled, Ricky cannot claim from the policy because he no longer has an insurable interest in the property. Assuming Lim has not purchased a fire policy on the factory, he too cannot claim from the old policy since he is not registered as the insured.

2. In marine insurance for instance, the insured only have an insurable interest when the cargo is on board as the insured's property. Hence, although an insurable interest does not exist at the time the insurance contract is issued, insurable interest exists in the goods at the time of loss.

Insurable interest is said to arise when an individual benefits by its safety or suffers by its loss. The following are examples of how insurable interest could arise:

- **Ownership of property;**
- **Trustees in respect of property held in trust for others;**
- **Mortgagees in respect of property held as security for a loan;**
- **Bailees (carriers, inn keepers, pawnbrokers, warehouseman, etc. in respect of property**
- **held by them;**
- **Tenants who have covenanted to insure a property;**
- **Losses in respect of leased property;**
- **Husband on the life of his wife or vice versa;**
- **A corporation on the life of an officer or employee;**
- **A person's liability under Common Law/Statutes.**

- **Subrogation**

  This is another insurance principle that strongly upholds the indemnity principle. The subrogation principle is a *process whereby the insurer is substituted for the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance*. This effectively means that the insurer is entitled to claim from a negligent third party any loss payments made to the insured on the case. For example, if David's car is damaged in a road accident when the other party is obviously at fault, he may choose to either claim under his first-party cover or against the other motorist's insurer. In any case, David is prevented from double claiming the repair bills by claim from both insurers – his and the party at fault.

- **Double Insurance**

  To prevent incidence of the insured claiming from multiple policies issued on the same risk, there is an inclusion in the policy to prevent the insured from claiming more that the amount

at risk. Commonly, there is a clause that provides for the sharing in the loss on some formulas when the risk event occurs.

Principle of Pooling Losses

In addition to eliminating risk at the level of the individual through transfer, insurance can help to reduce risk for those that participate in the pool. The principle of sharing or pooling losses is central to insurance. Essentially, **pooling** *in insurance is the spreading of losses incurred by the few over the whole group, so that in the process, average loss is swapped for actual loss*. Pooling also involves the grouping of a large number of exposure units so that the law of large numbers can work to furnish a materially precise prediction of future losses. The **law of large numbers** says that *the greater the number of exposures, the more closely will the actual results approach the probable results that are expected from an infinite number of exposures*. Preferably, there should be a large number of homogeneous exposure units – i.e. units that are similar but not necessarily identical. Hence, pooling implies two key sub-principles:

1. The sharing of losses by the whole group; and

2. Forecast of future losses with some exactness based on the law of large numbers.

Principle of Payment of Fortuitous (Unintentional) Losses

If a loss-bearing event can be foreseen to be happening in definite term, it is not an insurable event. The only exception is perhaps is death. Even then, the event is insurable because the exalt timing of death is generally not determinable. A fortuitous loss is one that is unforeseen and unexpected and occurs as a matter of chance. This is to say that the loss to be insurable must occur accidentally or unintentionally – such events happen randomly based on the law of large numbers. Example, a lorry skidded on a slippery road and knock into the shopping mall, the event would be considered a fortuitous event. If a plane crash due to bad weather, the incident is fortuitous.

Benchmarks for Insurable Risks

Hence, because of the possibility of loss, it gives reason why people purchase insurance against risks. It is quite assumable that not all risks, including pure risks, are insurable. For a risk to be insurable, it must meet certain criteria. We have learnt in the last chapter the concept of risk. It would be useful for the reader to refer back to that section on risk before moving on from this point. Additionally, to discuss insurable risk, the concept of "true insurance" versus "special arranged insurance" should be differentiated. You have probably heard of famous hairstylists insuring their hands and well-known movie actors insuring certain part of the body for large sum of money.

These arrangements are not what we termed as "true insurance" but are "specially arranged insurance" that covers specific risk that are undertaken by large underwriting groups like Lloyds of London. The premiums arrived at are estimates of the potential loss based on special techniques developed for such purposes that are not normally used by insurers to determine premium rates.

In practice, only those risks that meet the following requirements are considered insurable risks:

- **The loss is sufficiently certain for a monetary value to be determined, *e.g. the keyman of a firm can be valued by his job performance.***

  The basic nature of insurance is to conduct itself as a risk transfer device and thus furnish financial compensation for loss. You will note that insurance does not eliminate the risk, but merely provide financial protection against the consequences. This being the case, the said risk that may result in a loss must be capable of being ascertained in financial terms, i.e. it must have a financial value.

- **The loss is not exceedingly catastrophic in size, *e.g. insuring the whole population against war losses.***

  This factor basically means that an exceedingly large proportion of exposure units should not incur losses at the same time. As mentioned earlier, pooling is one of the essences of insurance. If for some reasons, most or all of the exposure units in a certain class simultaneously incur a loss, then the pooling concept is defiled and turns impracticable. To maintain the feasibility of insuring the class of people, the insurer may have to raise premiums rate to a prohibitive level, and the insurance of spreading the risk of loss of a few over an entire group becomes not feasible.

  Ideally, insurers would want to avoid all catastrophic losses, but this is unrealistic. We have seen, even in a relatively “safe” haven like Malaysia, a plane accident can cost insurers millions in compensation payments. Fortunately, there are available remedies for the insurers in facing catastrophic losses.

  One commonly used is reinsurance. Essentially, reinsurance is shifting of part or all of the risk originally underwritten by one insurer to another insurer called the reinsurer. Once the risk is reinsured in this manner, the reinsurer concerned is now responsible for his share of the loss.

  Another way insurers can avoid the concentration of risk is by dispersing their coverage over a large geographical area. This dispersal of coverage will ensure the insurer’s fortune is not wipe out by catastrophic losses that resulted from severe climatic or other occurrences that happened in a particular geographical area.

- **The loss is not something that is definite to happen, *i.e. it must be fortuitous*.**

  A fortuitous loss is one that is unforeseen and unexpected and happens purely by chance. From the insurer standpoint, it is simply not possible to insure against an event which will definitely occur, since it involves no uncertainty of loss and therefore no transfer of risk would be taking place. It is another way of saying the loss must be accidental for insurance coverage to be possible. The law of large numbers works on the assumption that losses are accidental and occur randomly. This would cut off definite events such as damage caused by wear, tear or depreciation and those that are inflicted voluntarily and intentionally by the insured or someone

hired by the insured. Even though death of a person is certain, life insurance works within this principle because the timing of death is fortuitous.

- **The possibility, magnitude and vacillation of future losses must be mathematically predicable, *i.e. the happening can be determined through calculation*.**

  For a risk to be insurable, the chance of loss should be calculable. The insurer must be able to mathematically determine both the average severity and the average frequency of future losses with some degree of accuracy. Otherwise, a proper premium cannot be charged to cover all future claims, cover all expenses and still make a profit at the end of the day.

  The reason why certain risks are difficult to insure is precisely because the chance of loss is difficult to calculate, and the possibility of a catastrophic loss is in place. Examples of such risks are wars and earthquakes.

- **The quantum of loss must be consequentially acceptable to the extent that the sum of future compensation to an insured is not a dominant part of the charge collected from him, *i.e. the face amount of the insurance must be far in excess of the premium paid or to be paid.***

  To insure a risk, the premium charged must make sense economically. The amount charged to insure an individual must be a sum that the insured can afford to pay. Furthermore, the premiums paid must be substantially below that of the policy face amount or else it would not make sense to purchase the cover.

- **The person insuring against the loss must have a legal standing to insure the subject matter, *e.g. insurable interest*.**

  It is mentioned earlier that one requirement of an insurable risk is that there must be some losses which can be measured in financial terms. Common sense will tell it is easy for a person to insure the property of someone else in anticipation of it being lost or damaged, and then to make a profit out of the "investment". In this case, there would be a financially measurable loss that fall within the context of what is a requirement of an insurable risk. However, this is not acceptable in law. For a risk to be insurable, there must be a recognizable relationship between the insured and the financial loss, i.e. insurable interest must be present. The concept of insurable interest has been quite adequately discussed in the earlier part of this chapter, and the reader should refer back to reinforce understanding of the concept.

- **Insuring the loss must not be considered to have violated any law or gone against public interest, *e.g. insuring against a hefty speed fine*.**

  Again, it is a practice in law that that court will not support an illegal contract, which would be the case if insuring a risk go against any law or is against public interest. Henceforth, insuring a loss that is created by the insured, for instance, will not be allowed.

For those risks that do not meet the above requirements, they are uninsurable. In our case, our discussion will be concerned entirely with pure risk, with special emphasis on those risks that are insurable.

The Importance of Insurance to the Economy

In reality, insurance cannot protect property or lives, but it can protect those insured against the adverse financial consequences of losing property and lives. If for instance a factory is insured, this does not prevent it from being burnt down. However, the insurance money collected can be used to construct a new factory in place of the destroyed one. Likewise, an insured person cannot be protected against dying or disease, but the dependent is protected financially if such events precipitate unexpectedly. In any of such similar cases, the insured would be in economic dire straits if not for the financial protection conferred by insurance. In short, insurance as an economic device provides the insured with financial certainty in an environment that is filled with the possibility of losses. In providing such benefits, insurance brings peace of mind to people – and to society at large.

Another benefit of insurance is its ability to provide for more optimal use of economic resources. In the absence of insurance, individuals and businesses will have to create and maintain a relatively large contingent fund to meet the risks they have to assume. To ensure the contingent fund is safe, it will be necessary to invest them in low yielding but secured investment like bank deposits. This would in effect deny the individual or business the opportunity to invest these funds more productively. With insurance, the risk of loss is minimized or eliminated through transference. The contingent fund against such risks could also be created immediately.

Understanding the Insurance Contract

It is an important advantage for a financial practitioner to better understand the insurance contract in terms of its structure and legal make-up. He may use the knowledge to support him when planning for the client in the area of risk management, of which insurance is an important tool. Now that we are conversant with the concept of risk and the characteristics of insurable risk and some important aspects of insurance, it is now appropriate to move into understanding the insurance contract itself.

Components of an Insurance Policy

An insurance policy is a contract and as such it operates based on the law of contracts. The word “contract” would denote that an insurance policy is an agreement enforceable by law. In Malaysia, contracts are governed by the Contract Act 1950, and by virtue of the Civil Law Act, English law can also apply within certain contexts. In addition, insurance as is sold in Malaysia is subjected to the provisions of the Insurance Act. Being a contract, an insurance policy to be legally enforceable must meet certain requirements of a valid contract. The following five requirements selected are discussed below:

1. **Offer and Acceptance**: For an insurance policy to be valid, the principle of offer and acceptance must be complied with. In general insurance, many agents can contractually bind the principal by accepting the premiums and proposal forms and issuing a receipt given by the insurer. When the premiums is paid and the cover note is issued, as in the case of motor insurance,

other things being equal, there exist a contract between the policyholder and the insurer. In the case of life insurance, the offer and acceptance rule is slightly different. Typically, the agent is not empowered to bind the principal. The applicant makes the initial offer where he submits the required premiums and the completed proposal form. If the insurer accepts the application, the policy contract becomes operative. In the case where the insurer decides to put some conditions before accepting the applicant's proposal, a counter-offer has being made. The offeror is now the insurer. If the applicant accepts the condition set by the insurer, a contract results.

2. **Consideration**: The second requirement is consideration. Consideration is the exchange of values between the contracting party – hence the term *valuable considerations*. In the case of an insurance contract, the consideration of the insured is the payment of the first and subsequent premiums and the agreement to abide by the conditions set out in the policy. The insurer's consideration is the promise to make payment of the insured sum or to do certain things at the happening of the insured event. This could be the payment of losses incurred or to defend a liability lawsuit, depending on the type of policy cover.

3. **Legal Capacity**: The third requirement is legal capacity of the parties to contract. Obviously, the issue will be more on the applicant rather than the insurer, although technically speaking, an insurer can run foul of the law and lose its capacity to contract. Under the Age of Majority Act, 1971, an individual must be 18 years old before he has the capacity to enter into a contract.

4. **Legality of Purpose**: The last requirement is for the contract to be for a legal purpose. If the purpose of the insurance is to promote something illegal or immoral, it would be against public policy to enforce the contract. For instance, a hard drug pusher cannot purchase a policy that pays compensation if enforcement officers seize his "goods".

5. **Consensus ad idem (or Meeting of the Minds)**: In a normal contract, each party is considered to have sufficient knowledge of the dealings and have come to a "meeting of the minds" in the agreement. This principle is reflected in the maxim "caveat emptor" or *let the buyer beware*. However, in insurance dealing, there is no way the insurer can know the applicant's situation other than what he had declared in the proposal form. It is for this reason, the law imposes a more stringent yardstick on the applicant in a contract of insurance, requiring him to disclose all material facts to the insurer. The underlying principle is called *uberrimae fide* or utmost good faith, and is a fundamental principle in insurance.

Characteristics of Insurance Contracts

Apart from the above common requirements that makes an insurance contract legal, there are several distinct characteristics that makes a contract of insurance different from other forms of contracts. Several distinctive characteristics of insurance have already been discussed, such as contracts of indemnity, insurable interest and utmost good faith.

The following are the additional unique characteristics of insurance contracts:

- Aleatory contract
- Unilateral contract
- Conditional contract
- Personal contract
- Contract of adhesion

These unique characteristics will be discussed in some details below

Aleatory Contract

An **aleatory contract** is a contract *where the value exchanged may not be equal but depend on an event that may or may not occur*. For example, the insured may have paid an annual premium of S$600 for a S$120,000 20-year term policy and died one month after. The beneficiary received S$120,000 from the insurer which is way above the amount paid by the insured as premiums. On the other hand, the insured may have paid the premiums faithfully for the next 20 years and live. In such a case, he gets nothing.

This differs from a **commutative contract** where the values exchanged by the contracting parties are considered even. For example, if someone buys a house for S$120,000, he will view the value of the house as equal to S$120,000.

Unilateral Contract

In a **unilateral contract**, *only one party to the contract makes a legally enforceable promise. In this case, it is the insurer who makes that promise* – i.e. to pay claims when the insured event happens. The insured on the other hand cannot be legally compelled to make premiums contribution after he has paid the first premium. Non-payment may only cause the policy to lapse and the obligation of the insurer to the insured is terminated, but no legal action can be taken against the insured. However, if the insured continue to make payment within the terms stated, the insurer cannot refuse the payments or to terminate cover. Again this differs from most commercial contracts where the contracts are bilateral, i.e. each party to the contract is legally bound by their promise to perform. Non-performance by either party may result in the injured party taking legal actions to compel performance or to sue for damages.

Conditional Contract

A conditional contract, of which an insurance contract is one, means that *the insurer's obligation to pay a claim depends on whether or not the insured or the beneficiary has complied with all the policy conditions*. These conditions are stated as provisions in the policy document that qualify or place limitation on the insurer's promise to perform. If these provisions are not complied with, the

insurer does not have to honour its promise. From the standpoint of the insured, he or she must abide by the conditions to qualify him or her to make claims when a loss occurs.

Personal Contract

Property contracts are personal contracts. Being a personal contract means that the insurance contract is between the insured and the insurer. In strict terms, a property insurance contract does not insure property but insures the owner of property against loss. Since the contract is personal, the applicant for the insurance must be acceptable to the insurer, in terms of the underwriting standard set regarding the character, morals and credit status. Such contract normally cannot be assigned to another person, unless the permission of the insurer is obtained. If for instance, a house is sold, the policy does not follow the new owner automatically.

Contract of Adhesion

Insurance contracts are contract of adhesion, meaning the insured must accept the entire contract with all its terms and conditions that is attached to the policy contract. The insured cannot bargain for the contract to be modified to suit his case. Essentially, the insurer designs and prints the policy, and the insured is compelled to accept the document without insisting any modification to it.

Principles of Islamic Insurance

In Malaysia, where a large population of Muslims exists, it is important for the financial practitioner to be familiar with how Muslims perceive insurance as it differs slightly from the conventional view. In Islam, the key question would be whether life insurance is *haram* or illegal under Islamic law. This is an important factor, as Muslims are not allowed to participate in schemes that are considered *haram* to the religion.

It should be noted that as a concept, insurance is not considered *haram* under Islamic law. In fact, Muslim Scholars have pointed out elements of insurance existed in Muslim societal practices even during ancient times. Life insurance is a good example. The essentials of life insurance are comparable to the system of mutual assistance in relation to the Arab tribal custom of blood money. Muslim jurists recognized that the basis of shared responsibility in the system of '*aqila'* as practiced between Muslims of Mecca *(muhajirin)* and Medina *(ansar)* laid the footing of mutual insurance.

Conventional Insurance

A question arises as to whether conventional insurance, in particular life insurance, adheres to Islamic principles. By conventional, we are referring to the types of policy sold by life companies in Malaysia.

The generally accepted views of the Muslim Jurists is that the operation of the conventional insurance as an exchange transaction under a buy and sell agreement does not in its present

form totally conform to the rule and requirements of the Syariah as it embodies the following three elements:

- *al-Gharar*
- *al-Maisir*
- *al-Riba*

These three elements are briefly discussed below:

- **al-Gharar**

  The first element is that of *al-Gharar* (unknown or uncertain factors in the operation of a contract). This element seems to be existing in both the life and general insurance policies of the conventional types. In Islam, one of the basic rules of contract is that the subject matter of the contract must be clear. The issue of *al-Gharar* turns out in conventional policies due to the uncertainty of the subject matter of the contract or *'ma'qud'alaih'*. In such a deal the insured or the policyholder agrees to contribute a certain sum of premium in exchange for coverage of a certain sum of compensation (sum insured) in event of a catastrophe or disaster. In the case of life insurance, it is death or permanent disability. But the insured or the policyholder is not told how the amount of the compensation is derived in conventional policies.

  In addition, any form of contact which is lopsided in favor of one party at the expense and unjust loss to the other is also classified as *Gharar*. This is prevalent in both the current forms of conventional life and general insurance policies. For example, there will be a loss of premium suffered by the policyholder if he cancels his policy before the policy acquires the forfeiture status. This is considered not in line with Islamic principles. Analogously, the customary practice of charging for short period in general insurance where the policyholder is responsible for the premium is applicable if the insurance company terminates the cover. This is considered a "double standard" practice and is un-Islamic.

- **al-Maisir**

  The element of *al-Maisir* (or gambling) arises as a consequence of the presence of *al-Gharar*, as in the case of conventional life insurance. When a policy owner dies within the insured period after paying only a portion of the premium, his dependants will receive the sum assured – a value the policyholder has no prior knowledge of how and from where it is to be obtained.

- **al-Riba**

  Finally, there is the practice of al-Riba (or interest) and other investment activities of the conventional insurers, which are considered "un-Islamic" according to the rules laid down in the Syariah.

The Concept of Takaful

Thus in parallelism to the above elementary attributes of acceptable insurance practices, Muslim jurists have come out with a system of insurance they consider falling within the confines of the Islamic setting of insurance – established on the concept of *'al-Takaful*.

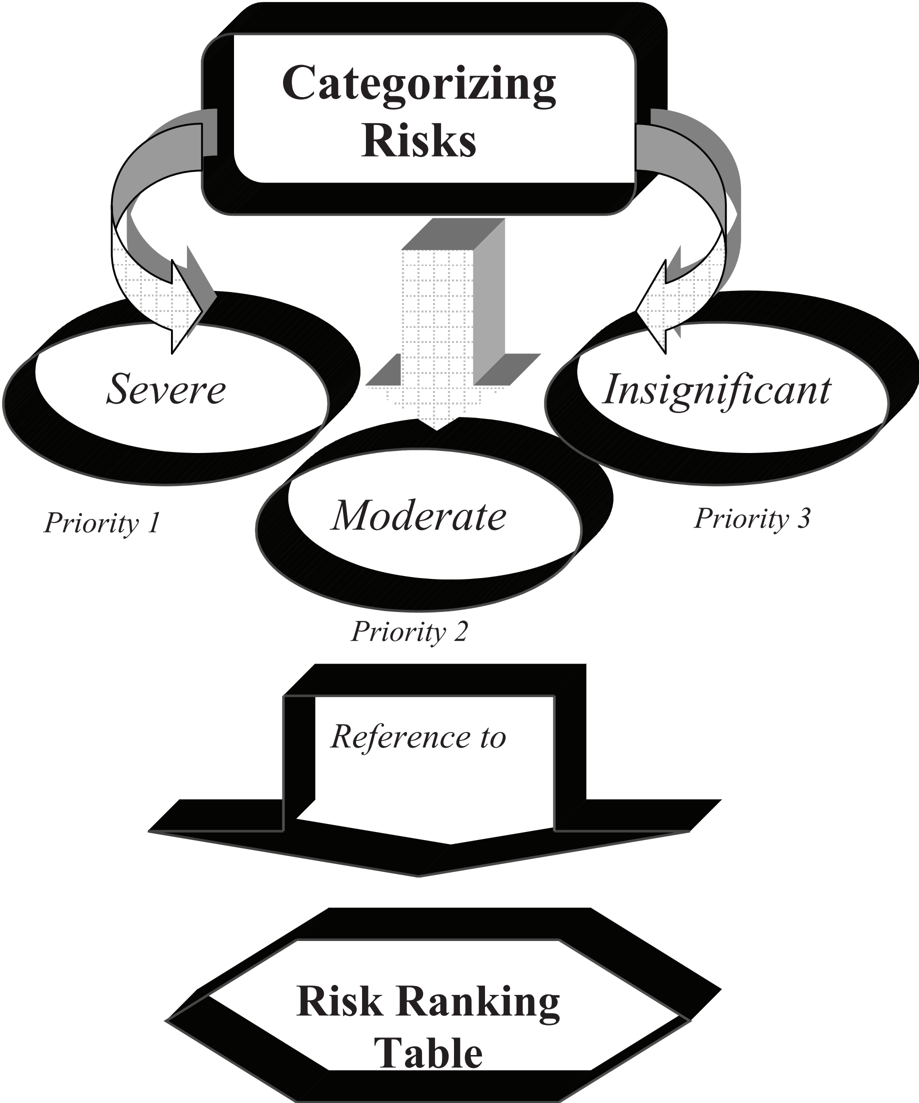
The term 'takaful' means joint guarantee in the Arabic language. The takaful concept can thus be described as a covenant among a group of members or participants who agree to jointly protect themselves against financial related losses. A fund is created through the contributions made by the participants, and is used for compensating members who suffered losses due to occurrence of disastrous or catastrophic events. The suffering member will receive a certain sum of money or financial benefit from the fund as a form of relief as earlier agreed upon by the group of contributors. From the above description, we can get the notion that the fundamental objective of Takaful is to compensate **predefined losses** of members from a **predefined fund**. It can be observed that this practice differs from conventional insurance of which the compensation payment and the fund are not predetermined. The Muslims consider takaful as a conduit through which members of the group pools effort to support each other in times of trouble. This type of insurance is thus allowed for a Muslims as it falls within Islamic practices.

Insurance Plan: Implementation

Having understood the various concepts of insurance, it is time to move on to the next step. Probably the most crucial step in the process is implementing the *loss-control* and *loss-financing* plan that has been devised. In this section, we will be discussing on the technique of selecting suitable insurance products and services to meet the client's needs and the major roles of the financial practitioner in the plan implementation phase.

Plan Formulation

In devising the insurance plan to cover the risks face by the client, it is important to select the appropriate insurance products that will match the needs of the client, i.e. the identified, measured and evaluated risks. The next step is to rank them in accordance to their gravity of seriousness in terms of the financial impact on the client. For our case, it could be listed as *severe, moderate* and *insignificant*. The client's resources are often limited and should be used efficiently. Accordingly, the most severe ones listed down in the ***Risk Ranking Table*** are **Priority 1** items to be insured.


Categorizing
Risks
Severe
Moderate
Insignificant
Priority 1
Priority 2
Priority 3
Reference to
Risk Ranking
Table

Mark Lim
Risk Ranking Table

Severe

1. Personal Risks
   - *Cleanup fund*
   - *Mortgage Redemption Fund*
   - *Income for Dependents*
   - *Tertiary Education Fund*

2. Property Risks
   - *Family's Staying Home*
   - *Collectibles*
   - *Three Cars – Husband & Wife Owned*
   - *Important documents*

3. Liability Risks
   - *Three Cars – Husband & Wife Owned*

Moderate

1. Personal Risks
   - *Travel*

2. Property Risks
   - *Other Household Items*

3. Liability Risks
   - *None*

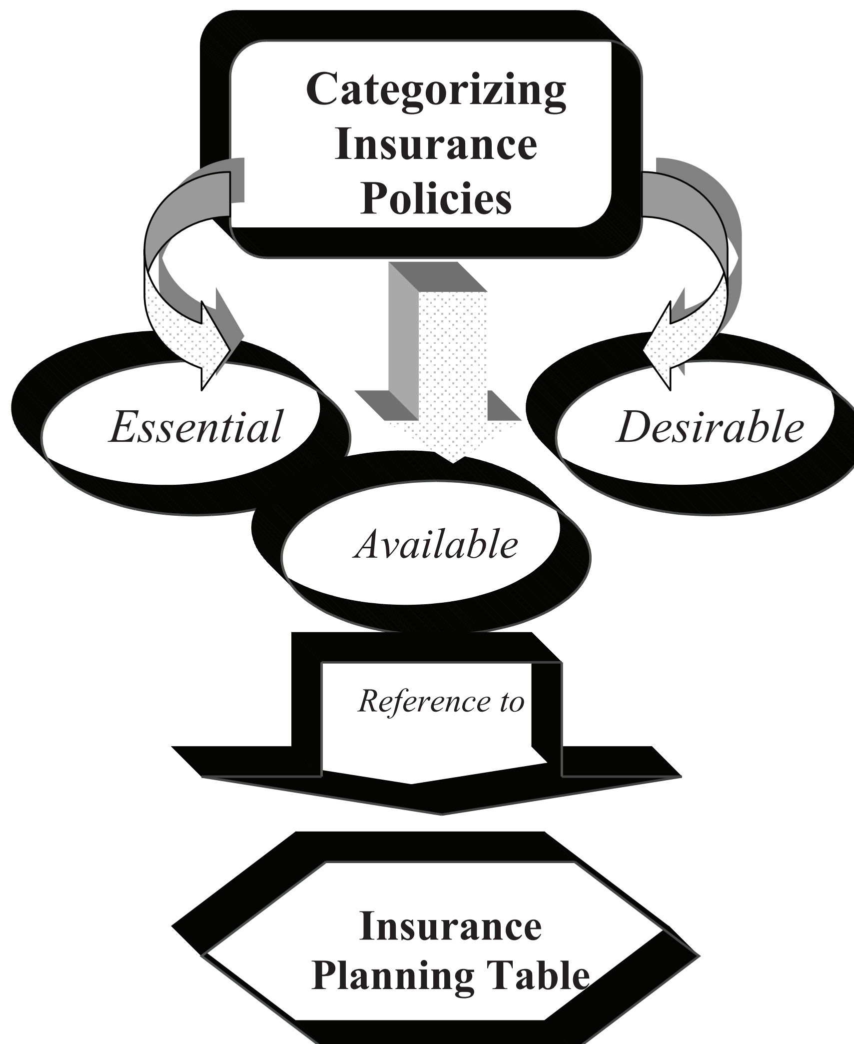
Insignificant

1. *Personal Risks*
   - *None*

2. *Property Risks*
   - *Bills to be paid*

3. *Liability Risks*
   - *None*

Insurance application to the client's situation can be shown by listing the insurance policies in accordance to their degree of desirability as methods of solving the problem, i.e. the risks identified. One way to do this is to classify the insurance policies in accordance to their preference in the application of the client's premium contributions as *essential, desirable* and *available*.



The insurance planning table (IPT) will illustrate to the client in brief his insurance priority and what are the degree of desired actions to be taken in insuring against the known risks. Below is an IPT of Mr. Mark Lim illustrating the plan of insurance utilization by listing the insurance policies in accordance to the principle laid down earlier.

- ***Essential Insurance*** includes those that are designed to protect against large losses the individual can ill afford and also those that are required by law, such as third-party motor cover.
- ***Desirable or important insurance*** include those that protect against loss exposures that would make the insured dependent on external source of funds to meet the losses.
- Available or optional insurance include those that guard against losses that could be met out of existing property or income.

It should be noted that the insurance technique should not be formulated independently without considering the client's financial plan as a whole or his current insurance program. For instance, most clients would already have motor policy and some form of insurance on his property. Those who take a housing loan from the bank are almost guaranteed to have a fire policy on the property as a requirement of the loan contract. In fact, many banks would insure the property themselves and bill the client on the premium amount as an automatic process. For some risks, e.g. retirement income risk, there may be better alternative techniques to help the client achieve his goal. Hence, it is important that the financial practitioner's approach to solving the client's problems should be unifying with the plan as a whole.

Mark Lim
Insurance Planning Table

Essential

1. Personal
   - Whole Life Policy on Ricky – RM2.5 Million
   - MRTA – RM700,000.00
2. Property
   - Comprehensive Cover:
   - − Volvo RM148,000.00
   - − BMW RM268,000.00
   - − Toyota Camry RM 98,000.00
   - Comprehensive House Owner – RM 250,000.00

Desirable

1. Personal
   - Investment-Linked Education Policy with PBR on:
   - − Andy (Aged 3) RM300,000.00
   - − Mae (Aged 5) RM250,000.00
   - Travel Insurance (when traveling) – RM1 Million
2. Property
   - Householder Policy – RM150,000.00
3. Liability
   - Personal Liability Insurance – RM2 Million

Insignificant

1. Personal
   - Endowment Education Policy with PBR on:
   - − James RM 50,000.00
   - − Connie RM 30,000.00
   - Whole Life Policy on Ricky – RM250,000.00

Basis of Selecting Insurers for the Client

In Malaysia, most financial practitioners are at this stage also providers of some form of financial products to generate revenue for their practice. Pure fee-based financial planning practitioners are rare.

For those involve in insurance advisory works, they must be guided as to what are the elements to consider when choosing an insurer. Usually this would involve three areas, namely:

- The financial strengths and stability of the insurer.
- The range of product and services and their quality.
- The product combination that provides the optimal costs and the costs of similar products and services offered by other insurers.

The financial strengths and stability of the various companies can be found in the report published by the Bank Negara via the DGI report each year. The solvency margin of an insurer reflects its financial strengths. The Insurance Act and the various guidelines provided by Bank Negara and LIAM also, among other things, provide that the solvency margin of an insurer is guided by regulations. This regulatory requirement provides general assurance to the public that their investments are well guarded by law.

As a general rule, assets should be valued at cost

The following ratios used by the regulator to analyse the financial health of insurance companies, may be adopted by the financial practitioner for similar purpose:

1. Ratios on Surplus

a. Surplus Adequacy Ratio =	Surplus
	Liabilities

If the ratio is high, the company will be better able to withstand a decrease in asset values and earnings, and vice versa

b. Rate of Surplus Formation =	Surplus Growth Rate
	Liabilities Growth Rate

A high ratio shows that the company ‘s net growth is healthy.

2. Ratios on Asset Quality

a. Asset Quality Ratio =	Surplus on Admitted Assets / Liabilities

In this ratio, the qualities of the assets are considered. Only the 'admitted assets are used in the computation of the ratio. Generally, a high ratio is desirable.

3. Ratios on Profitability

a. Return on Equity =	Net Operating Gains / Surplus

This ratio shows the effectiveness of the insurer in applying its funds. A high ratio would indicate that the insurer is effective.

b. Yield on Investment =	Net Investment Income / Investment Assets

A comparative higher yield will indicate that the insurer is performing well with comparable asset blends.

c. Net Operating Gains to Income =	Net Gains from Operation / Total Operating Income

A high ratio will indicate that the insurer's is effective in managing its operation.

4. Ratios on Liquidity

a. Current Liquidity Ratio =	Unaffiliated Investment / Liabilities

Unaffiliated investments are those assets minus bonds, shares and those investments held in affiliated companies. In addition, properties used by the insurer are excluded in the computation. A comparatively high ratio will indicate that the insurer is in a strong position and vice versa.

b. Investment in Real Estate Ratio =	Investment in Real Estate / Surplus

A lower ratio will indicate that the insurer is in a better liquid position with regards to its surplus asset holdings.

c. Investment in Affiliates = $\dfrac{\text{Investment in Affiliates}}{\text{Surplus}}$

This ratio defines the ratio of the insurer’s investment in affiliates to its surplus.

d. Investment in Non-Admitted Assets = $\dfrac{\text{Investment in Non-Admitted Assets}}{\text{Surplus}}$

This ratio defines the ratio of the insurer’s investment in non-admitted assets to its surplus.

5. Ratios on Leverage

Leverage is the indication of the insurer’s degree of use of debts to its equity. High leverage will provide better opportunity to earn a higher return but expose the insurer to greater risk.

a. Liabilities to Surplus = $\dfrac{\text{Liabilities}}{\text{Surplus}}$

This ratio will indicate the ratio of liabilities to the insurer surplus.

b. Net Premium to Surplus $\dfrac{\text{Net Premium}}{\text{Surplus}}$

This ratio measures the degree of exposure to pricing errors.

c. Surplus Relief Ratio = $\dfrac{\text{Reinsurance Commissions and Expenses}}{\text{Surplus}}$

This ratio will indicate the reliance of the insurer on reinsurance to operate its business. A high ratio will indicate the over reliance on reinsurance to operate and may reduce the profit potential of the business.

Understandably, a financially strong insurer will give better confidence to the insured as it is, theoretically at least, more likely to be able to keep their promises made in the policy contract. In addition, they will have more resources to develop a wider range of products and services to the customers, which may be important if all the needs of the client are to be met.

The next step is to examine the range of products to check if they have the kind of products to meet the peculiar needs of the client. Usually, the larger insurers will have a better range of products to select from to meet needs. But there are also some insurers that specialize in certain products that are not commonly available to other insurers. With the advent of the internet as a worldwide channel of distribution, it is also possible to source for suitable products from overseas to meet certain specified needs. Although this may face certain legal restrictions, with the opening up of the

economy and the way information technological advances is going, this may soon be a common practice everywhere.

Apart from product services, other areas of services are also important – especially when that insurer is under consideration because they have the right type of products for the client's needs. The speed and fairness in settling claims, obtaining policy loans and surrender values are important areas to consider. Of course, with the pressure from the consumer association, LIAM, NAMLIFA and the regulators, the industry as a whole has improved tremendously.

Next, the cost factor should be considered. When we talk of comparing cost, there are two aspects to consider. First, we have to relate it to a certain benefit provided in the respective policies in relation to the premium outlays. Is it worth buying the insurance cover?

The next is to compare similar cover offered by different insurers. Who can offer the lowest rates for the same cover? For general insurance policies, many of the common types of coverage are tariffed – meaning that the authority concerned has fixed the price. An example of a type of tariffed policy is motor insurance. Another is the workman compensation policy. In such cases, cost comparison is unnecessary, as all the insurers have to follow the tariffed rates. But for many other types of policies, like life-based policies, the cost can vary widely from one insurer to the other. Considering the need for insurance is a long-term and continuous commitment, the cost of coverage is an important factor for the financial practitioner to consider carefully.

Not all risks can be economically insured. For those that are not feasible for insurance, alternative method of financing the loss should be identified. Hence, there may be cases where part of the risk is retained rather than being transferred to the insurer. The retention principle has been discussed earlier.

Types of Life Insurance Coverage

There are three basic types of life insurance with a myriad of variations that are traditionally marketed by life insurers. The common ones are term, whole life and endowment policies, each having a specific use in estate planning.

- **Term Policies**

  A term policy is basically a low-cost life insurance policy designed to provide maximum coverage for the minimum investments of money. In fact, it is the cheapest of the three types of traditional plans. Because of its temporary nature to cover risks that are of short term, it is also known as temporary insurance, as opposed to permanent policies like endowment and whole life.

  Generally, it provides no cash values or paid-up values and the sum insured is only payable upon death or permanent disablement. Term policies may be convertible or renewable. "Convertible" means the policyholder can change it to a permanent plan, e.g. whole life or endowment, on a guaranteed basis within the term of the policy. The premium rate will be based on the

owner's age at the time of conversion. "Renewable" means at the expiry of the term policy, the policyholder may choose to renew the plan on a guaranteed basis, usually for the same period of coverage and at a new rate based on the policyholder's age at the time of renewal.

Term policies can be used in a situation where large but temporary risk exists, such as to cover short-term loans and mortgages.

- **Whole Life Policies**

  Whole life policies are basically long-term coverage permanent life policies with theoretically no maturity period and the sum insured is payable on death or permanent disablement. In practice, some companies may make payable the sum assured when the policy owner reaches a certain age, say 100. The premiums remain level over the period, although there are some modified whole life policies which vary the sum assured and the premium rates after the policyholder reaches a certain age. Commonly, the policy becomes paid up once the policy owner reaches around 85 years old.

  Whole life policies may be participating (par) or non-participating (non-par). Participating means the policies are entitled to bonuses (cash or reversionary) when the insurance companies make profits on its investments that are associated with that block of policies. Non-participating means the policies will not be entitled to any bonuses.

- **Endowment Policies**

  Endowment policies are shorter term permanent life polices ranging from 10-35 years in length or ending at age 55, 60 or 65 of the insured. The emphasis is on the saving elements with smaller coverage elements than whole life policies. For estate planning purposes, this policy could be used as a retirement or supplementary retirement plan for those who are less sophisticated in investments. There are many variations, including, par, non-par, limited payments plans and those with cash advances. Among the types of traditional plans, endowment policies are usually the most expensive types of plans.

Other Types of Life Insurance

- **Critical Illnesses Policies**

  Critical illnesses policies represent a new generation of policies that have their focus set on not just the death dimension of human problems, but also the living aspect. As health care and medical developments improve, the mortality of the populace will no doubt improve too.

  Long life will bring about many new problems to be solved; one of which will be critical illness and the medical cost of treatment. Modern day living, with high chemical addition to food and food chains and a higher level of stress imposed on people, will result in people contracting many forms of illnesses, some of which will be critical. Heart attack is currently in the forefront

of these illnesses, killing each year more than double the number of cancer patients in most countries.

As the cost of medical treatment escalates, the need to provide for these expenses becomes more and more imminent in estate planning. The best and easiest way to solve this issue of course will be the use of critical life policies. The Malaysia-based life insurer, The Great Eastern Life Assurance Co Ltd was the first life company to introduce critical life policies in this region.

- **Investment-Linked Policies**

Investment-linked policies are flexible premium adjustable death benefit policies, which credit present investment yields to the accumulated cash value. This type of policy provides greater transparency of the policy's ingredients to the policyholder because the three components of earnings, protection costs and expenses are "unbundled".

Investment-linked policies were introduced as a way of offering the local public a chance to invest in life policies whose values are directly linked to investment performance. This is achieved by linking the policy values to a life office-managed fund or to units of unit trusts. This type of policies was first introduced in the world of insurance in Holland back in 1956.

Generally, investment-linked policies provide more flexibility to the policyholders as compared to traditional policies because they allow the coverage and the investment portion to be varied over the term of the policy. The benefits of such policies are either wholly or partially defined by the number of units of the fund that are ascribed to the policyholder. The investment risk is largely borne by the policyholder. Cash values depend on the amount of insurance, premiums paid and the insurer's investment performance.

Types of General Insurance Coverage

- **Fire Insurance**

Fire insurance is a kind of property insurance and it covers the material damage of the property insured. Insurers will compensate or indemnify the insured for the repair costs or reinstatement costs if this is insured on a Reinstatement value basis (subject to the adequacy of the sum insured) of the property which had sustained damage by an insured peril.

It is therefore important for all owners of houses, shops, factories, machinery, stock etc to be covered by fire insurance, which is the simplest form of coverage offered to property owners.

- **Fire Consequential Loss Insurance**

This insurance is designed to cover the loss of profit following losses to physical assets covered under a fire policy in the event of a fire. The consequential loss insurance protects the

earning capacity by making good loss of net profit, enabling an insured to meet overheads and defraying increase in expenditure, subject to an indemnity period. This insurance can only be taken up together with fire (material damage) insurance.

- **Householders and House owners**

The house owners policy is designed to provide cover for the buildings of private dwellings and flats whilst the householders insurance provides cover for the contents within the private dwelling.

- **Motor Insurance**

The coverage's available under a Motor insurance policy includes:

- **Act Cover**

The minimum cover required by the Road Traffic Ordinance is death or injury to third party as a result of the negligence of the insured. The amount covered under this cover is unlimited. This is known as the 'ACT' cover.

- **Third-Party Cover**

This cover is a combination of

a) Act cover as described above
b) Indemnity for liability in respect of damage to property belonging to third parties

- **Third-Party, fire and Theft Cover**

This cover is a combination of

a) Act cover as described above
b) Third party cover
c) Indemnity in the event that the insured vehicle is stolen or damaged by Fire

- **Comprehensive**

This is the widest form of cover under motor insurance. It is the combination of Act and Third party coverage plus any physical damage to the insured vehicle and its spare part following accidental collision and other perils as more specifically covered in the policy.

Classes of Motor Insurance

The 3 classes of motor insurance under the Motor tariff are:

a) Private motor car
b) Motor cycle
c) Commercial vehicle

Each of the above classes has its own motor insurance policy and is rated separately under its own section of the Motor Tariff.

- **All Risks Insurance**

his is designed for equipment such as notebook, camera, walkie-talkie, handphone, personal effects, etc.

There are three main covers:

i. fire, external explosion, self ignition or lightning
ii. burglary, housebreaking or theft by forcible and violent entry
iii. accidental and external means

- **Machine & Equipment Insurance**

This policy designed for equipment that is immobile or static such as photostatting machines, duplicating machines, generators, offset machines, telephone switchboards, etc. The three main types of coverage under this policy are fire, theft and accidental damage (due to external causes only).

- **Equipment Insurance**

This policy is restricted mainly to cover mechanically propelled vehicles/equipment, which are not licensed for use on public roads. Such vehicles/equipment are cranes, tractors, forklift, excavators and bulldozers. All vehicles licensed for use on public road should be insured under the motor policy.

This policy will indemnify the insured against direct physical loss of or damage to the property insured arising from:

a) accidental collision or overturning

b) accidental collision or overturning consequent upon mechanical breakdown or consequent upon wear and tear

c) fire, external explosion, self-ignition or lightning or burglary or theft

- **Burglary Insurance**

This Policy is designed to cover:

a) Loss by theft consequent upon actual forcible and violent breaking into or out of a building

b) Damage to the property insured or to the premises as a result of theft

Access into the premises using original/duplicate/skeleton keys can be covered under a "Full theft extension clauses" upon request and on payment of an additional premium.

However, this extension should be given very selectively, only to insured whose integrity, and honesty is not in any doubt. A small excess is usually imposed for this extension.

It is important to note that in Burglary insurance policy, there are two basis of rating, namely;

– **Full Value Basis**

This basis is adopted when there exists a possibility of the entire insured property being stolen at anyone event and therefore the rate shall be on the full value of the property to be insured.

As these types of policies are subject to "Average" all property to be insured will not be fully indemnified at the time of loss if the property is under insurance.

– **First Loss Basis**

This basis is adopted when it is practically not possible for the entire insured property to be stolen at anyone event. The rate shall be on the amount, which in the Insured's opinion would represent the maximum potential loss at any one event.

The Insurer's liability is limited to the first loss value, which should be at least 10% of the total value of the stock. The Insured is required to declare the correct total value at risk, as average will apply if there is under declaration of the total value.

Example of Average in a Burglary Claim

Sum Insured / Actual Value	X	Loss
S$10,000 / S$20,000	X	S$ 5,000 = S$2,500

The rating of premium for burglary insurance is based on a selected rate X sum insured. The rate is normally selected based on the experience of the Underwriter in the presence of detailed information:

The rationale is based on:

i. the attractiveness of the property insured

ii. the security of the premises

iii. the location of risks

iv. the portability and disposability

- **Money Insurance**

This policy is intended to protect Banks, Industrial or Business establishment against loss of money which may be carried by messengers and/or employees of the Insured and which may be in transit from one place to another. It covers money in transit and money in premises against loss or destruction by any robbery, hold up or theft.

– **Money in Transit**

Loss or damage by any cause whilst in transit from banks to the Insured's premises or contract sites or vice versa and in respect of wages and/or salaries until paid to employees or otherwise disbursed.

– **Money in Premises**

Loss or damage by theft evidenced by visible marks from a locked safe or strong room or by hold-up whilst in the premises.

– **Damage to the Safe**

Loss or damage to the safe or strong room resulting from the theft or attempt thereat.

Definition of Money

Money would include cash, bank notes, cheques, money order, postal orders, and bills of exchange, postage and other stamps having monetary value for which the insured has accepted responsibility.

Business Hours: The period during which the insured's premises is actually occupied for business purposes and during which the Insured or his employees entrusted with money is in the premises.

In rating a money policy, the rate for money in transit is derived based on the estimated annual carryings. The money in premises is rated on the limit of indemnity required.

a) Money in transit between the bank & the insured's premises

Acceptability of risk & rates to be charged shall depend on the following factors:

i) Occupation or trade of the risk.

ii) Distance between Insured's premises & bank.

iii) Maximum amount carried at any one time.

iv) Frequency of carryings.

v) Adequacies of protection e.g. armed guards or police escort.

b) Money in Premises:

i) Money in locked safe or strong room. Depends on locality, security of premises e.g. presence of burglary alarms, locked bars & quality of safe.

ii) Money in Locked Drawers (Cover should never be granted unless approval is received from the Company)

- **Fidelity Guarantee Insurance**

It is not permissible to grant fidelity insurance cover without the other classes of insurance being placed with the company. In view of the high moral hazard involved, agents are advised to exercise prudence in canvassing & selecting risks. Cover should only be considered for well set up establishments i.e. organisations or firms with proper accounting procedures, full annual audit & effective systems of check & supervision.

Fidelity guarantee policies indemnify employers against loss of monies, negotiable instruments or goods belonging to them or for which are responsible as a result of dishonesty of their employees.

Examples of Dishonesty:

Theft, misappropriation of funds, false conversion of stock or forgery:

a) The acts of fraud or dishonesty must be committed: -

i. during the period of insurance

ii. during the uninterrupted continuance of employment of the said employee

iii. in connection with the occupation & duties of the said employee.

b) The act of fraud or dishonesty must be discovered during either

i. Period of insurance or

ii. Not later than 6 months after termination of this policy or

iii. Not later than 6 months after termination of employment of such employee.

Whichever event shall first happen.

- **Public Liability Insurance**

A public liability policy indemnifies an Insured in respect of his or her legal liability to third parties for death, bodily injury (including illness), and for any loss of or damage to property which happens in connection with the conduct of the business insured under the policy.

- **Employer's Liability Insurance**

The workmen Compensation Insurance provides protection to employees of Insured against any injury or disease arising during the course of employment. However for those categories of employees not protected by the Workmen's Compensation Acts or SOCSO, liability at law still exists and the Employer can obtain indemnity under the Employer's Liability policy.

The Employers' Liability insurance policy provides indemnity to the insured (the employer) against liability at law for damages and claimant's cost and expenses in respect of bodily injury or disease sustained by any person under a contract of service or apprenticeship caused during the period of insurance and arising out of and in the course of his employment by the insured in the business.

- **Contractor's All Risks Insurance**

The basic concept of Contractors' All Risks Insurance is to offer comprehensive and adequate protection against loss or damage in respect of the contract works to be performed, construction plant and equipment and/or construction machinery, as well as against third party claims in respect of property damage or bodily injury arising in connection with the execution of a project.

- **Erection All Risks Insurance**

The basic concept of EAR insurance is to provide coverage against loss or damage in respect of:

- Contract works involving in the erection of plant & machinery.
- Third party property damage or bodily injury arising in connection with the erection works.

- **Bond Underwriting**

Bonding is a kind of contract, which normally comes in the form of either a bank guarantee or insurance guarantee. The guarantee is given by a surety to accept responsibility for the performance of a contractual obligation entered into by one person primarily liable under the contract with another party in the event of that person's default.

The common types of bond in use in connection with the construction industry are:

- **Tender Bond**

This is required in connection with the submission of tenders for contract jobs with Public Authorities or Private Principals where relevant.

The main object of his type of bonds is to guarantee that the contractor who is awarded the contract will enter into the Contract at the terms that he has submitted to the Principal. If he is unable to maintain his quotation, then the Bond will be liquidated and either the bank of Insurance guarantee (whichever is in force) will have to indemnify the Principal for the damages sustained up to the amount of the bond.

- **Performance Bond**

This type of Bond is usually required by the principal to ensure that the Contractor fulfils his contractual obligations within the period specified or in accordance with other specifications as outlined in the Contract.

If the Contractor does not complete the contract within the period specified and if no extension in the period is allowed, then the Bond or Guarantee is liquidated.

- **Advance Payment Bond**

This type of bond is issued when the Principal required the surety to guarantee that the advance payment made to the contractor is invested in the pre-financing aspects of the contract, usually very large contracts. In disguise actually the principal is insuring credibility of the contractor.

There are namely 3 parties to a bond:

i) The Principal/Employer/Beneficiary – the party to whom the bond is given

ii) The Contractor – the party responsible for fulfilling the obligation set in the building contract

iii) The Guarantor (Insurer/Bank) – the party guaranteeing the contractor's obligation under the building contract.

- **Machinery Breakdown Insurance**

  This policy is specially designed for machine and mechanical installations of all types ranging from the smallest electric motor to the steam turbo alternators used in electric power plant.

- **Machinery Breakdown Insurance (Loss of Profits)**

  To indemnify the Insured against losses (profit) arising directly out of the interruption of or interference with production following the occurrence of machinery breakdown or other accidents covered under the Machinery Breakdown Insurance Policy.

- **Personal Accident/Group Personal Accident**

  Personal accident policies can be taken by individual on their own lives or on the lives of certain other persons. Policies can also be issued covering groups of individuals. Personal accident is one of the common classes and is a supplement to life insurance, it provides protection against death or disability caused solely by violent, accidental, external, and visible means.

  In addition, this insurance also covers the risks of unprovoked murder/assault and hijacking, food processing, strike, riot, civil commotion and natural perils such as earthquake, volcanic eruption, tidal waves, flood and lightning.

  The cover afforded by the personal accident insurance is on 24 hours basis, covering accidents happening during the course of employment as well as accidents happening at home, in the course of travelling to and from home to the place of work and during social or sports activities not specifically excluded.

  The geographical limits of the personal accident insurance is worldwide. Travelling by air as a passenger in any licensed passenger carrying aircraft on scheduled flights only is automatically covered.

  This insurance is not a contract of indemnity, the amount are payable irrespective of compensation which may be recoverable from any other policy except for medical expenses, which are on a reimbursement basis as per medical bills.

- **Group Hospitalisation Scheme**

  This Insurance is designed to provide reimbursement of hospital charges, surgical and medical expenses arising from hospital confinement on account of sickness, disease and accidental treatment. This scheme offers 24 hours a day protection anywhere in the world, whether at home or abroad, or whilst travelling for business or pleasure.

- **Marine Cargo Insurance**

  Marine insurance may be effected by either the buyer or seller of goods depending on the terms of contract of sale.

  The type of contract entered can either be FOB (Free on Board), C & F (Cost & Freight) or CIF (Cargo, Insurance & Freight) basis. Marine cargo insurance provides coverage to goods in the course of transit against losses and/or damages incidental to the marine adventure.

Types of Marine Cargo Policies

Marine cargo policies are issued on either one of the following basis:-

1. **Single Shipment policies**

   These policies insured the shipment of goods from one place to another; they cover on voyage in most cases, the policies cover from the time they leave the shipper's or seller's warehouse until they reach the consignee's or buyer's warehouse.

2. **Open policy or open covers insurance**

   The Open policy is a continuous policy that is issued on certain date and remains in force until cancelled. The policy provides automatic protection for all shipments described in the policy and duly declared to the insurer.

   This arrangement is suitable for merchants who are engaged in regular import/export or internal trade.

Who Is Obliged To Insure?

Whether or not cargo insurance is required, in a particular case, will largely depend upon the terms of the sale contract between the seller and buyer.

There are different types of recognised sales contracts, the most important ones affecting Marine insurance are:

F.O.B. (Free On Board)

i. seller's obligations to place the goods on board vessel at his own expenses and obtain a bill of lading

ii. sellers responsible for all loss or damage until goods are on board vessel

iii. thereafter the goods are at buyer's risk

C & F (Cost & Freight)

i. seller provides goods with all freight and other charges paid to the port of discharge does not include insurance charges

ii. seller responsible for losses or damage to goods until delivery on to the carrying vessel

iii. responsibility of buyer to arrange insurance

C.I.F. (Cost, Insurance & Freight)

i. Seller responsible for all costs of delivering the goods up to final destination

ii. C.I.F. terms – the C.I.F. price + a percentage (usually 10%) to cover incidental expenses and/or import duty.

- **Marine Hull**

  This insurance covers loss of or damage to the subject matter insured caused by the listed perils. The perils include perils of the sea, which comprise such risks as damage caused by heavy weather or by the vessel striking a submerged object. Other notable perils include fire, explosions, piracy, contact with dock or harbour installation etc. The perils in this section include loss or damage to the subject matter insured caused by bursting of boilers, breakage of shafts or any latent defect in the machinery or hull, negligence of mater officers, crew or pilots, accidents in loading discharging or shifting cargo or fuel etc.

- **Principle of General 'Takaful'**

  General insurance services operated based on the principle of Islamic practices are called **General Takaful**. The knowledge of such policies is necessary when planning for clients who are Muslims. General Takaful would include all takaful business that are not *family takaful* business.

  Essentially, general takaful schemes are short-duration *tabaruk* contracts that give cover to individuals or businesses against loss or damages due to a catastrophe or disaster. Contributors agree to pay the entire contributions/instalments as *tabaruk* for the purpose of creating a fund. This fund is called *General Takaful Fund*. This fund would be utilized for paying compensation or indemnity for a defined loss.

Self Assessment on Risk Management

1. Simon Lim bought a house for RM600,000. Which of the following best describes the pure risk situation of Simon?

   a. The risk that his house may be burnt down in a fire accident

   b. The risk that the value of his house may drop in a downturn

   c. The risk of losing the money had he invested it elsewhere

   d. None of the above.

2. One important aspect of financial planning is *risk management*. Which of the following is the best way to define risk management?

   a. The methods used in eliminating all the risks faced by an individual

   b. The systematic process of dealing with risks faced by an individual

   c. The use of insurance as the sole method to manage risks

   d. A process of increasing one's wealth by reducing risk exposures

3. Different professionals will define risk in a different way. As a financial practitioner, which of the following best describe the term "risk" in the context of your profession?

   a. Uncertainty about financial losses from an exposure

   b. Certainty about financial losses from an exposure

   c. Exposure to investment risks

   d. Exposure to systemic risks

4. Fill in the blanks. In risk management, _________ is the *unpleasant outcome* of __________.

   a. Loss; risk

   b. Risk; Loss

   c. Exposure; loss

   d. Loss; business ventures

5. There are two forms of loss. ____________________ is a loss that has precipitated; ________________ is a loss that may happen.

   a. Occurred loss; loss exposure

   b. Loss exposure; happened loss

   c. Loss event; loss risk

   d. Expected loss; unexpected loss

6. Harban Singh, a well-paid construction worker in a high risk/high rise area decides to buy a large accident policy from an agent. He is a single without dependent. In an attachment to the proposal form to the insurer, the agent reported that Harban is currently being pressed by the credit card company for outstanding payments of a large amount. The insurer promptly turns down the proposal. What are the likely grounds for the insurer to turn down the proposal?

   i. High physical hazard: Harban works in a high risk area

   ii. Likely moral hazard: Harban is in debts

   iii. Possible morale hazard: Harban has no dependents

   a. i only

   b. i, & ii.

   c. None of the above

   d. All the above

7. Risk exists in many forms. A _____________________ is a risk that affects *the entire economy*; whereas a ___________________ is a risk that affects *only individuals*.

   a. fundamental risk; particular risk

   b. particular risk; fundamental risk

   c. Speculative risk; pure risk

   d. static risk; dynamic risk

8. Risk management is primarily concern with *pure risks*. Which are the three main types of pure risk faced by individuals?

   a. Group risks, personal risks and liability risks.

   b. Insurable risks; property risks and liability risks.

   c. Personal risks; property risks and liability risks.

   d. Death risks, disability risks and illness risks.

9. Which of the following pure risk situations fall under personal risks for an individual?

   i. Risk of Premature death

   ii. Risk of Retirement

   iii. Risk of Health Deterioration

   iv. Risk of Unemployment

   a. i & ii only.

   b. ii & iii only

   c. i, ii & iii only

   d. All of the above.

(Questions 10 refers to this passage)

A fire burned down Mr. Kong's factory. Before the fire, he was doing a lucrative business manufacturing advertisement boxes for export before the fire. He has several contracts on hand, which require special precision printing machines to produce the materials to fulfill them on time. Because of the fire and the special machines destroyed, he cannot fulfill the contract on time and loss profits.

10. Property loss can be direct or indirect. In the above situation, which of loss can be classified as an indirect loss to Mr. Kong as a result of the fire?

    a. The loss of the factory

    b. The loss of the special printing machines

    c. The loss of profits

    d. The loss of printing materials

Answers: 1-A, 2-B, 3-A, 4-A, 5-A, 6-D, 7-A, 8-C, 9-D, 10-C.

Self Assessment On Life Insurance Planning

(For Questions 1 – 2, please refer to this passage)

After investing all his savings in the house, furniture and fittings, Mr. Wong has little spare cash left. Since he cannot withstand the loss, he is advised to insure the house well so that in the case of a happening (like a fire), he will be indemnified of the losses.

1. The shifting of risk to the insurer by Mr. Wong is based on the principle of _______________.

    a. risk transfer

    b. indemnity

    c. pooling losses

    d. shifting burden

2. If the peril (fire) occurs, Mr. Wong will not make a profit from the money received from the insurer. He may however recoup his losses, either in part or in full. What principle is this concept based on?

    a. Principle of risk transfer

    b. Principle of indemnity

    c. Principle of pooling losses

    d. Principle of shifting burden

3. In applying the **law of large numbers** in insurance, which of the following statements is true?

    a. Require a large number of homogeneous exposure units

    b. Require a small number of homogeneous exposure units

    c. The smaller the number of exposures, the more predictable the expected results

    d. The larger the number of exposures, the more difficult it is to predict the outcome

4. For a risk to be considered insurable, it must have the following features, EXCEPT ____________________.

   a. The loss must be certain for a monetary value to be determined

   b. The loss is an event that is definite to happen

   c. The possibility and magnitude of the future losses must be mathematically predictable.

   d. The loss is not exceedingly large for the insurer to bear

5. Mr. Chan likes to travel fast in the highway and is often caught speeding. To indemnify against the risk of being fined by the law, he decides to seek your advice on how to insure the risk. Which of the following replies would you choose to give?

   a. There is no legal way to insure such a risk as it is against public policy and interest

   b. The risk can be insured if the insured accepts a capped amount of compensation

   c. The risk can be insured for a larger premium than the ordinary case.

   d. All the above statements are true

6. Mr. Lee sent in his motor insurance proposal form and paid the premium for his car and was promptly issued a cover note by the agent. He met with an accident two hours later. Is Mr. Lee's losses covered? Why?

   a. Yes, Mr. Lee is covered. A valid contract exists.

   b. No, Mr Lee is not covered. No valid contract exists.

   c. Yes, Mr. Lee is covered. He insured his car over one hour before the accident

   d. No, Mr. Lee is not covered. The agent has no authority to bind the principle.

7. After a thorough analysis of the client's situation, you make a recommendation for insurance coverage. Your client asks you the basis of your recommending a certain insurance company. According to the text, which of the following are the factors to consider when choosing an insurance company?

   i. The performance of the products and services offered

   ii. The costs of coverage offered by the company

   iii. The strengths of the company

   iv. The stability of the company

   a. i & ii

   b. i, ii & iii

   c. i, ii & iv

   d. All the above

Answers: 1-A, 2-B, 3-A, 4-B, 5-A, 6-A, 7-B.