CHAPTER THREE

CHAPTER THREE
CONVENTIONAL INSURANCE CONTRACT SYSTEM

3.1 introduction

Conventional insurance being a system that penetrated all aspects of our daily life socially and economically has been the most controversial subject among the Muslim scholars. The majority of *Fuqahā'* (Jurists, or the scholars of Islamic Law) are of the opinion that the modern form of Conventional insurance does not conform to any one of the known valid Islamic contracts due to the presence of an element of gambling (*Maisir*) in all kinds of it as a matter of principle. Also the existence of other unacceptable features in its contract, (such as uncertainty (*Gharar*), and interest (*Ribā*)). However, the few among the Muslim writers see nothing unlawful (*Ḥarām*) in the basic principles underlying insurance, for them insurance is free form gambling and can be freed from interest, any want of knowledge (*Jahālah*) and uncertainty (*Gharar*) involved are not of a degree large enough to call for the prohibition of the conventional insurance and its contract.[107] However, the main purpose of this chapter is to study the general concept of the conventional insurance from the source (its contract, definitions, objectives, benefits, fields etc.) in order to get a clear picture on the subject.

---

[107] Ibrāhim b. 'Abd al-Raḥmān al-'Arwān, *'Aqd al-Ta'mīn al-Tijārī wa Ḥukmuh fī al-Fiqh al-Islāmī* King Saud University. Kingdom of Saudi Arabia, pp.1-56. See also 'Alī Muhee al-Dīn al-Qarrah Dāgī, *al-Ta'mīn 'ala al-Ḥayāt wa mustajaddāt al- 'Uqūd*. Qatar University, pp.117-122.

3.2 Definitions of Insurance

A definition of insurance may be developed from several viewpoints such as economic, legal, business, social etc. Regardless of which viewpoints is taken, a full interpretation should include both a statement of its objectives as well as the technique by which the purpose is achieved. There is no one brief definition that does justice to the many important viewpoints of insurance. It may be an economic system for reducing risk through transfer and pooling of losses; a legal method of transferring risk in a contract of indemnity; a business institution providing many jobs in a free enterprise economy; a social device in which the losses of few are paid by many; It is all of these and more, depending upon how one views the major purposes, methods, and results of insurance. [108] However. An adequate definition of insurance must include either the accumulation of a fund or the transfer of risk, but not necessarily both. And it must also include a combination of a large number of separate, independent exposure units having the same common risk characteristic into an interrelated group to achieve a workable measure of loss predictability. These exposure units include both an entity (e.g., one automobile, one house, or one business) and a time unit (e.g., one-year).[109] The term insurance, in its real sense, is community pooling, to alleviate the burden of the individuals, lest it should be ruinous to him.[110]

---

[108] David L. Bickelhaupt, *General Insurance*, 11th Edition, (Illinois : 1983) pp.43-44.
[109] Robert I. Mehr, *The Fundamentals Of Insurance*, 2nd Edition, (Illinois : 1986) p.37.
[110] Dr. Muhammad Musleh-ud-Dīn, *Insurance and Islamic Law*, (Lahore: 1969) p.3. See also Sa'dī Abū Jaib , *al-Ta'mīn Baina al-Hazar Wa al-Ibāhah*, (Dār al-Fikr al-Mu'āsir, Beirut, Lebanon 1983) pp.15-20

1. From the economic viewpoints insurance is defined as

a. A device for reducing risks by combining a sufficient number of exposure units to make their individuals losses collectively predictable. The predictable loss then shared by or distributed proportionately among all units in the combination.[111]

b. A method which reduces risk by a transfer and combination (or "pooling") of uncertainty in regard to financial loss[112]

c. A financial arrangement for redistributing the cost of unexpected losses, or a legal contract whereby an insurer agrees to compensate an insured for losses.[113]

2. From a legal point of view is defined as

A contract which is used to transfer risk for a premium from one party known as insured or policyholder to another party known as the insurer. By virtue of a legally binding contract, the insured exchanges the possibility of unknown large loss for a comparatively small certain payment. It is not really a guarantee against losses occurring, but a method of assuring that repayment, or indemnity, will be received for losses that do occur as the result of risk.[114]

3. From the business stand point is defined as

A plan by which large numbers of people associate themselves and transfers risks that attach to individuals to the shoulders of all.[115]

---

[111] Robert I. Mehr, *The Fundamentals of Insurance*, 2nd Edition, (Illinois : 1983) p.38.
[112] David L. Bickelhaup, *General Insurance*, 11th Edition, (Illinois : 1983) P.44.
[113] Mark S. Dorfman, *Introduction to insurance*, 2nd Edition, (United States of America: 1982) pp.4-15.
[114] David L. Bickelhaup, *General Insurance*, p.44.

[115] *Ibid.* p.45.

4. From the social angle is defined as

A social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of the risks of many individuals to one person or to a group of persons. Wherever there is accumulation for uncertain losses or wherever there is a transfer of risk, there is an element of insurance; only where these are joined with the combination of risks in a group is the insurance complete,[116] or a provision made by a group of persons, each singly in danger of some loss, the incidence of which cannot be foreseen, that when such loss occur to any of them it shall be distributed over the whole group.[117]

However, the essential characteristics of the concept of insurance as revealed in the above definitions, are: (1) Uncertainty is reduced, (2) Losses are shared by or distributed among the exposure units[118]

The important aspects of risk for the individual are uncertainty and loss. Therefore, insurance as risk management tool deals with both aspects of risk: it reduces uncertainty and provides a planned financing technique that distributes losses. However, insurance allows the individual insured to substitute a small definite cost (the premium) for a large but uncertain loss (not to exceed the amount of the insurance) under an arrangement whereby the fortunate many who escape loss will help compensate the unfortunate few who suffer loss. Even if no loss materializes, insurance helps to eliminate any anxiety the

---

[116] David L. Bickelhaup, *General Insurance*, p.45.

[117] Dr. Mohammad Musleh al-Dīn, *Insurance and Islamic Law*, (Lahore: 1969) p.3.
[118] Robert I. Mher, *Fundamentals of Insurance*, (Illinois : 1986) p.38.

insured might have about a potential loss. Insurance, therefore, provides the insured not only post loss, but also pre loss utility.[119]

3.3 Insurance General Functions and Objectives

General functions and objectives of insurance are to provide protection to the insured against losses on account of exposure to certain perils, and these may be arranged into five major objectives:

1. To provide protection for the insured against the consequences of losses of property, such as, houses, shops, factories, and other assets, due to natural disasters or dishonest actions of other parties, or act of negligence, or inability to perform by others.
2. To provide protection for the insured against loss of earnings of individuals arising from personal accident or illness, or loss of earnings from property owned, such as loss of profit arising from destruction or damage of premises, or equipment on account of fire, explosions, or other insurable causes.
3. To provide protection for the insured against the risk of having to incur substantial future expenses as a result of certain perils, such as health care, or accident.
4. To provide protection for the insured against serious financial loses owing to legal liabilities to third parties, such as paying compensation for injury, or death caused by his vehicle to other road users, or an employer is made liable to pay compensation to any of his employees injured in the course of work.
5. Financial intermediation, this is the basic function performed by general insurance industries. Premiums are collected in advance for the risks covered by the insurers,

---

[119] Robert I. Mher, *Fundamentals of Insurance*, (Illinois : 1986) P.38.

these fund become available for investment until a part of them is required for the payments of claims. At the same time they are also depositories of funds emanating from another source, namely, net income from their past investments. These two sources taken together make the general insurance companies an important investors and mobilizers of funds.[120]

3.4 General Benefits of Insurance

Insurance renders great services to individuals and the national economy. It plays an important role in development and economic growth to the nations. Hereunder are some of the insurance benefits according to those who see nothing unlawful in the system:

a. Peace of mind or Security. Almost everyone has a basic desire for some security or peace of mind. Adequate insurance protection transfers the risk of unexpected losses from the business operator to the insurer and gives him a degree of confidence to enable him to concentrate his own skills on affairs in hand. It improves the efficiency of individual or business decision by reducing anxieties. This is a psychological factor that is difficult to measure in terms of specific benefits.[121]

---

[120] Dr.Mohammad Musleh-ud-Dīn, *Insurance and Islamic Law*, (Lahore : 1969) pp. 3-6, See also *The Insurance Industry in Malaysia*, (Kuala Lumpur : 1997) Oxford University Press, Oxford Singapore, New York.

[121] David L. Bickelhaupt, *General Insurance*, (Illinois : 1983) p. 85, See also Gwilym Williams, *Understanding Insurance*, (London : 1983) p. 3.

b. Pays losses. The existence of insurance often supplies the financial aid, which permits a family or organization to continue despite serious losses that have occurred. The death or disability of a breadwinner can bring financial disaster to a family. Such perils can be met through insurance, which provides indemnification or repayment at the time of need in order to keep the family or business intact.[122]

c. Stimulates savings. Many kinds of insurance are important because they encourage the economy and help it to grow. An insurance premium, though small in relation to the possible loss it protects against, is basically a prepayment in advance of potential loss. All the payments are gathered together to form a fund from which those few who do suffer losses are paid. In essence, the plan of insurance encourages all to save so those unfortunates can be repaid for their losses.[123]

d. Provides investment capital. The savings held as assets by insurance companies are not stagnant. They provide a gigantic source of important capital for the national economy.[124]

e. Efficiency. It is perfectly feasible for a profitable firm to guard against the risks of losses by setting aside special reserves. Insurance removes the need for such reserves, enabling such funds to be invested in production thereby putting profits to most effective use. Plainly, even the largest reserves could be exhausted by a series of substantial

[122] *Ibid.*, pp. 85-86.
[123] David L. Bickelhaupt, *General Insurance,* (Illinois : 1983) p.86.
[124] *Ibid.*, p. 86.

claims. Inflation, too, has a damaging effect by reducing the value of reserves while at the same time increasing the potential size of losses. The uncertainty these factors create can indirectly result in, or require increases in, operating charges. The firm whose insurance premiums are a known quantity can operate more cost effectively and need only pass on a smaller percentage of the risk premium to the customer.[125]

3.5 Fields of Insurance

Insurance business traditionally is divided into two: (1) general business: (includes property, personal, liability, motor vehicles,) and (2) long-term business: (includes life insurance.).

According to the nature of the subject matter insured insurance is been categorized into four (1) Life insurance. (2) Property insurance. (3) Liability insurance. (4) Social insurance.

3.5.1 Life insurance.

People face four basic contingencies to their economic productivity: death; disability; compulsory retirement; and, unemployment. Life insurance is a financial instrument for providing support for survivors, paying estate obligations at death, helping businesses offset losses caused by death of key personnel, accumulating funds for retirement, emergencies, and business uses, and deferring or avoiding income taxes.[126] The life insurance agreement may be defined as a contract by which the insurer, for a certain sum

---

[125] Gwilym Williams, *Understanding Insurance*, (London : 1983) p.3.
[126] Robert I. Mehr, *Fundamentals of Insurnce*, 2nd Edition (Illinois : 1986) p.329.

of money or premium proportioned to the age, health, compulsory retirement and other circumstances of the person whose life is insured, if such person shall die within the period limited in the policy, will pay the sum specified to the person in whose favour such policy is granted[127]

3.5.1.1 Functions of life insurance.

Life insurance as means of regular savings for future has two functions:

1. Is to provide financial security and protection for dependants by the payment of a lump sum or other benefits on death.

2. It may be used for investment purposes on a long-term basis. Because life insurance premiums are eligible for tax relief this form of investment may be attractive to many high rate taxpayers. [128] These functions of life insurance are the motives that encourage people to purchase the type of life insurance that best meets their needs.

3.5.1.2 Types of life insurance.

Life insurance policies functionally are three types:

1. Term or Temporary life Insurance
2. Whole Life Insurance
3. Endowment Life Insurance.

The basic differences between these policies are their duration, benefits, price, and flexibility.[129]

---

[127] David L. Bickelhaupt, *General Insurance*, (Illinois : 1983) p.120.
[128] Gwilym Williams, *Understanding Insurance*, (London : 1983) p.45.
[129] Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, (Illinois : 1986) p.334.

1. Term or Temporary Insurance: The earliest form of life insurance contract on record provided insurance only for a stated period, or term.[130] Today term insurance is one of the popular forms.[131] Term insurance obligates the insurer to pay the policy's face amount if the insured dies within a specific numbers of years. If the insured survives the period, the contract expires without value and nothing is payable. Generally the term of the policy is between one to ten years. The premium payable for such cover is very low since nothing is payable if the life assured survives through the period of cover, and period of cover is generally not very long. A detailed explanation is as follows. If term insurance is written for a year, it provides protection equal to the face of the policy for one year, no longer. If it is written for five or ten years, the insurance covers for that period only. At the end of the term coverage as mentioned earlier, terminates, and the policy has no value whatever. If the contingency insured against happens, the policy pays in accordance with its terms. If the contingency fails to happen, the premium paid is fully earned, and, at the end of the term, the insurer is under no obligation to the insured.[132]

There are several different types of term life insurance policies. Among others are:

a. One- year term policies promise to pay if the subject dies within one year of the policy's purchase.

b. Five- year term policies pay if death occurs within five years of the policy's purchase.

c.Long-term policies may last for ten, fifteen, twenty years, for instance.

d. Others (as explained in the nex page)

---

[130] David L. Bickelhaupt, *General Insurance,* (Illinois : 1983) 162.
[131] *Ibid.* p.162.
[132] Robert I. Mehr, *Fundamentals of Insurance,* p.334.

(i) Renewable- term policies allow the insured to renew the policy before its expiry date regardless of the status of the insured's health).

(ii) Convertible- term policies allow the insured the option of converting the policy into a whole life policy. This privilege can be valuable if the term insurance is about to expire and the insured wishes to continue the coverage on a permanent basis. Term life insurance can prove useful in solving many financial problems. It can be used when the need for life insurance is temporary. It is useful when maximum coverage is needed and premium money is limited). [133]

2. Whole life insurance: Whole life insurance policies promise to pay the beneficiary whenever death occurs. (i.e. under whole life plan the sum assured is payable at death only). Premium payment under this plan may be selected to terminate on the assured attaining an agreed age, or continue till the assured lives.[134]

Three types of whole life insurance policies are differentiated according to how long the premiums are payable: (1) continuous-premium, (2) limited-payment policies, (3) and single-premium.

1. Continuos-premium whole life insurance policies or as also called straight-premium whole life policies are those for which the insured pays the same premium amount as long as he or she is alive. The premium must be paid until death.[135]

---

[133] Gwilym Williams, *Understanding Insurance*,p.46, See also Robert I. Mehr, *Fundamentals of Insurance*, p.334, See also Mark S. Dorfman, *Introduction to Insurance*, 2nd Edition, (United States of America: 1982) pp.239-242.

[134] Mark S. Dorfman, *Introduction to Insurance*, p.243, See also R C Kholi, *An Introduction to Insurance Practice and Principles in Singapore and Malaysia*,p.37.

[135] Mark S. Dorfman, *Introduction to Insurance*, p.244.

2. Limited-payment whole life policy provides for premium payments for a designated term or until the prior death of the insured. At the end of the premium-payment term, the insurance is paid up for the life of the insured, and no further premiums are required.[136]

3. Single-premium whole life policies are those for which, in exchange for one premium, the insurer promise to pay the claim whenever death occurs. This one premium will be relatively large. [137]

3. Endowment Life Insurance: Endowment insurance obligates the insurer to pay the beneficiary a stated sum if the insured dies during the policy term (called the endowment period) or to pay that sum to the policy owner if the insured survives the endowment period.[138] However. An endowment life insurance policy creates two rights for the insured:

1. Is to have the beneficiary paid if the insured dies before the policy mature.
2. Is for the insured to collect the endowment if he or she is alive when the policy mature.

The endowment policy can be viewed as a saving programs protected by life insurance. Thus, the investment feature of endowment insurance makes the premium charge substantially higher than for ordinary life insurance. Obviously, the shorter the term, the higher the premium. This plan of insurance serves both the object of life insurance; namely, financial provision for family in case of early death as also saving, it is the most popular plan, in regard to the premium income.

---

[136] David L. Bickelhaupt, *General Insurance*, p. 159.
[137] Mark S. Dorfman, *Introduction to Insurance*, p.243.
[138] Robert I. Mehr, *Fundamentals of Insurance*, p.336

One use of endowment insurance is to provide for the old age of an insured, and it is also used to accumulate funds for other specific purposes. Notable in this class are policies designed to provide funds for the education of children and etc. Through an endowment policy the fund may be accumulated gradually over a period of years and, at the same time, be guaranteed in the event of an untimely death.[139]

3.5.2 Property and Liability insurance

For the fortunate, their "home is their castle." For many more, their automobile(s) or other personal property are their escape across the moat to independence and mobility.[140] Most persons insure their homes, automobiles, and other property, even before insuring their life and health. Many also make sure that they protect themselves through insurance against the liability they may incur for injuries to other persons or damage to their property of others. The purpose of property insurance such as fire insurance is to indemnify a named insured in the event that certain described properties are destroyed or damaged by the peril of fire or other legal hazard. Without insurance, many fire losses could have disastrous financial results for families or businesses.[141]

3.5.2.1 Liability insurance:

When the protection provided is in respect of legal liabilities of the insured towards third parties, for bodily injury, death or property damage of others. These liabilities are insured under various liability policies and sometimes in combination with property damage covers, because property and liability insurance are often hard to distinguish from one

---

[139] David L. Bickelhaupt, *General Insurance*,pp.167-168, See also R C Kholi, *An Introduction to Insurance Practice and principles in Singapore and Malaysia*, pp.37-38
[140] David L. Bickelhaupt, *General Insurance*,p.381
[141] *Ibid.*, pp.383-384

another, since the liability sometimes arises at the same time as the physical damage which is caused to the property. The field of liability insurance is divided into two major kinds: (1) Bodily injury liability insurance. (2) Property damage liability insurance.[142] There are at least four major types of liability policies: (1) Public liability, (2) Product liability, (3) Professional liability, and (4) Workmen's liability.

a. Public Liability (General) This cover provides indemnity to insured for his legal liabilities as well as legal liabilities of his representatives and employees arising in connection with the insured's business, carried on at and from the specific place of business. Liability for bodily injury as well as damage to property of others is covered subject to specified maximum limits arising out of one occurrence. Legal costs and other charges and expenses are also payable when incurred with the consent of the insurer.[143]

b. Product Liability. The cover under this policy operates in respect of liabilities arising out of use of the specified product. Policies are issued subject to specified maximum limits of indemnity.

c. Professional Liability. Liability arises out of negligence. Professionals such as medical practitioners, legal advisers etc. may be held liable for loss or damage caused to others by their professional negligence. Indemnity for such liabilities is covered under these policies.

---

[142] David L. Bickelhaupt, *General Insurance*, pp.509-542.
[143] R C Kohli, *An Introduction to Insurance Practice and Principles in Singapore and Malaysia*, p.65.

d. Workmen's Liability. An employer may be legally liable to provide compensation to his workers, their dependants, for personal injuries or death by accident arising out of and during the course of the employment. [144]

In short, Property and liability insurance covers loss associated with hazard to persons and property, including legal hazards as well as those arising from accident and sickness. Property insurance includes fire insurance, marine insurance, homeowners insurance, automobile insurance, aviation insurance etc.

3.5.3 Social Insurance

Social insurance is defined as a device for pooling risks by transfer to a governmental service organization.[145] It covers social risks, which are whatever a particular society considers them to be at a given time. In a country like United States of America, a medical care for the aged and long-term disability at any age loss of income from unemployment, old age, and death of a working spouse are treated as social risk. The characteristics of social insurance are:

a. Coverage is compulsory by law in nearly all cases.
b. Benefit eligibility arises from contributions made to the program by or for the claimant.
c. The method to determine the benefits is prescribed by law.
d. Benefits are not usually related directly to contribution but generally redistribute income to groups with low wages or large numbers of dependants.

---

[144] *Ibid.* pp.65-66, See also David L. Bickelhaupt, *General Insurance*, pp.509-542.
[145] Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, p.483.

e. The benefit-financing plan must be designed for long-range adequacy.

f. The cost is borne primarily by contributions from covered persons, their employers, or both.

g. The plan is administered or supervised by the government.[146]

3.6 Concept of Risk

3.6.1 Definition of risk

Risk is a concept with several meanings depending on the context and scientific discipline in which it is used. People in the insurance business often use the word risk in different manner to describe the object of potential loss, or the object insured. Risk is the basis of insurance because without risk there would be no need for insurance. No one ever reaches the state of absolute certainty. From the moment of birth until life has ceased, every individual constantly faces the possibility of unexpected and unwanted happenings. Thus, risk may be defined as uncertainty concerning a possible financial loss.[147]

3.6.2 Classifications of Risk

There are two basic kinds of economic risks: (1) Pure risks, and (2) speculative risks.

1. **Pure Risks.** Pure risks are pure in the sense that they do not mix both profits and losses, and they are those which are ever present and we have no option but to face them, such as risks which occur due to the environments and natural events.

---

[146] Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, pp.483-520.
[147] Mark S. Dorfman, *Introduction to Insurance*, 2nd Edition, p.8. See also Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, p.24, See also David L. Bickelhaupt, *General Insurance*, 11th Edition, p.3.

The happening of these risks can result only in losses, which usually arise from the following sources:

1. Direct losses of property
2. Indirect losses of income
3. Liability losses
4. Losses due to death or disability of key personnel.[148]

The risks confronting human beings in their daily life are ordinarily divided into three kinds

a. **Risks involving the person**: This type of risk is ordinarily termed personal and is chiefly concerned with the time of the death or disability. Of death there is no uncertainty; but the time of its occurrence is uncertain. And aside from death, there is the risk of incapacity through accidental injury, illness, or old age. Personal risks are often divided into life and health risks.

b. **Risks involving loss or damage to property** (including indirect loss of income): This kind of risk is that which arises from the destruction of property. The possible loss of a cargo or ship at sea is considered a risk to those engaged in maritime operations. Direct losses by fire, lightning, windstorm, flood, as well as all kinds of personal property and property involved in any of transportation. Indirect losses also may occur, including the loss of profits, rents, etc.

c. **Risks involving liability for the injury to the person or property of others**: This kind of risk is occasioned by the operation of the law of liability. An individual may be legally liable for an injury to another, as, for example, through an accident when

[148] Mark S. Dorfman, *Introduction to Insurance*, pp.32-33, See also David L. Bickelhaupt, *General Insurance*, p.10.

the driver of a car is negligent and injures a pedestrian, etc. Such a risk is termed a "third-party" risk because when it is used to shift the burden of responsibility, the insurer and the insured person have agreed that a " third-party" (the injured) will be paid for injuries for which the insured is legally liable. The liability risk includes both bodily injury and property damage risks.[149]

2. Speculative Risks. Speculative risks involve an element of both profit and loss. These are the risks which are assumed voluntarily and knowing the possibilities of resulting consequences which may be losses or profits. Such risks are undertaken rather than faced and may result into profits or loss.[150] Because of the element of speculation and the prospect of gain such risks cannot normally be insured.[151] For example marketing a new product involves the risks of financial losses. Trade risks, risks from storage of goods with expectation to sell later for a profit, investment risks in gold, stocks and shares etc. fall into this category.

3.6.3 Insurable risks

Not all risks are insurable. The insurance covers pure risks only. Speculative risks, which are more of trading nature than fortuitous in origin, are not insured. In order such risks to be considered insurable, a risk must substantially meet the following five requirements:

---

[149] David L. Bickelhaupt, *General Insurance*, p.12, See also Mark S. Dorfman, *Introduction to Insurance*, pp.33-35.

[150] R C Kohli, *An Introduction to Insurance Practice and Principles in Singapore and Malaysia*, (Singapore:1982) pp.1-2, See also David L. Bickelhaupt, *General Insurance*, p.10.

[151] Gwilym Willams, *Understanding Insurance*, (London: 1983) pp.1-2.

1. Importance

2. Accidental in nature

3. Calculability

4. Definiteness of loss

5. No excessively catastrophic loss.

Importance. Because of the element of expense in carrying on the business of insurance, premiums include a charge to provide for this cost. In the case of small risks that involve a threat of no great consequence, the cost of handling the business would make the rate prohibitive. For example, a pen may be lost or eyeglasses broken.

To make risk insurable, the amount of loss must be of such importance as to make a risk the cost element a minor factor in premium charged. [152]

Accidental in nature. Insurable risks must also be normally be accidental in nature, because the aim of insurance is to cover fortuitous or unexpected losses. Intentional losses caused by someone the insured are usually uninsurable because they cannot be reasonably predicted, and payment for them would violate public policy by encouraging such actions as fraud etc. Other losses are so common as to be expected rather than unexpected. Wear and tear and depreciation are examples.[153]

[152] David L. Bickelhaupt, *General Insurance*, p. 13.
[153] *Ibid.*, p. 13.

Calculability. A third requisite of an insurable risk is that it be calculable. It must permit a reasonable statistical estimate of the chance of loss and possible variations from the estimate.[154]

Definiteness of loss. The losses should be definite otherwise estimates of possible loss are difficult. Many insurance contract provisions have the objective of making the uninsured losses as clear and definite as possible. The perils as well the losses must be clarified in the contract. Whether or not the loss actually occurred, and if so how many dollars of loss were involved, must be discernible.[155]

No excessively catastrophic loss. No excessive catastrophe possibility of loss should be associated with an insurable risk. Accepting a few such risks together with smaller risks would make accurate predictions of loss impossible and could destroy the financial stability of an insurer. Today many losses are called catastrophic if they exceed five million dollars (5 million dollars), but for most insurers losses are not excessively catastrophic unless many millions of dollars are involved. (e.g. war and nuclear risks). What size loss considered catastrophic depends upon the financial resources.[156] By insuring pure risks, insurance not only provides valuable financial relief to the insured but also provides considerable assistance for sound, stable and progressive economy. [157]

---

[154] Mark S. Dorfman, *Introduction to Insurance*, pp.31-44.
[155] David L. Bickekhaupt, *General Insurance*, p.14.
[156] *Ibid.*, p.14.
[157] R C Kohli, *An Introduction to Insurance Practice and Principles in Singapore and Malaysia*, p.4.

3.7 The contract of Insurance

3.7.1 Introduction:

Contract is a legal agreement creating rights and duties for those who are a party to it. If a contract is breached, or if disputes arise between the parties about the interpretation of the contract, the issues may be settled by a court of law, since courts have the ability to enforce their judgments. The right and obligations of the parties to an insurance agreement are determined largely by reference to the general laws, which govern contracts. The agreement by which insurance is effected is a contract in which the insurer in consideration of the payment of specified sum by the insured agrees to make good the losses suffered through the happening of a designated unfavorable contingency. The insurance contract need not be in writing, but as a matter of business practice such agreements are ordinarily written.[158] However, a knowledge of contract law is essential to an understanding of insurance, which always involves a contractual arrangement.

3.7.2 Definition of Insurance Contract

Because so many dissimilar contracts are classified as insurance, no short precise definition of contract of insurance is acceptable. Yet a broad, general definition would include contractual arrangements that are not insurance.[159] Examples for such definitions:

i. Insurance is a financial arrangement where one party agrees to compensate another for a loss if it results from the occurrence of a specified event.[160]

---

[158] David L. Bickelhaupt, *General Insurance*, pp. 98-99.
[159] Robert I. Mehr, *Fundamental of Insurance*, 2nd Edition, p.95.
[160] *Ibid*,. P.95.

ii. Insurance contract is an agreement by one party to assume another's risk of loss in consideration for the payment of a premium, as part of a general scheme for the assumption of similar risks. It is necessary that the occurrence of event risked be substantially beyond the control of either party.[161]

iii. An insurance is a contract whereby one party (the insurer) assumes the risk of un certain event (the insured event or the peril insured against), promising to pay to another (the insured or a third party) money or money's worth on the occurrence of such an event.[162]

While the above definitions generally define a contract of insurance, they fail to exclude contracts that are not insurance. For example contracts of personal surety ship such as a contract of guarantee which is a contract to perform the promise or discharge the liability of a third person in the case of his default, or the contract of indemnity whereby one party promises to save the other from loss caused to him by the conduct of any other person.[163] Insurance and non-insurance must be differentiated because an activity classified as insurance becomes subject to insurance regulation. With the understanding that no short definition can be completely accurate, the following definition may be acceptable:

Insurance may be defined as a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared by or distributed proportionately among all units in combination.[164]

---

[161] Irwin M. Taylor, *The Law of Insurance*, 3rd Edition, Oceana Publiction, INC. London, 1983, p.5.
[162] Nik Ramlah Nik Mahmood, *Insurance Law in Malaysia*, Butterworths, Malaysia, 1992, pp.1-7.
[163] *Ibid.*, pp.2.

[164] Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, p.96.

3.7.3 Essential Elements of an Insurance Contract

A valid contract is one that a court will enforce, therefore, knowledge of the legal form and the conditions for valid contracts, as applied to insurance, is useful to both buyers and sellers in order to prevent unpleasant surprises. Insurance contracts, like other contracts, in order to be a valid contract, four requirements must be met.

1. Offer and Acceptance.
2. Competent Parties.
3. Legal Purpose.
4. Consideration.

Offer and Acceptance: Agreement consists of an offer by one party and acceptance by another. In insurance the applicant or the buyer usually makes the offer in a request for coverage. The offer and acceptance may be oral or writing. Both forms are recognized by law. In many forms of insurance such as property and liability, the application might be oral request to an agent, either in person or by telephone. In contrast, the life and many forms of health insurance the offer must be made in a writing application. When purchasing insurance, an individual ordinarily will complete an application. This application is an offer to purchase insurance. If the insurer accepts the offer, it agrees to insure the applicant. It is interesting to note that rarely does the insurer make the offer. An exception is found in life insurance. If the premium is not paid with the application, the offer to insure is made by the insurer.[165]

---

[165] Mark S. Dorfman, *Introduction to Insurance*, 2nd Edition, pp.169-170, See also Gwilym Williams, *Understanding Insurance*, pp3-4.

Competent parties: Not every person legally has the capacity to enter into a contract. Valid contracts require that the parties making offer and those accepting the contract be legally competent to make agreement. A contract made by a minor (under age 18) with an insurer is voidable at the minor's option. If the minor chose not to void the contract, the youngster could ratify or affirm it when the required legal age is reached. A similar problem may occur in insurance contracts written for insane or intoxicated persons, who cannot make valid contracts because they fail to understand the agreement.

Insurers, too, must have the legal capacity to enter into contract by meeting all the requirements, such as license to operate and etc.[166]

Legal purpose: A legally binding contract must have a legal objective. Contracts that have antisocial purpose are legally unenforceable. The court will not enforce an insurance contract, if it has an illegal purpose or promotes results contrary to the public interest. An insurance policy taken out by the applicant with proven intention of murdering the insured in order to collect the payment; or a thief attempting to insure stolen property are considered null and void.[167]

Consideration: No contract is valid unless each party gives value or assumes some obligation to the other. In insurance, the contract may become effective on the basis of the applicant's promise to pay and to meet other conditions of the contract. The insurer's

---

[166] David L. Bickelhaupt, *General Insurance*, pp.99-100, See also Robert I. Mehr, *Fundamentals of Insurance*, pp.98- 101.

[167] *Ibid.*, p. 100.

consideration is its promise to pay for specified losses or to provide other services to the insured.[168]

3.7.4 Characteristics of insurance contract

All legal contracts must have the four essential features just mentioned above if a court is to enforce their provisions. Certain characteristics are peculiar to insurance contracts. These characteristics help to describe the fundamental ideas upon which insurance contracts are based, therefore, a good understanding of it should help the insurance consumer in reading insurance contracts and in comprehending the underlying legal concepts which are essential to most insurance contracts. The primary distinguishing features of insurance contracts are:

1. It is an aleatory contract
2. It is a contract of adhesion
3. It is a conditional contract
4. It is a contract of indemnity
5. It is a unilateral contract
6. It is a contract of utmost good faith
7. It is a personal contract.

Aleatory contract: Insurance contracts are aleatory; so are gambling events. This means that the parties to the contract know in advance that the money they will exchange will be unequal.[169] If a loss is suffered, a much larger money may be received

---

[168] Robert I. Mehr, *Fundamentals of Insurance*, 2nd Edition, p.101, See also David L. Bickelhaupt, *General Insurance*, p.100. And Gwilym Williams, *Understanding Insurance*, p.4.
[169] Mark S. Dorfman, *Introduction to Insurance*, 2nd Edition, p.178.

from the insurer than was paid in premiums, and if no loss is suffered the insurer will pay nothing to the insured. The distinguishing feature of an aleatory contract is the presence of chance. This aleatory feature of insurance policies is in contrast to other business contracts such as commutative contracts, in which consideration of equal value is presumably being exchanged.[170]

Contract of Adhesion: In contrast to a bargaining contract, the insurance contract usually is a contract of adhesion because the policy prepared in all its details by the insurer is presented to the insured already in its printed form, so that he either accepts it as prepared by the insurer or rejects it. In areas covered by standardized policies, applicants have little choice if they desire to purchase insurance. Because of unequal knowledge and unequal bargaining power, any ambiguities found in insurance contracts are construed in favour of the insured and against the insurer. The important not here is that the insured has no say or part in drawing up the contract clauses or determining its wording. This contract of adhesion as mentioned earlier is contrasted to a bargaining contract in which both parties contribute to the terms and condition.[171]

Conditional Contract: The insurance contract is conditional, requiring the insured to meet specified conditions in order to collect for losses. These conditions are not legally enforceable. A breached condition only makes the insurance uncollectible. The condition in the insurance contract is usually regarded as either precedent (before) which must take place before a promise becomes binding. For example, an insured who suffers a loss must give proper notice and proof to the insurer before the claim is payable, or subsequent.

---

[170] Robert I. Mehr, *Fundamentals of insurance*, 2nd Edition, p.102.
[171] *Ibid.*, pp.102-103.

Another example is that an insured's failure to cooperate with the insurer in defending a liability claim. Here the promise of the insured is not fulfilled, and that failure subsequently relieves the insurer of its earlier promise to pay. [172]

Contract of indemnity: Insurance protection is designed to provide compensation for losses sustained by an insured. For example, property contracts promise to pay losses on the basis of "actual cash value." By this it is meant that insurance provides reimbursement for actual damage sustained by the insured but no more. This being the case, the total policy amount is not the amount payable in the event of a loss but rather represents a maximum limit to the liability of the insurer. For instance, under the indemnity rule, if a property is valued at fifty thousand dollars (50,000) and insured for hundred thousand dollars (100,000), the insurer would pay fifty thousand (50,000) to the policy holder who suffers a total loss. Property, health (particularly for medical care coverage as distinguished from disability incomes coverage), and liability insurance contracts, in general, are contracts of indemnity which means the insured should be in the same financial position after the loss as before the insure event took place. Because the value of human life cannot be measured, life insurance policies are not contract of indemnity, but contracts to pay the certain amount of the policy upon the subject's death.[173] Two important insurance doctrines arise from the principle of indemnity: (1) insurable interest and (2) subrogation.

---

[172] David L. Bickelhaupt, *General Insurance*, p.102.
[173] Robert I. Mehr, *Fundamentals of Insurance*, p. 109, See also David Bickelhaupt, *General Insurance*, pp.104-107.

Insurable Interest: An insurable interest in general terms is a particular relationship between the person taking out an insurance policy and the subject matter of the insurance which must exist for there to be a valid contract of insurance.[174]. If an individual could insure property or a life not his or her own, and in which the individual had no financial interest, insurance contracts would become gambling devices. An insured would not be indemnified but enriched by a loss, therefore, it is important to note that the purpose of requiring an insurable interest in insurance contracts are to prevent gambling, to decrease moral hazard, and to help measure the actual loss, because without an insurable interest, the insurance contract will be turned a wager or gambling contract as mentioned above. However, a fundamental requirement for the validity of an insurance contract is that the party insured have an insurable interest in the subject matter of the policy. The law requires an insurable interest so that insurance policies are neither gambling devices nor tools for those who would profit by deliberately destroying the property of others. A clear example of insurable interest is the ownership of property, with a fire, windstorm, or other peril causing a financial loss. Insurable interest is basic to the structure of insurance; therefore one may not collect insurance proceeds unless the individual can demonstrate a personal loss from the insured event. In property insurance, an exposure to a financial loss must exist to create an insurable interest. In life insurance, an insurable interest is any reasonable expectation of financial loss caused by the death of the person whose life is insured.[175]

---

[174] Nik Ramlah Nik Mahmood, *Insurance Law in Malaysia,* (Butterworths Malaysia: 1992) p.25.
[175] Robert I. Mehr, *Fundamentals of insurance,* pp.109- 111, See also David Bickelhaupt, *General Insurance,* pp. 107-108. And Irwin M. Taylor, *The Law of Insurance,* 3rd Edition, pp.9-12. And Mark S. Dorfman, *Introduction to Insurance,* 2nd Edition, pp.172-173.

Subrogation: The literal definition of subrogation is the right to make a claim in the name of another person.[176] The doctrine of subrogation gives the insurer whatever rights the insured possessed against responsible third patties. It is basically a process of substitution, whereby the insurer will take over the rights of the insured that existed at the time of loss. Most insurance policies provide that the insurer can require the insured to assign all rights of recovery against another party who caused the loss, but only for the amount the insurer paid the insured for the loss. If a is loss caused by the insured's own negligence, subrogation does not apply. The right of subrogation gives the insurer only the right of action held by the insured. It would be contrary to the principle of indemnity to allow the insured to collect the proceeds of a policy from the insurer, and to collect again from the person responsible for the loss. If the insured were permitted to do this, a double collection of the loss, from both the insurer and the responsible party, might result in a profit to the insured. The positive aspect of the subrogation principle is that it holds wrongdoers responsible for the results of their wrongful actions instead of permitting them not to pay only because an insurance contract was in force. [177]

"If insurers were not allowed subrogation rights, either insureds could collect twice for the same loss, or tortfeasors could escape liability to pay a loss for which they are responsible. Neither alternative is in the public interest. A reasonable solution is to allow the insurer to collect from the wrongdoer under the right of subrogation".[178] Life and most health insurance contracts do not include subrogation clauses because these policies are not contracts of indemnity. A widow can collect the proceeds from the insurance on

[176] Gwilym Williams, *Understanding Insurance,* (London: 1983) p.11.
[177] David L. Bickelhaupt, *General Insurance,* pp.108-109, See also Robert I. Mehr, *Fundamentals of Insurance,* pp.112-113.
[178] *Ibid.*, p.113.

her husband's life, and also retain the benefits from a judgment against the culprit who caused his death.[179]

Unilateral Contract: Contract may be bilateral or unilateral. An exchange of a promise for a promise is bilateral, whereas an exchange of an act for a promise is unilateral. In general, the contract of insurance is unilateral. Only after the insured has paid the premium, the insurer is exposed to a legally enforceable promise.[180]

Utmost Good Faith: A person buying insurance is held to the highest standard of honesty in dealings with the insurer, therefore, the penalty for a lesser level of truthfulness is the insurer's right to avoid the contract. Most ordinary contracts are bona fide or good faith contracts. However, insurance contracts are contract *uberrima fides,* or contracts of utmost good faith.[181]

As mentioned earlier the greatest degree of good faith is needed in the negotiations before the contract of insurance is issued, because the insurers depend on information furnished by prospective buyers in deciding whether or not to write the insurance and in determining the premium to be charged.[182] If the information is false or incomplete, the insurer may be able to avoid the contract on one of the following three legal doctrines: (1) Warranty violation, (2) representation, and (3) concealment.

---

[179] Robert I. Mehr, *Fundamentals of Insurance,* p.113.

[180] *Ibid.,* p.104.

[181] Robert I. Mehr, *Fundamentals of Insurance,* 104.

[182] *Ibid.,* p.104, See also Mark S. Dorfman, *Introduction to Insurance,* pp.176-178.

Warranties. An insurance warranty stipulates that a particular statement in the policy about the subject of the insurance is true. When the application for the insurance contract is made a part of the policy, the answers to a specific questions on the application are deemed warranties. If false, they make the policy voidable by the insurer. For example, if the insured, under a theft insurance contract, agrees to lock the doors while the house is unattended, that promise is warranty, or promise in a burglary policy that an alarm system or security guards will be maintained, etc. [183]

There are two types of warranties: (1) Affirmative warranty. (2) Promissory warranty.

The affirmative warranty states that a fact is true, but makes no statement about the future. A promissory warranty states that a fact is presently true and will continue to be true.[184] If an insured obtains a special rate for fire insurance because of the installation and maintenance of an automatic sprinkler system, that system must be kept in good working order throughout the life of the policy. If a fire occurs and the sprinkler system is not in good order, the insurer can void the claim because the warranty would be held to be promissory.[185]

Representations. Before a consumer completes the purchase of insurance, he or she will be asked a certain question. The answers supplied to the insurer, usually in a formal application, are called representations.[186] However, representations are statements made by the insured to the insurer in the process of obtaining a policy, or formation of a

---

[183] Robert I. Mehr, *Fundamentals of Insurance*, p. 104, See also David L. Bickelhaupt, *General Insurance*, p.111.
[184] Mark S. Dorfman, *Introduction to Insurance*, p.177, See also Robert I. Mehr, *Fundamentals of Insurance*, 105.
[185] *Ibid.*, p.105.
[186] Marks S. Dorfman, *Introduction of Insurance*, p.177.

contract. Since it is the right of the insurer to have full knowledge of the subject of insurance, it frequently becomes necessary to depend upon statements of the insured, from whom it is most convenient to ascertain the pertinent facts. The general rule with respect to the representations is that, if the insured gives false statement, or false answers, and the answers are material to the risk, the insurer can void the contract.[187] A material fact has been defined to be the one, which would influence the judgement of a prudent insurer to accept or reject a risk, or to accept at one rate of premium or the other, or to accept subject to certain conditions.[188] However, each set of facts must be evaluated in the given situation, by the courts if necessary. For example, a response of "No" by a businessperson applying for theft insurance to the question "Have you had any theft losses?" might be considered a material misrepresentation if, in fact, the applicant carelessly forgot a large loss that occurred two years a go. Also facts which disclose special motive of the insured in taking the insurance may be treated to be material, e.g. overvaluing the property for speculative purpose, etc.[189]

Concealment. Concealment is the failure to disclose known facts when obligated to do so. Because the insurance contract is one of utmost good faith, the insured must reveal to the insurer all material or important facts that are the exclusive knowledge of the insured. For example, if there is knowledge on the part of the owner that the property insured was in grave danger of destruction at the inception of the agreement and if this information is

[187] David L. Bickelhaupt, *General Insurance*, pp.109-110, See also Mark S. Dorfman, *Introduction to Insurance*, p.117.
[188] R C Kohli, *An Introduction to Insurance practice and Principle in Singapore and Malaysia*, p.69.
[189] *Ibid.*, p.69. See also David L. Bickelhaupt, *General Insurance*, p.111.

not disclosed to the insurer, an unbalance agreement will result. [190] However, an insurer is not permitted to avoid the contract unless the fact concealed not only was obviously material, but also was concealed by the insured with intent to defraud.[191] Some times the motive for silence may be solely that of protecting the reputation of the applicant or that of a friend, and not one of deceiving the insurer, therefore, certain matters people should not be expected to talk about, regardless of their materiality to the risk. [192]

Personal Contract: The property insurance contract is personal and follow the person rather than the property concerned. Both the insured and the insurer rely on utmost good faith in the character, conduct, and credit of each other. Because a change in property ownership can affect the risk, the insurance is not attached to the property and does not pass with it to a new purchaser without approval from the insurer. Except life insurance which is not a personal contract, most insurance contracts represent a personal agreement between insurer and insured, therefore, to allow or permit a fire or automobile insurance contract to be assignable by the policyholder to other parties without the insurer's approval would be unfair to the insurer. Only by knowing and investigating each policyholder it insures can the insurance company correctly appraise the risk it is accepting. [193]

---

[190] Robert I. Mehr, *Fundamentals of Insurance*, pp.107-107.
[191] *Ibid.*, p.108.
[192] *Ibid.*, p 108.
[193] David L. Bickelhaupt, *General Insurance*, pp.101-102, See also Robert I. Mehr, *Fundamentals of Insurance*, p.109. Mark S. Dorfman, *Introduction to insurance*, p.176.

In modern economic activity interest is considered indispensable. However, it is important to point out in the conclusion of this chapter that gain itself is absolutely accepted in Islam, but unjustified gain or a gain received without giving a counter value is forbidden under the Islamic Law (*Shaī'ah*), because Islamic ethics cannot tolerate income without the labour which is the best and recommended cause of ownership in Islam. In the Islamic law of contract, interest is considered and regarded as "an unjust consideration," and therefore, any transaction implies *Ribā* (interest) is invalid. Gambling and risk are another types of consensual transactions condemned in the holy *Qur'ān,* as outlined by Allāh SWT. in *surah Al-mā'idah* (5), Verses 90-91. The *Sunnah* (i.e. sayings of the prophet *Muhammad,* peace be on him) takes this prohibition much further, in condemning not only gambling but also any aleatory transactions (transactions conditioned on uncertain event) such as *gharar* (i.e. risk or hazard).[194] Allāh SWT. says:

> "O you who believe! Intoxicants and gambling, and *Al-Ansâb,* and *Al-Azlâm*{arrows for seeking luck or decision} are an abomination of *Satan* handiwork, So avoid that in order that you may successful. *Satan* wants only to excite enmity and hatred between you with intoxicant and gambling and hinder you from the remembrance of Allâh and from the prayer. So will you not then abstain." (*Al-Mâ'idah* (5) 90-91).

[194] Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance,* (Kluwer Law International, The Hague, The Netherlands: 1998) pp.53-69, See also Dr. S. E. Rayner, *The Theory of Contracts in Islamic Law,* (Graham and Trotman, London: 1991) pp.86-102.