Research Notes

Some Issues In Risk Management and Insurance In a Non-Muslim State

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Introduction

This paper is not intended to be a discourse on whether or not insurance is permitted under Islam. The subject is controversial and, hence, there are at least five different viewpoints on the subject which are:[1]

1. Insurance is permissible *(mutbah)*.
2. Insurance is prohibited *(haram)*.
3. Insurance is not permitted in an Islamic state *(dar-ul-Islam)*.
4. Insurance may be permissible between Muslim policy holders and non-Muslim insurers in a non-Muslim state where Muslims have religious freedom and security *(dar-ul-amn)*, and in an enemy state *(dar-ul-harb)*, if required to do so.
5. Insurance provides important social benefits which are otherwise not available at all. However, some features and/or practices of modern insurance companies are undesirable and, hence, they must be changed before insurance can be permitted.

The controversy on insurance is quite understandable. There was no such institution in existence at the time of the Prophet (on him be peace) or the

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[1]For a summary of the arguments for and against, the reader may wish to consult M. Nejatullah Siddiqi's paper entitled "Muslim Economic Thinking: A Survey of Contemporary Literature," which appeared in Khurshid Ahmed's edited *Studies in Islamic Economics,* Chapter Ten (1980, pp. 191-269), especially the section on "Insurance," pp. 216-218. A somewhat shorter summary of the positions can be found in Omar Afzal's paper entitled "Insurance: Potentialities and Performance—An Islamic Viewpoint," which was presented at the 1981 Conference on Insurance and Investments, held at Ithaca, New York. I have utilized his summary here.

four pious caliphs. As economic activities became more complex and the magnitude of losses grew over time, new institutions emerged. The religious scholars responded with their opinions based on analogy *(qiyas)* of some features which some thought resembled gambling *(qimar* and *maisir)* or usury *(riba)*. There is no textual verdict *(nas)* on the subject in the Holy Qur'ān. Those who supported insurance based their arguments on the ground that insurance represents sharing of losses of the victim by their fellow men who willingly joined in a contractual venture. They traced the practice to the Muslim businessmen in Spain and also compared it with the system of sharing the blood money *(diya)*.

This paper starts with the proposition that those Muslims who live in *dar-ul-amn*, the democratic and secular states of the West, and those in *dar-ul-harb*—practically all but a precious few states of the rest of the world—have very little choice but to purchase insurance contracts to avoid or minimize catastrophic losses of lives and properties. It assumes, therefore, that the fifth view of insurance, stated above, is the realistic one in today's circumstances. Let us explain why.

Welfare Functions of Insurance

Insurance contracts make it possible to shift the financial burden of losses from falling solely on the affected individual to the insurance company and, hence, collectively, to all who subscribe to the policies of the insurance company and the shareholders who own it. In the case of mutual insurance companies, the individual policy holders are also the owners. Individuals buy insurance, i.e., sign contracts, to cover the losses from personal and business properties that occasionally do arise due to fires, accidents, and various natural calamities over which he/she may not have any control. For this protection, the individuals make periodic payments to the insurance companies in the form known as "premiums." Such premiums are determined on the basis of probabilities of such incidences in the past and the expected occurrences in the future. Setting of rates of premiums are strictly regulated in many, if not all, states in the United States. The premium rates are set in such a way that may allow the insurance companies to meet the claims of losses and to provide a reasonable rate of return for them. At times, however, insurance companies fail to achieve either of the two goals from the allowable premium rates.

The presence of insurance makes it possible for those who incur losses to rebuild or reacquire the properties they lost, if not fully, at least partially, and to remain economically viable. Without insurance, however, such persons could become dependent on public charities, as most families and/or relatives often have neither the funds nor the willingness to aid the afflicted. In such a situation the welfare-minded state may come in to provide assistance to the needy with funds from the public exchequer. If so, the entire society, through its taxation and/or levies, bears the burden of incidences of catastrophic losses to some. Insurance, on the other hand, shifts the burden of loss to those who face similar risks, and are willing and able to cover them with mutually agreeable contracts. Thus, it provides a more equitable system of compensation than the one provided by the state with everyone's money, which could be better utilized for meeting other pressing needs, such as to keep the very poor and the needy alive with subsistence allowances. Since most states neither help nor can afford to help individuals for routine losses of lives or limbs of the breadwinners, the absence of insurance can bring devastating results for the victims' families.

The state-based welfare systems are meant to assist the needy, the handicapped and the poor (if based on *zakah* funds, all eight categories are prescribed in the Holy Qur'ān) to sustain them. It is not desirable, and may not even be justifiable, to provide a businessman with funds to rebuild his burned-down establishment and restock the merchandise he lost with public money. The state may only assist him so that he can sustain life until he can find another means of earning a living. In addition to the actual fire victim, many others, e.g., suppliers of merchandise, suppliers of capital, the hired workers may possibly suffer losses without receiving any compensation. If this businessman had access to insurance, he could receive the funds to restore his business and resume contributing to the state's funds for general welfare. Similarly, a worker who loses his only mode of transportation to work, i.e., his car, from an accident, can expect to receive funds from his insurance company to buy another one. If there was no insurance he could lose his job because state funds could never be enough to replace peoples' cars, houses, factories or other personal and business properties.

Insurance is a service which cannot be performed by *zakah*-based funds or any other state-sponsored welfare system without creating much inequity. It is not the role of the state, even for an Islamic one, to help the victims of accidents or calamities with resources such as to restore them to their previous standards of living with public funds, but with only such funds that can save them from poverty and hunger.[2] A system of insurance based on

[2]For a good summary of the role of the state in economic matters please see S. M. Hasan-uz-Zaman's *The Economic Functions of the Early Islamic State* (1981), Chapter 12. Also to be read is, of course, Ibn Taymiya's *Public Duties in Islam: The Institution of the Hisba*. English translation by Muhtar Holland (1983). These, as well as Syed Ameer Ali's *The Spirit of Islam*, Pakistani edition 1969, Chapter VIII, provide us with a fairly detailed exposition

cooperation among the participating members, however, can afford to give the victim the resources that restores his previous position, and, thus, enable him, in turn, to help others who become victims.

It is important to remember that when a buyer of an insurance policy submits a claim to the company for a loss, he is not taking an undue advantage of the rest of the policy holders of the company. They all know that they themselves could have been the claimants if misfortune befell them instead of the present claimant. The statistical probabilities of such incidences are known as they are based on past records. The premiums for policies are determined on the basis of such probabilities. Thus, the risk of suffering a loss is pretty much understood by the participants. By paying premiums for their policies they are essentially pooling their resources to cover each other's losses. Those who argue that payments from insurance companies to the claimants of policies are akin to usury *(riba)*[3] seem to stretch too far what is meant by *riba* in the *sharia*. While insurance is a systematic pooling of individual resources to collectively cover the expected inherent risks of loss that each and every member faces, usury involves cases in which individuals engage in financial transactions with the sole purpose of monetary gain. The purpose of an insurance policy is to protect property and not to enhance it.

The Case of Life Insurance in Islam

The most controversial form of insurance for Muslims is insuring against the loss of life. For those who buy life insurance policies, the main objective is to protect their earnings so that in their absence their families do not become destitute and public charges. In today's modern societies where the extended families of earlier ages are conspicuously absent, the death of the main breadwinner usually brings financial catastrophe to the dependents. It is no wonder that so many Muslim children and even families from countries such as Ethiopia, Chad, Lebanon, etc. nowadays are being adopted by Christian families in the United States – no one else was willing to take care of them.

The question then arises, what is the responsibility of a Muslim breadwinner to secure his family from future financial ruin if something

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on the role of an Islamic state in economic matters. Nowhere will the reader find that the state's role was ever to compensate individuals or groups of individuals for accidental losses the way insurance companies do in modern economies.

[3]Muslehuddin (1978), among others, is the proponent of this argument. In his book, based on his Ph.D. dissertation, he seems to extend the principles of analogy (or *qiyas* related to *riba*) to business transactions and contracts a bit too far (see Chapters 6 through 10).

happened to him prematurely? Even in *dar-ul-Islam* there are no systematic institutions which take care of the dependents of the deceased income earners in a way that they get proper education and training in order for them to become economically independent when they come of age. At best the society provides them with enough food and shelter to keep their souls and bodies together, whereas a life insurance policy may provide enough funds not only to cover the costs of the bare necessities of food and shelter, but also the education and training mentioned above. Again, those who buy life insurance policies are simply pooling their resources together to *protect* the financial futures of their families and not to take advantage of anyone else's money. The fact is, life is transitory and death is sure to visit the soul at its appointed time. The risk of death can be calculated from the enormous data gathered everyday. While no one can predict the actual time of death, it is certainly plausible to estimate the life expectancy of different groups of people with different genetic factors and health conditions. It is based on these statistical probabilities that insurance companies are able to determine the premiums charged to individual policy holders at various times in their life cycles. The principle behind life insurance is the same as the ones for property and casualty insurance discussed above.

The argument that insurance is akin to gambling, put forward by some Muslims, is very puzzling.[4] This is because gambling generates risk that does not exist before one enters gambling, while insurance is specifically designed for the sole purpose of *managing risks* that are inherent in existence. If anything, insurance is the opposite of gambling rather than similar to it. Anyone who has any knowledge about the actual business of insurance should refrain from such misleading analogies. That insurance is a needed service which must be provided to those who seek it should be clear to all responsible Muslims. The question is how to organize this institution in such a way that it does not violate the basic principles of fairness and justice in Islam. It is to this issue we now turn.

Risk Management and the Process of Islamization of Insurance

The need to make provisions for future contingencies is incumbent on all Muslims.[5] Insurance is a means of protection from expected losses of life and property that are inherent in life. One can, however, reduce the risks of such losses occurring by taking a number of measures. Such measures,

[4]For reference to these works see Siddiqui (1980, pp. 216, op cit.).

[5]For an elaboration of this point the reader may wish to read Siddiqui's (1972) Chapter One, Section II, pp. 11-34.

known as risk management techniques, are now increasingly being emphasized by the insurance industry[6] and Muslims should first consider managing their risks, and only then take recourse to insurance to cover unmanageable risks.

In risk management, the first step is to identify the risks and then to evaluate them according to certain specifications. For example, a common risk to both individual property holders and businesses is fire hazards. Once this risk is identified, the next step is to determine the size and the importance of the loss, i.e., whether or not the loss is likely to be such that the individual, the family, or the business can bear the loss without financial ruin. If not, then attempts are to be made to lower the risks of fires by installing such devices as sprinkler systems, fire alarms, fire extinguishers, sensory devices that can detect imminent fires, special storage facilities for flammable items, and the like. Similarly, if the principal risk is determined to be premature loss of life or disability of the principal income earner of the family, measures can be taken to reduce even such risks. Thus, if the person is a law enforcement agent, for instance, he can either use additional protective gear while on patrol duty in a dangerous neighborhood or opt for a desk job, leaving the work of street surveillance to those who have little or no family obligations. If the main breadwinner has a hobby of hang gliding, he can give it up for a less dangerous hobby (sport); or, if the person has bad dietary habits that can cause heart disease or smoking habits which can cause lung cancer, the hazards of premature death can be reduced considerably by changing such habits. The accidental loss of life from automobile accidents can be reduced substantially by mastering the techniques of defensive driving, avoiding known dangerous roads and corners, avoiding late night driving, etc. Of course, there is no way one can foresee the actions of others who may have dangerous driving habits, and hence the need for covering losses through insurance for just such mishaps.

Once adequate measures are taken to minimize the avoidable risks, the task then becomes one of figuring out (1) how much insurance protection to buy, (2) in what form to buy, and (3) from whom to buy.

How Much Insurance Protection is Needed?

Insurance coverage for the unmanageable risky properties should not be in excess of their replacement costs. No one should take out insurance with the intention of making a profit in case the insured property is lost due

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[6]For risk management techniques, the reader may wish to consult standard texts, such as R. I. Mehr, and B. A. Hedges (1974). C.A. Williams and R.M. Heins (1981), and J.L. Athearn (1981).

to fire, theft or pilferage. That would not only be unethical, but clearly an un-Islamic act. The task of determining the replacement costs of properties to be insured is a difficult one, especially in developed Western countries. Professional assessors are listed in the "yellow pages" and their services can be hired. Besides, insurance companies themselves compile such lists. Individuals can also assess the values of properties to be insured by consulting price lists of advertised products and by other such means. Once the replacement value of such properties is determined, the insurance policy to be purchased should be for that amount or less, but not for more.

What Forms of Insurance Should Be Bought?

This question becomes quite important when we discuss life insurance. The idea of buying a life insurance policy is to prevent the family of the insured income earner from falling into financial ruin if he or she dies prematurely. If the person leaves behind young children, a spouse and parents, then the size of the policy contracted should be such to cover the costs of basic necessities and comforts of the family plus an amount sufficient for providing education and training so that they can take care of themselves.[7] To ensure this, the insurance policy should be in the form of a trust to be managed by a trustee (usually a trust company or bank) if none of the survivors is old enough, and in such a way that the funds are distributed only when needed. Since the insurance proceeds are to be invested in permissible ventures, the total net amount for which the policy is to be purchased could be lower than the estimated costs of upbringing the children and maintaining the other survivors (provided allowances are made for expected inflation and unforeseen circumstances in the calculation of the insurance policy to be purchased). This is because the earnings from the investments will be added to the proceeds of the policy. Where applicable, the size of the policy to be purchased should also be determined by assessing the Social Security allowances the survivors are likely to collect from the government and any other allowances from group life insurance policies that the employers may have provided or from any participatory pension and retirement funds the deceased may have had.

It is relatively easy to assess such benefits in case of death of the income earner by contacting the local Social Security offices and the benefits offices of the employee. Under no circumstances should a Muslim take out an insurance policy for amounts in excess of the required funds determined by the above steps. The purpose of the insurance is to protect the survivors from financial ruin and *not* to enrich them. Large policies are inequitable and,

[7]For the surviving children this could apply when they reach legal age, 18 in the U.S.

as such, cannot be justified under the Islamic principle of shared losses and cooperation among the fellow participants of insurance.

This brief description of the desireable life insurance policy should make one thing clear about the form this policy should take. It should not be a whole-life policy. A whole life policy is one where the insured goes on paying premiums over a period of time for a specified amount of face value until either dying before a specific age or until reaching a certain age. In case of the former, the funds are distributed to the survivors; and in case of the latter, the funds (the face value plus earnings over the years) revert back to the insured. Thus, a whole life policy has more than one objective—it is to provide financial protection to the survivor in case of premature death of the income earner, and to provide a lump-sum amount at the maturity of the policy if the insured member survives until then. It is the contention of this author that life insurance policies should only be purchased for protection and not for accumulation of wealth. The one form of policy that does exactly this is "term-life" policies.

The premiums of term-life policies vary over the life of the policy as these are determined based on the age of the insured member and the amounts of varying funds needed for the protection of the survivors. In case of an untimely demise of the policy holder the survivors receive the financial protection. If, on the other hand, the policy holder survives until the maturity of the policy, he receives no fund from the insurance company. Because of this, the premiums of term life policies are relatively cheap and, therefore, are affordable to most families. Yet, these policies provide the needed protection at a critical time for the family.

From Whom to Buy Insurance?

Most insurance companies in the United States (and in the Western world in general) are engaged in a variety of financial and non-financial activities. Some of them function as insurance companies, as investment bankers, brokerage houses, money managers, bankers, financial planners, investors in real estate, equipment, transportation, etc., all for earning hefty returns from these commercial ventures. In the process, they engage in activities that involve dealings in usury and speculation. It is difficult to separate one of their activities from any other.

Ideally, the Muslims should form their own insurance companies on a cooperative basis. This form of insurance company is known as a mutual insurance company, i.e., the policy holders themselves own the company. A mutual insurance company can provide the insurance protection and yet operate as a non-profit corporation. Forming a company in the United States is not a difficult one in principle. A group of individuals can jointly sponsor a company by filing the appropriate registration forms with the state agency responsible for supervising and regulating the insurance industry. What is difficult, though, is the support of large enough numbers of Muslims who would be willing to commit their participation in such a venture. For a mutual company to be operationally viable, thousands of policy contracts are needed to generate a pool of funds sufficient for meeting the expected claims of losses. Also needed is a pool of dedicated and qualified employees who believe in the basic Islamic economic precepts and are willing to work to implement them. It is not clear whether or not such a group of individuals are available at present in the United States and/or in the West.

There are quite a few mutual insurance companies in the United States. However, they are not run much differently than the publicly owned insurance companies. Investment policies of the small mutually-owned insurance companies can be influenced if sufficient numbers of Muslims join together and demand change. Until the Muslims are in a position to form their own mutual insurance companies, they should at least try to buy policies from those companies whose investment portfolio consists mainly of common stocks and very little, if any, fixed interest bearing assets. Individual insurance companies do furnish such reports upon request. Moreover, financial reports of all large companies are available upon request from the companies themselves or can be examined in libraries of academic institutions, public libraries and brokerage houses.

Summary and Conclusion

The basic theme of this paper has been that insurance is a needed service that must be provided to those who seek it in order to prevent financial catastrophes. The state-based welfare systems are not equipped to provide the type of protection for which an insurance company is geared. It is neither desireable nor practical for the state to engage in insuring individuals and businesses from the consequences of financial risks when funds are sorely needed to assist the poor and the needy with the bare necessities of food and shelter.

Individuals and business concerns can form their own insurance companies (known as mutual insurance companies) with the sole purpose of providing protection from losses of properties and lives, risks of which cannot be managed by other means. The principle they follow is the mutual sharing of losses by the participants. They are not in the business for profit, nor are they charitable organizations. They provide the service with the contributions of the willing participants and are to be considered a form of permissible partnership *(musharakah)*.[8]

Before one buys insurance policies, however, attempts must be made to analyze some of the risks of loss that can be reduced by taking measures that are within the reach of practically everyone. A significant portion of risks to property from such factors as fire and theft can be reduced or minimized by taking simple precautions as sprinkler systems, fire alarms, burglar alarms, and security locks. Similarly, some risks of losing life can be reduced by shunning dangerous hobbies, improper diets, and regular medical check-ups. Insurance policies should be bought only for unmanageable risks.

Whole-life insurance policies should be discarded in favor of term-life policies. The former has more than protection as the objective and it operates in a way that can be termed usurious. If possible, the Muslims should incorporate their own mutual insurance companies. As long as this is not possible, they should select those insurance companies that have little dealings with fixed-interest bearing investment assets.

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[8]For legal issues involved in *musharakah* and *mudarabah* (not necessarily related to insurance) the reader may like to consult M.N. Siddiqi (1985).

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And thou (standest) on an exalted standard of character.