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Article abstract

Takaful is the means of bringing the social and economic benefits of modern insurance coverage, in a form consistent with their religious beliefs, to Muslims and to the merging economics of many predominantly Muslims countries. As such, the development of Takaful is crucial, both to social inclusion in non–Muslim countries, and to economic development in a number of countries with emerging market economies. It is therefore only surprising that the Takaful industry is undergoing a period of rapid growth. Yet the development of Takaful faces some formidable barriers that are largely due to the complex structure of takaful understandings and the unresolved issues associated with it. These issues contribute to making the development of an appropriate legal and regulatory infrastructure, as well as financial reporting, corporate governance, rating and other related matters, problematic for the Takaful industry.

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Abstract To Islamic Insurance (Takaful)

by Bouaziz Cheikh

ABSTRACT

Takaful is the means of bringing the social and economic benefits of modern insurance coverage, in a form consistent with their religious beliefs, to Muslims and to the merging economics of many predominantly Muslims countries. As such, the development of Takaful is crucial, both to social inclusion in non–Muslim countries, and to economic development in a number of countries with emerging market economies. It is therefore only surprising that the Takaful industry is undergoing a period of rapid growth. Yet the development of Takaful faces some formidable barriers that are largely due to the complex structure of takaful understandings and the unresolved issues associated with it. These issues contribute to making the development of an appropriate legal and regulatory infrastructure, as well as financial reporting, corporate governance, rating and other related matters, problematic for the Takaful industry.

RÉSUMÉ

L'assurance « takaful » apporte des valeurs sociales et économiques aux bénéfices de l'assurance traditionnelle actuelle, qui sont en harmonie avec les croyances religieuses islamiques que l'on retrouve dans de nombreux pays. En cela l'assurance « takaful » opère en parallèle dans les pays non-islamiques notamment dans les économies émergentes et se développe rapidement depuis ces dernières années.

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Pourtant, le développement de l'assurance « takaful » est contraint par de nombreuses barrières largement issues de la structure complexe des concepts sous-jacents et de leur interprétation. Ces questions posent un problème au développement d'un cadre légal et réglementaire approprié, aussi bien qu'en ce qui concerne la publication de rapports financiers, les questions de gouvernance, les questions de tarification et autre problèmes liés au concept de l'assurance « takaful ».

1. WHAT IS TAKAFUL (INSURANCE ISLAMIC)?

Muslim jurists acknowledge that the basis of shared responsibility in the system of "aquila" as practiced between Muslims of Mecca and Medina laid the foundation of mutual insurance. Islamic insurance was established in the early second century of the Islamic era when Muslim Arabs expanding trade into Asia mutually agreed to contribute to a fund to cover anyone in the group that incurred mishaps or robberies along the numerous sea voyages (*marine insurance).*

We know that all human activities are subject to risk of loss from unforeseen events. To alleviate this burden to individuals, what we now call insurance has existed since at least 215 BC. This concept has been practiced in various forms for over 1400 years. It originates from the Arabic word *Kafalah*, which means "***guaranteeing each other***" or "joint guarantee". The concept is in line with the principles of compensation and shared responsibilities among the community. In those days there were trade caravans that were exposed to the similar risks to those faced today in trading activities. Muslim scholars acknowledge that the basis of shared responsibility in the system of Al Aaqilah as practiced between Muslims of Makkah and Madinah laid the foundation of mutual insurance. It consisted on contributions from tribes' members to share joint responsibility to indemnify the victim or the victim's family and relatives against financial liability arising from defined events. That system was accepted by Prophet Muhammad (pbuh) under the principle of mutual protection and cooperation in virtue and good deeds.

Takaful originated within the ancient Arab tribes as a pooled liability that obliged those who committed offences against members of a different tribe to pay compensation to the victims or their heirs. This principle later extended to many walks of life, including sea trade, in which participants contributed to a fund to cover anyone in a group who suffered mishaps on sea voyages.

Other early traditions practiced by Islamic and pre-Islamic Arab tribes also constitute the origins of Takaful; these include Diya, Kafalah, Aqd muwalat, Ju'hala, Daman Khatar Al-Tariq and Hilf. Diya is the indemnity paid as "blood-money" to the next-of-kin or the injured party of a murder victim; *Kafalah* is a surety-ship whereby a third party guarantees the performance of another party involved in a contract, it was used to assist victims of hazards on trade routes; Aqd muwalat is a contract to bring an end to mutual enmity or revenge; Ju'hala is a contract to be pay for a work that involves a significant part of uncertainty; Daman Khatar Al-Tariq is a guarantee against travel hazards; and Hilf is an agreement for mutual assistance among people. In all these agreements, Arab tribes and traders covered the losses and liabilities of individuals in the form of solidarity and brotherhood, and provided mutual financial aid and assistance in case of need

The Tabarru' system is the main core of the *Takaful* system making it free from uncertainty and gambling. Tabarru' means "donation; gift; contribution."

The Takaful market has been growing steadily and remains unsaturated with huge growth potential for many of our clients. Global Takaful contributions grew by 19 per cent in 2010 to US$8.3 billion and were forecast to reach US$12 billion in 2012 (*World Islamic Insurance Directory 2012 and Ernst & Young World Takaful Report 2012).*

Takaful is not limited to the Muslim community – its values are universal and accepted across all religions. It also has embedded within it an element of profit sharing which may be attractive to the growing ethical investment segment. The following theses underlie the concept of Islamic insurance:

a) Takaful has no contact with excessive gharar (*al-gharar al-kathir*) since the part of installments paid by each participant is considered to be a donation or voluntary contribution that is directed to a special fund. Should an insured accident occur, this fund is used to provide the compensation. In addition to paying the money necessary to cover the sum of the damage the participant can be sure he will be paid the income from the other part of installments on basis of the PLS (*profit and loss sharing*) system regardless of occurrence of insurance accident. The operator is aware of the amount of his share that the terms of a contract provide a certain amount of the share agreed upon by the parties to a contract. The amount of income depends exclusively on the operations carried out by insurance company and does not appear to be a fixed interest that does not depend on income. Life, health and property of a man is believed to be in the possession of Allah, so it is quite natural from the point of Islam that there is uncertainty about what is going to happen to them: "*Verily the knowledge of the Hour is with Allah (alone). It is He who sends down rain, and He Who knows what is in the wombs. Nor does any one know what it is that he will earn on the morrow" (surat Lukman, 34);*

b) The installments or a part of them paid by the participant can be used in operations on condition that those operations do not contradict with *Shariah*. In case an operation of a *Takaful* company contains the elements, prohibited under Shariah it will be acknowledged void and null. Articles and memorandum of agreement of every *Takaful* company provide that investment activity of a company is to be in compliance with *Shariah* principles;

c) The main purpose of Islamic insurance is to guarantee or cover participants' risks. Parties to a contract of Islamic insurance (*Takaful*) can be either a warrantor or a warrantee;

d) Takaful business is based on a very special mechanism of profit and loss sharing called mudarhabah. This mechanism helps to avoid the element of riba as it is which is inherent to conventional insurance;

e) *Shariah* Supervisory Board is to supervise business activity of *Takaful* companies. The main goal of *Shariah* Supervisory Board is to decide whether company's new products and operations comply with *Shariah* or not;

f) All parties to a contract must conduct in accordance to the utmost good faith principle;

g) Insurers are entitled to offer their representatives for positions in the Board of Directors;

h) Takaful unlike conventional insurance prevents from violating the terms of inheritance prescribed by *Shariah*.

Each participant that needs protection must be present with the sincere intention to donate to other participants faced with difficulties. Therefore, Islamic insurance exists where each participant contributes into a fund that is used to support one another with each participant contributing sufficient amounts to cover expected claims. The objective of *Takaful* is to pay a defined loss from a defined fund.

2. WHAT ARE THE BASIC PRINCIPALS IN TAKAFUL INSURANCE?

Takaful is founded on the cooperative principle and on the principle of separation between the funds and operations of shareholders, thus passing the ownership of the Takaful (*Insurance*) fund and operations to the policyholders. Muslim jurists conclude that insurance in Islam should be based on principles of mutuality and co-operation, encompassing the elements of shared responsibility, joint indemnity, common interest and solidarity. In *Takaful*, the policyholders are joint investors with the insurance vendor (*the takaful operator*), who acts as a mudarib – a manager or an entrepreneurial agent for the policyholders. The policyholders share in the investment pool's profits as well as its losses. A positive return on policies is not legally guaranteed, as any fixed profit guarantee would be akin to receiving interest and offend the prohibition against riba. For some time conventional insurance was considered to be incompatible with the Shari'ah that prohibit excessive uncertainty in dealings and investment in interest-bearing assets; both are inherent factors in conventional insurance business. However, *Takaful* complies with the Shari'ah (*which outlines the principles of compensation and shared responsibilities among the community*) and has been approved by Muslim scholars. There is now general, health and family (**life**) *Takaful* plans available for the Muslim communities.

Islamic insurance requires each participant to contribute into a fund that is used to support one another with each participant contributing sufficient amounts to cover expected claims. The underlying principles of Takaful may be summarised as follows:

- You must have a legitimate financial interest in the subject matter to participate in takaful plan.
- A takaful contract is based on the principle of utmost good faith (trust), whereby you need to disclose all material information required.
- You can only recover your financial loss and not gain any profit as a result of a quantifiable loss.
- Policyholders cooperate among themselves for their common good.
- In determining the compensation, the takaful operator will identify the actual most important cause that brought about the loss.
- Every policyholder pays his subscription to help those that need assistance.

- After you have been compensated for your loss, the takaful operator has the right to claim from any third party responsible for your loss.
- Losses are divided and liabilities spread according to the community pooling system.
- Uncertainty is eliminated in respect of subscription and compensation.
- It does not derive advantage at the cost of others.

Theoretically, Takaful is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. The purpose of this system is not profits but to uphold the principle of "bear ye one another's burden.

3. POLICY INSURANCE TAKAFUL

The takaful protection plan is based on Shariah principles and offers many unique features to policy owners. There are two types of takaful businesses: family takaful and general takaful

- *A family takaful plan* is a long-term savings and investment programme with a fixed maturity period. Apart from enjoying investment profit, the plan provides mutual financial assistance among its participants.

The family takaful plan is a financial programme that pools efforts to help the needy in times of need due to untimely death and other mishaps resulting in personal injury or disablement.

The takaful plans designed by the takaful company would enable participants to participate in a takaful scheme with the following aims:

a) To save regularly;

b) To invest with a view of earning profits which are Sharia-compliant; and

c) To avail of cover in the form of payment of takaful benefits to heir(s) should a participant die before the maturity date of his takaful plan.

The operations of family takaful·

A person who participates in any family takaful plan is called a participant. A participant may choose any one of the plans offered by the company. The family takaful plans have a defined period of participation.

The takaful company and the participant will enter into a long-term takaful contract, which is based on the principle of Al-mudharabah (profit-sharing).

The takaful contract spells out clearly the rights and obligations of the parties to the contract. The participant is required to pay regularly the takaful installments in consideration for his participation in the takaful plan.

The participant will decide the amount of takaful installments that he wishes to pay, but such an amount shall be subject to the minimum sum as determined by the company.

Each takaful installment paid by the participant shall be divided and credited by the takaful company into two separate accounts, namely the participant's account and the participant's special account. A substantial proportion, for example, such as 93% of this installment is credited into his participant's account solely for the purpose of his savings and investment.

The balance is credited into his participant's special account as tabarru' for the purpose of mutual help.

Mutual financial assistance such as takaful death benefits to fellow participants is paid from the participant's special account. What proportion of the takaful installment to be relinquished as tabarru' and credited into the participant's special account is determined based on sound actuarial principles.

The takaful installment credited into these two accounts will be pooled as a single fund for the purpose of investment activities undertaken by the takaful company in a manner permitted by the Sharia.

Any profits generated from the investment shall be shared between the participant and the company in a ratio to be mutually agreed between the participant and the company in accordance with the contract of Al-Mudharabah. For instance, if the ratio agreed is 7: 3 then the participant shall be entitled to 70% of the profits whilst the company shall be entitled to 30%.

The participant's share of the profits shall be credited into his participant's account. With the accumulation of such profits, the balance in the participant's account will increase over a period.

Family takaful benefits:

In the event that a participant should die before the maturity of his family takaful plan, the following takaful benefits shall be paid to him:

(i) The total amount of the takaful installments paid by the participant from the date of inception of his takaful plan to the due date of the installment payment prior to his death and his share of profits from the investment of the installments which have been credited into his participant's account;

(i) The outstanding takaful installments which would have been paid by the deceased participant should he survive. This outstanding amount is calculated from the date of his death to the date of maturity of his takaful plan which shall be paid from the participant's special account as agreed upon by all the participants in accordance with the takaful contract.

If a participant survives until the date of maturity of his takaful plan, the following takaful benefits shall be paid to him:

(i) The total amount of takaful installments paid by the participant during the period of his participation plus his share of profits from the investment of the takaful installments credited into his participant's accounts.

(ii) The net surplus allocated to his participant's special account as shown in the last valuation of the participant's special accounts.

In the event that a participant is compelled to surrender or withdraw from the takaful plan before the maturity of his takaful plan, he shall be entitled to the surrender benefits.

The participant is entitled to receive the proportion of his takaful installments that have been credited into the participant's account including his share of investment profits. However, the amount that has been relinquished as tabarru' will not be refunded to him.

The various types of family takaful plans available in the market are:

(a) Family takaful plan for education

(b) Family takaful mortgage plan

(c) Group family takaful plan

(d) Group hospitalization and medical benefit

- ***General takaful:***

General takaful schemes are basically contracts of joint-guarantee, on a short-term basis (normally one year), between groups of participants to provide mutual compensation in the event of a defined loss.

The schemes are designed to meet the needs for protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon properties, assets or belongings of participants.

In the event of a catastrophe or disaster resulting in a loss or damage to a property or bodily injuries or other physical disability to a person, the owner of the property or the person concerned may suffer substantial financial losses.

For instance, if a house is destroyed or damaged by fire, the owner would certainly require a sufficient sum of money to repair the house, or rebuild a new one as well as enough money to replace the damaged furniture, fixtures and fitting.

Similarly, a person being injured in an accident would require an adequate sum of money to pay for the medical treatment.

With the various general takaful schemes offered in the market, that person would be assured of takaful benefits in case of misfortune resulting from such loss or damage.

Participants of a general takaful scheme shall also enter into a contract with the company on the basis of the contract of Mudharabah. The contract stipulates the right and obligations of the participants as well as the company.

In consideration for participating in the various schemes, the participants agree to pay the takaful contributions as tabarru'. The company manages the general takaful business including managing the investment of the general takaful fund assets.

As the al-Mudharib, the takaful company will invest the general takaful fund in line with Sharia principles and all returns on the investment will be pooled back to the fund.

In line with the virtues of cooperation, shared responsibilities and mutual help as embodied in the concepts of takaful, the participants agree that the company shall pay from the general takaful fund, compensation or indemnity to fellow participants who have suffered a defined loss upon the occurrence of a catastrophe or disaster.

The fund shall also pay for other operational costs of general takaful business such as for the retakaful arrangements and the setting up of technical reserves.

Should there be a surplus (profits) in the general takaful fund after deducting all the operational costs of general takaful, that surplus will be shared between the participants and the company – provided the participants have not incurred any claims, and that no takaful benefits have been paid to them.

This sharing of the surplus will be in a ratio agreed in accordance with the contract of Al-Mudharabah. If the ratio agreed is 6: 4, then 60% of the surplus will be shared among such participants whilst the balance 40% is the share of the company. *(Source: The Star, Malaysia, Contributed by Bank Negara Malaysia.)*

4. HOW GENERAL TAKAFUL WORKS?

General Takaful refers to the Islamic concept where you contribute a sum of money to a Takaful fund in the form of participative contribution (tabarru).

You undertake a contract (aqad) to become one of the participants by agreeing to mutually help each other, should any of the participants suffer any form of misfortune, either arising from death, permanent disability, loss, damage or any other such misfortunes as covered under the Takaful you personally undertake.

The Contributions collected from the policyholders are considered as donations and they constitute the Takaful fund from which all claims are reimbursed. At the end of each financial year, after deduction of expenses, any remaining cash surplus will not be retained by the company or its shareholders, but returned to the policyholders in the form of cash dividends or distributions.

In this respect, Takaful business is different from the conventional insurance in which the policyholders, rather than the shareholders, solely benefit from the profits generated from the Takaful and Investment assets. The Investment assets representing the Takaful fund that accumulate over the retained reserves, surpluses and provisions are invested by the shareholders who manage the company on behalf of the policyholders. The shareholders are rewarded with a percentage of the profit on these investments.

Wakala & Mudarabah Model (Hybrid Model) A combination of the principal – agent (Wakala) and principal – manager (mudarabah) arrangement. Wakala is used for underwriting activities and mudarabah is used for investment activities.

5. PROHIBITIONS OF *GHARAR*, *MAYSIR* AND *RIBA*

Broadly speaking the following principles of traditional insurance are prohibited by Shari'ah law. The major unlawful elements that play within the conceptual insurance framework is *Riba* (*generally referred to as interests*), *Maysir* (gambling) and *Gharar* (uncertainty):

a) Riba:

The most accessible to the novice reader will be the element of *Riba*, when this concept is narrowed down to the common understanding of interests. prohibits the increase in value of a debt for which there is no consideration. This is present in most insurance contracts. In non-investment insurance contracts, the insured sums are likely to exceed the premium payable, and in investment insurance contracts, premiums may be invested in prohibited investments. Where the conventional insurance companies will pool the premiums mainly in fixed income financial instruments *(conventional bonds that are "sleeping" and by the mere laps of time generate a fix and guaranteed interest revenue),* such investment is prohibited to the Islamic insurance/investment activity. The available funds will need to be pooled and "put to work" to generate a possibly stable *(but not fixed)* revenue and in acceptable industries using compliant financial instruments.

b) Maysir (Gambling) and Gharar (Uncertainty)

Less obvious for the conventional reader will be the prohibitions of gambling and uncertainty. Conventional insurance indeed boils down – looked at from an objective distance – to gambling. One premium payment could give right to a payout *(provided the insured event occurs soon after)* or one could pay all his/her life without any result. The insured puts up some money, hoping to get more back than his input. This could be compared to buying a lottery ticket. Because of this, conventional insurance is also prone to moral hazard (*fraud*).

From their side, the insurers will weigh the bets *(and determine the premiums)* using educated guesses based upon statistical data and deal volume. The uncertainty occurs because both the payout and premium are dependent on the occurrence of the uncertain event. The insurer does not know if and when and how much he needs to pay out. And the client pays the premium but does not know whether any financial benefit will flow back. The way out will be formed by replacing the contract of sale (*of the risk*) against the price (*of the premium*) against a contract of donation (*Tabarru*) and a spreading of the risk over the participants. The donation is often accompanied by an additional saving, which then also gets pooled and invested.

c) Some Elements of Controversy

Since the donation actually is conditional (*upon claim for recuperation if and when the insured event takes place*), the practice remains slightly controversial in minority schools of Islamic law, in the same way as the principle of insurance itself (as the insured event by necessity is uncertain – and, therefore, arguably subject to minor or even excessive *Gharar*).

Depending on jurisdiction, it may be noted that (as for instance in Family/Life *Takaful*) that a policy taken out by a non-Muslim *(as such not excluded from subscribing to a*Takaful *policy)*, might contravene the Islamic principles of inheritance (*Faraid*) and perhaps even the personal law of faith of the insured. This aspect deserves the attention of all parties concerned.

Further, discrimination built against the conventional practice of statistical life expectancy of the policyholders sometimes rests debated as the life expectancy of a human being is determined only by Allah (swt) regardless of the sex of the creature and, therefore, no creature should overrule the power of Allah (swt). The *Qard Hassan*or benevolent loan – *as we will see below* – to which the *Takaful* operator can be called in case of deficiency of the pool of the premiums is arguably some kind of a capital guarantee, which in turn could be argued as unlawful under Islamic law.

6. CONVENTIONAL INSURANCE AND TAKAFUL, WHAT IS THE DIFFERENCES?

In modern business, one of the ways to reduce the risk of loss due to misfortunes is through insurance. The concept of insurance where resources are pooled to help the needy does not necessarily contradict Islamic principles. This is the important differences distinguish conventional insurance from Takaful:

- Conventional insurance involves the elements of excessive uncertainty (*gharar*) in the contract of insurance;
- Gambling (*maysir*) as the consequences of the presence of excessive uncertainty that rely on future outcomes
- Interest (*riba*) in the investment activities of the conventional insurance companies;
- Conventional insurance companies are motivated by the desire for profit for the shareholders;
- Conventional system of insurance can be subject to exploitation. For example, it is possible to charge high premium (*especially in monopolistic situations*) with the full benefit of such over-pricing going to the company.

Another essential difference is that conventional insurance by its conception is a risk-transfer mechanism. Takaful on the other hand does not entail a risk transfer mechanism, but rather a social function of mutual risk-sharing. The contract of Takaful is not a sale or an exchange, but is rather a membership contract to a common pool, of which every member is entitled to certain benefits but also exposed to some risks of loss. This also what makes Takaful system commercially more viable, as the remaining money after all claims does not belong to the shareholders, but rather to the participants and it should thus be given back. In addition, motivations of conventional and Islamic insurance companies are different; while conventional companies are directed by the search of profit. Takaful companies are also directed by ethical means for the overall benefit of society and the environment. Regulation in Takaful is undertaken through Shari'ah supervisory bodies that ensure that all operations are conducted in line with the Shari'ah principles and fulfil Islamic objectives of social welfare.

The key difference between Takaful and conventional insurance rests in the way the risk is assessed and handled, as well as how the Takaful fund is managed. Further differences are also present in the relationship between the operator *(under conventional insurance using the term: insurer)* and the participants *(under conventional it is the insured or the assured).* Takaful business is also different from the conventional insurance in which the policyholders, rather than the shareholders, solely benefit from the profits generated from the Takaful and Investment assets.

Besides, the distribution of profits in case of conventional insurance is a managerial decision from the insurer company which is not necessarily favorable for all parties. While, in case of Takaful, distribution mechanism is defined in advance and the operator has no claims in underwriting surplus; this reduces the possibility of conflict between shareholders and policyholders. Finally, in case of dissolution of a conventional insurance company, reserves and surplus belong to the shareholders. While in case of dissolution of a Takaful operator, capital is distributed back to participants or donated to charity.

7. CONCLUSION

As with Islamic banking developments, the *Takaful* market has been outgrowing the conventional insurance markets for some years now, both from a global as well as a regional Southeast Asian perspective. An exponential growing middle class in the Southeast Asian region consists largely of Muslims with no access to savings/insurance and a growing awareness of using their financial means in line with Islamic injunctions. Next to that, there is an expanding potential of conventional/non-Muslim clients that are inclined towards the ethical alternative that is comprised within the Islamic finance/insurance products or simply willing to accept the alternative/competitive offering. According to the World Bank,Indonesia's swelling number of middle-class consumers grew from 1999-2011 by 50 million *(mostly Muslim*) to more than 130 million and – *economic growth staying what it is* – another 50 million are coming up in the next decade. As a result thereof, Great Eastern is already eyeing regional expansion to weigh against the mature Singapore insurance market and also ETIQA announced an expansion in regional activities considerably (in Singapore, Indonesia, Brunei etc). At the center of the Southeast Asian markets, proficient lawyers should prepare to service *Takaful* companies and/or accompanying their clients overseas, particularly those who service clients with footprints in Indonesia. If Singapore intends to stay a regional, financial powerhouse in this shifting environment, strategic and regulatory decisions need to be taken and implemented fast.