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Birgit Bisani

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1. Introduction

For generations, Muslims around the world consider insurance to be suspect.¹ Many Islamic scholars reject conventional insurance, especially life insurance, since it involves elements prohibited by the *Shariah* (Islamic law).² There are several *fatawah* (juristic opinions concerning Islamic law) opposing insurance,³ such as the *fatwah* of the First International Conference on Islamic Economics held at Makkah in 1976, concluding that “commercial insurance as presently practiced does not satisfy the Islamic conditions for it to become acceptable”.⁴

It is important to understand that not the idea of insurance itself is unlawful but rather the current practice of conventional insurance.⁵ In 1985, the Fiqh Academy resolved that commercial insurance contracts are prohibited under the *Shariah* and should therefore be avoided by Muslims.⁶ However, at the same time, the Fiqh Academy approved *takaful* as *Shariah* compliant alternative to conventional insurance, based on the principles of *ta’awun* (mutual assistance), brotherhood and ethical operations.⁷ The Fiqh Academy can be regarded as the highest authority in jurisprudence affairs although its resolutions are not binding. As part of the OIC (Organisation of Islamic Conference), resolutions of the Fiqh Academy have nevertheless a strong impact.⁸

The word *takaful* derives from the Arabic verb *kafala* meaning ‘to guarantee’,⁹ and stands for guaranteeing each other.¹⁰ The origins of *takaful* can be traced to the customary practice of *aqilah* among Arab tribes in the pre-Islamic era.¹¹ *Aqilah* refers to an agreement of tribal solidarity. If a member of a tribe was killed by a member of a different tribe, the relatives of the deceased would receive *diyah* (blood money) from the family of the accused. Under this system, all members of the accused tribe pooled their resources to spread the financial burden.¹² Prophet Muhammad also approved this practice of mutual compensation and joint responsibility during his

¹ cf. Abdul Rahim et al. (2007), 375

² cf. Billah (1998), 391

³ cf. Ayub (2007), 430-431

⁴ Rashid (1993), 21

⁵ cf. Billah (1998), 391

⁶ cf. S. Abdi, *Taking takaful to the next level*, in: Jaffer (2007), 30

⁷ cf. Securities and Exchange Commission of Pakistan (2010), 13

⁸ cf. Munich Re Group (2008), 10

⁹ cf. A.P. Smith, *Takaful business models*, in: Jaffer (2007), 88

¹⁰ cf. Stagg-Macey (2007), 1

¹¹ cf. Rashid (1993), 17

¹² cf. Morgan Stanley (2008), 6

lifetime.¹³ Throughout the period of Islamic civilization, the concept of *takaful* expanded further in particular among Muslim merchants who contributed to a fund to cover anyone in the group suffering mishaps or robberies during sea voyages.¹⁴ Later on, the Ottoman Empire introduced the Western concept of marine insurance in its Maritime Code of 1863 and approved other aspects of non-life insurance by the Ottoman Law of Insurance in 1874. Only life insurance was regarded as *haram* (unlawful).¹⁵

The first modern *takaful* undertaking was founded in Sudan in 1979.¹⁶ Since its emergence, the Islamic insurance industry has been showing significant growth rates,¹⁷ and the awareness and acceptance of *takaful products* has been increasing in Muslim countries.¹⁸ The *takaful* market is currently concentrated in Southeast Asia and the Middle East. However, insurance companies and customers are realizing more and more that *takaful* is attractive to non-Muslims as well due to its combination of an ethical investment policy with a significant growth potential and price competitiveness.¹⁹

In the following, it is first of all examined why conventional insurance is prohibited under the *Shariah*. After the critical elements are revealed, the basic concept of *takaful* and its features are presented. For a better understanding, a direct comparison between Islamic and conventional insurance is given. Focus of this thesis is an examination of the different business models of *takaful* applied in practice. In this respect, the four most common *takaful* models, namely the *mudarabah*, the *wakalah*, the combined and the *waqf* model, are explained and discussed in detail. As it represents an essential part of the whole *takaful* industry, *retakaful* (Islamic reinsurance) is also commented on. Finally, the Islamic insurance market is analyzed, taking into account its current situation, its opportunities as well as its challenges.

¹³ cf. Farooq et al. (2010), 56

¹⁴ cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 67

¹⁵ cf. Mahmood (1991), 281

¹⁶ cf. Taylor (2005), 1

¹⁷ cf. Fitch Ratings (2007), 19

¹⁸ cf. E. Hassan and A. Rohayem, *Transparency and Financial Reporting in Islamic Insurance*, in: Archer et al. (2009), 265

¹⁹ cf. Ahmad et al. (2010), 6

2. Why is conventional insurance *haram*?

The Arabic word *Shariah* denotes literally 'the way to the source of life'.²⁰ The *Shariah* represents the body of Islamic religious law and provides a comprehensive code of conduct for human behaviour in day-to-day life including banking, business, economics, crime, politics, family, inheritance, prayer, food, hygiene and social issues. It is derived from two primary sources, the *Qur'an* and the *Sunnah* (word and actions of or approved by the Holy Prophet).²¹ Over the time, the two secondary sources *qiyas* and *ijma* came into being in order to deal with new developments which were nonexistent at the time of the Prophet. *Qiyas* refers to analogical reasoning applied by Islamic scholars. *Ijma* stands for the consensus of the Islamic community on a legal issue.²² It has to be taken into consideration, that there are different schools in Islamic law whereas the two main ones are the *Sunni* and the *Shi'a*. Hence, legal interpretations can vary among distinct schools and territories.²³ Different business models in *takaful* and their permissibility in different regions can be regarded as a consequence thereof.

It has to be emphasized again that efforts to avoid risk are not against Islamic teachings. The reason why conventional insurance is considered as *haram* (unlawful) under the *Shariah* is because it involves at least three forbidden elements, namely *gharar* (uncertainty), *maisir* (speculation) and *riba* (interest). These elements are examined in the following.

2.1. *Gharar* (uncertainty)

Any contract of exchange involving *gharar* is forbidden under the *Shariah*. *Gharar* appears in a contract when liabilities are uncertain, undetermined or contingent.²⁴ Mutual consent and veracity constitute basic requirements for a valid contract in Islam. Insufficient information can convey a wrong impression of significant aspects of a contract and, hence, renders mutual consent impossible.²⁵ In an insurance contract, there is uncertainty in respect to whether the insured suffers actually a loss,

²⁰ cf. Algaoud and Lewis (2007), 38

²¹ cf. Pervez (1990), 159-160

²² cf. Mohammed (1988), 115

²³ cf. Mankabady (1989), 199

²⁴ cf. Ayub (2007), 419

²⁵ cf. Abdul Rahim et al. (2007), 374

the amount of indemnity to be paid and the time of occurrence of a loss.²⁶ Furthermore, risk can be defined as uncertainty of loss and represents consequently already by nature a kind of *gharar*. Putting risk as the subject matter of a contract of exchange, as it is the case in conventional insurance, is therefore unlawful.²⁷

Nevertheless, most *Shariah* scholars start recognizing that actuarial work entails social benefits, and relate *gharar* now to legal or contractual uncertainty, not to uncertain outcomes.²⁸ *Dharura* (necessity) and *maslaha* (public interest) are also accepted grounds of justification in Islamic jurisprudence that render prohibited things permissible. In modern life, insurance conforms to the requirements of *dharura* as long as there is no viable alternative. In this case, however, the level of uncertainty and ignorance in an insurance contract has to be reduced as effectively as possible.²⁹

2.2. *Maisir* (speculation)

The Arabic word *maisir* stands for getting something too easily or taking profits without working for it. *Maisir* is therefore linked to gambling and speculation.³⁰ Conventional insurance involves *maisir* because policyholders are considered to be betting premiums on the condition that the insurer has to pay an amount of indemnity in case of a specified event. The insurance company, in turn, can be regarded as basing its fortune on good or bad luck of the policyholders.³¹

Generally, *maisir* is present in transactions entailing unnecessary risk in the spirit of speculation, which is the case in insurance whenever indemnities exceed premiums and vice versa.³² However, some jurists dissent the accusation that insurance involves *maisir*. According to them, the financial motivation for insurance is rather the desire for protection against loss than achieving gain from speculation.³³

²⁶ cf. Billah and Patel (2003), 5

²⁷ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 152

²⁸ cf. R. Wilson, *Concerns and misconceptions in the provision of takaful*, in: Jaffer (2007), 73

²⁹ cf. Rashid (1993), 23

³⁰ cf. Mohammed (1988), 121

³¹ cf. Munich Re Group (2008), 10

³² cf. Mahmood (1991), 284

³³ cf. Al-Ghadyan (1999), 334

2.3. *Riba* (interest)

Riba is explicitly forbidden in four different verses in the *Qur'an*. It is also stated in it that those who neglect the prohibition of interest are at war with God and his Prophet Muhammad.³⁴ Even though there is no specific justification for the prohibition of *riba* in the *Qur'an*, there is consent among Muslim scholars that *riba* is unlawful because it poses a source of social, economic and moral evil and therewith contradicts the Islamic principle of brotherhood.³⁵

In conventional insurance, *riba* occurs twofold – directly and indirectly. On the one hand, it is directly involved since the amounts of premiums and claims paid differ usually. On the other hand, there is an indirect involvement by reason of interest-based investment activities of the insurance companies.³⁶

Furthermore, there is a strict code of ethical investment required in Islamic finance. As a result, investing in *haram* activities or items, such as alcohol or pork meat, is unlawful under the *Shariah*.³⁷ Especially life insurance policies include a significant investment or savings element, and the insurance companies carry on their business by investing collected premiums in a mix of investments including interest-based finance and prohibited industries.³⁸

³⁴ cf. Algaoud and Lewis (2007), 39-41

³⁵ cf. Mahmood (1991), 282

³⁶ cf. Ayub (2007), 419

³⁷ cf. Algaoud and Lewis (2007), 39

³⁸ cf. Abdul Rahim et al. (2007), 375

3. Fundamentals of takaful

In order to align insurance with Islamic principles and to avoid the elements of *gharar*, *maisir* as well as *riba*, *Shariah* scholars recommend the concept of *takaful*. As defined in the Malaysian Takaful Act of 1984, *takaful* refers to “a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose”.³⁹ *Takaful* business is further characterized as a business “whose aims and operations do not involve any element which is not approved by the *Shariah*”.⁴⁰

In this sense, *takaful* should be based on the concept of risk pooling under inclusion of a professional services manager who charges for his services but does not take profit from insurance activities.⁴¹ From the policyholders’ point of view, mutual help is the major goal of *takaful*. Considering though that it represents a business venture, the operator is entitled to take fees and/or to share in profits in return for its services.⁴² The role of the insurance company therefore basically changes from a risk bearer to a risk manager.⁴³ Consequently, the profit for the *takaful* company should emerge from risk management and not from risk taking.⁴⁴

There are two principal steps to be taken to circumvent the *Shariah* problematic of conventional insurance. Firstly, instead of transferring risk to the insurer, a mutual structure is adopted for underwriting the insured risks. Put more simply, the participants (policyholders) mutually insure one another according to the principle of solidarity. Secondly, the contributions paid (premiums) are characterized as conditional and irrevocable donation (principle of *tabarru*). That means the participant makes a donation to the risk fund on condition of being entitled to benefit from mutual protection against insured losses.⁴⁵ In the following paragraphs, the fundamentals of *takaful* are explained in more detail.

³⁹ Takaful Act 1984, Art.2

⁴⁰ Takaful Act 1984, Art.2

⁴¹ cf. Munich Re Group (2008), 12

⁴² cf. Ayub (2007), 422

⁴³ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 153

⁴⁴ cf. Abdul Rahim et al. (2007), 376

⁴⁵ cf. Archer et al. (2009), 1-2

3.1. Hybrid structure

As Islamic insurance operates on the basis of shared responsibility, joint indemnity, common interest and solidarity, the fundamental philosophy of *takaful* can be compared to cooperative or mutual insurance whereby participants pool their funds together to insure one another.⁴⁶ Due to this similarity, it would seem natural to form a *takaful* undertaking as cooperative entity.⁴⁷ However, there are two obstacles for an establishment as pure mutual. First of all, the legal framework in many countries does not allow for cooperatives without share capital. And second, even where the legal infrastructure is available, it proves exceedingly difficult to raise enough capital to meet regulatory capital adequacy and solvency requirements.⁴⁸

To surmount these obstacles, a typical *takaful* undertaking operates on the basis of a two-tier structure that is a hybrid of a mutual and a commercial form of company.⁴⁹ The risk funds of the policyholders operate on a mutual basis, but are managed by a *takaful* operator which is a company with shareholders. Key role of the stock company with shareholders' funds is the provision of capital backing for underwriting to meet solvency requirements.⁵⁰ A *takaful* undertaking which is based on a commercial contract between the *takaful* operator and the participants, where the operator is expected to make profit, is also sometimes referred to as *tejari* model in literature.⁵¹

Due to the hybrid structure, there are two main stakeholders in a *takaful* undertaking, namely shareholders and policyholders.

3.2. Main stakeholders

Takaful participants (TPs) are policyholders of Islamic insurance who participate in a *Shariah* compliant undertaking of mutual risk cover. They pay contractually fixed contributions to the *participants' takaful fund* (PTF). This fund constitutes a separate risk fund or underwriting pool from which compensations and operating expenses are

⁴⁶ cf. Billah and Patel (2003), 5

⁴⁷ cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 69

⁴⁸ cf. Archer et al. (2009), 58

⁴⁹ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 170

⁵⁰ cf. Archer et al. (2009), 288

⁵¹ cf. Mortuza Ali (2006), 3

financed.⁵² The TPs are together the owners to the fund. The amount paid by the participant is not a premium in the conventional sense. The participant brings its risk into the pool and pays a specific amount which is equivalent to the risk brought in.⁵³ Not everybody who contributes to the PTF gets any compensation in return. Payments of indemnity depend ultimately on the occurrence of certain insured events against which the risk fund is established.⁵⁴ The monetary value of claims in the event of loss is also specified in the contract. Participants receive underwriting surpluses and investment profits and should therefore also bear deficits and losses.⁵⁵ The *takaful operator (TO)* represents the legal entity that initiates and manages the *takaful* fund.⁵⁶ It appears as a commercial management company with its own share capital and reserves.⁵⁷ The TO manages merely underwriting and investments by order of the TPs.⁵⁸ For these services rendered for and on behalf of the policyholders, the operator is entitled to a remuneration.⁵⁹ Depending on the business model applied, the TO serves either as agent (*wakeel*) for the TPs, as entrepreneur (*mudarib*) or as both agent and entrepreneur. In all the cases, the operator does not have any ownership rights of the *takaful* fund.⁶⁰

3.3. Concept of *tabarru'*

Due to the prohibition of *gharar*, a commercial contract has to be free from uncertainties regarding rights and liabilities of the parties.⁶¹ Conventional insurance involves unavoidable uncertainty as it is premised on the exchange of premiums for future indemnities in the case of specified events.⁶² Since uncertainties cannot be removed completely from insurance, *takaful* takes advantage of a type of contract which can tolerate the presence of *gharar* and is valid and enforceable in Islamic law. This contract is based on the concept of *tabarru'* and can be categorised as a unilateral declaration of intent that leads to a transfer of ownership to another party

⁵² cf. Archer et al. (2009), 11

⁵³ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 153

⁵⁴ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 32

⁵⁵ cf. Archer et al. (2009), 11

⁵⁶ cf. A. Murray, *Issues in Rating Takaful Companies*, in: Archer et al. (2009), 239

⁵⁷ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 154

⁵⁸ cf. Archer et al. (2009), 11

⁵⁹ cf. E. Hassan and A. Rohayem, *Transparency and Financial Reporting in Islamic Insurance*, in: Archer et al. (2009), 270

⁶⁰ cf. Patel (2009), 5

⁶¹ cf. Ayub (2007), 421

⁶² cf. Archer et al. (2009), 9

without the need for the recipient to pay any consideration.⁶³ The Arabic word *tabarru'* stands in general for donation, contribution or gift. Related to *takaful*, it means a voluntary individual contribution to a risk pool.⁶⁴

In commercial contracts, such as sale or lease, one party may be put at disadvantage due to elements of *gharar*. But for one-sided transfers, the requirement of certainty is irrelevant as its realization is based on the goodwill of the donor. Purpose of the donation contract is to benefit the recipient without any predetermined consideration in return. In *takaful*, it implies that a participant donates some money to give favour to the other participants according to agreed terms and conditions.⁶⁵ Overall what makes *gharar* acceptable in Islamic insurance is that *tabarru'* contributions aim at risk pooling not at taking profit from uncertainty.⁶⁶

However, it has to be mentioned that the motivation of a participant for donating his money into a risk pool is neither altruism nor the well-being of others. The TP rather expects to be indemnified himself in the case of damage or loss. That is to say, participants donate their contributions to the *takaful* fund on condition to be also compensated from the risk pool if they suffer a loss as specified in the contract.⁶⁷ This raises the question whether a donation can be made conditional upon consideration. A conditional gift for consideration exists in Islamic commercial law and is, according to Islamic jurisprudence, also in line with the *Shariah*. Donating something with the prospect of benefitting perhaps afterwards of it cannot be regarded as unlawful. It is not sure whether the donor makes ever a claim and even though he makes a claim, the indemnity is paid out of a common pool where moneys are mixed and in the end inseparable.⁶⁸

3.4. General versus family *takaful*

As also classified by the Takaful Act of Malaysia of 1984, there are two main lines of Islamic insurance, namely general (non-life) and family (life) *takaful*.⁶⁹ General *takaful* covers losses accruing out of personal accidents and property damage. Family

⁶³ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 35

⁶⁴ cf. M.T. Ahmad Nordin, *Strengths and opportunities of takaful: the spiritual dimension*, in: Jaffer (2007), 156

⁶⁵ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 35-36

⁶⁶ cf. R. Wilson, *Concerns and misconceptions in the provision of takaful*, in: Jaffer (2007), 76

⁶⁷ cf. Archer et al. (2009), 9

⁶⁸ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 36-37

⁶⁹ cf. Takaful Act 1984, Art.3(1)

takaful represents the *Shariah* compliant alternative to life insurance. Its aims are threefold. First of all, it should encourage participants to save regularly. Secondly, it allows for investment in line with Islamic principles. And in the third place, it provides protection to the heirs of TPs who die prematurely.⁷⁰ Besides long-term life insurance plans, family *takaful* offers as well medical and health, accident and education plans.⁷¹

In the case of non-life *takaful*, the entire contribution of a TP is treated as a donation for protection purposes and paid into the PTF. Due to the *tabarru'* contract, the participant loses his individual ownership rights in favour of the *takaful* fund. All participants own the risk fund collectively and the underwriting surplus belongs to them. In case of a deficit, the *takaful* company provides a *qard hasan* (interest-free loan) to the fund. Each TP has the right to claim from the *takaful* fund in certain cases which are specified in the contract.⁷²

In life business, the contribution incorporates a savings or investment element in addition to the risk protection element. The savings component is not a donation into the collective risk pool, but a payment into a separate investment fund referred to as *participants' investment fund* (PIF).⁷³ In contrast to the risk fund, the ownership rights of the investment funds remain with each participant individually. In general, contributions in family *takaful* can be looked upon more as an investment than a donation since the investment part for generating returns is usually much larger than the protection part.⁷⁴ Consequently, the *takaful* operator⁷⁵ is especially in charge of the profitable investment of contributions on behalf of the TPs.⁷⁵

3.5. Qard hasan

In *takaful*, there is the contingency that the actual amount of claims exceeds the amount available in the risk fund, that is to say, the risk pool runs into deficit. Therefore the question arises, who is liable for the deficit. Since the TPs hold

⁷⁰ cf. Mahmood (1991), 288

⁷¹ cf. Morgan Stanley (2008), 7

⁷² cf. Ayub (2007), 422-423

⁷³ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 170

⁷⁴ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 38-39

⁷⁵ cf. Archer et al. (2009), 11-12

collectively the ownership rights of the risk fund and the TO is merely its custodian, it suggests itself that the participants also have to cover the deficit.⁷⁶

Nevertheless, coverage through the participants is only possible by the means of future contributions, and future contributions do not solve the problem of immediate insolvency. For that reason, the TO is expected to provide an interest-free loan referred to as *qard hasan*, which can be recovered from future contributions by the participants.⁷⁷ Since the loan increases liabilities of the risk fund contemporaneously with the assets, it does not clear the deficit but it provides liquidity so as to obligations of the fund can be fulfilled.

In most countries, the financial regulatory authority forces *takaful* operators to provide a *qard hasan* when underwriting leads to a deficit in the risk pool.⁷⁸ However, not all present Takaful Acts stipulate explicitly the obligation of a TO to grant a *qard hasan* facility. Even so, such a facility is very visible and useful for rating agencies. It indicates that interests of participants are protected in case of a deficit in the *takaful* fund due to the availability of sufficient shareholders' funds.⁷⁹

3.6. Shariah Board

The operations of a *takaful* undertaking are monitored by an independent body referred to as Shariah Supervisory Board or Council. The establishment of a Shariah Supervisory Board is a precondition for the commencement of a *takaful* corporation.⁸⁰ The Shariah Board is composed of internal or external religious advisors, and it ensures the adherence to *Shariah* rules and principles throughout the operations of a *takaful* undertaking.⁸¹

Nevertheless, in most jurisdictions, there is a lack in explicit legal support for the establishment of Shariah Councils and decent rules to ensure their integrity are absent. As a result, the effectiveness and enforceability of contracts employed by the TO as well as the legality of its practices can be challenged. Furthermore, only in few jurisdictions, there is a central Shariah Board in existence. However, a general

⁷⁶ cf. Archer et al. (2009), 10

⁷⁷ cf. Fitch Ratings (2007), 16

⁷⁸ cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 78-79

⁷⁹ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 40

⁸⁰ cf. Swartz and Coetzer (2010), 336

⁸¹ cf. Fitch Ratings (2007), 17

authority functioning as the highest Shariah Board could ensure a consistent opinion on Islamic insurance issues and with it avoid confusion among consumers. A central Shariah Council could as well provide substantial legal corroboration in order to enforce *Shariah* compliance in courts.⁸²

⁸² cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 80-81

4. Comparison to conventional insurance

In conventional insurance, the insurer provides indemnity in return for a certain amount of money which is called premium and paid by the insured.⁸³ By the use of insurance, the insured transfers his risk to the insurance company. In doing so, the insured replaces uncertainty with certainty at the expense of the premium paid.⁸⁴ The premium is determined by the frequency and severity of the risk as well as by the sum insured. The insurance company receives commercial gain from both underwriting surplus and return on investment. In summary, conventional proprietary insurance can be regarded as business of selling protection for money to the amount of the premium.⁸⁵

One of the key differences between *takaful* and conventional insurance is that Islamic insurance is based on risk sharing instead of risk transfer. *Takaful* participants mutually insure each other by the means of a collective risk pool. Whereas in conventional insurance the insurance company is exclusively held responsible for paying all the claims, this obligation lies within the risk fund in the case of *takaful*.⁸⁶ Merely in cases where claims exceed contributions as well as reserves accumulated in the risk fund, the TO may be under obligation to provide a *qard hasan* which has to be paid back by the participants out of future contributions (as explained under section 3.5.).⁸⁷

The risk pool is owned jointly by all participants who share profits and bear deficits of the *takaful* undertaking. As the TO does not take over risk like a conventional insurance company, it should not be viewed as an insurer but rather as an operator who manages the *takaful* operations, including in particular underwriting, risk calculation, investments and claim processing.⁸⁸ In consequence, the TO generates income from fees and/or profit-sharing determined by the business model applied. For a conventional insurer in contrast, the underwriting surplus makes for the principal source of profit.⁸⁹

⁸³ cf. Morgan Stanley (2009), 14

⁸⁴ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 152

⁸⁵ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 31-33

⁸⁶ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 172

⁸⁷ cf. Oliver Wyman (2007), 7

⁸⁸ cf. Tolefat (2006), 1

⁸⁹ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 31-34

Another decisive difference to conventional insurance is that all *takaful* products and operations must be thoroughly *Shariah* compliant. Conventional insurers make an extensive use of interest-based investments and do not take note of *haram* activities.⁹⁰ Islamic insurers, in contrast, oblige to undertake solely interest-free, *Shariah* justified investments. Investment profit cannot be based on any unethical commercial activity. Investments in gambling institutions, alcohol businesses or arms production are, for instance, explicitly prohibited.⁹¹

In order to render Islamic insurance permissible, the concept of *tabarru'* is employed. While in conventional insurance a simple exchange contract of sale and purchase is applied between the insured and the insurer, *takaful* makes use of a donation contract to allow for *Shariah* conformity (see section 3.3.).⁹² As a result, TPs pay contributions in form of a conditional donation instead of premiums. In this manner, Islamic insurance eliminates the issues of *gharar* and *maisir* which are present in conventional insurance.⁹³

Transparency is also a crucial principle of the whole *takaful* system. It is essential in all Islamic insurance models that participants' and shareholders' funds are separated.⁹⁴ Different risk and investment pools are as well segregated from each other. Hence, underwriting surpluses and deficits cannot be transferred between different pools. In conventional insurance, the underwriting surplus belongs to the company with the result that there is generally no severe differentiation between pools.⁹⁵

Stimulated by the desire to maximize profit for shareholders, the risk premium is commercially driven in conventional insurance. In *takaful* however, an underwriting deficit is first of all absorbed by reserves, then by a *qard hasan* facility, and lastly by a general increase in contributions. Irrespective of the amount of premium, the underwriting surplus is shared between the TPs commensurate with their contributions. That way, overpriced premiums of conventional insurers can be

⁹⁰ cf. Farooq et al. (2010), 58

⁹¹ cf. Billah and Patel (2003), 8

⁹² cf. Ernst & Young (2011), 6

⁹³ cf. Fitch Ratings (2007), 14

⁹⁴ cf. Tolefat (2006), 1

⁹⁵ cf. E. Hassan and A. Rohayem, *Transparency and Financial Reporting in Islamic Insurance*, in: Archer et al. (2009), 271

studiously avoided. The concept of *takaful* promotes therefore adequacy and incorporates the rules of equity, justice and ethics into the profit element.⁹⁶

To be pointed out explicitly, conventional insurance and *takaful* employ a different terminology as already used largely in the preceding parts. Whereas an insured in conventional insurance is called policyholder, he is referred to as participant or *takaful* participant (TP) in Islamic insurance. The insurance company per se represents an operator not an insurer and is therefore labelled as *takaful* operator (TO). In *takaful*, participants do not pay premiums but rather contributions or donations with the concept of *tabarru'* in mind. Table 1 summarizes once again the main differences between conventional and Islamic insurance.

Table 1: Main differences between conventional insurance and *takaful*

	Conventional insurance	Takaful
Role of insurance company	insurer	operator / risk manager
Approach to risk	risk transfer	risk sharing
Contractual basis	contract of exchange	contract of <i>tabarru'</i>
Obligation to pay claims	insurance company	<i>takaful</i> fund
Underwriting surplus	belongs to shareholders	belongs to participants; (might be shared with TO under <i>mudarabah</i> arrangement or part of it given to TO as incentive fee)
Underwriting deficit	borne by shareholders	borne by participants; solely <i>qard hasan</i> by TO
Risk premium	commercially driven	calculated on ethical principals and transparency
Investment activities	no restrictions	<i>Shariah</i> compliant
Principal source of profit for insurance company	underwriting surplus	fees and/or profit sharing

⁹⁶ cf. Ayub (2007), 427

5. Business models

There are different *takaful* models in practice around the world and *Shariah* scholars have raised various concerns pertaining to each model.⁹⁷ Every model implies distinct rights and obligations between the TO and the TPs. However, all business models pursue the same goal of sharing individual risks collectively for the purpose of reducing the risk exposure of each individual participant against a specified loss. There is no evident legal advantage of one business model to another. Consequently, *takaful* operators base their decision of which business model to adopt rather on its economic viability than on its legal factors.⁹⁸ In some jurisdiction, there are also regulatory restrictions concerning the applicability of business models.

At a global level, there are two standard models applied, namely the *mudarabah* model and the *wakalah* model. Another model prevalent in practice is the combination of these two models. The fourth and most recent model gaining popularity constitutes the *waqf* model.⁹⁹ In principle, these business models differ solely in the kind of remuneration of the TO. All models are built upon the main idea of *tabarru'* and all of them are in complete accordance regarding the relationship among TPs. What makes the difference is the definition of the relationship between the operator and the participants.¹⁰⁰

Under the *mudarabah* model, the TO represents an entrepreneur and the TPs provide the capital required. This model implies that profits are shared between the operator and the participants. Pursuant to the *wakalah* model, the TO acts as agent on behalf of the participants. Under this contract, the operator receives a fee in return for its services. In the combined model, a *wakalah* arrangement is used concerning underwriting business whereas in terms of investment activities a *mudarabah* contract is applied. Consequently the TO is remunerated by a fee for underwriting but shares in also the upside of investment profits.¹⁰¹ In terms of the *waqf* model, the relationship between the operator and the TPs is established via a trust, or more specifically via the *waqf* fund. The trust is initially created by a part of the

⁹⁷ cf. Abdul Rahim et al. (2007), 377

⁹⁸ cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 68-69

⁹⁹ cf. Archer et al. (2009), 13

¹⁰⁰ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 153

¹⁰¹ cf. Fitch Ratings (2007), 15-16

shareholders' fund.¹⁰² The combined model is then applied for underwriting and investment.¹⁰³ Table 2 gives an overview on these four different business models and their respective characteristics. In the following, each model is explained and discussed in detail.

It has to be mentioned that there is no consistent terminology in literature in respect to business models. For instance, some authors designate the combined model as *wakalah* model. The prefixed terms 'pure' and 'modified', signifying variations of the same model, can be switched also depending on the interpretation of the author. In the following, the prevailing terminology is used.¹⁰⁴

5.1. *Mudarabah* model

The *mudarabah* model, which is also known as profit-sharing model, is based on a principal-manager agreement.¹⁰⁵ It was introduced in the Malaysian market in 1984,¹⁰⁶ and is now mainly applied in the Asia-Pacific region.¹⁰⁷

5.1.1. Basics of the *mudarabah* model

In this model, the *takaful* participants appear as capital providers (*rabb al maal*). The TO acts as entrepreneur (*mudarib*) who provides the skills required for managing the capital, or more specifically the risk funds and in the case of family *takaful* as well the investment funds. The operator is solely the manager of the funds which are owned by the TPs. The profit generated by the *takaful* operation is shared between the participants and the operator in a pre-agreed ratio, like 60:40 or 50:50 for example. The ratio has to be approved by the Shariah Board of the *takaful* undertaking each year in advance.¹⁰⁸ Although profits are shared according to the *mudarabah* contract, losses are solely borne by the participants as *rabb al maal*. However, in this case, the efforts of the operator as *mudarib* remain also uncompensated. Furthermore the TO is expected to provide a *qard hasan* to a risk fund in deficit.¹⁰⁹

¹⁰² cf. PricewaterhouseCoopers (2008), 7

¹⁰³ cf. Ernst & Young (2011), 38

¹⁰⁴ at the author's discretion

¹⁰⁵ cf. Morgan Stanley (2009), 18

¹⁰⁶ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 156

¹⁰⁷ cf. Ayub (2007), 424

¹⁰⁸ cf. Farooq et al. (2010), 59

¹⁰⁹ cf. Archer et al. (2009), 14

Table 2: Overview business models

		<i>Mudarabah</i> model	<i>Wakalah</i> model	Combined model	<i>Waqf</i> model
Relationship between TO and TPs		principal-manager arrangement → <i>mudarabah</i>	principal-agent arrangement → <i>wakalah</i>	<i>Wakalah</i> for underwriting; <i>mudarabah</i> for investment	risk fund: relationship via <i>waqf</i> ; investment fund: <i>mudarabah</i>
Remuneration for TO		profit-sharing	management fee (<i>wakalah</i> fee)	management fee for underwriting; profit-sharing for investment	management fee for underwriting; profit-sharing for investment
PTF	Creation	through contributions of <i>takaful</i> participants			through initial donation by shareholders
	Ownership	collectively by all <i>takaful</i> participants			<i>waqf</i> entity
PIF	Creation	through contributions of <i>takaful</i> participants			
	Ownership	by each participant individually			
Underwriting surplus		shared between TPs and TO	belongs to TPs	belongs to TPs	belongs to <i>waqf</i> fund; can be allocated to TPs
Underwriting deficit		<i>qard hasan</i> (interest-free loan) → obligation of participants to pay back loan			<i>qard hasan</i> by TO → obligation of <i>waqf</i>
Investment profit		shared between TPs and TO	belongs to TPs	shared between TPs and TO	shared between <i>waqf</i> and TO

Remark: In this overview, both the *mudarabah* and the *wakalah* model refer to its pure form of appearance. The shown characteristics of each model correspond to the detailed description of chapter 5.

In a pure *mudarabah* model, profits can be considered as investment profit plus underwriting surplus, just as in conventional insurance.¹¹⁰ However, there are severe objections by *Shariah* scholars in taking underwriting excess for profit. Consequently, there are also *mudarabah* models in practice referring profit exclusively to investment income.¹¹¹ Those models are well practicable in family *takaful* where the investment part dominates heavily. But in general *takaful*, a *mudarabah* model without profit-sharing in underwriting surplus is virtually not workable since the proportion available for generating investment profits is relatively small.¹¹²

5.1.2. Procedure of the *mudarabah* model

With reference to a pure *mudarabah* model in general *takaful*, the contributions of participants as well as the investment income are first of all used to compensate for claims, *retakaful* expenditures, reserves and other claims-related costs. The remaining amount constitutes the surplus which is shared between the TPs and the operator or respectively the shareholders. In the case there is a deficit, the TO has to provide a *qard hasan* to the participants. Expenses from running the business, that is to say all management and marketing-related expenses should be covered by the shareholders in return for their share in the underwriting excess and investment profit.¹¹³ Hence, shareholders can only realize profit when their share in the total surplus exceeds the expenses of managing the *takaful* undertaking. However, there are also *mudarabah* arrangements that enable operators to charge their operational costs to the *takaful* fund before the total surplus is calculated.¹¹⁴ This practice is not in line, though, with the concept of *mudarabah*.¹¹⁵ Figure 1 illustrates the pure *mudarabah* model in general *takaful*. Figure 2 shows the structure and procedure in family *takaful*.

5.1.3. Discussion of the *mudarabah* model

From the operator's perspective, the breakeven point is achieved relatively late under the *mudarabah* model since it takes time to gather sufficient assets for a decent

¹¹⁰ cf. Ayub (2007), 424

¹¹¹ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 182

¹¹² cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 43-44

¹¹³ cf. Abdul Rahim et al. (2007), 378-379

¹¹⁴ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 182

¹¹⁵ cf. Ayub (2007), 426

Figure 1: *Mudarabah* model in general *takaful*

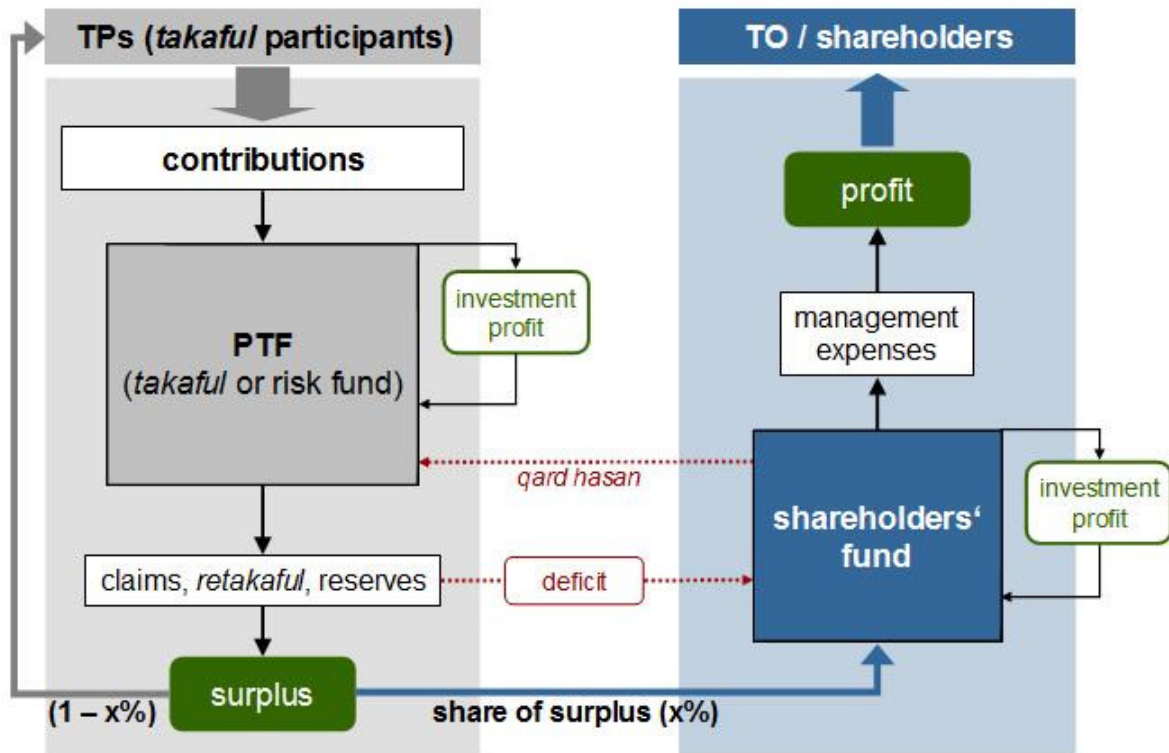
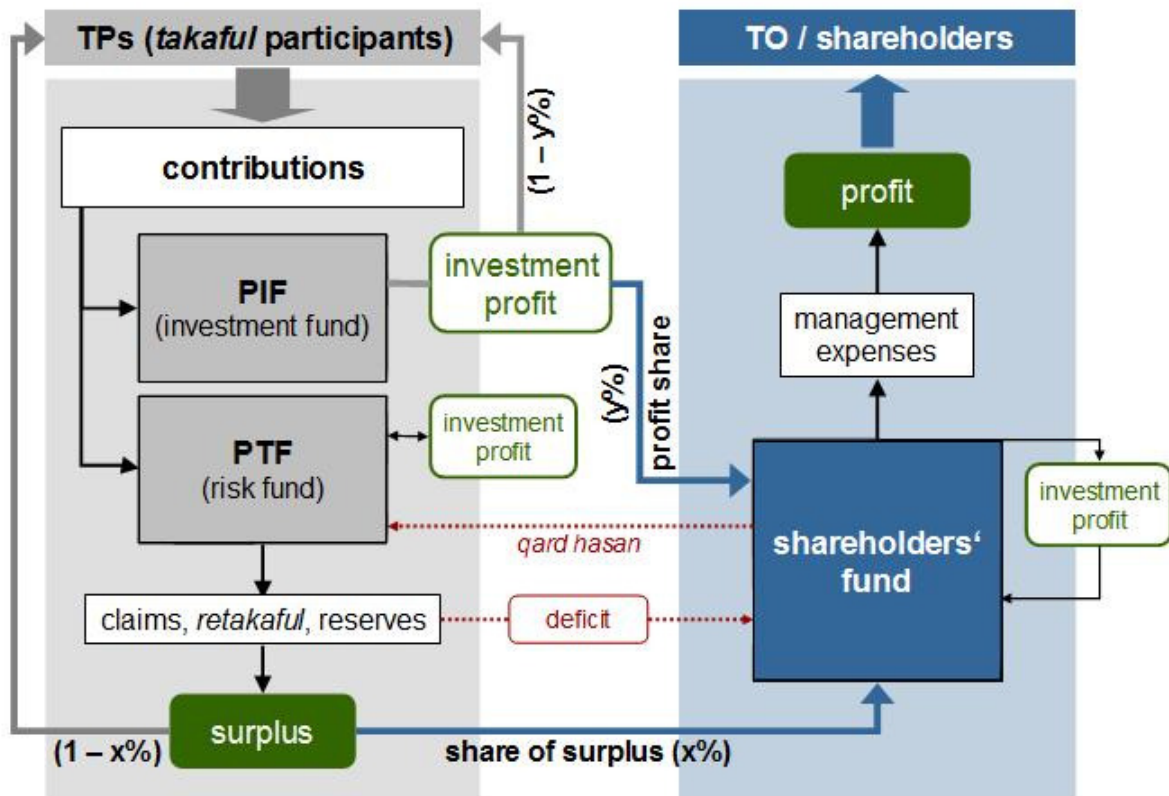


Figure 2: *Mudarabah* model in family *takaful*



investment income.¹¹⁶ The profit for shareholders is also comparatively volatile. However, the returns realized are also frequently higher than in other business models.¹¹⁷ Concerning the TPs, this model can be regarded as a very sound model. Under a usual *mudarah* arrangement, the participants do not account for the operator's expenses directly. All their contributions are in the first place provided to satisfy claims. Merely, if there is an underwriting surplus, the TO is compensated. And only when its share in the surplus or rather the surplus itself is sufficient, the operator takes profits.¹¹⁸ There are though several concerns about Shariah compliancy, especially in respect to the underwriting surplus, of the *mudarah* model for *takaful*.

An objection towards this business model is that contributions in the form of *tabarru'* cannot constitute at the same time *mudarah* capital. The concept of *tabarru'* represents one of the main principles of Islamic insurance. Applying a profit-sharing contract to a risk fund made up of donations can be considered indeed doubtful as it contradicts its initial cooperative nature. Whereas the idea of *mudarah* is eminently suited for Islamic banking, it might not be convenient for *takaful*.¹¹⁹

Another point of issue poses the sharing of underwriting surplus as already mentioned. By sharing in an underwriting surplus, the TO in principle closely resembles a conventional insurance company. In conventional insurance, risk is transferred to the insurer who in turn receives the underwriting surplus, or if necessary bears the deficit. In *takaful*, risk should be pooled and shared among participants so as to any underwriting surplus is due to them. However, in the common *mudarah* model, shareholders are entitled to a share of the underwriting surplus. What it even makes worse is the fact that shareholders only share in an underwriting surplus but do not bear any underwriting deficit.¹²⁰

Apart from the perspective of most *Shariah* scholars why sharing in an underwriting surplus is seriously challenged, there is also an economic argument against it: By participating in an underwriting surplus, the profit of a TO increases in relation to the surplus realized. Consequently, the operator is encouraged to maximize the surplus

¹¹⁶ cf. A. Ayabe, *The development of comprehensive takaful products*, in: Jaffer (2007), 57

¹¹⁷ cf. A. Murray, *Issues in Rating Takaful Companies*, in: Archer et al. (2009), 251

¹¹⁸ cf. Z.A.M. Kassim, *Takaful: a question of surplus*, in: Jaffer (2007), 49

¹¹⁹ cf. Ayub (2007), 424-426

¹²⁰ cf. Abdul Rahim et al. (2007), 380-381

and, by implication, also the level of contributions. From the participants' point of view, however, an underwriting surplus converging towards zero can be considered as optimal, given that an adequate amount of reserves has been accumulated. Surplus is built up if contributions of TPs are fixed above its risk-equivalent and therewith are overpriced.¹²¹

The major concern by *Shariah* scholars in this context is that an underwriting surplus per se does not represent a profit. Accordingly, *mudarabah* or more precisely the concept of profit-sharing can practically not be applied.¹²² Underwriting surplus is the result of contributions less claims, *retakaful* costs, reserves and other operational expenses. Therefore, it should not be considered as profit but as excess due to advantageous conditions leading to fewer claims than usual. A *mudarabah* arrangement aims at generating profit which can be shared between an entrepreneur and the capital providers. As a consequence, the practice of *mudarabah* in connection with underwriting appears questionable as an underwriting surplus by definition is no profit.¹²³

A further issue related to the *mudarabah* model concerns the *qard hasan* facility. In the *mudarabah* business model, the TO is compelled to grant a *qard hasan* in case there is a deficit in the *takaful* fund. This practice contradicts however by definition the idea of *mudarabah* as profit-sharing contract. It can be regarded as irrational that the operator as entrepreneur (or *mudarib*) is expected to be a guarantor for the capital providers.¹²⁴

5.2. *Wakalah* model

The *wakalah* model is grounded on a principal-agent arrangement.¹²⁵ In an agency contract, rights or businesses are delegated to an agent who acts on behalf of someone else. He is in charge of contributing his knowledge, skills and abilities in

¹²¹ cf. Archer et al. (2009), 15

¹²² cf. Z.A.M. Kassim, *Takaful: a question of surplus*, in: Jaffer (2007), 48-49

¹²³ cf. R. Wilson, *Concerns and misconceptions in the provision of takaful*, in: Jaffer (2007), 76

¹²⁴ cf. Ayub (2007), 426

¹²⁵ cf. Securities and Exchange Commission of Pakistan (2010), 27

order to fulfil his duties.¹²⁶ The development of the *wakalah* model started in Sudan and the Middle East,¹²⁷ where it is also still widely used.¹²⁸

5.2.1. Basics of the *wakalah* model

In the *wakalah* model, the TO acts as *wakeel* (agent) at the behest of the participants who assume the role of the principal. They remain also the actual owners of the *takaful* fund. The operator manages both underwriting and investment and is compensated for its services by a contractually pre-agreed fee, referred to as *wakalah* fee. This fee can appear either in the form of an absolute amount or in the form of a percentage. However, a fee on a percentage basis refers to the turnover of contributions or of investment funds, such as 30% of the participants' donations. It may on no account refer to the profit of the *takaful* undertaking, as in the *mudarabah* model. Consequently, the fee which is deducted from the participants' contributions at the outset of a contract has to cover all management expenses as well as the profit for shareholders.¹²⁹ The *wakalah* fee is fixed each year in advance upon approval by the *Shariah* Council of the *takaful* undertaking.¹³⁰

Under a pure *wakalah* contract, all profits resulting from the *takaful* undertaking belong to the TPs who in turn also bear the risk. Accordingly, the shareholders do not share in any underwriting surplus.¹³¹ The investment profit is also due to the participants.¹³² Part of the surplus can be retained as contingency reserve. The remainder should be redistributed to the participants as specified in the contract.¹³³ There are different options permissible as to how surplus is distributed. For instance, it can be paid to all participants in proportion to their contributions or it can be distributed between participants who did not make any claim or alternatively who made claims less valuable than their contributions.¹³⁴ On the off chance that there is an underwriting deficit, the TO is expected to grant a *qard hasan* to the risk fund.¹³⁵

¹²⁶ cf. Abdul Rahim et al. (2007), 381

¹²⁷ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 156

¹²⁸ cf. Stagg-Macey (2007), 1

¹²⁹ cf. Archer et al. (2009), 13

¹³⁰ cf. Farooq et al. (2010), 59

¹³¹ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 43

¹³² cf. Ayub (2007), 424

¹³³ cf. Abdul Rahim et al. (2007), 383

¹³⁴ cf. Sabbagh (2010), 2

¹³⁵ cf. PricewaterhouseCoopers (2008), 8

5.2.2. Procedure of the *wakalah* model

As per the pure *wakalah* model in general *takaful*, first of all, the *wakalah* fee is deducted from the participants' contributions and transferred to the shareholders' account. The remaining amount is assigned to the *takaful* fund and invested in accordance with the *Shariah*. The investment profit is then transferred to the risk fund. The balance of the risk pool is used to cover the operational expenses of the *takaful* undertaking, such as claims, *retakaful* costs, reserves and other claims-related costs. The remainder constitutes the underwriting surplus, which is allocated entirely to the TPs. The TO or respectively the shareholders account for all management and marketing expenses. Consequently, shareholders draw profit when the *wakalah* fee plus the investment income on shareholders' funds exceed expenses from running the business.¹³⁶ Figure 3 shows a flow chart of the pure *wakalah* model for general *takaful*. Figure 4 illustrates the model respectively for family *takaful*.

5.2.3. Discussion of the *wakalah* model

In the case the *wakalah* fee can be matched in accordance to the expense level of the *takaful* undertaking, the capital requirements of the TO can be diminished.¹³⁷ The downside of the pure *wakalah* model is that it proves difficult for the *takaful* company to take profits unless the *wakalah* fee is set at a high level.¹³⁸ Without any incentive system, turnover-related fees also tend to result in that profit-oriented operators only concentrate on increasing the volume of contributions and neglect its performance in underwriting and investment as it has no direct impact on their income.¹³⁹

Therefore, there exists also a *wakalah* model with performance fees. In order to provide an incentive, the operator receives, in addition to the *wakalah* fee, a performance-related fee which is taken off the underwriting surplus. Nevertheless, an underwriting loss would be solely borne by the TPs.¹⁴⁰ From the participants' point of view, a *wakalah* contract with performance elements may be generally preferred to a pure *wakalah* model if the upfront *wakalah* fee is reduced accordingly.¹⁴¹ However,

¹³⁶ cf. Abdul Rahim et al. (2007), 381-383

¹³⁷ cf. A. Murray, *Issues in Rating Takaful Companies*, in: Archer et al. (2009), 251

¹³⁸ cf. R. Wilson, *Concerns and misconceptions in the provision of takaful*, in: Jaffer (2007), 77

¹³⁹ cf. Archer et al. (2009), 13-14

¹⁴⁰ cf. Ayub (2007), 424

¹⁴¹ cf. Z.A.M. Kassim, *Takaful: a question of surplus*, in: Jaffer (2007), 50

Figure 3: Wakalah model in general takaful

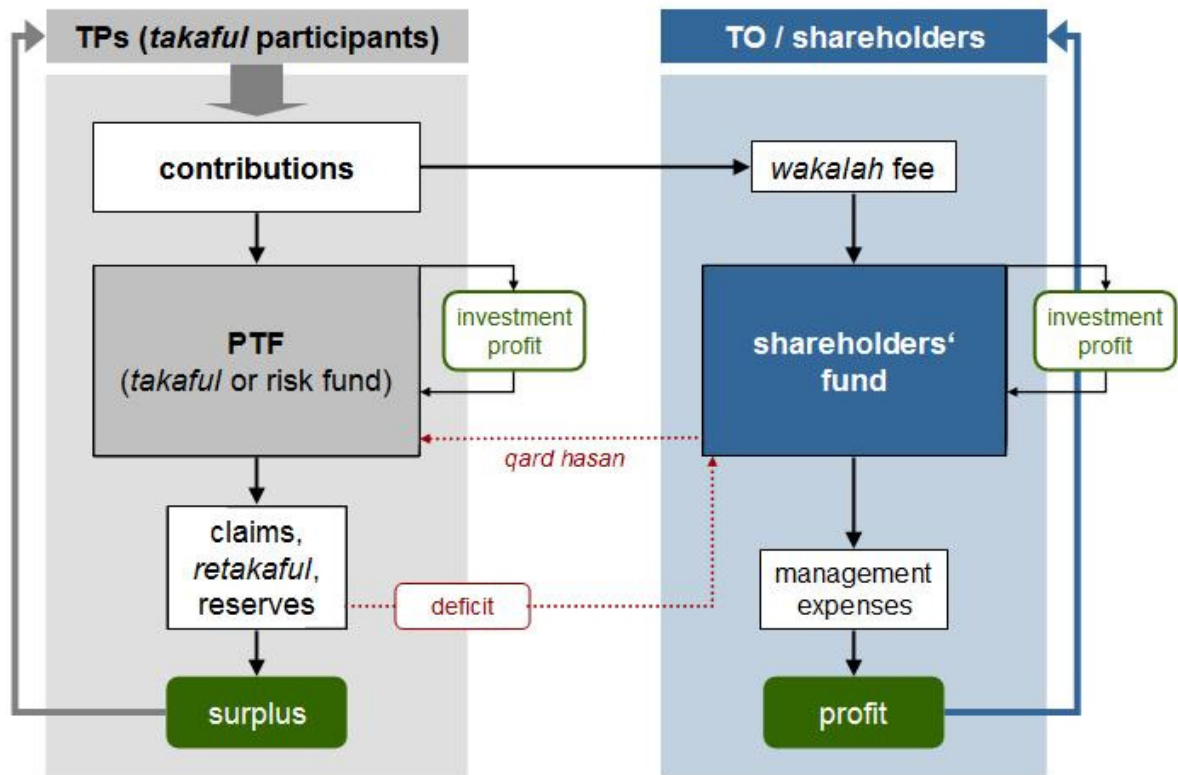
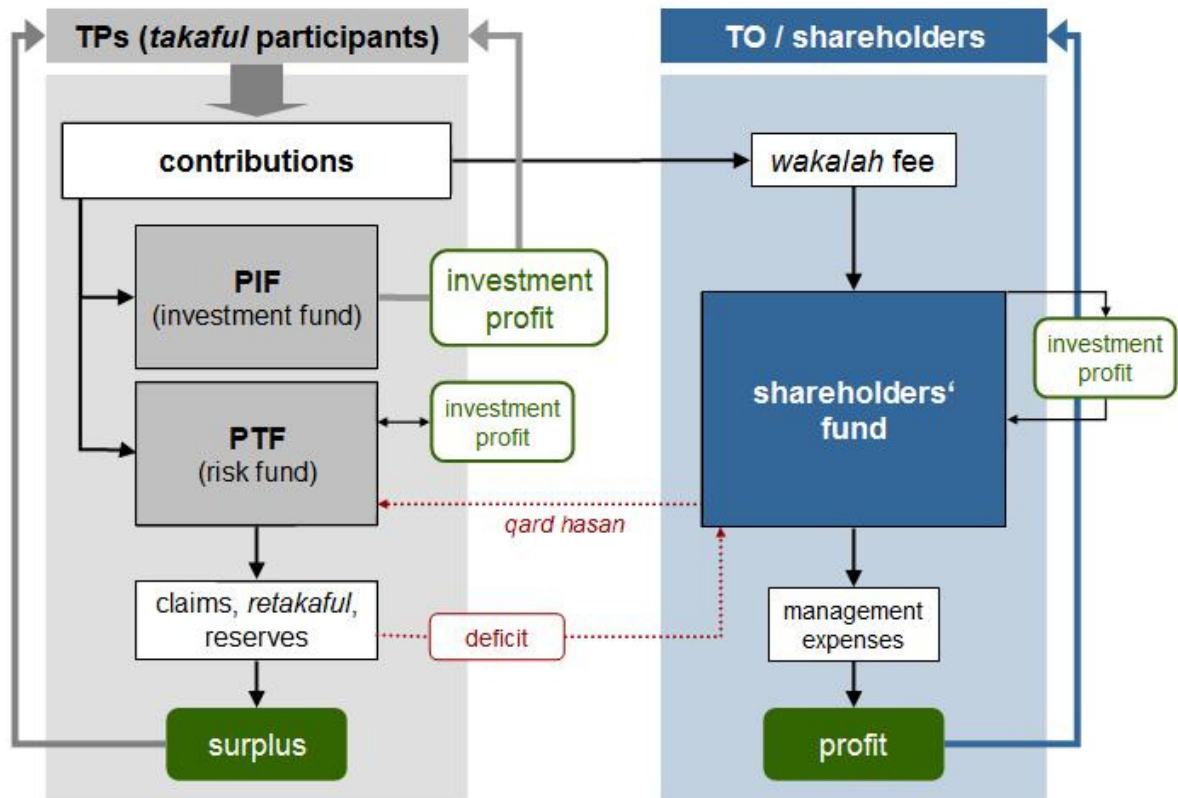


Figure 4: Wakalah model in family takaful



from the perspective of *Shariah* scholars, the modified model leads to a change in the incentive and governance structure. It provokes the same problems as the *mudarabah* model. Many scholars hold that an underwriting surplus as excess of contributions belongs completely to the *takaful* participants. Moreover, if the performance element is set at a high level, operators may be induced to claim higher contributions from TPs.¹⁴² One may argue, however, that providing an incentive to the operator is in the interest of participants as it likely enhances its performance. But in principle the TO is expected as *wakeel* to manage the *takaful* fund as effectively as possible. For that, he receives the *wakalah* fee in return. Besides, if more surplus can be distributed among TPs as a result of excellent management on the part of the TO, more clients may be attracted. More clients, in turn, will increase the overall income of the operator. Under this perspective, the realization of a higher surplus in itself should already represent a performance incentive for the operator.¹⁴³

Shariah scholars also have expressed concerns in respect to the pure *wakalah* model, or more specifically in terms of the *wakalah* fee. The fee for the operator is charged to the PTF generally as a fixed percentage of gross contributions. Contributions are calculated on the basis of a risk premium plus expense margins and profit margins for the operator. In order to be competitively viable, insurance companies (or TOs) may need to be price-competitive and give discounts on premiums (or contributions), be it for large clients or due to the importance of certain business lines.¹⁴⁴ This is not problematic in conventional insurance as the whole premium paid by the policyholder belongs to the insurer. In *takaful* though, a distinction has to be made between the single components of contributions since part of it belongs to the participants and part of it is due to the TO. Following realistic scenario may happen otherwise: Contributions are priced competitively in order to attract clients. That means a discount is given to participants. However, the *wakalah* fee in form of a fixed percentage, such as 30% of the participants' donations, is charged unmodified to the risk fund. As a consequence, the funds in the risk pool may not be commensurate to the risk brought into the pool with the result that the pool may run into deficit. Thus, the concern in this respect poses the fixed *wakalah* fee and its impact on the *takaful* fund in a competitive market. It may also bring about

¹⁴² cf. Archer et al. (2009), 13-14

¹⁴³ cf. Abdul Rahim et al. (2007), 383-384

¹⁴⁴ cf. Ayub (2007), 426

issues of inequality among participants which contradicts the concept of *takaful*. It has to be emphasized that this problematic nature can be solved though. The risk premium has to be determined separately in relation to the actual risk and discounts should be given only in terms of expense and profit margins so as to underwriting results do not fluctuate.¹⁴⁵

5.3. Combined model

The combined model, also referred to as *wakalah mudarabah* model, represents the most prevalent business model in Islamic insurance. As the name suggests, this model combines the *wakalah* model for underwriting with the *mudarabah* model for investment.¹⁴⁶ This *takaful* model is also accredited and recommended as standard practice by the AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions).¹⁴⁷

5.3.1. Basics of the combined model

Under the combined model, a *wakalah* arrangement is used for the underwriting business. That is to say, the TO receives a management fee for its underwriting services. In respect to investment activities, a *mudarabah* contract is applied.¹⁴⁸ Funds are basically managed by the operator as *wakeel* but on the principles of *tabarru'* and *mudarabah*, meaning that investment returns are shared.¹⁴⁹ Consequently, in general *takaful*, the profit earned from investing the risk fund is shared between the TO and the participants. In family *takaful*, the operator also shares in the profit generated from the participants' investment funds. To sum up, it can be stated that the operator receives both a *wakalah* fee charged on gross contributions and a share in investment returns. In terms of underwriting surplus, however, there is no profit-sharing.¹⁵⁰

¹⁴⁵ cf. Abdul Rahim et al. (2007), 384-386

¹⁴⁶ cf. Archer et al. (2009), 15

¹⁴⁷ cf. Tolefat (2006), 1

¹⁴⁸ cf. PricewaterhouseCoopers (2008), 9

¹⁴⁹ cf. Abdul Rahim et al. (2007), 381

¹⁵⁰ cf. M.D. Bakar, *Shari'ah Principles Governing Takaful Models*, in: Archer et al. (2009), 43-44

5.3.2. Procedure of the combined model

The components as well as the procedure of the combined model in general *takaful* are illustrated in Figure 5. In family business, the PIF has to be integrated into the model, as shown in Figure 6.

5.3.3. Discussion of the combined model

The combined model avoids the *Shariah* conflict pertaining to *mudarabah* in underwriting. Still, this business model enables the operator to yield equivalent commercial results. Overall, the TO can take advantage of both standard models under this arrangement. From the participants' point of view, however, this *takaful* model entails the potential of maximizing governance issues.¹⁵¹

In the view of Islamic principles, this model cannot solve all issues. *Shariah* scholars have also added generational matters for consideration. Firstly, there appears an intergenerational equity issue due to the accumulation of contingency reserves. In early years, reserves need to be build up so as to a higher percentage of the surplus is retained for prospective contingencies. Since the participants of a risk fund are changing continuously, they may be concerned by an unequal exposure to reserve accumulation. Secondly, there are concerns in respect to the provision of a *qard hasan* by the operator, or more specifically in terms of its repayment. Purpose of an interest-free loan is to solve immediate illiquidity of the *takaful* fund. The loan is then recovered from future contribution by the participants. It is though very likely that the ones who repay the loan are different from the ones who benefited from the loan. This leads again to generational inequality.¹⁵² However, it has to be pointed out that generational issues are not only confined to the combined model, but apply equally to its underlying standard models. Furthermore, it could be argued that generational concerns are not justified under the concept of *tabarru'* or that they are at least of inferior relevance. Contributions are considered as donations for mutual help so as to the equity issue might seem inappropriate.

¹⁵¹ cf. Archer et al. (2009), 15

¹⁵² cf. Abdul Rahim et al. (2007), 386-387

Figure 5: Combined model in general *takaful*

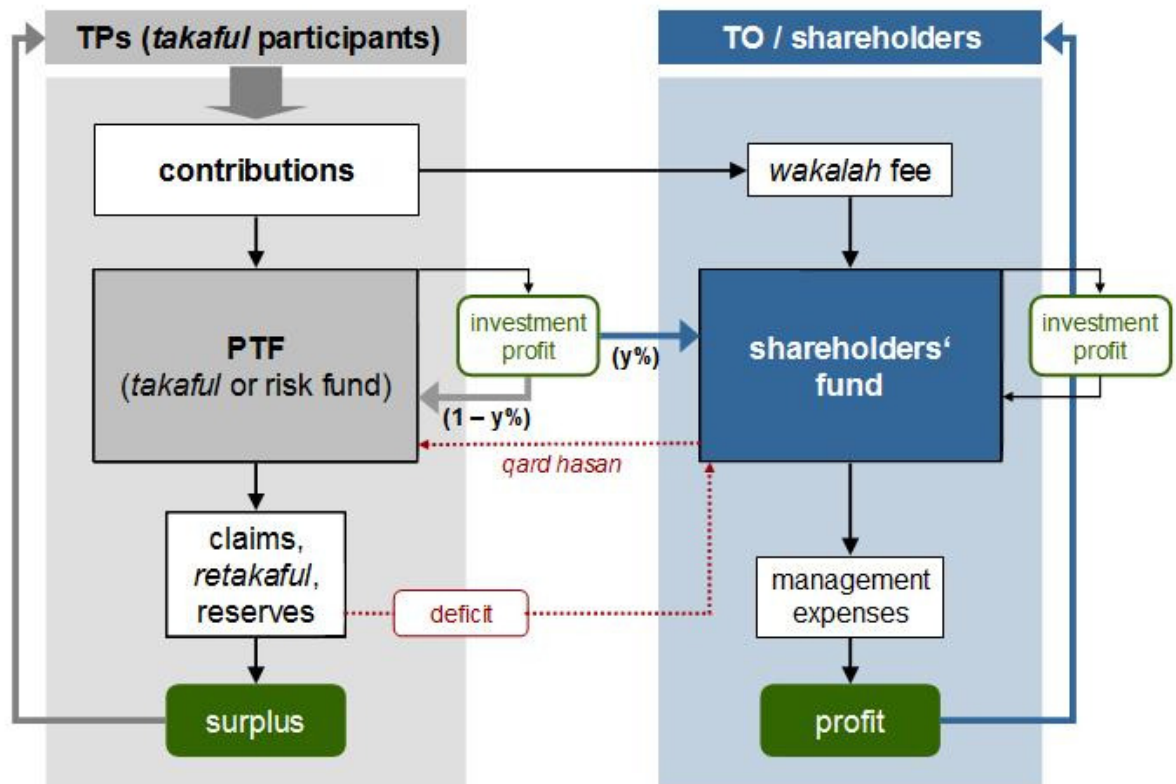
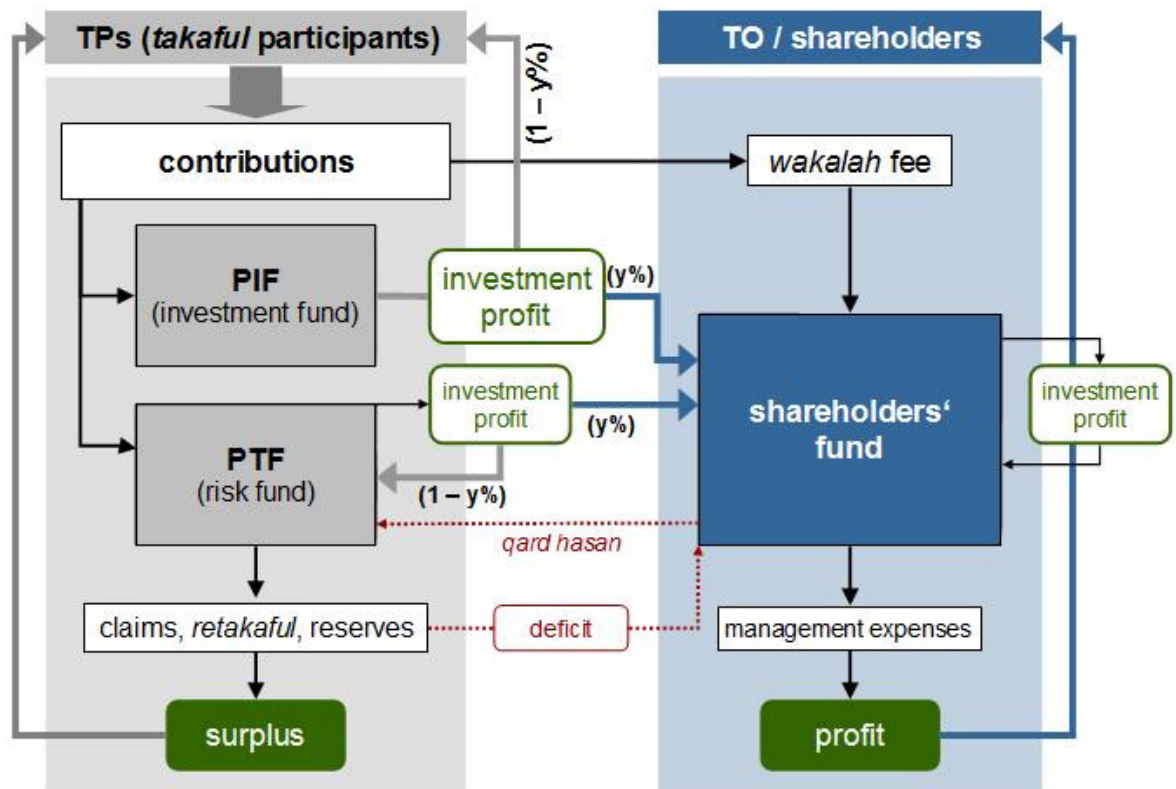


Figure 6: Combined model in family *takaful*



5.4. *Waqf* model

The *waqf* model, also frequently referred to as *wakalah waqf* model, was developed and is practiced in Pakistan. It shows some resemblances to the combined model. The main difference towards the previous models is that, in this business model, the PTF constitutes a separate legal entity in form of a *waqf*. As a consequence, the risk fund belongs neither to the operator nor to the participants. The ownership rights of the *takaful* fund are transferred from the TPs to the *waqf*.¹⁵³ The relationship between the TO and the participants is established via the *waqf* entity.¹⁵⁴

5.4.1. Concept of *waqf*

Waqf is a generally accepted entity in Islamic law which exists since the era of the Prophet. *Waqf* rules are present in most Muslim countries.¹⁵⁵ The Arabic term *waqf* stands for a 'religious endowment'. That means donated assets are detained in order to benefit a charitable purpose or a defined group of people, such as the relatives of the donor.¹⁵⁶ A *waqf* is established as a separate *Shariah* entity which has incorporated the ability of accepting or transferring ownership. The assets of a *waqf* cannot be alienated, but its usufruct can be allocated to the beneficiaries. There is nothing to be said against that members or donors of the *waqf* are beneficiaries themselves. In *takaful*, the beneficiaries of the *waqf* are both the TO who creates the *waqf* and the TPs who contribute for the purpose of mutual protection.¹⁵⁷ Object of the *waqf* is to support participants in the case of a defined loss as required by the regulations of the *waqf* entity.¹⁵⁸

5.4.2. Characteristics and procedure of the *waqf* model

Under the *waqf* model, the shareholders of the TO donate initial capital in order to establish the *waqf* fund as legal personality. The shareholders relinquish their ownership rights immediately after the *waqf* fund is created. Nevertheless, they are entitled to manage the fund,¹⁵⁹ or more precisely to appoint an administrator who

¹⁵³ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 156-157

¹⁵⁴ cf. Farooq et al. (2010), 59

¹⁵⁵ cf. Abdul Rahim et al. (2007), 387

¹⁵⁶ cf. Hashim (2007), 65

¹⁵⁷ cf. Ayub (2007), 421

¹⁵⁸ cf. Archer et al. (2009), 16

¹⁵⁹ cf. Mortuza Ali (2006), 3

manages the fund as *wakeel* on a commercial basis for a fee, and to develop rules and regulations concerning it. For distinct types of risk and with it different lines of *takaful* business several *waqf* funds can be formed. The initial donation of shareholders for each *waqf* fund has to be invested safely and in line with the *Shariah*.¹⁶⁰ To comply with the concept of *waqf*, the initial donation may not be used to settle claims. Solely its investment return is to be used for the benefit of participants.¹⁶¹

The TPs donate their contributions as well to the *waqf* fund whereby they become beneficiaries of the fund as specified in the contract. In general *takaful*, the whole donation remains with the *waqf*. In the case of family *takaful*, contributions are divided into two parts. One part constitutes the risk-related donation for the *waqf* fund; the other part represents the savings element paid into the investment fund.¹⁶² The participants lose likewise their ownership rights of moneys deposited in the *waqf* fund, or more precisely of donations for protection purposes.¹⁶³

Funds are invested on the basis of a *mudarabah* arrangement. That is, the TO acts as *mudarib* and is therefore responsible for the profitable and *Shariah* compliant investment of both *waqf* and investment funds. In respect to the *waqf* fund, the *mudarabah* contract takes place between the TO and the *waqf*, not the participants. Hence, the investment profit arising thereby is shared between the *takaful* company and the fund. Investment funds are managed in the same way as in the *mudarabah* or the combined model.¹⁶⁴

The *waqf* fund compensates for all operational costs like claims and *retakaful* or other operational expenses linked to the *takaful* undertaking. Apart from ordinary technical reserves, the *waqf* fund may accumulate contingency reserves from both contributions and the profit earned on their investment. Reserves as well as investment income realized on it remain assets of the *waqf*.¹⁶⁵ Issues regarding the compensation of claims, the distribution of profits, the remuneration of the operator or the creation of reserves are laid down by the *waqf* fund rules.¹⁶⁶

¹⁶⁰ cf. Abdul Rahim et al. (2007), 387

¹⁶¹ cf. Ernst & Young (2011), 38

¹⁶² cf. Ayub (2007), 424

¹⁶³ cf. Abdul Rahim et al. (2007), 388

¹⁶⁴ cf. Ayub (2007), 424-425

¹⁶⁵ cf. Abdul Rahim et al. (2007), 388-392

¹⁶⁶ cf. Mortuza Ali (2006), 3

The underwriting surplus or deficit is due to the *waqf* fund. There is no obligation to distribute the surplus, but it can be allocated to the participants. Alternatively, an underwriting surplus can be used to accumulate reserves,¹⁶⁷ or to pay back a previously given *qard hasan*. An interest-free loan is given by shareholders in the case of an underwriting deficit in the *waqf* fund. However, the *qard hasan* is granted directly to the *waqf* entity and not to the individuals as in the other business models.¹⁶⁸

Sources of income for the shareholders are the same as under the combined *takaful* model. They receive a management fee which is paid out of the *waqf* fund as well as a proportion of its investment profit and the investment income from shareholders' money. They bear the management expenses of the *takaful* undertaking and the balance constitutes the shareholders' profit (or as the case may be the shareholders' loss).¹⁶⁹

As mentioned previously, the contractual relationship of both participants and the operator is directly with the *waqf* fund. The components and relations of the *waqf* model in general *takaful* are visualized in Figure 7. In family *takaful*, it has to be taken into account that only part of the participants' donation is due to the *waqf* fund. The remainder is paid like in the other models into the participants' investment fund. Figure 8 exemplifies the *waqf* model for life business.

5.4.3. Discussion of the *waqf* model

As against the other business models, the *waqf* model implies legal specificities that induce economic differences with profound conceptual consequences. The key differentiator of the *waqf* model is the transfer of ownership of the participants' donations from the TPs to the *waqf* fund. Consequently, claims are established directly against the *waqf* fund. As participants lose their ownership rights, they are also not directly entitled to the underwriting surplus. Instead the surplus belongs to the *waqf* as separate legal entity. Its appropriation depends therefore on the decision of the TO who manages the *waqf* fund. The participants lose analogously to their rights the obligation to pay further contributions in case of an underwriting deficit.¹⁷⁰

¹⁶⁷ cf. Ayub (2007), 424

¹⁶⁸ cf. Abdul Rahim et al. (2007), 392-394

¹⁶⁹ cf. Ayub (2007), 426

¹⁷⁰ cf. Archer et al. (2009), 16

Figure 7: *Waqf* model in general *takaful*

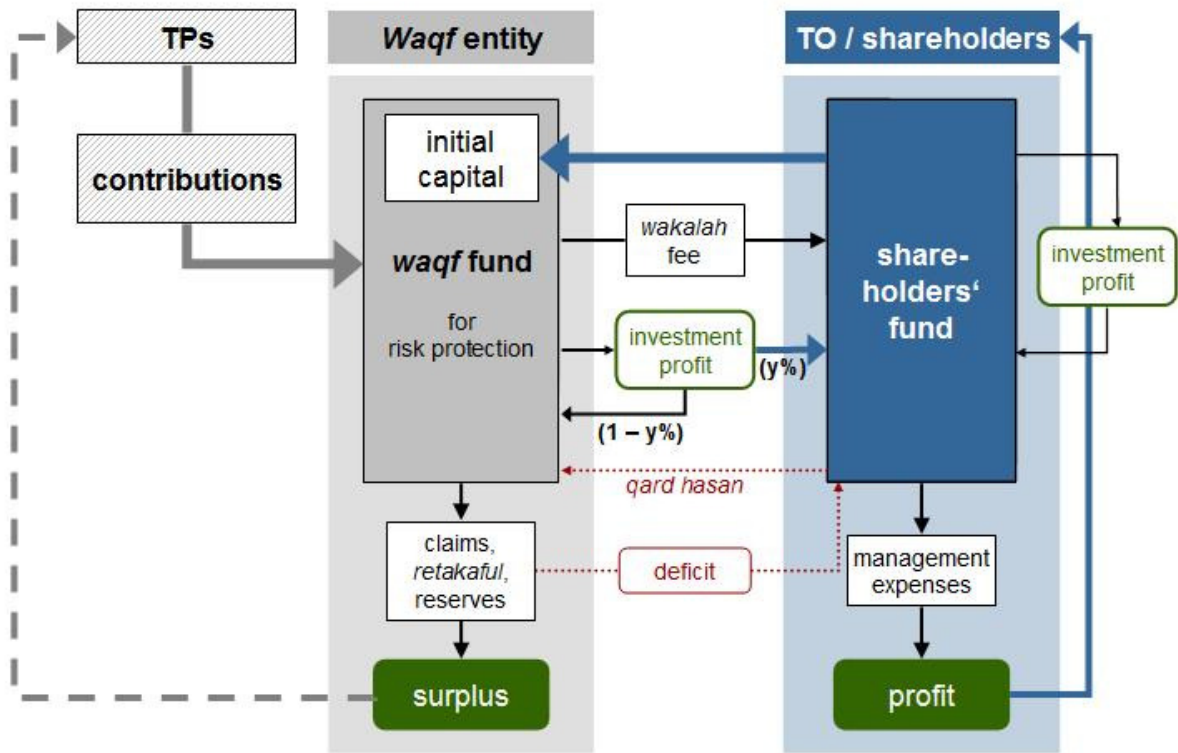
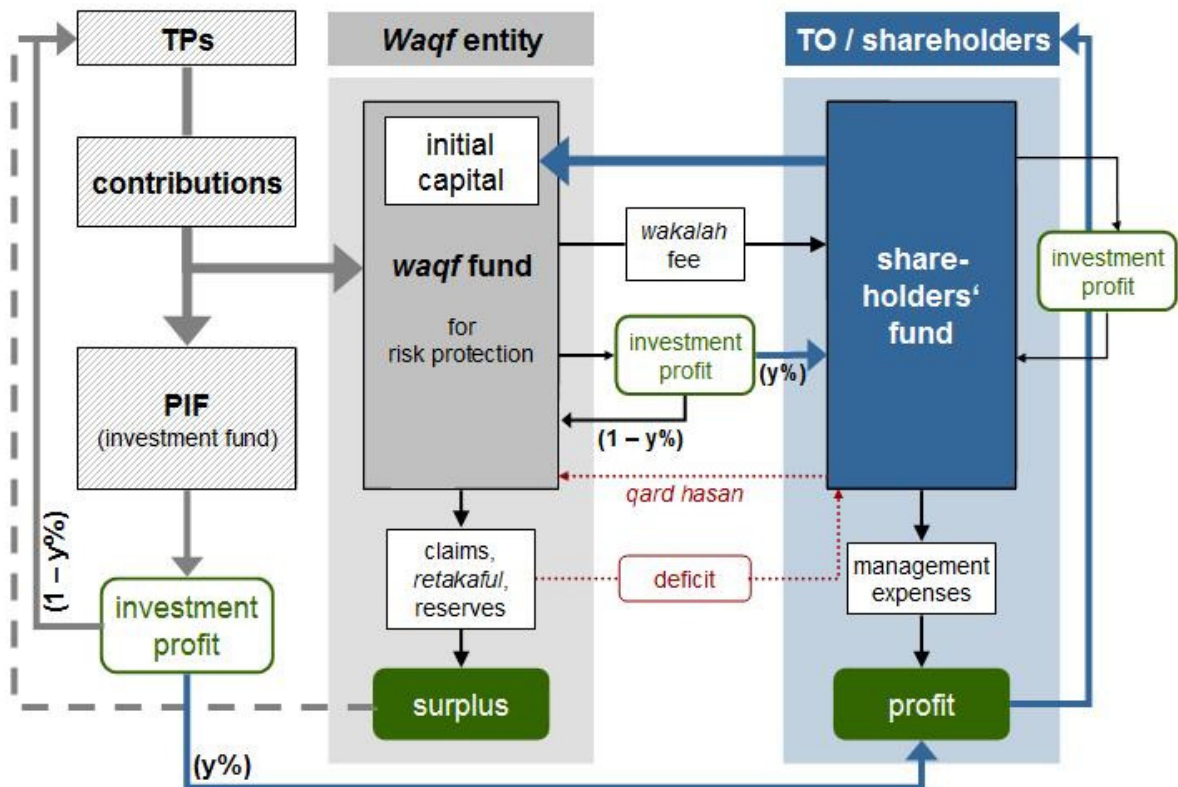


Figure 8: *Waqf* model in family *takaful*



However, it has to be remarked that this obligation is also not fully efficient in the other *takaful* business models since operators are expected to grant a *qard hasan* in the case of a deficit. Theoretically, the beneficiaries of the loan should pay back the loan. But in practice, the repayment of the loan happens out of future contributions with the result that the group of participants is quite likely to have changed. Hence, it is also not each participant individually but rather the PTF who pays back the *qard hasan*. Nevertheless, the *waqf* model is clearer in this case. As separate legal entity the *waqf* fund benefits of the loan and has to repay it accordingly. The underlying economic relations remain the same though. A *qard* can only be paid back by future contributions and not by the *waqf* with nominal capital.¹⁷¹

In literature, there are contradicting opinions pertaining to the *waqf* model. Whereas some research signalizes the business model as best practice for Islamic insurance, it is approached with scepticism by others. It is beyond question that the incorporation of a *waqf* structure in *takaful* raises more issues than *Shariah* compliancy and governance principles. Legal or tax aspects can play also a prominent role.¹⁷²

Opponents of the *waqf* model are especially sceptical about the permissibility of a *waqf* with nominal capital that is not sufficient to back up the beneficiaries as well as about the temporary membership of participants based on term contracts. Some scholars reject the *waqf* model arguing that it corresponds technically to conventional insurance. By establishing the risk fund as separate legal entity, the principal characteristic of *takaful*, namely mutuality in risk protection, is considered to dissolve. Accordingly, participants in a *waqf*-based scheme do not form a solidarity group but rather purchase insurance from a legal person so as to differences to conventional insurance remain solely in terms of asset management.¹⁷³ Regarding the fee and incentive structure of the operator, the *waqf* model faces the same concerns as the *wakalah* model.¹⁷⁴

As opposed to this, there are also *Shariah* scholars who consider the *waqf* model as “best basis for evolving a practical *takaful* system in line with the *Shariah*

¹⁷¹ cf. Archer et al. (2009), 16-17

¹⁷² cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 75

¹⁷³ cf. Archer et al. (2009), 16-17

¹⁷⁴ cf. Abdul Rahim et al. (2007), 392

principles".¹⁷⁵ According to them, the incorporation of the *waqf* concept into the *wakalah* (or combined) model constitutes a definite improvement.¹⁷⁶ In these business models, the donations of participants are conditional as they might come back to them in form of indemnities or surplus distribution. As a consequence, proportionate ownership remains with the TPs and *tabarru'*, or in other words their donation, can be regarded as incomplete. In the *waqf*-based scheme, *tabarru'* becomes part of the *waqf* fund and is therewith complete.¹⁷⁷ In the view of the proponents of the model and contradictory to the preceding opinion, the concept of *waqf* emphasizes the non-commercial structure of *takaful* undertakings being based on mutual assistance.¹⁷⁸

5.5. Concluding remarks

All four business models presented are currently in practice. It is obvious that each model can be criticized to a certain extent. It is therefore important to keep in mind that interpretations of the *Shariah* can vary widely among Islamic scholars and jurisdictions. A *fatwah* issued does not automatically become applicable to all Muslims around the world. It can be observed though that the *mudarabah* model with surplus sharing is most commonly rejected, especially in the GCC (Gulf Cooperation Council) countries, and that there is a trend towards the combined and the *waqf* model.

Nevertheless, the ultimate goal is a uniform business model that minimizes current and future *Shariah* concerns.¹⁷⁹ A unified approach by all *takaful* companies is essential to achieve consumer confidence, to compete with conventional insurance and to ensure sustainable growth of the whole *takaful* industry. At a national level, a trend towards standardization can be already noted.¹⁸⁰ However, a global standard is not yet in sight.

¹⁷⁵ Ayub (2007), 423

¹⁷⁶ cf. Mortuza Ali (2006), 3

¹⁷⁷ cf. Abdul Rahim et al. (2007), 387

¹⁷⁸ cf. M.M. Hussain, *Legal Issues in Takaful*, in: Archer et al. (2009), 75

¹⁷⁹ cf. Abdul Rahim et al. (2007), 395

¹⁸⁰ cf. Tolefat (2006), 2

6. Retakaful

Retakaful can be regarded as Islamic alternative to reinsurance. Just as reinsurance can be defined as insurance of insurance, *retakaful* can be explained as *takaful* of *takaful*. The first *retakaful* undertaking was launched in 1985 by Al Baraka.¹⁸¹

6.1. Role of *retakaful*

Reinsurance is an essential precondition for a vital global economy as it provides risk protection across geographical regions. *Retakaful* answers the same purposes as reinsurance. First of all, it allows for risk spreading over different *takaful* pools while providing underwriting capacity for each pool. By the means of *retakaful*, risk portfolios cannot only be spread effectively across risk pools but also across territories. In addition, *retakaful* can mitigate substantially the ramifications of catastrophic events. Due to Islamic reinsurance, TOs are also in a position to underwrite major industrial and mega risks without the need to put up colossal amounts of capital. Thereby, they are up to competing with established conventional insurance companies. Moreover, in cases of natural or man-made disastrous events with monumental losses, *retakaful* is indispensable in order to reduce the chance of risk of ruin for the whole *takaful* industry.¹⁸²

6.2. Principles of *retakaful*

In principle, a contract of *retakaful* can be considered as a *takaful* agreement which, in turn, implies that all *takaful* principles must be applied as well.¹⁸³ A *retakaful* fund is consequently subject to the same ideas as a *takaful* fund. This entails that the *retakaful* pool is equally built on the concept of *tabarru'*. By combining the risks of several *takaful* pools of different TOs, the *retakaful* pool can be regarded as an instrument to widen the spectrum of solidarity.¹⁸⁴ *Retakaful* basically extends the idea of mutual help as participants of one *takaful* pool back up the participants of another

¹⁸¹ cf. C. Abouzaid, *The role of pure re-takaful operators versus conventional reinsurers*, in: Jaffer (2007), 62

¹⁸² cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 154-155

¹⁸³ cf. Arbouna (2000), 336

¹⁸⁴ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 159

pool and vice versa. This represents a unique feature of Islamic reinsurance with respect to conventional insurance.¹⁸⁵

Although in practice *retakaful* arrangements are contracted between the TO and the *retakaful* operator, it is ultimately a contract between the *takaful* and the *retakaful* fund. The *retakaful* company does not bear any risk; it is solely the manager of the *retakaful* pool. Under a *retakaful* arrangement, the TO transfers part of a risk fund's obligation to a *retakaful* fund. For this purpose, a part of the assets in the risk pool has to be donated to the *retakaful* fund. This amount constitutes the *retakaful* contribution. The *retakaful* fund compensates for claims and other *retakaful* related expenses. The *retakaful* operator, whose role can be compared to the one of a TO, is also entitled to a fee (or profit-sharing) which is paid out of the *retakaful* fund in return for his services rendered. His remuneration depends on the underlying business model. For instance, in a pure *mudarabah* model the *retakaful* operator will share in the results of the *retakaful* fund; in a pure *wakalah* model he will receive a management fee. Irrespective of the model adopted, the fee or profit-sharing ratio has to be contractually defined between the *takaful* and the *retakaful* operator. In the case the *retakaful* fund runs into deficit, the *retakaful* operator has to provide a *qard hasan* to the fund. However, neither the *retakaful* operator has to grant an interest-free loan for a *takaful* fund in deficit, nor the TO has this obligation for a *retakaful* fund.¹⁸⁶ Figure 9 illustrates the basic structure of *retakaful*.

6.3. Necessity of *retakaful*

Due to the rapid growth of the *takaful* industry, the existence of Islamic reinsurance is imperative in order to achieve long-term sustainability.¹⁸⁷ Given the fact that the *takaful* industry is characterized by rather small companies, its dependence on *retakaful* is even more pronounced.¹⁸⁸

As *takaful* operators commit to full *Shariah* compliancy, they principally have to draw on Islamic reinsurance. However, owing to the absence of sufficient *retakaful* capacity, TOs got temporary permission by Islamic scholars to reinsure with conventional reinsurance companies based on the Islamic concept of *dharura*.

¹⁸⁵ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 154

¹⁸⁶ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 157-159

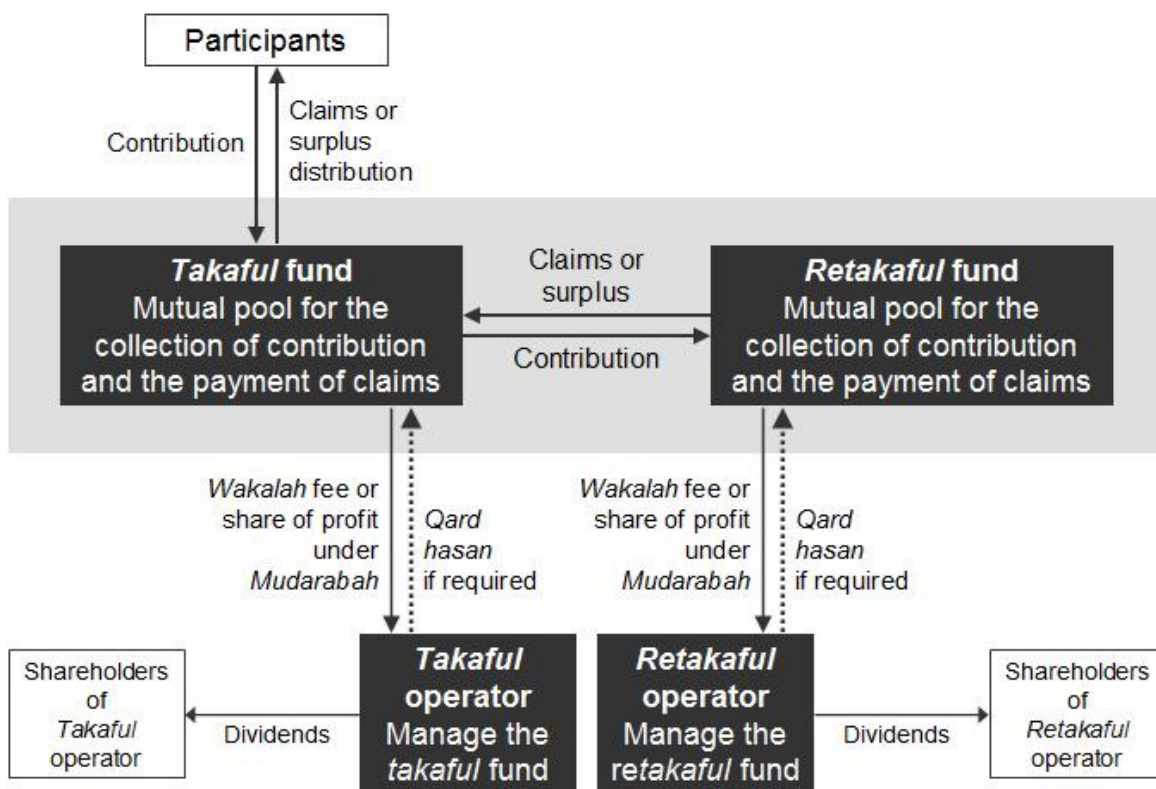
¹⁸⁷ cf. Morgan Stanley (2008), 11

¹⁸⁸ cf. P. Casey, *Supervisory Issues in Takaful: An Overview*, in: Archer et al. (2009), 136

Consequently, this exemption is only applicable as long as there is no suitable *retakaful* supply.¹⁸⁹ It can be observed that the *retakaful* capacity is increasingly expanding. Thereby, the possibility for pooling risk with other TOs across diversified locations is more and more provided and the temporary permission is getting gradually void.¹⁹⁰

In consideration of the limited number of *retakaful* operators, the variety of practiced *takaful* models can be critical. Therefore, it is vital for the *retakaful* industry to be equipped with business models that are compatible with any underlying models employed by TOs. *Retakaful* contracts should not founder on business model incompatibility as this would be a strain on the whole *takaful* industry.¹⁹¹

Figure 9: Basic model of *retakaful*



Source: M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 157

¹⁸⁹ cf. C. Abouzaid, *The role of pure re-takaful operators versus conventional reinsurers*, in: Jaffer (2007), 63-65

¹⁹⁰ cf. J. Smith, *Solvency and Capital Adequacy in Takaful*, in: Archer et al. (2009), 212

¹⁹¹ cf. M. Akoob, *Reinsurance and Retakaful*, in: Archer et al. (2009), 159-160

7. Takaful market

The *takaful* industry commenced only in 1979 and has experienced rapid and vigorous growth since 2003.¹⁹² *Takaful* business has an enormous potential as insurance penetration in Islamic countries is eminently low.¹⁹³ Along with it, it has to be emphasized that Islam constitutes the second largest as well as the fastest growing religion in the world.¹⁹⁴ However, the *takaful* market is also challenged by the underlying conditions in most Islamic countries, such as the low level of awareness about financial protection.¹⁹⁵

In the following, after an analysis of the current *takaful* market, both opportunities and challenges for the Islamic insurance industry are examined.

7.1. Current situation

The *takaful* market is currently concentrated in the MENA (Middle East and North Africa) region and in Southeast Asia.¹⁹⁶ Global gross *takaful* contributions reached US\$ 7 billion in 2009 and are expected to accomplish US\$ 12 billion by 2011.¹⁹⁷ The compounded annual growth rate of the *takaful* industry amounts to at least 20 to 30%. There are more than 250 *takaful* undertakings worldwide.¹⁹⁸ However, the majority thereof is situated in Malaysia and the GCC countries.¹⁹⁹

Malaysia represents so far the most significant market for Islamic insurance alongside the Arab region and makes up 72% of the non-Arabic business.²⁰⁰ Due to the fact that it constitutes one of the largest and most developed *takaful* markets, Malaysia has become a reference point for the whole industry. Surprisingly, its Muslim population accounts for only 60%. Hence, Malaysia's pioneering role is rather attributable to its regulatory authorities which enforced and drove growth notably in this market. With an insurance penetration²⁰¹ rate of 4.94% in 2006, Malaysia's

¹⁹² cf. Z.A.M. Kassim, *Takaful: a question of surplus*, in: Jaffer (2007), 48

¹⁹³ cf. Stagg-Macey (2007), 1

¹⁹⁴ cf. Billah and Patel (2003), 15

¹⁹⁵ cf. Ahmad et al. (2010), 9

¹⁹⁶ cf. Oliver Wyman (2007), 3

¹⁹⁷ cf. Ernst & Young (2011), 7

¹⁹⁸ cf. Morgan Stanley (2009), 12

¹⁹⁹ cf. A. Tolefat, *Investment Portfolios of Takaful Undertakings*, in: Archer et al. (2009), 218

²⁰⁰ cf. Ahmad et al. (2010), 7

²⁰¹ insurance penetration is commonly defined as gross insurance premiums divided by the GDP

overall insurance market is one of the most developed of the MENA and Southeast Asia. Furthermore, it has one of the highest life penetration rates of these countries. Life business adds up to 3.2% and is therewith even higher than the non-life business with 1.74% respectively.²⁰² In 2009, Malaysia's *takaful* penetration rate amounted to 0.60%.²⁰³

In the GCC countries with an average Muslim population of approximately 95%,²⁰⁴ the growth rates of *takaful* exceed distinctly the ones of conventional insurance.²⁰⁵ However, life business is still undeveloped. The penetration of insurance as a whole and especially of family *takaful* is extremely low.²⁰⁶ It can be observed that growth in the GCC is primarily due to the fact that insurance is increasingly made compulsory and not due to voluntary policies.²⁰⁷ In 2005, the Central Bank of Bahrain set up the region's first comprehensive insurance rulebook, containing also specific *takaful* regulations and is therewith one of the more proactive regulators in the GCC.²⁰⁸ Bahrain has as well the highest overall insurance penetration rate of the GCC region with 2.59% in 2009. The *takaful* penetration rate amounts to 0.45%. The United Arab Emirates also have a relatively high insurance penetration rate of 2.19% in 2009, and a *takaful* penetration rate of 0.31% respectively. Saudi Arabia shows the highest *takaful* penetration rate in the region with 1.05% in 2009 corresponding virtually to the overall insurance penetration.²⁰⁹ Qatar represents one of the fastest growing economies in the world.²¹⁰ Nevertheless, its insurance penetration rate was still below 1% in 2009, just as in Kuwait and the Oman.²¹¹

7.2. Market opportunities

Takaful represents the fastest growing area of the global insurance market. With growth rates of way beyond 20% annually it outnumbers significantly conventional insurance business at an average growth level of approximately 5% per annum.²¹²

²⁰² cf. Morgan Stanley (2008), 19

²⁰³ cf. Ernst & Young (2011), 12

²⁰⁴ cf. Morgan Stanley (2008), 2

²⁰⁵ cf. Ahmad et al. (2010), 6

²⁰⁶ cf. A. Tolefat, *Investment Portfolios of Takaful Undertakings*, in: Archer et al. (2009), 232

²⁰⁷ cf. Ernst & Young (2011), 22

²⁰⁸ cf. Morgan Stanley (2008), 13

²⁰⁹ cf. Ernst & Young (2011), 11

²¹⁰ cf. Morgan Stanley (2008), 16

²¹¹ cf. Ernst & Young (2011), 21

²¹² cf. Swartz and Coetzer (2010), 337

Whereas the insurance market in Western countries is already quite saturated and shows a penetration rate of 9.45% on average for the G7 countries in 2006, Islamic countries exhibit frequently an insurance penetration rate below 1%.²¹³

The pronounced underinsured status of the world's 1.6 billion Muslims²¹⁴ is in particular conducive to the immense growth potential of Islamic insurance. No insurer can afford to neglect this potential customer base. Furthermore, the clientele is characterized by a youthful demography. 60% of the Muslim population is under 25 years old and achieving gradually affluence. Such a customer base – if it can be captured early – presents a great opportunity for the *takaful* industry.²¹⁵

In the light of the economic boom for oil production, the future of the *takaful* market in the Middle East looks auspicious. Especially the life insurance business is still extremely undeveloped and offers therefore a huge growth potential for family *takaful*. This is also likely to be stimulated by the demographic change and its strain on the social welfare systems. An increase in compulsory insurance drives also the Islamic insurance demand in this region.²¹⁶

It has to be considered that there are large Muslim communities in the Western countries as well. Although Western Europe accommodates less than 1% of the world's Muslim population, it is suggested that it accounts for 40% of the potential Muslim demand for *takaful* at present. By adding the US, this proportion increases even to 60%. Consequently, *takaful* undertakings should not consider only the actual Islamic population but also affluence and propensity to buy *takaful* products. Muslim communities in Western countries offer therefore a tremendous untapped opportunity for the Islamic insurance industry.²¹⁷

So far, it is generally accepted to insure with conventional insurers if there is no *Shariah* compliant alternative. Due to the ongoing development of the whole *takaful* industry, it may become more and more unacceptable for Muslims to make use of conventional insurance. In particular in Western countries, *takaful* may not only

²¹³ cf. Morgan Stanley (2008), 3

²¹⁴ cf. Oliver Wyman (2007), 3

²¹⁵ cf. Ahmad et al. (2010), 6

²¹⁶ cf. S. Abdi, *Taking takaful to the next level*, in: Jaffer (2007), 23-27

²¹⁷ cf. Oliver Wyman (2007), 3

attract new uninsured customers but also induce Muslims to change to *takaful* products.²¹⁸

It has to be emphasized at this point that *takaful* is not limited to Muslims only. It is acceptable to all communities and faiths.²¹⁹ *Takaful* puts an emphasis on transparency and on an explicit ethical structure. Ethical financial services appeal to Muslim as well as non-Muslim customers alike.²²⁰ It is suggested that up to 20% of the total *takaful* revenues could arise from non-Muslim customers.²²¹

To these opportunities a spiritual dimension can be added, promoting especially life insurance. Doing good deeds is deeply held in the Islam. For instance, the payment of *zakat* is one of the principal injunctions on Muslims as per the *Qur'an*. It is an almsgiving for the redistribution of wealth and constitutes one of the five immutable pillars of Islamic faith.²²² *Zakat* is a compulsory levy, in general 2.5% of the income, to transfer revenue from the wealthy to the needy.²²³ If the *takaful* industry succeeds in designing and promoting *takaful* products so as to buying insurance is associated with doing good deeds, there is a further huge market potential for *takaful*. Such a spiritual motivation is, though, not limited to Muslims only. It can be observed, for example, that people of all religious orientations respond to donation campaigns in the case of natural disasters. The sole difference is that donations are collected after a tragedy occurred whereas in *takaful* contributions are made prior to any such event. Compared to conventional insurance where policyholders receive nothing if there is no claim, participants in a *takaful* scheme may at least derive satisfaction from doing good deeds. This spiritual benefit can be a very powerful motivation for *takaful* customers.²²⁴

7.3. Challenges

Despite all these opportunities, *takaful* companies are also faced with several challenges as they are still in their start-up phase compared to conventional

²¹⁸ cf. Fitch Ratings (2007), 19

²¹⁹ cf. Ahmad (2007), 2

²²⁰ cf. PricewaterhouseCoopers (2008), 5

²²¹ cf. Oliver Wyman (2007), 5

²²² cf. Choudhury (1983), 101

²²³ cf. Algaoud and Lewis (2007), 40-41

²²⁴ cf. M.T. Ahmad Nordin, *Strengths and opportunities of takaful: the spiritual dimension*, in: Jaffer (2007), 157-159

insurers.²²⁵ The Islamic insurance market is in its formation and, in most countries, affected by a poor infrastructure for this novel industry. Hence, *takaful* operators are especially strategically challenged.²²⁶

One of the main challenges of the *takaful* industry is to create customer awareness about the *takaful* concept itself. Many Muslims oppose insurance on grounds of religious reasons. It is therefore important to assure the Islamic clientele full *Shariah* compliancy of Islamic insurance. Sustained success can only be ensured by educating potential customers about the characteristics of the entire *takaful* system. In GCC countries for instance, the public welfare systems as well as the joint-family network represent one of the main competitors for *family* *takaful*. Hence, the additional advantages of *takaful* need to be signaled.²²⁷ Furthermore, there is the misconception that Islamic insurance is exclusively for Muslims. Only Malaysia succeeded so far in attracting a significant non-Muslim customer base. In this context, it is necessary to offer a wide range of *takaful* products in order to compete with conventional insurers. Also low income groups need to be taken into consideration with accordingly suitable products.²²⁸ All in all, it is essential for the *takaful* industry as a whole to raise awareness and a deeper understanding amongst the general public.²²⁹

Growth of *takaful* depends heavily on the development of Islamic banking. The Islamic financial services industry is still concerned with a lack in asset classes that are in line with the *Shariah*.²³⁰ Due to the restricted investment universe, the management of investment portfolios is a lot more challenging for *takaful* operators than for conventional insurance companies.²³¹ There is especially a shortage of short-term non-equity financial instruments as well as *Shariah* compliant market instruments.²³² As a consequence, there is a strong reliance on assets like equities and real estate which may be subject to volatility and liquidity risk. However, as the Islamic banking industry is expanding, the spectrum of Islamic financial products is also broadening and more investment options such as *sukuk* (Islamic bonds) are

²²⁵ cf. Standard & Poor's (2010), 4

²²⁶ cf. Stagg-Macey (2007), 2

²²⁷ cf. S. Abdi, *Taking takaful to the next level*, in: Jaffer (2007), 26-27

²²⁸ cf. Swartz and Coetzer (2010), 336-337

²²⁹ cf. Mortuza Ali (2010), 3

²³⁰ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 180

²³¹ cf. Morgan Stanley (2008), 12

²³² cf. Ahmad et al. (2010), 13

becoming disposable to *takaful* operators.²³³ A key challenge for the *takaful* industry is therefore the availability of *Shariah* compliant investment avenues.

The *takaful* industry is also lacking an explicit regulatory and accounting framework in most countries. *Takaful* faces widely different legal systems. Some jurisdictions, like Saudi Arabia or Sudan, are solely based on Islamic law. Other countries, such as Malaysia and Bahrain, operate on a dual judicial system, meaning a combination of *Shariah* based law and common or civil law. And there are also jurisdictions, like the Western European countries, where the *Shariah* has no influence on the legal system.²³⁴ Besides this legal disparity, specific laws governing *takaful* are still missing in many jurisdictions.²³⁵ It is vital that regulatory authorities draw up appropriate laws, rules and regulations for the *takaful* business in order to ensure its unobjectionable progress.²³⁶

Due to the fact that there are different schools of thought in Islam, scholars vary also in their interpretations concerning the *Shariah*. This complicates standardization and the creation of rules by regulators.²³⁷ Considering the relative immaturity of the *takaful* industry, differing *takaful* practices and interpretations may also lead to a negative public image in the future.²³⁸ Pluralism in Islam is unavoidable. However, regarding the *takaful* industry, a more standardized approach is absolutely essential.²³⁹ A major challenge is the development of business conduct standards that are in line with the *Shariah* and in accordance with a conventional regulatory framework.²⁴⁰ In this context, dissensions appertaining to different *takaful* business models need to be resolved. Competition between these models is likely to create confusion among customers which may impair the growth of the whole *takaful* industry. In particular, criticism of competing business models by TOs is a strain on the Islamic insurance market.²⁴¹

A serious shortage of qualified human resources poses another challenge for the *takaful* industry. TOs require staff who have both insurance know-how and

²³³ cf. J. Smith, *Solvency and Capital Adequacy in Takaful*, in: Archer et al. (2009), 210

²³⁴ cf. A. Murray, *Issues in Rating Takaful Companies*, in: Archer et al. (2009), 246

²³⁵ cf. R. Wilson, *Concerns and misconceptions in the provision of takaful*, in: Jaffer (2007), 80

²³⁶ cf. Mortuza Ali (2010), 3

²³⁷ cf. A. Chatterjee, *Business Conduct in Islamic Insurance with Special Reference to Emerging Markets*, in: Archer et al. (2009), 103

²³⁸ cf. Morgan Stanley (2008), 12

²³⁹ cf. Taylor (2005), 3

²⁴⁰ cf. A. Chatterjee, *Business Conduct in Islamic Insurance with Special Reference to Emerging Markets*, in: Archer et al. (2009), 101

²⁴¹ cf. Fitch Ratings (2007), 20

knowledge of *Shariah* compliance.²⁴² Business continuity of *takaful* undertakings may be jeopardized by the loss of senior officers. Due to the rapid growth of the Islamic insurance market, staff retention may become demanding and costly.²⁴³

Furthermore, *takaful* operators are facing more and more competition from both conventional insurance companies and other *takaful* undertakings. They are also generally outperformed by conventional insurers in terms of investment returns and economies of scale. Owing to their small size, economies of scale represent a major challenge for many of them.²⁴⁴ It can be observed that the number of Islamic insurance players is increasing strongly in the key markets. Especially small local operators are in competition with established conventional insurers. As a consequence, further capacity, underwriting expertise and enhanced broker relationships are vital for TOs.²⁴⁵

²⁴² cf. PricewaterhouseCoopers (2008), 14

²⁴³ cf. A. Haron and D. Taylor, *Risk Management in Takaful*, in: Archer et al. (2009), 190

²⁴⁴ cf. A. Murray, *Issues in Rating Takaful Companies*, in: Archer et al. (2009), 260

²⁴⁵ cf. Ernst & Young (2011), 22

8. Conclusion

Takaful is a relative new concept with an immense potential. It is a viable alternative to conventional insurance for the 1.6 billion Muslims around the world. Islamic insurance represents an instrument for economic growth and social improvement in Islamic countries. Due to its ethical structure and transparency, *takaful* is appealing to non-Muslims likewise.

Islamic insurance is based on the principles of mutual assistance and *tabarru'*. That way, it avoids the critical elements of *gharar*, *maisir* and *riba* that render conventional insurance unlawful under the *Shariah*. *Takaful* undertakings operate as a hybrid of a mutual and a commercial form of company. Participants participate in a mutual scheme of risk cover. The *takaful* operator, as a company with shareholders, manages underwriting and investment for and on behalf of the participants. The TO does not take profit from insurance activities but is remunerated for its services rendered. *Takaful* draws a distinction between general and family business. General *takaful* is intended for protection purposes only so as to the whole contribution of the TPs is paid into the participants' *takaful* fund. Family business serves both protection and saving purposes. As a consequence, one part of the participant's contribution is paid into the PTF and the other part is used for investment. In the case of a deficit in the risk fund, the TO is expected to provide a *qard hasan*. This loan has to be repaid out of future contributions. To ensure *Shariah* compliancy, *takaful* undertakings are monitored by a Shariah Supervisory Board.

There are different *takaful* models used in practice. This thesis concentrates on the four common business models: the *mudarabah*, the *wakalah*, the combined and the *waqf* model. All business models pursue the same goal of sharing individual risks collectively to reduce the risk exposure of each individual. They differ primarily in the definition of the relationship between the operator and the participants and in the thereof resulting remuneration of the TO. By examining the models closely, critical issues can be detected for each model. Pertaining to the concerns of Islamic scholars, one should keep in mind that interpretations of the *Shariah* can vary widely amongst scholars and territories. As a consequence, the choice of a business model and its permissibility depend also on the characteristics of the respective region or jurisdiction. Although real standardization is not yet in sight, a regional tendency of

takaful models can be observed. Nevertheless, a consensus-based approach by the entire *takaful* industry as well as a uniform business model that minimizes current and future *Shariah* concerns would be highly desirable.

Standardization in general poses a major challenge for the Islamic insurance industry. Besides a unified *takaful* model, business conduct standards as well as legal and regulatory norms need to be developed. The complexity of this issue is obvious considering already the contradictory terminology concerning business models. It is imperative for the whole *takaful* business to meet the challenge. Only that way, consumer understanding and awareness of the *takaful* concept can be achieved and with it sustainable success of the industry.

Apart from this, it has to be emphasized that the *takaful* business shows great market opportunities. On the one hand, the low insurance penetration in Islamic countries promises gigantic growth rates. On the other hand, *takaful* has also a non-neglectable potential in Western countries appealing to both Muslims and non-Muslims due to its unique nature. All in all, increasing awareness, the development of the Islamic banking industry, as well as globalization and an expected increase in the Muslim population will be conducive to *takaful* gaining critical mass and becoming a real and identifiable sector of the world insurance market.

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Appendix

Glossary

A

aqilah agreement of tribal solidarity

D

dharura necessity

diyah blood money

G

general takaful Islamic non-life insurance

gharar uncertainty

H

haram unlawful, forbidden

I

ijma consensus of Islamic community on a legal issue

F

family takaful Islamic life insurance

fatwah (pl. fatawah) juristic opinion concerning Islamic law

K

kafala to guarantee

M

maisir speculation, gambling

maslaha public interest

mudarabah principal-manager agreement based on profit-sharing

mudarib entrepreneur

P

participants' investment fund (PIF) investment fund in a *takaful* scheme

participants' takaful fund (PTF) risk fund in a *takaful* scheme

Q

<i>qard hasan</i>	interest-free loan
<i>qiyas</i>	analogical reasoning by <i>Shariah</i> scholars
<i>Qur'an</i>	central religious text of Islam

R

<i>rabb al maal</i>	capital providers
<i>retakaful</i>	Islamic reinsurance
<i>riba</i>	interest

S

<i>Shariah</i>	Islamic law
<i>Shariah Supervisory Board/Council</i>	internal or external religious advisors who ensure adherence to <i>Shariah</i> rules and principles of a <i>takaful</i> undertaking
<i>sukuk</i>	Islamic equivalent of a bond
<i>Sunnah</i>	word and actions of or approved by Prophet Muhammad

T

<i>ta'awun</i>	mutual assistance
<i>tabarru'</i>	donation, contribution, gift (in <i>takaful</i> contract = contribution paid by TPs)
<i>takaful</i>	Islamic insurance
<i>takaful operator (TO)</i>	equivalent to the insurance company in conventional insurance
<i>takaful participant (TP)</i>	equivalent to a policyholder in conventional insurance

W

<i>wakalah</i>	principal-agent agreement (a person nominates another to act on his behalf)
<i>wakalah fee</i>	management fee
<i>wakeel</i>	agent (in <i>takaful</i> , this is the TO)
<i>waqf</i>	religious endowment, trust fund

Z

<i>zakat</i>	one of the Five Pillars of Islam; giving of a fixed portion of one's wealth to charity
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Abstract (English)

Conventional insurance is considered as unlawful under the Islamic law as it involves at least three forbidden elements, namely *gharar* (uncertainty), *maisir* (speculation) and *riba* (interest). In order to align insurance with Islamic principles, *takaful* (Islamic insurance) was introduced. *Takaful* is based on the concepts of mutual assistance and *tabarru'* (voluntary contribution). In a typical *takaful* undertaking, the risk funds of the participants (policyholders) operate on a mutual basis, but are managed by a *takaful* operator which is a company with shareholders.

Main focus of this thesis is an examination of the different business models of *takaful* applied in practice. In this respect, the four most common *takaful* models, namely the *mudarabah*, the *wakalah*, the combined and the *waqf* model, are explained and discussed in detail. In principle, these business models differ solely in the definition of the relationship between the operator and the participants and the thereof resulting kind of remuneration of the operator. There is no clear overall preference of one business model, only regional trends can be observed. However, the ultimate goal is a uniform business model.

Retakaful (Islamic reinsurance) represents an essential part of the whole *takaful* industry in order to ensure its sustainable growth. *Takaful* business shows an enormous potential with growth rates of way beyond 20% annually. The industry is still in its start-up phase and therefore promising great opportunities but also facing several challenges.

Abstract (German)

Westliche Versicherungen werden unter islamischem Gesetz als rechtswidrig betrachtet, da sie gegen mindestens drei Verbote verstoßen. Zu diesen zählen das Verbot von Unsicherheit in Verträgen (*gharar*), das Verbot der Spekulation (*maisir*) sowie das Zinsverbot (*riba*). *Takaful* stellt als Islamische Versicherung eine Alternative zur herkömmlichen Versicherung dar. *Takaful* berücksichtigt islamische Grundsätze und basiert auf dem Prinzip der gegenseitigen Hilfe. Ein Hauptunterscheidungsmerkmal zur konventionellen Versicherung ist die Verwendung eines Spendenvertrags (*tabarru*), der den gewöhnlichen Kaufvertrag ersetzt. Die Versicherten zahlen in einen gemeinsamen Fonds ein und teilen damit das Risiko ähnlich wie bei einem Versicherungsverein auf Gegenseitigkeit. Der Versicherer oder besser gesagt der *Takaful Operator* verwaltet lediglich den Fonds und berechnet dafür Gebühren.

Schwerpunkt der Magisterarbeit liegt auf der Auseinandersetzung mit den verschiedenen *Takaful*-Modellen, die in der Praxis zur Anwendung kommen. Diesbezüglich werden die vier geläufigsten Geschäftsmodelle dargestellt und erörtert. Dazu gehören das *Wakalah* Modell, das *Mudarabah* Modell, das *Waqf* Modell sowie eine Kombination der ersten beiden Modelle. Im Grunde unterscheiden sich die Modelle nur in der Beziehung zwischen dem *Takaful Operator* und den Versicherten und in der sich daraus ergebenden Vergütung des *Operators*. Insgesamt kann keine eindeutige Präferenz für ein Geschäftsmodell festgestellt werden, sondern lediglich regionale Tendenzen. Endziel wäre jedoch ein standardisiertes *Takaful*-Modell.

Retakaful (Islamische Rückversicherung) ist ein wesentlicher Bestandteil der gesamten *Takaful*-Branche, um nachhaltigen Erfolg sicher zu stellen. *Takaful* zeigt ein immenses Potential mit jährlichen Wachstumsraten von weit über 20%. Die islamische Versicherungsbranche befindet sich noch in ihrer Anlaufphase. Damit hat sie die besten Voraussetzungen, um von vielversprechenden Möglichkeiten zu profitieren, muss sich aber im Gegenzug auch einigen Herausforderungen stellen.

Birgit Bisani *CURRICULUM VITAE*

PERSONAL INFORMATION:

Contact details: Mariahilfer Gürtel 31/19
1150 Wien, Austria
✉ birgit_bisani@web.de
☎ +43 676 536 4573

Date and place of birth: July 30, 1986 - Munich, Germany

EDUCATION:

Since Oct 2009 **Master in International Business Administration (Mag./M.Sc.)**
University of Vienna, Austria
Majors: Operations Research & International Management
Thesis: Takaful and its Business Models

Oct 2005 - July 2008 **Bachelor in Business Administration (B.Sc.)**
University of Regensburg, Germany
Thesis: Einfache Entscheidungsheuristiken und ihre Relevanz für
die Marktforschung

Sept 2007 - June 2008 Additionally **ERASMUS** (semester 5 and 6)
Université IX Paris-Dauphine, France

Sept 1996 - July 2005 **Comenius-Gymnasium**, Deggendorf, Germany
Major fields: Mathematics and French

WORK EXPERIENCE:

July 2010 - Sept 2010 **Intern at eka people solutions**, Bangalore, India
Field: Business Development

Mar 2009 - Aug 2009 **Project work for Allianz Deutschland AG**, Munich, Germany

Oct 2008 - Feb 2009 **Intern at Allianz Deutschland AG**, Munich, Germany
Department: Information and Qualification Management

Mar 2007 - Apr 2007 **Intern at Munich-Eventlocations**, Germany