

## Chapter 12

# Takaful

## Preview

The chapter exposes students to the principles and practical framework of *takaful* as one of the important components of Islamic financial market. As one of the risk mitigation tools, *takaful* complements its counterparts, namely Islamic banking market, Islamic capital market and Islamic money market. Indeed, mitigation and prudent management of risk are integral parts of Islam in order to achieve justice in the system which is in line with the objectives of *shari'ah* (*maqasid al-shari'ah*).

To date, *takaful* market is considered as one of the fastest growing service industry, although it needs to work on further improvements in areas such as accounting, regulatory, jurisprudential and operation. Nevertheless, due to its growing demand, the *takaful* industry seems to have a bright future awaiting it. This chapter covers the basic conceptual framework of *takaful*, its evolution, models and regulatory framework affecting its proper functioning.



The conventional insurance contract is basically constructed between the insured and insurance company. *Takaful* differs from conventional insurance in the sense that the *takaful* operator is not the insurer insuring the participants. *Takaful* participants mutually insure one another while the *takaful* operator simply functions as the administrator and manager of the *takaful* fund.

## Learning Outcomes

At the end of the course, you should be able to:

- Discuss the general *shari'ah* principles which govern the operationalisation of *takaful* and *re-takaful*.
- Discuss the underlying theories and the conceptual framework related to the *takaful* and *re-takaful* system.
- Explain the operational mechanism of contemporary *takaful* and *re-takaful* products.
- Analyse issues arising from *takaful* and *re-takaful* operations including *takaful* fund management, accounting treatments, legal aspects and regulatory perspectives.

# Section 1: Insurance and Risk Management

## Concept of Insurance

Literally, insurance as practised in conventional financial system refers to a financial protection system which involves the execution of contracts (insurance contracts) between the insurer and the insured in which the insurer agrees to underwrite the subject risk of such contracts.

Mehr (1986) defines the insurance as “a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared by or distributed proportionately among all units in the combination.” Based on this definition there are two important characteristics of the concept of insurance that need to be underlined and highlighted. Firstly, insurance is a tool to reduce uncertainty. Secondly, the uncertainty is reduced because losses are shared by or distributed among the exposure units. Therefore, insurance can be broadly described as a risk management strategy or tool that deals with two aspects of risk: it reduces uncertainty and provides a planned financing technique that distributes losses.

Concept of insurance: Firstly, insurance is a tool to reduce uncertainty. Secondly, the uncertainty is reduced because losses are shared by or distributed among the exposure units.

## Insurance as a Risk Management Strategy



Human beings are exposed to all sorts of hazards. A peril is usually a cause of loss. Typical perils include theft, accident, sickness, flood, premature death and fire. When a peril happens, property may be destroyed or lost and people and animals, killed or injured. Any loss of lives or property will invariably lead to financial losses. Although we are continually exposed to perils, we are uncertain as to when such loss producing events will occur. We are also left in the dark on the degree of losses that may affect us if such perils happened. In other words, we are uncertain about the loss we may suffer in the future. An uncertainty regarding loss is often termed as risk.

In fact, risk and uncertainty are an integral part of most human behaviour. These risks and uncertainties arise when the future is unknown and most often than not, the outcomes of human actions are unpredictable. Consequently, these risks affect the lives of many individuals in a society in a way, which is sometimes so devastating and shattering, leaving these unfortunate people vulnerable and helpless. One of the most commonly asked question is: how can we mitigate such a risk?

One of the ways to attend, manage and mitigate the risks would be through the application of insurance. Indeed insurance exists as one of the important instruments in financial markets in managing risk and uncertainty. Before discussing the concept and operation of insurance in-depth, it is imperative to first understand the concept of risk and its various characteristics. The ensuing sections delineate the understanding of the concept of risk.

### Types of Risk

There are generally two types of risk, namely pure risk and speculative risk.

Pure risk exists in situation when there is only two possibilities of outcomes: loss or no loss at all. This can be personal or collective, direct or indirect. The parties involved do not plan the incident, rather it occurs naturally. Examples include risk of damage to property resulting from fire and risk of premature death. As an illustration, let us take the case of fire. If a property is destroyed due to fire, the owner will suffer losses but if there is no fire, the owner will neither suffer any loss nor gain anything.

Speculative risk involves three possibilities: the possibility of loss, profit or no change in value. These are often planned because the outcome can be manipulated. Examples include investment in stock market or real estate, venturing into business and betting in a horse race. Let us take the case when a person invested his money in a share market, this money will be used to buy shares of stock for a particular length of time. Here, the investor naturally faces risk or uncertainty whether he is able to sell the shares at profit, loss or no change in value. If the market share price increases, he can gain by selling his shares at profit. At the same time if the market share price declines, he will bear the loss because the value of his holding share is lower than the market value. He also faces the possibility of no change in value, if the share price remains the same.

Insurance serves as a risk management strategy against pure risk which for the most part, is unavoidable. Pure risk exists in situations in which the outcomes could involve loss or no loss at all. The parties involved do not plan the incident but rather, it occurs naturally.

	Pure Risk	Speculative Risk
Nature of Outcome	Loss/No Loss	Loss/Gain
Origin of Risk	For the most part, unavoidable	By deliberate choice of action
Examples	Death, fire, accident	Fluctuations in market value of trade goods
Common risk management method	Insurance	Use of derivatives

**Table 12.1**  
Types of Risk



Five concepts of risk management:  
 Prevention of risks  
 Assumption of risks  
 Spread of risks mutually  
 Transference of risk by insurance  
 Buying an insurance policy

For managing risks, man has developed five main concepts over the centuries. These are:

1. **Prevention of risks** – When building a house, the risk of fire may materialise. So in order to mitigate such risk, one can equip themselves with a fire extinguisher.
2. **Assumption of risks** – One can save money to cater for a future eventual loss.
3. **Spread of risk mutually** – One can spread the risk with a group of people sharing the same concern. For instance, a group of boat owners can distribute their commodities among themselves in different boats while transporting their goods.
4. **Transference of risk by insurance** – To transfer the risk to someone else, i.e., to create a financial security in the face of risk is that of spreading the risk among a number of persons all exposed to the same risk and all prepared to make a relatively negligible contribution towards neutralising the detrimental effects of this risk which may materialise for anyone or more of their number. This is known as insurance in the economic sense. For instance, a group of soldiers can contribute for their funeral expenses. The pool of money created will be of help to the inflicted family.
5. **Buying an insurance policy** – This is the case where a policy-holder enters into an insurance contract with a third party, who takes the responsibility of indemnifying him in case the risk insured materialises, provided he pays a premium to the commercial company. This is the most widely adopted means of mitigating risk which has evolved through centuries.

Conventional insurance contains *riba* in two situations:  
 No equality between insured's instalments and insurer's compensation  
 Receives profit from its involvement in *riba*-related transactions

## Why Conventional Insurance is Not Accepted by *Shari'ah*

The present approach to risk mitigation is to buy an insurance policy whereby an insured will transfer his risk to the insurance company which in exchange of a premium accepts the responsibility of indemnifying the insured in case the risk insured for materialises. This method of risk mitigation has been declared to be *haram* by most Muslim scholars as it contractually contains *haram* elements such as *riba*, *gharar* and *maysir*.

The main elements which make conventional insurance unlawful are discussed as follows:

### **Riba (Interest or Usury)**

*Riba* is evident in conventional life policies in two situations; firstly, the amount of money received by the insured, either on the occurrence of the insured event or upon maturity of the policy, is always in excess of total premiums he has actually paid. *Riba* is clearly affecting the two parties to the contract since there is no equality between installments paid by the insured party and the compensation paid by the insurance company. What the company actually pays may be more, less or equal to that which is paid by the insured and equality is very unlikely. Moreover, since the payments are deferred, the compensation which is greater than the instalments paid by the insured constitutes surplus *riba* (*riba al-fadl*) and credit *riba* (*riba al-nasihah*).

Secondly, even if someone may argue that the insurance contract is based on the foundation of charitable (*tabarru'*) and cooperation (*ta'awun*) to ameliorate losses and injuries, *riba* is still present in the compensation by the insurance company since the profits of the latter are accumulated through *riba*-related transactions like fixed-income and interest-based transactions.

### **Gharar (Unknown or Uncertain Factors)**

*Gharar*, or uncertainty in Islamic jurisprudence, refers to purposive cheating and deception as well as ignorance of the object of sale and undeliverability of the object. Professor Al-Zarqa' defines *gharar* as a sale of probable items whose existence or characteristics are not certain due to the risky nature that makes it similar to gambling. Muslim jurists are unanimous in prohibiting *gharar* sales. This prohibition is based on an authentic *hadith* of the Prophet (p.b.u.h.) narrated by Muslim, Abu Dawud, Al-Tirmizi, Al-Nasai and Ibn Majah on the authority of Abu Hurayrah, whereby the Prophet has forbidden *gharar* sales. However, jurists make a distinction between two kinds of *gharar*: *gharar fahish* (substantial) and *gharar yasir* (trivial). While the former is prohibited, the latter is tolerated since this may be unavoidable without causing considerable damage to one of the parties. For example, *gharar fahish* or excessive and substantial uncertainties is avoidable, and hence prohibited like selling an undeliverable asset or selling something which is not owned.

*Gharar* exists in insurance contracts whereby the subject matter of the contract is not certain until the insured event has taken place.

An insurance contract appears to have an element of *gharar* when it is often involved with doubtful and uncertain matters. The element of *gharar* exists in both the life and general insurance policies, whereby the subject matter of the contract or *ma'qud 'alayhi* is not certain until the insured event has taken place. This is particularly true since the amounts being paid by the two parties are not known at the contract session. This is the case since an accident may occur immediately after the insured makes the first payment, and the latter may make all the payments without any accidents happening.

Insurance contains an element of *maysir* because policyholders often bet premiums on the condition that the insurer will pay compensation in an amount higher than the premium paid during the occurrence of the insured event.

The *shari'ah* requires that all particulars relating to the contract must be known to the parties at the time of contract, otherwise the contract will become invalid. In such a contract, the policyholder agrees to pay a certain premium sum in consideration that the insurance company guarantees to pay a certain sum of compensation (sum insured) in the event of a catastrophe or disaster. But the policyholder is not informed, for example, of how the amount of the compensation that the company will pay him is to be derived nor is he certain of the amount.

### **Maysir (Gambling)**

*Maysir*, or gambling, means to court such risk as it involves both the hope of gain as well as the fear of loss, and which is not a necessary part of any of the normal activities in life. Islam also prohibits all kinds of gambling and games of chance. This is based on clear texts in the *Qur'an*. For example:



*“O you who believe! Intoxicants (all kinds of alcoholic drinks), and gambling, and animals that are sacrificed in the name of idols, and arrows thrown for seeking luck or decision are an abomination of Satan’s handiwork. So avoid that (abomination) in order that you may be successful.” (Al-Qur’an, 5:90).*

The nature of insurance is said to contain an element of *maysir* because policy holders are held to be betting premiums on the condition that the insurer will make payment (indemnity) contingent upon the circumstance of a specified event. On the other hand, the insured does not get anything from his premiums if the insured event does not happen at all.

Section 2 of the *Takaful Act of Malaysia 1984* defines *takaful* as “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.”

### **Islamic Alternative to Insurance – Takaful**

The term *takaful* is derived from an Arabic root word “*kafala*” which means responsibility, guarantee, amenability or suretyship. Hence, *takaful* literally means joint guarantee, shared responsibility, shared guarantee, collective assurance and mutual undertaking, which reflect a reciprocal relationship and agreement of mutual help among members in a particular group.

Thus, there are three aspects of mutuality embodied in *takaful*, namely mutual help, mutual responsibility and mutual protection from losses. So *takaful* is a system whereby participants contribute regularly to a common fund and intend to jointly guarantee each other, i.e., to compensate any of the participants who are inflicted with a specific risk. It is similar to a mutual insurance in spirit but inclined more towards commercial insurance in its business endeavour. When a person participates in a *takaful* scheme, he does not only seek protection for himself but also jointly cooperate with other participants to mutually contribute to one another in case of need.

Section 2 of the *Takaful Act of Malaysia 1984* defines *takaful* as “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.”

Therefore, *takaful ta’awuni* or Islamic cooperative insurance is not a contract of buying and selling where a party offers and sells protection and the other party accepts and buys the service at a certain cost or price. Rather, it is an arrangement whereby a group of individuals each pay a fixed amount of money, then compensation for losses of members of the group are paid out of the total sum. Hence, it manifests a sense of brotherhood and solidarity amongst the participants who are willing to help and assist one another in times of difficulty and need.

## Historical Development of *Takaful*

The essence of insurance could be seen in the system of mutual help in relation to the custom of blood money under the ancient Arab tribal custom, and eventually was approved by the Prophet (p.b.u.h.). The basis of shared responsibility in the system of “*aqila*”, as practised between Muslims of Mecca (*muhajirin*) and Medina (*ansar*) laid the foundation of mutual insurance. This practice was then followed by the Prophet’s companions. *Aqila* is non-commercial in nature and is aimed at helping those in need without demanding contractual payments. Instead, it is motivated by the sense of brotherhood and mutual responsibility to help fellow members in the tribe, who are in need of contribution. For instance, in case of unintentional murder involving two different tribes, the accused person’s paternal relatives will bear the responsibility of paying the blood money which is pooled from the group members’ contributions to the victim’s relatives.



In the present day, the spirit of insurance is often portrayed in social work such as cooperation in helping fellow friends or neighbours make a big feast, repair a defective house and lift the belongings to those who are moving out. Likewise in the case of “*khayrat*” fund, which is usually held by the mosques or rural communities and contributed by all members in the society to help the local deceased’s family.

The basis of shared responsibility in the system of "aqila" becomes the foundation of mutual insurance. For example, the accused person's relatives will be responsible to pay blood money (*diyat*) to the victim's relatives. The payment is pooled from the contributions of the group members.

This way of mutual cooperation and responsibility and the provision of financial benefits are indeed encouraged by Islam. Therefore, a system of mutual help being the basis of insurance and *takaful* is not contradictory to *shari'ah*.

The evolution of *takaful* has a long history. The main identifiable phases are the following:

1979 The first *ta'awuni* model (cooperative) was developed in Sudan.

1984 The *mudharabah* model was developed in Malaysia .

1984 The *wakalah* model was developed in the Gulf.

1996 The *waqf* model was developed in South Africa.

It is interesting to note that most *takaful* models are the hybrid of the above models.

### Shari'ah Ruling on Takaful

In 1965, the Congress of Islamic Research in Cairo had discussed the legitimacy of insurance in the Islamic world. In the First International Conference on Islamic Economics held at Mecca, Saudi Arabia in 1976, international consensus was reached that insurance for profit is contrary to *shari'ah*. This was confirmed by the Islamic Fiqh Academy at Jeddah in 1985: "*The contract of commercial insurance with periodical fixed premium provided by the present day insurance companies is a contract which is void and therefore haram in accordance with the requirement of shari'ah.*"

Besides the above rulings, the academy has also approved the mutual insurance or *takaful* system as an alternative form of insurance because it is based on a system of cooperation and mutual help for the good of society. The European Council for Fatwa and Research has reaffirmed the rulings: "*Commercial insurance is originally haram as agreed upon by most contemporary scholars. It is well-known that in most non-Islamic countries there are cooperative and mutual insurance companies. There is no harm from the shari'ah point of view to participate in these activities.*"

To further uphold the legality of *takaful*, the government of Malaysia, which is committed in promoting the Islamic legal system to govern *shari'ah*-compliant transactions, has passed the *Takaful Act 1984*. The Act is the first written law to regulate *takaful* business in the world in which the *Shari'ah Advisory Council* authorises supervision, monitoring and advisory of *takaful* operations at the national level and the *Shari'ah Advisory Committee*, at the institutional level.

In view of the above rulings and the real need for insurance, Muslim jurists have decided that insurance in Islam should be based on the principles of mutuality and

Concept of insurance which is acceptable in Islam:  
Mutual cooperation  
Mutual indemnity  
Brotherhood



cooperation. On the basis of these principles, Islamic system of insurance embodies the elements of shared responsibility, joint indemnity, common interest, solidarity, etc. This concept of insurance is acceptable in Islam because:

- The participants will cooperate among themselves for their common good.
- Every participant will pay his contribution in order to assist any fellow members who needs assistance.
- His contribution is considered as a donation (*tabarru'*) to the members in the group.
- The donation contribution is intended to divide losses and spread liability according to the community pooling system.
- The element of uncertainty will be eliminated insofar the terms in the contribution and compensation are made clear to the participants.
- It does not aim at deriving advantage at the cost of other individuals.

Therefore, the concept of insurance itself is not against the spirit of *shari'ah*. In fact, mitigation of risk by adopting the law of large numbers was widely used, particularly in the practice of "*aqilah*" as mentioned earlier. However, there are some means and methods used in conventional insurance which are not acceptable to *shari'ah*, elements such as *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling).

## Differences Between *Takaful* and Insurance

The fundamental difference between *takaful* and conventional insurance is rooted from the type of contract adopted. The conventional insurance contract is basically constructed between two parties, namely the insured and an insurance company. The insured deals with the insurance company by paying regular installments (premium) in return for the guarantee to pay compensation, in case the event stipulated in the contract happens. It is thus one of the probabilistic contracts since the compensation is contingent on events that may or may not occur. This definition and nature of conventional insurance invoke many *shari'ah* issues.

*Takaful* differs from conventional insurance in the sense that the *takaful* operator is not the insurer insuring the participants. In fact the persons participating in the scheme or *takaful* participants mutually insure one another. This is the essence of *takaful* that signifies mutual guarantee, help and cooperation to one another. The *takaful* operator simply functions as administrator of the *takaful* fund whose responsibility includes managing and investing the fund according to the *shari'ah* principles.

The fundamental difference between *takaful* and conventional insurance is rooted from the type of contract adopted:

Conventional insurance adopts bilateral contracts, i.e., payment of premium in consideration of payment of compensation in the event of defined loss.

*Takaful* is based on *tabarru'* (donation contract) which is unilateral in nature. All *takaful* participants mutually insure one another based on the spirit of brotherhood, mutual help and mutual indemnity.

Differences between *Takaful* and Conventional Insurance

<i>Takaful</i>	Conventional Insurance
A combination of <b>tabarru'</b> contract and agency and/or profit-sharing contract.	Contract of exchange (sale and purchase) between insurer and insured.
Participants are duty-bound to make contributions to the scheme and are expected to mutually share the surplus.	Policyholders are duty-bound to pay premium to the insurer
<b>Takaful</b> operator earns a return for rendering a service of managing the <b>takaful</b> programme and from the <b>mudharabah</b> profit-sharing scheme as <b>mudarib</b> .	Insurance company makes a profit when there is an underwriting surplus.
Counter-value ( <b>'fwad</b> ) is effort and/or undertaking of risk.	No clear valid counter-value. Source of profit is anticipating (hoping) that the uncertain future will be in their favour (that total premiums will exceed total claims).
<b>Takaful</b> operator acts as administrator of <b>takaful</b> fund and pays benefits from it. If there is any insufficiency in the fund, <b>takaful</b> operator must provide interest-free loan to rectify the deficiency.	Insurer is liable to pay the benefits as promised from insurance funds or/and shareholders' fund.
Indemnification component is based on mutual contribution, reciprocal donation ( <b>tabarru'</b> ).	Indemnification component is a commercial relationship between insurance company and the insured.
There is no insurer-insured relationship between <b>takaful</b> operator and participants. Participants act as both the insured and the insurer simultaneously.	There is a clear insurer-insured relationship.
<b>Takaful</b> funds must be invested in <b>shari'ah</b> -compliant instruments.	There is no restriction in investment of funds.

## Shari'ah and Regulatory Framework for *Takaful*

A *takaful* operator acts as administrator of the *takaful* fund, thus earns a return for rendering service. In contrast, an insurance company owns the insurance bonds and is liable to pay compensation in accordance to the insurance contract.

There are three levels of supervision and regulation of the *takaful* industry which are premised on local jurisdiction, the IFSB's Standards and the Core Principles of the International Association of Insurance Supervisors (IAIS):

- A. **Local jurisdiction** – For instance, countries like Malaysia or Bahrain have special legislation for *takaful* operators while countries such as UK adopt the fair level playing field, i.e., they do not give any special treatment nor create hurdles but instead allow any *takaful* operator to evolve within the existing legal and regulatory framework without any discrimination against it.
- B. **IFSB standards:** The IFSB and the IAIS prepared a joint-issue paper in 2006 on "Issues in Regulation and Supervision of *Takaful*" which deals with the application of the IAIS core principles that need attention to accommodate *takaful* such as corporate governance, financial and prudential regulations, transparency, report and market conduct and supervisory review process.

In November 2009, the IFSB issued the "Guiding Principles on Governance for *Takaful Undertakings*" dealing mainly with governance and prudential issues for *takaful*. In December 2009, an Exposure Draft on Standard for

Three levels of supervision and regulation of *takaful*:  
 Local jurisdiction, e.g.,  
*Takaful* Act 1984  
 IFSB standards  
 Core principles of IAIS

Solvency Requirements for *Takaful* Undertakings, which aims at establishing solvency rules for *takaful* operators in line with Solvency II, was issued. It aims at building up more emphasis on capital adequacy to meet solvency requirements and building confidence in the *takaful* market. There are other relevant standards regarding *shari'ah* governance such as “*Guiding Principles on Shariah Governance Systems for Institutions Offering Islamic Financial Services*”. This standard addresses issues such as qualities to be displayed by *shari'ah* scholars sitting on *shari'ah* boards – competence, confidentiality, independence, consistency and avoiding conflict of interest. As far as the *shari'ah* governance is concerned, it remains an unresolved issue because of difference in jurisdictions, nomination/choice of the members of the *Shari'ah* Supervisory Board (SSB) for marketing purposes, willingness or unwillingness of regulators to be involved in religious matters, etc.

### C. Core principles of the International Association of Insurance Supervisors:

In a 2005 paper, “*A New Framework for Insurance Supervision*”, IAIS sets out the different factors of supervision to be considered. According to the said documents the framework for insurance supervision consists of three groups of issues: financial issues, governance issues and market conduct issues. It also encapsulates three aspects in relation to these issues, reflecting three different responsibilities:

The IAIS framework provides three aspects of responsibilities:  
Effective insurance supervision  
Regulatory requirements  
Supervisory actions

1. Preconditions for effective insurance supervision (e.g., existence of an institutional and legal framework, efficient financial market and an authoritative and independent supervisory body). These preconditions support the financial, governance and the functionality of the insurance company in the market place.
2. Regulatory requirements, which are addressed to the operations of the insurer.
3. Supervisory actions, which has regard to the responsibilities and activities of the supervisory authority.

The distinction between regulatory and supervisory action are interdependent and may be complementary. Some scholars use them interchangeably. They work hand-in-hand to monitor the risks profile of insurance and *takaful* operators. Some risks faced by *takaful* operators that need attention are:

1. **Asymmetric Information** – *Takaful* is a blend between a mutual/cooperative insurance and a profit-oriented insurance where the *takaful* operator acts as a *wakil-cum-mudarib*. This raises the issue of principal-agent caused by asymmetric information. Thus the participants of the *takaful* fund are exposed

Prevailing risks faced by *takaful*:  
 Asymmetric information  
 Shari'ah risk  
 Solvency risk  
 Market risk

to greater risk of wrong governance compared to the mutual insurance or commercial insurance because the *takaful* participants own the *takaful* risk fund and also they jointly guarantee each other. It is not appropriate for regulators to dictate governance issues. They would usually adopt a non-prescriptive regulatory framework. One of the key governance issue faced by *takaful* operator is the *shari'ah* governance. It would most probably be argued that the shareholders interest will be more safely guarded than the participants of the *takaful* fund.

2. **Shari'ah Risk** – If *shari'ah* scholars are being paid by the *takaful* operators, they may indirectly tend to side with the company, even though independence is expected from them. Also, there may be conflict of interest if the *shari'ah* scholars sit on the *shari'ah* board of competing *takaful* operators. Various jurisdictions demand that *takaful* rules and model be adopted. This also creates regulatory issues. Another area that needs supervision and regulations with *takaful* is the *wakalah* fee or *mudharabah* profit-sharing. The *takaful* operator may tend to underwrite risky participants or invest in a non-compatible-sensitive manner to optimise his interest. It is difficult for supervisors and regulators to be prescriptive on these issues. Maybe via a thorough *shari'ah* review the cost lent need to be reconsidered.
3. **Solvency Risk** – As far as regulation of the financial side of *takaful* operators is concerned, it falls within the ambit of Capital Adequacy and Solvency II (discussed below).
4. **Market Risk** – As far as the market conduct (or conduct of business) is concerned, the main focus is on the ways the *takaful* operator deals with the participants to the *takaful* fund (policyholders) as well as other market players and its behaviour as an investor. With regards to the participants, disclosure of information to them is important so that they can make an informed decision whether to enter the *takaful* agreement or not. Suitability of the product in favour of the consumer is another factor to be considered by *takaful* operators. The product should not involve *gharar* and should be quite distinct compared to the conventional insurance products.

## Section 2: Operational Framework of *Takaful*

Some important principles governing the *takaful* contract need to be understood before entering such a contract. These are briefly discussed here.

## Participants' Benefits

The competency of a person to enter into a *takaful* contract is determined by his legal capacity to contract and his interest in the subject matter covered. The cover afforded under a *takaful* contract is not the subject matter covered but the participant's pecuniary interest in the subject matter. It is the participant's pecuniary interest which forms the subject matter of the contract and not the cover afforded.

Utmost good faith imposes a duty to both the *takaful* operator and participant to disclose all material facts relating to the *takaful* contract.

## Utmost Good Faith

The *takaful* contract imposes a duty on the contributor to disclose all material facts bearing on the contract. The duty of utmost good faith applies to both the participant and the *takaful* operator. The contributor is expected not to withhold information vis-à-vis the *takaful* operator because this leads him into a less favourable contract which ultimately affects all participants.

Islam demands that good faith be a major component of any transaction. Fairness, justice and honesty should prevail. When deciding which risk to be covered, the *takaful* operator must ensure that the *specific exception* to the risk to be covered should be revealed to the participants and the participants in return should disclose any aspect related to the risk associated to him and that needs to be underwritten, e.g., his full health conditions should be disclosed in the case of a medical cover.

## Insurable Interest

A person has an insurable interest in something when a loss or damage would cause that person specifically to suffer a financial loss or certain other kinds of loss.

## Proximate Cause

The essence of the *takaful* contract is the provision of indemnity for financial loss suffered by the participant as a result of the happening of an event which is covered against in the contract. It is necessary to state the perils against which cover is given, so that the intentions of the parties are clearly defined.

In *takaful* claims, the question which is often asked is not whether an event (consequence as defined in the contract) has occurred, but whether it was the result of a cause as defined. This means that a claim will be met if the fact for which a claim is brought is the result of the proximate cause included in the perils insured against, or that its

liability will be excluded if the proximate cause was an excluded peril. Usually, for a claim to succeed, the participant must show that the loss was proximately caused by the peril covered for.

Subrogation refers to a set of rules that facilitates for the reimbursement of a *takaful* operator when the operator has indemnified its participants under a contract of indemnity from a third party. This occurs when a third party has caused damages to a participant and the *takaful* operator indemnifies him. The money disbursed is claimable from the third party that has caused the damages.

## Indemnity

The *takaful* contract is a contract of indemnity; it is a contract to pay the actual loss sustained by the participant. It is a mechanism by which the *takaful* operator provides financial compensation in an attempt to place the participant in the same pecuniary position after the loss as he enjoyed right before the loss.

## Claims and Distribution

When claims are paid out, especially in case of family *takaful*, the proceeds disbursed should be distributed to the legal heirs according to Islamic law and not to the stipulated nominee as in the case with conventional insurance.

## Contribution and Subrogation

Contribution from participants (i.e., *takaful* installments payable by the participants) is the starting point for creating the *takaful* fund from which claims are paid. Once the *takaful* operator pays the claims from the *takaful* fund, the *takaful* operator will have to claim this disbursement from the person who caused the damage. Subrogation refers to a set of rules that facilitates for the reimbursement of a *takaful* operator when the operator has indemnified its participants under a contract of indemnity from a third party. This occurs when a third party has caused damages to a participant and the *takaful* operator indemnifies him. The money disbursed is claimable from the third party that has caused the damages. The underpinning purpose of the subrogation is to provide the *takaful* operator with a right of recourse.

The *takaful* contract not only upholds the principle of indemnity but also equity. Both the contribution and subrogation principles are corollaries to the principles of indemnity and equity.

## Underwriting

This is a process of selection through which the *takaful* underwriter determines which of the risks offered should be accepted, and if so, on what terms, conditions and rates.

## Classification of Takaful Operation

In general, there are two types of *takaful*: general *takaful* and family *takaful*, which is comparable to life insurance.

### General Takaful

The general *takaful* contract normally is a short-term policy where *takaful* participants pay contributions and operators undertake to manage the risk. The contributions paid by the participants are credited into the general *takaful* fund, which is then invested and the profits generated are paid back to the fund.

*Tabarru'* element is more apparent in general *takaful* as participants will normally undertake to regard his contributions as donation to fellow participants. All contributions go to a common pool of funds which will be used to compensate *takaful* participants in the event of loss. There is no saving and investment elements, but the *takaful* operator will distribute any underwriting surplus to the participants on annual basis. Typically, general *takaful* is short-term but renewable periodically. *Takaful* operators everywhere typically provide a full range of general *takaful* products in both retail and corporate segments. General *takaful* is categorised into two types: motor *takaful* and non-motor *takaful*. Motor *takaful* provides protection for private car, motorcycle and commercial vehicle. Non-motor *takaful* ranges from fire, personal accident, marine, health *takaful* and many others.

### Family Takaful

The family *takaful* is a long-term policy for which most participants aim at saving for their long-term needs, for example their children's education, their pension and compensation for dependants in the event of death and disability, amongst others. This type of *takaful* has a long-term time horizon which ranges from 10 to 30 years. In family *takaful*, operators normally divide the contributions into two parts: first, the participant's account (savings account). Secondly, the participant's special account (*tabarru'* account) for meeting losses of the fellow participants. In the event of loss, the participant will be compensated according to a pre-agreed formula. Accordingly, the clause of *tabarru'* is incorporated in the contract. Both accounts are invested in *shari'ah*-approved securities. Depending on the type of underlying contract, the *takaful* operator may receive a fee or share of investment profit.

Typically, it is long-term in nature, loosely comparable to conventional life insurance. If a participant dies prematurely, his family gets the amount in the participant's account plus dividends, and amount in participant's special account as if he continued contribution until their maturity period. If the participant withdraws from the *takaful* programme, he will get the amount in the participant's account only. Among the most common and typical family *takaful* products offered include savings and educational

General *takaful*:  
Short-term policy  
General *takaful* fund  
*Tabarru'* as the core element  
No savings  
Motor *takaful* and non-motor  
*takaful*

Family *takaful*:  
Long-term policy  
Savings and investment elements  
Two funds: participant account  
(savings) and participant's special  
account (*tabarru'*)

plans, retirement plans, retirement annuities, *waqf* plans and ancillary benefits added to the main plans, such as protection for critical illness, disability, accidental death, or waiver contribution.

## Underlying Contracts in *Takaful*

*Shari'ah* provides various types of contract to suit the needs of contracting parties. Each contract has unique features and rules which are in line with the objective of the respective contract. It is important to choose the suitable and right contracts which are capable to achieve the purpose of *takaful* and fulfill the needs of parties involved in the *takaful* arrangement. However, the parties cannot simply modify the rules and conditions of each contract which will change the nature of the contract itself.

From the current practice, the contracts adopted depend on the contracting parties. For instance, *tabarru'* contract which is a form of mutual indemnity, is used between the participants. As between the participants and the operator, there are few contracts to choose from depending on their arrangement and interest.

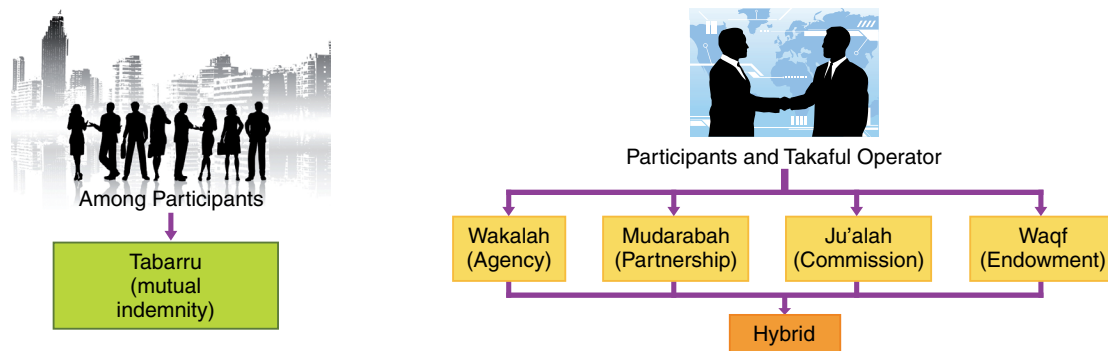


Figure 12.2 Underlying Contracts In *Takaful*

### Contract Among *Takaful* Participants: *Tabarru'*

*Tabarru'* is an agreement by a participant to relinquish, as donation, a sum of contribution that he or she agrees to pay into a *takaful* fund. Participants give certain portions of his contribution as donation with the purpose of providing mutual indemnity to *takaful* participants, where the donation acts as a mutual help and joint guarantee should any fellow participants suffer from a defined loss. The current practice does not specify the exact form of donations, whether it is an outright gift (*hibah*) or endowment (*waqf*). According to AAOIFI, the practice is known as *Iltizam bit Tabarru'* or *Nihd*.

It is important to note that *Waqf takaful* model focuses on the *tabarru'* aspect.



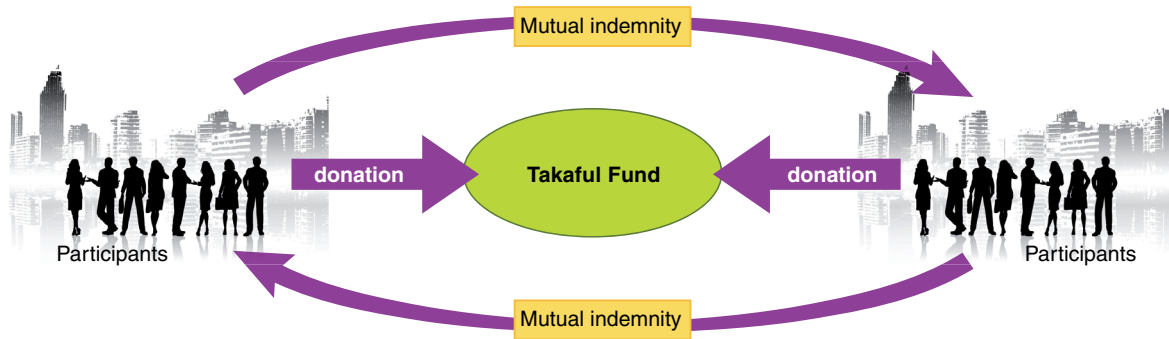


Figure 12.3 Contract Among Takaful Participants

### Contracts between Participants and Takaful Operator

There is no insurer-insured relationship between participants and the *takaful* operator because the participants are insuring themselves. The *takaful* operator is engaged by participants (in a group) to manage the *takaful* scheme for them. The parties can adopt any of the following contracts depending on their needs; namely, *mudharabah*, *wakalah*, *ju'alah*, *waqf*, or combination of the earlier contracts (hybrid).

*Tabarru'* is an agreement by a participant to relinquish, as a donation, a sum of contribution that he or she agrees to pay into a *takaful* fund.

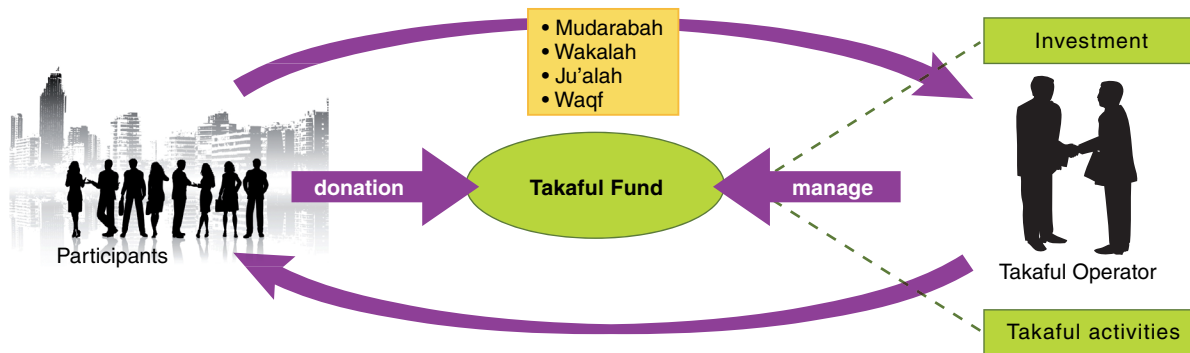


Figure 12.4 Contracts Between Participants and Takaful Operators

#### 1. Mudharabah

*Mudharabah* means giving of capital to another person who will trade with it for the purpose of sharing the profits according to a pre-agreed ratio. Investment is a side activity to optimise the fund. In *takaful*, whereby the capital provider (*rabbul mal*) are the participants and the investment manager (*mudharib*) is the *takaful* operator. Investment manager (operator) must invest in a *shari'ah*-compliant manner and according to terms in the *takaful* contract. Profit, if any, will be shared based on a pre-agreed ratio. If there is a loss, it will be borne by the capital provider. However, if the loss is due to the manager's negligence, then the manager must be jointly responsible for the loss.

Contracts between participants and takaful operators:  
Mudharabah  
Wakalah  
Ju'alah  
Waqf

## 2. *Wakalah*

*Wakalah* is a contract of agency, whereby participants remain the actual owners of the *takaful* fund. In this arrangement, the principal is the participant while the agent (*wakil*) is the *takaful* operator. The principal appoints or authorises the agent to manage the *takaful* fund for two main duties, namely, *takaful* activities (underwriting, paying claims, etc.) and investments. As an agent, the operator is entitled to an agency fee (agent's remuneration) and performance fee (agent's commission).

## 3. *Ju'alah*

*Ju'alah* refers to a commitment to pay a specified amount of reward for the performance of a prescribed task. On the basis of this contract, the participants collectively appoint the operator to manage the *takaful* fund in a prescribed manner, for a specified reward if done accordingly. Payment is based on actual output and performance.

## 4. *Waqf*

*Waqf* means a unilateral contract to relinquish a right over property and allocate it for general enjoyment of the usufruct by the specified beneficiaries. It can be made applicable in the treatment to *takaful* fund, while management and operational aspects of *takaful* fund may still use *wakalah* and *mudharabah* contracts. Participants will give contribution into a *waqf* fund, and thus completely lose the right over their contributions. *Takaful* operator acts as a trustee to the *waqf* fund.

## Models of *Takaful*

There are currently four *takaful* models being operated worldwide which apply several forms of contract governing the relationship between participants and *takaful* operator. The most widely practised models are *mudharabah* and *wakalah*. Some *takaful* operators adopt a hybrid model either combining *mudharabah* and *wakalah* or *wakalah* with *waqf* model or even *mudharabah* and *waqf*. However, the most commonly used contracts are *mudharabah* (profit-sharing), *wakalah* (agency) and *waqf* (endowment).

The descriptions of each model of *takaful* are presented below:

### **Mudharabah Model**

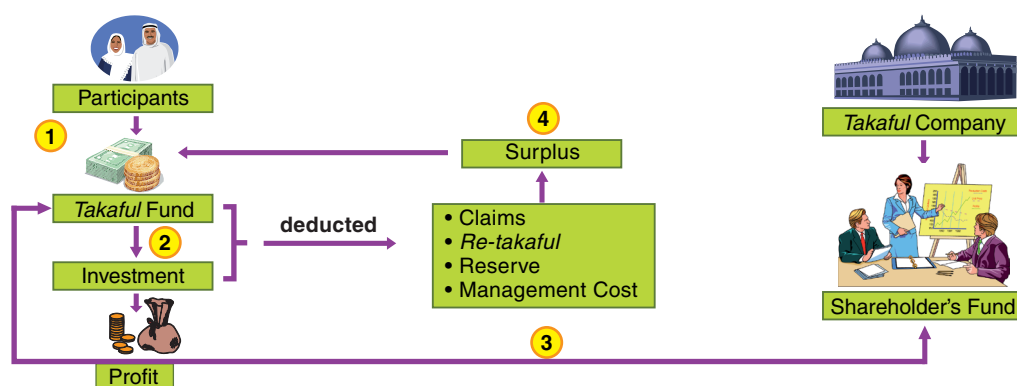
By the principle of *mudharabah*, the *takaful* operator who acts as an entrepreneur or *al-mudharib* will accept payment of the *takaful* contributions (premium) termed as *ra's-*

Models of *takaful*:  
 Mudharabah model  
 Wakalah model  
 Hybrid *mudharabah* and *wakalah*  
 model  
 Waqf model

*ul-mal* from *takaful* participants acting as *sahib-ul-mal*. The contract specifies that the share of profit (surplus) from the operations of *takaful* managed by the *takaful* operator is to be distributed between the participants as the providers of capital and the *takaful* operator as the entrepreneur, in accordance with the principle of *mudharabah*. The sharing of such profit (surplus) may be in a ratio of 5:5, 6:4, 7:3, etc., as mutually agreed between the contracting parties. The *shari'ah* committee approves the sharing ratio for each year in advance. The operator is entitled to a fixed percentage of any investment profit, if any.

In a *mudharabah* model, the *takaful* operator must be actively involved in the investment because the main income is generated from a certain ratio of investment profit.

Generally the risk-sharing arrangements allow the *takaful* operator to share in the favourable investment performance of both the participant's account (savings account) and the participant's special account (*tabarru'*). However, if there are losses in the participant's special account, the *takaful* operator provides an interest-free loan (*qard al-hassan*) that has to be repaid when the participant's special account returns to profitability and before any future surplus is distributed. Therefore, *takaful* operator must be both prudent and active in investing the *takaful* funds to gain profits because their main income is generated from a certain ratio of such investment profit. Of course, when investing the funds, the instruments used should be *shari'ah*-compliant. The *mudharabah* contract is cancellable, and upon cancellation all cumulative capital plus profit must be returned to the capital provider (participants), after deducting administrative expenses.



**Figure 12.5 Operation of General Takaful in a Mudharabah Model (Short-Term Scheme)**

Explanation:

1. Participants pay *takaful* contributions which form a *takaful* fund.
2. The fund will be invested in *shari'ah*-compliant investments.
3. The profit, if any will be shared among participants and the *takaful* operator on the basis of the agreed ratio.

- At year end, the surplus (after deducting claims, *re-takaful*, reserve and management expenses) will be distributed to the participants (share with operator in modified *mudharabah*).

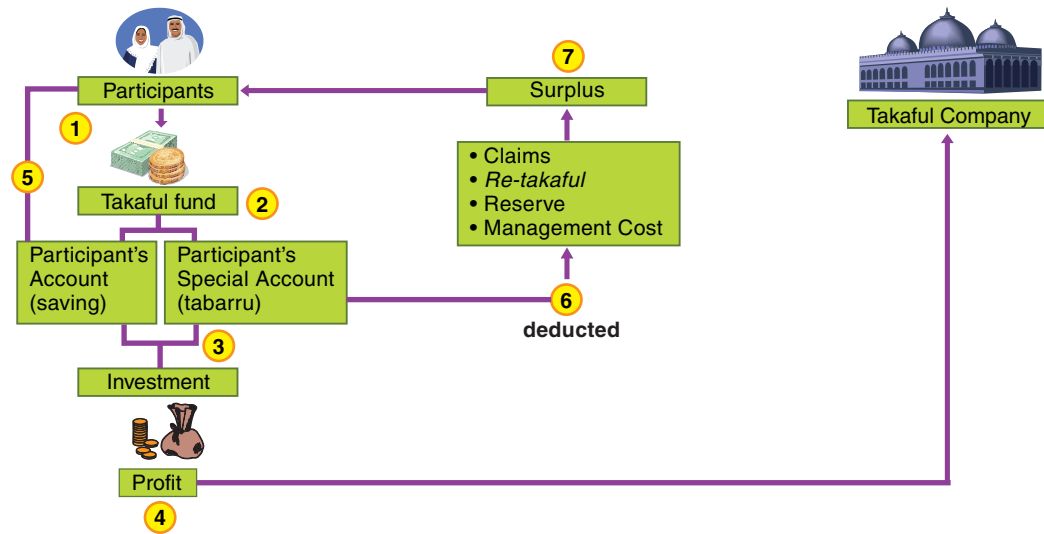


Figure 12.6: Operation of Family *Takaful* in *Mudharabah* Model (Long-Term Scheme)

Explanation:

- Participants pay *takaful* contributions which form a pool of the participants' fund.
- Participants' fund are divided into: (a) participants' account for saving; and (b) participants' special account – known as participants' risk account which is based on the *tabbarru'* concept. The amounts allocated in these two accounts are based on the agreed percentage decided upfront in the contract.
- The fund in both accounts will be invested in assets, such as government Islamic instruments, Islamic private debt securities and equities, fixed assets and fixed deposit accounts.
- Investment profit, if any, will be shared among participants and the *takaful* operator on the basis of the agreed ratio.
- Amounts in the participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme.
- Amounts in the participants' special account will be used for paying claims, *re-takaful*, reserve and management.

In family *takaful* on the basis of a *mudharabah* model, the participants' contributions are divided into: Participant's Account which will be paid to participants upon death, or maturity, or early surrender; Participants' Special Account which will be used for paying claims, *re-takaful*, reserve and other costs.

- At year end, the surplus will be distributed to the participants (and *takaful* operator on the agreed ratio-modified model).

The *mudharabah* model for *takaful* is rapidly losing ground as the *takaful* model of choice. This is due to the current trend among *takaful* operators which are inclined to adopt *wakalah* model. The *mudharabah* model is suitable for shorter term products, such as one-year renewable products, like motor insurance in which the sharing of surplus happens earlier than that in long term business. Another challenge for *takaful* operators adopting this model is their direct exposure to the ups and downs of business since they share profits from investments.

In Malaysia, of the eight *takaful* operators at the time of writing, Syarikat Takaful Malaysia Berhad (STMB) was operated based on this model since its establishment. However, STMB has changed it to *wakalah* model recently. Other countries that practise *takaful* based on *mudharabah* is Takaful International (Bahrain).

In a *wakalah* model, participants remain the owner of the *takaful* fund and appoint the *takaful* operator as their agent (*wakeel*) to manage the fund for a defined fee.

### Wakalah Model

*Wakalah* model is becoming increasingly popular. As mentioned earlier, *wakalah* is a contract of agency. Based on this principle, participants remain the actual owners of the *takaful* fund, and the *takaful* operator acts as an agent for the participants to manage the fund for a defined fee. As an agent, the operator is entitled to agency fee (remuneration) and performance fee (as commission). The surplus of the participants' fund investments goes to the participants. The agency fee rate is fixed annually in advance in consultation with *shari'ah* committee of the company. Performance fee which is related to the level of performance is given as an incentive for good administration and governance of the participants' fund.

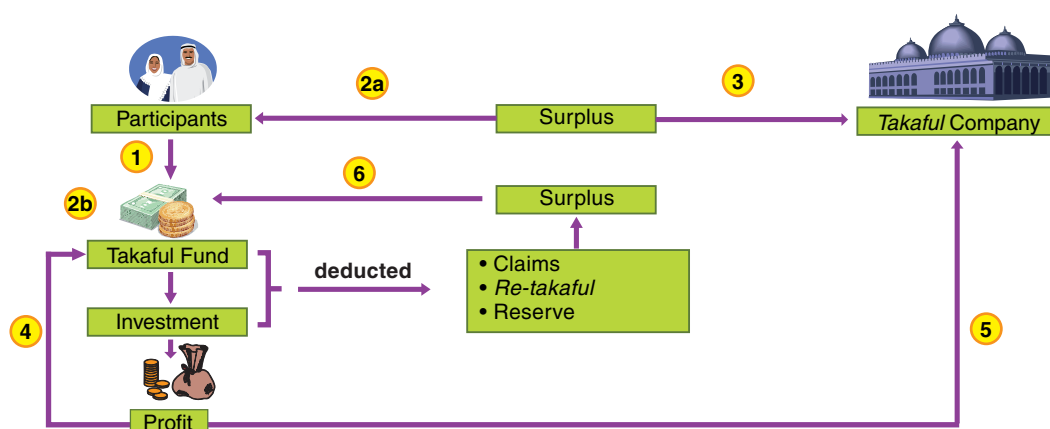


Figure 12.7: Operation of General Takaful in Pure Wakalah Model (Short-term Scheme)

In family *takaful* on the basis of a *wakalah* model, a participant's contribution will be first deducted on an agreed ratio as a *wakalah* (agency) fee while the remaining contributions will be channelled to the Participant's Account and Participant's Special Account.

Explanation:

1. Participants pay contributions under the *takaful* scheme.
2. The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between the *takaful* operator and the participants in the contract.
3. Agency fee which consists of agent's remuneration and administration expenses will be channelled to the *takaful* operator.
4. The group *takaful* fund will be invested and any income or profit will be returned to the group fund.
5. *Takaful* operator will be entitled to a performance fee (as commission) for managing the investment on behalf of the participants.
6. End of year surplus (after deducting claims, *re-takaful* and reserve) will be distributed to the participants (share with operator in modified *wakalah*).

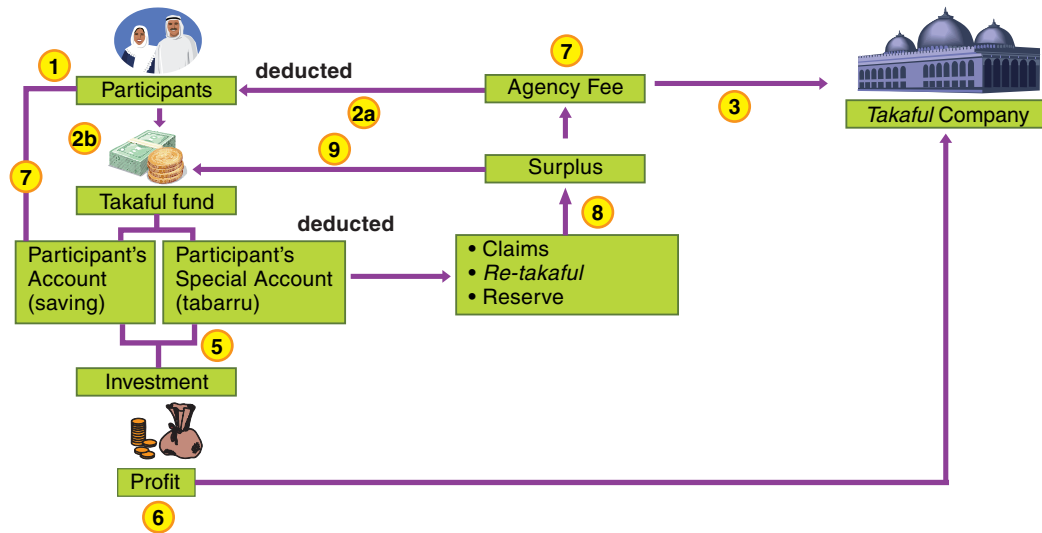


Figure 12.8 Operation of Family Takaful in Wakalah Model (Long-term Scheme)

Explanation:

1. Participants pay contributions under the *takaful* scheme.
2. The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between *takaful* operator and participants in the contract.

3. Agency fee which consists of agent's remuneration and administration expenses will be channelled to the *takaful* operator.
4. *Takaful* fund is divided into: (a) participants' investment account for saving, and (b) participants' special account – known as participants' risk account which is based on *tabbarru'* concept. The amounts allocated in these two accounts are based on the agreed percentage decided upfront in the contract.
5. The fund in both accounts will be invested in assets, such as government Islamic instruments, Islamic private debt securities and equities, fixed assets and fixed deposit accounts.
6. Investment profit, if any, will be returned to the fund. *Takaful* operator will be entitled to a performance fee (as commission) for managing the investment on behalf of the participants.
7. Amounts in participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme.
8. Amounts in participants' special account will be used for paying claims, *re-takaful*, reserve and management.
9. At year end, the surplus will be distributed to the participants (and *takaful* operator on the agreed ratio-modified model).

*Takaful* operators in a *wakalah* model cannot share in the investment profit; rather they are entitled to a fee based on their performance in the investment.

This model is widely used currently, for example, Bank Aljazira in Saudi Arabia (2001) and *Takaful Ikhlas* in Malaysia (2003). In fact, Bank Aljazira became the pioneer in the Middle East by introducing *Takaful Ta'awuni*, based on the *wakalah* model.

The main issue in a pure *wakalah* model is that, the management and shareholders of a *takaful* operator cannot share in the profits because they merely act as an agent to the participants. However, they may be entitled to a fee based on their performance in the investment. Therefore, many *takaful* operators today attempt to adopt a combination of *wakalah* and *mudharabah* or modified *wakalah* model.

### Hybrid of *Wakalah* and *Mudharabah* Model

This model basically combines some features in both *wakalah* and *mudharabah* model. *Wakalah* principle is applied in underwriting activities while *mudharabah* contract is used in investment of the *takaful* funds. Thus, the *takaful* operator is entitled to agency fee for managing the fund as a *wakil* and a share of profit for managing the investment of the fund as a *mudarib*.

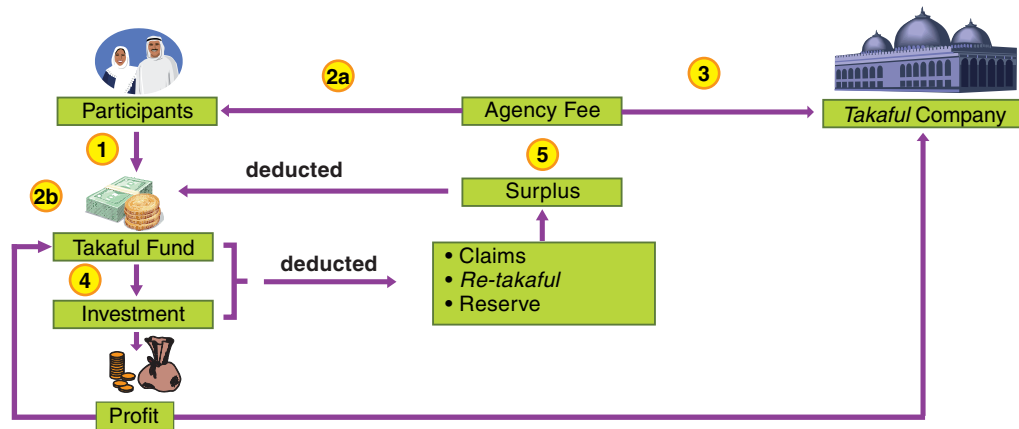


Figure 12.9 Operation of General *Takaful* in a Hybrid of *Wakalah* and *Mudharabah*

Explanation:

1. Participants pay contributions under the *takaful* scheme.
2. The contributions are divided into: (a) agency fee and (b) *takaful* fund. The division is made based on the agreed ratio between *takaful* operator and participants in the contract.
3. Agency fee, which consists of agency commission and administration expenses will be channelled to the *takaful* operator’s fund.
4. The fund will be invested in *shari’ah*-compliant investments. The profit, if any, will be shared among participants and *takaful* operator on the basis of the agreed ratio.
5. At year end, the surplus (after deducting claims, *re-takaful* and reserve) will be distributed to the participants and *takaful* operator on the agreed ratio in the contract.<sup>1</sup>

In a hybrid of *wakalah* and *mudharabah* model, the *takaful* operator is entitled to an agency fee for managing the fund as a *wakeel* and a share of profit for managing the investment of the fund as *mudharib*.

This approach seems to be more well-accepted and favourable than the other models and is widely adopted by many newly-established *takaful* operators and international organisations, e.g., Abu Dhabi National *Takaful* Operator.

### Hybrid of *Wakalah* and *Waqf* model

In addition to the earlier models, the latest model that has emerged from Pakistan was introduced by renowned *shari’ah* scholar, Taqi Usmani. The general concept of the

<sup>1</sup> This is based on the current prevailing practice, though in principle, underwriting surplus under *wakalah*, should be distributed to the participants only.



*takaful waqf* plan is designed to enable any individual to save regularly with the aim of accumulating a fund that can be left as a donation under the *waqf* system. In this model, the shareholders of the *takaful* operator will initially make a donation to establish the *waqf* fund. The fund needs to be invested in a *shari'ah*-compliant investment, and the returns will be used for the benefit of the participants. *Tabarru'* fund from participants' special account also becomes part of a *waqf* fund.

Therefore, *waqf* fund consists of donations from the shareholders and participants seeking *takaful* protection. The combined amount will be invested and any profits earned will be returned to the same fund. Based on *waqf* principles, the donors (shareholders and participants) would lose ownership rights on their monetary contributions into the *waqf* fund. The monies eventually become the property of *waqf* fund which can only be used for the benefits of all participants.

A *waqf* fund consists of shareholders' donation and participants' contributions in which they (shareholders and participants) lose ownership rights because the *waqf* fund can only be used for the benefits of all participants.

The shareholders, who act as the owner of the *waqf* fund, delegates authority to the operator to become the administrator of the fund, whose function among others, include paying claims from the fund. The operator also undertakes the role of investment agent (*wakalah bil-istithmar*) when it invests the *waqf* fund and is entitled to a certain percentage of the investment profit as a performance fee.

Generally, there are two types of *waqf* model in respect of surplus sharing, namely:

1. Pakistani model (pure *waqf* model), in which the underwriting surplus is returned to the *waqf* fund, thus not distributed to either the participants or operator.
2. Commercial *waqf* model, in which the terms on surplus-sharing are spelt out in the *waqf* deed in accordance to the intention of the contracting parties involved in the *waqf* arrangement.

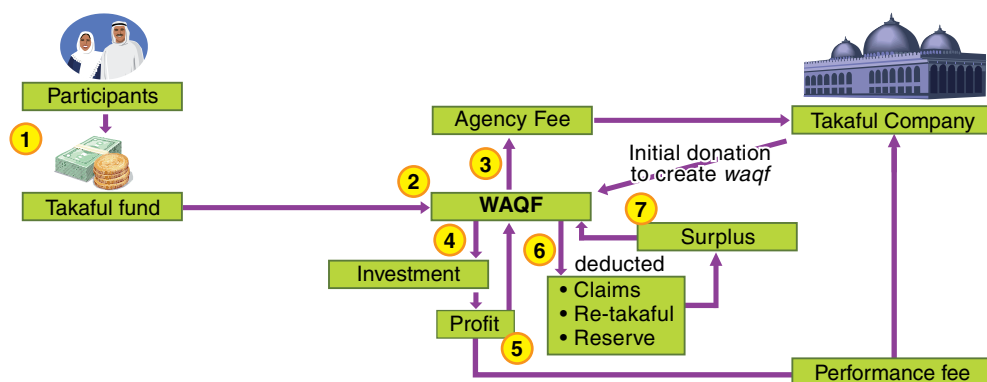


Figure 12.10 Operation of Takaful in a Combination of Wakalah and Waqf Model

Unlike the Pakistani model (pure *waqf* model), the *waqf* deed in a commercial *waqf* model provides the terms of surplus-sharing according to the intention of the contracting parties.

#### Explanation:

1. Participants pay *takaful* contributions which form a pool of participants' fund.
2. A *waqf* fund, which receives initial donation from the shareholders, followed by the participants, is formed.
3. Agency fee is deducted from the *waqf* fund. The fee which consists of agent's remuneration and administration expenses will be channelled to the *takaful* operator.
4. *Waqf* fund will be invested in *shari'ah*-compliant assets investment.
5. Investment profit, if any, will be channelled into the *waqf* fund, while the *takaful* operator (investment agent) will be entitled to a performance fee on the basis of the agreed ratio.
6. Accumulated amounts in participants' account will be paid to the participants upon death, or delivery or maturity of a *takaful* scheme. Amounts in *waqf* fund will be used to pay claims, *re-takaful* and reserve.
7. At year end, the surplus (after deducting claims, *re-takaful* and reserve) in *waqf* fund will be returned to the same fund again.

The sources of income in this model is similar to that under the *wakalah* model, namely:

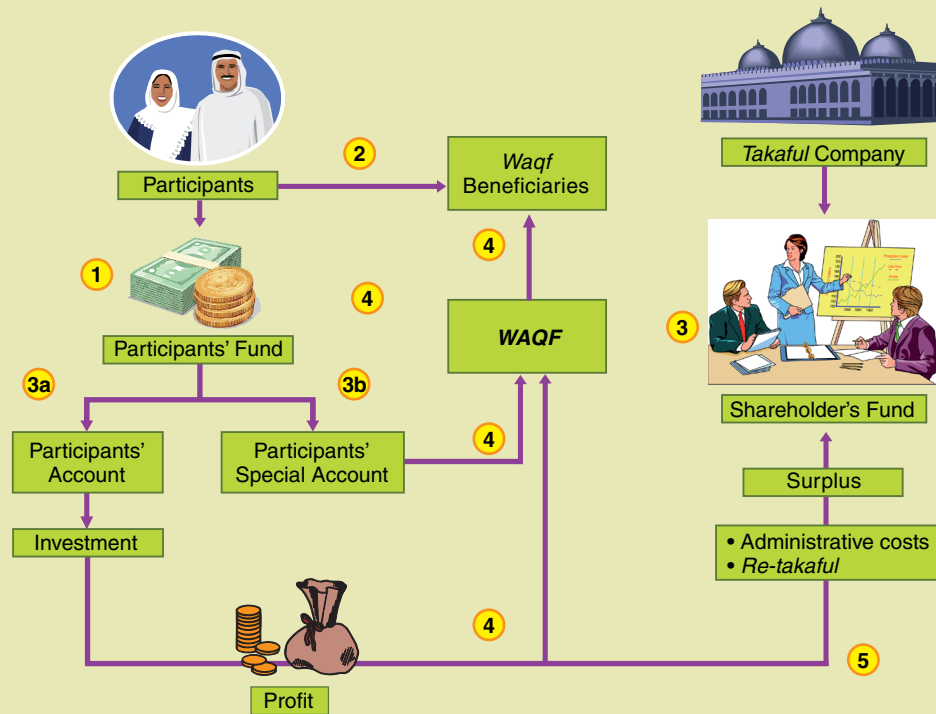
- Agency fee for undertaking service as a *wakil* against a defined remuneration payable from the *waqf* fund.
- Performance fee for acting as an agent for investment. This model is relatively new and usually adopted by non-profit organisations.



### Case Study 1

## Mudharabah with Waqf Plan: Syarikat Takaful Malaysia Berhad

*Mudharabah* with *waqf* plan is designed to enable any individual to save regularly with the objective of accumulating a fund that can be left as a donation under the *waqf* system. Under this model, the participants accrue a considerable sum of money through the accumulation of the contributions, paid regularly over a certain period of time, which would then be sufficient to be endowed as *waqf*. Any benefits derived under the plan, either upon the premature period due to unexpected death of the participant or upon its maturity, are to be remitted by the *takaful* operator to the parties named as the *waqf* beneficiaries.



**Figure 12.11** Operation of Takaful in a Combination of Mudharabah dan Waqf Plan

Major steps in this arrangement may be discussed as follows:

1. Participants enter into *takaful waqf* plus *mudharabah* plan and pledge certain amount of payment to be contributed. Participants pay *takaful* contributions which form a pool of the participants' fund. Prior to signing the *takaful* plan, they also need to agree to the time period of the plan. In the case of Syarikat Takaful Malaysia Berhad, participants are allowed to choose the period ranging from 5, 10, 15 up to 45 years. However, the plan must mature upon the participants reaching the age of 75. Based on this, the regular contributions can be calculated and paid either on a monthly or yearly basis. Syarikat Takaful Malaysia Berhad offers various methods of contribution payment either to be paid directly to the operator, through salary deduction or bank standing instruction.
2. Participants must name an institution of his choice as the beneficiary of the *waqf*. In the case of Syarikat Takaful Malaysia Berhad, the participants are confined to the list of institutions provided

by the operator which include mosque building funds, orphanages, education funds, etc. This is part of the element of *waqf* contract that must be transparent at the beginning of the contract.

3. All contributions before its maturity will be divided into two accounts:

(a) **Participant's Account**

The amount of fund under this account will be utilised by the *takaful* operator at its discretion in order to be invested in any appropriate business or investment. This is based on the principle of *mudharabah mutlaqah*, or unrestricted *mudharabah*, in which the capital providers (participants) allow the entrepreneur (*takaful* operator) to use and invest their funds without any restrictions and limitations. The profit is then shared between both parties according to the agreed ratio, while the loss, if any, need to be borne solely by the participants. If this actually happened, the amount of money in the participants' accounts will be less than what is expected. In the end, they would be unable to donate the intended amount of money for *waqf*.

In the case of Syarikat Takaful Malaysia Berhad, the contract of *takaful waqf* plus *mudharabah* plan stipulates that any monthly profits are to be divided between the participants and the company at the ratio of 70:30. The participants' portion of profits is further divided between the Participant's Account and the Participant's Special Account.

Based on *waqf* contract, the participant agrees to relinquish the whole balance in the participant's account, which must be paid to the *waqf* recipient. In other words, the participants are no longer the real owner of whatever amount available in the account. Therefore, if the participants die before the plan actually matures, the heirs have no right to claim for a disposable inheritance.

(b) **Participants' Special Account**

The remaining amount after deducting a portion of a participants' contributions to the participant's account will be allocated into the participants' special account. This portion is treated as a *tabarru'* or donation portion. In the case of Syarikat Takaful Malaysia Berhad, only 1% of the total contributions are deducted for this account. As the name implies, based on *tabarru'* principle, the amount is solely treated for the purpose of solidarity, brotherhood and cooperation among the participants.

For example, if any of the participants died before his *takaful* plan matures, the *takaful* operator shall pay to the *waqf* beneficiaries comprising the balance from the participant's account and the unpaid amount of *takaful* contributions for the period from the date of his death until the date of maturity. The payment is actually taken from the participants' special account, i.e., the funds from other participants who are still alive based on the principle of *tabarru'*. This implies that the intention of the deceased to contribute a certain amount of *waqf* before his death can still be fulfilled even though he died before the maturity of his plan.

- (c) Upon maturity of the plan, the *takaful* operator will pay the *waqf* recipient the balances from the participant's account including the actuarial surplus (if any) arising from the participants' special account.
- (d) The source of income for *takaful* company is derived from its share of profit realised from the investment, after deducting the costs of managing the plan and *re-takaful* expenses.

Source: Hashim, 2007.

In addition to the above operating models, there is one newly proposed model operated on the basis of *wadi'ah* contract. The *wadi'ah* model mainly aims to overcome some issues in the other models, such as ownership of the *takaful* fund, sharing of surplus, entitlement to the investment profit, etc. This model is currently under review and discussion, thus, it will be beyond the scope of discussion in this chapter.

## Takaful Stakeholders

*Takaful* stakeholders are the *takaful* operator, participant, nominee and beneficiary. All these parties are dependent on each other to ensure the smooth running of an insurance practice. The main parties to a *takaful* contract are the operator and participants.

### Takaful Operator

An operator is the one who undertakes on behalf of all participants, in consideration of contributions paid by the participants, to indemnify or provide a financial security against unexpected peril, which may happen on the subject matter of the policy. *Takaful* operator must observe the following requirements:

1. An individual, a company or a cooperative society wishing to operate *takaful* activities must have contractual capacity provided in the general principles of commercial contracts.
2. An individual, a company or a coop society, which intends to operate *takaful* practices as an operator must get registered before the commencement of the operation.
3. An operator must be able to show that at all times he is able to maintain a surplus of assets over liabilities of not less than the amount as may be prescribed from time to time, which may depend on the economic condition.

A *takaful* participant can enter into a *takaful* contract under his own name when he is sixteen years old. If he is between 10 to 15 years, he can only affect the *takaful* contract with his parent's or guardian's consent.

4. The operator has to make a deposit before obtaining a licence for his operation. The deposit is a requirement, which is kept for security against an unexpected bankruptcy which might be suffered by the operator.

## Participant

The participant pays regular contributions to the *takaful* operator for the purpose of future security of the subject matter at risk. Theoretically, everybody, regardless of age, class, religion, sex or any form of identification, has a natural right to buy a policy for the material security of property, life or business ventures which are at unexpected risk. But in practice, the right of mutual cooperation may not be rendered to some people in society because of some reasons which do not permit them to exercise the equal right of mutual cooperation.

A participant who is competent to enter into a *takaful* contract must fulfill the following conditions:

1. **Age:** A participant can affect a *takaful* contract under his own name as early as 10 years old but only with his parents' or guardians' consent. He has a full capacity to *takaful* or insurance contract upon reaching the age of sixteen.
2. **Medical Fitness:** A person who is suffering from serious illness, or is of unsound mind, or has been certified by a doctor as a patient who is unable to manage his own affairs, or is dependent on others to survive, may be regarded as unfit to be a participant to a *takaful* policy.
3. **Legally Qualified:** A person whose debt exceeds the value of his own property may be declared bankrupt immediately once his creditor demands the right of credit from him. It should also be grounds for disallowing one to be a participant. If one is already bankrupt and is subject to the creditor, he is unable to contribute to the *takaful* operator.
4. **Free:** If a person is imprisoned, he has already lost his freedom of the management of his own financial affairs. Therefore, a captive should also cease to have the right of being an insured in a policy.
5. **Authorised:** A person who wishes to protect a particular property or business which is not legally owned by him is not allowed to enter into a *takaful* contract. An unauthorised person shall not be qualified as a participant because this may give an opportunity for him to gain over the property of others, which may disrupt the whole objective of *takaful* to sustain mutual cooperation, solidarity and brotherhood.

The beneficiary must be a living person. An artificial entity or unborn child is disqualified as beneficiary because it has no capacity to a *takaful* benefit.

## Beneficiary

Under Islamic law, the beneficiary in a *takaful* policy cannot be determined based on a nomination clause. A beneficiary must have an insurable interest in the policy and simultaneously be nominated by the participant in the policy. The current practice seems to recognise those who are entitled to the deceased's estate as having a legitimate insurable interest, although this point is not clearly expressed in any regulation or guidelines. Therefore, a beneficiary who has an insurable interest but is not nominated, may be disqualified from receiving any benefits from the policy as he is not considered as a legal beneficiary. Another condition is that the beneficiary must be an ordinary and alive person. So, an artificial entity or unborn child cannot be nominated as beneficiary because it has no capacity to a *takaful* benefit. The right of the beneficiary in any kind of policy should first go to the participant who pays regular contributions as savings for future security against unexpected risk. Once the participant dies, the right of beneficiary over the benefits of the policy may move from the participant.

## Nominee

The nominee is a trustee and the governing principles of nominee under Islamic law could be derived from the doctrine of *al-Amanah*. The word *al-amanah* means reliability, trustworthiness, good faith, honesty, and fidelity. If a person is being entrusted or nominated to hold the minor's property as a trustee, it is the nominee's responsibility to hand over the property upon confirming the maturity of minor. The nomination shall not constitute a gift or an ownership over the benefits of the policy but only a mere trust in the policy and distribute them among the beneficiary of the participant.

In *takaful*, the nominee acts as a trustee who holds the *takaful* benefits as a trust and distributes the benefits when the beneficiaries have attained full capacity to receive such benefits.

## Re-Takaful

In conventional insurance, it is common for insurance operators to collectively share the risks they have taken on. These risks are "transferred" to an even larger pool of risks, managed by a larger insurance operator. This process is known as the re-insurance process. *Takaful* operators have also been known to resort to re-insurance as a method of risk management.

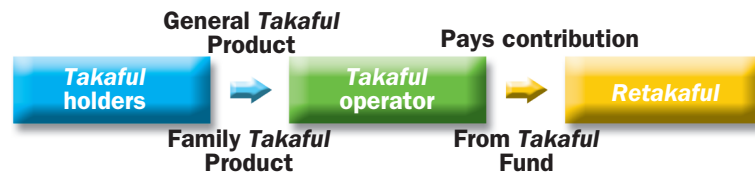
*Re-takaful* is a form of mutual assistance among participating *takaful* operators in which the operators pay certain amount of contributions into the *re-takaful* fund in order to share a certain defined risk in a specified category if these exceed prudent underwriting limits. Item 2/1 of *Shari'ah* Standard No. 41, AAOIFI 2010 defines Islamic re-insurance (*re-takaful*) as:

"... the agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for avoidance of part of the risks which the insurance funds may encounter. On the basis of such agreement, a re-insurance fund which has a distinct legal personality and independent financial liability is formed through making contributions out of

the insurance funds paid by the insurance clients on the basis of donation. The re-insurance fund, thus formed, assumes the task of covering part of the risks encountered by the insurance funds.”

Obviously, the present *re-takaful* industry is very small and mainly dominated by very large conventional re-insurance companies. There are only a few *re-takaful* operators, and these are considerably smaller and operate only at national and regional markets. The process of sharing the insured risk between the *takaful* operator and other conventional insurance companies is either due to lack of sufficient insurance capacity for such risk, or because of regulatory requirements of risk-sharing with regard to the magnitude of the risk in question. This poses an issue that the re-insurance process as executed by conventional re-insurance companies may not observe the *shari'ah* principles of *takaful*.

Figure 12.12  
Re-takaful  
Arrangement



### Methods of Re-Takaful

*Re-takaful* currently adopts two main methods, namely, facultative and treaty. Facultative method is affected only in special cases and placed on individual risk basis, e.g., individual family, group family or mortgage *takaful*. The second method is treaty in which the *takaful* operator agrees to cede during a specified period, and the *re-takaful* operator agrees to accept all risks included within the terms of the *re-takaful* contract up to specified amount.

Both methods are acknowledged by Item 4 of *Shari'ah* Standard No. 41, AAOIFI 2010 that provides that *re-takaful* can use one of the following methods:

1. Selective method (facultative): the operator presents the individual risk which constitutes the subject matter of *re-takaful* to the *re-takaful* operator along with a summary of all the information related to it, so that the *re-takaful* operator can study the information and decide whether to accept the risk or not. The *re-takaful* operator becomes committed to what it accepts.

Facultative method is a type of *re-takaful* for individual policy or risk. This arrangement can be on a proportional basis, which is the original form or non-proportional basis. Facultative means “optional”, i.e., the power to act according to a free choice. So, the facultative underwriter of *re-takaful* operator is free to accept or decline any offer from a *takaful* operator that wants to cede its risk to such *re-takaful* operator.

*Re-takaful* is an agreement among *takaful* operators to contribute into a larger fund (*re-takaful* fund) which assumes the task of covering part of the risks encountered by the participating *takaful* operators.



Example of facultative *re-takaful* operation:

• Risk	70% retained by TO	30% placed facultatively to RTO
• Contribution	70% retained by TO	30% paid to facultative RTO
• Loss	70% paid by TO	30% paid by facultative RTO

Note:  
 TO – *takaful* operator  
 RTO – *re-takaful* operator

In the facultative method, the *re-takaful* operator (RTO) may accept or decline any offer from the *takaful* operator that wants to cede its risk to the RTO. Prior to that, the *re-takaful* operator must first study the *takaful* operator's application and information so that the RTO becomes committed to what it accepts.

2. Comprehensive method (*re-takaful* agreement/treaty): the *re-takaful* operator assumes the commitment to accept all the risks which fall within the scope of the agreement signed with the *takaful* operator.

There are four ways of applying the treaty method:

1. **Quota share:** When the *takaful* operator and *re-takaful* operator share each and every risk proportionately on the original terms and condition.
2. **Surplus:** When the *takaful* operator by arrangement with the *re-takaful* operator cede only that portion of each and every risk which it does not like to retain in his own account.
3. **Excess of loss:** When *takaful* operator bears all claims arising up to specified amount and only when this ultimate net loss (after taking into account all recoveries) exceeds this amount, can they recover from the re-insurer up to a specified maximum. In this case, there is no proportional sharing of risk between *takaful* operator and the *re-takaful* operator.
4. **Stop loss:** *Re-takaful* operator will not be responsible for any loss, big or small, until the loss ratio for the year reaches an agreed percentage of the premium.

*Takaful* operators are not allowed to re-insure with conventional re-insurance companies, except when such re-insurance is sought as a transitional arrangement stemming from a public need which amounts to necessity.

Facultative	Treaty
• Not automatic cover	• Automatic cover
• Optional – <i>re-takaful</i> operator can accept or decline	• Obligatory – <i>re-takaful</i> operator must accept valid cessions
• Single risk – may be grouped together in a cover	• Many risks – portfolios may include thousands of risks
• Full details – must be disclosed with each placing	• No details – except special cases

Source: Nor Azman Nusi, 2009, MNRB *Re-takaful*.

Figure 12.12: Comparison between Facultative and Treaty *Re-Takaful*

### Shari'ah Opinions on Re-takaful

Item 3/2 of *Shari'ah* Standard No. 41, AAOIFI 2010 provides that *takaful* operators are not allowed to re-insure with conventional re-insurance companies, except when such re-insurance is sought as a transitional arrangement stemming from public need which amounts to necessity. The basis for such permissibility include:

1. Such a re-insurance coverage is based on a legal maxim which is consistent with the *hadith* stating that “No harm and no reciprocal harm”. This is also affirmed by the principles of Islamic *fiqh* which stipulate that coverage should be for the actual harms and not at all for making a wealth out of it.
2. The re-insurance agreement embodies *tabarru'* or donative nature of a *takaful* contract.
3. It is endorsed by the *fatwas* issued by competent bodies such as *Fatwa* No. 3 of the 10th Seminar of Al-Barakah and the *fatwas* issued by the *Shari'ah* Boards of Islamic banks and insurance companies. For example, a *fatwa* has been issued by Faisal Islamic Bank of Sudan (*Fatwa* No. 5/3).

As such, the practice of *takaful* operators to re-insure with conventional re-insurers is permissible with certain conditions. Sheikh Wahbah Al-Zuhaily also concurred with the *fatwa* which ruled that re-insurance is valid since it satisfies a need that cannot be satisfied otherwise, as determined by the bank's experts. However, the ruling is conditional on the following stipulations:

*Takaful* operators must work towards the establishment of a strong *re-takaful* operator that would allow them to avoid dealing with conventional re-insurance companies.

1. That payment to re-insurance companies be kept to the minimum possible amount to satisfy the need, following the rule: “necessities are measured by their degree.” The evaluation of the amount needed to satisfy this need is left to the bank's experts to determine.
2. That the *takaful* operator does not collect a profit commission, or any other commission, from the re-insurance companies.
3. That the *takaful* operator does not keep any reserves with the re-insurance company for natural (heavenly) disasters, since keeping such reserves would lead to interest payments to the re-insurance companies.
4. That the *takaful* operator should not be involved in determining the investments of the reinsurance companies. It should not demand any share in the profits they gain from such investments, nor ask about any losses they incur.

5. That the contract with the re-insurance company be for the shortest possible period.
6. That the *takaful* operator works towards the establishment of a *re-takaful* operator that would allow it to avoid dealing with conventional re-insurance companies.

In addition, Item 6 of *Shari'ah* Standard No. 41, AAOIFI 2010 provides certain guidelines to the *takaful* operator which re-insures with conventional re-insurance companies. Such conditions are:

1. *Takaful* operators should re-insure first with *re-takaful* operators, to the largest possible extent.
2. *Takaful* operators should not keep any cash reserves for ongoing risks that belong to conventional re-insurance companies and on which interest has to be paid. Nevertheless, an agreement can be reached between the *takaful* operators and the conventional re-insurance company in order to specify a certain portion of the premiums payable to the conventional re-insurance company to be retained by the Islamic insurance company.
3. The *takaful* operator can invest retained funds through *mudharabah* or investment proxy, where the *takaful* operator assumes the role of the *mudarib* and the conventional re-insurance company assumes the role of *rabbul-mal*. When profit is distributed as per the ratio agreed upon, the share of the conventional re-insurance company is to be added to its account with the *takaful* operator, whereas the share of the profit earned by the *takaful* operator for performing the investment as an independent personality is to be added to the account of the participants.
4. The periods of the re-insurance agreements sought by *takaful* operators from conventional re-insurance companies should commensurate with the actual need.
5. Before signing agreements with conventional re-insurance companies, *takaful* operators should seek the approval of their *shari'ah* boards.
6. *Takaful* operators should stick to the minimum size of re-insurance with conventional reinsurance companies, and *shari'ah* boards should undertake the follow-up in this matter.

It is important to note that, while in the previous years, there were only a few active *re-takaful* operators in the global *re-takaful* market, which was the reason why most

In the present day, there is a significant increase in *re-takaful* operators with strong capital base and financial ratings in the market. Therefore, the principle of "*darurat*" (necessity) may not be applicable based on the maxim, "Harm is measured by its degree." If harm (inexistence of RTO) is able to be minimised or removed, then resorting to prohibited things (conventional re-insurance companies) based on *darurat* is no longer permissible.

*takaful* operators did primarily cede to re-insurance based on the *darurah* principle (necessity allows what is prohibited), but that is not the case in the present day. There are significant increase in multinational *re-takaful* operators with strong capital base and financial ratings in the market. Therefore, the exemption may need to be reviewed. In fact, this is also based on the maxim, "Harm is measured by their degree". So, if harm is able to be minimised or removed, then resorting to prohibited things based on *darurah* is no longer permissible.

IFSB in Item 91 of Guiding Principles on Governance for *Takaful* (Islamic Insurance) Undertakings (2009) states that:

"*Takaful* operators shall ensure that any *re-takaful* arrangement duly serves the purpose of the *takaful* undertakings and is undertaken with the interests of *takaful* participants as the foremost consideration. The pricing and protection offered by the *re-takaful* operator shall be consistently reviewed from time to time to ensure that it is commensurate with the needs and requirements of the *takaful* undertakings. As far as possible, *takaful* operators should strive to use *re-takaful* operators, rather than conventional re-insurers, in support of a fully *shari'ah*-compliant financial system for the *takaful* undertakings."

## Challenges in Re-Takaful Industry

In view of its relatively new presence in the market, *re-takaful* poses five identified challenges as follows:

Challenges of *re-takaful* industry:  
 Limited capacity  
 Competition  
 Lack of rating  
 Lack of expertise  
 Lack of transparency in reports

1. **Limited Capacity:** The current scenario shows that existing *re-takaful* is inadequate to meet the needs of *takaful* operators. Therefore, it needs the national will and efforts to establish more *re-takaful* operators with sufficient funds to support the needs of *takaful* players today.
2. **Competition:** *Re-takaful* faces certain constraints to stay competitive in terms of *shari'ah*-compliance. *Re-takaful* must therefore find its own way to increase its competitive advantage.
3. **Lack of Rating:** Very few *re-takaful* operators get a minimum of Arating. Thus, the *re-takaful* operator needs to strengthen its financial condition and improve underwriting practices to achieve a good rating.
4. **Lack of Expertise:** This is a major weakness of the industry in terms of asset management, underwriting, accounting and marketing staff. It is proposed to the *re-takaful* providers to develop a proper educational tools and continuous staff training.

5. **Transparency in Report:** Globalisation requires the standardisation of accounting methods, management and corporate governance. *Re-takaful* operators must have a great respect for ethical aspect in operation.

## Section 3: Issues, Opportunities, and Challenges

### Shari'ah Issues in Takaful

Despite the *takaful* industry expanding at an exponential rate, and with a few models developed reflecting its versatility, there are still some *fiqh* issues which some Muslim jurists have raised. The fact that *takaful* operation differentiates itself on the premise of *tabarru'* rather than premium, this raises some *fiqh* discussions. The nature of donations has been viewed with scepticism by some Muslim scholars as it is supposed to be a unilateral rather than bilateral contract, unlike the conventional insurance contract. Consequently, it is argued that if a claim is made because one has made a donation, then this changes the nature of the *takaful* transaction into one of a bilateral contract of exchange because the claim is based on the donation made. Hence, this type of transaction will be considered as an "*'aqd al-mu'awadah*" (contract of exchange) which then attracts *riba*, *gharar* and *maysir* because money is exchanged for money. Another concern is if *tabarru'* and joint-guarantee are unilateral contracts, how can these be demanded and claimed legally? The Maliki's view of giving a binding force to a promise (*wa'ad*) is used. This raises the validity of such promises in commercial transactions. The answers given by the Muslim scholars who endorse *takaful* transactions to those concerns are:

1. Firstly, it is argued that the *takaful* agreement is an '*'aqd al-mu'awadah* because there is still a contractual nexus between the donation and the compensation one receives from the fund. As the compensation is claimable, it is thus argued that it is a bilateral contract, or a contract of exchange. Hence, the money received from the pool may still contain *riba* (interest) and *gharar* (uncertainty). The famous legal maxim "*al-ibratu bi al ma'ani la bi al-alfaz*" (one should look at the end result of a contract and not at its wordings) is used to back up this objection. That is, one can name the money given to the insurance company as donation/contribution but in fact it is a premium because the participants are still being indemnified on that basis. It is a question of form over substance. Practically, the donation is similar to the premium the way it is calculated and enforced in conventional insurance

The participants' contributions are considered *iltizam bi al-tabarru'* (self-imposed donation); whereby the payment of compensation from the *takaful* operator in the event of a calamity is similarly considered as *iltizam bi al-tabarru'* on behalf of the other participants.

industry. So the burning question is, how can these voluntary acts of donating a *tabarru'* qualifies as an obligation?

The answer given by those endorsing the *takaful* transaction is that the principle of obligating voluntary acts is from the *shari'ah* principles adopted by the Maliki Mazhab and Allamah Hatab has compiled the *Masail* of undertakings in his book, *Tahreerur Kalam fi Masail Iltizam*. Imam Hatab says: "That which is known of the Mazhab of Imam Malik and all of his companions in regards to a person who obligates something upon himself, then that ruling will be applied to him as long as he does not pass away or become insolvent." Based upon the Maliki principles of jurisprudence, the payment of contributions from the members will be considered as *iltizam bi al-tabarru'* (self-imposed donation) based on this principle because it is from one side (unilateral); therefore it is not a contract of exchange (*aqd al-mu'awadah*). Similarly, the payment of compensation from the *Takaful* operator in the event of a calamity in conformity to the principle will be considered as *iltizam bi al-tabarru'* from one side and there is no inter-relation of one *iltizam* to the other.

Issue of uncertainty (*gharar*) in *takaful* is tolerable because of the unilateral contractual nature of *tabarru'* and joint guarantee among all *takaful* participants.

2. Secondly, the issue of *wa'd* (promise) has also been questioned by many scholars. They argue that if a *wa'd* is a not a contract, why should it be taken as a contract so that a contractual claim may arise? The same answer given above has been used to answer this objection, it is a unilateral promise which is binding. This is analogous to the English law whereby if a promise is made under a deed, it will be binding. A self-imposed promise is enforceable according to the Maliki School of Law, and also the issue that a promise is legally binding was resolved in the year 1409 by the Islamic *Fiqh* Academy.
3. The third issue raised is that *gharar* (excessive uncertainty) still persists in *takaful*. For instance, one does not know exactly when the risk will materialise for which he or she is making a *tabarru'*. Here the answer lies in the question of quantifying the extent of *gharar*. Many scholars have argued that *al-gharar al-yasir* can be calculated and thus it will be tolerable. Also he argues in favour of a non-zero sum game theory, in that if the *gharar* is not a win-lose situation, i.e., only one winner and one loser, then it will be acceptable. In the case of a *takaful* transaction, it can be argued that there is *al-gharar al-yasir* or no *gharar* because of the unilateral contractual nature of *tabarru'* and joint guarantee. The legal maxim used is that "uncertainties are tolerable in the gratuitous contract." Others argue that the real issue is not that of *gharar* but that of *ghurn* (effort to justify a counter value in the transaction).
4. Fourthly, there is the issue of underwriting surplus. Technically, the bulk of the money in the fund is due to no claims from the donations. So can one take his own donation back or is one allowed to share it as a profit? Different

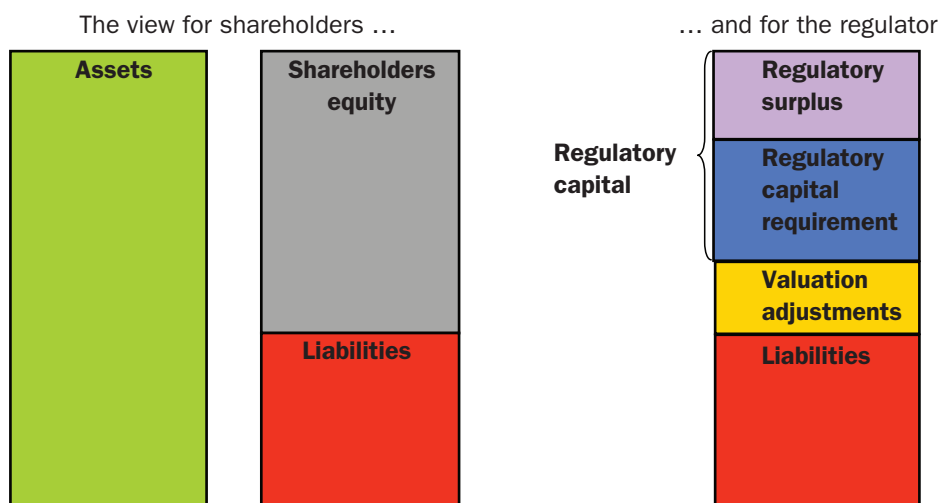
views exist to this question. The most appropriate one in our opinion is that the money should remain in the fund as reserves for three reasons:

- (a) it consolidates the fund for the following year to pay claims.
  - (b) the subsequent contributions can be brought down due to that reserve which means less financial burden on participant regarding their contributions.
  - (c) this drop in the pricing makes the *takaful* industry more competitive.
5. The fifth point is the concern that *takaful* allows for a contract of indemnity in a *mudharabah* model. So have we really resolved the issues against the contract of *takaful* being a contract of indemnity? The same argument will apply that this is not an indemnity but a mutual help among the participants.

Underwriting surplus should remain in the fund as reserves because: it will be used to pay claims in the following years if there is deficit in the fund the subsequent contributions can be reduced the contribution reduction and pricing will make *takaful* more competitive.

### Capital Adequacy Ratio and Solvency

These terms are often used interchangeably. Solvency or capital adequacy is a form of prudential regulation aimed at ensuring that regulated entities operate safely and soundly. The essence of the solvency test is a comparison between an institution’s capital – the excess of its assets over liabilities – and a required minimum amount. Regulators want to ensure that *takaful* operator can meet their liabilities. In doing so, there should be regular assessment of their risk profile (see diagram below). The assets and liabilities are measured according to prescribed valuation, which may differ from accounting rules. This determines the extent of solvency.



Source: Casey, 2009:196.

Figure 12.13 The Relationship between Shareholders’ Surplus and Regulatory Surplus

Solvency is needed because:

1. It creates a level of confidence in the market for people to take economic risk.
2. It helps in preventing big enterprises needing *takaful* cover from collapsing and which may have a domino effect in the economy if such risks are not mitigated.
3. It helps redressing the imbalance due to information asymmetry that exists in the retail financial markets between the retail financial institutions and the consumers by reassuring them that financial institutions are safe.
4. Solvency margin buys time. The solvency requirements provide some comfort to consumers regarding the risks which materialise over long periods and can be dealt with by insurance companies.





Solvency requirements affect *takaful* operators due to the way *takaful* operators' capital is construed for risk management. Capital is treated as a residue according to accounting theory representing the difference between the assets and the liabilities. Current international thinking is that in modern insurance regimes, it should be made explicit that the undertaking should have given probability of meeting all its liabilities over a defined period (such as 99.5% over a year). Hence, the risk profile should be well gauged. It is in this spirit that the risk-based capital is being adopted as the new prudential regulation focusing on the solvency issues. The essence of the solvency test is a comparison between an institution's capital – the excess of its assets over its liabilities – and a required minimum amount. To this end what the regulator consider to be an asset may be different from what the accounting standards are, hence adjustments are needed.

The regulator aims at reducing the amount available for surplus and fits in the true regulatory surplus which would only be the amount by which the available excess of assets over liabilities exceeded the required margin of solvency or regulatory requirements.

*Takaful* operator consists of a two-tier structure that is a hybrid of a mutual and a proprietorship company. The issue is that there will be two funds, a shareholders' fund and a participant fund's where the *tabbaru'* goes. In order to ensure that the solvency requirement are being met, the devise of *qard* (benevolent loan) from the *takaful* operator/or shareholders' fund to the participants' risk fund has been suggested. This nevertheless has its own *fiqh* issues that needs to be addressed, such as forcing the *takaful* operator to make available a benevolent loan. It is suggested that the *wa'd* (unilateral promise) mechanism can be used to resolve some of the *fiqh* issues in this line. Therefore as far as solvency is concerned, the *takaful* operator should hold enough capital to cover up for any *qard* needed to supplement the participant fund required if there is deficiency of any reserve for that purpose. Thus, the participants' claim would rank above any *qard* in case of insolvency.

To manage the solvency issue, the IFSB has suggested some standards in its Exposure Draft Standard on Solvency Requirements for *Takaful* (Islamic Insurance) Undertakings (December 2009) which still needs to be finalised. You can refer to the five key features discussed in the above-mentioned IFSB documents.

The risks to which *takaful* funds are exposed to are discussed below. Based on these risks exposures, some mathematical formulae have been suggested to calculate these risks, both for the participant risk fund and the shareholders' *takaful* fund. Risks faced by the respective funds in a *takaful* undertaking are described in Figure 12.14. As can be seen, more risks can be attributed to the personal risk fund (PRF).

A *takaful* operator in necessity consists of a two-tier structure, which is a hybrid of a mutual and a proprietorship company.

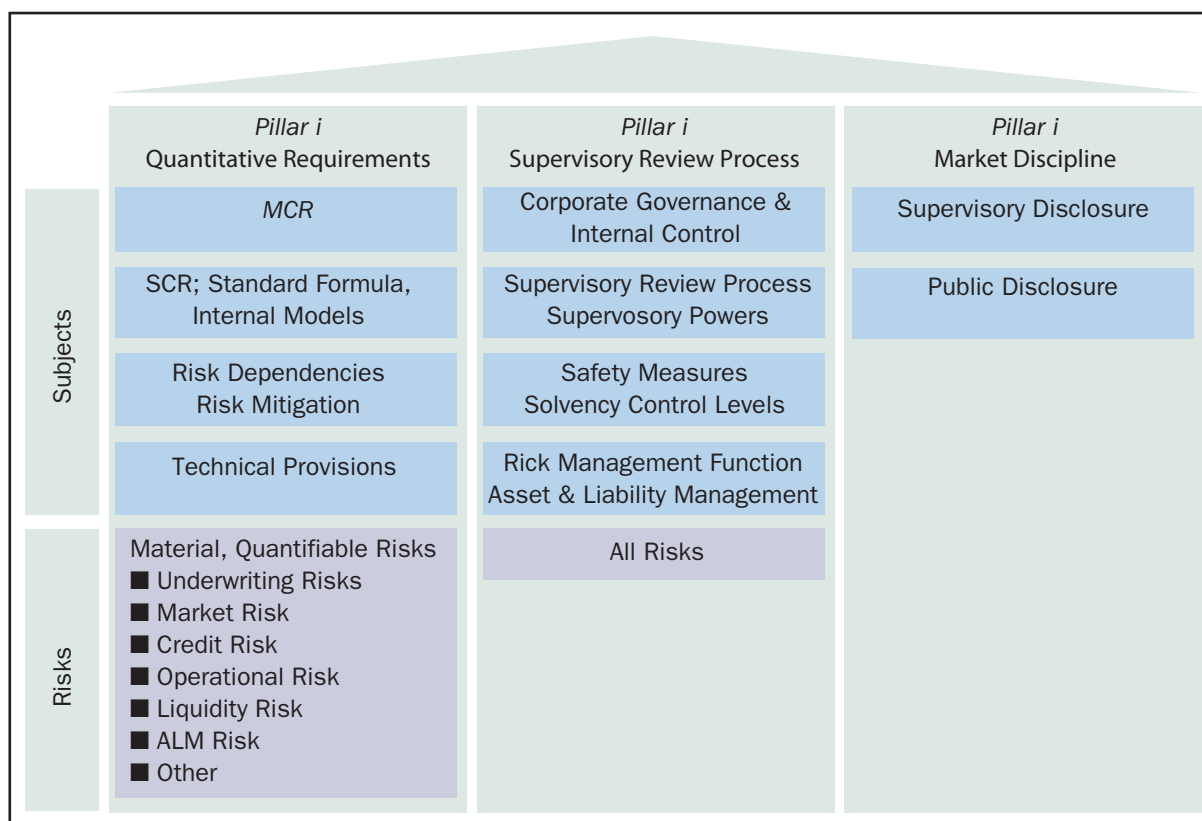
Categories of Risk	PRFs	Shareholders' Fund
<b>Operational Risks</b> The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. <i>Shari'ah</i> non-compliance risk should also incorporate possible causes of loss resulting from non-compliance and failure in the TO's fiduciary responsibilities.	Loss of income from the purification of tainted income due to <i>Shari'ah</i> rulings. Losses due to claims fraud. Losses due to legal risk (e.g. in court interpretations of policy terms).	Administration and acquisition expenses for developing and maintaining the <i>Takaful</i> contracts. This relates to the business risks whereby the fund will not have adequate cash flow to meet the operating expenses. Also liable for losses arising from its negligence, misconduct or breach of fiduciary duties in the management of <i>PRFs</i> (fiduciary risk).
<b>Liquidity risk</b> The potential loss to a <i>Takaful</i> undertaking arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.	Additional costs through raising additional funds at a premium on the market or through the sale of assets which simultaneously affect the overall appropriate provisioning and reserving methodologies of <i>PRFs</i> .	Additional costs through raising additional funds at a premium on the market or through the sale of assets which simultaneously affect the overall appropriate capitalisation and reserving.
<b>Provisioning and Reserving Risks</b> The risk of under-estimation of the underwriting liabilities and adverse claims experiences.	<i>General Takaful</i> exposed to losses due to random events such as natural perils, fire, pollution, crime, war, terrorism, and others.  <i>Family Takaful</i> is exposed to losses arising from severity and frequency of claims due to changes in anticipated mortality, morbidity and longevity as well as catastrophic events such as epidemic, major accident or terrorist attack.	
<b>Underwriting Management Risks</b> The risks of poor management of accepting risk and claim payouts.	<i>Family Takaful</i> and <i>General Takaful</i> are exposed to losses arising from poor selection, pricing and acceptance of risk and inappropriate product design.	
<b>Credit risk</b> The risk of a counterparty failing to meet its obligations in accordance with agreed terms.	Exposed to profit and capital receivables from invested assets. <i>Takaful</i> contributions receivable and <i>Re-takaful</i> recoveries.	Exposed to risk of non receipts of profit and capital receivables from invested assets. <i>Wakalah free</i> (due to contributions receivable) and other trade debtors <sup>20</sup>
<b>Market Risks</b> The risk of losses arising from movements in market prices, i.e., fluctuations in values in tradable, marketable or leaseable assets (including <i>sukuk</i> ) and a deviation of the actual rate of return from the expected rate of return.	The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a <i>Salam</i> asset, the market value of a <i>sukuk</i> , the market value of assets purchased to be delivered to a <i>murabahah</i> customer over a specific period, the market value of <i>ijarah</i> assets) and of foreign exchange rates.	The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a <i>saham</i> asset, the market value of a <i>sukuk</i> , the market value of assets purchased to be delivered to a <i>murabahah</i> customer over a specific period, the market value of <i>ijarah</i> assets) and of foreign exchange rates.

Source: IFSB Standard of Solvency, draft Exposure.

Figure 12.14: Risks Faced by *Takaful* Funds

The underwriting surplus transferred to reserves form part of equity. There are two main issues with regards to *takaful* fund. Firstly, the *takaful* operator accepts *tabarru'* into the *takaful* risk fund which is owned by the participants themselves and secondly *tabarru'* is treated as capital because it is the participants' money. So what really should be used as a buffer to absorb loss is either the shareholders' capital or the participants' funds? Therefore, the *qard* concept to be provided by the *takaful* operator seems to be the way out, provided it can be guaranteed.

Being a financial institution, *takaful* operators are bound to certain levels of financial regulation. The two main issues that need attention are the solvency ratio to ensure that they are not over-exposed to risk. Thus, the three pillar strategy of the European Solvency II suggestion as described in Figure 12.15 below is a good inspiration for *takaful* operators.



Source: Caggemini 2006.

**Figure 12.15: Three Pillar Strategy of European Solvency II**

## Underwriting

Underwriting is a fundamental aspect of covering risk. It is a process that enables an insurance company or *takaful* operator to choose whether to cover a specific risk or not. Underwriting helps to create a portfolio, the *takaful* operator generates charges, it helps in selecting which risk to take on board and it also ensures *shari'ah* compliance with regard to the risk taken and also protecting the *takaful* fund. *Takaful* underwriting aims to provide equitable and fair risk-sharing schemes amongst participants that are relatively homogenous in nature.

Muslim scholars have expressed some reservations regarding some risks being covered. For instance, it is argued that if someone suffers from AIDS he cannot be underwritten because his risk profile is high and also due to the high probability that he or she is a

Underwriting is a process that enables a *takaful* operator to choose whether to accept a specific risk or not. The main aim is to provide an equitable and fair risk-sharing scheme amongst participants that are relatively homogenous in nature.

prey of a disease that could have been caused by illicit sexual intercourse. Islam does not endorse illicit sexual intercourse and covering such risk might pollute the fund. This is a debatable issue because the law of the land may not allow such discrimination. In countries like South Africa, it would not be allowed due to Section 9 of the constitution which does not allow unjustified discrimination.

Another case would be the coverage for partners rather than spouses. In UK for instance, *salam* insurance allowed for such provision due to the law of the land that does not allow discrimination based on sex orientation. However, Malaysia will not accept underwriting with such condition. Other scholars have also raised issues with regard to women in case of murder arguing that the *diyah* is less. Under modern legislation this will not be allowed and also the case of *takaful* need not necessarily be based on Islamic criminal law for analogical deduction.

Family *takaful* usually underwrites risks related to death, total and permanent disability, critical illness, hospital and surgical cost, and so on.

The risks to be underwritten can fall either under family or general *takaful* (this is analogous to the long-term and short-term insurance underwriting respectively). In the case of family *takaful*, the following risks are usually underwritten: death, permanent disability, hospital and surgical cost and surrender.

In the case of general *takaful*, there are many risks that are underwritten. However, the two main risks covered are fire and motor. In the case of fire, the factors influencing the underwriting are the construction, occupation of the insured, location and access to it. With regard to motor *takaful*, the factors influencing the underwriting are: model of the car, its year of manufacture, age of drivers, location of car, colour and access. The age of a driver can in turn affect high fine which impinges on the underwriting premium to go up.

### Consumer Perception

Despite having advantages that make *takaful* a better option in the eyes of consumers, the customers seem to perceive *takaful* to be closely similar to conventional insurance in respect of getting protection, but hardly understand the nature of contract and relationship among the parties. A segment of them would prefer *takaful* due to religious reason, but majority of them still consider the service quality as the most important patronage factor. Such factor includes giving adequate explanation on the plan, offering the plan which is really needed, reasonable amount of premium payment, and most importantly the company's efficiency in processing and paying claims.

### Investment Management

The different models of *takaful* influence the investment policy of *takaful* operators. The point remains that investment of the contributions can be broadly categorised into two main streams: those meant for covering individuals and those meant to build up the fund. Not many *halal* avenues exist for investing the contributions. The main ones are stocks, *sukuk*, infrastructure financing.

Currently, there is no international standard for stock screening. However, what is apparent is that the *shari'ah* scholars have laid down two levels of screening: the qualitative and the quantitative.

The qualitative screening procedure aims at eliminating those listed companies whose core businesses are *haram* such as alcohol, pork, etc. Whereas the quantitative procedure establishes some ratios to be observed in order to mitigate the elements of *riba* or other forms of *haram* elements that may contaminate the portfolios. This is often followed by a purification phase such as getting rid of the *haram* element from the dividend received or capital gains and also to pay *zakat* if need be. Various ratios are used by different indices and companies. All try to bring in an element of toleration for some *haram* income that may contaminate the fund. These ratios focus on establishing a tolerance ceiling in terms of percentage for debt over total asset, *haram* income to total income, liquidity ratios, etc.

In Malaysia, the Securities Commission's guidelines can be considered to be an amalgam of both the qualitative and quantitative criteria for screening of shares. However, their focus has been on the types of industries under which companies are being listed. The importance of companies falling within the ambit of each industry will be considered depending on the extent of importance of that industry for the economy. There are also the different indices having different criteria for the quantitative analysis such as the FTSE Islamic Index compared to the Dow Jones Islamic Market Index. The reason for those differences is mainly because buying and selling of shares is an area of *fiqh* that demands some sort of *ijtihad* and also due to the volatility of the stock market which often affects the portfolios of shares, depending on the ratios used.

Regarding family *takaful*, one may look into long-term investment/financing such as *sukuk* or even infrastructure financing which yields in the long run. However, this type of investment should be viewed in the light of the solvency ratio and other jurisdictional regulatory limitations on investment.

It is observed that the investment in shares is more pronounced among the GCC *takaful* operators. In Malaysia, under the family *takaful* funds, about 45.4% of the funds are invested in Islamic securities and equities, 33.2% in investment accounts and Islamic market and 8.5% in government Islamic papers. In the case of investment-linked *takaful* and investment-linked insurance with *shari'ah*-approved securities, the bulk of investment is in equities.

Regarding investment in *sukuk*, although the AAOIFI disapproved of non-asset-backed *sukuk*, due to the under-developed *sukuk* secondary market, *takaful* operators will not





enjoy such facilities as in the case with equities. In the case of family *takaful* fund, an interesting development for investment is the infrastructure financing which provides long-term return.

### Corporate Social Responsibilities

*Takaful* operators are encouraged to be involved in corporate social responsibilities activities in order to maintain a good corporate reputation which adds to the “reputational capital”. It is believed that corporations may become profitable in the long run, since market forces provide financial incentives for such perceived socially responsible behaviour.

In some jurisdictions, *takaful* operators are very committed to CSR activities such as giving scholarships, activities related to environmental issues, giving cash contribution, building homes for the underprivileged, and building canteen and hostel for community. In Malaysia, some CSR activities and social events done by the company are tax-exempted.

In addition to CSR, an Islamic institution is also expected to pay *zakat*, but there is no such tax exemption for *zakat* payment by institution. As a result, these companies have to double-pay, i.e., *zakat*, which is imposed by *shari'ah* on an Islamic entity and tax, which is imposed by the government. This double-pay issue may impede the company's profit and competitiveness. For this reason, some companies, for example Etiqa Takaful (Malaysia) gives contribution via corporate zakatable responsibility (CZR) in which such payment is taken from *zakat* proceeds and channelled to social activities involving

Corporate zakatable responsibility (CZR) is a social activity undertaken by certain *takaful* operators in which *zakat* proceeds are channelled to social activities involving qualified *zakat* recipients.

*zakat* recipients, such as single mothers, orphans, students, disabled and the hardcore poor. With CZR, the company fulfils both obligations prescribed by *shari'ah* as well as the government. It is, however, important to the department of *Shari'ah* Advisory to monitor the activities so that such events are held within the *shari'ah* limits to ensure its permissibility in the company's operation.

## The Way Forward

The promising trajectory of the *takaful* industry is eminent from the projection made. This will most definitely entice other players to join in, such as opening of windows, creation of retro-*takaful* in the future, etc. However, the most important factors for successful operations are the transparency of operations, the establishment of *shari'ah*-compliant and robust *shari'ah* supervisory board that guides product design and ensures *shari'ah* compliance.

Another concern is the need to produce more Muslim actuaries who understand the products and the markets. Experts in the field have indicated this shortcoming. The development of actuaries focusing on *takaful* is important because they play a role in determining the pricing. The contributions should be invested in appropriate channels to meet both general and family *takaful* claims but the spectrum of financial instruments for investments is limited for *takaful* operators. There is a need for more investment products.

The key challenge for the *takaful* industry is to improve efficiency and to reach critical mass in order to benefit from the economies of scale that is currently the privilege of only a handful of players. It is hoped that these will be met with the expansion of the market and proper regulation.

## Summary

1. This chapter introduced the main conceptual framework of the *takaful* industry and the important issues needed for its proper functioning.
2. Historical development and differences between *takaful* and the conventional insurance have been highlighted.
3. The models of *takaful* are based primarily on the *tabarru'* (donation) which is a way out to mitigate *riba* and *maysir*. However, with regard to *gharar*, a complete elimination is difficult to achieve in the *takaful* industry. But as long as this falls within the ambit of *gharar al-yasir* (minimum level) that will be accommodated in *shari'ah*.
4. The chapter explained that insurance in Islam should be based on the principles of mutuality and cooperation because the Islamic system of insurance embodies the elements of shared responsibility, joint indemnity, common interest, solidarity, etc.
5. This chapter also touched upon the regulatory issues of *takaful* industry. Some countries such as Bahrain, Pakistan and Malaysia have developed sound regulatory framework for *takaful*, but there is still much to be done in countries like UK and France, etc., since they have no specific standard for *takaful* industry.

## Key Terms and Concepts

Actuarial Investigation Report

Participants' Investment Account (PIA)

Participants' Risk Account (PRA)

*Takaful*

*Takaful* Operator (TO)

Underwriting Surplus or Deficit

Corporate Governance

Pre-contract Illustration

Stakeholders

*Takaful* Fund

*Takaful* Undertakings

*Mudharabah*

Provisions

*Tabarru'*

*Takaful* Participants

*Wakalah*



## Review Questions and Problems

1. Explain the legal and *shari'ah* position regarding the capacity of *takaful* participants.

---

2. Elucidate the contract among *takaful* participants.

---

3. List the rights and duties of a *takaful* operator in a modified *mudharabah* model.

---

4. Compare the *wakalah*, *mudharabah* and *waqf* models of *takaful* in terms of operations, investment and surplus distribution. Which model is more effective, cooperative and in line with *maqasid al-shari'ah*?

---

5. Describe the nature of the relationship between the *takaful* operator and participants.

---

## Problems

Ismail, an independent auditor is engaged to audit the operational aspect of Takaful Ihsan Co. He randomly selects one *takaful* policy, and discovers the following issues:

1. One participant, Ibrahim nominated Iffah, whom he is about to marry.
2. Ibrahim did not state that he is a heavy smoker.
3. Provision that Takaful Ihsan will deduct certain portions of the contributions for *re-takaful* in Selamat Re-Insurance Co.
4. Provision on share of surplus:
  - (a) if there is any, that Takaful Ihsan will give 10% of the surplus to Ibrahim as *hibah*; or
  - (b) if the surplus is very small, Takaful Ihsan will give it away as charity.
5. No provision on *zakat* payment.

Ismail comes to you to seek your expert opinion on the issues stated above. As a *takaful* consultant, advise Ismail in respect of *shari'ah*, and operational issues for the purpose of *shari'ah* auditing to Takaful Ihsan.

---