Islamic *Takaful*: Business Models, *Shariah* Concerns, and Proposed Solutions

Abdul Rahim Abdul Wahab ■ Mervyn K. Lewis ■ M. Kabir Hassan

Executive Summary

*Islamic insurance (*takaful*) is nearly as old as the Islamic banking system and dates back to 1979, when the concept was launched in Sudan and later in Saudi Arabia. Yet, unlike its banking counterpart,* takaful *has been covered less in the literature on Islamic finance, and its workings are not fully understood.* Shariah *scholars have raised a number of concerns about the* Shariah *permissibility of the business models employed in the industry. This article examines the basic principles of* takaful *and then analyzes the*

Abdul Rahim Abdul Wahab is a fellow of the Society of Actuaries in the United States and is currently the director and head of actuarial services of Sidat Hyder Morshed Associates and SHMA Private Limited in Pakistan. He has over 20 years of work experience in the product design, pricing, actuarial valuation, business plan development, embedded value calculations, and operational matters of life and health insurance plans for both conventional and *takaful*-based plans. He is a consulting actuary to 11 *takaful/*insurance companies in Pakistan, the Middle East, and Zimbabwe. He also has consulting experiences in employee benefits and retirement plans. He presented papers on actuarial and *Shariah* aspects of *takaful* business models at a number of international and local conferences. He also worked as a consultant to Swiss Re in setting up their Life *Retakaful* Fund, a first of its kind based on the *wakala* model and set up by a highly reputed reinsurer. Most recently, he has been a member of the committee set up by the Securities and Exchange Commission of Pakistan (SECP) to formulate the *takaful* rules and a member of the task force established to finalize the *takaful* rules set up by the Government of Pakistan. He can be reached via e-mail at abdul.rahim@sidathyder.com.pk.

M. Kabir Hassan is a tenured professor in the Department of Economics and Finance at the University of New Orleans, Louisiana, and currently holds a visiting research professorship at Drexel University in Philadelphia, Pennsylvania. He is editor of the *Global Journal of Finance and Economics*. Dr. Hassan has edited and published many books along with articles in refereed academic journals, and is coeditor (with Mervyn K. Lewis) of Islamic Finance: *The International Library of Critical Writings in Economics* (Edward Elgar, 2006). A frequent traveler, Dr. Hassan gives lectures and workshops in the United States and abroad, and has presented over 100 research papers at professional conferences. He can be reached via e-mail at mhassan@uno.edu.

Mervyn K. Lewis is a professor of banking and finance at the University of South Australia. Previously, he was the Midland Bank Professor of Money and Banking at the University of Nottingham, a consultant to the Australian Financial System Inquiry, and visiting scholar at the Bank of England. He was elected a fellow of the Academy of the Social Sciences in Canberra, Australia, in 1986. Professor Lewis has authored or coauthored 18 books and over 100 articles or chapters. The latest volume, edited with M. Kabir Hassan, is *Islamic Finance* (Edward Elgar, 2006). Other recent coauthored books include *Islamic Banking* (Edward Elgar, 2001), *Public Private Partnerships* (Edward Elgar, 2004), *The Economics of Public Private Partnerships* (Edward Elgar, 2005), and *Reforming China's State-Owned Enterprises and Banks* (Edward Elgar, 2006). Professor Lewis is a foundation member of the Australian Research Council Islam Node Network. He can be reached via e-mail at mervyn.lewis@unisa.edu.au.

Thunderbird International Business Review, Vol. 49(3) 371–396 • May–June 2007

Published online in Wiley InterScience (www.interscience.wiley.com).

 • DOI: 10.1002/tie.20148

mechanics of the two models most commonly used in the industry—namely, the mudarabah *system that was developed by the Malaysians and the* wakala *(agency) system that is now being used by most* takaful *operators and has achieved tremendous popularity and acceptance in recent years even in countries where the* mudarabah *model was earlier implemented.* Shariah *scholars have, however, expressed some misgivings about both approaches, but because of its wider acceptability among* Shariah *scholars in the case of the* wakala *approach, this is more urgent. With regards to the* mudarabah *model for risk management, there are major discrepancies that have been highlighted by* Shariah *scholars effectively rendering it inappropriate to apply this for insurance contracts. For this reason, the article outlines a third model, a* wakala *with* waqf *fund, that seeks to remain within the* wakala *framework while incorporating modifications that may render it more acceptable from a* Shariah *perspective.*

THE *TAKAFUL* MARKET

The concept of *takaful*, which started in Sudan in 1979 and later in Saudi Arabia, now has operators and products offered in more than 22 countries and is gaining popularity elsewhere as well. Overall, the global *takaful* market (life [family] and general) was thought to be over U.S.$2.1 billion of premiums for 2002 and is estimated by market analysts to increase to premiums of U.S.$12.5 billion by 2015 with over U.S.$30 billion in funds. Interestingly, this figure for 2015 was revised from an earlier similar estimate of $7.5 billion done in 1999, which in a way indicates that business expectations may be materializing at a faster pace, driven to a large extent by strong market growth in the Gulf region and especially Malaysia (Lewis, 2003).

This expansion may be related to many factors including greater recognition among Muslims in recent times that they need to focus more on Islamic principles in their lives. An awareness of the issue created by a large number of conferences on Islamic finance and *takaful* around the world may also have been of value. On the distribution side, a recent expansion of banks launching *takaful* products linked with other Islamic financial products either as *bancassurance* products or through agency-based sales holds great potential. In addition, in some non-Islamic countries with significant Muslim populations the concept may be introduced by conventional players through Islamic insurance "windows" (paralleling the development in Islamic banking).

Insurance penetration among the Muslim countries is low. Swiss Re's research publication *Sigma* demonstrates this: less than 1% of GDP per capita is spent on insurance premiums in most of the Middle Eastern countries even where affordability is not an issue. Within Asia, Pakistan, Bangladesh, and Indonesia—all with largely Muslim populations—the percentage spent is between 0.1 to 0.3%. In India, the GDP and socioeconomic conditions being somewhat similar, and the Muslim population being some 15 to 20% (over 160 million Muslims), the percentage of GDP spent on insurance is 0.6%. This tends to indicate that among Muslims, the low insurance penetration also relates to religious beliefs, besides other reasons. Penetration is greater on the nonlife side, perhaps due to compulsory insurance requirements in many areas of nonlife business. Muslims are more reluctant when it comes to insuring their lives (life, health, and personal lines such as motor) due to religious concerns (Abdul Rahim, 2006). The religious objections to conventional insurance are covered briefly later in this article.

…an increasing need has been felt in many Muslim and non-Muslim countries over many years to have an alternative solution to their insurance needs.

Insurance has always been a debated issue in Islamic financing with some financial arrangements requiring compulsory insurance leading to a lot of discomfort among Muslims, especially within an Islamic country. Unlike interest products, people have not always had an alternative recourse to insurance when the law requires mandatory insurance. Also, a large number of Islamic financial products based on trading and dealing in underlying assets require that the assets be insured through an Islamic insurance company if one is available. Consequently, an increasing need has been felt in many Muslim and non-Muslim countries over many years to have an alternative solution to their insurance needs. The growing interest in this area and the global growth of *takaful* during the last 25 years as an alternative system has attracted practitioners worldwide to explore in detail the basis of *takaful* systems prevalent in various countries. Different countries have adopted different models or variations as approved by *Shariah* scholars in their country. This article examines two alternative arrangements and the associated juristic concerns, and offers a third that seeks to address some of these issues. But first we begin by looking at the basic principles of *takaful*.

BASIC PRINCIPLES

Insurance as practiced by conventional insurance companies is not permissible under *Shariah*. What is permissible is mutual insurance, where participants themselves are the owners of the fund. If any member or participant suffers a catastrophe or disaster, he or she would receive financial benefit from a fund to help meet that loss or damage. The amount is drawn out of a common pool created with the individual contributions of participating members. Thus, *takaful*, stemming from the Arabic verb *kafal*, meaning to take care of one's needs, is descriptive of a practice whereby participants in a group agree jointly to guarantee themselves against loss or damage. For example, in Malaysia, Section 2 of the *Takaful* Act 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," and *takaful* business as a "business of *takaful* whose aims and operations do not involve any element which is not approved by the Shariah." This is in contrast to conventional insurance, which poses a number of difficulties to Muslims.

Gharar is objected to in any transaction because it is said to undermine the element of consent necessary for a valid contract.

From the viewpoint of Islamic law, the basic objection to conventional insurance is that it is effectively a gamble upon the incidence of the contingency insured against, because the interests of both parties are diametrically opposed, and both parties do not know their respective rights and liabilities until the occurrence of the insured events. In all, according to Islamic scholars, there are three main problems with conventional, especially life, insurance (Lewis, 2005).

First, standard insurance violates the prohibition of *gharar* (uncertainty) since the benefits to be paid depend on the outcome of future events that are not known at the time of signing the contract. It would appear that the *gharar* or uncertainty objected to by certain scholars is from the aspect of the delivery of the subject matter, with uncertainty as to whether the insured will get the compensation that has been promised, how much the insured will get, and when the compensation can be paid. This prohibition in particular nullifies a conventional whole-of-life policy contract because this type of policy is based on a time frame, the lifetime of the insured, which is not known and cannot be known until the event (death) itself occurs. *Gharar* is objected to in any transaction because it is said to undermine the element of consent necessary for a valid contract. There cannot be mutual consent when one party, because of inadequate information, does not have the correct impression of the material aspects of the contract. It would not be fair to expect that party to consent to something of which the essential elements are not known. Mutual consent and truthfulness of the parties to a contract is therefore a moral obligation and a basic requirement for a valid contract in Islam.

Second, insurance is regarded as *maysir* (gambling) because policyholders are held to be betting premiums on the condition that the insurer will make payment (indemnity) consequent to the circumstance of a specified event. For example, when policyholders take out a pure endowment policy they are taking a gamble that they will still be alive by the end of the term of the policy to receive the benefits stated in the contract. According to one writer (Ismail, 1998):

> There are similarities between the conventional insurance contract and gambling. The amount insured is paid back to the insurer when certain events occur. If the event never occurs, the insurance company keeps the premium. It's like putting money in a pot and rolling the dice, the lucky winner takes the pot. In the case of conventional insurance companies, they play the role of the "House" and the insuree plays the role of the gambler by placing a bet. The gain for the "House" is always certain, while the gain for the better is doubtful; the person may gain or lose. Overall, the "House" is against the gamblers, and the insurance company is against the insured, the "House" and the insurance company are always winners. (p. 3)

…all insurance policies have a significant investment or savings element built into them, as the insurer invests prepaid premiums on behalf of those insured.

Third, all insurance policies have a significant investment or savings element built into them, as the insurer invests prepaid premiums on behalf of those insured. Many forms of life insurance in particular are merely thinly disguised investment methods, and the insurance companies conduct their business by investing collected premiums in a mix of investments that includes interest-based or other such investments, thereby contravening the Islamic laws regarding *riba* along with *gharar* and *maysir*.

Many in the Islamic community, in fact, consider all forms of insurance to be suspect. As recently as 1995, Sheik Al-Azhar Al-Sheikh Jad-al Haq Ali Jad al-Haq of Egypt declared all life insurance to be prohibited under *Shariah* (Billah, 2001; Wahib, 1999). Other scholars, however, argue that a system of life insurance can be worked out, based on mutuality, which addresses the presence of *gharar*, *riba*, and *maysir* in conventional life insurance. This is the essence of *takaful* insurance, based on solidarity, responsibility, and brotherhood among members, where participants agree to share defined losses to be paid out of defined assets (Anwar, 1994; Muslehuddin; 1982, Siddiqi, 1985).

What makes *takaful* acceptable on these grounds are the following features: the policyholders cooperate among themselves for their common good; every policyholder pays his or her subscription in order to assist those of them who need assistance; it falls under a donation contract, which is intended to divide losses and spread liability according to the community pooling system; the element of uncertainty is eliminated insofar as subscription and compensation are concerned; and it does not aim to derive advantage at the cost of other individuals.

According to Shariah *principles, an Islamic insurance system should be based on the concept of a pooling of risks, with a professional services manager charging for his services and not making a commercial gain from the insurance activities.*

According to *Shariah* principles, an Islamic insurance system should be based on the concept of a pooling of risks, with a professional services manager charging for his services and not making a commercial gain from the insurance activities. Profit for shareholders therefore should be from risk management and not risk taking. Importantly, the contract should be based on the concept of *tabarru* as *gharar* is acceptable in *tabarru* and not in a usual contract of compensation. *Tabarru* means donating, contributing, offering, or granting. In the context of *takaful*, what it means is a voluntary specific amount of donation made among participants and managed by the *takaful* operator. The pooled fund is then utilized to help the unfortunate members. The spirit embodied in the concept of *tabarru* is that the participants are not thinking only of their own protection but they should also be thinking of helping other participants. Without the concept of donation, the transaction would be that of buying and selling of insurance (i.e., the purchase of a promise that some form of benefit will be paid in the event that the insured faces a misfortune). The promise may or may not be fulfilled depending on whether or not the event insured against occurs. Should there be no claim, the insurers will stand to earn the premium paid. However, in the case of *tabarru*, the risk is equally shared by the participants; the *takaful* operator is not the owner of the fund, just its custodian. Uncertainty (*gharar*) in *takaful* remains but is among only the participants whose interests are the same and hence permitted, whereas in conventional insurance it is between the insurer and insured, whose interests are different.

It is argued, for example, by Sharif (2000) that the concept of *tabarru* will also eradicate the element of gambling perceived by the Islamic jurists as existing in insurance. Take, for example, a participant with a contribution of, say, $1,000 who participates in a particular *takaful* scheme. After some time, this participant faces a misfortune that incurs a claim of, say, $10,000. A jurist might look at this situation and conclude that this participant gained $9,000, which can be interpreted to be somewhat like a gambling transaction. Moreover, the source of the compensation is unclear. The *tabarru* element can explain and correct both problems. Since every participant donates the contribution for the benefit of all members of the pool, the extra $9,000 comes from those donations consented by the participants, and furthermore, it is transparent as to the source of the fund. In this case, the *tabarru* element addresses the issues of both *gharar* and *maysir*.

However, there are different business approaches to realizing this vision. It is useful to try to differentiate between the different models being followed in different parts of the world and the concerns that *Shariah* scholars have raised. Also, it is important to note that the basic variations revolve around the application of the model to the underwriting risk portion and not the investment portion where a *mudarabah* approach is generally applied under most models, although the *wakala* approach is also used and equally acceptable. A blending of models and inclusion of other *Shariah*-permitted contracts and elements also exist in different contracts. Further variations between different models followed in practice by different operators relate primarily to charging of expenses (marketing versus administration) and the basis of the fee structure, especially with regard to sharing in the underwriting profits as an incentive for the operator. This last aspect has become an issue where some have adopted the view that sharing in underwriting profits is permissible, although if one analyzes this position in detail it makes *takaful* almost the same as conventional insurance (other than investment in *Shariah*-compliant instruments), which only leads us back to why there is an objection to conventional insurance in the first place.

The ultimate goal is to evolve a consensus-based takaful *model where the* Shariah *concerns can be minimized so that the consumer has greater confidence in a uniform* takaful *model as an alternative system.*

This article covers the *mudarabah* and *wakala* models as well as refinements suggested to address some *Shariah*-related concerns. No model can be assumed to be workable unless practitioners highlight practical issues, which can then be further raised with *Shariah* scholars for clarification, guidance, and appropriate solutions (Yaquby, 2000). The ultimate goal is to evolve a consensus-based *takaful* model where the *Shariah* concerns can be minimized so that the consumer has greater confidence in a uniform *takaful* model as an alternative system. If the proposed refinements offer a slightly better solution with not much in the way of complexities in implementation, it may be tested in other countries as well, taking into account local *Shariah* rulings as well as other laws and regulations. If the refinement resolves some *Shariah* concerns and makes the approach more acceptable around the globe, it will be better for the *takaful* system as a whole.

THE *MUDARABAH* MODEL

Under the *mudarabah* concept, two parties, basically the participant or capital provider (*rabb al-mal*) and the entrepreneur or *takaful* operator (*mudarib*), operate on a joint venture basis. Both the *takaful* company and the participant share the direct investment income, in which the participant is entitled to a defined percentage of the profits, with no deduction made prior to distribution.

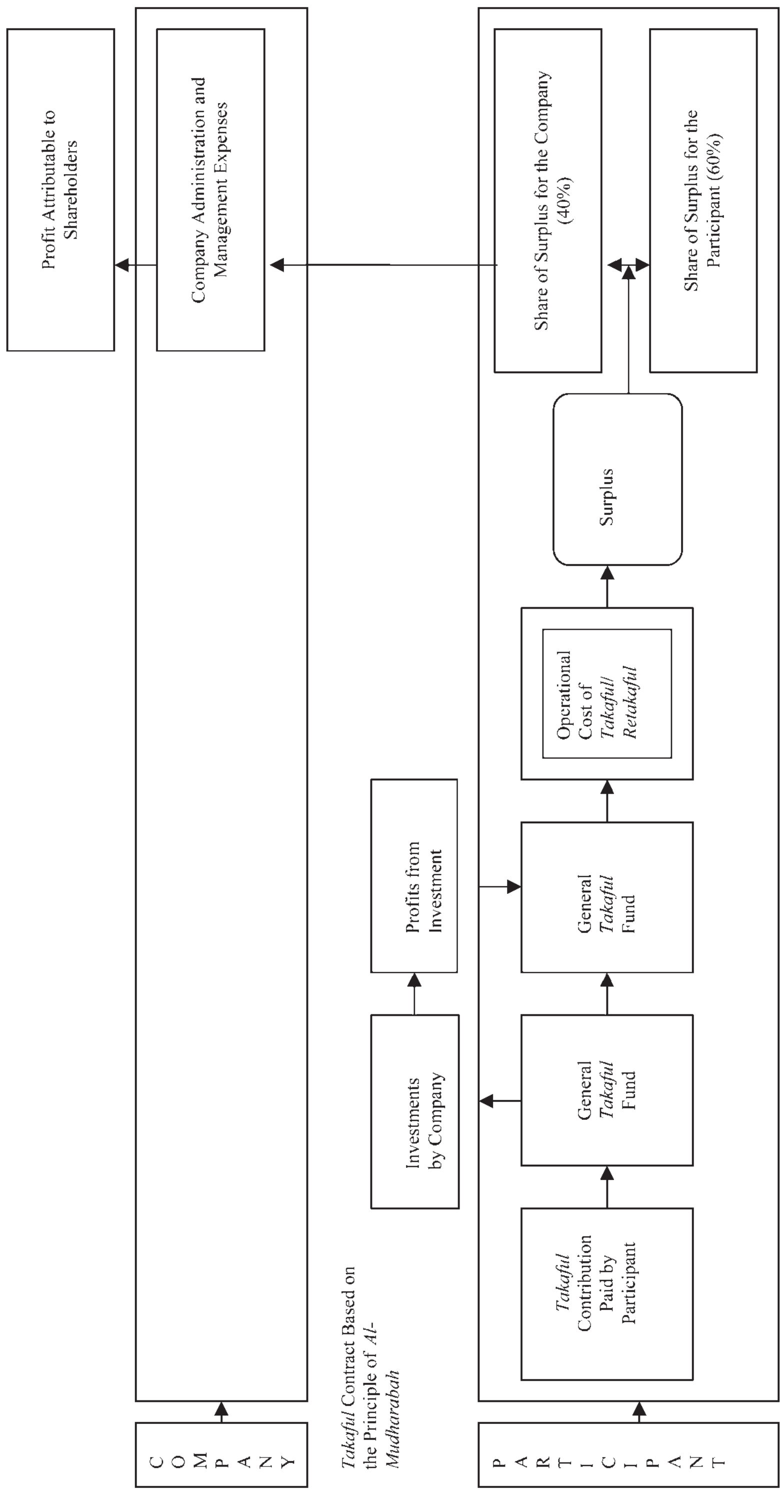
This model may be applied to individual life (family) *takaful* and adapts the U.K.-style unit-linked life insurance policy (in the United States, it is called investment-linked) to suit the needs of the Islamic community (Lewis, 2005). The policies deduct a proportion of the premiums paid and credit it into a separate account (i.e., a *tabarru* account for the *takaful* policy and a special investment management fund for the unit-linked policy). Also, the sum assured depends on the investment performance of the remaining portion of the premiums, subject to a minimum guaranteed sum assured on death. The *tabarru* account belongs fully to the participants, with no sharing by the operator in the surplus in this account, except for any sharing in investment returns of this fund. This is an acceptable form of the *mudarabah* model for *takaful*. However, under this approach, the returns for the operator come over the long term as the life funds build up.

For the mudarabah *contract to be permissible, a number of elements need to be present: the capital provider (participant); the entrepreneur (*takaful *operator); capital; an appropriate activity; profit-and-loss sharing; and offer and acceptance.*

For the *mudarabah* contract to be permissible, a number of elements need to be present: the capital provider (participant); the entrepreneur (*takaful* operator); capital; an appropriate activity; profit-and-loss sharing; and offer and acceptance. In the event of a loss, it is the duty of the capital provider to top up. The *mudarabah* contract is cancellable, and upon cancellation all cumulative capital plus profit must be returned to the capital provider less administrative expenses. Also, the capital provider will have to give consent to appoint the entrepreneur to work on his behalf. Of course, when investing the funds, the instruments used should be *Shariah*-compliant.

A flowchart showing the *mudarabah* model for general *takaful* is given as Figure 1. It may be seen from this figure that the participants' contributions and investment income is being used to pay for claims, *retakaful*/reinsurance costs, and other claims-related expenses from the general *takaful* fund. The overall surplus in the *takaful* fund is then shared between the participants and the shareholders in a defined proportion (60:40 here). The shareholders are responsible to meet all management- and marketing-related expenses (although there can be variations on charging of marketing expenses) from their share, and any remaining amount would be the shareholders' profits. It is here that the *mudarabah* model has many concerns by *Shariah* scholars as it is applied to a risk contract with participation in the underwriting surplus being treated as *mudarabah* profits (Abdul Rahim, 2003).

Figure 1. *Mudarabah* Model: Sharing in Underwriting Surplus and Investment (Management and Marketing Expenses Borne by Operator)



The basic objective is to pay for a defined loss from a defined fund, which is set up mutually by policyholders but is managed by a *takaful* company. The contributions given are based on the principle of *tabarru*. A *tabarru* is a one-way transaction in which once the contribution is paid, the contributor has no right to take any benefits out of it. Rather, the fund is used for any participant who faces financial difficulties or losses within the time period as agreed upon in the insurance policy. A number of issues arise.

Essentially, an investment on a mudarabah *basis of 100 should at the end of the period give more than 100 to be termed as profit and for the operator to share in that.*

First, there is a question whether all *takaful* operators comply with the recommendation to accept *ta'awun* as a basis for Islamic insurance. When people contribute their money, they are usually expecting something in return (i.e., financial reward or profit sharing). There is consequently a question mark regarding the true nature of *ta'awun*. Is it really cooperative in nature? There are some operators using the cooperative insurance model, such as ICMIF London and NTUC Income Singapore, but they are rarities. While most insurers/*takaful* operators are described as the custodians or treasurers of the common fund, most of them are more than treasurers and, notwithstanding the words used, believe that they are actually the owners of the fund (Billah, 2007). Moreover, few of those who buy Islamic insurance are conscious that the premium is for mutual help (Al-Qaradawi, 1989).

Second, the relationship between the participants is one of *tabarru* (donation) as defined in the contract and not of *mudarabah* (profit-sharing contract). It is therefore of concern to *Shariah* scholars that a profit-sharing contract should not be applied here, as a donation cannot be *mudarabah* capital at the same time (Abdul Rahim, 2003).

Third, in a *mudarabah* contract, a profit is generated to be distributed (although there are the usual concerns as to cash or accrual basis for accounting). Essentially, an investment on a *mudarabah* basis of 100 should at the end of the period give more than 100 to be termed as profit and for the operator to share in that. However, profit is not the same as surplus (excess of premiums over claims, reserves, and expenses), and in the insurance context, no profit can be generated by definition so the question of distribution of profit is of concern.

Fourth, the sharing in underwriting surplus makes the contract essentially the same as conventional insurance contracts, where the shareholders become risk takers and therefore bear the risk and return from the underwriting results just as any ordinary business venture and not a contract for mutual assistance with a fee charged by the operators as risk managers.

Fifth, the requirement to provide a top-up interest-free *qard hasan* (in case of a deficit) in a *mudarabah* contract by definition is against the concept of *mudarabah* (even if this really is a *mudarabah*), which is a profit-sharing contract, and the *mudarib* cannot be a guarantor.

Under the wakala *model, the participants remain the actual owners of the* takaful *fund into which the contributions are pooled.*

Sixth, because of a recognition that the application of the *mudarabah* approach to risk sharing does not seem to be correct, most new operators are applying the *wakala*-based model as far as risk sharing is concerned (especially in the case of general *takaful* and group family *takaful*-type contracts where the investment element is not a part of the contract) (Abdul Rahim, 2003).

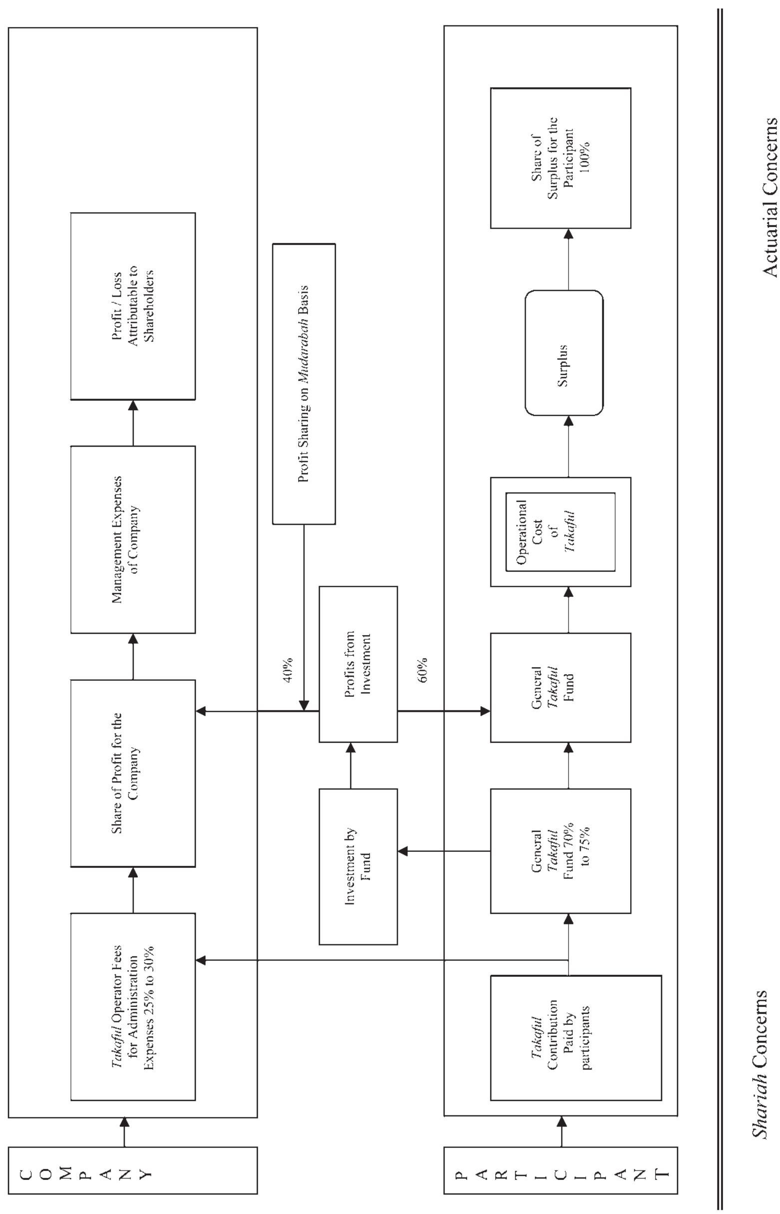
THE *WAKALA* MODEL

This model is commonly used in the Gulf countries as approved by their *Shariah* scholars. *Wakala* is a contract of agency. On the basis of this principle, a person delegates his right or business to other people to act as his agent or *wakil*. The agent is responsible to contribute his knowledge, skills, and abilities in performing the tasks assigned to him. In a *takaful* operation, the basic conception is that the *takaful* operator acts as a *wakil* for the participants. His role is to manage the affairs of the pool for a defined fee. The flowchart is given as Figure 2.

Under the *wakala* model, the participants remain the actual owners of the *takaful* fund into which the contributions are pooled. This fund is then managed by the *wakil* (agent) on the principles of *mudarabah* and *tabarru*. Before the agent starts managing the fund, he will first deduct out a predefined amount as a *wakala* fee/operator fee for management and services expenses. The remaining balance will be deducted to allocate costs (i.e., unearned contributions, claim reserves, technical reserves, *retakaful* cost, and items incurred but not reported [IBRN]). The balance is called underwriting surplus. The funds will also be used for investment that does not violate the rulings of *Shariah*. Surplus will be distributed between the participants in a defined manner, which may or may not relate to the person making a claim.

Thus, considering Figure 2, the *wakala* fee will usually be defined up front and transferred to the shareholders' account. The remaining

Figure 2. *Wakala* Model: Fee-Based Agency Contract



portion of the contributions will be transferred to the *takaful* account, which is used to pay claims, *retakaful* costs, and so on. The surplus may then be allocated 100% for the benefit of the participants. Generally, a portion of the surplus may be retained as a contingency reserve and the balance may be distributed to participants in proportion to their contributions (to those who have not had a claim with other methods also applicable). In case of a deficit, the shareholders would be required to give a *qard hasan* to the *takaful* fund to pay for the deficit (as recovery from participants may not be practical), which may be returned from future surpluses (should these arise). The shareholders would be responsible for all expenses of management and marketing (variations exist), and their earnings would come from expenses being less than the fee and the investment income share as a *mudarib* for the *takaful* fund and investment income on the shareholders' funds.

…better underwriting results through careful risk selection and management would ensure that higher surpluses arise in the takaful *fund for distribution to participants.*

An increasing number of companies have embarked on implementing the concept of *wakala* in their *takaful* operation including in Malaysia. There are, however, certain issues within some variations of the *wakala* model that *Shariah* scholars have also objected to. These issues are first examined before we look at some of the other *Shariah* concerns.

Incentive Fee Related to Underwriting Surplus

A basic *wakala* model is a widely acceptable form for risk-sharing contracts. Differences in opinions, nevertheless, still exist relating to the charging of expenses (marketing versus administration) and also the fee structure. One major issue still under deliberation involves the distinction between the pure *wakala* model (where the operator charges a fee for services) and recently modified approaches where, within a *wakala* model, a percentage share of the underwriting surplus is paid as a performance incentive for the operator. Sharing in underwriting surplus is something that does not appear to be in line with the concept of mutual assistance and hiring of the professional expertise of a risk manager, although it may be argued that it is meant to provide an incentive to the operator to better manage the risk. One may argue that as a *wakil* and trustee the operator is responsible to ensure careful and fair management of the *takaful* fund for the fee that is being received. Moreover, better underwriting results through careful risk selection and management would ensure that higher surpluses arise in the *takaful* fund for distribution to participants. Higher surplus distribution in itself is an incentive for the operator, as more clients may get attracted to the company due to its better risk management capability. This would be an indirect benefit of better management and not a direct one, which seems more acceptable given the principles of *takaful* and also given the concerns relating to the *mudarabah* model where underwriting profits are shared (Abdul Rahim, 2004, 2006). The view of most prominent *Shariah* scholars in this regard is also that any sharing in surplus by way of an incentive is not permissible.

…in the takaful *system based on* wakala, *the underwriting surplus belongs to the participants, and therefore an adequate risk premium needs to be identified separately.*

Risk Premium (for Claims) and Operator Fee

Another concern relates to the *wakala* operator fee being charged to the *takaful* fund, which is expressed as a fixed percentage of the total contributions. This practice is basically because the operator is the *wakil* of the whole fund on behalf of the participants, and so the fee is based on and recovered from the *takaful* fund. The concern stems from the way commercial insurance contracts are generally priced in a competitive market and the effect that a fixed percentage fee might have on the *takaful* fund risk pool in relation to the risk that the fund may bear.

A typical contract has a risk premium to which one may add expense margins and profit margins for the operator. Both the expense and profit margin would need to be competitively priced on the volume of premiums for a single contract. Identification of these separately is not required in a conventional insurance contract, as the expense surplus and underwriting risk surplus both belong to the shareholders. However, in the *takaful* system based on *wakala*, the underwriting surplus belongs to the participants, and therefore an adequate risk premium needs to be identified separately.

Suppose, for example, that Client A has one motor vehicle to be insured and the risk premium rate is 4% of the sum assured. Adding to this, 30% of gross premium as margin for expenses and profits takes the gross rate to 5.71% [4%/(1 – .30)]. Client B, a corporate, has a fleet of 100 cars to be insured for its different employees. The actuarial risk premium rate of 4% under the two contracts does not change. What changes is the expense and profit margin, which has to be much lower in a large contract due to greater competition as well as due to a real reduction in expenses and the profit objective. If this margin was just 15%, the gross rate charged would be 4.71% [4%/(1 – .15)].

Should Clients A and B constitute the total portfolio (101 motor cars) of the operator, the total premium (assuming a unit of 1 for sum assured and a 30% fee) would be:

CLIENT A:	5.71 × 1	= 5.71
CLIENT B:	4.71 × 100	= 471.00
TOTAL PREMIUM		= 476.71
LESS OPERATOR FEE (30%)		= 143.01
RISK PREMIUM FOR CLAIMS		= 333.70 (for 101 cars)
RATE PERCENT PER CAR ACHIEVED		= 3.30%
ACTUARIAL RISK PREMIUM RATE		= 4.0%

On actuarial grounds, the risk premium rate for undertaking the risk for the *takaful* fund should have been 4%. What has happened is that when writing business and pricing and attracting clients, a discount was given to be competitive but when charging the fee to the fund, the fixed percentage fee being removed may imply that the *takaful* fund might be left with less to pay claims (3.30%) in relation to the risk being undertaken (4.0%) (Abdul Rahim, 2004).

Further, there are situations where, due to the importance of certain clients and business lines for the company, an operator may give an extraordinary discount to get the business. Here again, an overall fee would mean what is left in the *takaful* pool for claims would get reduced. This would mean that equity among individuals in the risk pool may get disturbed, due to the removal of the fixed percentage of a contribution as an operator fee, as more risk is passed into the pool by larger clients than the appropriate risk premium.

This aspect should be visited by practitioners, who may very well have devised mechanisms to ensure that this may not happen. However, if this is not the case, then there is a concern that, depending on the portfolio mix of the operator, the underwriting results could fluctuate. In cases where the major portion of the portfolio is reinsured to a large extent, this risk may get transferred to the reinsurance pool (assuming at least similar levels of commissions are payable by the reinsurer as the operator fee). Nevertheless, the risk premium issue remains and it would ultimately get reflected in the *takaful* fund.

A solution may be to define at the stage of pricing the appropriate risk premium for the particular risk. For the expense loadings, an operator may have a percentage fee table based on premium size or something similar, possibly with different tables for different lines of business with the flexibility of taking business decisions to reduce fee levels as suitable to a particular case or client.

Discussion with *Shariah* scholars on the above two concerns needs to be with a full explanation of possible outcomes of different scenarios in order to get a clear response. Such discussions need to take place in an environment where they are not associated with companies briefing their *Shariah* advisors on the process. Otherwise, an element of bias could come on the part of the company management as to how the contracts work in practice, and accordingly the *Shariah* scholars' response may not be appropriate if they are not given full knowledge of the workings of the contracts. This is an issue where it is possible that management's disclosure of the intricacies of these contracts may not be full or may not be in a manner that leads to a different conclusion being reached or may not point to the real equity issue at hand.

…under a typical wakala *model, the* tabarru *(donation) remains the property of the participants unless consumed, as they have the right to receive the surplus back and therefore it becomes a conditional gift.*

Shariah Concerns Relating to the *Wakala* Model

Although *Shariah* scholars agree with the conceptual basis underlying the basic *wakala* model, they have expressed some concerns, and some proposed solutions might better address these concerns (Abdul Rahim, 2004).

First, under a typical *wakala* model, the *tabarru* (donation) remains the property of the participants unless consumed, as they have the right to receive the surplus back and therefore it becomes a conditional gift. This feature in turn gives rise to issues such as inheritance (not possible to measure the share of surplus in the pool at time of death) and *zakat* in the case of the death of the persons, as the donation is a conditional gift. Also, the relationship is between the participants and the operator and also among the participants (exchange of gift for a gift). As such, doubts are created about the contract becoming a contract of compensation.

Second, there are various generational matters. For example, contingency reserves may not be equitable between generations as the operator is likely to hold higher proportionate reserves in the early years for future contingencies. Since the participants keep changing on a continuous basis, it leads to an intergenerational equity issue. In a pure pooling arrangement, one should be able to call on members to actually contribute more in the case of a deficit on a pro-rata basis. This is not seen as practical in retail commercial insurance, and therefore alternative solutions may need to be explored for *takaful*.

Third, another generational issue arises from the *qard hasan* for deficits. This is an obligation on shareholders that would be returned by future generations and is different from those that may have given rise to the deficit, as the participants keep changing on a continuous basis. Related to this, the *wakil* should not be the guarantor of the participants he represents.

These three concerns are considered to be less serious than the two earlier ones. Solutions can be sought to these latter issues within the *wakala* model as in principle this model is well accepted by most scholars from a *Shariah* perspective. The proposed refinements suggested are discussed next and referred to as a *wakala* with *waqf* fund.

WAKALA WITH *WAQF* FUND

The objective of the waqf *fund is to provide relief to participants against defined losses as per the rules of the* waqf *fund.*

The concerns related to the *wakala* model and the solutions to them that could be offered acceptable to *Shariah* scholars take the form of a *wakala* model with a separate legal entity of *waqf* in between. These refinements are presented here for the sake of conveying the concept and differences (Abdul Rahim, 2003).

Waqf Fund—A *Shariah* Entity

A *waqf* (plural *awqaf*) is a well-recognized *Shariah* entity that has been in existence since the days of the Prophet (*pbuh*). *Waqf* fund rules exist in most Muslim countries (Cizakca, 1998). There are three kinds of *awqaf* in Islam: religious *awqaf*, philanthropic *awqaf*, and family *awqaf*. A *waqf* may be set up as a separate *Shariah* entity that has the ability of accepting ownership or making someone the owner of any asset. The objective of the *waqf* fund is to provide relief to participants against defined losses as per the rules of the *waqf* fund. Many examples of cash *waqf* funds exist to give interest-free loans or to handle monies given to manage where the returns may be used for social benefits. The fund may be managed on a commercial basis for a fee by a fund manager or an administrator appointed for this purpose.

A conventional insurance contract is a contract between two parties where there is an offer and an acceptance, and therefore an *aqd-e-moawza*. The shareholders become the owner of the premiums against which they take on the obligation to pay claims. In the case of *waqf*, the *tabarru* becomes a part of the *waqf* fund that becomes the owner and not the operator. With a typical *wakala* contract, the *tabarru* or *hiba* (gift, donation) is not complete, as it is conditional on being used to pay claims, and there is an element of surplus that may come back to the participants. From a *Shariah* perspective, proportionate ownership therefore remains with the participants to the extent of the funds not utilized for claims.

Initial Donation

The shareholders would initially make a donation to establish the *waqf* fund. The donation can be of any reasonable amount (*Shariah* scholars may specify such an amount). After the creation of the *waqf* fund, the shareholders would lose their ownership rights on the *waqf* fund. However, they will have the right to administer and develop rules and regulations of the fund. The original donation of the *waqf* fund needs to be invested in a very safe *Shariah*-compliant investment, and its returns would be used for the benefit of the participants. The idea is that the *waqf* fund should remain intact with high likelihood. A *waqf*-based model flow has been illustrated in Figure 3.

The original donation of the waqf *fund needs to be invested in a very safe* Shariah*-compliant investment, and its returns would be used for the benefit of the participants.*

For different lines of *takaful* services (or different types of risks), more than one *waqf* fund can be formed with the shareholders' money to form a *waqf* fund further allocated into different portions to form separate *waqf* funds for different lines of *takaful* services.

Relationships

In this modified *wakala* model with *waqf*, the relationship of the participants and of the operator is directly with the *waqf* fund (see Figure 4). The operator is the *wakil* of the *waqf* fund, and the participants pay one-sided donations to the *waqf* fund (not conditional) to become members. This also takes care of the doubt expressed relating to the possibility of a contract of compensation under a typical *wakala* model that leads to the issue of *gharar*. In addition to being an agent with the *waqf*, the company also has the role of *mudarib*, when it invests the *waqf* fund.

Donations

The donations received from the participants seeking *takaful* protection would also be a part of this fund, and the combined amount would be used for investment and the profits earned would again be deposited into the same fund. As per *waqf* principles, a member (donor) can also benefit from the *waqf* fund. The company would take this donation on behalf of the *waqf* fund as administrator of the fund and deposit this amount in the fund. Ownership by the participants (donors) would be lost as soon as they pay donations to the *waqf* fund, for the monies would become the property of the *waqf* fund (see Figure 5 in line with as per applicable actuarial and underwriting principles).

Compensation of Losses, Surplus, and *Qard Hasan*

The *waqf* fund rules would define the basis for compensation of losses to its members and may also define the sharing of surplus and other rules under which it would operate, but there would be no obligation to distribute the surplus. Besides this, all operational costs that would be incurred for providing *takaful* services (e.g., *retakaful*

Figure 3. *Wakala* with *Waqf* Model

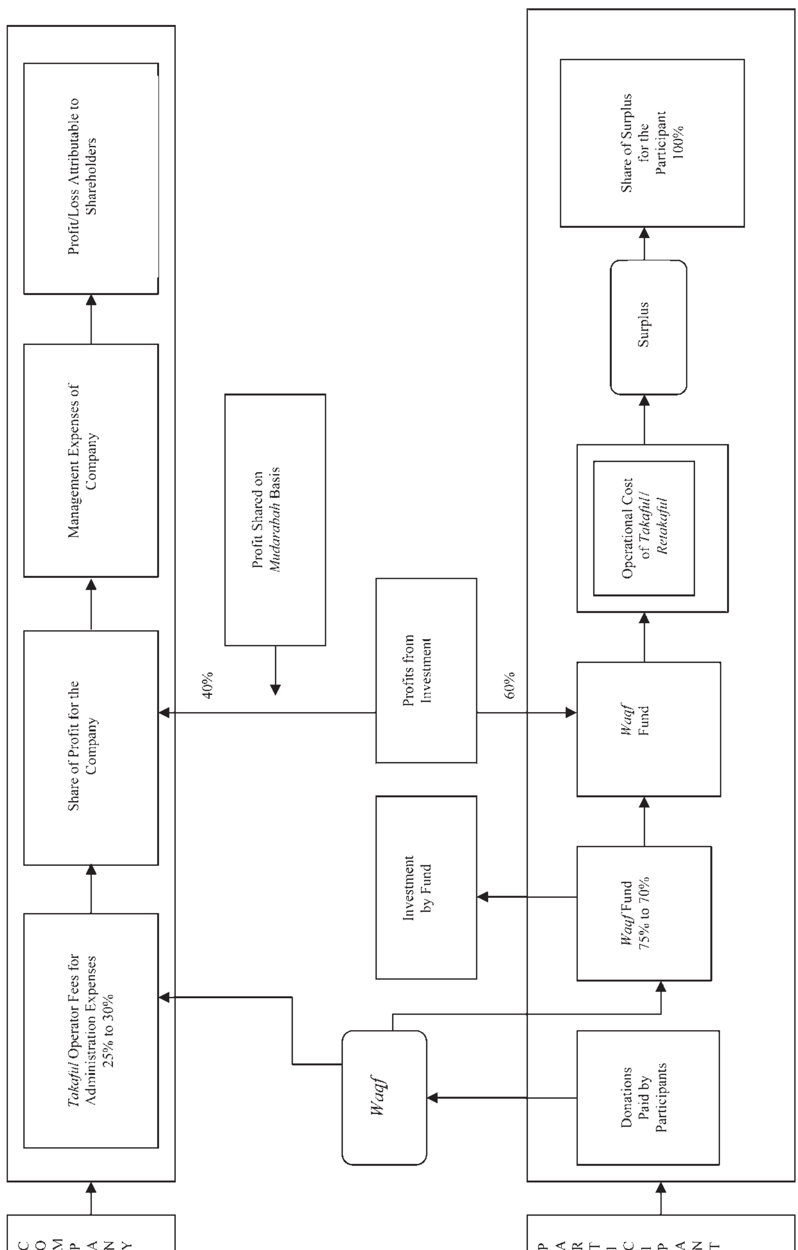


Figure 4. Relations among Participants in *Wakala* with *Waqf* Model

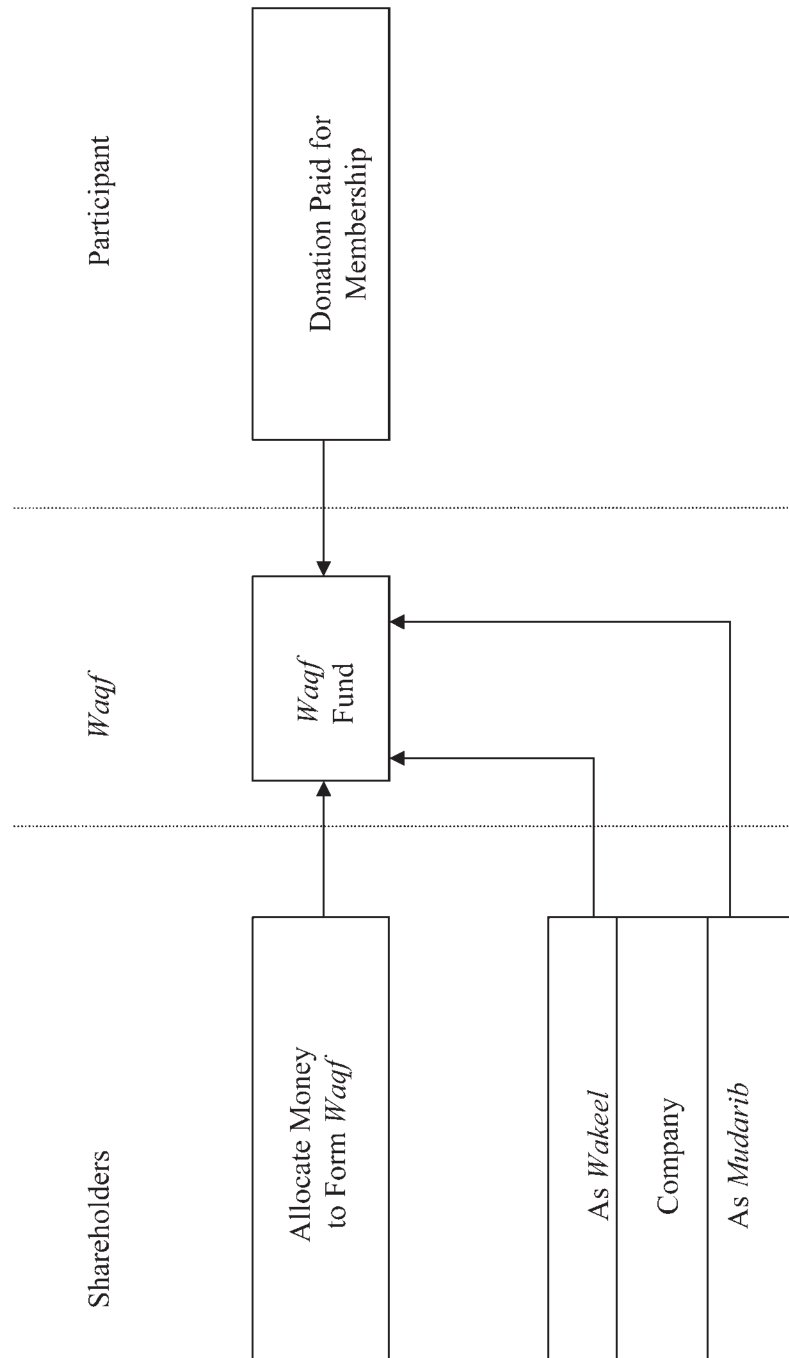
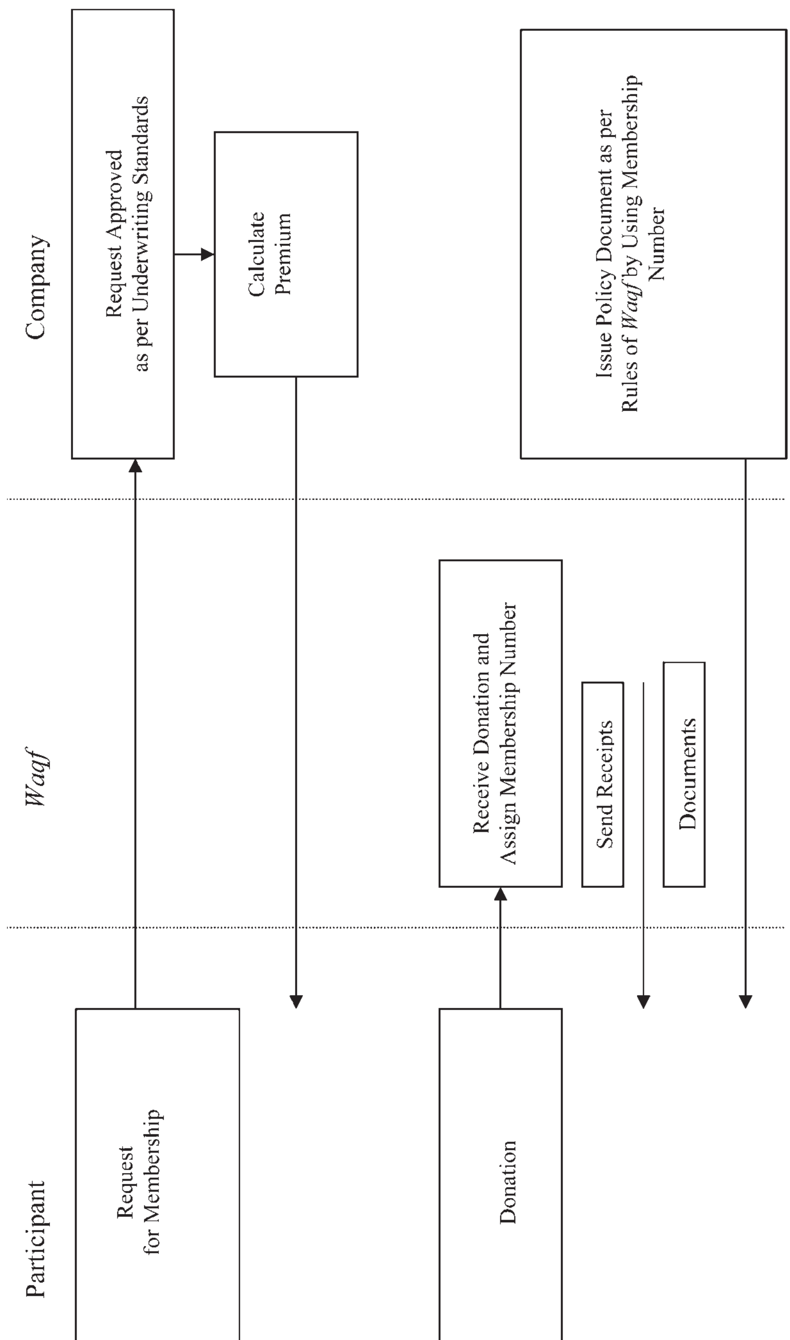


Figure 5. New Members in *Wakala* with *Waqf* Model



costs, claims investigations, etc.) would also be met from the same fund (see Figure 6).

Further, the *qard hasan* would be given by the shareholders to the *waqf* entity and not to individuals as in the typical *wakala* model. The shareholders may give a unilateral undertaking to give a *qard* to the *waqf* fund in order to meet its obligation to its members should there be a deficit. The company would be allowed to recover this loan from the *waqf* fund over any period without charging any interest (see Figure 7).

The shareholders may give a unilateral undertaking to give a qard *to the* waqf *fund in order to meet its obligation to its members should there be a deficit.*

Reserves

In addition to the usual technical reserves, such as unearned premium and IBNR reserves, the *waqf* fund would be allowed to form a contingency reserve fund for future situations from the contributions received and profits earned on the investment. This reserve would also be the property of the *waqf* fund, and the profit received on it would also be treated as a property of the *waqf* fund. With the help of this fund, *waqf* may compensate the current as well as the future participants and would not need to refund the reserve to the participants at any given period of time.

Sources of Income

The sources of income in this framework would be the same as under the typical *wakala* model. Thus, the concerns relating to the fee structure and incentive basis expressed earlier apply equally in this case as well. The three sources are:

1. *Operator fees.* For performing the services, the company would be eligible for taking a defined remuneration, which would be paid from the *waqf* fund. A deduction can be made from the *waqf* fund for this purpose.
2. *As* mudarib *by sharing in the investment profits or as an agent for investment by taking service charges*
3. *By investing the money of the shareholders and earning profits*

From this remuneration, the company would bear the expenses related to the salaries of those involved in setting up operations.

General Comments

The refinements to the *wakala* model discussed here follow in principle the same approach as under a typical *wakala* model but with some refinements that address some of the concerns and doubts that *Shariah* scholars have identified. It is considered that these refine-

Figure 6. Compensation of Loss in *Wakala* with *Waqf* Model

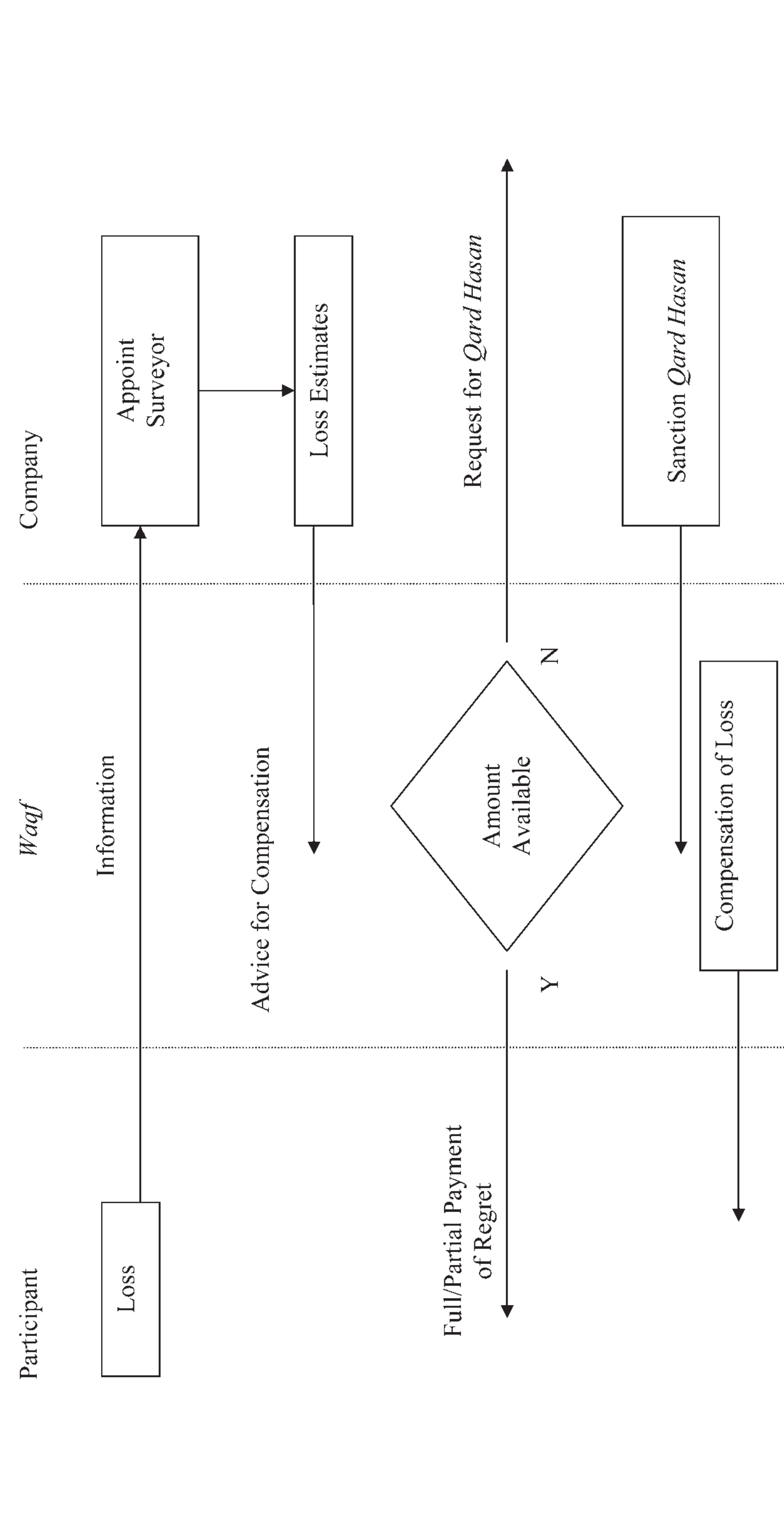
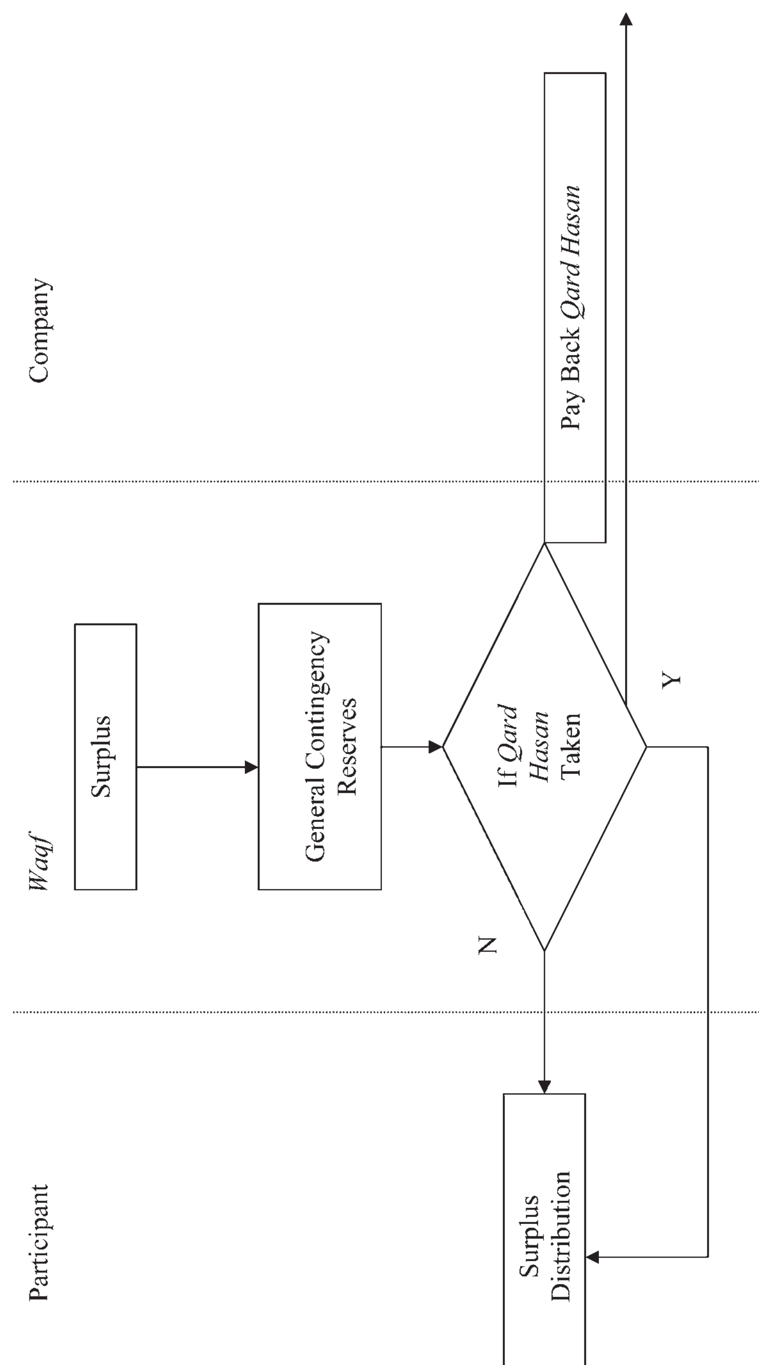


Figure 7. Surplus Distribution in *Wakala* with *Waqf* Model



ments meet some of the concerns with the *wakala* model and at the same time ought not to be difficult to implement.

CONCLUSION

The *takaful* system is still in the process of evolving, with a number of issues raised by various *Shariah* scholars. It is therefore desirable to encourage a process of discussion and advance alternative approaches with ideas that may come from anywhere around the world. The ultimate aim is to have a consensus model addressing as many current as well as future legal concerns as possible. Such a process seems to be a logical way to move forward and ensure that the *takaful* at some stage is governed by a uniform consensus-based model.

The ultimate aim is to have a consensus model addressing as many current as well as future legal concerns as possible.

At a global level, two basic models of *takaful* are currently in operation. The *mudarabah* model is acceptable as long as the operator benefits only by sharing in the investment returns of the funds. However, there are some very serious reservations if it is applied to risk contracts with underwriting surplus being shared. These issues do not seem to have a solution and hence most operators now adopt the *wakala* model. The *wakala* model has much wider acceptance and is most suited to risk contracts. The *Shariah* concerns as well as some actuarial concerns in a typical *wakala* model were identified and some solutions proposed. Issues relating to the sharing in underwriting surplus in a *wakala* contract, and the issue of the risk premium and operator fee outlined here, deserve attention, as these can have an impact on the results of the fund and the operator. *Shariah* scholars need to have discussions with insurance professionals in an environment not associated with a particular *takaful* client, as this could possibly lead to a bias on the part of the operator in explaining the intricacies of the insurance contracts and arrangements.

As a basis for such an interchange, a third model has been sketched out here—*wakala* with the *waqf fund*. In this suggested approach, the *Shariah* concerns relating to the *wakala* model are addressed by creating a separate *waqf* entity in between the participants and the *takaful* company. These refinements do not disturb the basic model, and the result for the consumer ought not to change. Nevertheless, some of the *Shariah* issues are tackled in a different way.

This alternative framework is offered here in the hope that industry practitioners will consider with their *Shariah* advisors whether this proposed model better addresses the concerns raised about the *wakala* system and whether the modifications are suitable in their setup and can contribute further to the growth of the *takaful* industry. Being a refinement of the *wakala* model, those operators adopting the agency approach ought not to have strong objections to the proposal, which seeks to align *Shariah* concerns and industry objectives in a conceptually more satisfactory manner.

REFERENCES

Abdul Rahim, A. W. (2003, September). International Conference on Takaful, London.

Abdul Rahim, A. W. (2004, September). International Conference on Takaful, Jeddah.

Abdul Rahim, A. W. (2006, February). International Conference on Takaful, Langkawi, Malaysia.

Abdul Rahim, A. W. (2006). Swiss Re SITC publication.

Al-Qaradawi, Y. (1989). The lawful and the prohibited in Islam. Kuwait: International Islamic Federation of Student Organizations.

Anwar, M. (1994, Winter). Comparative study of insurance and takafol (Islamic insurance). Pakistan Development Review, 33, 1315–1330.

Billah, M. M. (2001). Principles & practices of takaful and insurance compared. Malaysia: GECD Printing Sdn. Bhd.

Billah, M. M. (2007). Islamic banking and the growth of takaful. In M. Kabir Hassan & M. K. Lewis (Eds.), The handbook of Islamic banking, pp. 401–418. Cheltenham, UK: Edward Elgar.

Cizakca, M. (1998). Awqaf in history and its implications for modern Islamic economics. Islamic Economic Studies, 6(1), 43–70.

Ismail, A. (1998, April/May). Insurance & Shari'ah (2/2) takaful: A practical alternative. Nida'ul Islam (http://www.islam.org.au), pp. 1–4.

Lewis, M. K. (2003, August/September). Challenges to the takaful industry. New Horizon, 132, pp. 10–14.

Lewis, M. K. (2005). Wealth creation through takaful (Islamic insurance). In M. Iqbal & R. Wilson (Eds.), Islamic perspectives on wealth creation (pp. 167–187). Edinburgh: Edinburgh University Press.

Muslehuddin, M. (1982). Insurance and Islamic law. Delhi: Markazi Maktaba Islami.

Sharif, K. (2000). Mujdharabah and tabarru in takaful contracts. International Conference on Takaful/Islamic Insurance, June 22–23, Kuala Lumpur.

Siddiqi, M. N. (1985). Insurance in an Islamic economy. Leicester: Islamic Foundation.

Wahib, R. B. (1999). Islamic takafol insurance. New Horizon, Part 1, 86, 10–12; Part 2, 87, 16–17; Part 3, 88, 10–12.

Yaquby, N. (2000). Between Shari'a scholars and takaful practitioners: Bridging the gap. International Conference on Takaful/Islamic Insurance. June 22–23, Kuala Lumpur.