



# ISLAMIC FINANCE GATEWAY

## A TAKAFUL PRIMER: BASICS OF ISLAMIC INSURANCE

One of Takaful industry's preeminent pioneers explains the fundamentals in easy-to-read language to spread public awareness and empower individuals to more informed decisions about everyday risks.

*"TO ALLAH BELONG ALL THINGS IN HEAVEN AND EARTH: VERILY  
ALLAH IS HE THAT IS FREE OF ALL WANTS, WORTHY OF ALL PRAISE."  
V.31:26*

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## FOREWORD

No entity is an island unto itself, especially in the growth story of Islamic finance. In collaborating with leading institutions and individuals, we, the Islamic finance team at Thomson Reuters, continue our partnership approach to bring thought leadership, vision, and a way forward to educate ourselves and our stakeholder clients. Takaful, mutual insurance, is one of the five pillars of Islamic finance, and needs to 'catch-up' to, say, Sukuk growth and development. Our approach, collaborating with one of the foremost authorities in Takaful, Dr Omar Fisher Clark, will shine a bright light of awareness and education in an area that has been murky and misunderstood. We are extremely proud of our continued contribution to take Islamic finance, generally, and Takaful, specifically, to the next development benchmark.

## PROFILE OF AUTHOR



Dr. Omar Clark Fisher began his career as a management consultant with Arthur D. Little, Inc of Cambridge, Mass and, while on residential assignment in Cairo Egypt (1980), embraced Islam. Between 1983-1992, Dr. Fisher worked at the Overseas Private Investment Corp in Washington DC where he first learned about political risk underwriting and investment guarantees. Thereafter, he launched the first Islamic equipment leasing business. Later he lead a team that introduced Takaful insurance into America (1997) and built up a network of licensed agents in 6 states across USA. Between 2000-2004, Dr. Fisher organized a core team at Bank Al Jazira to launch the first Family Takaful program into Kingdom of Saudi Arabia. Then, he lead a senior team at Unicorn Investment Bank to launch the first regional Takaful company under license from Central Bank of Bahrain (2007), with affiliates in 3 countries. Since 2009, Dr. Fisher is advising numerous Takaful players in UAE and Saudi Arabia plus contributing as a Mentor to young entrepreneurs through Dubai Silicon Oasis, UAE. He earned a PhD in Takaful (2005). He is author/editor of two books on Takaful and many articles and speeches on Islamic finance, wealth and asset management, risk and social enterprise networking.



## SECTION A

# INTRODUCTION – HOW TO READ THIS BOOK

**You probably have many questions, like most people today, about what is Takaful? What are the roots and historical background? How does Takaful differ from conventional insurance? What are the important aspects that a Takaful must contain to be fully Shariah compliant? What are the latest innovations? Which kinds of risk exposures can be covered by Takaful and how? This comprehensive yet simplified guide to Takaful will answer these questions and more.**

The global Takaful industry is approaching a junction point on the pathway of its 33 year evolution. Huge progress has been achieved in its introduction into 36 countries, however, with the passage into retirement of the original industry pioneers, where will the new leaders arise and what directions will the next impetus take Islamic insurance?

As a testament to its allure and because Takaful products are required by 22% of the world's population to fulfill their religious duties, we observe that major multinational insurance companies have opened Takaful businesses, "windows" or acquired shares in joint ventures. Nonetheless, this main-stream acceptance may prove to be short-lived. What will happen if the Takaful industry falters and fails to reach the expected acceptance (penetration rates) or falls short without billions of dollars of new premium volume from participants – by Muslims as well as non-Muslims<sup>1</sup>? What if Takaful profitability disappoints and is insufficient to sustain interest amongst shareholders and multinationals alike – they could elect to close down such business lines because Takaful is not a charity. Despite a global resurgence in interest in Islam and how financial services can be conducted according to Shariah rules, an obvious challenge is how to build up informed public awareness among potential end-users to overcome the skepticism and doubts surrounding Islamic Financial services that generally persists in emerging markets.

By reading this booklet the reader will become familiar with the basics of Islamic insurance and understand how to employ shared risk protection – through Takaful system – to fulfill his/her religious obligations and to safeguard himself, his assets, his family and his business.

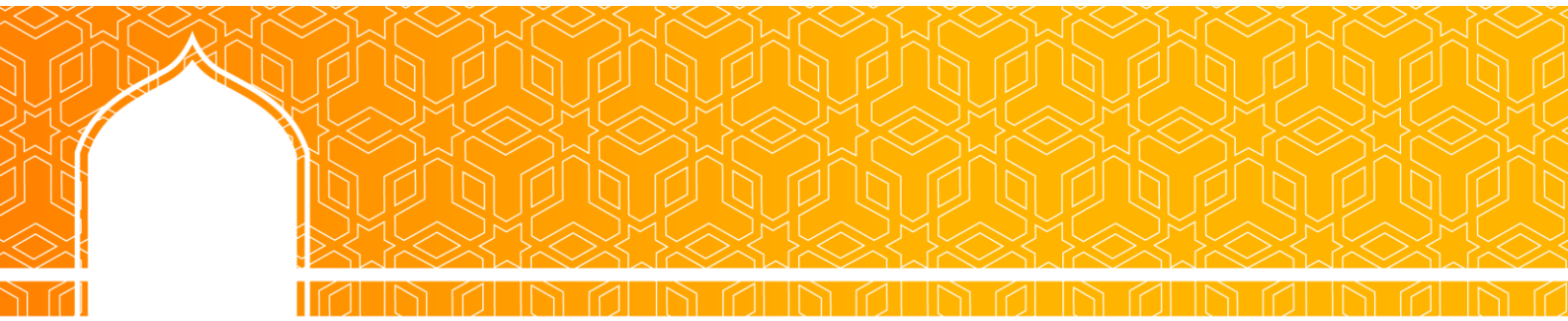
The reader should enter this booklet with an open mind, dedicating 60-90 minutes of time towards familiarization of basic principles of insurance. This booklet is prepared as a non-technical practical guide for students, young adults and parents, community leaders, and other lay-persons. Additional helpful resources are described in the Appendix and Resources Directory for those readers who would like to learn more and delve more deeply into Takaful principles, Shariah issues, regulations and insurance rules, compliant investments, Re-Takaful and similar technical topics.

The contents were developed especially for adaptation to digital and e-book formats for the widest possible circulation to the public of all ages. Your feedback, comments and any questions are most welcome. These may be sent along to: [info@khidr.ae](mailto:info@khidr.ae)

So let's begin.

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<sup>1</sup> See Appendix A. Myth One – Takaful is Only for Muslims.



## SECTION B

### WHAT IS RISK? A NEED FOR PROTECTION



REUTERS/Akhtar Soomro



## B.1 WHAT IS RISK?

Risk is everywhere around us. Wherever one goes or whatever action one takes, there is an element of “risk”. This is because the future, even the next few seconds of life, is unknowable. Hence, everything we do contains an element of risk and uncertainty.

One definition of risk points to “the possibility of loss occurring in the future”. The occurrence of such a loss is measured by probability (likelihood) and impact (severity). Common understanding takes a view that risk is “negative” and consists of two parts:

- **Uncertainty** – an event *may or may not* happen
- **Loss** – an event has unwanted consequences or causes loss. In insurance terms, a loss is an unexpected decrease or disappearance of economic or monetary value

The Australia/New Zealand Standard for Risk Management (AS/NZS 4360:2004) defines risk as “...*the possibility of something happening that impacts on your objectives. It is the chance to either make a gain or a loss. It is measured in terms of likelihood and consequence.*”

Note that risk can also bring about gain, or favorable circumstances; that is a view of “opportunity.” Although, risk is viewed typically as involving unpleasant or negative outcomes, it is important to point out that to seize opportunities in life, or in business, it is imperative to “take a risk” also. In fact, no real progress or advancement can be accomplished without taking such risks. With all that said, in general, then there are no striking differences between **Islamic** and **non-Islamic** perspectives of risk.

Universally, Muslims are urged to depend wholeheartedly upon God (tawakkul) in all respects yet guidance from Holy Quran and hadith [see Section D.] make clear each person has an instinct of self-preservation and a duty to take appropriate precautions. Precautionary actions are done to manage the **uncertainty** and **risks** associated with the future. Some references to this point are:

*“And put all your trust [in the God], if you truly are believers.”*

**Quran Al Maidah V.5:2-3**

*“If you all depend on Allah with due reliance, He would certainly give you provision as He gives it to the birds who go forth hungry in the morning and return with full bellies at dusk.”*

**Hadith ~Al-Tirmidhi by Umar bin Khattab (rah)**

*“One day Prophet Muhammad (pbuh) noticed a Bedouin leaving his camel without tying it and he asked the Bedouin, “Why don’t you tie down your camel?” The Bedouin answered, “I put my trust in Allah.” The Prophet then said, “Tie your camel first, then put your trust in Allah.”* **Hadith ~At Tirmidhi**

*“...let them pray with you taking all precautions and bearing arms...but there is no sin on you if you put away your arms because of the inconvenience of rain or because you are ill, but take every precaution for yourselves.”*

**An-Nisa V. 4.102**

A risk always involves uncertainty – the likelihood that an event or outcome will or will not happen, or will occur unpredictably. Many types of risks can be shared (or transferred) using insurance, especially in those circumstances where the magnitude of the impact of the risk occurrence is outside the control of the individual, or where financial consequences to that person might be disastrous. Risk is the **reason** insurance exists. Without risk, there would be no need for insurance.

Whereas the full impact of that risk may be mitigated by human intervention (i.e. Loss control or insurance), generally the result of a risk occurring is viewed by experts and measured as if a worst case might occur. While it may be impossible to measure risk in exact terms, yet its impact on an individual(s) can usually be quantified in monetary terms and traditionally is measured in terms of the amount of financial loss. That is why insurance coverage payouts are commonly in the form of money.

## B.2 INSURANCE AND COOPERATION

The word “insurance” is troubling to many believers because of a belief that only **Allah** (SWT) [God] is able to assure or guarantee anything – especially continuation of life, individual well being and safety of property. The specific difficulty for Muslims is that conventional insurance has evolved under man-made regulations since the 16th century gradually transforming community risk-sharing into a for-profit enterprise. This is further complicated by associated conventional practices that are prohibited by the Shariah (Islamic Law) because of their involvement with *al-maisir* (gambling), *al-gharar* (uncertainty), and *al-riba* (interest and usury) [descriptions are in Section E].

Nevertheless, the concept of recovering a portion (or all) of a financial loss due to damage or destruction of tangible assets or property, or even injury to one’s person, is not considered by Islam to be unlawful or prohibited. The mechanism of risk sharing as well as the means of such recovery, however, must conform to the Shariah and its legal guidelines and principles. A system of lawful protection under Shariah against perils, risks and hazards that employs such acceptable means was established 1400 years ago and is known as **Takaful**.

Quite naturally, humans congregate in groups, share workloads and generally promote social cooperation – for individual self as well as species preservation. Most people make a conscious effort and strive for sound decision-making for a common good – yet also use judgment on events to protect her/himself and her/his personal interests. By so doing, each of us is engaging in social cooperation with these laudable goals:

- Self-help
- Equality and equity
- Solidarity
- Honesty and openness
- Caring for others

Muslims are specifically instructed to seek out social cooperation as a check on each individual's wayward (perhaps sinful) activities and instead to promote common virtue. Quranic injunctions makes clear:

*"Help you one another in al Birr and al Taqwa (virtue and righteousness and piety) but do not help one another in sin and transgression."*

**Surah Al Maidah V.5.2-3**

Another reason for collective action is to cushion each individual member of that community against misfortune, accident or loss which impacts may be troublesome, or even devastating if the singular burden were not spread across the entire group.

Takaful is a mechanism of **mutual indemnification** based on the principle of ta-awun, or mutual assistance, that can include financial aid. A cooperative fund organized to offer protection for the assets, property and other items of value of its members which adheres to Shariah rules is called a **Takaful**. Risks of each member are shared collectively by the group (not transferred as in conventional insurance from an individual to the insurer company) through participation in the cooperative fund. In the case of loss occurring to one or more of the members, the Takaful cooperative fund will provide financial assistance on behalf of the group to repair damage, replace assets or otherwise compensate a participant for eligible loss(es) s/he suffers. Not unlike mutual insurance, a Takaful can be seen as a pact or agreement between members of a group to be jointly responsible for sharing the defined risks of loss occurring to individual members of the group.

Some historians point out that Takaful groups were probably the precursors to modern conventional mutual insurance. Indeed, the core practices of mutual insurance today are generally deemed by Muslim jurists and scholars to be lawful and not contradictory to the principles of Shariah. The idea of collective compensation and group responsibility has its roots in the tribal customs prevalent at the time of the Prophet Muhammad (PBUH)<sup>2</sup>. One example was practice of blood rite (diyat or wergild). Moreover, Muslim jurists have attested to the permissibility of Takaful risk sharing in much the same way the concept of *aqila*, or group responsibility for accidental death, is held to be lawful. [Refer to Section C.]

### B.3 TYPES OF RISK

When considering risk, it is important to make a distinction between two types – Pure risk and Speculative risk.

**Pure Risk** has only two possible outcomes: There is either a loss or an absence of loss (no change). For instance, a car will hit another vehicle, or it will not; a store will go bankrupt, or it will not; a thunderstorm will uproot a tree and cause it to fall on top of a building, or it will not.

**Speculative Risk** involves three possible outcomes: loss, no change, or gain (some profit or benefit). Gambling is speculative – taking chances on a casino game will result in loss, breaking even or winning. Many business ventures contain speculative risks as well.

Insurance seeks to treat **pure risks** solely. No insurance coverage is available for speculative risks. For a risk to become the subject of insurance (i.e. insurable), there must be no opportunity for gain by the owner of the policy (the insured).

### B.4 RESPONSES TO RISK

To manage your exposures to pure risks, four methods are widely accepted:

- risk avoidance
- loss control, with reduction in exposure
- risk retention, also called self-insurance
- risk transfer

Insurance is central to the method of risk transfer, but is only one type of risk response.

Under the principle of indemnity, an insurance policy usually compensates up to the value of a financial loss and does not contemplate a chance for gain by the person insured. Risk that is insured must be observable and measurable, not subjective or intangible. Hence, any loss or damage occurring should be likewise measurable and quantifiable. The goal is to restore the person to be "made whole" and returned to his/her condition just prior to the risk event and loss.

### B.5 INSURABLE INTEREST AND DISQUALIFIED RISKS

The owner of the risk is said to have an "insurable" interest in the item covered because the covered losses harm him/her directly – such as loss of assets, jewelry, property or income, exposure to law suits due to negligence, legal liability claims and damages that trigger unexpected expenses.

On the other hand, not every risk can be insured. Examples of risks disqualified as insurable risks include:

- No monetary value
- No insurable interest (as required by law)
- Illegal or unlawful activity
- Vice or dishonest behavior contributing to the risk (i.e., fraud)
- Certain catastrophic risk such as nuclear accident, famine or war
- Public policy exclusions such as fines or criminal acts
- Usual wear and tear and depreciation on property
- Other factors or limitations that contribute to making a risk insurable are delay, vermin, market agreements, government confiscation or authority, etc.

Grounds for the rejection of coverage due to factors described above, shows no appreciable difference between conventional insurance and Takaful.

Now that we have a basic understanding of what is risk, insurance, and insurability, let us examine the historical roots and development of Takaful and its successor- conventional insurance.

<sup>2</sup> Time of Prophet Muhammad's Life on the Arabia peninsula is CE624 and on.







## SECTION C

# ORIGINS OF INSURANCE



REUTERS/Akhtar Soomro

## C.1 OLD DAYS AND ANCIENT WAYS

Exact origins of insurance are ambiguous yet most scholars agree that in Babylonia times, “bottomry” contracts for marine and trade protection were used in 3,000 BC and around 2100 BC, the Code of Hammurabi was the first basic written insurance policy. This policy was paid for by commercial traders in the form of a loan to guarantee the safe arrival of their goods by ship or caravan. Repayment made above the principal loan amount borrowed (i.e. premium) occurred upon safe arrival at destination. Ancient ships and camel caravans faced the perils of uncertain roads and seaways – like robbery, bad weather and breakdowns. The lender provided compensation to those traders who suffered losses or misfortune during trade travels from the proceeds of the premiums collected.

As history progressed, the need for insurance increased. The Phoenicians and the Greeks wanted the same type of insurance with their seaborne commerce. The Romans were the first to have burial insurance – people joined burial clubs which paid for the funeral expenses of deceased on behalf of surviving family members. In medieval times, the guilds used insurance to protect their members from loss by fire and shipwreck, paid ransoms to pirates, and provide respectable burials as well as support in times of sickness and poverty.

Then came the first underwriters to insurance risks, signed in Genoa in 1347 CE<sup>3</sup>. They each wrote their name and the amount of risk they were willing to assume as a liability under an insurance proposal. This explains how the term **underwriter** came to be.

Underwriters play a big part in the insurance industry. They're the ones who calculate the risk, based on statistics, and decide what the premiums paid in advance will be. In 1693 CE, the astronomer Edmond Halley created a basis for underwriting life insurance by developing the first mortality (death rates) table. He combined the statistical laws of mortality and the principle of compound interest. However, this table used the same rate for all ages. In 1756, Joseph Dodson corrected this error and made it possible to scale the premium rate charged to different ages.

By this time, the practice of insuring cargo while being shipped was widespread throughout the maritime nations of Europe. Then in London, in 1688, the first insurance company was formed. It got its start at Lloyd's Coffee House, a place where merchants, ship-owners, and underwriters met to transact their business. Lloyd's grew into one of the first modern insurance companies, Lloyd's of London.

## C.2 MORE MODERN TIMES

As commerce grew – so did the need for insurance and in the 17th and 18th centuries, British commerce was rapidly growing and so were the size of risks. In a way, progress was actually working **against** the collective form of insurance industry – there were more and more ways of goods being damaged or lost, as goods were shipped greater distances and by more advanced methods. Therefore, there were higher payouts for claims. In Britain, Marine cargo and hull coverage was formalized in 1575 CE under the Royal Exchange, which proved to be a precursor to Lloyd's of London in early 1600s

The members of stock companies saw an opportunity for a profitable business. In response to the great fire of London 1667, the Sun Fire Company opened in 1710.

The first chartered insurance business began in England in 1720. The first American mutual insurance fraternalities were founded in the British colony of Philadelphia (PA) the **Philadelphia Contributionship for the Insurance of Houses** in 1735. One was sponsored by a church – the Presbyterian Synod of Philadelphia – for their ministers and their dependents. Later on in 1787 and 1794 respectively, the first fire insurance companies were formed in New York City and Philadelphia. Then other needs for insurance were discovered and, in the 1830s, the practice of classifying risks by major categories began. Although there was religious prejudice by the church against the practice of insurance as a business, after 1840 this declined and allowed life insurance to boom as a profitable enterprise.

The Travelers Insurance Company sold its first accident policy in 1864 and in 1889 issued the first auto insurance policy. The **Workmen's Compensation Act of 1897 in Britain** required employers to insure their employees against industrial mishaps. This also fostered what we know today as public liability insurance, which came strongly into play when more automobiles arrived on the scene.

As time progressed, new types of insurance have been developed to match the risks emerging along with an increasingly modern lifestyle. Whereas insurance policies were usually issued to individuals, with the advent of the industrial revolution most employers began to offer group insurance policies for their workers, providing them with group life insurance, sickness and accident benefits, and access to retirement plans or pensions.

The first modern takaful cooperative model was started in 1979 in Sudan, by virtue of the establishment of Islamic Insurance Co-Ltd., ( Dar-al-Mal Islami Group), and Islamic Arab Insurance Co., of Saudi Arabia (al-Baraka Group).

<sup>3</sup> History Of.net, web site 2011.

### C.3 NEED FOR RESERVES AND REINSURANCE

People in the 19th and 20th centuries accepted the fact that they needed to pay premiums to protect themselves and their loved ones in case of loss, including major losses like fires. However, in 1835 when the New York fire struck the losses were unexpectedly high and no reserves were prepared for such a situation. As a result of this, Massachusetts led the states in 1837 by passing a law that required insurance companies to maintain such reserves as contingency for future losses. The great Chicago fire in 1871 reemphasized the need for these reserves, especially for risks in large dense cities.

Insurance companies soon realized that mounting significance of losses required a pooling of risks. So insurers devised a system called **reinsurance** whereby losses were distributed among many companies (in the form of co-insurance) or distributed to new companies with substantial paid up capital – called reinsurers. This system is now commonly used across all types of insurance.

### C.4 TRIBAL PRACTICES ON ARABIAN PENINSULA

Fully 11 centuries before the advent of conventional stock insurance companies, a form of mutual risk sharing was common practice among the tribes of the Arabian Peninsula. Merchants of Mekkah formed funds called *hilf*, to assist victims of natural disasters or hazards of trade journeys. A surety, called **daman khatr al-tariq** was placed on traders against losses suffered during a journey caused by bandits or pirates. Another common practice called *a'qila* prevented tribal bloodshed by extending compensation to ransom captives or to settle a claim from an accidental killing. Such practices from the **Jalilaya**, or pre-Islam period (200 to 600 CE), were validated by Prophet Muhammad (PBUH) and incorporated into acceptable practices of the early Islamic state.

In fact, in 622 A.D (C.E.) the first Constitution of Medina describes use of **ta-awun** or social insurance in three instances, including (a) mutual assistance extended to “Jews, Ansar and Christian minorities in the community.” (Articles 3, 18, 20-21) (b) Article 3 reference to “*wergild*” or blood money (**a'qila**) and c) Article 5 provision for **Fidayiah**, ransom for captives.<sup>4</sup>

Hardships of desert life and a war-like vigilance were essential conditions of nomadic life that forged a unity among groups to act as a social unit for survival. Dr. M. Muslehuddin describes it: “...not only does the [tribal] unit consider the loss of its individual member as its own, it also takes steps to cover such loss; either by revenge and blood-letting, or alternatively by payment of blood money by the group on behalf of the individual.”<sup>5</sup> This perspective can be viewed as an early form of **social insurance** within a tribal society.

Therefore, we can conclude that more a thousand years prior to the advent of modern day conventional stock insurance companies, **Takaful** or mutual assistance was commonplace among Arab tribes. It is important to point out that the mutual assistance among tribes was not originally a commercial transaction nor contained any profit or gain at the expense of others. Rather, it evolved as a useful social practice to mitigate the burden of an individual by dividing it among his fellow members (group/ social unit) or tribe.

In contrast, modern day insurance is a capitalist-based commercial enterprise, whereby losses are statistically projected in advance and funds (premiums) allocated to risks exposures to cover them with a “profit”. In short, former social practices involved compensation for actual losses upon an occurrence by dividing them among the group, whereas the latter involves the transfer of losses in advance based upon past loss experiences for that risk group. This transfer of risk from many policyholders to few shareholders (owners of the insurance company) voids the age-old principle of mutual risk sharing and **ta'awun**, mutual assistance.

Intuitively, people feel safer in a group. Providing that the cost of joining that group (i.e. premium) is affordable, most people will opt for the security, relative safety and economic benefits to themselves of mutual risk-sharing. When dealing with insurance, the over-arching factor in the transaction should be the contractual relationship between the insured and the risk-taker (insurance company). In Section F. we explore of the differences between types of insurance mechanisms; notably, **Stock** insurers, **Cooperative/Mutual** insurers and **Takaful** insurers.

Next we turn to the foundation of what makes up Shariah principles.

<sup>4</sup> First Constitution of Medinah of 622 CE. Also see “Roots of Takaful In Medinah Constitution”, Dr.Omar Fisher 2012.

<sup>5</sup> Dr. M. Muslehuddin, “Insurance and Islamic Law,” Islamic Publications, Lahore, Pakistan, 1969.





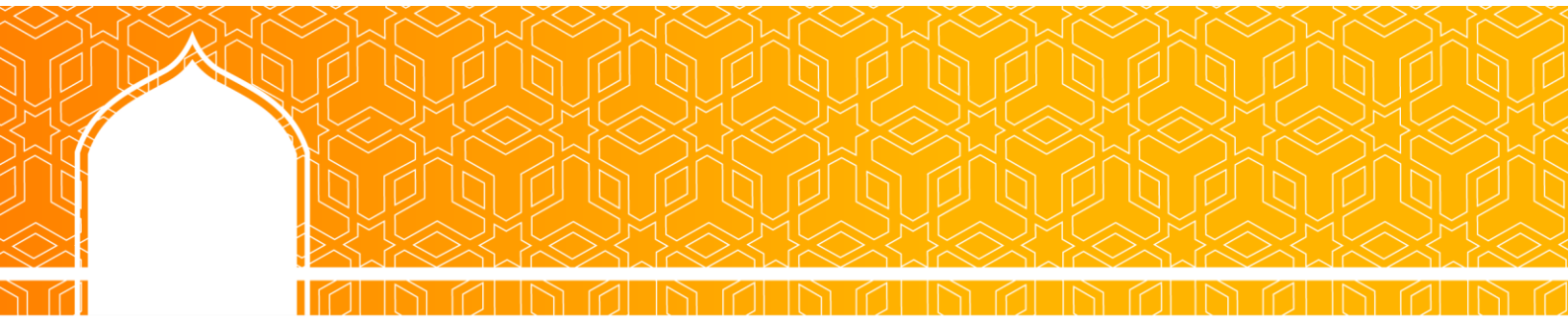
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## SECTION D

### FIRST PRINCIPLES – SHARIAH OVERVIEW



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## D.1 PURPOSES OF SHARIAH AND BACKGROUND TO COOPERATION

The Islamic Shariah forms a legal framework for the purposes of regulating all aspects of Life: a person's relationship to the Creator (God), relations with spouse, family, community, governance of nation, how to give charity, make pilgrimage, offer prayers and fasting, etc. To simplify, goals of Shariah are:

1. Guidance: to attract benefits (masalah) and to avert evil (mafasid)
2. avoidance of harm as much as possible
3. promote cooperation
4. risk mitigation
5. mutual self-help

Mutual cooperation (3 and 5) make up a cornerstone of Islam beliefs that is explicitly encouraged: "Help one another in furthering virtue and God-consciousness (Taqwa), and do not help one another in furthering evil and enmity."<sup>6</sup>

The Prophet Muhammad's (pbuh) sayings on this topic are numerous, some of which are:

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*"Whosoever fulfils the intention of a brother, Allah will fulfill his intentions."*<sup>7</sup>

*"Always help those who helps his brother."*<sup>8</sup>

*"Assist one another in the doing of good and righteousness. Assist not one another in sin and transgression."*

**Surah Al Maidah, V5:2**

*"...Let the trustee (faithfully) discharge his trust, and let him fear Allah (swt), his Lord. And conceal not the evidence..."*

**Surah Al Bakarah V2:283**

*"Those who believed and emigrated...are all friends and protectors, one to another."*

**Surah Al Anfal V8:72**

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Cooperation among people brings out and emphasizes certain human values which are essential to a healthy and harmonious community life. The selected Hadith from the Sunnah of Prophet Muhammad (PBUH) demonstrate the repeated references to encourage cooperation to instil such values as: solidarity, empathy, mutual aid and compassion. Amongst others, these state:

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*"Believers are to other believers like parts of a structure that tighten and reinforce each other."*

**Reported by Al Bukhari and Muslim**

*"Whosoever removes a worldly hardship from a believer, Allah (swt) will remove from him one of the hardships of the Day of Judgment. Whosoever alleviates from one, Allah (swt) will alleviate his lot in this world and the next."*

**Al Bukhari**

*"Help your brother, either those oppressed or those who oppress." The companions ask "Oh Messenger of Allah, we understand about helping the oppressed how do we help those who oppress?" The Messenger replied "relieve them of their power."<sup>9</sup>*

*"The believers in their compassion and cooperation are like one body. If a part of that body suffers, the rest will suffer as well."<sup>10</sup>*

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## D.2 SOURCES OF SHARIAH

Sources of Shariah are based on two primary and three secondary sources. The two primary sources are:

- The Holy Quran, or divine word of Allah (God)
- The Sunnah and Hadith, or actions and sayings of the Prophet Muhammad (PBUH)

The secondary sources are:

- Ijma, or consensus
- Qiyas, or reasoning by means of analogy
- Ijtihad, or independent argument by learned Muslim scholar in absence of consensus

Throughout this **Takaful Primer**, we will refer to the two primary sources.

## D.3 RELATION TO MANKIND

The higher purpose of the Shariah is guidance to the human being (niaqasid) to preserve:

- Faith (din)
- Life (nafs)
- Intellect ('aql)
- Posterity (nasl)
- Property (mal)

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<sup>6</sup> Surah Al-Maidah verse: 2

<sup>7</sup> Reported by Ahmad & Abu Daud.

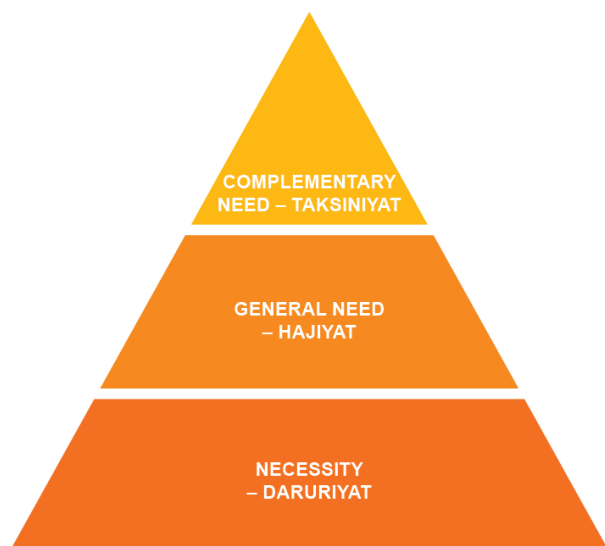
<sup>8</sup> Reported by Ahmad & Abu Daud.

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<sup>9</sup> Mutafaq 'alaih

<sup>10</sup> Riyadh Al-Salihin, page 131

Whatever serves to further ameliorate or protect these is considered by the Shariah to be fundamental to life, and is known as *maslahah* (beneficial or public good). Any activity counter to this or a failure to uphold the Shariah's intent is considered sinful (*zu'afasadah*).



Human actions are of three forms: 1. A compelling, unavoidable necessity (*daruriyat*); 2. A general need (*hajiyat*), which is below the level of necessity of *daruriyat*; and 3. Neither *daruriyat* nor *hajiyat*, but rather that which is noble and complementary to a decent life (*tahsiniyyat*). Resorting to *Takaful* collective risk sharing is one example of *tahsiniyyat*.

#### D.4 TAKAFUL REFERENCES IN SHARIAH AND FIQH

Although **Takaful** is a term not actually appearing in the text of the Holy Quran, there are numerous references to the concept and injunctions to believers for mutual caring and cooperation:

*“Help one another in furthering pious and piety, but do not help one another in furthering evil and enmity.”*

**Surah Maidah V. 5: 2.**

*“The Believers in their mutual love and live together, are like a body. If one part complains, all parts will feel the pain.”*

**Hadith Imam Bukhari and Muslim.**

*“Verily a believer is one who can give security and protection to life and property of fellow humans.”*

**Hadith reported by Ibn Majah**

*“Whosoever fulfills the intention of a brother, Allah will fulfill his intentions.”*

**Hadith reported by Ahmad and Abu Daud**

An imminent Islamic scholar, Dr. Yusuf Qaradawi, remonstrated in his famous book **The Lawful and the Prohibited in Islam** that; “In my view insurance against hazards can be modified in a manner which would bring it closer to the Islamic principle by means of a contract of donation with a condition of compensation; a further requirement is that the company must be free from usurious business.”<sup>11</sup>

This notion of donation is elaborated on by a scholar in Malaysia as the essential mitigating factor for Muslims in a transaction which is otherwise prohibited (*haram*). His opinion appears in a report from 1985:

“Under the Islamic insurance system, part of the contribution from every participant must be made with the intention of *tabarru* not for buying and selling. The existence of *tabarru* makes the transaction permissible and valid according to the Shariah.”<sup>12</sup> The very definition of *Takaful* as it appears in section 2 of the *Takaful Act of 1984* (Malaysia) asserts that interaction amongst *Takaful* participants should be deliberately based upon brotherhood and mutual cooperation:

*“...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 participant’s mutually agree to contribute for that purpose.”*

In fact the single most important fatwa on *Takaful*, according to some industry practitioners, is the Resolution No. 9 from the Jeddah Fiqh Academy on December 22-28, 1985. As translated, the fatwa states:

*... “the commercial insurance contract, which earns fixed premium as practised by commercial insurance companies, involves significant *gharar* that makes contract null and void. This form of transaction is prohibited by the standard rules of Shariah.*

Likewise, the Fatwa Committee of the National Council for Islamic Religious Affairs in Malaysia deliberated on life insurance on the 15th June, 1972 and resolved:

*“That life insurance as provided by present-day insurance companies is a business transaction which is void because it contradicts the Islamic principles as it contains the elements of *gharar* (uncertainty), *riba* (interest/usury) and *maisir* (gambling).*

*The alternative contract which conforms to the principles of Islamic dealings is the contract of cooperative insurance, which is founded on the basis of charitable donation and Shariah compliant dealings.”*<sup>13</sup>

<sup>11</sup> The Lawful and the Prohibited in Islam, Yusuf Qaradawi, p. 276.

<sup>12</sup> Badan Petugas Khas Report, translated into English, p. 19.

<sup>13</sup> Islamic Fiqh Academy (part of OIC) meeting in Jeddah 10 to 16 Rabul Thani 1406 H (Dec. 1985) issued as a Resolution.

## D.5 MEANING AND ROOTS OF TAKAFUL

The word al-**takaful** is al-masdar, an indefinite noun, and derived from the root word kafal, whose main meaning is “sharing”<sup>14</sup> with a sense shared guarantee. Takaful, being a noun, is extracted from the verb takafala. Takafala means, “committing one’s self to avert the loss of somebody”. This verb in turn is derived from the noun Kafil that means, “whatever protects the back of the rider”. Al-Kafil, which means “guarantor”, is the doer of the action. The Kafil is the sponsor and the meaning of “was kafeeled” (by Zakaria) is that Zakaria (may Allah bless his soul) sponsored the orphan and took care of her.<sup>15</sup>

The words “takaful” “kafal” and “kafil” are mentioned in the Holy Quran and Sunnah in several places, such as follows:

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*“To the care of Zakaria was she assigned.”<sup>16</sup>*

*Abu-Huriara narrated “The Messenger of Allah (may Allah bless his soul) said: The children of the believers are in a mountain in paradise and will be taken care of by Ibrahim (may Allah bless his soul) until returned to their fathers on doomsday”.<sup>17</sup>*

*Sahil Ibn Said reported that “The Messenger of Allah (may Allah bless his soul said) “Myself and the Orphan’s Sponsor are close like my fingers in paradise.”<sup>18</sup>*

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A takaful relationship insists on the need for sincerity in helping one another in good and virtuous acts, such as al **ta’awun**.

Thus al-Takaful is a deliberate arrangement as precaution by a group living in a same society to “assure” or mutually guarantee the security and protection of anyone’s life, assets, property or valuables.

As such, the takaful contribution is made in the spirit of **tabarru’ (donation)**, with the condition that the participant agrees that his contribution can be used to help other participants within the Takaful program. In modern times, such relationship is arranged and licensed as a business to be managed by the Takaful Operator, a private corporation. In this regard, the Takaful Operator should practice al Amin, custodianship of affairs of the takaful fund to assure its preservation and prudently act against over-due exposure to risks<sup>19</sup> associated with and amongst the participants. These risks can be of any kind but are usually of a homogeneous nature that may ultimately result in financial loss to participants- whether individuals or business groups. Each risk transaction then should uphold the duty of amanah, to safeguard and balance the interests of both participants and the Takaful Operator, which is best accomplished with transparency and openness in all activities.

The most striking example of this tribal cooperation was the practice of ‘aqilah. If one tribal member were to kill another person unintentionally, the offender was obliged to pay a form of wergild or deya (“blood money”), equivalent to value of 100 camels, to the family of the victim and the payment normally would be collected from funds of the family of the offender. By this practice, each tribe bound by blood ties, mutual respect and tolerance, was obliged by custom and tradition to come to the assistance of the offender and take suitable measures to cover such losses or liabilities collectively.<sup>20</sup> This took the form of mutuality and gave rise to the custom of losses being the responsibility of and shared by a group (tribe) of people as a whole.

## D.6 MORAL FOUNDATION FOR RISK PROTECTION USING TAKAFUL

As we have now seen, Islam is a world religion that encourages believers to avoid any unnecessary risk and harm and to prepare to reduce and/or mitigate the unavoidable consequences of risk that may be inflicted on one self, his family or his fellow brother occurring by God’s Will.

As everyone is aware, no person can exclude himself from Divine destiny (qada’ and qadar). What has been ordained, will most certainly happen and no power on this earth will be able to delay, shift or change this Divine pre-determination. However, Muslims are also advised to take all necessary steps to protect ourselves from results of this pre-destined event which is unknown to him/her (before the occurrence). This can be clearly seen in the teaching of the Prophet Muhammad (PBUH) to the owner of a camel, to tie his camel first before relying on what has been pre-destined by Allah.<sup>21</sup>

In another incident, Umar, the second Caliph, was reported to have prohibited people from entering Syria when cholera disease was rampant there. Upon objection by some of his companions on his seemingly non-reliance on the destiny of Allah, he responded that his decision was, as a matter of fact, “moving from one Divine destiny to another”.<sup>22</sup>

The same argument applies to other pre-Islamic customary laws that were subsequently approved by Prophet Muhammad (PBUH) such as **qasamah**. **Qasamah** was a customary practice under circumstances of war or duress or journey for a group to collect food and provisions and to “ration” or share such provisions until the danger (or journey) was over, then the remainder of provisions would be shared back to each participant – even during the journey participants may have eaten unequally from the provisions.

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<sup>14</sup> Dr. Mohd Masum Billah, Shariah Model of Quantum of Damages in Takaful, International Islamic University, Malaysia, 2001.

<sup>15</sup> Lisan Al-Arab, page 3906

<sup>16</sup> Al-Imran Chapter , verse # 37

<sup>17</sup> Al-Imam Al-Suyuti in his book “Al-Durar Al-Manthur” 1st volume.

<sup>18</sup> Riyadh Al-Saliheen, page 144.

<sup>19</sup> Ahmad Mazlan Zulkifly, BIMB Institute Malaysia.

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<sup>20</sup> see section 4.3.3

<sup>21</sup> al-Tirmidhi, vol. 4, p. 668, Dar Ihya’ al-Turath al-‘Arabi

<sup>22</sup> Ibn Hajr, Fath al-Bari, vol. 10, p. 178-179 (hadith no. 5728), Dar al-Ma’rifah, Beirut, no date.

Taking an Islamic point of view, four fundamental factors should co-exist to establish the proper framework for a Takaful system:

- A. **Nea'a**, or utmost sincerity of intention for knowingly following guidance and adhering to the rules for a Takaful insurance system
- B. **Integration of Shariah Conditions:** namely, risk protection sharing under ta-awuni principle, coincidence of ownership, participation in management by policyholders, avoidance of riba and prohibited investments, and inclusion of al mudharabah and/or wakala principles for Takaful management
- C. **Presence of Moral Values and Ethics**, business is conducted openly in accordance with utmost good faith, honesty, full disclosure, truthfulness and fairness in all dealings
- D. **No unlawful element** that contravenes Shariah and strict adherence to Islamic rules for commercial contracts<sup>23</sup>

Commercial contracts relating to risk protection should contain these elements:

- Parties have legal capacity (i.e. +18 years old) and are mental fit
- Definable Insurable interest
- Principle of Indemnity prevails
- Payment of specific premium as consideration (offer and acceptance)
- Mutual Consent (which includes voluntary purification)
- Specific Time Period of Policy and underlying Agreement

<sup>23</sup> Modern insurance contracts are structured as strict commercial dealings. Ideally, a Takaful contract/policy would contain elements making clear the nature of the relationship between participant and risk pool, the donation-contribution, the calculation of surplus and the sharing of surplus and how the affairs of the mutual risk pool will be governed.



## SECTION E

### WHAT ARE OBJECTIONS TO CONVENTIONAL INSURANCE?



REUTERS/Majed Jaber

## E.1 KEY DIFFERENCES

The bedrock differences between conventional insurance as currently practiced and Islamic cooperative risk-sharing can be summarized briefly in three main points:

- A. Takaful is an ethical system with absolute rather than normative values revealed by God (Allah – swt) that are not subject to periodic reinterpretations
- B. Takaful's main drivers are:
  - Piety {meaning individual purification}
  - Brotherhood {via Ta'awun or mutual assistance}
  - Charity {Tabarru or donation}
  - Mutual Guarantee
  - Self-sustaining Operations as opposed to profit maximization

And (C) Cooperative risk-sharing and profit-sharing arrangements prevail throughout. This applies to the primary insurance level as well as in any Re-Takaful arrangements, as opposed to using a brokerage fee-based relationship common in conventional re-insurance.

It should be well understood that one fundamental motivating factor for Muslims to utilize a Takaful system is to perform acts of piety... using Tabarru (donation) and Ta'awun (mutual assistance) to promote community well-being as well as achieve individual purification.

The core basis of the Takaful system is **not** to promote business (of risk-taking) for profit but rather to uphold the principle of “bear ye one another's burden”. Therefore the distinctive feature of Islamic insurance is its primary motive-self-help thorough mutual cooperation.

*“Takaful is...a system based upon solidarity, peace of mind and mutual protection which provides mutual financial and other forms of aid to members (of the group) in case of specific need, whereby Members mutually agree to contribute monies to support this common goal.”*

**O.Fisher 2003**

By contrast the main driver for conventional insurance is commercial enterprise to generate profits for Shareholders. Insurers use knowledge, statistics and actuarial sciences as applied to risk of groups or categories of hazards and perils in order to protect the economic interests of their Shareholders-the providers of capital. Risk of Policyholders are transferred to the Shareholders' risk pool for an agreed price (premium). In this manner, a few Shareholders exploit the misfortune of many Policyholders for the sake of profiteering.<sup>24</sup>

Since Takaful Operators have imitated the conventional insurance contracts, the main elements are similar: i) offer and acceptance for consideration (contribution/premium), ii) description of covered uncertain events, iii) limits and exclusions of protection against legal event harmful to insured if occurs. Regrettably, because Takaful Operators have chosen to adopt terms and conditions of conventional insurance policies there is little or no “plain language” and hence the

contractual relation has asymmetric information. Importantly, this contract is not negotiated between “buyer” and “seller”, rather insurance contracts are agreements of “adhesion” meaning one side sets the terms and conditions which the second party must consent to.

Because globally Takaful (hybrid) models have adopted the standard insurance contract, then item i) above introduces potential for **Riba** as an exchange contract involving money. Item ii) opens the door for Participants to experience **Gharar fahish** and **al Maysir** due to the obvious uncertain and unknowable aspects of the covered future event. Item iii) confirms risk protection only in instances when there is insurable interest, yet allows for inequalities (one-sidedness) in the contract and the purchase of an intangible.

As an outgrowth of ancient forms of Takaful, conventional insurance does contain some of cooperation elements, however, there are serious factors integral with conventional insurance that are impermissible to Islamic principles. Namely, the conventional insurance commercial transaction combines elements of uncertainty and a lack of clarity in terms and conditions relating to future events (so-called aleatory contract). This is known as **al Gharar** in Arabic. In addition, most types of insurance, and life insurance in particular, contain some element of speculation or gambling referred to as **al Maisir**. The investment practices of commercial insurance usually involve the concept of **al Riba** (debt securities and interest). Finally, the explicit goal of commercial insurance is to maximize profits, not the mutual well-being of the group members who are insured.

Lets briefly examine each of these objectionable items.

## E.2 IMPERMISSIBLE ELEMENTS

### AL-GHARAR (UNCERTAINTY)

Gharar is prohibited by Hadith (prophetic traditions): “...the holy Prophet (PBUH) prohibited transactions with gharar.” Sahih Al Muslim. Gharar occurs when the consequences of an action (or purchase) are concealed, or the outcome is uncertain or doubtful. For example, buying harvest of fruit trees before they ripen, or the fish catch prior to completion of the fishing voyage. Risk and deception in a business context are associated with transactions/contracts where uncertainty, ignorance and insufficient knowledge of details exist. Generally, the element of Gharar is unavoidable in conventional commercial insurance exchange contracts where both parties may not know their respective rights or obligations before or at the time of the actual occurrence of a covered risk (insured event). Moreover, modern day insurance contracts are often written with dense, legalese and in small print with many exclusions and limitations that raises doubts and constrains the insured party (Participant) to clearly understand the transaction and his/her benefits.

Most scholars acknowledge that some element of uncertainty prevails in future-oriented insurance transactions, hence Gharar cannot be eliminated totally. However, a consensus from fatwas allows Muslims to engage in Takaful risk protection scheme because the tabarru (donation), ta'awun (mutual sharing of risks) and Islamic investments portfolio aspects collectively minimize Gharar to a level of “acceptable forgiveness” and where the overall public good (maslahah) outweighs the remaining portion of uncertainty that each individual faces.

<sup>24</sup> Observation by Prof. Adel-Rahman Yousri Ahmad, editor “Principles of Takaful”, BIBF, Bahrain 2009, p. 38.



**MAISIR (GAMBLING/SPECULATION)**

The activity of maisir or gambling in Islam is a major sin to be avoided. Insurance is declared **maisir** because the Policy holders are seen to bet premiums (usually small) on the condition that the insurer will make payment (indemnity- large?) upon the happening of a specified event. The advocates of insurance argue that insurance is a contract of indemnity which is altogether different from gambling as relates to speculative risk. In gambling a specified event must occur by an appointed time whereby one of the gamblers must win while all the others must lose. In the case of insurance, the specified event may or may not happen during the fixed policy period. Moreover, the policyholder has a specific financial interest (insurable interest) in the subject-matter of insurance that is subject to loss. He is entitled to compensation only if he suffers any loss or damage and the coverage (indemnity) is limited to the actual amount of loss or damage. In gambling, the parties have no other interest than the sum to be won or lost by the determination of an event. Notice too that gambling creates a **new risk** while insurance tries to manage inherent, though unpredictable, risks to make losses bearable to the individuals susceptible to such risks. The risk of financial loss courted by a gambler can be avoided if desired, but the inherent risks in our lives or businesses cannot be avoided.

**RIBA (INTEREST/DEBT/USURY) AND HARAM INVESTMENTS**

The presence of Riba can occur in conventional insurance in two ways:

1. associated with investments and money management by the insurance company due to interest earnings
2. when compensation to the insured does not equal the premium installments already paid. The single most important aspect that differentiates Islamic finance from conventional finance is the absence of interest

The Shariah prohibits the taking or paying of “interest” (riba) no matter what the purpose of the transaction, or how small the amount of “interest” charged. Apart from a minority interpretation of Shariah by a few scholars, the consensus among Islamic jurists is that riba and modern finance interest are the same.

On the issue of securities and investments: both the Holy Quran and the Sunnah prohibit riba. (See the following verses on the Holy Quran: V.2:275-276; 2:278-280; 3:130; 4:161.)

- Usually, insurance companies place premium dollars in interest-bearing accounts like T-bills, T-Notes, municipal and corporate bonds. Some insurance companies engage in un-Islamic investment activities or make investments in prohibited businesses such as pork and alcohol
- Prohibition of riba is accepted by all Muslim jurists and is considered to be an absolute prohibition covering both simple and compound interest and both productive and consumption loans
- The debate is ongoing whether or not interest is intrinsic to and an integral part of major investments by insurance companies due to a regulatory mandate to invest in bonds and fixed-income securities

In addition, for investment securities and asset types to be compliant with Shariah principles all Haram (prohibited) investments must be avoided. Conventional insurers, even church mutuals, are not restricted in their investment practices- so investments in pork, alcohol, munitions, tobacco, pornography, casinos, unethical businesses etc. are permitted to conventional insurers but impermissible to Takafuls.

**E.3 EVIDENCE FOR SCHOLARLY OBJECTIONS TO CONVENTIONAL INSURANCE**

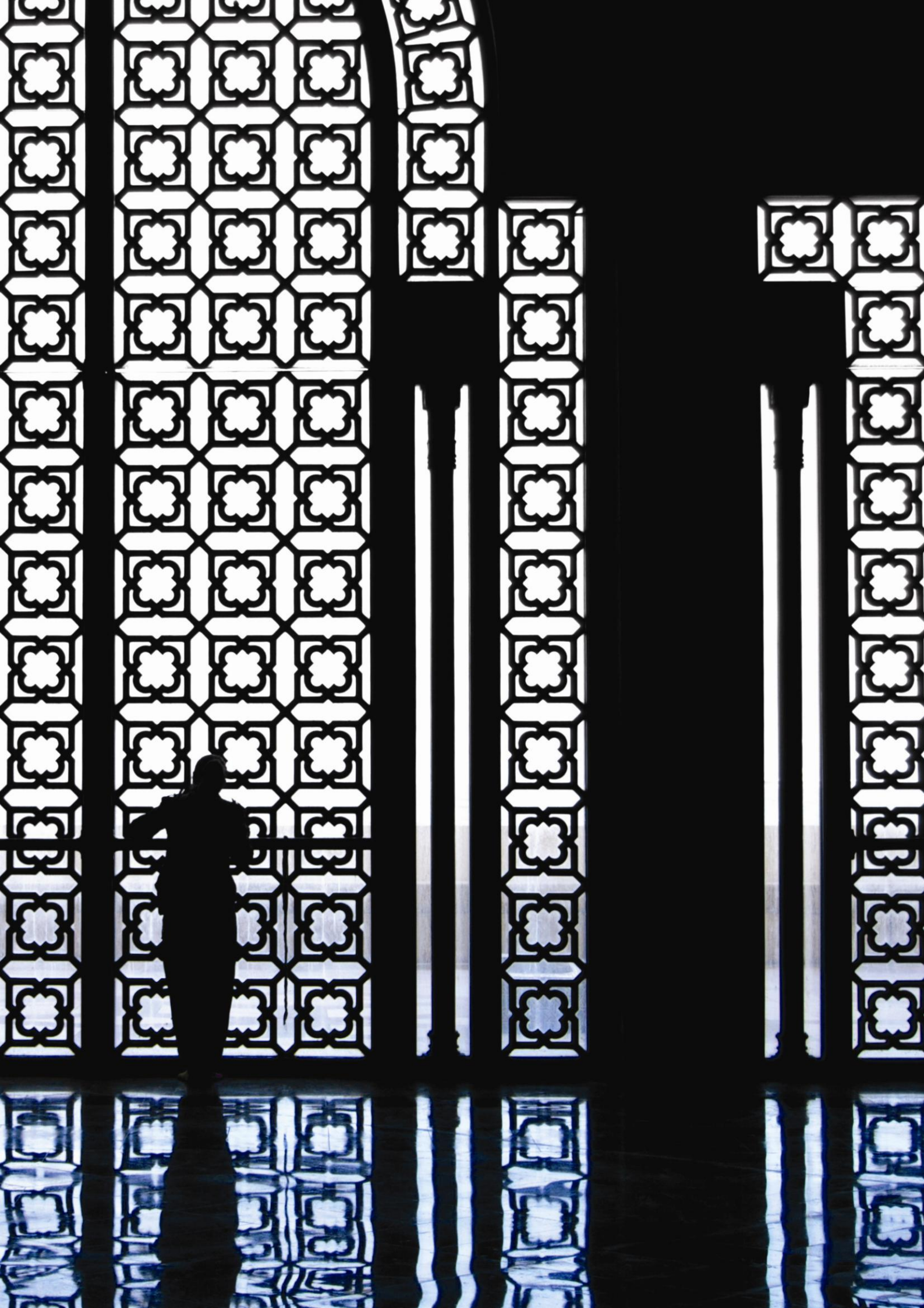
The Assembly of Islamic Jurisprudence held in Mekkah in 1977 (H.1398) ruled in Resolution No. 55 that “all sorts of trade (commercial) insurance are prohibited.” With the exception of Sheikh Mustafa Al Zarqa, all scholars agreed that trade (commercial) insurance “in all its kinds whether self insurance or on commercial commodities or others is prohibited” and provided the following arguments:

- Trade insurance contracts are financial compensatory in nature wherein the risk is aleatory (unknown) so the insured does not know at the time of insuring (entering into the contract relationship) the amount will may take or give. The scholars stated that Prophet Muhammad (PBUH) specifically forbade the sale of risk
- Trade insurance is considered sort of gambling and financial compensatory risk. It is a loss without cause and gain without effort, or with unequal effort. Prohibition derives from Surah 90, Al Balad (The Table)
- Trade insurance contracts include grace usury and credit usury. The insurer pays to the beneficiaries or to the insured more than what he paid (grace usury) and the insured pays to the insurer after a period of time on a credit basis, which are both prohibited by text and consensus
- Trade insurance consists of taking money from others at no cost, and taking others’ money for nothing in a financial compensatory arrangement. This is clearly prohibited: “O Ye who believe! Eat not up your property among yourselves in vanities...” in Surah 29, Al Ankabit (Women)
- Trade insurance involves the transfer of risk from the insured to the insurer; however, the insurer does not execute the risk nor causes it but consents to compensate the insured if the risk happens

According to many Takaful practitioners, the Resolution No. 9 from the Islamic Fiqh Academy – Jeddah on December 22-28, 1985 is very important because it points to cooperative risk sharing as the only permissible form of insurance for Muslims. The precise model structure for cooperation was however left unsaid.

“The commercial insurance contract with a fixed periodical premium, which is commonly used by commercial insurance companies, is a contract which contains major elements of deceit, which void the contract and, therefore, is prohibited (haram) according to Shariah. The alternative contract, which conforms, to the principles of Islamic dealings is the contract of cooperative insurance, which is founded on the basis of charity and cooperation. Similarly in the case of reinsurance based upon the principle of cooperative insurance.”

Hence, we now turn to the various legal structures which contain Takaful.







# ISLAMIC FINANCE GATEWAY

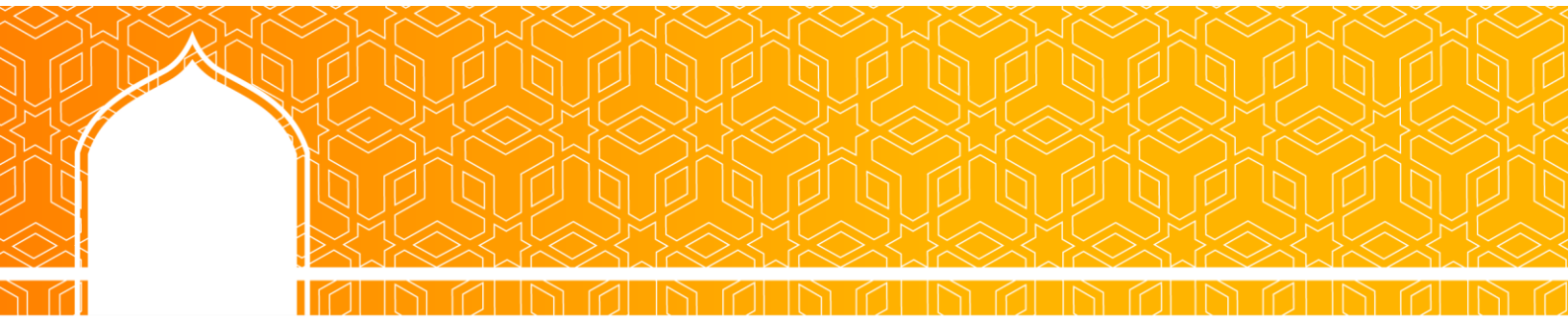
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## SECTION F ORGANIZATION STRUCTURES



REUTERS/Jumana El-Heloueh

To understand the legal and organizational framework within which a Takaful functions, let us show the four (4) major types of structures licensed worldwide to conduct risk protection/insurance business. These are: stock companies (often publicly listed on share exchanges), mutuals which are private to their members as there are no shareholding interests, fraternal and friendly non-profit societies, and Takafuls. For brevity, we exclude Re-Takaful companies which are discussed in more detail in Section G. however these can be classified within the Takaful segment.

**TABLE \_\_. LEGAL STRUCTURES FOR INSURANCE**

STOCK	MUTUAL	FRATERNAL	TAKAFUL-HYBRID
SH OWNERS	PH ARE OWNERS	MEMBERS ARE OWNERS	SH MANAGE AND OWN SH FUNDS
SEPARATE FUNDS FOR SHS AND PH'S RISK POOL	ONE RISK POOL	SMALL OR NO CAPITAL	PH RISK POOL IS SEPARATE
	NON-PROFIT COOPERATIVES	NON-PROFIT & FRIENDLY SOCIETIES	ISLAMIC COMPLIANCE

**Key:** SH = Shareholders, PH = Policyholders

A comprehensive analysis and description of each type of insurance operations can be found in various Takaful conference presentations and a paper by the author.<sup>25</sup>

For clarity here, we shall classify insurance structures into two contrasting operational models: (A) Non-Profit – Cooperative, Friendly and Social societies and Takaful models, and (B) For-Profit – Commercial Stock model. While there are significant similarities amongst Cooperative, Social and Takaful systems, one salient difference is the Takaful model contains religious and spiritual aspects which are absent from Cooperative and Social systems. Given that Takaful has evolved into more than 36 countries across the globe, it is customary that some variations sanctioned by Shariah scholars have marked the Takaful Model; namely:

- Mudarabah operations – more commercial and profit-directed and favored for 20 years in Malaysia (which today is promoting Wakala operations)
- Modified Mudarabah operations – combination of mudarabah and Wakala as practiced in Malaysia and Indonesia
- Wakala operations – also commercially minded to return profits to shareholders yet fixes management fees and expenses with full disclosure to policyholders popular in MENA since advent in Jordan 1990
- Waqf operations – substitution of an Islamic trust for shareholders whereby trustees manage the risk pool and operations for policyholders as favored in Pakistan
- Non-Profit Cooperatives<sup>26</sup> – most original model for modern Takaful re-discovery as pioneered in Sudan in 1979 and some scattered examples exist in USA as community-based risk vehicles

<sup>25</sup> White Paper on the "Comparison of Modes of Insurance from an Islamic Perspective", OFisher, May 2003 (Jeddah).

<sup>26</sup> As contrasted to the for-profit Cooperatives mandated by the new Insurance Law and regulations promulgated in Saudi Arabia in 2006.

Features of the two main Takaful models may be summarized as below with more extensive examination of each available in textbooks and training manuals referenced in the Appendix.

Under the **Al-Mudarabah** agency contract, the Takaful operator (the Mudareb or Agent) accepts payment of Takaful premium installments [termed as Ra's-ul-Mal] from Takaful members, i.e. the providers of capital [or Sahib-ul-Mal].

The agreement between the parties, which is the Takaful policy, specifies how the premiums will be invested and how any surplus (profit) from operations will be divided. The sharing of surplus must be specified in a pre-determined ratio, like 50:50, 60:40 or 70:30, as mutually agreed and disclosed by the Takaful operator in the policy wordings. Year end profits are determined by adding up the premiums paid less claims settled and incurred, expenses of Re-Takaful protection, less provisions and fees and charges plus any investment income attributed to the PH's risk pool. Some scholars observe that because the Takaful Operator (shareholders) are not taking any underwriting risk- i.e. All claims payouts are charged exclusively to the PH's risk pool, then the Takaful Operator is not entitled to share in the underwriting surplus if that results. This controversy is resolved by the Wakala model for Takaful.

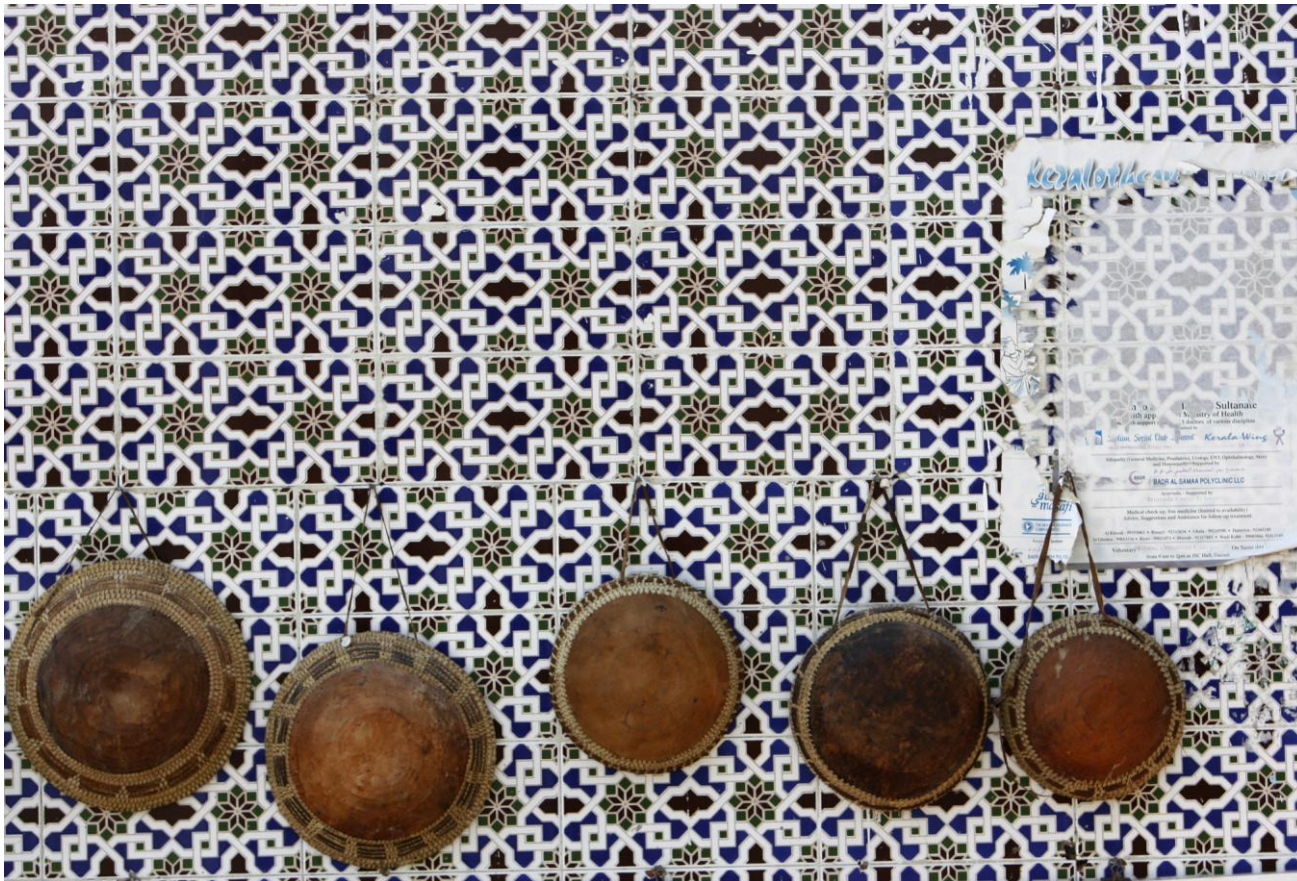
Al Wakala is an alternative agency form of Islamic contract that segregates the funds of policyholders from the funds of shareholders. Hence the professional management (TO) of the risk pool is entitled only to specified fees disclosed in the policy document- called Wakala fees. The contributions by policyholders form a bond amongst themselves for risk-sharing and mutual assistance to those unfortunate to suffer losses during the year. Resultant deficit or surplus performance from operations is solely the responsibility of policyholders. However, as we have shown in Section G. prolonged operating deficits may be covered by benevolent "loans" (Qard al Hasan) extended by shareholders to stabilize the PH's risk pool capital until these funds can be repaid out of future surplus. Some Takaful Operators deploying the Wakala model like Bank Al Jazira (Saudi Arabia) and Methaq Takaful (UAE) have adopted further fees under the Wakala contract as authorized by their Shariah Supervisory Boards, called Performance Incentive Fees (PIF). The purpose of PIF is to reward the Takaful Operator for exemplary underwriting and claims management as this fee only applies to net surplus at year end and to enhance the commercial profitability otherwise limited by the Wakala model.





## SECTION G

### TAKAFUL UNIQUE FEATURES



REUTERS/Ahmed Jadallah

**A historical fact is that 14 centuries ago the first institution established within the Islamic State was the Bait Al Mal (or house of finance) to redress poverty by channeling periodic and annual charitable donations (called Sadaqa and Zakat) to the poor and disadvantaged. The second institution developed to strengthen the social fabric, to ameliorate community morals as well as to spur economic self-help, was the Takaful.**

The **Takaful** was formed as a community fund which might generate a surplus under favorable circumstances that was to be redistributed back to the Participants in case of need, or donated to charity. We should debunk a popular notion today that Islamic financial services must be “free”. There is nothing wrong in making surplus (defined as excess capital after all expenses not “profit”) from such risk mitigation practices – which often results more from favorable claims outcomes than due to professional management. The critical question is: who owns this surplus and what to do with it?

While the focal point for attention in Takaful is usually the operations model (see Section F.), yet no Takaful set up can be complete without several other important characteristics. The Takaful risk-sharing system demonstrates Islamic values in manifold ways, which are discussed next.

## G.1 UNIQUE AND NOBLE ASPECTS

### G.1.1 TABARRU

A Takaful transaction begins with a contribution or **Tabarru** (donation) which defines the relationship between the Participant and the risk pool (as managed by the Takaful Operator) in a manner that is fundamentally non-commercial. Participant contributions do not pay for the transfer of risk (as in conventional insurance) but rather are sincere donations for those other members of the group who are struck with misfortune. However, since most Takaful companies use a hybrid stock-mutual format (see Section F.) an in-built conflict exists because shareholders, who pledged capital to establish the stock managing company, are taking commercial risk and thus are motivated to realize monetary rewards as profits from

operations. In contrast, the Participants’ interests are donation and mutuality – following a Takaful Islamic contract that combines elements of generosity (Tabarru-al-mukarama) and exchange (mu’ awadah). In Islamic law, this form of donation may be circumscribed with a condition or qualified. There are two types of gifts:

- Absolute gift (hibah mutlaqa)
- Qualified gift or a gift with aim (hibah al Thawab)

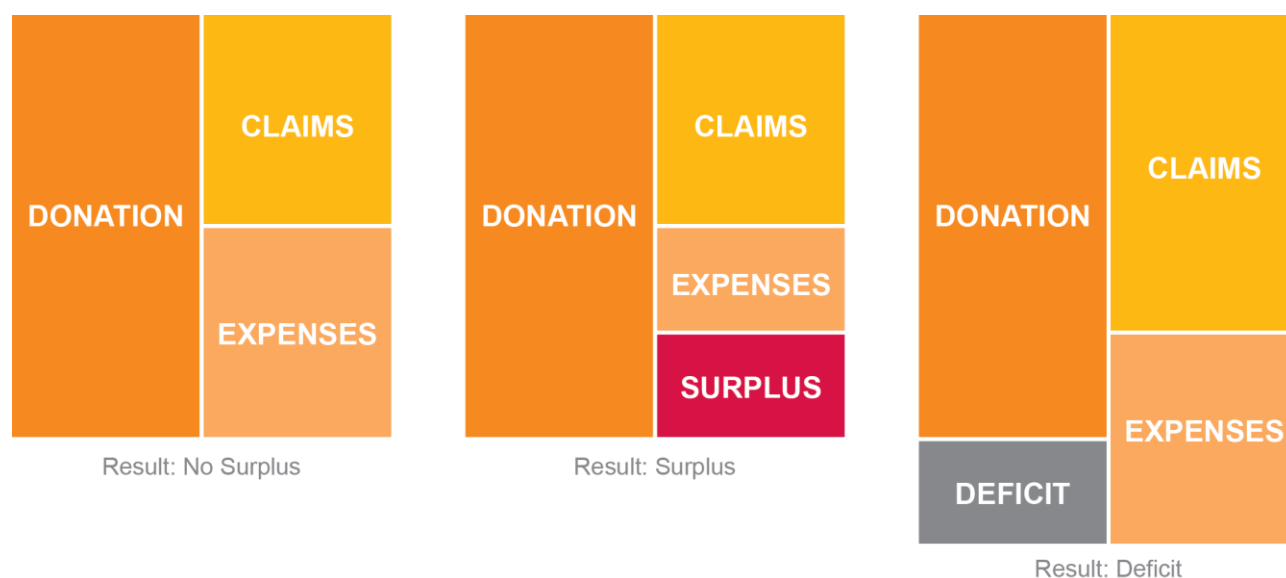
The scholar Dr. M. Arbouna asserts, “The uniqueness of donation in Takaful is payment of contributions is based on a principle of ‘unilateral binding undertaking to donate’.” Dr. Mohammed Al Darir, the Sudanese scholar and pioneer of Takaful states that: “The parties to the Takaful contract are not aiming at profit making in isolation. Their intention is to cooperate on overcoming misfortunes of life. This is a special donation contract which has no parallel to the Shariah-nominated donation contracts.”

### G.1.2 QARD AL- HASAN (BENEVOLENT LOAN)

Only one type of loan is permitted under Islamic principles, a **Qard al-Hasan** (literally benevolent loan). To avoid Riba, a lender of money may not demand any fixed charge or premium above the actual amount loaned out.

As mentioned in the Holy Quran, Qard al-hasan is purely a philanthropic gesture whereby the reward is meant for the hereafter and not to attract any premium or surplus capital above that which was provided in the first place. Instructions specially encourage extension of time in event that the borrower has difficulty in repayment, or forgiveness of the capital sum itself as being more praiseworthy. However, it is difficult to comprehend in today’s regulated insurance world how shareholders could “forgive” Qard al-Hasan without attracting significant criticism.

Chart \_\_\_. Below graphically shows in simple format three potential yearend financial results for a Takaful: a) no surplus because cash outflows (claims and other operating expenses) are equal to inflows (contributions donated). Or b) surplus declared because outflows are less than annual inflows leaving “excess” or surplus funds. Or c) deficit and a shortage of cash because outflows exceed the inflows leaving certain claims expenses unpaid until additional funds can be transferred (typically from the shareholders capital) into the Participant’s risk pool.





An operating deficit might also be covered by additional assessments upon Participants to pay or contribute more. Recovery of the Qard al Hasan comes about in two ways: either by repayment out of future surpluses, or by raising the level of contributions requested from participants the following year. Standards from the International Financial Services Board (IFSB standard 11) of Malaysia propose that Takaful Operators extend a Qard al-Hasan to cover any operating deficits in their risk pools so that operations may continue. In practice there are many “gray” areas as relates to accounting for such benevolent loans – It is not yet clear how this will be treated under Basel Solvency II rules. Is a Qard an “asset” for TO-shareholders and hence included in their capital reserves for purposes of solvency calculations, or is it to be expensed through the Participants’ Income Statement and thus not part of the capital reserves, until repaid as a recovery item (which itself is an uncertain future event)?

### G.1.3 SHARIAH SUPERVISORY BOARD (SSB)

To assure that Shariah principles and rules are adhered to, each Takaful company should appoint a Shariah Supervisory Board (SSB)- typically with 3-7 members (but at least one advisor) who have appropriate educational degrees and training in Islamic Shariah.

The SSB meets at least quarterly to:

- Supervise set up of Takaful, governance and policies
- Review all products, Re-Takaful/Re-insurance treaty arrangements
- Monitor financial transactions and approve financial statements and fulfillment of Zakat
- Advise on calculation and distribution of Surplus, if any
- Consult on all issues relating to Shariah application to operations
- Oversee an audit of compliance with SSB rulings

It is recommended that the Articles of Association under which a Takaful is organized contain explicit requirements for the SSB and clearly sets forth the role and scope of SSB supervision of Takaful operations under an advisory committee charter approved by the Board of Directors.

### G.1.4 DISSOLUTION

In the event of the dissolution of the Takaful company/risk pool, there are two aspects to the resolution of the financial affairs and wind up operations:

- All assets belonging to Policyholders are applied to settle outstanding liabilities and expenses, any remainder after liquidation is to be used for charitable purposes and general public welfare (see Section F. Non-profit GCC model)
- All assets belonging to shareholders are applied to settle outstanding liabilities and expenses, with the remainder of shareholder assets to be distributed among them in proportion to their respective ownership

Unlike a conventional insurance company where all assets in excess of liabilities upon bankruptcy or winding up will be transferred to the shareholders only, a Takaful contains a risk pool consisting of donations, which must be directed to charitable purposes upon its dissolution.

### G.1.5 RE-TAKAFUL

The fundamental premise of primary level of Takaful is spreading (sharing) of risks. Hence when Takaful risk pools seek to share a portion of their retained risks, through a mechanism of re-insurance, this is called Re-Takaful and should replicate the same system of Shariah compliant joint and mutual guarantee. Typically, Re-Takaful operators accept risks cross-borders and on regional basis to prudently manage their geographical risks as well as categories of risk exposures through agreements on a company-to-company basis called “treaties”. Another role for Re-Takaful operators is to bolster and enhance the technical risk assessments and underwriting capabilities of the primary Takaful players – quite often in the form of new product design, actuarial assistance and provision of technical underwriting/quotation software applications. Re-Takaful operators are responsible for managing the risks ceded from Takaful Operators, investing contributions in Islamic securities, and settling the claims notified by each Takaful Operator in accordance with treaty provisions. At year end, any resultant surplus in the Re-Takaful risk pools are divided and distributed back to the Takaful Operators pro-rata to their original ceded contributions, or consistent with terms of the agreed Treaty.

In summary, Re-Takaful exists to assure the financial strength and solvency of Takaful Operators by sharing risks cross-border. Partnership with Re-Takaful operators enables local Takafuls to diversify the risks they underwrite, expand the volume of business they can accept, and tap into sophisticated analytical software and expertise that assists them in prudent risk management.

In modern era, the first Retakaful, established in 1995, was Asean Takaful Group (ATG) as a step towards forging cohesiveness and greater mutual co-operation among the Takaful Operators in the Asean Region. ATG agreed on the formation of ATG Pool which commenced operation in 1996. The proliferation of these Takaful Operators, caused a separate full-fledged retakaful entity known as Asean Retakaful International (L) Ltd. (ARIL), to be formed as off-shore Retakaful Operator (Labuan Malaysia) in 1997. Malaysia, as the co-ordinator for the sector on Finance, Banking and Privatization, of the Group of Developing Eight (D8) countries namely, Turkey, Indonesia, Iran, Pakistan, Egypt, Bangladesh, Nigeria and Malaysia, at the D8 Summit in Dhaka, Bangladesh, in March 1999 endorsed Malaysia’s proposal to transform ARIL into a well-capitalized retakaful company for the D8 member countries.<sup>27</sup>

In addition to the Retakaful “windows” launched by major reinsurers like Munich RE, Swiss RE and Labuan RE, there are today some 18 Retakaful Operators and facilities headquartered in Tunisia, UAE/DIFC, Sudan, Saudi Arabia, Kuwait, Malaysia, Indonesia, UAE and Bahrain. Collectively, their paid up capital is approximately \$2.0 Billion dollars, and currently supports about 25% of the global primary Takaful contributions written annually. The remaining Takaful contributions ceded out are channeled to conventional reinsurers.

<sup>27</sup> The International Workshop on Retakaful (Islamic Insurance) For D8 & OIC Member Countries, Realising and Maximising The Retakaful Market. Hilton Kuala Lumpur, Malaysia 31st May – 01st June 1999

### G.1.6 SURPLUS-SHARING

What is Surplus? While not entirely unique to Takaful because mutual insurance and some cooperative forms of life insurance (i.e. with profit plans) practice surplus sharing, it is a fundamental feature of any Takaful model. In practice, modes of calculation of surplus, the timing of distribution, even the split between reserves and payouts to participants are supervised by the SSB, which clearly differentiates Takaful surpluses from treatment of conventional surplus.

Here we must pay attention to an important distinction between Takaful insurance transactions and profit/loss making commercial transactions, frequently characterized as Mudarabah, which helps clarify the difference between surplus and profit. In a buy–sell commercial transaction, any profits generated result only after the operating and selling expenses are deducted from the selling price. Hence, profits are excess of capital required to make the item sold. By contrast, a Takaful insurance transaction begins with a contribution (premium) sum paid, out of which the main operating components are paid – i) claims and benefits to policy holders, ii) operations, management and sales expenses, and iii) required set asides for technical and general reserves and unearned premiums. Any gains from investing the contributions during the year may be added to the base policy holders' contributions but these are typically modest funds as compared with revenues. Hence, contributions/premiums are reduced by operations expenses, claims, legal and management fees, so that the resultant financial outcome is the residue, or "surplus" amount as remainder of contributions. It can be understood that surplus is not the same as profit.

How is Surplus distributed? Any remaining funds from annual operations of the Takaful model forming the surplus should be treated in one of three approved ways.

- Surplus may be distributed to all policyholders equally on a pro-rata basis to their original contributions
- Surplus may be distributed to all policyholders except those who were awarded a claims settlement compensation
- Surplus may be adjusted so that any claims settlements are offset to each policyholder's surplus allocation prior to distribution

It is noteworthy that the last option of charitable community donation is not offered by conventional insurance companies. Charitable donation of surplus may be accomplished on an individual basis as a matter of conscience by each policyholder, or may be organized collectively by the operator on behalf of and according to instructions approved by individual policy holders.

Which Parties are eligible to receive surplus? The appropriate answer to this question is determined properly by the mode (model) of insurance elected. For Stock companies: conventional insurers retain the surplus, if any, and distribute it only to the shareholders. Their rationale is that policyholders transferred their risks to the "pool" owned by the shareholders and hence the resultant excess of funds (surplus) is a fair reward for acceptance of that risk. For Mutuals and co-operatives: conventional insurers distribute the surplus, if any,

only to the members of that co-operative, as no shareholders exist. For Takafuls: the consensus of Islamic scholars holds that surplus belongs legally solely to the policyholders as excess of their original contributions. However, a minority of Takaful hybrid models (Mudarabah model) allow for sharing of surplus with shareholders of the stock organized Takaful Operator company. This controversy is disappearing because new Takaful models favor the Wakala format with clear segregation of funds as between shareholders and policyholders.

### G.1.7 ZAKAT

The purpose of Zakat<sup>28</sup> as an annual charge on a person's wealth is two-fold: i) individual purification through acts of charity to benefit the poor and disadvantaged, and ii) protection and purification of the remaining portion of wealth. The payment of Zakat is obligatory as one of the five pillars of Islam. Zakat is a major economic means for establishing social justice and leading the community towards shared prosperity and security.<sup>29</sup> To calculate the appropriate amount due, the wealth must exist for one lunar year, exceed a nisab (minimum amount) and adhere to specific regulations pertaining to the classification of that wealth. As applies to the common "hybrid" Takaful model, participants will not be charged for Zakat on their donations to the Takaful risk pool. However, the accumulated savings in their individual investment accounts linked to Takaful risk-sharing is Zakatable whether payment is made annually on the incremental gains in wealth or upon withdrawal on the entire principal amount.

Usually the Shareholders of the Takaful Operator company will pay personal Zakat on each one's share of net income. While some Takaful Operator's assist the shareholder in making such calculation, it is the individual responsibility of each shareholder to pay annual Zakat at the 2.5% rate on qualified funds.

It is noteworthy that Takaful Operators which pay this Zakat on corporate basis, whether or not they are profitable, (as in Saudi Arabia) are at competitive disadvantage to other cooperative and conventional insurers not burdened by Zakat.

## G.2 SUMMARY

We can sum up. Takaful is a modified form of insurance whereby Shariah rules impose features on the underlying insurance relationship in order make it permissible for Muslims. Collectively these features form a system of values that reinforce each other and work together to perform a risk-sharing function. Highlights of the values are:

- Non-commercial transaction combining exchange and generosity
- Fulfillment of religious duty
- Solidarity, brotherhood and caring for others
- Security mechanism to aid the misfortunate
- Active supervision by scholars to assure integrity and purpose
- Goal is risk-sharing and community well-being and not profits
- Expert and prudential management using actuarial and scientific methods

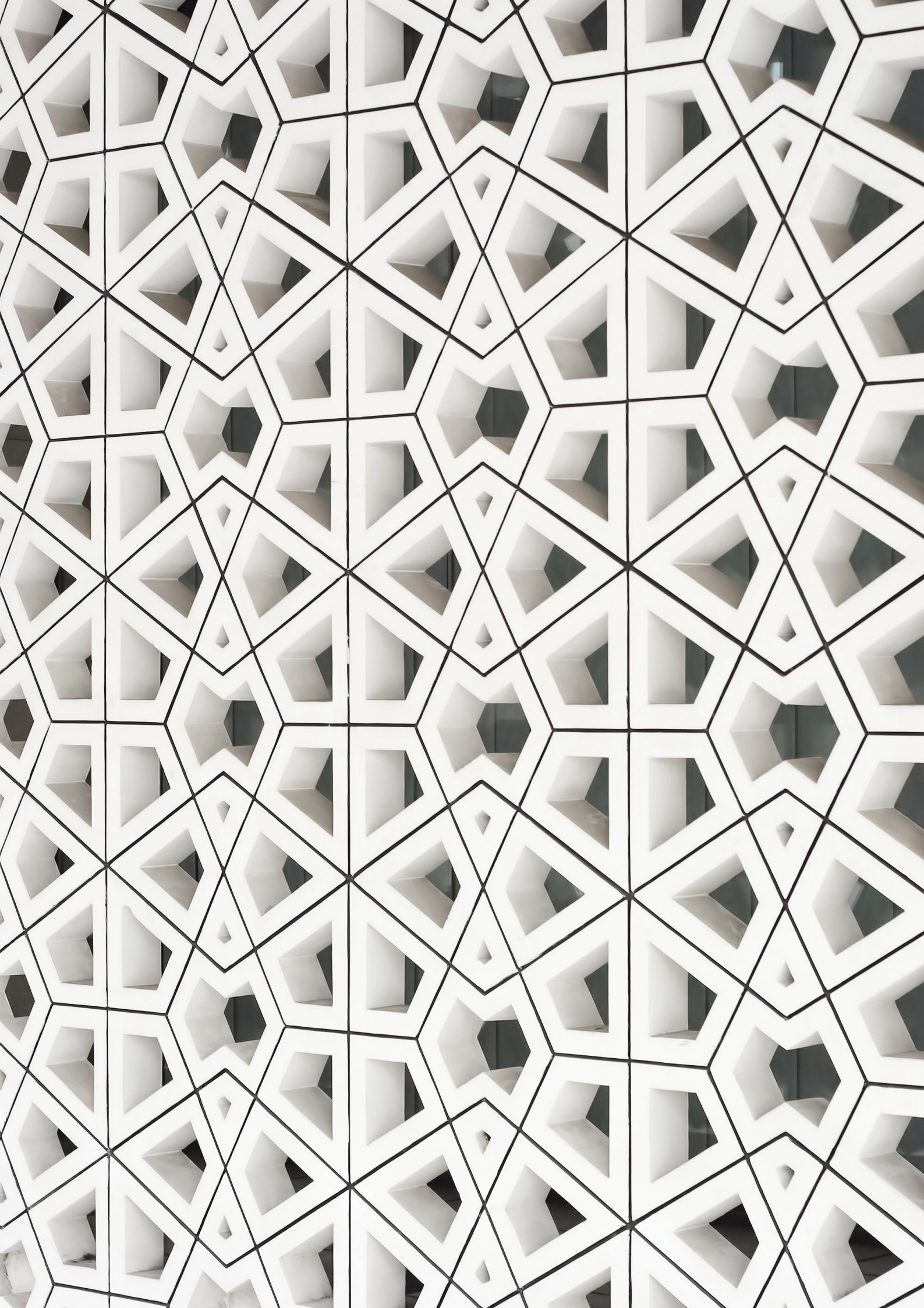
<sup>28</sup> References Holy Quran Surah Al Araf V.7.156 and Surah Al Baqarah V.2.3

<sup>29</sup> Refer to Sahih Al Bukhari, Vol 2., Book of Zakat No 24, Yusuf Ali Holy Quran, p.3

A Takaful contract is an exchange of promises that upholds fairness and virtues derived from reciprocal actions and obligations. It describes a structure with these elements:

- Use of an Islamic legal contract (i.e. policy) with prescribed terms and conditions
- Maintenance of two separate fund accounts- one for Shareholders and one for Policyholders
- Relationship between Policyholder and Takaful Operator is:
  - Agency-agency; or Agency-cum-Mudarabah
  - Where the Operator is appointed under the contract to manage the operations, the insurance business and to settle claims
  - Operator's main goal is to strive to facilitate Policyholder's cooperation and solidarity ("well-being") and not profits only
- Minimizes/eliminates Gharar (uncertainty and unknowns)
- Avoids Riba and prohibited aspects of investments
- Distribution of surplus to policyholders rather than shareholders
- Use of Qard al hasan if deficit occurs
- Guidance under Shariah advisers and via internal Shariah audits
- Corporate governance that permits policyholders to be involved in administration and supervision of operations, namely:
  - Representation in management meetings or on the board
  - Open accounts and books for transparency
  - Consultation in important future decision-making; i.e. mergers and acquisitions, launch of major products, dissolution, etc.







## SECTION H INVESTMENTS



REUTERS/Ali Jarekji

Takaful Operators must conform to Islamic guidelines when investing funds in four (4) ways:

- a. temporary placement of policyholder funds from the risk pool
- b. longer term placement of funds under mudarabah arrangements for various Takaful savings plans
- c. safe placement of reserves (both technical and statutory general reserves)
- d. investment of shareholder funds

Shariah provides a set of contracts that govern the relationship between investor (whether individual, Takaful Operator or group) and the asset acquired. Generally, these contracts fall into three sections – partnership, trust, or security.<sup>30</sup>

Partnership contracts include musharaka and mudarabah which used by Takaful Operators when making investments on behalf of the policyholder risk pool- usually longer term types of securities. This contract involves profit-loss sharing yet the Mudareb is not the guarantor for the capital. Whereas the Trust contracts of wadia, amanah, wakala, and jo'ala relate more to the Takaful Operator's role as manager and prudential custodian of operations on behalf of the policyholders. A majority of Takafuls employ the Wakala contract (see Section F) whereby the Takaful Operator earns a fee charged to the donation contribution for agency services on behalf policyholders such as underwriting risks, managing operations, reporting and accounting, liaison with regulators, claims management and settlement, PR, marketing and sales. Of the Security contracts only kifala (suretyship) applies to insurance (the others relate to Islamic banking) as fiduciary obligations embedded in the Takaful policy itself where the Takaful Operator assures its performance, timely delivery and fulfillment of actions plus transparency and honesty in operations.

Overarching Shariah principles apply to every commercial transaction and investment by Takafuls to assure consistency and compliance with Islamic values that revolve around no exploitation of any party, fairness, full disclosure, avoidance of prohibited elements (see Section D.), and adherence to ethical and moral activities throughout. In the way, Takafuls have additional challenges to conventional insurance companies partly due to the youthful development of the Islamic securities markets; namely:

- Due to the prohibition of riba and buying-selling of debt securities, secondary Islamic capital markets do not exist forcing Takaful Operators to invest directly into mudarabah, musharaka and other permissible securities. This means that Takaful Operators must possess expertise in assessing investments risk, choosing and managing investment assets

- Since insurance regulations restrict the percentage of assets held in various classes (equities, bonds, real estate, cash, alternative structures, etc.), Takaful Operators are hard-pressed to diversify investments while also safeguarding asset quality, volatility of price and liquidity. Between 1990s-2007, most Takafuls invested in shares/equities and in real estate properties which classes of assets after 2007 have produced negative rates of investment returns and losses of principal as market valuations plummeted
- Because of the limited scope of Islamic securities for investment – especially rare are assets with tenors longer than 5-7 years – it is very difficult for Takaful Operator to match the timing of cash flows for assets and liabilities. This resultant mis-match often impacts on liquidity management and might constrain swift settlement of claims to policyholders
- Central to the fiduciary responsibility of the Takaful Operator is to manage funds flows to always have ready sufficient money as could be required for future misfortunate events. Conventional insurers rely upon special securities called “derivatives” which are paper contracts to transfer risk to other institutions (as investors seeking profits) as a hedging mechanism against large losses from unpredictable events. Islamic rules reject derivatives and options futures as suitable investments so that Takaful Operators must hedge future risks in other ways. On the other hand, conventional banks and insurance companies have frequently revealed huge monetary losses sometimes in billions of dollars<sup>31</sup> occurring due to such derivatives and trading options turning bad that has negatively impacted public confidence and their financial ratings

Although not a complete listing, Takaful Operators may invest in the following assets:

- Equity securities and mutual funds
- Real estate and income properties
- Land
- Agricultural enterprises
- Commodity and metals trading
- Leasing (commercial equipment and buildings)
- Partnership and commercial business ventures
- Participation in sukouks, and asset-backed securities
- Participation in profit-loss sharing accounts, unit trusts, deposits, certificates
- Trade and barter arrangements
- Cash

<sup>30</sup> For extensive descriptions of Islamic finance and banking kindly refer to “An Introduction to Islamic Finance: Theory and Practice” by Z.Iqbal and A. Mirakhor, Wiley Finance, 2007.

<sup>31</sup> For example, Citibank 2011 and JP Morgan June 2012.





## SECTION I PRODUCTS



REUTERS/Ali Jarekji

## I.1 LIFE STAGES

As a person progresses through life stages, new risk exposures arise and the needs for risk protection change. The complexities of modern living plus the rapid evolution of technology and computer power have triggered extension of traditional risk coverages to new subjects and types of risks both for individuals and for commercial enterprises and large corporations. Insurance contracts divide risk exposures into two main categories: Non-Life and Commercial risks, and Life/Medical risks. Sometimes Medical and healthcare insurance can be grouped within the Non-Life segment. The Takaful adaptation of conventional Life/Medical insurance is called Family Takaful because truly it is the policyholder's family relations who benefit from the compensation that is paid after his/her demise. In most jurisdictions, Takaful/insurance companies are licensed to issue and manage risks in only one such category – i.e. Commercial-General risks only. This limitation comes from regulations and is meant to focus management on becoming experts in a relatively few risks and to assure higher consumer protections. There are several insurers that are licensed to underwrite both categories of risks (called composite companies) – as in UAE and Bahrain; however, newly established insurers must segregate risks.

Partly due to the immense influence of terms and conditions of reinsurance treaties by which Takaful Operators partner with reinsurers and Retakaful to spread their risks, the primary Takaful products usually appear to imitate the conventional products. Moreover, an examination of the budget allocation to R&D by Takafuls shows only a minimal investment in development of new products, as opposed to the 3% to 5% of R&D budgets expended by conventional counterparts. Nonetheless, strict adherence to Islamic Shariah activities can give rise to unique products that could make Takaful products distinctive. For example, mortgage credit and debt protection coverages must be applied only to Islamicly compliant financings. Takaful savings plans can help accumulate sufficient funds for future pilgrims to cover planned expenses of Hajj and/or Umra in Saudi Arabia.

What follows in the next two sections are brief profiles and examples of Non-Life and Life/Medical products which clearly are indicative and not exhaustive listings.

## I.2 NON LIFE

### NON-LIFE AND COMMERCIAL RISKS

This category of risks are short-term, usually one year in duration and designed for protection against material loss or damage to tangible assets or properties- such as buildings, homes, motor vehicles, stock-in-trade, etc.). Types of protection include: liability, casualty, accidents, marine, cargo, engineering, and comprehensive risks.

- Motor Takaful – comprehensive and collision coverage, third-party claims and liability, driver's license coverage (Saudi Arabia) for commercial as well as passenger vehicles
- Fire Takaful – home coverage, commercial and office buildings, warehouses, inventory, stock, boats, transportation, arts collections, etc.
- Accident and Liability Takaful – both personal injury and group injury coverage due to accidents which provides a fixed amount of compensation to cover medical and treatment expenses, workers' compensation for on-job

injuries, public liability, protection for money in transit, fidelity and fraud coverages, etc.

- Engineering Takaful – machinery breakdown coverage, boiler and pressure vessels, erection all risks for construction projects, contractor's all risks, and project bonds like bid and performance bonds
- Marine and Cargo – marine hull protection, cargo and goods on board coverage, marine liability, etc.
- Specialized coverages also exist for risks in business such as Directors & Officer's liability cover (D&O), banker's Blanket cover for certain fidelity exposures, export credit coverage for exporters in the event their buyers fails to pay

## I.3 FAMILY TAKAFUL (LIFE)

### FAMILY TAKAFUL AND LIFE/MEDICAL RISKS

This category of risks are multi-year risk coverage and offered for a fixed term – e.g. 3, 5, 7, 20 years. Generally, the terms and conditions of risk protection do not change once agreed at inception even though the age of the insured will naturally increase. Some policies keep the annual premium charged level, whereas other policies vary the charges which may rise in tandem with passing years to reflect the higher risk of death or disability due to age. Although, the Term risk protection can be purchased alone, many policyholders choose to link up a savings/investment component to their periodic contribution. These Family Takaful plans are called Unit-linked plans- such as Education Savings, Marriage Savings, Retirement Savings. Long term savings plans can be arranged by a single lump sum payment (up front) or by a series of periodic installments – typically monthly or quarterly – until the end of the Term elected, or maturity date. One element that differentiates Takaful savings plans is that all the invested funds must adhere to Islamic principles as pertains to nature of security and scope of underlying business activity.

- Credit Takaful – mortgage balance coverage, debts of credit cards or leases (auto/machinery) coverage, guarantees on personal loans, etc.
- Individual Savings Takaful – to achieve accumulated savings for marriage, education, retirement and pension planned expenses
- Groups Savings Takaful – thrift and employee group savings schemes whereby the employer might match a portion of the individual employee's savings
- Term Risk Protection – available as individual fixed Term plans or as group Term plans, where the employer will pay for the contributions and offer to each employee as an HR benefit
- Specialty Takaful – special events public liability coverage (i.e. Sporting or music concert events)
- Medical and healthcare Takaful – either on individual (and extended family) coverage basis or on group medical basis offered as a benefit at the workplace to cover medical treatment expenses whether well-care (preventative exams and treatments), outpatient (non-invasive procedures and treatments usually same day not requiring hospitalization), and in-patient when the medical care occurs over an extended period while the insured is hospitalized
- Long Term Care Takaful – a new emerging field of risk protection for individuals to receive monthly payments to address on-going expenses of medical care and treatment (sometimes at home or hospice) for chronic or debilitating diseases once diagnosed



Should you have any questions about risk exposures at home or in business, please consult a licensed professional insurance broker or agent who can help you.

## I.4 PRODUCT INNOVATIONS

There would appear to be substantial scope of innovation in the Takaful insurance field, as many Takaful players operate in emerging markets where the take-up (or penetration rate) of insurance products is limited, often less than 3% of annual GDP per capita. As food for thought, some recent innovations in Takaful product offerings include the following:

- **Medic Pro:** a health rider developed in 2012 by **Hong Leong MSIG Takaful** in Malaysia for “hassle free hospital admissions” and can be linked to a Family Takaful Savings plan. Minimum coverage limit is RM 300,000 annually
- **Waqf Charitable endowment plan** developed in 2011 by **T’azur** (Bahrain) which was recognized with an industry award for encouragement of legacy and charity donations. The first Waqf Charity Takaful Plan was developed in 2002 by Takaful **Ta’awuni** of Bank Al Jazira (Saudi Arabia) and proved to be popular
- Complete protection for damage and loss to mobile and digital devices on offer by Bahrain’s **Takaful International** in 2012 and available for purchase through a special downloadable insurance app

Some new features and benefits of Takaful are designed to satisfy a purely Islamic need – waqf or charitable giving for example – others focus on daily needs of the general population.

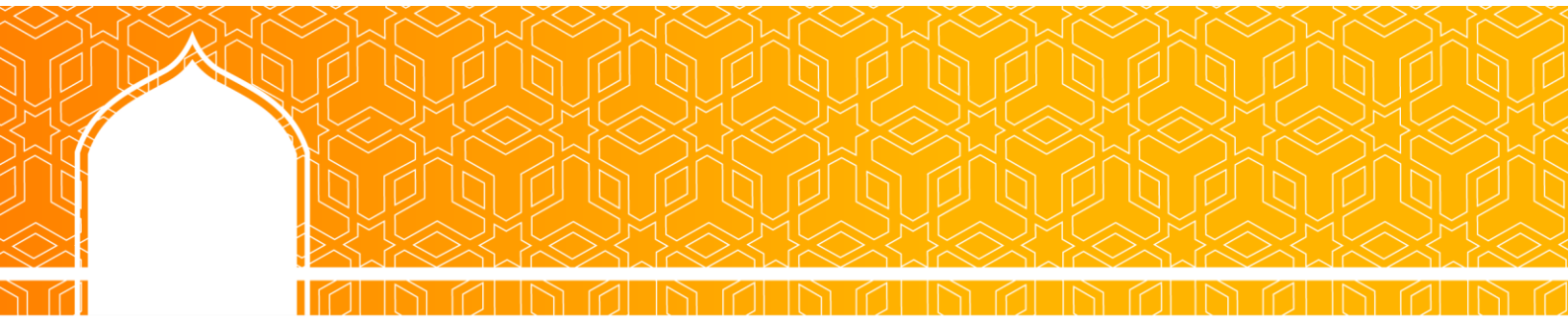
## I.5 DISTRIBUTION

Takaful Operators, whether Family Takaful or General Takaful, have chosen to follow the lead of their conventional competitors in distribution of products. For decades, the insurance industry has relied upon:

- Dedicated sales force of company employees
- Agency sales – independent agents or tied agents
- Internet and web-based sales
- Brokers (both for primary coverage and reinsurance)
- Bancassurance sales – forging partnerships with banks to cross-sell Takaful products to bank clients

Developed insurance marketplaces – such as USA, EU, Malaysia and parts of Asia/Japan – utilize a mixture of all five (5) distribution channels. In the MENA emerging markets, however, Agency sales have yet to be developed and bancassurance sales are still in early stages of implementation between Takafuls and bank partners.

From the policyholder’s point of view, an independent Agent or Broker would best explain terms of coverage and represent client interests in arranging effective risk protection from a choice of insurers. On the other hand, a dedicated sales force or bancassurance sales staff typically represent the interests of a single insurer, so that the policyholder should request full disclosures and exercise caution when using these distribution channels.



## SECTION J

# SOURCES OF INCOME – POLICYHOLDERS AND SHAREHOLDERS



REUTERS/Ahmed Jadallah

**To better understand the roles and responsibilities of the two parties to the Takaful, and to strike a balance in their competing interests, we shall now examine what are the types of income each party enjoys. Keep in mind that insurance authorities and increasingly capital markets (stock exchanges) mandate that TOs prepare separate financial statements [Income statements and Balance Sheets] for Policyholders and Shareholders as well as one consolidated financial statement.**

### FROM THE INCOME STATEMENTS WE CAN SEE:

Takaful Operator's or Shareholder's Income sources:

- Profits generated from the investment of shareholders' funds
- Management fees earned on contributions (Mudarabah or Wakala model) and on investment assets under management
- Share of profits generated, if any, from the management (as Al-Mudareb) of both the family Takaful fund and the general (commercial) Takaful fund in accordance with the predetermined profit-sharing arrangements declared in policies
- Possibly, a Performance Incentive fee (PIF) on surplus if permitted by SSB
- Any advisory or training fees earned
- Reinstatement (recovery) of capital funds loaned if Qard al Hasan is repaid

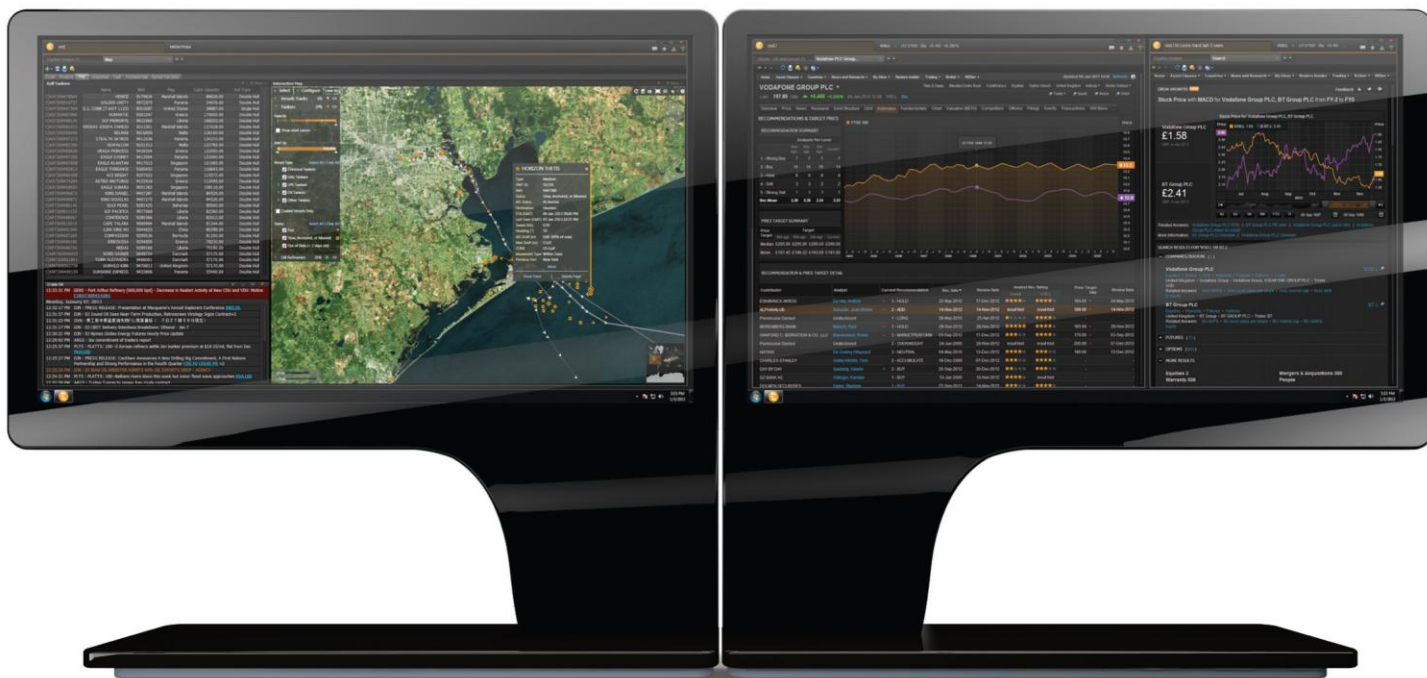
As a collective group, Policyholders' Income sources:

- Profits generated by temporary investment of contributions made to risk pool (Takaful funds)
- Re-Takaful share of "profit-loss" making, called recoveries
- Salvage funds recovered under claims settlement or loss adjustments
- Changes in accounts of Unearned contributions (opening vs. ending balances)
- After settling all claims and expenses, share of direct surplus, if any, at year end

In case of an individual Family Takaful (Life) plan, the PH owns an individual saving account (e.g. Education plan) where investments are his personal choice of assets/securities and he alone enjoys the returns to those investments as profit or loss.



# CONNECTING THE GLOBAL FINANCIAL COMMUNITY WITH NEW WAYS TO PROSPER



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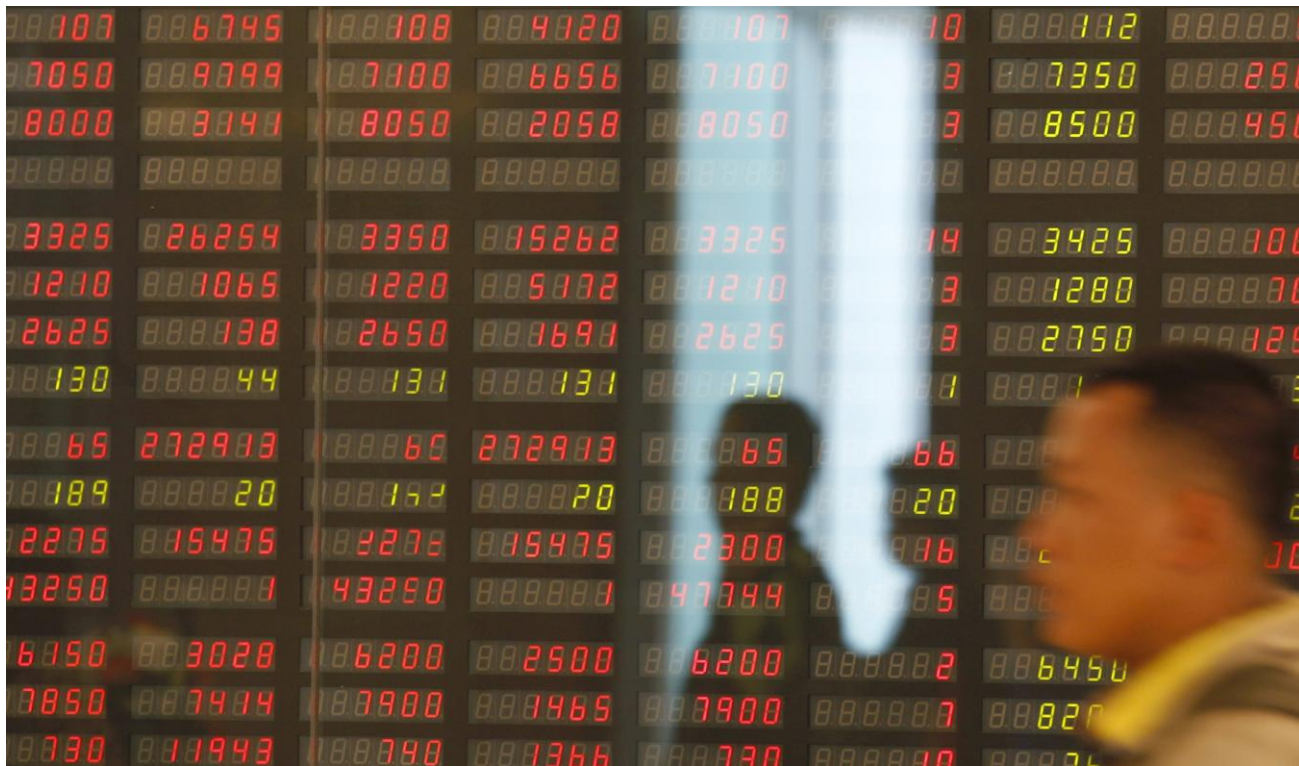


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## SECTION K

### TAKAFUL STATS IN MODERN ERA



REUTERS/Supri

## K.1 OVERVIEW OF GROWTH IN TAKAFUL SECTOR

The global Takaful segment of the insurance industry is 33 years young (vs. conventional mutuals that are +270 years old) and is rapidly emerging worldwide as an alternative risk mechanism to conventional insurance. From a handful of players in 1980s, Takaful operators have swelled to more than 235 globally (including dedicated Takaful companies, Takaful “windows” within conventional insurers and Re-Takafuls). Four of the OIC countries (Sudan, Pakistan, Malaysia and Bahrain) have promulgated distinct and independent Takaful regulatory frameworks. Several full-fledged Family (Life-only) Takaful Operators are flourishing. Specialized Islamic accounting and auditing standards have been developed (by AAOIFI-Bahrain and by IFRS-Malaysia) specifically for Takaful Operators.

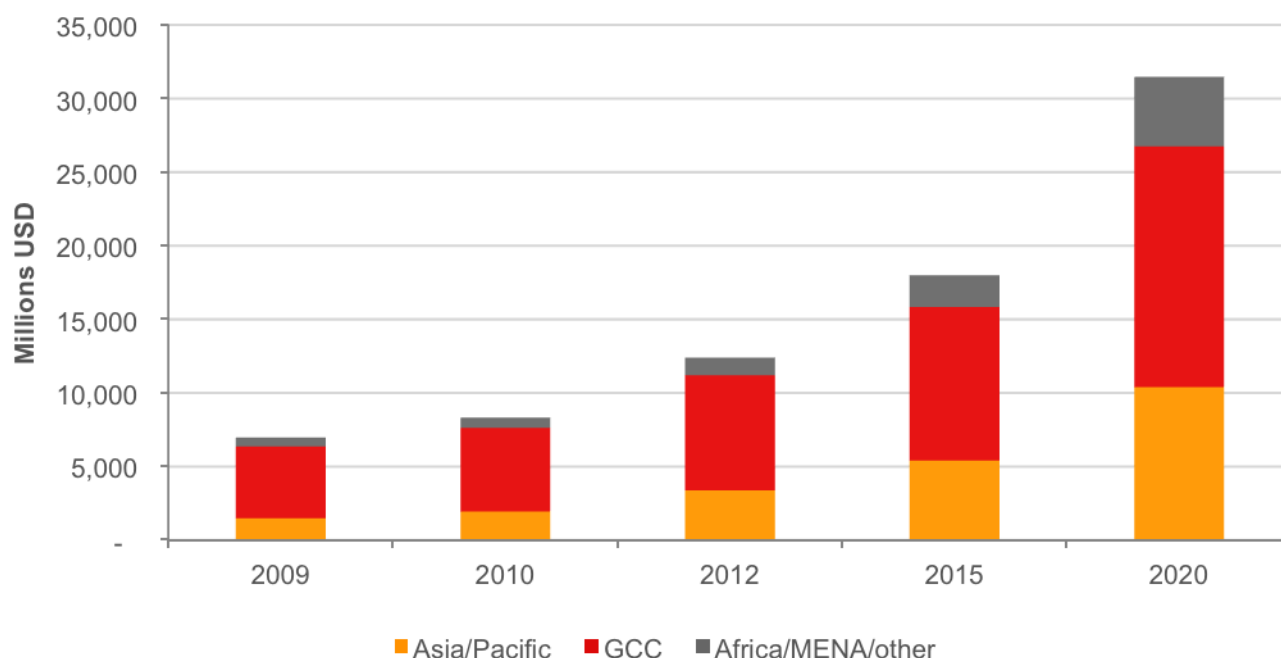
Focus on retail products and services dominates in this niche and results in 32% of global Takaful revenues are derived from motor coverage, 48% from medical and Family (Life), with Property, Accident and Marine/Aviation accounting for the remaining 20%. In addition, multi-national insurers – such as **HSBC, AIG, Axa and Prudential** – have noted this remarkable growth, begun to embrace Takaful and are entering the global industry in multi-markets.

Worldwide gross annualized Takaful contributions achieved a modest \$750 Mil dollars in 2000, increased nearly 3X by end of 2005 and tripled again by end of 2010. Overall global contributions have grown impressively to \$8.3 Bil in 2010<sup>32</sup> [an

annualized growth rate of +24%]. However, in the last 5 years (between 2006-2010<sup>33</sup>) the industry’s compound annual growth rate (CAGR) of gross contributions seems to have moderated slightly – being 22% per annum. Many observers forecast global Takaful volume of business to arrive at a range of \$18 Bil by 2015 and \$31 Bil by 2020. The chart below shows the relative markets sizes forecast to Asia/Pacific region, GCC/Middle East region and MENA/Africa and Other regions. It is anticipated that despite the rapid penetration of Takaful in non-Middle East countries, that the GCC/Middle East region will continue to dominate with half the global contributions.

Data from ARIG’s report on Arab world insurance (2006), indicates that the mixture of General (Non-Life Takaful) business and Life (Family Takaful) business favors General 50:1, perhaps reflecting a strong cultural and traditional public aversion in Arab and near East markets to the concept of Life insurance. Industry experts forecast that future demand of Takaful, however, will place more emphasis on Family (Life) Takaful – especially as savings instruments – whereby the future business mix could shift to 4:1 by 2015. Nonetheless, a realization of such optimistic forecasts will depend heavily upon building primary demand for Takaful generally as well as enhancing public awareness to utilize Takaful for promotion of long-term savings, private retirement and pension plans. In addition, a broader range of Islamic financial instruments and securities, including capital-protected offerings that support Takaful savings plans, must be developed and floated into the market.

**CHART 1. FORECAST OF GLOBAL TAKAFUL GROWTH 2009 TO 2020**



<sup>32</sup> Source Ernst & Young World Takaful Report 2012, April.

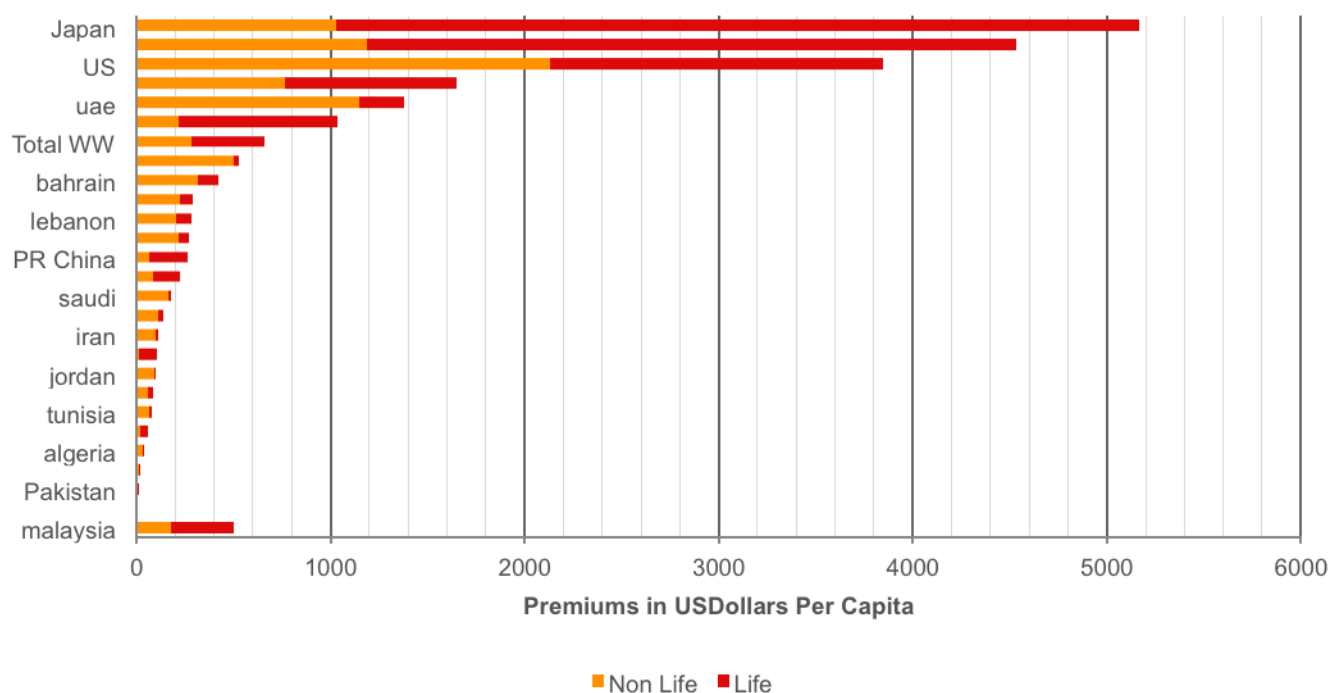
<sup>33</sup> Source: Swiss Re SIGMA, E&Y World Takaful Report 2012 and author’s estimates.



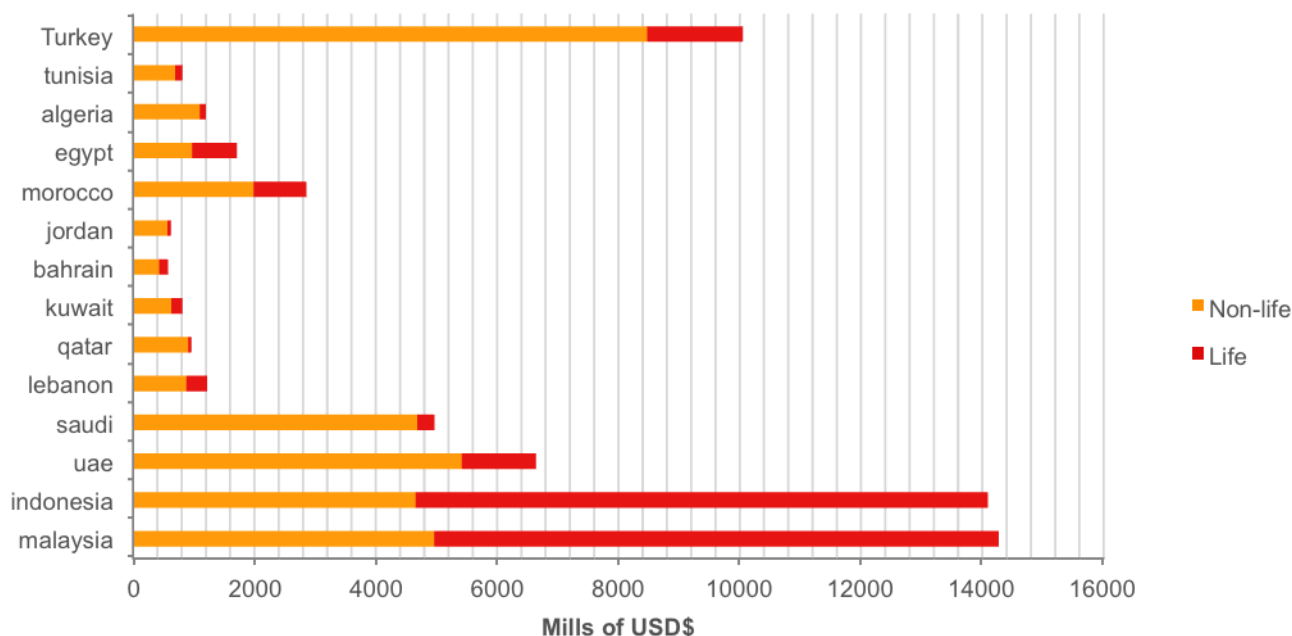
## K.2 LIFE VS. NON LIFE BUSINESS

From Chart 2. below, one can see that the dominant usage of insurance coverage across the Arab and near East is Non-Life, or General, protection of assets and property. Typically, Life insurance protection accounts for 35% to 60% of insurance sales – mostly as a savings mechanism, with the worldwide average being 57%. Across the MENA region, traditional forms of savings have not included insurance (largely because of the prohibited elements described in Section E.) so commonly Life insurance sales range from 2% to 15%. Bahrain's Life usage at 26%, Morocco's at 30%, Egypt's 43% and Pakistan's 50% are clear exceptions where the emergence of Family Takaful is encouraging a re-consideration of insurance. Malaysia, where Muslims represent 50% of local population, is in the forefront of introduction of Takaful since 1983 and hence Family (Life) Takaful plans in 2011 were 65% of total annual premiums nationwide (\$936 Mil dollars), in reaction to the Central Bank's – Bank Negara – active encouragement of savings habits and because payroll deduction schemes make it convenient to do so.

**CHART 2.**



**CHART 3. SPLIT LIFE VS. NON-LIFE TAKAFUL PREMIUMS 2011**



Over the past 30 years, the 6 states of the Gulf Cooperation Council (GCC) have cultivated Islamic financial services, which has propelled growth in Takaful business. GCC's share of global Takaful contributions ranges annually from 50% to 55%. Nonetheless, its regional dominant role is gradually eroding as more Takaful operators come on-stream in Africa, Levant, Near East and Asia Pacific regions as well as in the EU, where two new Takaful Operators are under establishment in 2007-2008. Of the 103 new Takaful enterprises developed globally between 2006 and 2012, 35 were established in GCC states but double that number were launched in other non-Arab regions: Asia/Pacific 37, Africa/Levant/EU/other 31.

Despite this record of remarkable growth of Takaful enterprises globally, the cold fact remains that of global insurance gross premiums written of \$4.3 Trillion dollars in 2011, only \$8.6 Billion (or 2/10 of one percent- 0.2%) were written on Takaful basis (refer to SIGMA data, 3/2012).

In addition, to date there is no popular global or even regional recognizable Takaful brands.

Many sources point to the low penetration rates for insurance generally across the Arab and Near East as compared with developed markets and conclude that this foreshadows enormous future potential due to youthful demographics and high birth rates. Yet in aggregate this insurance compares to only 14% of the total insurance written in South East Asian and Japan markets and only 10% of that written in Europe and Russian markets. Conversely, many observe that the high

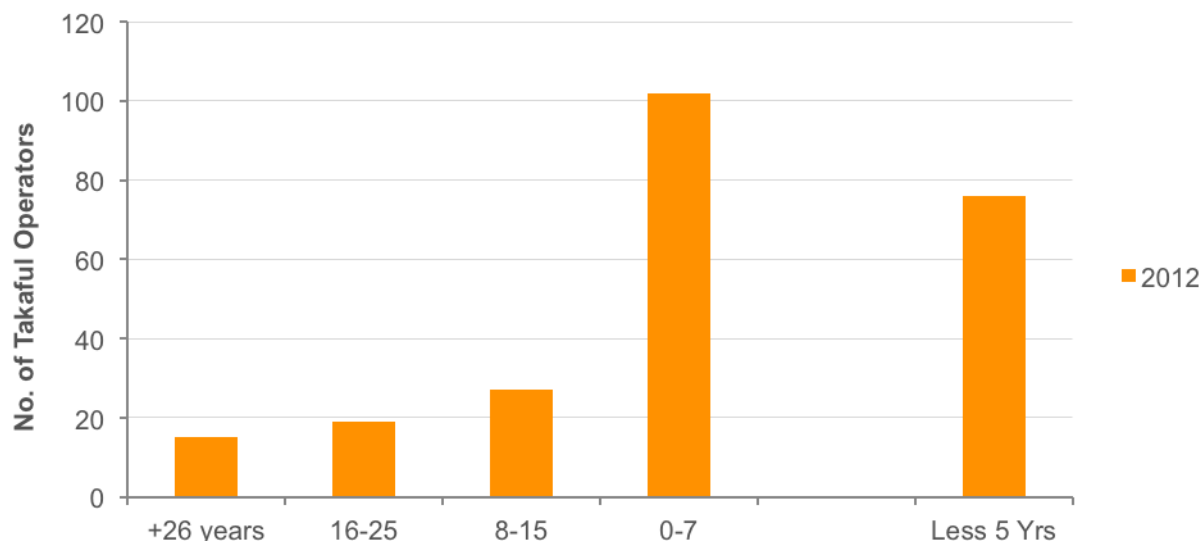
growth rates in the Muslim world (2011 collectively 9.4% p.a.) represent a very attractive emerging insurance market – however, when compared with growth rates in Latin America (10.1% p.a.), Oceania (5.2% p.a.), Central and Eastern Europe/Russia (5.3% p.a.) and South East Asia (3.5%), there may arise a note of caution: perhaps additional resources and insurance capital could be better deployed into other fast growing markets that display less political risks. Mature markets by contrast over the past two years show stagnant or negative growth: USA 1.3% and Europe -5.2%, World Average for advanced markets -1.1% vs. emerging markets 1.3%.<sup>34</sup>

### K.3<sup>35</sup> A PROFILE OF TAKAFUL INDUSTRY-TIME IN BUSINESS AND MODELS

The re-discovery of Takaful mechanism for risk sharing is a recent phenomenon starting only in 1979 in Sudan. As of 2012, 102 (63%) of dedicated Takaful Operators are in business less than 7 years. Only 15 (9%) are older than +26 years<sup>36</sup>:

Whereas in 2005, 36 Takaful Operators (50% of a sample survey of 72) were in business less than 7 years, by 2012 this rose to 102 Takaful operators (63% of 163) were in business less than 7 years. This is clearly a youthful industry. Notice that between 2005 and 2012 more than 93 new Takaful Operators were established – mostly located in Africa, MENA and GCC regions.

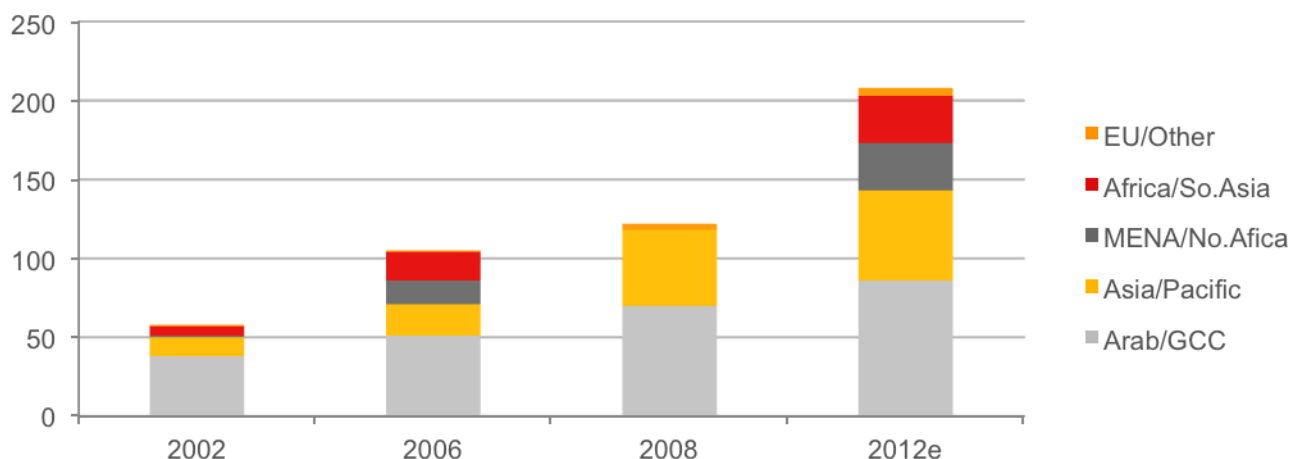
**CHART 4. GLOBAL TAKAFUL OPERATORS 2012 TIME IN BUSINESS – YEARS**



<sup>34</sup> Swiss RE SIGMA 3/2012.

<sup>35</sup> Source: O Fisher PhD unpublished Thesis, November 2005 for International Islamic University of Malaysia and Camden University of Delaware, USA.

<sup>36</sup> From sample of 163 of 235 Takaful Operators worldwide, source OFisher, 2012.

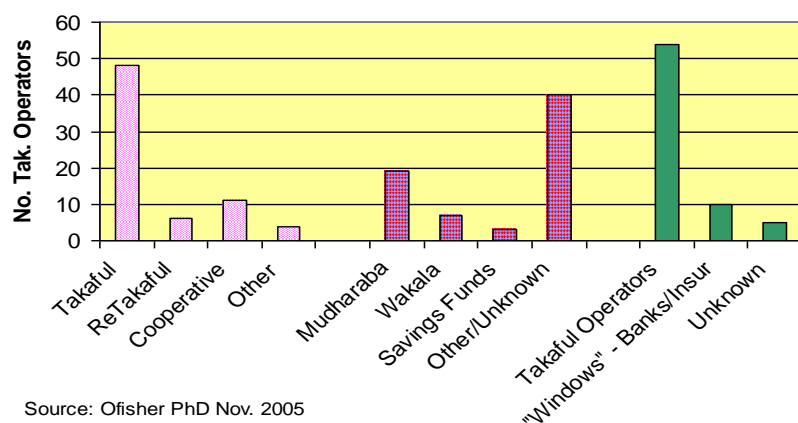
**CHART 5. GROWTH IN NO. OF TAKAFULS 2002-2012E**

Globally, there is an explosion in the number of Takaful Operators – prior to 2001 some 58 companies operated in and handful of countries. Middle East region dominated with more than 29. Between 2002 and 2006 about 47 new companies were formed worldwide, with 30% in GCC, 30% in North Africa and MENA, and nearly 25% in Africa and South Asia, the remaining 8 started up in Asia and 1 in EU. Between 2007 and 2012, another 83 companies were launched. Again, GCC leads with 35 companies and 10 in North Africa and MENA, 12 in Africa and South Asia, and 8 new in Asia and 1 new in EU/India. In short the number of takaful companies globally nearly doubled in 5 years after 2001 and then new company formation nearly doubled again!

**GROWTH IN NO. OF TAKAFULS 2002-2012**

	2002	2006	2008	2012e	2012	
ARAB/GCC	38	51	70	86	75	
ASIA/PACIFIC	12	20	48	57	57	INDONESIA
MENA/NO.AFICA	1	15		30	70	IRAN
AFRICA/SO.ASIA	6	18		30	26	
EU/OTHER	1	1	4	5	7	
<b>TOTAL</b>	<b>58</b>	<b>105</b>	<b>131</b>	<b>208</b>	<b>235</b>	

Of a sample of 83 Takaful Operators (2005), 48 (70%) are pure Takaful models, the remainder are a blend of Re-Takaful/Takaful, cooperatives and Other models.

**CHART 6. MODES OF TAKAFUL RISK SHARING (2005)**

From this global sample, it can be seen that: a) 20 (29%) have adopted a Mudharabah model, b) about 12% (10) have chosen a Wakala model, which is gaining in popularity especially in Middle East region and c) no firm data is currently available on a majority of Takaful Operators (+40) as to which operational model they have adopted.

Source: Ofisher PhD Nov. 2005





## SECTION L

# OPPORTUNITIES AND CHALLENGES



REUTERS/Murad Sezer

## L.1 INSURANCE INDUSTRY AND LANDSCAPE TRENDS

Within the Islamic world, there is a strong revival of religious interest and specifically a gathering momentum of public demand for Islamicly acceptable finance and banking services which, in turn, is stimulating renewed demands for Islamic insurance. In 2010, the Muslim population globally was approximately 1.58 billion – or 23% of world's population of 6.9 Bil. By 2030, Muslim population should consist of 2.15 Bil, or 26% of world's population of 8.3 Bil. A majority of this population is residing in emerging or developing economies where rural and agrarian methods of production still dominate. To date, Islamic finance has not ventured outside major urban centers- with the recent exception of a few scattered Islamic microfinance projects. However, there is increasing migration into urban areas and hence a rapidly expanding need for banking and financial services in cities. The Muslim population in the early 1980s placed assets under management among the Islamic banks and investment companies totaling US\$6 billion. In 1998, these assets swelled to US\$166 billion and by 2011, assets worldwide had surpassed US\$1 trillion under Islamic management.

On an annualized per person basis, an estimate is Muslims engaged Islamic financial services equivalent to \$5.5 dollars in 1980, which increased to \$1,360 by 1998. By 2010, this figure further expanded to \$6,250 per person on global basis associated with \$1 trillion assets under management. As forecast, the Muslim population could exceed 2.1 bil (of 8.3 bil) with some \$5 trillion to be managed. Given the synergies between Islamic finance and Takaful, it is quite possible that by 2030 Takaful global contributions could become a potent third force in the global insurance industry following after conventional and mutual insurers.

Insurance is a dominant factor in modern economy – influencing some 5% to 10% of Gross Domestic Product (GDP). Significant trends in the overall insurance industry globally are:

- Consolidation into larger companies – because size does matter
- Demutualisation, further shrinkage of mutual operators whereby profits take priority over policyholder interests
- Convergence of banks and insurance companies to share data, products and customers
- Securitization of insurance risks (started in 1990s), whereby homogeneous insurance risks can be packaged and sold to investors in the form of securities similar to the bundling of mortgages, credit card debts or auto leases
- Transparency and more disclosure – the ability of all market participants to determine the available range of prices for financial instruments and financial services
- Differential pricing – whereby finer and finer distinctions are made among groups of customers, setting their prices based upon the revenue streams they generate, the costs to serve them, and their resulting profitability as profit-units

- Disintermediation or bypass – internet-based transactions in USA and EU to replace direct interaction with financial advisors, retail stock brokers, and insurance agents. While this does put the consumer more directly in control of the insurance buy-sell transaction, it also requires each consumer to become more informed on technical aspects so to avoid mis-selling and mis-representations about insurance policy he purchases

In contrast, current worldwide emerging insurance markets strongly supports the agency system and a direct sales force deployed by the insurer. However the present insurance industry broker/agent fee structure, when compared to other financial services, contains excess “fat” which is shielded from view by broker and sales commissions built into the premium rates. This practice of hidden commissions paid by policyholders is incompatible with a Takaful operation. Disclosure of all aspects of the financial transaction between the Takaful operator and the policyholder is a basic tenet of Shariah. This engenders mutual trust, fair dealings and ethical business practices. As we have seen, Takaful operators must avoid al-Gharar (deception and unclear terms).

Hence, Takaful operators should not fail to embrace new technology and adapt to modern delivery mechanisms such as the worldwide Internet, while sustaining high levels of disclosure and transparency. Otherwise, their Takaful products will most likely appear disadvantaged and non-competitive to potential buyers despite a presence of Islamic values.

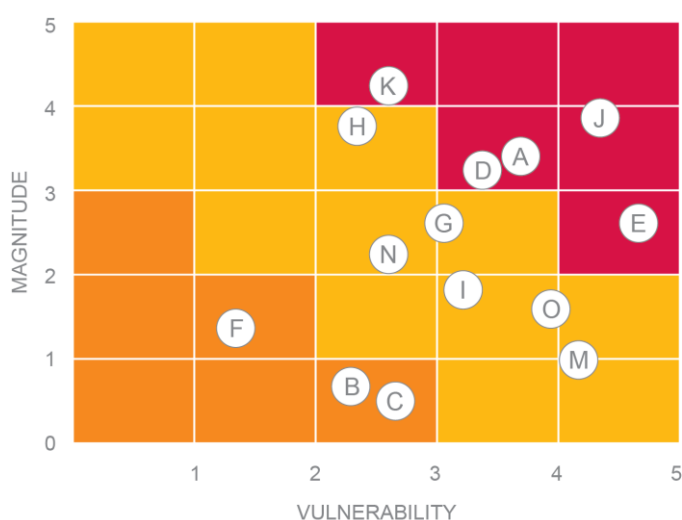
## L.2 TAKAFUL'S COMPETITIVE CHALLENGES

To advance rapidly and gain acceptance among clients in emerging markets owning property/assets (as well as those with little or no property), Takaful operators will need to focus more resources on developing a message attuned to their potential customers in their respective local markets. Given the level of ignorance that currently prevails (even amongst Muslims) about principles of Islamic finance, banking and insurance (Takaful) practices, one can safely state that the No 1 challenge to rapid progress is education of the end-user (the insured). In classic business textbook terminology, Takaful operators must build “primary demand” for their Takaful products.

In addition, substantial resources must be deployed into product innovation and development. Keep in mind that many industries channel up to 7% of gross revenues annually into research and development of new products/services. Takaful Operators cannot realize their considerable potential simply by imitating conventional insurers' products and services. Alternatively, risk protection coverages adhering to Shariah rules could be developed to complement numerous Islamic banking transactions, such as coverage for leased assets, or project completion guaranties.

Because of the turbulence in global equity markets and the correction in real estate and property prices, insurance companies these days are unable to count on investment returns to sustain profits as prior to the financial crisis beginning in 2007/8, so that much greater attention is being paid to technical operations (underwriting and claims management) and operating efficiency. However, given the fierce price competition amongst the MENA and Asian region's numerous insurers, sustainability of businesses is becoming a main driver to operations.

By 2013- five years on, however, most companies have exhausted cost-cutting measures and must seek improvements elsewhere. In the apparent absence of products and services innovations, Takaful Operators are very hard pressed to build market-share and to improve technical results so that ample surplus can be distributed to participants to reward loyalty. In fact, many Takaful players who depend upon imitation of conventional products are quite likely to suffer operating losses and confront pressures to consolidate.



Increasingly, the sustainability of insurance companies in emerging markets depends upon their risk management capabilities. Key elements are agility and their adaptability to the many changes occurring – from price competition, to weak investment climate, to regulatory and disclosure rule changes to new accounting and solvency tests being imposed. Hence, the most nimble and agile Takaful Operators will not simply survive but thrive. One such positive example is **Takaful Iklas** in Kuala Lumpur Malaysia.

Even after 33 years of operations, there are no global brands for Takaful and only two quasi- regional, cross-border Takaful players- **Salama**, headquartered in UAE which was formed in 1997 by the consolidation of several MENA existing insurers that spun out from Dallah Al Barakah Group under the leadership of RUSD Bank (Jeddah) and **Takaful Malaysia** formed in 1983 which has expanded into joint ventures in Indonesia, Colombo and Saudi Arabia. Salama's wrote \$610 Million in gross contributions (2011) and maintains \$444 Mil Islamic assets under management, of which 50% belongs to policyholder's fund. Hence, its business model is robust enough to challenge **AXA, Prudential, Allianz, or Chartis** (formerly AIG) which multinational insurers manage "**Takaful windows**" on multiple continents. Takaful Malaysia, established in 1983, has grown into group annual contributions

of \$144 Mil for Family Takaful and \$153 Mil for General business. Total assets have risen to \$1,480 Mil (2011) and spread of 4 countries.

### L.3 THE WAY FORWARD – HURDLES TO OVERCOME

It is well documented that for businesses to survive long term, there should be visionary management, clear mission statements communicated to employees and customers, agility and nimbleness during competition and a value proposition that can adapt to customer needs to engender loyalty and repeat business.

Across the Takaful industry, this prescription will require Takaful Operators to embrace innovation, technology and social media in ways that remain consistent with Islamic values in order to join the mainstream business arena, or likely risk being marginalized as a niche alternative insurance provider. As Takaful Operators face the split in the pathway ahead: the future challenges which require revitalized efforts and agility by Takaful players to resolve are:

- Broadening distribution channels beyond agency system, including bancassurance
- Promoting regional and international Takaful cooperation and alliances- particularly through establishment of Takaful Associations or Unions
- Expanding and enhancing the capacity for Retakaful globally
- Addressing the current skills shortages, including skilled underwriters and other technical personnel, by increased training and re-training
- Cross-training Takaful managers to be knowledgeable about Islamic finance as well as risk management (Takaful)
- Modernization of data-processing systems and interface between conventional software and Islamic values
- Development and promulgation of Takaful standards for accounting, management operations and auditing (AAOIFI based in Bahrain is beginning to address this)
- Refine regulatory rules to reflect the unique circumstances of Takaful companies without weakening risk management and financial stability standards
- Provide proper levels of consumer protection in terms of risk and disclosure in policy wordings
- Modifying supervisory rules to allow variant asset risk profiles for Takafuls as different from conventional insurers due to different capital structure and lower risk appetite
- Adjustments to rating methodologies to account for Takaful risk pool's lower financial security – due to a lack of diversification, short operating history and uncertainty about circumstances of Qard Hassan from shareholders to cover deficits
- Solvency Margin- issue is the relationships among the various types of capital deployed in the hybrid takaful model, namely: Participant risk pool funds (including Waqf funds); Shareholder funds; Participant's donations and allocation of Wakala fee; And their treatment in consolidated financial statements as required by accounting rules
- Reduce the existing concentration of investment risks by Takafuls because of a narrower range of available investment assets that are Shariah compliant



- Build effective responses to strong competition from conventional insurers, which may be able to earn a greater investment returns and have greater economies of scale, many of whom have launched Takaful product lines
- Modest levels of capitalization among many Takaful businesses, especially within the Takaful fund, can limit capacity to take on risks and delay realization of surplus for policyholders
- Immature enterprise risk management systems and trained personnel can postpone grappling with requirements of Basel II (2010) to increase capital and operate under risk-weighted capital rules which can disadvantage Takafuls
- Develop suitable business processes and IT software/infrastructure which is Takaful friendly, rather than being forced to adapt to conventional insurance systems
- How to evaluate the “contingent guarantee” from shareholders (Qard Hassan) to cover a deficit in the risk pool and what are implications for capital adequacy and solvency margins
- Designation of a Shariah audit at least annually to assure that the instructions of the SSB are being implemented properly and consistent with Shariah principles

#### L.4 SPECIAL MENTION FOR GOVERNANCE ISSUES

As described above, there are several important challenges confronting the global Takaful industry which must be neutralized if the optimistic revenue forecasts so widely circulated are to be realized. However, one item must be singled out for special mention: advancing transparency and better governance. Takaful Operators that can meet this challenge head-on will become leaders, while others may lag behind and eventually could be marginalized as participants/clients gravitate towards more transparent and customer-friendly operators.

#### GOVERNANCE ISSUES AND RIGHTS OF TAKAFUL POLICYHOLDERS

Typically, in mutual insurers (similar to Takafuls) policyholders have rights that divide into three categories: (a) membership rights, (b) contractual rights and (c) governance rights. These can be explained briefly as:

**Membership rights** – covers the legal and ownership rights of policyholders as a member of the mutual. While not identical to “ownership” rights of shareholders of a stock insurers because there is no control over property, a mutual member does have a shared right to excess surplus and may have a claim against assets of a mutual in bankruptcy or dissolution. How should such rights carry over into Takaful operations?

**Contractual rights** – covers the express benefits and obligations under the policy contract which is binding upon the member/policyholder. Technically, the member shares in the mutual risk pool only and should have no claim against the Takaful Operator’s shareholder capital nor related investments. What happens in the event the Takaful Operator “refuses” to extend funds (Qard Hassan) to cover risk pool deficits? What recourse is available to policyholders?

**Governance rights** – covers governance of the entire organization. Mutual policyholders should have a voice in how an entity is managed, how the records and books are kept as well as open access to financial accounts, and ideally in selection of a board of directors. In similar fashion, it is common sense that a Takaful is operated for the chief benefit of policyholders, and yet very few Takaful Operators globally have a mechanism whereby representation by members is included on the board level. Many conventional mutuals enable members to exercise governance rights pertaining to fundamental “corporate” transactions such as mergers, acquisitions, or sale of substantial portions of mutual assets. What should be the scope of governance role by Takaful policyholders?

If Takaful enterprises are to truly differentiate themselves from conventional insurance companies, including mutual insurers, they must eventually address these members’ rights and actively encourage the empowerment of a customer base with possibly significant additional benefits accruing to the Takaful model, including staunch loyalty.





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