TITLE OF THE PAPER: IS ISLAMIC INSURANCE AN ALTERNATIVE TO CONVENTIONAL INSURANCE?

AUTHORS
SHEILA NU NU HTAY[1]
sheila@iium.edu.my

SYED AHMED SALMAN[2]
salmaniium@gmail.com

Contact details
SYED AHMED SALMAN
HNO: 16-2-45/SM/2, AKBER BAGH MALAKPET HYDERABAD AP. 500036

SHEILA NU NU HTAY
NO. 11, JALAN BULLION MEWAH 12, TAMAN BULLION MEWAH
68100, BATU CAVE, KUALA LUMPUR, MALAYSIA
006-0123736640

[1] Sheila Nu Nu Htay is a lecturer at IIUM Institute of Islamic Banking and Finance Malaysia. sheila@iium.edu.my
[2] Syed Ahmed Salman is a PhD candidate at IIUM Institute of Islamic Banking and Finance Malaysia. salmaniium@gmail.com

ABSTRACT
The significance and importance of Takaful in the Islamic Finance has captured the attention Muslim communities in today's world. Takaful can be seen as an alternative to conventional insurance due to its strong foundation of Islamic principles which are based on the concept of brotherhood, mutual co-operation and solidarity. It has become a fast growing and developing industry with great potential and has certainly evolved into a comprehensive system which eliminates *non-Shari'ah* compliant features such as interest, uncertainty and gambling that exist in the conventional insurance.

1. Introduction

Having insurance becomes a common practice and it is unavoidable by human being nowadays due to the complex nature of business transactions and life styles. However, the involvement of prohibited elements in insurance makes the Muslim scholars think to introduce takaful as an alternative to insurance. Takaful products are designed to meet the needs of the society at large, including non-Muslims. The objective of this paper is to highlight that takaful can be an alternative to insurance and how takaful can bring benefits for the betterment of the society. This paper discusses problems of conventional insurance from the Islamic perspective. In addition, takaful concepts, its features, types and models are explained.

2. Problem with conventional insurance

Is there really a need for takaful? After all, the concept of insurance has been around in the conventional financial domain for the past decades. Conventional insurance is defined as "a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable, this predictable loss is then shared by or distributed proportionately among all units in the combination" (Mehr, 1986). Essentially, it is a form of risk management primarily used to hedge against the risk of uncertain loss.

According to Usmani (2007), there are 2 aspects to conventional insurance namely conceptual and practical. As far as the conceptual aspect is concerned, it involves covering the risk of loss or "fortunate many helping the unfortunate few" – a concept that is not only recognized but encouraged and rewarded in Islam, as evidenced in the Holy Quran Sura al-Maidah 5:2;

And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah; indeed, Allah is severe in penalty.

The practical aspect, however, is problematic as conventional insurance contractually contains elements of riba (usury), gharar (ambiguity) and maysir (gambling), hence majority of Muslim scholars have declared it as haram (prohibited). Looking at it from the perspective of policyholders, the following elements are evident in conventional insurance;

Riba: The amount received by the policyholder when an insured event occurs or upon maturity of the policy is typically in excess of the total premium he has paid. Payments are also deferred so when the compensation given by the insurance company is greater than the installments paid by the policyholder, the surplus is regarded as riba al-fadl (due to excess) and riba al-nasiah (due to delay).

Gharar: The subject matter of an insurance contract is unknown. Based on the insurance company's guarantee to compensate the policyholder in the event of a catastrophe, he agrees to pay a certain premium but he does not know how much compensation he will be paid until the actual catastrophe occurs.

Maysir: The policyholder are said to be betting premiums on the condition that the insurance company will make payments should a specific event occur. However, the policyholder does not get much from his premiums if the event does not happen. This is akin to the 'zero-sum game' that is not allowed by Shariah.

3. Concept of Takaful

Takaful is the Islamic alternative to conventional insurance. It is defined as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose" (Bank Negara Malaysia, 1984).

There are three aspects of mutuality represented in Takaful namely mutual help, mutual responsibility and mutual protection from losses. It is an arrangement in which participants contribute regularly to a common pool of funds with the intention of jointly guaranteeing each other. When a participant enters a takaful scheme, it does not only involve seeking protection for him but it also includes cooperating with other participants and contributing to help those in needs.

Hence, unlike its conventional counterpart, Takaful ta'awuni or Islamic cooperative insurance is ideally not a contract of buying and selling where one party sells protection and another buys the service for a certain price.

4. Legality and evolution of Takaful

Historically, the concept of Takaful can be traced back to a custom of giving diyat (blood money) under the ancient Arab tribal custom that was approved by the Prophet (p.b.u.h.) himself. The system of aqila (shared responsibility) laid the foundation of mutual insurance in Islam.

In the context of contemporary Takaful, the Congress of Islamic Research in Cairo first deliberated on the legitimacy of insurance in the Islamic world back in 1965. Subsequently, a universal consensus was reached at the First International Conference on Islamic Economics in 1976 and conventional insurance for profit was deemed as contradicting Shariah. On the contrary, Muslim jurists resolve that insurance in Islam based on the principles of mutuality and cooperation is not merely acceptable but necessary.

The evolution of takaful can be divided in four main phases (Billah, 2004: pp.5-8);

The first ta'awuni model (cooperative) was developed in Sudan in 1979
The Mudharabah model was developed in Malaysia in 1984
The wakalah model was developed in the Gulf in 1984
The waqf model was developed in South Africa in 1996

5. Distinguishing features of Takaful

As mentioned earlier, one way Takaful differentiates itself from its conventional counterpart is on the basis of Tabarru'. It is an agreement to relinquish (as a donation) a sum of contribution that a participant makes into a Takaful fund. Participants will allocate part of their contributions as a donation for the provision of mutual indemnity to other Takaful members, with the objective of communal help and joint guarantee should any member suffer from losses. As such, the Tabarru' contract is used between Takaful participants. Interestingly enough, out of all existing Takaful models available in the market today, only the waqf model focuses on the Tabarru' aspect (Farooq et al., 2010).

The fundamental difference between conventional insurance and Takaful is in its contracts. The former is a bilateral contract between the insured (policyholder) and the insurance company. The nature of the contract is at best, probable because compensation is dependent on events that may or may not occur. In contrast, a Takaful operator is an administrator of the Takaful fund, responsible for managing and investing the funds in accordance to Shariah.

Other features that distinguish Takaful from its conventional counterpart include the existence of a Shariah Supervisory Board and separation of two funds namely participants' and shareholders' funds. For example, the role of members in a Shariah Supervisory Board is to review the takaful operations and supervise the development of Islamic insurance products in terms of its Shariah compliance.

Shariah and regulatory framework for Takaful

According to Omer (2011), there are three levels of supervision and regulation of the Takaful industry namely local jurisdiction, the Islamic Financial Services Board (IFSB) Standards and the core principles of the International Association of Insurance Supervisors (IAIS);

⇒ **Local jurisdiction**: While countries–such as Bahrain and Malaysia introduced special legislation for Takaful operators (Sohail Jaffer, 2007), others like the United Kingdom (UK) simply adopt a general 'level-playing field' approach. This means UK allows for Takaful as long as it can be established under the existing legal and regulatory framework without further assistance or discrimination.

⇒ **IFSB Standards**[3]: In November 2009, the IFSB issued the 'Guiding Principles on Governance for Takaful Undertakings', essentially dealing with governance and prudential issues. Successively, the board issued the 'IFSB Standard 11: Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings' in December 2010 to address capital adequacy and solvency rules.

⇒ **Core principles of IAIS**: The IAIS framework provides three aspects of responsibilities; namely effective insurance supervision, regulatory requirements and supervisory actions based on the paper 'A New Framework for Insurance Supervision' released in 2005.

6. TYPES OF *TAKAFUL* CONTRACT

6.1 General Takaful

The General Takaful contract is normally a short-term policy where Takaful participants pay contributions and operators undertake to manage risk. The contributions paid are credited into the General Takaful Fund and funds are later invested and generated profits are returned to the Fund. In this type of takaful, there are no savings and

[3] See http://www.ifsb.org/published.php

investment components. The Takaful operator will distribute any underwriting surplus to the participants on an annual basis. Even though General Takaful is typically for the short-term, the contract can be renewed periodically. Takaful operators typically provide a full range of General Takaful products for both retail and corporate customers. General Takaful can be further categorized into motor and non-motor Takaful. As its name suggests, the former provides protection for private and commercial vehicles. The latter, on the other hand, safeguards from fire, personal accident and health. In the context of Malaysia, examples of General Takaful products in the market today are Takaful my PA Care (for Personal Accidents) and House owners and Householder's Takaful by Takaful Malaysia as well as Takaful Ultra Medic Rider by Etiqa, the insurance and Takaful arm of Maybank Group.

6.2 Family Takaful

Family Takaful is a long-term policy for which most participants aim at saving for their long-term needs such as children's education, their pension and compensation for dependents; for example, in the event of death and disability. This type of Takaful has a long-term time horizon from ten to thirty years. In Family Takaful, the operators usually divide contributions into two parts namely the participant's account (savings account) and the participant's special account (Tabarru' account). The second account is used in the case of potential losses of fellow participants who will be compensated according to a pre-agreed rate. Both accounts have to be invested in Shariah-compliant securities and the Takaful operator can either earn through fees or a share of the investment profits. Some of the common Family Takaful products include savings and education plans and retirement plans. In the context of Malaysia, examples of Family Takaful products in the market today are Takaful myGenLife by Takaful Malaysia as well as Etiqa Harmoni (savings) and Etiqa Intelek (education).

7. Models available in the market

There are many models available in the market today including purely Mudharabah and Wakalah models as well as hybrid of the two and hybrid of Wakalah and Waqf model.

7.1 Mudharabah model

According to the principle of Mudharabah, the Takaful operator acts as a mudarib (entrepreneur) who accepts payment of the Takaful contributions as capital from the rabb al-mal or Takaful participants. The contract specifies that the share of profit (surplus) from the operations of the Takaful fund as managed by the Takaful operator is to be distributed between participants and the Takaful operator. This model is used by most Takaful operators in Malaysia (Mohammed Obaidullah, n.d.) and Takaful International in Bahrain (Fisher and Taylor, 2000).

7.2 Wakalah model

The Wakalah model is becoming gradually more popular. This takaful model is based on the contract of agency, whereby takaful participants remain the actual owners of the Takaful fund and the Takaful operator acts as an agent for the participants to manage the fund with a specified fee. As an agent, the Takaful operator is entitled to agency fee as remuneration and performance fee for incentives. The surplus of the participants' investment funds goes to the participants not to the Takaful operators. This model is used by Bank Aljazira in Saudi Arabia (2001) and Takaful Ikhlas in Malaysia (2003) (Mohammed Obaidullah, n.d. & Yon Bahiah. n.d.). In the Middle East, Bank Aljazira is the pioneer in practicing Takaful Ta'awuni based on the Wakalah model (GIFF, 2012).

7.3 Hybrid of Wakalah-Waqaf model

Prominent Shariah scholar in Islamic finance, Sheikh Justice Taqi Usmani introduced the latest model that has emerged in the market. The general concept of the Takaful Waqf plan is designed to allow participants to save regularly – accumulation of funds that can be left as donation under the waqf system. In this model, shareholders of the Takaful operator initially make a donation to establish the Waqf fund. The Fund needs to be invested in a Shariah-compliant investment and returns will be used for the benefit of participants. The Tabarru' fund from participants' special account also becomes part of the Waqf fund. In the context of Malaysia in particular, the Waqf is still not in practice.

With regards to Takaful models, the Wakalah-Mudharabah 'hybrid model' remains one of the most widely applied models and more than 9 countries are adopting it. This is followed by "pure" 'Wakalah with and without fee' and Mudharabah. The past few years however, have seen certain countries moving away from the latter model to the hybrid model to take the advantage of receiving the upfront Wakalah fee as incentives for Takaful agents to invite more participants.

8. Conclusion

This paper has recognized the need of insurance protection for us. Since the conventional insurance is prohibited in Islam, takaful should be an alternative solution. This is a conceptual paper to open the eyes of the people to understand why there is a need for takaful and its benefits for the people regardless of any religion. Furthermore, the types of takaful and available models which could be adopted by the existing and potential takaful operators are elaborated.

References

Bank Negara Malaysia (2010) Shariah Resolutions in Islamic Finance 2nd Edition

Farooq, S. U., Chaudhry, T. S., Alam, F., & Ahmad, G. (2010). An Analytical Study of the Potential of Takaful Companies. European Journal of Economics, Finance and Administrative Sciences.

Fisher, O. C., & Taylor, D. (2000). Prospects for the Evolution of Takaful in the 21st Century. Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University, pp.237-254.

Mehr (1986). Fundamentals of Insurance, Illinois: Richard D. Irwin Inc.

KFH GIFF 2012 report about Global Takaful Industry

Mohd Ma'sum Billah (2004). "Different models of takaful in global sound market",

Mohammed Obaidullah. (n.d.) Islamic Financial Services, Islamic Economics Research Center King Abdulaziz University Jeddah, Saudi Arabia.

Omer, A. S. M. (2011). Issues and Challenges Faced by Takaful Industry in Dual System, INCEIF

Sohail Jaffer. (2007). Islamic Insurance: Trends, Opportunities and the Future of Takaful. Euro money Institutional Investment Plc.

Usmani, Muhammad Imran (2007),Takaful, SECP Takaful Conference

Yon Bahiah. (n.d.). Takaful – An Option to Conventional Insurance: A Malaysian Model.