Islamic Insurance: An Alternative to Conventional Insurance

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Abstract

The significance and importance of Takaful in The Islamic Finance has captured the Attention of Muslim communities in today's world. A prevailing misperception about Takaful is that it is simply the Islamic version of traditional insurance, and thus is confined to those of the religion. The truth is, not only is Takaful open to anyone regardless of religion or creed, it is a financial management tool that differs in certain aspects from traditional insurance. Takaful can lead to better financial security and peace of mind knowing that you would be part of a risk management system that firmly upholds principles. 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 and solidarity which eliminates non-shari'a compliance such as interest.

Keywords: Insurance; Takaful; Islamic Finance; Riba; Interest Paper

Type: Theoretical

Introduction

The life styles and business transactions that people interact with nowadays, mandates having insurance as a common practice in everyday affairs. However, the involvement of prohibited elements in insurance makes the Muslim scholars think to introduce takaful as an alternative to insurance.

Both Takaful and conventional insurance policies work on the same basic system, which is the pooling of funds to manage the risk of a group of people. Having said that, there are major differences in the workings of the two systems, stemming from the fact that Takaful adheres strictly to the Islamic principles it was developed upon.

The objective of this paper is to explore and highlight that takaful can be an alternative to insurance and how takaful can bring benefits for the betterment of the society. This paper discusses differences between Takaful and conventional policies and what that means when reflected in societies. In addition, some Takaful concepts and models are explained.

Problem with conventional insurance

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). It is a form of risk management primarily used to guard 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 almaidah 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.}

While the conventional investment units of insurance invest based on their assessment of what fits their profiles, Takaful investments follow strict principles. They cannot invest in anything containing elements of gambling, uncertainty and usury (practice of lending money at unreasonably high interest rates). This is regulated by Shariah requirements specified by the regulator. Muslim scholars have declared it as haram (prohibited). In conventional insurance and as policyholders, the following prohibited elements are evident in a policy:

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 alfadl (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 is 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.

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. 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.

Legality and evolution of Takaful

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 while the waqf model was developed in south africa in 1996.

Distinguishing features of Takaful

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 standards3: 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.

Types of Takaful Contract

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 investment components.

General Takaful is provided to give protection to participant for losses arising from perils such as accident, fire, flood, liability and burglary. For instance, insuring your house and belongings against fire or vehicles against accidental damage or theft. You will also be covered on your liabilities to others. When you participate in the General Takaful plan you will be covered when something happens to the items that are being covered. For instance, if you participate in General Takaful for your house and it was damaged in a storm, your Takaful protection will cover the cost of repairing your house but as long as you are up to date on your Takaful certificate.

Family takaful: provides a protection and long-term savings. You or your beneficiary will be provided with financial benefits if you suffer a tragedy. At the same time, you will enjoy a long term personal savings because part of your contribution will be deposited in an account for the purpose of savings. You will be able to enjoy investment returns from the savings portion based on a pre-agreed ratio.

Takaful concept in family takaful: When you participate in family takaful, you will contribute a certain amount of money to a takaful fund. You will undertake a contract (aqad) for part of your contribution to be in the form of participative contribution (tabarru') and the other part for savings and investment. Your contribution in the form of tabarru' will be placed in a fund (Participants' Special Account or PSA) that will be used to fulfil your obligation of mutual help, should any of the participants face a misfortune arising from death or permanent disability. If you survive until the date of maturity of the plan, you will be entitled to share the net surplus from the fund, if any. The takaful operator will invest your savings and investment contribution (Participant's Account or PA) and the profit will be shared between you and the takaful operator according to a pre-agreed ratio.

Islamic Insurance 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.

Mudharabah

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).

Wakalah

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).

Hybrid of wakalah-waqaf

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.

Conclusion

This paper explored the dire need of insurance protection for the vast majority members of all societies. Due the limited options of permissible insurance in the market, Takaful should be an alternative solution to conventional insurance. However, this paper is just a conceptual paper to only pave the way to understand why there is a dire need of Takaful and the benefits it offers people at large regardless of their faith and religion.

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