Islamic Insurance: An Alternative to Conventional Insurance

Muamar Dahnoun

Al-Huda University
1902 Baker Rd, Houston, TX 77094

Abstract

The significance and importance of Takaful in Islamic Finance has captured the attention of contemporary Muslim communities. A prevailing misperception about Takaful is that it is simply the Islamic version of traditional insurance, and thus is confined to a religious paradigm. Takaful is a financial management tool that differs in certain aspects from traditional insurance. Therefore, Takaful is potentially useful to anyone regardless of religion or creed. Takaful, can be seen as an alternative to conventional insurance due to its cooperative principles. These are foundational Islamic principles that are based on the concept of brotherhood and solidarity; thereby eliminating non-Shari'a compliance such as interest.

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Type: Theoretical

Mentor: Dr. Basil Al-Qudwa

Introduction

From buying a home to operating a business, twenty-first century society mandates procuring insurance. However, there are prohibited elements in insurance that create the need to introduce an alternative to Western insurance products. Muslim scholars advocate Takaful as the best substitute.

Both Takaful and conventional insurance policies work on the same basic system; the pooling of funds to manage the risk of a group of people. However, there are major differences between the two systems. The most obvious is that Takaful adheres strictly to the Islamic principles upon which it was developed.

The objective of this paper is to explore and highlight how Takaful can be an alternative to insurance; thereby benefitting society. This paper discusses differences between Takaful and conventional insurance policies. Additionally, Takaful concepts and models are explained.

The concept of insurance predates the founding of the United States. In fact, insurance can be traced back to 1667, the year after the *Great Fire of London*. 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). Basically, insurance is a form of risk management primarily used to guard against the risk of uncertain loss.

According to Usmani (2007), there are two aspects to conventional insurance: conceptual and practical. The conceptual aspect, 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 an assessment of what fits their profiles, Takaful investments follow strict principles. Prohibited Takaful investments include 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 haram (prohibited). Conversely, in conventional insurance policies, the following prohibited elements can be found:

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 that was 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. In other words, the client agrees to pay a certain premium but until the actual catastrophe occurs will not know how much compensation he will be paid.

Maysir: Essentially, 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 obtain much from paying premiums if the event does not come to pass. 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; 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 personal loss, but it also includes cooperating with other participants and contributing to help those in need. Thus, Takaful ta'awuni or Islamic cooperative insurance is 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

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.) 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 in 1965. Subsequently, a universal consensus was reached at the First International Conference on Islamic Economics in 1976. Conventional insurance for profit was deemed as contradicting Shariah. Conversely, Muslim jurists resolved that insurance in Islam is based on the principles of mutuality and cooperation was thus not merely acceptable but necessary.

The evolution of Takaful can be divided in four main phases (Billah, 2004); The first Ta'awuni model (cooperative) was developed in Sudan in 1979. Several years later the Mudharabah model was developed in Malaysia in 1984. Also, in 1984, the Wakalah model was established in the Gulf. Then, in 1996, the Waqf model was developed in South Africa.

Distinguishing features of Takaful

One-way that 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 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 with Shariah.

Other features that distinguish Takaful from conventional insurance include the existence of a Shariah supervisory board and the separation of two funds: 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 accordance with Shariah compliance.

According to Omer (2011), Shariah and regulatory framework for Takaful include three levels of supervision and regulation: local jurisdiction, Islamic Financial Services Board (IFSB) 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 states such as the United Kingdom (UK) simply adopted a general 'level-playing field' approach. This means that the UK allows Takaful as long as it can be established under the existing legal and regulatory framework without further assistance or discrimination.

In November of 2009, the IFSB issued the 'Guiding Principles on Governance for Takaful Undertakings.' Essentially this standard focuses on governance and prudential issues. Subsequently, the board issued 'IFSB standard 11. These particular standard addresses solvency requirements for Takaful (Islamic insurance) undertakings' especially the question of capital adequacy.

Based on the paper '*A New Framework for Insurance Supervision'* released in 2005, the core principles of the IAIS framework provides three aspects of responsibilities; effective insurance supervision, regulatory requirements and supervisory actions

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. Funds are later invested and any profits produced are returned to the fund. Therefore, this type of Takaful, savings and investment components are not generated.

Generally, Takaful gives protection to participants for losses arising from perils such as accident, fire, flood, liability and burglary. For example, insuring homes and belongings against fire or vehicles against accidental damage or theft. Also covered are liabilities to others. As with conventional insurance when one participates in a General Takaful plan if an accident occurs, the items that are covered are insured. For instance, if a home is damaged during a storm, the Takaful protection will cover the cost of repairing the house as long as the Takaful certificate is up-to-date.

Family Takaful: provides protection and long-term savings. Somewhat analogous to disability or life insurance, the beneficiary will be provided with financial benefits if the insured suffers a tragedy. At the same time, there is a long-term personal savings component as part of the contribution is deposited in an account for the purpose of savings. The insured is able to enjoy investment returns from the savings portion based on a pre-agreed ratio.

When participating in Family Takaful, a certain amount of money is contributed to a Takaful Fund. Aqad- a contract, delineates the amount of the contribution to (Tabarru') for savings and investment. The Tabarru is placed in a fund (Participants' Special Account or PSA) that will be used to fulfil the obligation of mutual help, should any of the participants face a misfortune arising from death or permanent disability. If the participant survives until the date of maturity of the plan, then the partcipant is entitled to share the net surplus from the fund, if any. During the lifetime of the Family Takaful, the operator invests savings and investment contributions into the Participant's Account or PA. The profit will be shared between the participant and the Takaful operator according to a pre-agreed ratio.

Islamic Insurance Market

There are many Islamic insurance 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 gradually becoming more popular. This particular Takaful model is based on the contract of an agency, whereby the 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. In other words, 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.

The Wakalah-Mudharabah 'hybrid model' remains one of the most widely applied models. More than nine countries have adopted this model. The "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 various types of Takaful insurance protection and compared it to conventional insurance. Due the limited options of Shariah permissible insurance coverage in the Western markets, Takaful should be viewed as an alternative solution to conventional insurance. This paper is just a conceptual introductory paper to pave the way to understand Takaful and the benefits it offers to all members of society regardless of their religion or culture.

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