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Review

Takaful: An Islamic insurance instrument

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The *Takaful* concept evolved from individual common interest during the industrial era of the early 1900's. Only eighty million of the world's 2.5 billion poor are currently covered by some form of micro-insurance. Only 3% of the poor in India and China are insured, and only 0.3% of the poor in Africa are insured. In 23 of the 100 poorest countries in the world, there is currently no identified micro-insurance activity. The majority of the population is in the low-income bracket. On top of that, society's awareness regarding the importance of insurance is rather low. In this paper, it will be stressed that efforts still need to be directed towards educating the public on Islamic insurance to appreciate the protection aspects that insurance can offer. Conventional insurance involves the elements of uncertainty, gambling, and interest, all of which are unacceptable under Islamic law. There existed anxiety among Muslims regarding the inconsistency of conventional banking and insurance in compliance with Islamic laws. This allowed the creation of a new industry, *takaful*, which offered risk protection and savings products to the world's 1.6 billion Muslims. One of the greatest challenges facing the *takaful* industry is the misconception that it is exclusively for Muslims. *Takaful* products have attracted even non-Muslim communities, despite the obvious religious and cultural differences. Nonetheless, the interest shown by non-Muslims and the support of Muslims is not enough to promote the awareness and the growth of *takaful* and what it has to offer. It is this lack of awareness that presents one of the greatest challenges to the development and growth of the national and global industry.

Key words: Takaful, insurance, kafal, conventional insurance, gambling, interest.

INTRODUCTION

The article aims to stress the preference for *takaful* above conventional insurance. The conventional model of insurance will be discussed first, followed by the *takaful* model. After the discussion of these two models of insurance, the article includes an evaluation or comparison between them. This will enable the reader to make a sound choice between these two forms of insurance.

The fact that *takaful* insurance is available to both Muslims and non-Muslims is of paramount importance. Takaful has an explicit ethical structure which can be marketed to both Muslims and non-Muslims.

The economic recession is fast becoming a worldwide economic catastrophe. This economic crisis is the worst ever since the Great Depression in the United States in 1930. This crisis creates fresh opportunities for the insurance industry. Amidst the impending global economic crisis, *takaful* is set to continue concentrating on upward business growth. Although facing economic crisis, the low market penetration in the *Shari'ah* insurance opportunity creates an attractive opportunity for the insurance players to continue to grow and prosper (Ahmad, 2009).

In Islam, the basic principle of investment is that reward must be accompanied by risk. *Takaful* businesses cannot therefore invest in products which are debt-based, have a guaranteed or minimum return on the investment, or are based on *haram* practices (casinos and gambling companies) (Anwar, 2008). *Takaful* is the Islamic answer to the modern concept of insurance. In Islam, insurance is free from gambling and interest (Saleh, 1986).

Under the *takaful* model, the ethical nature of this

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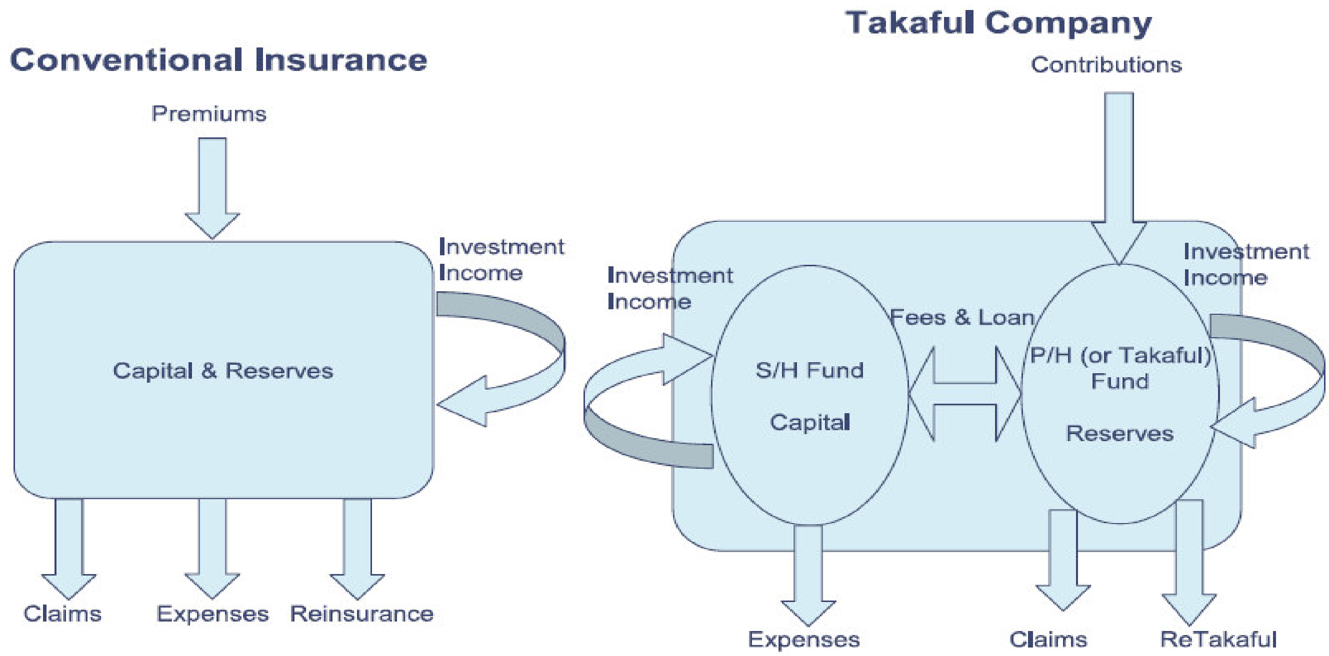

Figure 1. Khan (2008, p. 7) graphical illustration of the difference between takaful and the conventional western model.

instrument is prevalent, while the conventional form of insurance lacks this characteristic. This ethical nature of *takaful* triggers the hegemony of *takaful* as an Islamic instrument to be discussed in depth. Takaful, however, is not to be confined to Muslims only. There is a need for *takaful* globally. The ethical structure of *takaful* serves as an offshoot of the principles of fairness and the sharing of each other's burden. This will extend protection to the less fortunate members of the community.

CONVENTIONAL INSURANCE

Conventional insurance can be defined as an agreement whereby an insurer undertakes (in return for the agreed premium) to pay a policyholder an amount of money (or its equivalent) on the occurrence of a specified event. The specified event must have some element of uncertainty about it. The uncertainty may either lie in the fact that although the event is bound to happen in the ordinary course of nature, the timing of its occurrence is uncertain; or the fact that the occurrence of the event depends upon accidental causes, and the event, therefore, may never happen at all (Anwar, 2008). Modern conventional insurance contracts are unacceptable to Islam. Life insurance involves the use of certain elements that directly contradict the rules of *Shari'ah*. They are: *al-maisir*-this is also known as gambling; *gharar*-also known as uncertainty; and *riba*-known as "interest", and can be defined as making money on money. Most conventional insurers invest in interest-bearing assets. *Takaful* is restricted to an interest-free system. A *takaful* entity must ensure that both its policyholder and shareholder funds are invested in assets which do not have *riba* and that any bank with which the *takaful* entity has dealings should not be involved in the practice of *riba* (Anwar, 2008).

Kahn describes the difference between *takaful* and the conventional Western model of insurance graphically as shown in Figure 1. In Figure 1, Khan (2008) describes the difference between takaful and the conventional western model graphically.

The fundamental principle of the Islamic economic system is an equitable distribution of wealth. *Takaful* is a system where people are encouraged to contribute money for mutual help in times of need. The Islamic economic system combats the accumulation of wealth and its concentration in the hands of a small minority. The Islamic law of inheritance provides for the shifting and distribution of wealth. It divides the estate of the deceased over a wide range of beneficiaries, without benefiting a single heir to the exclusion of all others. The nominee in a family *takaful* scheme is only a trustee and the policy money needs to be distributed to all the heirs (Ali, 1954).

With the *takaful* scheme, financial responsibilities are shared to assist each other. It provides mutual financial aid and assistance to those who are members of the *takaful* scheme. It has its origin in the concept of collective sharing of an individual's loss.

Takaful is being practiced now as an alternative to the conventional insurance system. This is an Islamic way of mutual assistance to deal with uncertainties of life.

it from conventional insurance. If one were to adulterate this spirit underpinning takaful and treat it as a pure become meaningless. The elements of philanthropy and benevolence should be reflected in *takaful* to differentiate pure regulated and standardised commercial venture, the *Shari'ah* spirit may be dishonoured (Manjoo, 2007).

There must be cooperative principles in *takaful*, but there need not necessarily be Islamic principles in conventional mutual or cooperative insurance (Stagg-Macey, 2007).

For any legal system to survive, especially in an era of globalisation and universalism, one should allow *takaful* to evolve. This proves the versatility of Islamic law.

ORIGIN OF *TAKAFUL*

The concept of *takaful,* or Islamic insurance, has been familiar for centuries and was practiced by the Muhajirin of Mecca (http://en.wikipedia.org/wiki/Muhajirun) and the Ansar of Medina (http://en.wikipedia.org/wiki/Ansar), following the Hijra of the Prophet Muhammad over 1400 years ago (Anwar, 2008).

Takaful derived from the *'aqilah* and *diyah* systems, whereby people of a given tribe would come to the financial rescue of one of its members should he face an unexpected liability, such as paying for blood money (*diyah*) (Manjoo, 2007).

MEANING OF *TAKAFUL*

Takaful is an Arabic word stemming from the verb "*kafal*", which means to take care of one another's needs or "guaranteeing each other" (Stagg-Macey, 2007). According to this scheme, the members or participants in a group jointly agree to guarantee themselves against loss or damage. The entire group would assist the incumbent person to indemnify his loss and to provide him with financial help. *Takaful* is a legally binding agreement between all the participants of the scheme to pay any of its members who suffer a loss as specified in the *takaful* policy document. According to Catherine it is an Islamic system of mutual insurance built around the concept of donation (Stagg-Macey, 2007). The *takaful* scheme has evolved from the teachings of Islam, on the basis of the *Qur'an* and the *Sunnah*. The Holy *Qur'an* says:

"Help ye one another in righteousness and piety, but help ye not one another in sin and rancour (Ali, 1954, 2008) (Holy Qur'an)".

Takaful literally means "mutual guarantee" or "guaranteeing each other" (Anwar, 2008). Under *takaful*, resources are pooled to pay for events/losses that individually none of the members of the pool could afford. For example, a group of people collectively use their combined money to pay for events and large expenses such as births or marriages, or if a financial loss occurs to a member of the group. It is a form of mutual insurance and is not dissimilar to the mutual cooperative schemes that exist in Europe and the United States (Anwar, 2008).

Takaful is based on the concept of mutual cooperation, where the insured is also the insurer and therefore shares in the profit or loss of the institution to which they are paying (the contribution) (Anwar, 2008). *Takaful* exists primarily to spread a risk and to alleviate a financial loss suffered by somebody. Unfortunately, in our contemporary commercial ethos this benevolence has

EVOLVEMENT OR DEVELOPMENT OF *TAKAFUL*

In modern-day contexts, the first *takaful* company - the Islamic Insurance Company of Sudan - was founded in Sudan by the Faisal Islamic Bank in January, 1979 (Anwar, 2008). The Bank's *Shari'ah* Supervisory Board approved this endeavour, and in January 1979, the Islamic Insurance Company was established as a public company (under the *Companies Act,* 1925). In Malaysia, the Islamic Insurance Company was established as a private limited company. The Malaysian government took steps to form a special body known as a "Task Force" on the establishment of Islamic insurance in Malaysia. In its report to the government, the task force suggested that an Islamic insurance company should be established in Malaysia. The Malaysian government then promulgated legislation known as the *Takaful Act,* 1984, which regulates the Islamic insurance (*takaful*) of Malaysia (Ali, 2008).

In 1985, the Council of Islamic Scholars in Mecca approved *takaful* as a *Shari'ah*-approved alternative to the conventional insurance system. This led to mutual *takaful* companies being established in different Muslim countries, including Dubai, Bahrain, and Malaysia (Anwar, 2008).

In the Middle East, *takaful* has developed in Saudi Arabia, Bahrain, Iran, and Qatar, with new operations recently opening in Egypt, the United Arab Emirates, and Kuwait. Steps have also been taken in Europe and the US to establish similar companies. There are no doubt that there are tremendous opportunities for *takaful* in those Western countries harbouring large Muslim communities. As such, the potential for *takaful* is enormous.

Currently, Malaysia has the most mature *takaful* businesses operating alongside conventional banking and insurers (Anwar, 2008).

Modus operandi of *takaful*

Contributions are made into the risk pool. From this pool, direct and indirect expenses and claims are paid. If there is a surplus, it is shared amongst the participants. Deficits are also made up with additional contributions from participants or with an interest-free loan from the operator.

Takaful generally means joint guarantee. It is an understanding among a group of people who agree to reciprocally guarantee each other financially should any event occur. The basic objective of a *takaful* contract is to pay from a common fund, which is set up by the participants of the scheme (Ali 2008).

The operation of *takaful* practices is supervised by an independent body called the *Shari'ah* Supervisory Board or Council. The establishment of a *Shari'ah* Supervisory Board is a prerequisite for the commencement of the *takaful* operation (Ali 2008).

Takaful has emerged as a profit-sharing business venture between the Operator and the individual members of a group of participants who desire to reciprocally guarantee each other against certain loss or damage that may be inflicted. *Takaful* contracts are based on the principles of *mudarabah* (limited partnerships), which means profit and loss sharing. Any surplus or deficit of the *takaful* operation has to be shared by the participants, or the members themselves. It means that when a *takaful* scheme is operated on a commercial basis, the surplus has to be shared between the operator and the participants in accordance with the principles of *mudarabah*. The concept of *tabarru* (donation) is also incorporated in a *takaful* life scheme. This means a participant will agree to relinquish a certain amount of *takaful* contributions to fulfil his obligation of mutual help and joint guarantee, should any of the fellow participants suffer a loss. (Ali 2008).

Advantages of *takaful*

Under *takaful* the up-front costs are minimized. Business can be transacted immediately. In this way, risk is capped and costs become predictable, whereas under the conventional system, the operator has to invest in software licences, hardware, and expensive IT skills. He may have to wait and hope for a number of years while the system is prepared for use. Additional advantages of *takaful* are the transparent charging of fees and commissions and how these features would assist a *Shari'ah* Board to decide if a *takaful* scheme is really operating in a fair, *Shari'ah*-compliant way in handling deductions from its participants' contributions. The ability to hold a separate *tabarru* fund for each class or sub-class of business and the inherent ability to manage risk in real time is regarded as a big advantage (Ferguson, 2008).

The principles of fairness and sharing each other's burden will undoubtedly extend protection to the less fortunate members of the community. In the *takaful* model, surpluses can be use for *zakat* and funds can be channelled into projects which are for the common good, such as a new school or hospital. Based on the principles of fairness, transparency, simplicity and sharing the burden, *takaful* appeals to the very greatness of the Human Spirit (Ferguson, 2008). On the basis of this ethical dimension, *takaful* will succeed, because it is bound to succeed (Ferguson, 2008). The *takaful* business has an explicit ethical structure which can be marketed to both Muslims and non-Muslims. The dramatic rise in the demand for *takaful* insurance can be attributed to this ethical nature of the product.

Takaful practices are free from the elements of *riba* and other prohibited elements and are evolved around the elements of *mudarabah*, *tabarru,* and other *Shari'ah*-justified elements. Conventional insurance may involve *riba* and some other elements which may not be justified by *Shari'ah* principles (Anwar, 2008). Although both conventional and *takaful* businesses generate profits for the shareholders, in *takaful* business the expenses paid to the shareholders are explicitly transparent - in conventional insurance this is not necessarily the case (Anwar, 2008).

Uses of *takaful*

Typical uses of *takaful* are insuring property, vehicles, goods, valuables, health, accidents and life (Divanna, 2009). *Takaful* insurance is offered for a wide range of business and personal activities, such as engineering/construction, motor vehicle, property, marine general accident, liability, personal (mortgage, acci-care, credit shield, critical care and comprehensive care), and medical (Divanna, 2009).

Hitches/bottlenecks in *takaful* operations

Takaful products reveal themselves in emerging markets, and as such, they face challenges such as immature banking infrastructure and poor communications infrastructure. On top of this, there is little infrastructure for the new business. Many of the challenges facing *takaful* operators are strategic as this formative market tries to establish itself. Skills and resources can be borrowed from conventional insurance markets (Stagg-Macey, 2007).

As *takaful* originates from an Islamic concept, one of the greatest challenges facing the *takaful* industry is the misconception that it is exclusively for Muslims (Divanna, 2009). For example, in multi-racial Malaysia, *takaful* products have attracted even the non-Muslim communities, despite the obvious religious and cultural differences. Nonetheless, the interest shown by non-Muslims and the support of Muslims is not enough to promote the awareness and the growth of *takaful* and what it has to offer. It is this lack of awareness that presents one of the greatest challenges to the development and growth of the national and global industry (Ahmad, 2007).

Another stumbling block that has to be overcome is that the financial strength, stability, and standards of conventional insurers are established and known. These conventional insurers have been in the industry for many years and their service levels are more obvious than those of *takaful* operators. To overcome this problem a wider range of *takaful* products must be offered as an alternative to those offered in the conventional market. The needs of the lower income groups must also be addressed. Micro-*takaful*, a concept of providing affordable cover to the poor, comes to mind (Ahmad, 2007).

End purpose of *takaful*

Modern *takaful* practice is similar to insurance in practice whereby the contribution amount is calculated and is fixed for a standard normal person at a certain age for a certain amount of benefit. Through participation in *takaful* schemes, participants are given the chance to assist one another. The *takaful* operator is required to accumulate as much *tabarru* funds as possible to help those in need (Daud, 2009).

When somebody enters into a *takaful* scheme, he is not supposed to have any intention of making money. His intention should be to share his wealth *via* contributing money or giving his money as *tabarru* towards a fund that is used to help somebody else who requires assistance. He should look beyond worldly rewards in the knowledge that when his time comes to face death, the *takaful* operator who manages the fund shall also ease the burden of his family in the same way as he acted towards others in similar circumstances. The goal is to please God and achieve prosperity in this life and the hereafter (Daud, 2009).

Conventional insurers make use of uncertainty and interest in their business practice. *Takaful* is viewed by Islamic scholars as the acceptable alternative - being guided by *Shari'ah* principles. The social relationships between the scheme members are also significant. Islam promotes cooperation and sharing (Willis, 2007).

ISLAMIC BANKING AND ISLAMIC INSURANCE

Insurance in modern trade and commerce provides safety for the people as security against accidents and calamities. Likewise, modern trade and commerce cannot be conceived without involvement of insurance and banking. The conventional systems of insurance and banking, which are based on interest, cannot be adopted by Muslims as a *Shari'ah*-compatible system. There is an intrinsic relationship between Islamic banking and Islamic insurance. The progress of Islamic insurance depends on a healthy growth of Islamic banking.

Islamic banks have already attained considerable success in the banking sector. It is only the beginning of *takaful* and it is likely to flourish in the insurance sector. To attain the desired level by both the Islamic bank and Islamic insurance, a strong relationship needs to be built up between the Islamic bank and Islamic insurance throughout the world (Ali, 11).

Banking and insurance without interest is feasible, viable, competitive, and sustainable in the face of competition from the conventional interest-based system.

The current century is going to be the century of Islamic banking and insurance for the benefit of the people at large, coupled with equity and justice for all. *Takaful*, like Islamic banking, has become a viable reality. *Takaful* is a financially viable and competitive alternative insurance for Muslim countries. Islamic banking cannot be fully *Shari'ah*-based unless there are *takafuls* to take their insurance business (Ali, 12).

Customers now have the choice between typical as well as Islamic insurance products. Similarity of functions between the insurance and *takaful* products cannot be denied and should be expected, given that the concept of mutually helping each other, which is found in insurance, is also a concept applauded by Islam. However, from the conceptual and operational perspective, many differences were noted between *takaful* and insurance, due mainly to elements found in an insurance contract which are prohibited in any Islamic transactions, such as interest (*riba*), uncertainty (*gharar*), and gaming (*maysir*). Hence, *takaful* products are designed to function as any typical insurance product, but operated differently, to avoid the prohibitive elements.

TAKAFUL AND THE GLOBAL MARKET

Takaful is the fastest-growing area of the world insurance market. It is growing at 20 to 25% *per annum*, compared to the world average growth of conventional insurance at 5 to 5% *per annum*. The validity of this growth was made possible in the demand and the prospects of potential rewards both for the customers and entrepreneurs of Islamic insurance. In a market place, the attraction of *takaful* business may be ascribed to its connection with the Islamic *Shari'ah* as well as its being a better and more just system. This aspect should be attractive to everyone, irrespective of any religious basis upon which the system stands. *Takaful* business has an explicit ethical structure which can be marketed to both Muslims and non-Muslims. The dramatic rise in the demand for *takaful* insurance is due to this ethical nature of the product. It bears stressing once more, as has been done repeatedly throughout these pages, that on the basis of its ethical foundation, *takaful* ought to be attractive to both Muslims and non-Muslims. The *takaful* industry is, however, small in comparison to its conventional insurance counterpart. This market, therefore, needs to gain worldwide brand recognition. This is what this paper aims to do.

The main difference between *takaful* and conventional insurance

The customers (policyholders) of the *takaful* business agree to pool their contributions and share the liability of each policyholder. So if one policyholder has to pay a claim, it is paid out of the combined pool of the policyholder's contributions. This eliminates the principle of *gharar* (uncertainty) which is not allowed within Islam (Anwar, 2008).

As with mutual insurance, the policyholders share in the profit and loss of the *takaful* business - that is, the policyholders all share the insurance risk. They do not give the risk to the *takaful* company (as it occurs in a conventional shareholder insurance company). Consequently, if at the end of a financial year, the *takaful* business makes a surplus, this is shared between the *takaful* policyholders (Anwar, 2008).

The assets of the *takaful* business have to be invested in *Shari'ah*-compliant assets. For example, investments cannot be made in gambling institutions, businesses that make alcohol, businesses that sell weapons or assets that pay interest (*riba)* (Anwar, 2008).

The operators of the business are paid explicit fees for setting up and running the company on behalf of the policyholder. These fees should cover all the setting up costs, running costs and profit-loading of the shareholders, and are the only way that the shareholders are remunerated. After the fees are deducted, any surplus arising from the *takaful* business is shared amongst the policyholders only. These explicit fees are in the *takaful* contract, which each policyholder signs with the *takaful* company, and are fully transparent (Anwar, 2008).

The structure of *takaful* companies on profit basis is totally different from conventional commercial insurers. The central idea for all Islamic insurance models is the segregation between participants and shareholders' funds as the company role is only to manage participants' funds on their behalf. Any *takaful* company is usually called a "*takaful* operator" instead of an insurer. For the Islamic model, contributions (premiums) should be paid on donation (*tabarru*) in order to remove the element of *gharar* from the *takaful* contract. These two principles are considered essential elements from the *Shari'ah* point of view, and all Islamic models have to comply with these principles (Tolefat, 2006).

Takaful practices are free from the elements of *riba* and other prohibited elements and are evolved around the elements of *mudarabah*, *tabarru,* and other *Shariah*-justified elements. Conventional insurance may involve *riba* and some other elements, which may not be justified by *Shari'ah* principles. In *Takafu*l, the paid premium is treated as both donation (*tabarru'*) and saving (*mudarabah*). In the conventional system, the paid premiums create an obligation against the insurer on a sale and purchase relation. The underwriting profit in *Takaful* is distributed to the policyholders. The shareholders' profit is generated from the return in the investments of the shareholder capital and expenses paid to the shareholder by the policyholders for (i) managing the company on behalf of the policyholders, and (ii) managing the policyholders' investment funds on behalf of the policyholders. In the conventional scheme, the policyholders do not get any share of the underwriting profit (except in mutual companies); shareholders' profit is generated from the company's underwriting profit plus any investment returns. Under *takaful*, the policyholder's funds belong to the policyholders on collective basis and are managed by the shareholders. Under the conventional scheme, all funds belong to the company, though separation of assets may be maintained between shareholders and policyholders for specific insurances (for example, with profits) (Anwar, 2008).

CONCLUSION

One of the greatest challenges - the misconception that *takaful* is for Muslims only - has been settled in this paper. Due to its explicit ethical structure, *takaful* can be marketed for both Muslims and non-Muslims. In multi-racial Malaysia, for example, *takaful* products have attracted even the non-Muslim communities. The belief that *takaful* is only for Muslims has hopefully been refuted. This is, however, not enough to cultivate a culture of awareness for *takaful* products. Although *takaful* products are faced with challenges such as immature banking infrastructure, awareness can be cultivated by offering a wider range of *takaful* products as an alternative to those offered in the conventional market. The strength of *takaful* products to announce their awareness lies in its ethical structure. The ethical structure of *takaful* serves as an offshoot of the principles of fairness and the sharing of each other's burden. This will extend protection to the less fortunate members of the community. On the basis of this common humanity, *takaful* products stand a chance to be accepted by both Muslims and non-Muslims, despite the obvious religious and cultural differences. It seems probable that *takaful* companies will attract new clients from the existing conventional insurance franchises. Takaful is being practiced now as an alternative to the conventional insurance system.

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