

# The growth of the takaful industry economics essay



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Takaful is derived from an Arabic word “ Kafala” which means mutual guarantee, whereby a group of participants agree to mutually guarantee among themselves against a defined loss. This simple concept of takaful is the foundation of the takaful business, which is the present Shari’ah-compliant insurance

Takaful is “ 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”

The contemporary jurists acknowledge that the foundation of Takaful was laid down in the system of “ Aaqilah”, which was an arrangement of mutual help or indemnification customary in some tribes at the time of the Prophet (peace be upon him). Takaful provides solidarity in respect of any tragedy in human life and loss to the business or property.

The elements present in the conventional insurance viz; Gharar (uncertainty), Riba (interest) and Maisir (gambling) are against the tenets of Islam. Muslim Scholars do not object to insurance per se but only to certain weaknesses in the insurance contract (which weaknesses render the insurance contracts fasid). It is for this reason, 1972 Fatwa by National Council for Islamic Religious Affairs of Malaysia that life insurance is not lawful as it contains gharar, Maisir and riba.

Hence, takaful tries to remove all these facets present in the conventional insurance and works within the guidelines of Shari’ah. The concept of tabarru makes the transaction permissible and valid according to Islamic law. It

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changes the basis of contract from an exchange contract (mu'awadat) which is bilateral in nature, to a charitable contract, which is unilateral.

## **2. 0 Takaful – Industry overview**

Globally, the takaful industry has been growing rapidly, appealing to both Muslims and non-Muslims. Currently, there are more than 110 takaful operators worldwide. As per the Ernst & Young's World Takaful Report 2009, global Takaful contributions have risen to \$3. 4bn in 2007 as compared to \$2. 5bn in 2006 (36% Growth). The new projections for 2012 for Takaful Market are US\$ 7. 7 bn and US\$ 11. 0 bn by 2015. Saudi Arabia was the biggest market in the Gulf Cooperation Council (GCC), with contributions totaling USD 1. 7 bn in 2007, and Malaysia the largest takaful market in Southeast Asia with contributions of USD 800 mn.

Malaysia has achieved significant milestones in the development of its takaful industry. With the enactment of the Takaful Act 1984, the first takaful company was established in 1985. Since then, the industry has been gaining momentum and increasingly recognized as a significant contributor to Malaysia's overall Islamic financial system. There are currently eight takaful operators and two re-takaful operators, with five foreign participations from the UK, Bahrain, Germany and Japan. These takaful operators conduct both domestic and foreign currency business.

## **2. 1 Current Trends and Future prospects**

With the expanding demographics of Islamic countries and that of the Islamic population globally, the prospect of takaful looks promising. The Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) has been

playing a key role in framing and reviewing the regulatory standards governing takaful companies. With improved standards of living and increasing awareness of Takaful, the market is expected to see steady growth in per capita spend on Takaful premiums and also in terms of market share in comparison with conventional insurance.

## **2. 2 Strategic Issues and Challenges**

With projected growth as described above, the industry will experience much change. As with all new product offerings, success will depend on several factors, both internal and external. Highlighted below are a number of strategic issues and challenges that providers will contend with as the industry expands.

### Distribution Challenges

New entrants should create synergies that can be used to leverage existing distribution channels, banc-Takaful and strategic alliances across geographies. This will also enable the operators to increase premium volumes to improve profitability; a key factor in surviving the ' start-up' years.

### Developing Innovative Products

Developing attractive and competitive products that meet diverse customer needs will be a major challenge for Takaful operators. Though Takaful operators cater to a very specific and presently unsatisfied market, they still need to create product offerings that are as sophisticated and innovative as their conventional competitors.

## Improving Marketing and Branding Tactics

The present brand value of Takaful is relatively limited particularly in non-Islamic countries. Analysts have suggested that Takaful has enormous potential for Islamic and non-Islamic populations, offering an ‘ethical’ insurance alternative. Experts also propose that Takaful can potentially be a useful mechanism for poverty alleviation.

## Raising the Standards in Customer Service

As the industry grows and becomes more competitive, building customer service skills and developing best practices will become increasingly important. At present, general customer service standards are average among Takaful providers, relative to their conventional counterparts.

## IT Solutions for Takaful

Issues such as innovative product development, time to market, servicing of policies and claims within acceptable time lines, accuracy of calculations, cost containment, and improvement in service standards can all be facilitated by the implementation of robust and flexible IT solutions. Takaful compliant IT solutions serve an important purpose from a regulatory compliance standpoint and can help operators avoid susceptibility to unfavourable regulatory decisions and the possibility of increased regulatory compliance costs.

### **3.0 Takaful – Models**

A takaful model depicts the relationship between the company and the participants. Based on the nature of relationship between the company and <https://assignbuster.com/the-growth-of-the-takaful-industry-economics-essay/>

the participants, there are various models like Wakalah (agency) Model, Mudarabah Model and the combination of agency and Mudarabah models.

In Mudarabah model that is practiced mainly in the Asia Pacific region, the policyholders get profit on their part of funds only if Takaful Company earns profit. The sharing basis is determined in advance and is a function of the developmental stage and earnings of the Company.

In Wakalahmodel, the surplus of policyholders' funds investments – net of the management fee or expenses – goes to the policyholders. The shareholders charge Wakalah fee from contributions that covers most of the expenses. In order to give incentive for good governance, management fee is related to the level of performance.

#### **4. 0 Takaful – Categories**

##### **4. 1 General takaful**

The general takaful provides protection on a short-term basis, normally covering a period of one year. It commonly provides protection for property loss or damage, liability arising from damage. In general Takaful, the company raises a fund, which called as ' tabarru'fund or account, where the participants pay to the fund. The company will invest the remainder of the fund after deducting the operational cost of the scheme. Any profit or return from the investment will be returned back to the fund. If there is any participant who faced loss or damage to his property or belonging, then the particular participant will be compensated from this fund.

## **4. 2 Family takaful**

The family takaful is a combination of protection and long-term savings, usually covering a period of more than one year. It provides benefits if the insured is inflicted by a tragedy as well as potential profits. Risks covered include premature death, illness and permanent disability, and regular income during retirement.

## **5. 0Shari'ah issues in Takaful:**

As is the case with any industry in its nascent stages, the takaful industry too is facing its own set of teething problems. Whenever we go to conferences (or) read the literature and article related to takaful, the general and the most common allegation (or) complaint is that, " Inconsistency in the interpretations of certain Shari'ah rules or standards is said to be an issue of the Takaful Industry". Some of the commonly discussed Shari'ah issues relating to takaful are: which is the right model to follow?, who are the real owners of the takaful fund?, the methodology and the process to be adopted to share the surplus between the participants, the issue of hibah (gift) in a takaful policy, the issue of insurable interest and whether underwriting in concordant with the principles of maqaasid as-Shari'ah etc.

So, let us analyse these issues in the light of Shari'ah to understand the arguments for and against each of these issues to get a clear idea on the issue. Finally, we will also try to analyze if the issue of inconsistency is as serious as it is being projected and what are the areas which need to be standardized, if at all it is required.

## **6. 0 Issue #1: The dilemma of choosing the right takaful model**

In many of the takaful conferences and literature available, the question that is manifested is regarding the different takaful models existing in the world market. Some people express a desire towards a standardisation of takaful products as this will avoid confusion, facilitate regulation etc. Before we analyze the pros and cons of this thought, let us understand the modus operandi of the mudarabah model. Some people, usually criticize the mudarabah model since the operator too shares the underwriting surplus which should ideally belong to the participant.

### **6. 1 The modus operandi of the mudarabah model**

Generally, many Takaful companies (especially those using the Mudaraba principle) claim that their operations are based on the concept of mutual or co-operative insurance as approved by the Muslim jurists. This claim is on the basis that:

- They receive the premium or contribution from the insured on the basis of the Mudaraba principle, whereby the company becomes the entrepreneur (Mudarib) and the insured party the capital provider (Rab al-Mal).
- The insured party agrees to donate a certain percentage (or in some cases as in General Takaful the whole of the amount paid) of the premium/contribution to a special fund used to pay compensation or benefits to contributors.
- Any surplus left in the fund after settlement of all claims is shared by the company and the insured as profit in a ratio as agreed in the contract. An insured party who has received compensation, the



amount of which is greater than what he could have received as a share of the surplus had he made no claim, is not entitled to share such a surplus. The company uses normal actuarial principles to calculate risk and premium.

## **6. 2The industry practice**

Until recently, the Mudaraba model adopted by Malaysian takaful operators refers to profit as the underwriting surplus, which is the excess of premiums over claims, plus investment returns. This arrangement marks a departure from the original Mudaraba model, which will entitle the takaful operator a ratio in the investment returns, without sharing in the underwriting surplus.

The modified Mudaraba model justified the sharing of the underwriting surplus on the grounds that such an arrangement would allow takaful operators to withstand competition and avoid overpricing, which may eventually sway takaful participants from takaful, and be attracted to conventional insurance, with all its non-Shari'ah compliant elements. This is further justified by the fact that there is nothing haram in sharing the underwriting surplus, in the view of the absence of any textual or general Shari'ah principle disapproving such a practice.

## **6. 3Modes of surplus distribution**

Generally the surplus which is generated after paying all the claims and other expenses is distributed in the following ways.

Pro-rata mode: Whether the surplus is underwriting surplus plus profit or underwriting surplus only, it is distributed in proportion to the premium paid

by the participants, without differentiating between claimable and non-claimable accounts.

Selective mode: This mode tends to indemnify non-claimable accounts only. Takaful operators tend to deprive claimable accounts, so that they become more prudent in the future.

Off-setting mode: This mode tends to offset the rate of underwriting surplus from the amount claimed. This is applicable only on accounts whose underwriting surplus less than the claims. If the underwriting surplus is equal or more than the claims, then the participant does not share in the surplus.

#### **6. 4Do Takaful models need to converge?**

While the positive desire towards a standardisation of takaful products to avoid confusion, facilitate regulation etc, are welcome, the other side of the coin is that takaful is an Islamic phenomenon and should be viewed through the prism of fiqh and socio-cultural context.

We should realise that takaful per se is not a product, and thus should not be equated with insurance. It is described as a system, rather than a product, which aims at the joint-guarantee between the contributors in a risk-covering scheme. We should not lose focus of the source of the inspiration of takaful. It is primarily to spread a risk to alleviate financial burden when it inflicts a person in a spirit of humanism.

Unlike in the past, presently money is contributed in advance. This element of philanthropy should also be reflected in takaful to differentiate it with insurance, which is a pure tug of war between maximising premium to be

paid and minimising the compensation to be paid. If one adulterates the spirit of takaful and treats it as a pure standardised commercial venture then the Shari'ah spirit may be lost.

The different models in fact create a space to reactivate the juristic acumen. For any legal system to survive, especially in an era of globalisation and universalism, one should allow the system to evolve. This evolution is in turn influenced by many external factors such as politics, schools of law, tax implication etc, which differ from country to country. For instance, many multinational banks offer different home financing products in different jurisdictions. May be in one country Ijarah (lease) will best suit everybody while in another country the Murabaha (differed payment). This shows the versatility of Islamic law. The same spirit should prevail for takaful.

One cannot replicate these products on the basis of Islamic law and then try to standardize the Islamic products developed on the premise of conventional products. This should not be the case, a change in mind set is required because Islamic financial products should have its own features ultimately. Standardization is good in a way as it brings in more certainty. However, one should ponder on Imam Malik's attitude towards standardization of Islamic law when Ibn Muqaffa asked the caliph of that time to standardize Islamic law. But he refused on the basis that the jurisprudence developed by other imams also had their proofs from Shari'ah. Hence one cannot accept only Maliki school of law.

In other words Islamic law must preserve its legal elasticity. By standardizing Islamic finance one will lose the legal beauty inherent in Shari'ah. Therefore by accommodating various models different branch of fiqh is revived.

### **7.0 Issue #2: The issue of surplus distribution**

The most critical issue in takaful is the issue of surplus distribution. Being a ta'awuni instrument to provide a mutual guarantee for possible risks, surplus arises as an issue of what to do with it if such risks are dealt with through risk transfer or indemnification. A recorded surplus at the end of the financial year of a particular takaful operator is an issue that invokes both Shari'ah and legal scrutiny.

As far as surplus distribution is concerned, two juristic views have surfaced and dominated the takaful industry in the Middle East and Malaysia. The first one categorically prohibits the sharing of the underwriting surplus between the takaful operator and the participants, but the other view validates the sharing, based on ratios that differ according to the line of products offered. The opponents of sharing the underwriting surplus back their contention by decisions taken by highly acclaimed institutions, such as AAOIFI, whose standard on takaful reads: " The Takaful operator does not share in the (underwriting surplus)".

The AAOIFI Standard on takaful states: " The underwriting surplus and its returns, less expenses, and payment of claims, remain the property (milk) of the policyholders, which is the distributable surplus. This is not applied in commercial insurance, where the premiums become the property of the

(insurance) company, by virtue of contract and acquisition, which would make it revenue and a profit for commercial insurance”

This statement by AAOIFI raises the issue of ownership claimed on the premium paid. On one hand, the participant has donated the premium as *tabarru'*, hence, losing title over it, as prescribed by the rules of *hibah* in the *Shari'ah*, but on the other hand, he still holds claim over it in the form of getting the whole underwriting surplus or a part thereof. Hence, let us analyse the ownership issue element in *hibah* and the extent of its *Shari'ah* compliancy.

There are a number of jurists who emphasized that pure *hibah* leads the *wahib* to relinquish his ownership over the object of *hibah*. Ibn Qudamah asserts that “ *al-hibah tamalik*”- a *hibah* which requires the *wahib* to enable the beneficiary to claim title of the object of *hibah*. Al Imam al- Shirazi points out that “ *Al-hibah tamlik bighayri ' iwadd* “- a *hibah* which enables the beneficiary to own the object of *hibah* without an exchange. In such a case, the juristic implications of *hibah*, as Ibn Nujaym al- Hanafi asserts, will be the transfer of *hibah* to the beneficiary, entitling him to hold title over the object of *hibah* (*thubut al-Milk lil mawhubi lahu*).

Generally speaking, the Shafi'is view *hibah* as transferring the ownership of an asset without exchange during one's lifetime, on a voluntary basis. The other *mazahib* (schools of jurisprudence) refer to the same meaning, with a special emphasis on the element of “ no exchange”, i. e.: *bi ghayri ' lwadd*. This transfer of ownership would be effective, either by way of acquisition (*qabd*) on the part of the beneficiary, which is the view of the Shafi'is and

Hanafis, or by way of ijab and qabul (offer and acceptance),, which is the view of the Malikis. This juristic approach is an evidence that tabarru' requires the relinquishing of ownership over the object of hibah. Since the latter entitles tamlik to the beneficiary, we can rightly say that the mutabarru' (donor) does not hold any legal right or claim over the asset donated. Having said so, the takaful operators are at liberty to stipulate conditions on how the underwriting surplus should be distributed, invoking the doctrine of shurut (conditions) in contracts, as articulated in Islamic jurisprudence. The only shroud of right that the donor may still enjoy to hold title of his hibah is when he donates it in exchange for a counter value, a principle known as "hibah al-thawab"

Contemporary scholars like al-Qurdaghi are of the view that the principle of hibah al-thawab (a gift for on exchange) is a good premise to justify the confinement of surplus to the participants only. It is true that some of the Prophetic hadiths referring to hibah al-thawab have secured some right of ownership to the donors after donation. Abu Hurairah narrated that the Prophet (s. a. w.) said: "The donor holds an exclusive right of ownership over his hibah, provided he is not rewarded for it". This hadith is the only piece evidence attesting to a conditional ownership of the hibah by the wahib, allowing him to retract his hibah if he is not rewarded or satisfied with the reward. However, as clearly understood from the hadith, this evidence only gives conditional retraction of the same gift, not a surplus of it. In the case of Islamic insurance (takaful), this hadith is not applicable to surplus distribution, rather it is about retraction of hibah.

Another hadeeth which is given as an argument for confining the surplus distribution to the participants only is the hadith of Nahd/Nihd. It has been mentioned in Saheeh Al-Bukhari, (Book of Sharikah) that “ Muslims did not see any harm in Nahd”. The latter, as Ibn Hajar explains, is “ The allocation of a fund in proportion to the number of participants (in the fund)”. Although this arrangement was more useful and practical in journeys to provide mutual coverage of expenses, it has been viewed as a mechanism to transfer risks, whether in a journey or otherwise. After citing the same hadith, the appendix of AAOIFI Standard on Takaful provides an explanation to Ibn Hajar’s definition of Nahd. The Standard states that Ibn Hajar’s definition of Nahd refers to the underwriting surplus, which should be redistributed to the participants, so that it could be used in another journey. Revising Ibn Hajar’s view in his Fath al-Bari, it can be hardly understood that Ibn Hajar’s definition and explanation of Nahd does not refer in any way to surplus redistribution to the same participants. The hadith, is thus, completely silent about surplus, opening the doors for ijtiḥad to be exercised, in view of the maqasid al-Shari’ah and general Islamic financial principles.

Another issue raised by those who oppose the sharing of surplus to the takaful operator is that Sharing in the underwriting surplus is a kind of taking peoples’ property unjustly. This contention is held by prominent scholars like Hussein Hamid Hassan and Al-Qurgaghi. The contention seems to go beyond the accepted parameters of justice. Although there could be plausible grounds for such a view, in light of the practices of some takaful operators that seize the lion’s share of the underwriting surplus, there should not be any shred of doubt that, in light of our earlier juristic analysis, sharing the

underwriting surplus is Shari'ah-compliant as long as it falls within the parameters of accepted conditions (shurut), as well as the principle of the rida (satisfaction), featuring such contracts. With the existence of sound regulatory framework that caps the percentage of the distributable surplus, takaful operators will not be in a position to take people's property unjustly.

### **8. 0 Issue #3: Distribution of death benefit in family takaful**

Another Shari'ah issue (or) concern raised is in family takaful on to whom should be the death benefit is paid after the death of the participant. One group of scholars and Takaful operators say that it should be given entirely given to the beneficiary as in the case of conventional insurance and the other group feels that the beneficiary should act as a executor of the deceased and the benefit should be distributed to the legal heirs of the deceased. So, let us analyse the arguments put forth by the two sides in the light of Shari'ah.

### **8. 1 The concept of mal in the light of Takaful benefit**

The Arabic word māl, or property, originates from the root word mawala that literally means to finance. Zuhaylī defines mal literally as being anything a man owns that is in his actual possession and this includes corporeal and usufruct. The classification of māl by Dr. Muhammad Daud Bakar, which is suitable to the modern context, appears to adopt the majority's definition. According to him, māl or property can be classified into three types:

- Tangible assets like landed property, present items and stock including Islamic bonds that are asset-based such as ijārah, musyārah and mudarabah bonds.



- Intangible assets such as copyright and royalty, trade name, trademark etc
- Financial rights (haqq māliyy) such as rights to receive (receivable) that include Islamic bonds, deferred dowry & maintenance, right to damages, the right to takaful compensation, etc.

In the modern application, takaful benefit is also treated as mal (property). According to Sec. 2 Takaful Act 1984, takaful benefit includes any benefit, pecuniary or not which is secured by a takaful certificate, and “ pay” and other expressions.

In family takaful, there are two accounts, namely the Participant Account and the Special Participant Account. The premium is paid into both accounts based on a ratio agreed by the takaful operator and the participant. The Participant Account is considered to be the deposit account of the participant whereas the Special Account is for the sole purpose of making donations. When a participant dies, there is no question regarding the heritability of the money in the Participant Account as it is part of the deceased’s estate. However, the money payable by the takaful operator taken from the Special Participant Account for the death benefit is still questionable.

It is a standard practice in Malaysia that the payment of the money by the takaful operator to the nominee appointed by the deceased participant is subsequently distributed among the participant’s legal heirs in accordance with the farā`id law. The distribution of the proceeds among the legal heirs of the deceased participant has seemingly become standard practice in Malaysia. Section 65(1) of the Malaysian Takaful Act, 1984 stipulates that the

payment of takaful benefits is made to the proper claimant. Section 65(4) explains that the 'proper claimant' is a person who claims to be entitled to the sum in question as executor of the deceased or who claims to be entitled to that sum under the relevant law.

### **8. 2The concept of ownership in Takaful benefit**

Islamic law provides four legitimate means for acquiring absolute ownership[13]:

(i) The contract of exchange such as trading and leasing contracts, and unilateral contracts such as wasiyyah, hibah and waqf, (ii) the replacement, or khalafiyyah, i. e. inheritance, the payment of diyyah and compensation, (iii) the control over permissible things such as fish in the sea and birds in the sky and (iv) The growth and the production of things owned such as eggs, milk, etc.

Takaful benefit falls under the second part of the first category, i. e. unilateral contract (tabarru'at). It could be contended that without the participation of the policyholder, the takaful operator would never pay the money. In other words, it is the contract entered into by the policyholder for family takaful, which generates the benefits. This contention is based on the fact that one's effort becomes a justification for ownership. As a result, the money is divisible among the heirs of the policyholder according to the law of farā`id.

### **8. 3The takaful benefit to sole beneficiary vs. to the legal heirs**

Takaful contracts realize the obligation upon the company to pay. They do not create wealth in the insured's ownership, but rather they create an

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obligation to ease the burden suffered due to the losses of fellow participants. The participant's contribution is his or her donation for the good of others, not for himself. The proceeds payable belong to the fund of the participants, not the takaful operator.

Therefore, even though it is the deceased's effort, the money is more appropriately to be regarded as an obligation upon the takaful tabarru' fund to pay on behalf of other participant as financial assistance to the insured's family in case of death. This is the importance of considering a legal and financial entity for the fund. This monetary obligation is directly based on the agreement or promises of mutual assistance stated in the contract. In other words, the tabarru fund managed by the takaful operator on behalf of the participants agrees to pay the proceeds, and the matter of to whom they are paid should be freely and totally left to the agreement or the stipulation made by the policyholder to the company. This is similar with the condition made by the performer of wakf as he stipulated condition is binding.

The primary objective of takaful is to provide financial assistance to the participant's family. If the payment is payable strictly only to the heirs of the participants or insured, it implies that it is the property of the deceased. If this is so, the money is subject to the fulfilment of certain rights that must be carried out before distribution to the heirs, such as the payment of burial expenses, the deceased's debts. This would mean that the compensation is not being used to ease the burden of the family but rather it seems that other fellow participants are under an obligation to settle the debts of the dead participants. In this regard, the creditors would have prior rights over

the participant's dependants. The dependants would only receive the benefits after the creditors' claims have been satisfied.

As such, inserting a clause legally and strictly imposing a duty on the appointed nominee to distribute the money among the legal heirs of the dead participant seems to contradict the objective of both the takaful. Inserting such a clause as currently practiced in Malaysia is not based on valid arguments. Furthermore, by considering it an estate for inheritance purposes, the takaful and insurance activity becomes a source of income. This is contradictory to the purpose of takaful i. e. mutual cooperation to ease a burden. Interestingly there are a number of contemporary fatwas allowing the distribution of takaful benefit to a particular beneficiary which is the common practice in the conventional insurance. The SAC of Bank Negara in its 34 meeting held on 21st April 2003 resolved:

- Takaful Benefit can be used for hibah since it is the right of the participants. Therefore the participants should be allowed to exercise their rights according to their choice as long as it does not contradict with Shari'ah.
- The status of hibah in takaful plan does not change into will (wasiah) since this type of hibah is a conditional hibah, in which the hibah is an offer to the recipient of hibah for only a specified period. In the context of takaful, the takaful benefit is both associated with the death of the participant as well as maturity of the certificate. If the participant remains alive on maturity, the takaful benefit is owned by the participant but if he dies within such period, then hibah shall be executed.

- A participant has the right to revoke the hibah before the maturity date because conditional hibah is only deemed to be completed after delivery is made (qabd). The Participant has the right to revoke the hibah to one party and transfer it to other parties or terminate the takaful participation if the recipient of hibah dies before maturity
- The takaful denomination form has to be standardized and must stipulate clearly the status of the nominee either as a beneficiary or an executor (wasi) or a trustee