

Operational Issues and Shariah Harmonisation Towards the Development of Corporate Takaful Business: Conventional Debt Financing and Reinsurance Mechanism

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Abstrak

Objektif kertas ini adalah untuk membincangkan harmonisasi beberapa isu-isu syariah dan operasi dalam pembangunan perniagaan korporat takaful khususnya terhadap dua isu iaitu pembiayaan pinjaman konvensional dan mekanisme reinsurans. Kebanyakan aset atau harta bagi pelanggan-pelanggan korporat takaful menggunakan pinjaman sistem perbankan konvensional. Walau bagaimanapun, mereka ingin beralih kepada produk takaful dan retakaful yang patuh syariah sebagai mekanisme perlindungan bagi melindungi aset-aset yang rosak atau hilang akibat bencana. Takaful sebagai skim insurans Islam hanya akan lengkap melalui retakaful. Realitinya, dalam sesetengah keadaan, reinsurans secara konvensional perlu digunakan dalam takaful berikutan keupayaan kewangan yang terhad pihak syarikat takaful. Oleh itu, perbincangan dalam kertas ini akan menjurus kepada pengaplikasian prinsip-prinsip fiqh dalam pembiayaan hutang konvensional dan mekanisme reinsurans untuk pembangunan perniagaan korporat takaful.

Abstract

The objective of this paper is to discuss the harmonisation of some operational and shariah issues towards the development of corporate takaful business particularly on two issues which are conventional debt financing and reinsurance mechanism. Most of the assets or properties of the corporate customers have been leveraged using conventional debt/banking system, however the corporate customers want takaful as a tool of insurance to cover their properties following loss or damage due to any disaster. Besides that, Takaful as an Islamic insurance programme cannot be developed without practicing retakaful mechanism, however to some extent reinsurance (conventional) should be used in takaful due to takaful's constraint on financial capacity. Thus, this paper discusses on how and rationale, the principles of fiqh (al-qawaid al-fiqhiyyah) have been applied in this two cases for the development of corporate takaful business.

Introduction

The word *takaful* is derived from the Arabic word *kafala* which means to guarantee, look after or trust. The noun *takaful* is derived from the verb *takafala* which can be literally translated as “helping one another” or “looking after one another”. Section 2 of the *Takaful Act 1984* of Malaysia defines *takaful* as a scheme that is 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. *Takaful* is also defined as a Shariah compliant insurance. It is also clearly mentioned in Section 2 of the *Takaful Act 1984* that *takaful* business is a business of *takaful* whose aims and operations do not involve any element which is not approved by the Shariah.

Mohammad Daud Bakar (2002) asserts that *takaful* differs from conventional insurance in the sense that the company is not the ‘insurer’ insuring the participants. The persons participating in the scheme mutually insure one another and this is the very essence of the

word *takaful* in Arabic. It means that *takaful* is a scheme or a social programme for the collection of funds for the aid of participants for future contingencies.

Position of conventional insurance in Islam

The central arguments among the Shariah scholars on the position of conventional insurance in Islam revolve around three major issues. First, the contract between the insurer (insurance company) and the insured (policy holder) contains some degree of the unknown. This is termed as *gharar*. Second, the investment made by the insurance companies involves the element of *riba*. Third, the excessive element of *gharar* can lead to the issue of *maysir* (gambling). Consequently, the majority of the juristic scholars come to the agreement that the practices of conventional insurance are not in line with the Shariah and are therefore, not permitted in Islam, unless these major elements could be eliminated.

Thus, it is clear to conclude that *takaful* is very much needed especially for Muslims due to these non-permissible elements present in conventional insurance.

In Malaysia, a fatwa was made by the Fatwa Committee of the National Council for Islamic Religious Affairs Malaysia, at its meeting on 15 June 1972 which discussed and deliberated on the issue of life insurance. It was resolved that life insurance provided by conventional insurance companies is a business transaction which is not valid because it contradicts the Islamic business principles because the contract contains the elements of *gharar*, *maysir* and *riba*. A similar fatwa on the same issues was issued by several states of Malaysia, for example, Selangor (1970), Negeri Sembilan (1972), Perak (1974), Kelantan (1975) and Malacca (1980).

Unlawful elements of conventional insurance

It was mentioned earlier that the practices of conventional insurance do not conform to the requirements of Shariah because of the three elements that exist in the contract as well as in the insurance business, namely *gharar*, *maysir* and *riba*.

Gharar (uncertainty)

According to Shariah scholars, the business of conventional insurance is based on a buy and sell contract that does not fulfil the characteristics of a buy and sell contract according to Islam. A buy and sell contract, according to Islamic principles, has three features or characteristics, namely:

- a. Parties to the contract, *'aqid* (buyer and seller),
- b. Subject matter to the contract, *ma'qud alaih* (goods or services), and
- c. Offer and acceptance, *sighah*.

The arguments on the issue of *gharar* in the context of conventional insurance arise in the contract between the policy holder (the insured) and the insurance company (the insurer). In this contract, the insured pays a certain amount of premium in the expectation of gaining compensation for losses in the event that any accident occurs involving the loss of life or property. This is a kind of contract of exchange of goods or property which involves *ma'qud 'alaih* (object, service or payment), whereby one of the conditions of *ma'qud alaih* found in the principle of *'aqad* is clarity of the object. In actual fact, in conventional insurance there are elements of *gharar* in *ma'qud 'alaih* that can lead to cheating or injustice because:

- i. It is not certain whether the policy holder may or may not get any benefits for the premiums that he/she pays. The payment of the compensation depends on the outcome (death within the term in the case of life insurance and occurrence of an accident in the general insurance), which may not happen;
- ii. The amount that the policy holder will get in terms of benefits is also unknown. The amount that he/she will receive may vary from zero to the maximum amount as determined by the insurance company; and
- iii. The time frame in which a risk will occur and when the compensation will be paid to the policy holders is unknown. In Islamic commercial law involving an exchange contract as sales

and purchase agreement, the period involved must be known in order for goods to be delivered.

Mohammad Hashim Kamali (2000) classifies *gharar* into three categories: (a) Excessive *gharar* (*al-gharar al-kathir*); this would render the contract invalid, (b) trifling *gharar* (*al-gharar al-yasir*); this is tolerated and permissible, (c) average *gharar* (*al-gharar al-mutawassit*) which falls between the two. Based on the above arguments, the insurance contract that exists at present is found to contain an excessive element of *gharar* (*al-gharar al-kathir*). As such, *ulama* have reached the consensus that the conventional insurance practice is *haram* and invalid. This is based on the Hadith of Prophet SAW which prohibited Muslims from engaging in any kind of transactions involving *gharar*.

“Verily, the Prophet s.a.w forbids trades involving gharar”

(Hadith narated by Muslim)

Maysir (gambling)

The existence of *al-gharar* in the contract of insurance as explained above has led to the existence of *al-maysir* in the contract. The majority of *ulama* have the opinion that there is a certain element of gambling or speculation in an insurance contract. In gambling, a certain stake is paid for a certain unknown outcome. That is also similar in an insurance contract where the compensation is linked to a certain unknown outcome. It is a contract of exchange and with an element of *gharar*, therefore, it is assumed to be speculative or gambling in nature.

Riba (Interest)

The insurance contract is a *riba* contract since the insurance contract is an exchange contract between premium and compensation in an unequal exchange of value. The premium paid by the policy holder is much lower than the compensation paid by the insurer. This is a *riba* contract based on the hadith of the Prophet SAW.

The concept of *takaful* and *tabarru'*

Ulama' have agreed that the basis of insurance contract which is an exchange contact (buy and sell) must be changed to another type of contact in order to eliminate the above three objectionable elements. Thus, the Islamic concepts that can replace the concept of conventional insurance are based on those of cooperation, protection and mutual responsibility (Kamaruddin Shariff, 1998). These concepts have their basis in the Quran and the *Sunnah*. Allah says to the effect:

“Help you one another in righteousness and piety but help not one another in sin and rancor”.

(Al-Quran, 5:2)

In order to eliminate the elements of uncertainty (*gharar*), interest (*riba*) and gambling (*maysir*) in the operation of conventional insurance and hence to make it lawful in Islam, the concept of *tabarru'* (donation) is incorporated in it.

In this case, a participant agrees to contribute as *tabarru'*, a certain proportion or all of his/her *takaful* contributions that he/she agrees or undertakes to pay thus enabling him to fulfill his obligation of mutual help and joint guarantee should any of his fellow participants suffer a defined loss (Mohd Fadzli Yusof, 1996). *Tabarru'* would enable the participants to perform their deeds in sincerely assisting fellow participants who might suffer a loss or damage due to a catastrophe or disaster. The effect of *tabarru'* changes the basis of the insurance contract from an exchange contract to a charitable (donation) contract in *takaful*. When a contract is charitable (*tabarru'at*), the unknown (*gharar*) is tolerated. The donation contract is, in fact, by nature unknown. For instance, all participants do not know when and how they will suffer from loss of life and loss or damage to their property due to pure risks. What they can do is to contribute money among themselves to help each other in the event of loss. This is totally different from the contract of conventional insurance that is based on buying and selling protection (subject matter). The contributions (premium) contributed by participants are for the purpose of mutual indemnity and assistance amongst the members. Thus, the

tabarru' element removes the objectionable features in conventional insurance and makes it Shariah compliant.

Models of general *takaful* business in Malaysia

An Islamic insurance company (*takaful* operator) transacts business in accordance with and subject to the principle of the Shariah. All the functions of conventional insurance companies, i.e. underwriting, claims, reinsurance, marketing, investment, company management, etc. of the Islamic insurance company should fully conform to the Islamic Shariah Code. The basic products of *takaful* are still the same as those of conventional insurance business but must fulfil the rules and requirements of the Shariah. Products under general *takaful* business are short-term in nature, usually for a period of one year and may be renewed. These schemes are meant to provide cover against material loss or damage to assets such as buildings, houses, motor vehicles, stocks and other related interests.

The contract of *takaful* in Malaysia as practiced in *takaful* industry is a combination of the *tabarru'* contract (donation) and either profit sharing contract (*al-mudharabah*) or agency (*al-wakalah*).

Al-mudharabah model for general *takaful*

By this principle, the entrepreneur or al-mudharib (*takaful* operator) will accept payment of *takaful* contributions (premiums) termed as ra'sulmal (capital) from *takaful* participants termed as sahibulmal or rabbulmal (capital providers). The contract specifies how the profit from the operations of *takaful* managed by the *takaful* operator is to be shared in accordance with the principle of al-mudharabah, between the participants as the providers of capital and the *takaful* operator as the entrepreneur. The sharing of such profit may be in a ratio 50:50, 60:40, 70:30, etc. as mutually agreed between the contracting parties.

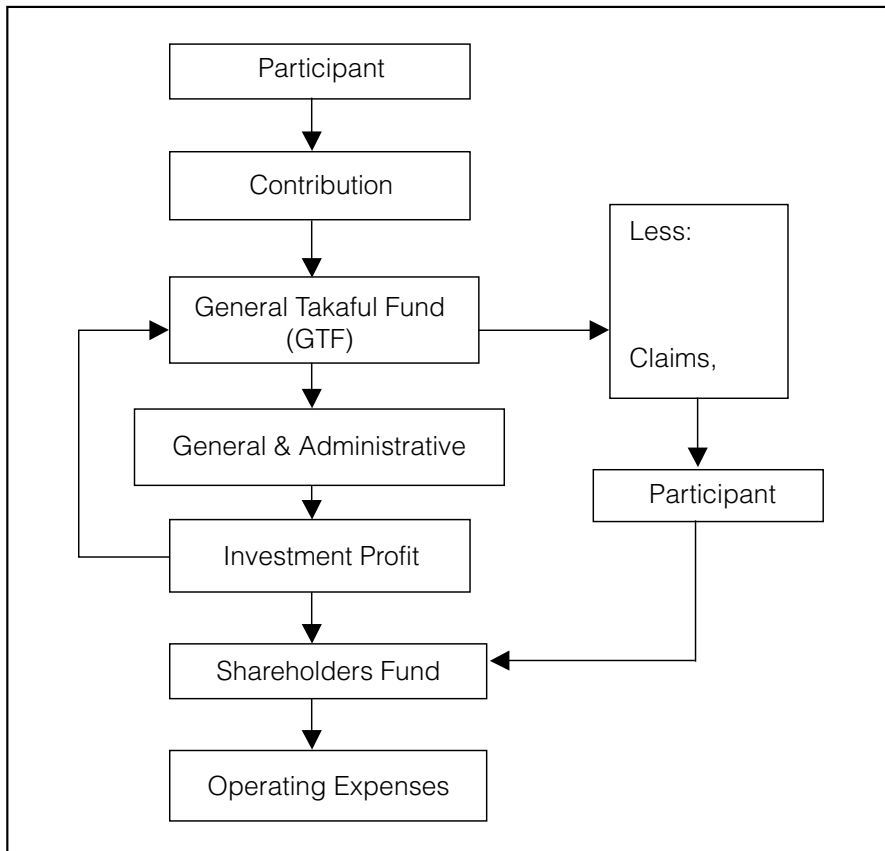


Figure 1: Al-Mudharabah Model for General *Takaful*.

Source: Bank Negara Malaysia, Annual Report 2005

Figure 1 shows the modus operandi of al-mudharabah model for general *takaful*. The participants pay a contribution as a donation (tabarru') to help each other and the contribution will be put into the General *Takaful* Fund (GTF). Excess in the GTF after deducting general and administrative expenses in managing the operations will be invested and the investment income will be ploughed back into the fund. Surplus at the end of the year after deducting claims (depending upon the occurrence of actual losses and damages), *retakaful* (Islamic reinsurance) and reserves will be distributed to the *takaful* operator and the participants based on the pre agreed ratio as stipulated in the contract.

Al-wakalah model for general *takaful*

The wakalah concept is essentially an agent-principal relationship, where the *takaful* operator acts as an agent on behalf of the participants and earns a fee (wakalah fee) for services rendered. The fee can be a fixed amount or based on an agreed ratio of investment profit or surplus of the *takaful* funds.

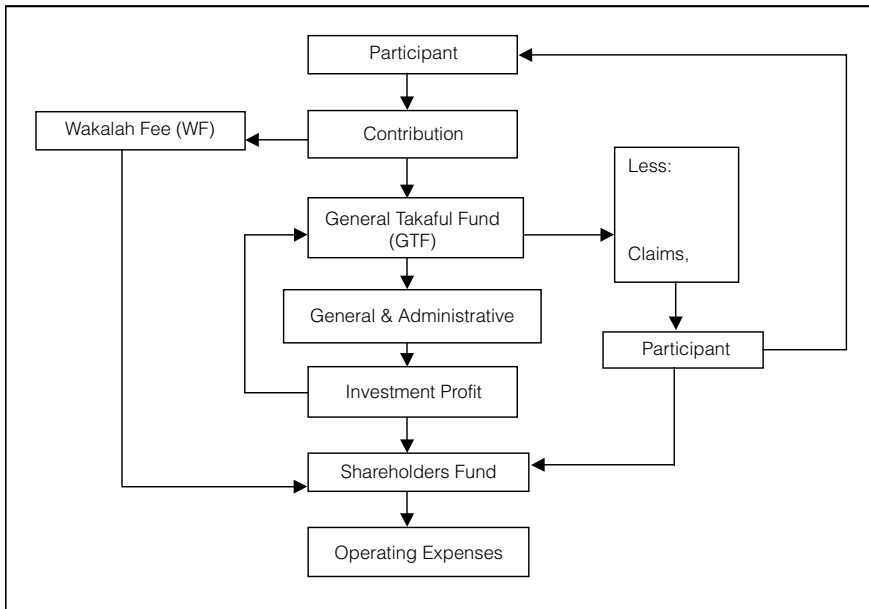


Figure 2: Al-Wakalah Model for General *Takaful*

Source: Bank Negara Annual Report 2005

Figure 2 shows the modus operandi of al-wakalah model for general *takaful*. The participants pay a contribution as a donation (tabarru') to help each other and the contribution will be divided into two types of accounts i.e. Wakalah Fee (WF) and General *Takaful* Fund (GTF). The allocation between WF and GTF is based on the pre-agreed ratio between participant and *takaful* operator as specified in the contract. The WF, which consists of commission and management expenses, will be paid into the shareholders' fund. Any surplus at the end of the year after deducting claims, *retakaful* and reserves will be distributed to the *takaful* operator and participants based on the pre-agreed ratio as stipulated in the contract.

Corporate *takaful* business and principles of fiqh (al-qawa'id al-fiqhiyyah)

In this section, two issues pertaining to corporate *takaful* business are further discussed. The first is Islamic reinsurance which is known as *retakaful* and the second is *takaful* coverage for asset financing using the conventional loan system. This section is very important since it is related to the study of how *takaful* can provide products and services to corporate clients despite insufficient financial capacity to provide amount of coverage and Islamic financing products offered by Islamic banking still being at the development stage whereby most corporate customers use conventional loans to finance their assets.

Retakaful

It is important to highlight that *takaful* services cannot move forward without the concept of reinsurance due to financial capacity limiting its coverage to the policy holders or participants. For example, if let's say there are 100 corporate *takaful* participants of fire *takaful* (under general *takaful* schemes) with one particular *takaful* operator. The total value of their property being covered (sum covered) is 100 properties \times RM5,000,000 each = RM500 million. The total contribution (premium) which was collected from the risks is RM500 million \times 10% = RM50 million. This means that the *takaful* operator is willing to pay claims due

to any defined loss and damages up to 10 properties only. That is one of the reasons for *takaful* services needing to have the *retakaful* arrangement i.e. to expand its coverage and sharing of risk among *takaful* operators.

After collecting the contributions (premiums), the efforts are then focused on ensuring the prudent management of the *takaful* fund, including the use of *retakaful*. *Retakaful* is one of the risk management tools used by *takaful* operators to share part of the risk under the *takaful* fund with another *takaful* operator or *retakaful* company. The amount of risk retained by the *takaful* operator for its own account is called the retention limit. Mohammed Obaidullah (2005) defines *retakaful* as a second arrangement between a *takaful* operator and a larger operator as the former may not have the capacity to absorb all possible losses out of its own resources, given the large sums that are insured. Fathi Lashin, a member of the Shariah Supervisory Board of the Dubai Islamic Bank stated that *Retakaful* does not, in principle, differ from *takaful* operations. The shariah principles applying to *takaful* apply to *retakaful* operations as well. The difference, if any, is that in the *retakaful* operations, the participants are *takaful* operators instead of individual participants. It is argued that the current practice of insurance business has shown that a *takaful* ceding company cannot do without the *retakaful* facility. Therefore, there is a need for *takaful* operators to split risks by way of establishing *retakaful* operators. In doing so, they share their risks with *retakaful* companies. The *retakaful* operator, on the other hand, assumes the responsibility of managing and investing the premiums of *takaful* operators on the basis of profit loss sharing.

Figure 3 overleaf shows the operational mechanism of *takaful* and *retakaful* where a part of the risk is shared between the *takaful* operator and the *retakaful* operator.

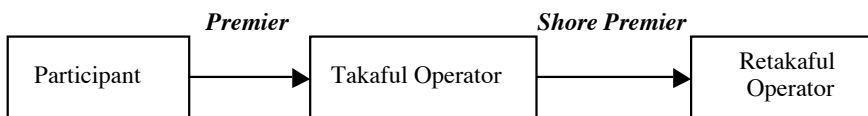


Figure 3: Mechanism of *Retakaful*

However, there are very few *retakaful* companies in operation; with growing numbers of *takaful* companies the existing *retakaful* capacity is not sufficient to meet the demand. The only route available left for *takaful* companies is to reinsure on a conventional basis, contrary to the customer's preference of seeking cover based on Islamic principles. Shariah scholars have allowed *takaful* operators to reinsure on a conventional basis so long as there is no *retakaful* alternative available. If there is a need to turn to the conventional reinsurance market, then the *takaful* operator should first try to obtain coverage from the cooperative and mutual insurance sector. *Takaful* reinsurance or *retakaful* requires clearly defined joint responsibility which means that it is likely to be arranged under quota share or surplus treaties.

In this case, the Shariah Advisory Council of Syarikat *Takaful* Malaysia has found with a solution by applying the principle of fiqh as stated below:

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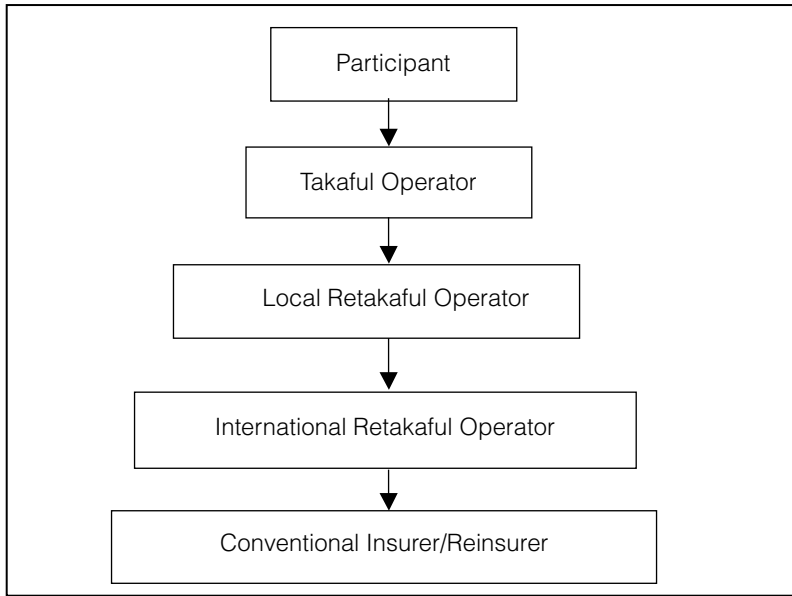
"Necessity renders prohibited things permissible".

However, the necessity must be limited and the following principle is applied in the arrangement of *retakaful* using conventional insurance:

الضرورات تقدر بقدرها

"Necessity is determined by the extent thereof".

Thus, the arrangement of *retakaful* must be given and according to the priority of *retakaful* operators and followed by the conventional insurers in the final stage of *retakaful* arrangement. Figure 4.



Assets financing/loan from the conventional banking system

Another issue concerning the corporate *takaful* business is the corporate demand for *takaful* coverage from the corporate sector for which their assets financing or loans derive from the conventional or interest-based banking system. Banks have required their debtors to buy property insurance policies to cover the assets being financed by them irrespective of whether in Islamic or conventional insurance system. Thus, *takaful* operators should have concrete reasons for accepting or rejecting this type of risk which is financed by conventional banking. There is no issue about the risk accepted by the *takaful* operators on assets being financed by Islamic banks or Islamic banking system. According to the Shariah Advisory Council of Syarikat *Takaful* Malaysia, it is permissible for the *takaful* to accept the risk being financed by conventional banking since the coverage provided is not for the loan but for the mutual indemnity of the assets owned by the participant i.e. in this case, the debtor of the bank. This decision is according to the following principle of fiqh:

الأمر إذا ضاق اتسع

“Latitude should be afforded in the case of difficulty”. In other words, when a matter is narrow, it is made wider. There are several reasons

for permitting this risk based on the above practical fiqh principle:

- a. To prevent Muslims being involved in the conventional insurance contracts.
- b. To minimize non-Muslim business activity.
- c. Islamic banking is still at its infancy or development stage.

Conclusion

The purpose of introducing *takaful* is to ensure that the operation of insurance is totally free from the three objectionable elements in conventional insurance i.e. *gharar* (uncertainty), *maysir* (gambling) and *riba* (interest). In order to achieve this purpose, a contract of *tabarru'* is incorporated. Currently, there are two types of model for *takaful* business either based on the principle of *al-mudharabah* or the principle of *al-wakalah*. Two issues pertaining to corporate *takaful* business are further discussed. The first is Islamic reinsurance which is known as *retakaful* and the second is *takaful* coverage for asset financing using the conventional loan system. It is very important since it is related to the study of how *takaful* can provide products and services to corporate clients despite insufficient financial capacity to provide amount of coverage and Islamic financing products offered by Islamic banking still being at the development stage whereby most corporate customers use conventional loans to finance their assets. It shows that *takaful* business can be expanded and developed through the harmonization of operational and shariah issues through the application of the principles of fiqh with specific justifications.

End Notes

1. Mohammad Daud Bakar, "The Problem of Risk and Insurable Interest in *Takaful*: A Jurisprudential Analysis"; A paper presented at the 4th International Conference on Islamic Economics and Banking, Loughborough University, UK, August 13-15, 2000. pp 179-193.
2. Bank Negara Malaysia, 20 years Experience of Malaysian *Takaful* Industry (2005) p. 2.
3. The insurance contract is categorized as a riba al buyu': the riba in excess which occurs in trading transactions involving the exchange of riba bearing commodities without observing the required rules. Two types of riba al buyu', namely riba al-fadhhl and riba al-nasiah.
4. Hadith narrated by Muslim, Al-Timidhi and Al-Nasa'I, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt – like for like, equal for equal, hand to hand (spot); if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand or spot transaction"
5. Assoc. Prof. Dr. Engku Rabiah Adawiah Engku Ali in "*Shari'ah Principles in Takaful*", presented at the workshop on *Takaful* (Islamic Insurance), 16-17 August 2005 at Istana Hotel, Kuala Lumpur.
6. Mohd Fadzli Yusof (1996), Introduction to takaful p. 51.
7. Lashin, Fathi, "Sigha Muqaddama li-al-Sharikat Ta'min wa I'adat al-Ta'min fi al-Islam", Bayt al-Tamwil al Kuwaiti. '*Amal al-Nadwa al-fiqhiyya al-Thaniya*', 28-31 May, pp. 95-122. Quoted from Mohammed Burhan Arbouna, "The Operation of *Retakaful* (Islamic Reinsurance) Protection", Journal IIUM, p.336

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