
Chapter 5. *Takaful*: Islamic Insurance

Islamic insurance, or *takaful*, has enjoyed remarkable growth in the past three decades in the Muslim community. Conventional, Western insurance is viewed by Islam as violating two of its primary tenets—the prohibitions against engaging in activities involving *gharar* (uncertainty) and *maisir* (gambling).¹⁹

In a conventional insurance system, the insured transfers the risk of loss or damage to an insurance company, which makes a profit if its premium and investment income exceed its incurred losses and underwriting expenses. In a *takaful* system, participants make payments to a common fund that is managed by a *takaful* operator under one of three models: *mudharabah* (profit sharing), *wakalah* (an agent who receives a management fee), or *wakalah* with *waqf* (a hybrid form of the *wakalah* model that uses a foundation, or *waqf*). The *takaful* operator does not assume the risk of loss or damage on the part of the participants. Rather, the risk is shared among the *takaful* participants whose contributions provide the means to cover any losses or damages incurred by themselves or others.

The first *takaful* company was established in 1979. As of 2006, more than 250 such companies operated around the world; in 2005, total premium income exceeded US\$2.0 billion (“Takaful: A Market with Great Potential” 2006). The global *takaful* industry has recently been growing by an impressive 20 percent per year globally and at 25 percent per year in the GCC (Bhatti 2008). Moody’s Investors Service predicts that global *takaful* premiums will reach US\$7.0 billion by 2015. The Islamic insurance industry could be worth up to US\$15 billion globally within next 10 years (Bowman 2008).

This chapter explains the *takaful* models, types of *takaful*, and the system’s growth prospects. The focus is on the *takaful* industry in Malaysia, the current leader in the market.

Definition of *Takaful*

The word “*takaful*” is derived from the Arabic word “*kafalah*,” which means “guaranteeing each other” or a “joint guarantee” and is based on the concept of social solidarity, cooperation, and mutual indemnification of losses. *Takaful* operates on the Islamic principles of *taawun* (brotherhood or mutual assistance) and *tabarru* (donation, gift, or contribution). Thus, in *takaful*, the risk of loss is shared collectively and voluntarily by the participants, who guarantee each other against defined

¹⁹In 1985, the Islamic Fiqh Academy, a subsidiary of the Organization of the Islamic Conference, ruled that conventional commercial insurance is *haram* (forbidden) but that *takaful* is *halal* (permissible) because it is based on the application of shared responsibility, joint indemnity, common interest, and charitable donations.

losses or damages. Each participating member contributes resources (premium payments) and personal efforts to support the needy participants within the group. Consistent with Islamic beliefs, *takaful* is an example of how the fortunate may assist the unfortunate few.

The essence of *takaful* is to maintain equity among the members of a group and to assist those in the group who have suffered misfortune. Earning a profit is not the sole objective of the *takaful* operator or participants (who share in any surplus *takaful* funds). The *takaful* participant is viewed as both the insurer and the insured.

The following key elements must exist for a proper *takaful* system to be established:

- All *takaful* activities must be in compliance with *Shari'a*, which requires the presence of risk sharing based on the principles of *taawun* and *tabarru'*, coincidence of ownership, participation in management by policyholders, avoidance of *riba* (giving or receiving of interest) and prohibited investments, and inclusion of *mudharabah* and/or *wakalah* principles in management practices.
- *Takaful* participants must act with utmost sincerity (*neaa*) and adhere to the purpose and principles of *takaful*, which are cooperative and characterized by risk sharing and mutual assistance.
- All *takaful* dealings must be conducted in good faith and with honesty, transparency, truthfulness, and fairness, and all should be consistent with Islamic social and moral goals.
- All *takaful* activities must be free of *haram* (forbidden) elements.
- All *takaful* contracts must involve parties who have adequate legal knowledge and who are mentally competent.
- *Takaful* policies should be based on mutual consent and should specify a defined time period of policy coverage; the principle of indemnity must prevail.
- Oversight by a *Shari'a* advisory council must be provided because Islamic scholars have a role in defining what can be insured and also in approving the structure of final agreements.
- *Takaful* operations must undergo regular Islamic audits.

Precursors to *Takaful*

The foundations of *takaful* predate the rise of Islam. In the pre-Islamic era, the practice of *aquila* was common among ancient Arab tribes. *Aquila* was a mutual agreement or joint guarantee among Arab tribes to spread the financial liability should a member of one tribe kill or injure a member of another. When someone was killed, blood money, or *diyab*, was to be paid to the heirs of the victim by the paternal relatives of the accused. To mitigate the financial burden, the members of the accused tribe who were participants in the scheme would contribute until the *diyab* had been satisfied. Participating tribal members, therefore, collectively shared responsibility for sums individually owed.

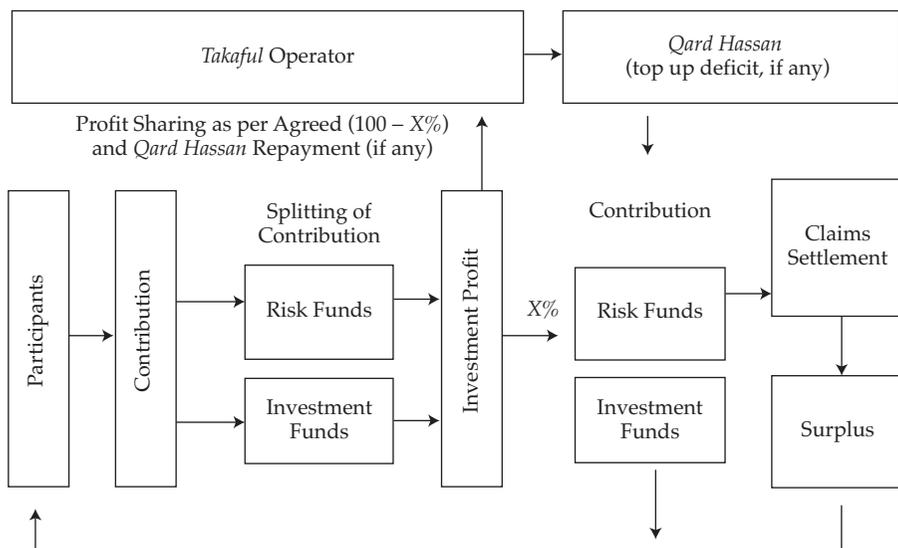
Following the rise of Islam, Muslim Arab merchants who were expanding trade into Asia adopted the practice of *aquila*. They mutually agreed to contribute to a fund that would cover participants who incurred mishap or robbery during the numerous and dangerous sea voyages they undertook. The obligation to make regular financial payments to such a fund was similar to premiums paid for conventional insurance today. The compensation amount in the event of a mishap was similar to the indemnity or sum insured under modern insurance practices.

Today's *takaful* system incorporates many of the practices of its historical precedents.

Mudharabah Model of Takaful

Under the concept of *mudharabah* (profit sharing), the *takaful* participants (*rabb-ul-mal*) provide funds to the *takaful* operator (*mudarib*), who manages the funds and generates profits through *Shari'a*-compliant investments or trade. The parties to the *takaful* transaction enter into cooperative risk-sharing and profit-sharing agreements. The *takaful* operator shares in the profits earned from investments but not in the losses; the participants bear the sole burden of losses. The *mudharabah* model is depicted in Figure 5.1.

Figure 5.1. Simplified Form of Takaful Based on Mudharabah Model



Sources: Kassim (2005) and Bank Negara Malaysia (2005).

Contributions are given on trust (*amanah*) to the *takaful* operator and, therefore, are repayable to the participants in due course minus the operator's costs. Contributions are split into two accounts—donations (*tabarru'*) and investment funds. These accounts must be clearly segregated to ensure that the participants are mutually insuring and bearing the risk of loss through their *tabarru'*.

Tabarru' Contribution. The *tabarru'* contribution, or risk fund contribution, is a donation dedicated to the compensation of *takaful* participants who experience losses or damages. The *takaful* participant agrees to relinquish as *tabarru'* a certain percentage of the total *takaful* contribution or premium. The *tabarru'* contribution fulfills the participant's obligation of mutual help and joint guarantee that is necessary in accordance with *Shari'a*.

Investment Fund Contribution. The investment fund contribution is the amount remaining after the total *takaful* contribution is reduced by the percentage designated as *tabarru'*. The *takaful* operator invests the funds in *Shari'a*-compliant investments for the purpose of generating profits. The investment profits are distributed, under the principle of *mudharabah*, among the participants and the operator on the basis of a predetermined percentage. All investment losses are borne entirely by the *takaful* participants; the *takaful* operator does not participate.

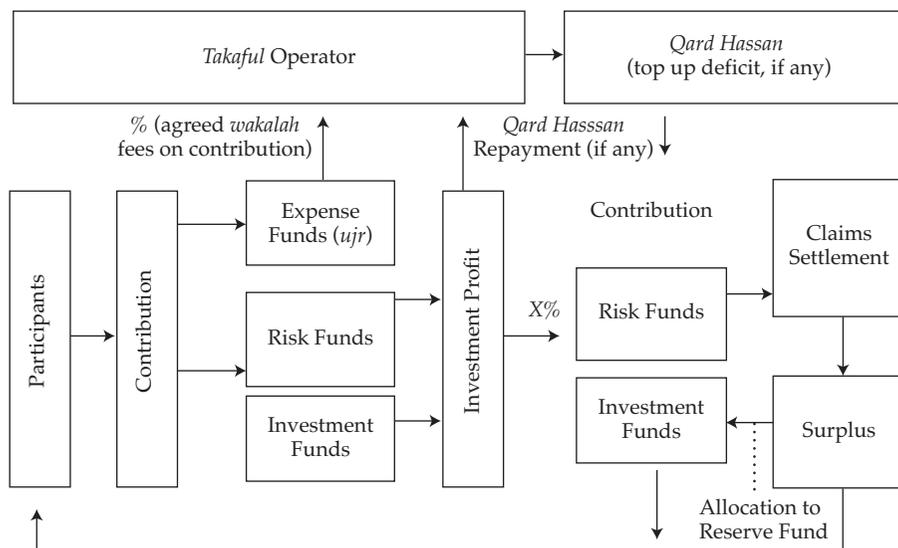
Tabarru' Surplus. The funds remaining in the *tabarru'* account after all claims and related expenses have been paid are considered the surplus or, if the amount is negative, the deficit. The surplus or deficit is shared collectively on the basis of a predetermined ratio among the participants (the operator is included in certain countries) at maturity of the policy. In the event of a loss in the *tabarru'* fund, the *takaful* operator typically offers participants financing to fund their portion of the loss on the basis of the principle of *qard hassan* (a benevolent, or profit-free, loan). The *qard hassan* loan has to be repaid when the *tabarru'* fund returns to profitability and prior to the distribution of any future *tabarru'* surplus.

Wakalah Model of Takaful

In the *wakalah* model (the word "*wakalah*" is Arabic for "delegation" or "representation"), a contract provides that the *takaful* operator will manage the *takaful* fund on behalf of the participants and will be compensated by a fee called a *wakalah* fee. In effect, the operator is appointed as an agent (*wakalah*), and a fee (*ujr*) is paid for this agent's expertise. The fee may be a percentage of the *takaful* contribution (premium) or an absolute amount. Figure 5.2 illustrates the simplified form of the *wakalah* model of *takaful*.

The *wakalah* model is gaining in popularity because of increasing objections to the practice of sharing the surplus funds with the *takaful* operator, as is provided for in the *mudharabah* model. In the *wakalah* model, the *takaful* operator acts as agent and does not share in any surplus funds earned from investing. The *wakalah*

Figure 5.2. Simplified Form of *Wakalah* Model of *Takaful*



Sources: Kassim (2005) and Bank Negara Malaysia (2005).

model of *takaful* is currently offered in 30 countries. The *wakalah* model is preferred also because it is regarded as providing better insurance protection than the *mudharabah* model, which is considered more friendly to the investment manager.

***Tabarru'* Contribution.** As in the *mudharabah* model, a percentage of the total *takaful* contribution is segregated as *tabarru'*. The *tabarru'* contribution is further split into a risk fund and an investment fund. The rationale for having two funds is the same as in the *mudharabah* model. The risk fund is used to pay claims; it is treated as a donation to help the needy (participants who experience losses or damages) and to fulfill the *Shari'a* requirement of mutual risk sharing. The investment funds are invested in *Shari'a*-compliant investments.

Expense Fund Contribution. The *ujr* equals the difference between the total *takaful* contribution, or premium, and the amount of the *tabarru'* contribution. The *ujr* funds are segregated in the expense fund.

***Tabarru'* Surplus.** Any surplus funds that are generated from the *tabarru'* funds may be used in one of three ways. First, the entire surplus may be kept in the *tabarru'* fund. Second, a certain portion may be kept in the fund as a contingency reserve, and the balance may be distributed to the participants. Third, after making provisions for a contingency reserve, the balance may be distributed among the participants and the *takaful* operator. The method by which surplus funds will be distributed is disclosed to participants prior to their participation in the plan.

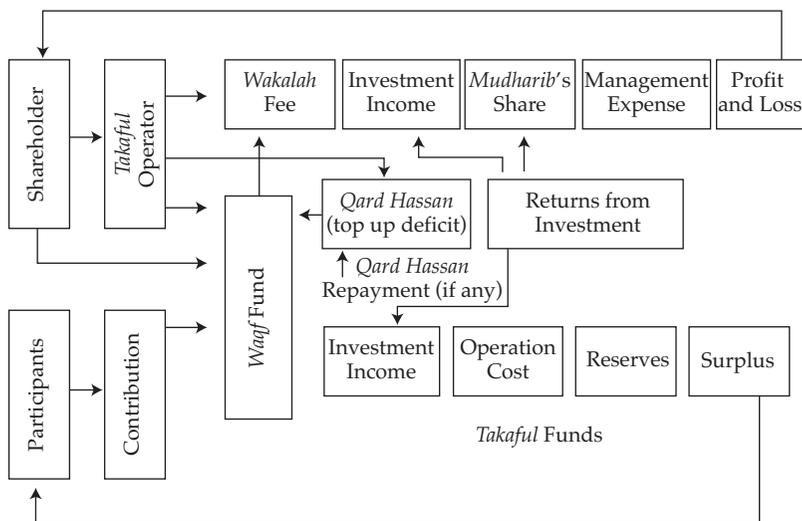
As in the *mudharabah* model, any losses in the *tabarru'*, or risk, fund are borne by the participants. The *takaful* operator typically extends financing on the basis of the *qard hassan* (benevolent loan) principle. The loans must be repaid by participants before any future surplus is distributed to them.

Wakalah-with-Waqf Model of Takaful

The *wakalah-with-waqf* model is a refinement of the *wakalah* model and incorporates a separate legal entity known as a *waqf* to hold shareholder donations and participant contributions. A *waqf* is essentially a gift of land or property intended for religious, educational, or charitable purposes, and the use of a *waqf* is an accepted practice in most Muslim countries. The *waqf* is a *Shari'a*-compliant entity that can operate under direct ownership of the *waqf* assets or, alternatively, with a third party that owns the assets. Unlike in the *mudharabah* and *wakalah* models, the participants do not own the *takaful* or *waqf* funds. Figure 5.3 shows the simplified form of the *wakalah-with-waqf* model.

The *waqf* funds are managed on a fee basis by an appointed fund manager or administrator. The *takaful* operator, or *mudarib*, has its own shareholders and, in addition to receiving a fee to manage the *waqf* assets and to administer the *takaful* plan, shares in any profit from the *waqf*'s investments, which are funded by both shareholder donations and participant contributions. The profit or loss of the *takaful* operator is passed on to its shareholders.

Figure 5.3. Simplified *Wakalah-with-Waqf* Model of *Takaful*



Source: Adapted from Pirani (2007).

Shareholder Donations. Shareholders of the *takaful* operator's company, who may also be *takaful* participants, make a donation (the amount may be specified by Islamic scholars) to establish the *waqf* fund. The shareholders have no ownership rights in the *waqf*, but they do have the right to administer the *waqf* funds and to develop the rules and regulations that govern it. The *waqf* funds are invested in *Shari'a*-compliant products, and the returns are used for the benefit of *takaful* participants. There is no obligation to distribute any surplus *waqf* funds to the shareholders.

Participant Contributions. The *tabarru'* contributions made by the participants are also deposited in the *waqf*. The *waqf* funds, after the *takaful* operator's fees to cover management, administration, and marketing expenses are deducted, are invested in *Shari'a*-compliant products. Any claims from participants to cover losses or damages are paid from the *waqf*. In addition, all operational costs, such as re-*takaful* (similar to re-insurance in the conventional insurance model) or the building up of reserves, are met from the *waqf*.

Surplus Funds Distribution. The rules of the *waqf* define the basis for compensation to participants for losses suffered and may also provide for the manner in which any surplus funds are to be shared, but no obligation exists to distribute surplus funds to *takaful* participants.

As in the case of the *mudharabah* and *wakalah* models, the *takaful* operator covers any losses in the *waqf* through a *qard hassan* (benevolent) loan. This loan is made to the *waqf* entity, however, not to individual participants. Such loans must be repaid by participant contributions before any future surplus funds can be distributed.

Types of Takaful

Takaful plans can be divided into family *takaful* plans and general *takaful* plans.

Family Takaful Plans. A family *takaful* plan has three basic forms: the individual *takaful* plan, a mortgage *takaful* plan, and a health/medical *takaful* plan.

The individual *takaful* plan is a long-term savings and investment program with a fixed maturity period. It is similar in purpose to a term life insurance plan in the conventional insurance system but is entirely different in terms of mechanism and transaction structure. Its aims are

1. to encourage people to save regularly,
2. to earn and share profits from investing in *Shari'a*-compliant products, and
3. to pay *takaful* benefits to any heir(s) should a participant die before the maturity date of his or her *takaful* plan or to the participant in the case of disability.

If a participant dies before the end of the plan's terms, the participant's family members are entitled to the following benefits:

- the total contribution paid to date—that is, up to the due date of the installment payment just prior to the participant's death—plus the participant's share of the profits earned from investments credited to the account and
- the participant's remaining *takaful* installments under the term of the plan calculated from the date of death (these benefits are paid from the *tabarru'* fund).

If a participant outlives the *takaful*'s term, the following benefits are paid to the participant:

- the total amount of contributions paid by the participant plus the share of profits earned from investments credited to the participant's account and
- any surplus *tabarru'* funds allocated to the participant's account.

Should the participant be compelled to surrender or withdraw from the *takaful* plan before the maturity of the plan, the participant is entitled to receive the proportion of *takaful* installments that have been credited to the account plus the participant's share of investment profits. The amount that has been relinquished as *tabarru'*, however, is not refunded.

Mortgage *takaful* is a family *takaful* plan that automatically settles the policyholder's house financing in the event of his or her death or permanent disability. In most cases, the policyholder needs to pay only a single contribution for the mortgage *takaful*. The contribution rate depends on the policyholder's age, the amount of protection bought, the profit rate, and the amount of time for which the protection is valid. If the policyholder sells the house or redeems the financing earlier than the term, the policyholder is entitled to receive a pro rata refund of the contribution for the unexpired period of *takaful* ("Home Takaful" 2007).

Health or medical *takaful* covers the cost of private medical treatment, such as the cost of hospitalization and a doctor's care, if the policyholder is diagnosed with certain illnesses or has an accident. The coverage could be on a stand-alone basis or could act as a supplementary contract to a basic family *takaful* plan ("Medical & Health Takaful" 2007).

General Takaful. General *takaful* schemes are basically joint-guarantee contracts that provide compensation to participants in the event of a defined loss. They are short term in nature (normally one year), cover individuals or commercial entities, and insure real and personal property. The types of general *takaful* schemes offered include fire *takaful*, motor (automobile) *takaful*, and marine *takaful*.

History of Takaful in Malaysia

Malaysia, with a penetration rate of about 30 percent compared with about 5 percent in other Muslim countries, is ahead of most Muslim countries in developing the *takaful* market. Malaysia's *takaful* industry began in 1985 when the country's first

takaful operator, Syarikat Takaful Malaysia, opened for business. This development followed the establishment in 1982 of a special task force to study the possibility of establishing Islamic insurance in the country.

The second *takaful* operator, MNI (Malaysia National Insurance) Takaful, opened its doors in 1994. Renamed Takaful Nasional in 1998, it is a subsidiary of a Malaysian conventional insurer. In 1997, a full-fledged re-*takaful* company, ASEAN Retakaful International, was incorporated in Malaysia's offshore financial center, Labuan, to support the re-*takaful* needs of the region's *takaful* operators. Its shareholders are *takaful* operators based in Malaysia, Brunei, and Singapore. In 2008, the country had eight *takaful* operators, twice the number in 2003.

At year-end 2007, total *takaful* contributions in Malaysia had risen 48.6 percent year-over-year to 2.6 billion Malaysian ringgits (RM), or US\$845 million. At year-end 2003, total *takaful* contributions in Malaysia stood at RM1.0 billion, or US\$264 million. And at year-end 2007, total *takaful* fund assets in Malaysia had climbed 18.6 percent year-over-year to RM8.8 billion, or US\$2.65 billion, and accounted for 7.2 percent of total Malaysian insurance company assets. Approximately 85 percent of *takaful* assets were held in family *takaful* plans, with the remaining assets in general *takaful* plans. In 2003, total *takaful* fund assets were RM4.4 billion, or US\$1.16 billion—that is, 5.6 percent of the total Malaysian insurance industry's assets (Ernst & Young 2007).

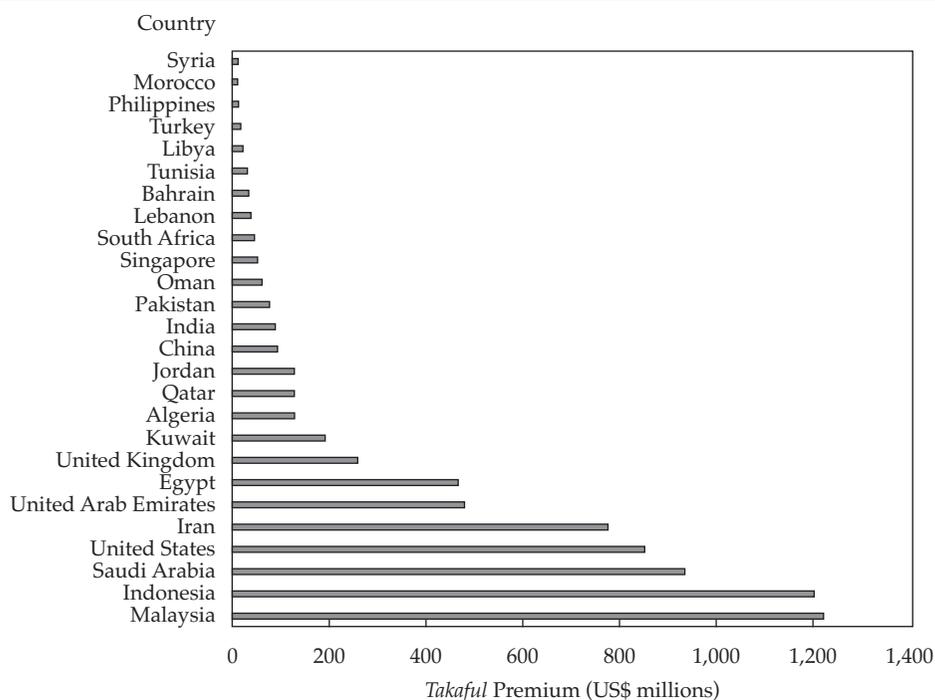
Malaysia actively promotes *takaful* products, especially family *takaful* plans, as a tool to increase savings within the Muslim community and as an essential component in ensuring economic growth and accelerating the investment potential of the *ummah*—the Muslim community as a whole.

Prospects for Global *Takaful* Growth

Takaful market growth is forecasted to increase substantially over the next decade. Moody's Investors Service projects global *takaful* premiums to rise to US\$7.4 billion in 2015; Ernst & Young estimates that global *takaful* premiums will reach US\$4.3 billion in 2010 if Iran is excluded and reach almost US\$15 billion if Iran is included (Ernst & Young 2007).

The greatest prospects for growth in the *takaful* market are in the countries of the Middle East, which have historically had a low level of insurance penetration—conventional or *takaful* (Ernst & Young 2007).

Figure 5.4 compares the prospects for *takaful* by 2015 in various countries as projected by premium revenues in U.S. dollars. Malaysia is expected to continue to dominate the market, but Indonesia is expected to follow closely on its heels, with Saudi Arabia, the United States, and Iran rounding out the top five nations in terms of projected *takaful* premium revenues in 2015.

Figure 5.4. Potential for Takaful by Year 2015 for Selected Countries

Source: Reorient Legal (no date).

The following factors point to the potential for growth in the *takaful* market over the next five years:

- The global trend of a Muslim preference for Islamic financial products, including *takaful*, will continue.
- Bancatokaful (*Shari'a*-compliant bancassurance) offers a venue for *takaful* to expand by tapping into a bank's infrastructure and marketing mechanism.²⁰
- Support by regulators, such as Bank Negara Malaysia, the Islamic Financial Services Board, and the Accounting and Auditing Organization for Islamic Financial Institutions, is facilitating the development of all Islamic financial products, including *takaful*.
- A broad range of products is needed to stimulate new demand as conventional insurers enter the market.

²⁰Bancassurance (a term for the Bank Insurance Model) is the term used to describe the partnership or relationship between a bank and an insurance company whereby the insurance company uses the financial institution's sales channels to sell insurance products.

- Global insurance giants, such as Prudential and Allianz, are raising awareness of the Islamic insurance industry through their significant brand recognition.
- An active marketing appeal to non-Muslims is being undertaken. In Malaysia, non-Muslims account for around 35 percent of the *takaful* customer base; in Sri Lanka, some 15 percent of *takaful* policyholders are non-Muslims.
- There is a shift in perception toward the idea that *takaful* is both an investment solution and an insurance product.

Challenges for the *Takaful* Industry

Although growth in the *takaful* industry has been strong in certain countries and the prospects for broader, more sustained growth are positive, the *takaful* industry still faces a number of challenges.

First, because *takaful* is a fairly young industry, corporate governance policies for *takaful* operators are still developing. Regulatory bodies must step in to implement appropriate policies and standards to ensure *Shari'a* compliance and to avoid conflicts between the operators, shareholders, and policyholders.

Second, a greater number of well-known, established credit-rating agencies need to rate *takaful* companies regarding their *Shari'a* compliance, financial strength, and solvency to strengthen consumer confidence in them. Currently, only the Islamic International Rating Agency and Moody's offer such ratings.

Third, consumers need more information about the benefits and mechanics of *takaful*. The three *takaful* business models—*mudharabah*, *wakalah*, and *wakalah with waqf*—create confusion among consumers and doubt about *Shari'a* compliance.

Fourth, more *takaful* products are needed that are competitive with conventional insurance products, particularly in meeting the needs of commercial customers. More investment needs to be made in cost-effective technology and methods to take advantage of new distribution channels, such as the internet and *bancatakaful*, to reach more customers.

Fifth, a shortage of skilled *takaful* staff exists.

Sixth, the pace has been slow in solving a combination of technical, legal, tax, *Shari'a*, and accounting issues in certain Muslim countries, such as Indonesia, which has hampered the entry of international *takaful* players into potentially strong markets.