

## AN ANALYSIS OF LEGAL AND REGULATORY ISSUES FOR TAKAFUL OPERATIONS UNDER ISLAMIC LAW

By

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### Abstract:

*Takaful* is the alternative method of providing insurance services that is deemed acceptable for Muslims but since its introduction, questions have been raised concerning the methods used in providing the service and the legal implications attached to each facet of operations. The aim of this paper is to highlight the various concerns raised by Muslim scholars and analysts concerning *takaful* operations. Using a mainly doctrinal method, this paper looks at the different views of Islamic scholars on conventional insurance and the legal and practical aspects of *takaful* insurance. Without limiting the study to a particular country, it also looks at the different models used by *takaful* operators and analyses several issues which may still riddle *takaful* practice. It concludes by proffering suggestions and recommendations that may resolve issues that have been noticed.

**Key words:** *Takaful*, Islamic insurance, *takaful* models, issues in *takaful*.

### 1.1 Introduction

During the time of the Prophet and even in the first century after his death, every activity, financial or otherwise was regulated by Islamic principles. However, during ensuing years, particularly from the era of industrialization, Muslims worked under the unfortunate mistaken belief that Islamic law has no facility for banking and insurance, or that the one provided by Islamic law would not be adequate for the modern –and complicated- economic system. Thus there

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was a shift away from classical Islamic financial and economic systems<sup>1</sup>. In recent times however, there has been a shift towards re-islamization of all activities. To this end, a system of insurance has been introduced by Muslim economists to provide insurance within Islamic confines. The question that needs to be asked is 'is it wholly islamically acceptable or are there are aspects of it which may require further modification?

The service of insurance, as it is provided in conventional economies, is a commercial enterprise which undertakes to take over the risk of possible loss of assets due to the happening of an event in exchange for periodic payments of a determined amount by the beneficial owner of such assets<sup>2</sup>. The insurer pays to the owner, either an amount of money which had been previously determined between them or an amount that covers the actual loss suffered. Either way, the insurance company hopes to collect more in premium payments than it has to pay out as claims from policy holders otherwise it would be operating at a loss. Any insured person, who never had to make a claim, loses the money he paid out as premium and profits are shared by shareholders of the company<sup>3</sup>.

The insured may sometimes recover nothing or more or less than the actual value of the loss. He may even eventually make a claim but the amount he has paid as premium may be greater than his claim<sup>4</sup>. This feature, unfortunately, has a lot in common with gambling (*maysir*) or wagering and some persons actually buy insurance with the hope that they may gain more than they have risked in premium payments. Gambling is unlawful for Muslims as indicated *Surah al Baqarah* (2: 219) and *Surah al Maida* (4:90) of the Qur'an.

The possible absence of certainty regarding time and amount of payment and the amount the insured will claim at the time of loss raise questions as to the existence of *gharar* (uncertainty) in an insurance contract<sup>5</sup>. There is also the possible existence of elements of *riba* (also prohibited in Islamic law) in the transaction as insurance is often an unequal exchange between the insured and the policy holder. Finally In conventional insurance, a beneficiary to a life insurance is considered absolute and may deal with the benefits of the policy as he deems fit.

<sup>1</sup>Kuran, T. (2005). The Logic of Financial Westernization in the Middle East, *Journal of Economic Behaviour & Organization*, No. 56, pp. 4593-4615.

<sup>2</sup>Dorfman, M. (1994) *Risk Management in Insurance*. Prentice-Hall New Jersey. P11

<sup>3</sup>Hardy :vamy, E.R, (1970). *General Principles of Insurance Law*. Butterworths, London. 1970

<sup>4</sup>Rejda E. G. (2011). *Principles of Risk Management and Insurance*, eleventh edition, Prentice Hall, United States.

<sup>5</sup>Iqbal, M. (2005), *Takaful General Practice: Technical Approach to Eliminate Gharar (uncertainty), Maysir (gambling) and Riba (usury)*, Gemalnsani,.

This is in contravention of Islamic rules of inheritance as the beneficiary may, in such a case, take to the detriment of legal heirs of the deceased.

These issues do make conventional insurance questionable for Muslims. Though Siddiqi<sup>6</sup>, and Al Zarqa<sup>7</sup>, both eminent Islamic scholars, have made distinction between insurance and gambling. Yet the fact that the insured may lose his premium payments if no claim is made and the fact that monies paid are invested into interest bearing or illegal transactions cannot be ignored.

Scholars of Islamic economics have not been unanimous in their rulings regarding the position of conventional insurance and are divided into three groups<sup>8</sup>; The first group views insurance as illegal (haram) because it contravenes, under Islamic due to the existence of *riba*, *gharar* and *maysir* and there is no express permissibility for insurance in the Qur'an or traditions of the Prophet Muhammad SAW. Scholars are who fall into this category include Sheikh Muhammad Salih al Munajjid, Rahman Wahab Al Zuhayli and Shaikh Muhammad Ibn Adam Al Kawthari<sup>9</sup>.

The second group (though a minority) considers conventional insurance, as it stands, as a necessary part of economic life which can be distinguished from those elements which would normally vitiate a contract for Muslims. Scholars who are in this category include Ibn Abidin a Hannafi jurist. The late Sheikh Mustafa Al Zarqa<sup>10</sup> and Nejatullah Siddiqi<sup>11</sup> also hold this view.

The third group takes a moderate course from the former views. That insurance can be and is legal but if done within the confines and dictates of Islamic economic guidelines and regulations. Scholars who hold this view include Muhd Ma'sum Billah and Mufti Muhammad Taqi Usmani<sup>12</sup>. As an extension of this view, Muslim scholars and economists came together to reintroduce the concept of Islamic insurance into modern day society with modifications so that it would develop and grow in today's economic environment. In Sudan in 1979, the

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<sup>6</sup>Siddiqi, M. N. (1985). *Insurance in an Islamic Economy*, The Islamic Foundation, Leicester, UK,

<sup>7</sup>Al Zarqa, M. (1962). *The Insurance System: Its Reality and the Sahara Opinion*, Al Resala

<sup>8</sup>Rashid, S. K. (1993). Islamization of Insurance-A Religio-Legal Experiment in Malaysia, *Religion and Law Review*, No. 2, pp. 16-40.

<sup>9</sup>Sohail, J. (2007). *Islamic Insurance*. Euromoney Books. P24

<sup>10</sup>Al Zarqa, M, op. cit

<sup>11</sup>Siddiqi, M. N. Op. cit

<sup>12</sup>Muhammad Taqi Usman, (2000.) *The Historic Judgement on Interest Delivered in the Supreme Court of Pakistan*. Idaratul- Ma'arif, Karachi. Pakistan. P35

first company which would provide *Shari'ah* compliant insurance services was established and the service was called *Takaful*.

## 1.2 The Islamic Insurance Company

*Takaful* is the Arabic word for 'guaranteeing each other' and comes from the root word *kafala*<sup>13</sup>. Different definitions have been advanced for the term *takaful*. It has been variously defined as "The Islamic insurance concept which is grounded in Islamic muamalat (commercial transactions) observing the rules and regulations of Islamic law"<sup>14</sup> and as "A type of Islamic insurance, where members contribute money into a pooling system in order to guarantee each other against loss or damage. *Takaful*-branded insurance is based on *Shari'ah*, Islamic religious law, and explains how it is the responsibility of individuals to cooperate and protect each other"<sup>15</sup>

*Takaful* insurance is modeled on the framework of mutual insurance. A group of persons with the desire to 'help one another' in times of distress, contribute money into a common fund which will be sufficient to pay claims of members as they arise<sup>16</sup>; The *takaful* system is based on what is referred to as the principle of '*Tabarru*' (donation/charity). While other insurance contracts are usually entered into with a view to making profit, *takaful* is basically a tool for risk management and distribution based on *ta'awun* (solidarity and mutual assistance). Individual risks are not transferred to a third party -par adventure an insurance company- as is the case with conventional insurance<sup>17</sup> but is shared among the members who agree to defray the losses of each other. At the end of each financial year, if the fund has not been exhausted by the payment of claims, any excess is distributed among the members to the ratio of their contributions<sup>18</sup>.

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<sup>13</sup> Bekkin, J. (2007). Islamic Insurance: National Features and Legal Regulation, *Arab Law Quarterly*, Vol. 21, pp. 109-134.

<sup>14</sup> Usmani, M. T (2005). *An Introduction to Islamic Finance*, Idaralsha'at -E- Diniyat (P) Ltd, New Delhi, p 31

<sup>15</sup> Ahmed, M and Ahmed, S. *Islamic Insurance: Theory and Practice*, [www.albaraka.com](http://www.albaraka.com)

<sup>16</sup> Maysami, R. C. (2006). Evidence on the Relationship between *Takaful* Insurance and Fundamental Perception of Islamic Principles, *Applied Financial Economic Letters*, 2(4). 229-232. Research Collection School of Accountancy.

<sup>17</sup> Rejda, E. G. (2011). Op. cit

<sup>18</sup> Muslehuddin, M. (2006) *Insurance and Islamic Law*, Adam Publishers & Distributors, New Delhi. P29

### 1.2.1 *Modus Operandi*

The common practice has therefore become that persons place money within a fund via *tabarru* and undertake to indemnify each other for specified losses. The fund is managed by a *takaful* operator which is an entity separate from the contributors to the fund. It is usually a company with shareholders (not inclusive of the contributors to the fund). Therefore, the Islamic insurance company is a hybrid of a *Shari'ah* compliant mutual structure for participants and a *Shari'ah* compliant management company<sup>19</sup>.

In administering the *takaful* fund, three general models have been adopted by Islamic insurance companies, with some variants of these models. The models are basically the methods designed for the purpose of providing remuneration for the *takaful* operator. Each model is expected to provide funds to cover not only operating expenses of the operator, but also include profits that will be distributed to its shareholders if any<sup>20</sup>.

- i. The *Mudarabah* Model creates a partnership where the contributors are considered to be the *rabb al mal* (owners of the money) and the *takaful* operator is the *mudarib* (manager of the money)<sup>21</sup>. The *takaful* operator is expected to provide entrepreneurial skills to manage the fund by investing reserves from the fund so that profit is realized which is shared with the operator on a predetermined ratio. Any loss suffered is absorbed by the *takaful* participants<sup>22</sup>. A modified *mudaraba* model allows the operator to receive remuneration that will cover operating and management expenses before calculating the deficit or surplus realized from underwriting and also shares profits made from investments<sup>23</sup>.
- ii. The *Wakala* Model is a management contract where the *takaful* participants employ the operator to manage the fund on their behalf as

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<sup>19</sup>Dikko, M. (2016). An Analysis of the Regulatory Framework Governing *Takaful* Industry in Nigeria. Unpublished PhD Thesis submitted to Islamic Business School, Universiti Utara, Malaysia

<sup>20</sup>Fahmy and Sarkar, *Islamic modes of Finance and Financial Instruments for Resource Mobilization: A Survey* In: Ahmad Ausaf and Khan (ed): Islamic Financial Instruments for Public Sector Resource Mobilization, Islamic Research and Training Institute, Jedda

<sup>21</sup>Rahman, (1979). *Banking and Insurance*, Vol. 4, The Muslim Schools Trust, London ;Pasha, A. T. and Hussain, M. M. (2013). *Takaful Business Models: A review, a Comparison*, *Business Management Dynamics*, Vol. 3, No. 4, pp. 24-32; Nagaoka, S. (2010). Reconsidering *Mudarabah* Contracts in Islamic Finance: what is the Economic Wisdom (Hikmah) of Partnership-based Instruments. *Review of Islamic Economics*, Vol. 13, No.2, pp.65-79; Chua Abdullah, O. (2000). *A Critical Evaluation of Insurance and Takaful*. A paper presented at the International Conference on *Takaful/ Islamic Insurance*, Kuala Lumpur.

<sup>22</sup>Abdullah, H. & Dawood, T. (2009) Risk Management in *Takaful*. In Archer Simon et al Ed. *Takaful Islamic Insurance: Concepts and Regulatory Issues*. P 182

<sup>23</sup>Siddiqi, M. N. Op.

- wakeel* (agent) and this is done following set guidelines laid down by them. In this model, the operator imposes an upfront fee for managing the fund<sup>24</sup>. The operator is not entitled to share in the income generated from the *takaful* fund. The participants, on the other hand assume the risks involved with underwriting.
- iii. The *Wakala Mudarabah* Model combines the principles of *mudarabah* – sharing of profits realized from investment of reserve funds- with those of *wakala* which involve the payment of agency fees for the management of the *takaful* funds. The principles of *mudarabah* are applied towards the investment of funds while *wakala* is applied for running the business of the *takaful* operator. This means that the operator not only gets its fees for services rendered, it also becomes entitled to share in any profits made from investments as incentive<sup>25</sup>. It is however, not entitled to a share of any underwriting surplus.
- iv. In the *Waqf* Model the shareholders of the *takaful* operator are the contributors to a fund which they cede to be used to compensate persons who suffer loss. A party becomes a policyholder, not by making a contribution to the fund, but by filling out a form and taking out a subscription to the fund. The shareholders determine to whom and how much money should be paid. They also determine investments and use of surplus. The *Wakala Waqf* model implies that the *takaful* participants contribute money to the fund which is then considered as a contribution to be used for charity and could include the provision of compensation for loss of property by any member. The operator is entitled to payment of management fees and a portion of returns on investment as *mudarib*<sup>26</sup>.

### 1.2.2 Legal Structure.

The common practice is to have, attached to a *takaful* company, a *Shari'ah* supervisory board which ensures that its practices do not deviate from the *Shari'ah* accepted standard. In countries which operate the Islamic legal system, laws have been enacted which deal with issues ranging from the establishment of,

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<sup>24</sup>NuHtay, S. and Zaharin, H. R. (2011). Critical Analysis on the Choice of *Takaful* (Islamic Insurance) Operating Models in Malaysia; and *Regulatory Issues*; Mohd, B. (2009) *Shari'ah* Principles Governing *Takaful* Models. In: Archer, Simon et al., *Takaful Islamic Insurance: Concepts and Regulatory Issues*, op. cit. page 43

<sup>25</sup>Akter, W. (2010). *Takaful Models and Global Practices*, MPRA paper No.40010, July 2012; Kwangit, et al (2012). The Management of *Takaful* Models in Malaysia, *Advances in Natural and Applied Sciences*, 6 (4), pp. 561-564.

<sup>26</sup>Abdullah, A. and Yaacob, H. (2012). Legal and Shariah Issues in the Application of *Wakala-waqf* Model in *Takaful* Industry: An Analysis, *International Congress on Interdisciplinary Business and Social Science, Procedia-Social and Behavioral Sciences*, Vol. 65, pp 1040-1045.

to registration and regulation of the *takaful* company. In others, it has been argued that since the operation of *takaful* company is similar to the mutual cooperative, they should be regulated by the same mechanism that handles mutual companies. Unfortunately, in most countries where there are *takaful* operators, there is no structure for the control of mutual and cooperatives.

The guiding principles of *takaful* companies are not usually found in enacted laws but in rulings of scholars of Islamic law and finance. However, a few countries like Malaysia (with the Financial Services Act (IFSA) 2013 which replaced the Takaful Act 1984) and Pakistan (the Insurance Ordinance 2000 and Insurance Rules 2002 regulate all insurance business in the country including Takaful. The Takaful Rules 2005 and later the Takaful rules 2012 were however made to provide for the additional requirements of Takaful) have absorbed or enacted these into binding laws to regulate the industry. In Nigeria, the *takaful* guidelines made in 2013 is the only Industry specific regulation made and is subject to the provisions of enacted Law for the regulation of the insurance industry as a whole.

### 1.3 Issues in *Takaful*

In the provision of insurance for Muslims via *takaful*, there are certain issues that exist- both legal and regulatory. These issues span questions as to the legality of certain practices from the point of view of the *Shari'ah*, to conflict of laws and the adequacy of the framework for *takaful* operations.

The first of these is the framework for *takaful* itself. The common practice is to refer to donations made by policyholders as '*tabarru*' which means donation. The *Shari'ah* ruling on donation, similar to those concerning gifts and charity, is that once made, the maker loses any right to it and may not recall it or receive back any portion of it<sup>27</sup>. Therefore, if paid contributions are referred to as *tabarru*, the policyholder would legally be unable to make a claim and receive compensation in cases of loss.

Secondly, indemnification is made from the fund to which donations are made annually. However, where the fund is insufficient to cover all claims made on it, the donors to the fund are sometimes asked to make further donations to cover the deficit. This implies that the initial voluntary donation may be tied to a

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<sup>27</sup>Mohd, Op. cit; Bekkin Op. cit

possible future compulsory indeterminate amount<sup>28</sup>. However, this particular issue has been addressed in a number of jurisdictions by regulations asking the *takaful* operator to provide a benevolent loan (a non interest loan referred to as *qardhasan*) to the *takaful* fund to maintain its solvency.

Third, the models used in *takaful* also raise some questions. The *mudarabah* model creates conflict because *tabarru* is not meant to be a profit making and sharing relationship<sup>29</sup>. Therefore, *tabarru* fund cannot be *mudarabah* capital at the same time. The sharing of underwriting surplus between the *takaful* participants and the operator turns the mutual insurance into a commercial venture not an agreement for mutual cooperation and assistance. Jeffery, Ismail, Noor & Unwin<sup>30</sup>, express misgivings about the practice of the *takaful* operator advancing a non-profit loan (*qardhasan*) to the fund in the case of deficit. This technically converts the operator, as *mudarib*, to a guarantor which is not a feature of the *mudarabah* contract.

Also worrisome about the *mudarabah* model is the fact that with *mudarabah*, it is not legal for a party to the agreement to stipulate a certain amount as his proceeds from the arrangement. Only ratios of possible profits may be fixed<sup>31</sup>. However, in the practice of the modified *mudarabah* model, the fee of the *takaful* operator is fixed beforehand and is paid even if no profits are realized. Again, the fact that the contributor has the right to payment of a fixed amount (particularly in family *takaful*) as compensation which amount is determined at the time of entering into the *tabarru* agreement also goes against this basic principle of *mudarabah*.

The common practice among *takaful* operators is of mixing financing models so as to maximize profits of operators. In fact Muhd<sup>32</sup> raises the important issue of whether the *takaful* scheme is really a mutual cooperation or proprietorship and one gets the feeling that Islamic ideals have been sacrificed to ensure the economic viability of the *takaful* company. Also, in *takaful*, the question to which there is no unanimous answer is whether the amount on the

<sup>28</sup> Archer, A. and Nienhaus (Ed). *Takaful Islamic Insurance: Concepts and Regulatory Issues*, John Wiley & Sons (Asia) Pte. Ltd. 2009. P55

<sup>29</sup> Jaffer, S., Ismail, F., Noor, J., Unwin, L. (2010). *Takaful (Islamic Insurance): Concept, Challenges, and Opportunities*, Millman Research Report, November, 2010. P44

<sup>30</sup> ibid

<sup>31</sup> Abdul Gafoor, A.L.M. (2001) *Mudarabah-Based Investment and Finance*, <http://users.bart.nl/~abdul/article2.html>.

<sup>32</sup> Mohd, B. op. cit

policy should be regarded as a gift to the beneficiary, or that he holds it in trust for the heirs of the deceased which may or may not include him<sup>33</sup>.

A number of *takaful* companies purchase reinsurance from conventional reinsurers due to the lack of adequate *retakaful* providers<sup>34</sup> or the *retakaful* operator may not be subjected to the same rigor of scrutiny concerning Islamic principles as is done for the *takaful* company<sup>35</sup>. This means that though a person may presumably obtain *Shari'ah* compliant insurance, there is still some tinge of illegality inserted into it as his operator does not enjoy same.

Finally, a crucial issue is created by the conflict of laws regulating *takaful*. In most cases, the company may be bound to follow regulations and implement practices which are not *Shari'ah* compliant. In addition, each *takaful* operator usually has a *Shari'ah* Advisory Board whose function is to ensure that the *takaful* company operates within and remains *Shari'ah* compliant. The problem here is that there is no central *Shari'ah* board which would ensure the uniformity of practices amongst the companies.

The absence of uniformity of laws regulating *takaful*, is also a deterrent to ensuring that the same service is obtained worldwide. While certain jurisdictions may have achieved a significant degree towards ensuring the system conforms to every Islamic ideal, others are still far behind. For example apart from the IFSA Act in Malaysia, specific provisions are found within a number of guidelines which include the Takaful Operational Framework (TOF), Risk-based Capital Framework for Takaful Operators (RBTO), guideline on Operating Costs for Family Takaful Business (OCC guideline), guidelines on Claims Settlement Practices and a Concept Paper on Appointed Actuary: Appointment and Duties (AA Concept paper) among others. The cumulative effect of these regulations is improved sharia compliance in the provision of *takaful* services. In Nigeria, on the other hand, the fact that the only legislation regulating *takaful* is subject to other laws regulating regular insurance means increased chances of operators having to conform with provisions contrary to the rulings for Islamic financial services<sup>36</sup>.

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<sup>33</sup> Ismail (2009) *Nomination and Hibah Issues in the Takaful Industry*. A Paper Presented at the ISRA *Shari'ah* Conference on *Takaful*, 2009. P33

<sup>34</sup> Arbouna, M. B. (2000). The Operation of *Retakaful* (Islamic Reinsurance) Protection. *Arab Law Quarterly*, Vol. 15, No 4, pp.335-362.

<sup>35</sup> Mohammed, A. (2009). Reinsurance and *Retakaful*. In: Archer, Simon et al., *Takaful Islamic Insurance: Concepts and Regulatory Issues*. p 52

<sup>36</sup> Dikko, M. (2018). A Comparative Review of *Takaful* Frameworks in Nigeria, Malaysia and Pakistan. *International Journal of Islamic Business*, Vol.3, Issue 1, pp 57-70

#### 1.4 Conclusion, Observations and Recommendations

The assessment of conventional insurance indicates that an Islamic alternative is the preferred choice for Muslims thus the introduction of mutual insurance referred to as *takaful*. However, this system though striving to encapsulate Islamic principles still faces challenges. One must, however, agree that monumental bridges have been crossed towards the islamization of financial services. Thus, despite the presence of certain practices and principles which should be subjected to closer scrutiny, *takaful* insurance is still the better alternative for Muslims.

There may still be room for improvement. It is suggested that the term *tabarru* in *takaful* should be replaced with *Musahamah* (contribution). The participant will then have no restriction in Islamic law to make a claim against the risk on the subject matter of the policy. The beneficiary under a life insurance policy should be regarded as a trustee on behalf of the heirs. Third, the *takaful* company should not purchase reinsurance from companies that are not *Shari'ah* compliant and efforts should be made to establish companies which would provide adequate *retakaful*.

Furthermore, scholars of Islamic finance and other stakeholders should come together to establish two things: a uniform framework for the operation of all *takaful* companies and a general *Shari'ah* supervisory board to ensure uniformity of practices. Finally, the *takaful* company must be liberated from the control of laws governing conventional insurance companies.