Exposition of different Takaful Models: Business Models and treatments

1. TAKAFUL BUSINESS MODELS

The acceptance of the Takaful Business Model by the consumers is a key factor which could derive the future business volumes. The selection of the Shariah Board itself is again a key decision-maker which could have a significant impact on the credibility of the Takaful company.

It is critical that the Takaful Business Model to be followed is discussed at length in the very initial stages when setting up a takaful company. This is to ensure that all subsequent decisions are taken keeping in view the model to be adopted. The model would also need to comply with the local Shariah board requirements.

The selection of technical partners should also be subject to the business model being followed by the technical partners to be compliant with local Shariah board or be flexible enough to be modified to comply for local purposes.

This section covers the different business models that are prevalent amongst Takaful operators. The senior management of a Life company needs to understand these and after discussions with local Shariah scholars/ potential technical and equity partners may need to decide on the details of the model to be adopted.

The issue relating to the classes of business that the company should be able to underwrite as well as the type of risks to be underwritten has been discussed later in this section. This aspect would also involve clearance from Shariah advisors.

There are a number of significant differences between Takaful and conventional insurance companies. Takaful companies not only follow the principles of Shari’a, but also have distinctive features compared to conventional companies.

The following is a comparison between Takaful and conventional insurance companies:

<table>
<thead>
<tr>
<th>Takaful Companies</th>
<th>Conventional Insurance Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Takaful is based on mutual cooperation.</td>
<td>Conventional insurance is based solely on commercial factors.</td>
</tr>
<tr>
<td>Takaful is free from interest (Riba), gambling, (Maysir), and uncertainty (Gharar).</td>
<td>Conventional insurance includes elements of interest, gambling, and uncertainty.</td>
</tr>
<tr>
<td>All or part of the contribution paid by the Participant is a donation to the Takaful Fund, which helps other Participants by providing protection against potential risks.</td>
<td>The premium is paid to conventional insurance companies and is owned by them in exchange for bearing all expected risks.</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>Takaful companies are subject to the governing law as well as a Shari’a Supervisory Board.</th>
<th>Conventional companies are only subject to the governing laws.</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is a full segregation between the Participants Takaful Fund account and the shareholders' accounts.</td>
<td>Premium paid by the Policyholder is considered as income to the company, belonging to the shareholders.</td>
</tr>
<tr>
<td>Any surplus in the Takaful Fund is shared among Participants only, and the investment profits are distributed among Participants and shareholders on the basis of Mudaraba or Wakala models.</td>
<td>All surpluses and profits belong to the shareholders only.</td>
</tr>
<tr>
<td>In case of the deficit of a Participants’ Takaful Fund, the Takaful operator (Wakeel) provides free interest loan (Qard Hasan) to the Participants.</td>
<td>In case of deficit, the conventional insurance company covers the risks.</td>
</tr>
<tr>
<td>The Plan Owners’ and shareholders’ capital is invested in investment funds that are Shari’a compliant.</td>
<td>The capital of the premium is invested in funds and investment channels that are not necessarily Shari’a compliant.</td>
</tr>
<tr>
<td>Takaful companies have re-insurance with Re-Takaful companies or with conventional re-insurance companies that adhere to certain conditions of Shari’a.</td>
<td>Conventional insurance companies do not necessarily have re-insurance with re-insurance companies that abide by Shari’a principles.</td>
</tr>
</tbody>
</table>

Takaful is not conventional insurance because in conventional insurance:

- **Maysir (gambling)** – underwriting of risks by shareholders in anticipation of a profit is prohibited

- **Gharar (excessive uncertainty)** – the insured pays premiums in exchange for indemnity against risks that may not occur

- **Riba (usury)** – the company engages in investments that derive their income from interest and/or prohibited industries

Takaful in principle is Mutual because:

- **Solidarity and joint guarantee**

- **Self-reliance and self-sustaining for community well-being**

- **Assist those that need assistance • Community pooling system**

- **Shari’ah approved investments and products**

Moreover, Takaful's main drivers are:

- **Piety (meaning individual purification)**
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- Brotherhood (via Ta'awun or mutual assistance)
- Charity (Tabarru or donation)
- Mutual Guarantee; and
- Self-sustaining Operations as opposed to profit maximization

### 1.1. Takaful Models

#### 1.1.1. Al Wakalah

Under this approach the takaful operator acts as an agent ‘wakeel’ for the participants. The idea is that to successfully manage a takaful operation, the participants appoint an agency with the expertise to carry out the operations on behalf of the participants.

The agency may be paid a fixed fee which may be a percentage of the contributions. Some contracts also provide for an incentive fee in the form of a percentage of the underwriting surplus. The rationale for this second component of fees is that it would act as an incentive to ensure prudent underwriting, minimize claims costs etc. We are not sure about the Shariah aspect of this as we think that sharing in any portion of the underwriting surplus would basically make it similar to conventional insurance. The agent should as a part of his responsibility as an agent ‘wakeel’, ensure that the objectives of maximizing the benefits for the takaful participants are met.

The policyholders are the owners of the company instead of being customers as in conventional insurance. The agent merely collects the policyholders into common pools so as to derive economies of scale and underwriting capacity so that insurance under mutual cooperation is possible. Any underwriting surplus is then also distributed to policyholders, subject to conditions. The shareholders earn return on their investment through wakala fees (net of administrative expenses). Only expenses related to claims and claims performance is deducted from participant’s funds when calculating surplus for the policyholders.
1.1.2. **Al Mudarabah**

Under this model, the contract specifies how the profits from the operations of takaful would be shared in accordance with the principles of Al Mudarabah. The sharing may be in the ratio of 50:50, 60:40, 70:30 etc as mutually agreed.

The basic issue which many scholars disagree with under a Mudarabah model is the sharing in the underwriting profits which makes it similar to a commercial contract whereas Takaful is not a commercial contract but is a contract of mutual cooperation and protection.
1.1.3. WAQF Model (Wakah based)

The key details between wakala waqf and wakala prevalent model in a comparative format are shown below:

<table>
<thead>
<tr>
<th>Wakala WAQF based</th>
<th>Wakala prevalent model</th>
</tr>
</thead>
<tbody>
<tr>
<td>In waqf model, the participants’ real relation is with the Waqf and not the company and the company has the relation with the waqf and not the participants.</td>
<td>Relationship is between the participants and the company and also amongst the participants.</td>
</tr>
<tr>
<td>All the donations (tabarru) become the Waqf’s property once they are paid. No issue of Miras/inheritance.</td>
<td>The donations (tabarru) remain in the ownership of the participants until there occurs any loss to any of them due to the requirement of surplus distribution. This also leads to issues of inheritance etc.</td>
</tr>
<tr>
<td>The company is wakeel (agent) of the Waqf</td>
<td>The company is agent of the participants.</td>
</tr>
<tr>
<td>The ‘Waqf Fund’ is a separate legal entity.</td>
<td>The ‘Tabarru Fund’ is not a legal entity.</td>
</tr>
<tr>
<td>Underwriting profit or loss belongs to ‘Waqf Fund’.</td>
<td>Underwriting profit or loss is to be borne by the participants.</td>
</tr>
<tr>
<td>Qardul Hasnah by Takaful Operator (as agent) is in some cases an obligation of shareholders.</td>
<td></td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th></th>
<th>Different generations would return Qard and not the same.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Also it is preferred that Wakeel should not be guarantor.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>It is not necessary to distribute the surplus (donation once given does not retain the right to get back) but the Waqf fund may do so as per its rules.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The participants have the right to receive the surpluses. This means that the donation is a conditional donation.</td>
</tr>
</tbody>
</table>

Waqf Fund would basically be a separate legal entity to which the Shareholders would initially make a donation to establish the Waqf Fund. The donation can be of any amount. The objectives of the Waqf fund would be to provide relief to participants against defined losses as per the rules of the Waqf fund.

Saudi Arabia follows the cooperative insurance model instead of takaful. Cooperative risk-sharing and profit-sharing prevails throughout such companies in the primary insurance level as well as in any Re-Takaful arrangements, as opposed to using a brokerage fee-based relationship common in Wakala model.

<table>
<thead>
<tr>
<th><strong>Factors</strong></th>
<th><strong>Saudi Cooperative Model</strong></th>
<th><strong>Takaful Model</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract</td>
<td>Similar to conventional insurance with the difference being that for eg. 10% of Shareholders profits need to be distributed to the participants.</td>
<td>Participants own the Participants Takaful Fund (PTF) which is managed by the operator. Participants give up individual rights to gain collective rights over contribution and benefits.</td>
</tr>
<tr>
<td><strong>Responsibility for providing protection</strong></td>
<td>The insurance company provides protection in return for the premiums paid by the policyholders.</td>
<td>The participants are in a way responsible for protecting each other on the concept of mutual cooperation and contribute in the form of ‘tabarru’ (donation). The Takaful operator is responsible for managing the Takaful operations on the behalf of participants.</td>
</tr>
<tr>
<td>Surplus</td>
<td>The surplus emerging from insurance operations (investments, expenses, and risk/morbidity) is shared between shareholders and policyholders according to a ratio (for eg. 10% of the surplus goes to policyholder). The return on Shareholder’s fund would 100% belong to the Shareholders and not be a part of the 90:10 distribution.</td>
<td>The surplus in the Takaful Fund (risk/morbidity surplus) belongs to the participants. The surplus in the Operator Fund belongs to the Operator.</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th><strong>Liability of the insurer/operator</strong></th>
<th>Insurer carries risk in lieu of premium and is responsible to pay claims from its assets.</th>
<th>The Takaful operator, acting on behalf of the participants as Risk managers, pays claims from the Takaful fund. In case of a deficit in the Takaful Fund, the operator has to provide an interest free loan (Qard e Hasnah) to the Takaful Fund that is recoverable from future underwriting surplus.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment</strong></td>
<td>regulator specifies the investment limitations for each class of assets.</td>
<td>All funds have to be invested in Shariah compliant investments.</td>
</tr>
</tbody>
</table>

### 1.2. Differences in the prevalent Wakalah model and Wakalah model based on Waqf

The major differences in the prevalent Wakalah model and the Wakalah model based on Waqf are highlighted below:

### 1.3. Waqf Approach

The key elements under the Waqf concept as applied in Takaful, has been expressed in the following slides.

The introduction of Waqf is for the elimination of the element of "Contract of Compensation". Consequently, this also eliminates the elements of Maisir (Gambling) and Gharrar (risk) from the insurance contract.

The graphical presentation of Waqf model is given below:
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1.3.1. Purpose of Waqf Fund from Equity

Shareholders (SH) would allocate a share of its Capital/equity to form a Waqf.

This allocated share may be in the form of Fixed Assets or Liquid Assets or a combination of both.

The basic objective of Waqf is to develop a fund, which would be used to help those who are seeking financial compensation in case of unforeseen losses and to help them in restoring their losses.

The fund, after its creation, would form a separate legal entity that has the ability of accepting ownership or making someone the owner of any asset.

After the creation of the Waqf fund, the Shareholders would lose their ownership rights on the Waqf fund. However, they will have the right to administer and develop rules and regulations of the fund.

1.3.2. Operation of Waqf Fund

The donations received from the participants, seeking takaful protection, would also be a part of this fund and the combined amount will be used for investment and the profits earned would again be deposited into the same fund.

Company on the basis of set rules and regulations would pay the losses of participants of the fund from this same fund.

Besides this, all operational expenses that would be incurred for providing takaful services e.g. arrangements of Re-takaful and building-up of Reserves will also be met from the same fund.

For different lines of takaful services (different types of risks), more than one Waqf fund can be formed with the shareholders’ money to form a waqf further allocated into different portions to form separate waqf funds for different lines of takaful services.

1.3.3. Remaining Money Of Shareholders (SHs)

Other than Waqf (original donation), the remaining SHs money is basically not required to provide the services of Takaful.

But to fulfill the basic legislative need of capital and to increase the strength of the company, the shareholders may provide this as equity.

Company may use the remaining capital i.e. after excluding Waqf to generate profits for the shareholders.

The loss and profit on this investment would belong to the shareholders.

This amount may be used along with Waqf and donations to generate profits.
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1.3.4. **Donation to The Waqf**

Participants would contact the takaful company for seeking the coverage/protection against unforeseen future losses.

Company can also contact potential clients for sales.

Company would take the installments from the participants as per the defined rules.

Participants would pay their premium as donation to the Waqf.

Company would take this donation on behalf of the Waqf fund as administrator of the fund and deposit this in the fund.

The ownership of the participants (donators) would be lost as soon as they pay donation to the Waqf fund and would become the property of the Waqf fund.

Participants would as per the rules of the Waqf fund be entitled to receive compensation against defined future losses.

1.3.5. **Rate Of Tabarru**

The rules of Waqf would define the basis to identify the rate of donation for a participant.

It would not be necessary that the same rate would apply to all participants, instead it may be defined on the basis of actuarial principles.

However, the company would be required to define same rate of donation for each type of risk for different individuals on the principle of equity.

It would not be permitted to ignore the Waqf rules by charging lower rate for acquiring the business of a particular client i.e. to charge lower rate of donation and/or provide coverage for greater amount. This would count as a serious offence by the company against the Waqf fund.

If any participant does not pay the full donation after the agreement, then it would be permissible for the Waqf to cut-down the compensation rate in case of loss or the participant may be disqualified for any compensation.

1.3.6. **Compensation Of Loss**

Loss will be compensated with the help of donations and the profits of the Waqf Fund. The original money of the Waqf Fund would not be permissible to be used under any circumstances.

1.3.7. **Relations & Rights**
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Takaful company works as a Trustee & Agent of the Fund. It receives the donations from the participants as Agent of the Waqf and acts as Trustee for delivering and using the waqf funds.

Company would be entitled to take charges for the service that it renders.

In case of loss, it would be the responsibility of the waqf fund (not company) to compensate the losses as per the defined rules & regulations of the fund.

In waqf model, the participants’ real relation is with the Waqf and not the company and the company has the relation with the waqf and not the participants.

There are basically only two parties involved i.e. waqf fund and participants and the company is only the agent of the waqf fund.

In addition to the relation of agent with the waqf, the company also has a relation of mudarib, when it invests the waqf fund as mudarib.

1.3.8. Income Of The Company

Company may receive income from three resources:

1. Service Charges: For performing the services, company would be eligible for taking a defined remuneration, which would be paid from the Waqf fund.
2. As Mudarib by sharing in the investment profits OR as Agent for Investment by taking service charges
3. By investing the money of the SH and earning profits

From this remuneration, Company would bear the expenses related to the salaries of its employees, rents and other administrative expenses, expenses related to capital and the expenses related to its fixed assets.

Company can take this remuneration in the form of a fixed and defined lump sum amount OR a fixed defined percentage of donations. Company can deduct its remuneration up-front.

1.3.9. Relationship of Donors with each other and with the Waqf

There would be no direct contractual relationship between the participants with each other, as they have not entered into any agreement directly with each other nor through the company.

Participants direct contractual relation would be with the Waqf fund.

They donate to the Waqf fund and Waqf fund is responsible to compensate them for the losses. Company simply acts as an Agent in the contractual relationship between the participants and the Waqf fund.
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1.3.10. Distribution of Surplus

The premium paid by the Participant to the waqf fund would immediately be considered, as the property of the waqf fund.

After compensating for the losses if there is any surplus left from this contribution or from the profit received on the investment of this contribution, then there would be no right of the Participant on that surplus amount.

Instead, if there is any predefined rule of the waqf fund that the surplus would be distributed amongst the participants then this would be considered as an additional benefit given by the waqf fund.

1.3.11. Reserves

Waqf fund would be allowed to form a Reserve Fund for future situations from the contribution received and the profit earned on the investment.

This Fund would also be the property of the waqf fund and the profit received on it would also be treated as a property of waqf fund.

With the help of this fund Waqf may compensate the current as well as the future participants.

Waqf does not need to refund that reserve to the participants at any given period of time.

1.3.12. Loan From The Company To Waqf Fund

If the waqf fund is in a deficit which cannot be met despite Re-Takaful coverage, then the company from its own assets would be allowed to provide loan to the waqf fund, so that the waqf may be able to perform its responsibilities.

Company would be allowed to recover this loan from the waqf fund over any period without charging any interest.

1.4. Takaful Model To Be Adopted

The Middle Eastern model based on Wakalah should be preferred over the Malaysian model based on Mudarabah. This is because under the Mudarabah model, there is apparently no difference from conventional insurance as the operator shares in a portion of the underwriting profits which is not acceptable to Shariah scholars in the Middle East neither to scholars in Pakistan due to gharar (excessive uncertainty).

We are of the opinion that since the Waqf based model would have more credibility and acceptance amongst the Shariah scholars and as a result more credibility amongst the consumers, it would be prudent to adopt the Waqf basis.

Waqf basis in technical terms is the same as the well-recognized Wakalah based approach being followed by many takaful operators. It only addresses some of the concerns that Shariah scholars
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have relating to the Wakalah model by forming a separate trust mechanism (Waqf). So this would involve some changes in the documentation and the initial creation and contribution to the waqf fund as a separate legal entity.

It is proposed that the approach may also be discussed with Technical partners to obtain their clearance / acceptance to this refinement which would ensure greater acceptance and therefore, appeal amongst a larger consumer base.

1.5. Classes of business and types of risks that may be underwritten

“Takaful Insurance” means a scheme based on mutual assistance in compliance with the provisions of Islamic Shariah, and which provides for financial aid and assistance to the participants in case of occurrence of certain contingencies and whereby the participants mutually agree to contribute to the common fund for that purpose. The principle of Takaful requires that the Takaful operator / shareholders of the company should not in any form benefit from the underwriting results of the pooling arrangement. This implies that any surpluses in the Takaful Fund would need to either remain in the Takaful fund or used for the benefit of the Takaful participants in any form but would never in any form revert to or be used for the benefit of the Takaful operator.

1. The objects for which the Company is established is to design takaful schemes or plans that meet the needs of participants and to act as a Takaful/Retakaful Operator to manage insurable risks.

2. To carry on takaful, all kinds of Family/Life and General Insurance business under the principles of Takaful as may be permissible by the Shariah Board.

3. To accept reinsurance relating to all types of risks permissible from other takaful or retakaful pools. The company cannot, however, accept reinsurance of risks insured under a conventional insurance contract.

4. To reinsure risks from takaful pools operated by the company to retakaful pools managed by other companies. However, in the event of non-availability of retakaful arrangement(s) and provided that this is permitted by the Shariah Board, the company may seek reinsurance from conventional reinsurance companies.

The company would need to have all its products and operational practices approved by the Shariah Board. Most Takaful operators internationally may be able to offer all Family/Life General Insurance products that are prevalent in the conventional insurance system takaful based products have been developed.

There are however some insurance products such as loss of profits etc which may be prohibited by some Shariah Boards as the nature of the loss is not real but based on expected future earnings. This does not mean that liabilities insurance is prohibited as well. Liability insurance claims in courts that certain damages have already occurred in the past and that compensation should be provided to cover those losses. That is why this does not present a problem of Shariah
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for takaful companies. It would in any case be essential to have all products and material approved by the Shariah Board. The technical partners once on board would have knowledge of specific issues in specific products and would need to interact with the Shariah Board to finalize the products which may be finally launched.

Another issue to be considered relates to the types of risks that may be underwritten. It is understood that Takaful companies would not provide contracts for "prohibited activities" for e.g. import of alcohol would not be covered by a takaful operator. It is not very clear whether for instance cars or other assets of a conventional bank can be insured by a takaful operator.
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1.5.1. INVESTMENT PLAN

Investment Avenues for a Takaful Company

In addition to its prime business, and as a support thereof, a Takaful Company also needs to invest the available funds in various profitable ventures, in order to ensure a good return on capital, as well as, ensure stability of the Company to cope with the circumstances that might be faced in case of excessive number of claim than anticipated.

The current Investment Rules relating to conventional insurance companies may not be acceptable for a takaful operator and need to be defined separately.

In the ensuing paragraphs we would like to touch upon various investment options and modes which may be available to a Takaful company in accordance with the conjunctions of the Islamic Shariah enabling it to achieve its prime objective and operate its business efficiently and effectively. Islamic shariah raises the concept of Takful, which is a scheme of mutual support that provides insurance to individuals against hazards of falling into unexpected and dire needs.

The basic investment modes and options which may be available to a Shariah compliant Takaful company may be as follows:

➢ Real estate business;
➢ Investments in joint stock companies and mutual funds;
➢ Investments in redeemable capital;
➢ Placement of excess funds with banks and Islamic financial institutions; and
➢ Direct financing under Islamic modes.

Amendments are needed to allow for Shariah compliant investment options but with limitations to protect the takaful funds from being invested in highly risky alternatives. These limitations need to consider the risk profile of each type of investment and set limits to protect the takaful funds. Islamic Bonds called ‘sukus’ or other secure alternatives can also be availed by Takaful companies.

In the ensuing paragraphs, we wish to briefly define the above-mentioned options and to describe the basic rules and conditions therefore ensuring that these generate purely Halal profits and also providing an outlook on the accounting procedures for such investments.

1.5.1.1. Real Estate Business

Investment in real estates has always been a center of concentration for an insurance company, even operating under conventional insurance because it is an investment for the long term and generates high returns. Even for short returns for general insurance, rent is quite attractive. Fortunately, this stream of investments for a Takaful Company is a Halal source of income subject to a very few conditions implied by the Shariah.

Basic Rules

Basic rules for investments in real estate include the following:
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➢ The use and intended use of the property should be in compliance with the Shariah;
➢ Return on rented property may be in form of fixed rent but in case of delayed payments no interest or mark-up may be charged;

Classification and Accounting Treatment

Generally, an investment in real estate has two motives of earning profits. The first one is capital accretion due to fluctuation in prices during which an investment in real estate is held by the investor, whereas, the second one is to earn rentals by lending such real estate on tenancy basis. A real estate property can be classified and accordingly qualify for recognition under relevant accounting treatments depending on the intended use of property by the investor:

i) Investment Property; and
ii) Property, Plant and Equipment.

Investment Property

A real estate property is classified under this category if property is purchased for capital appreciation or letting it out to others on one or more operating leases and not used substantially for its own business.

Takaful Company may choose the fair value or cost model for measurement of investment subsequent to initial recognition at cost. If it chooses the fair value model, all of its investment property shall be carried at fair value and a gain or loss arising due to change in the fair value of investment property shall be included in net profit or loss for the period in which it arises. However, cost model suggests measuring the investment property at cost less accumulated depreciation and any accumulated impairment losses.

Property, Plant and Equipment

Real estate property qualifies for recognition under this category if it is owner occupied (used substantially for its own business purposes). Takaful Company can purchase property and use for its own purposes or let it out to others and generate economic benefits.

An item of Property, Plant and Equipment which qualifies for recognition as an asset, may be carried at cost less accumulated depreciation and any accumulated impairment losses or at revalued amount being the fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses, subsequent to initial recognition at cost.

1.5.1.2. Investment In Joint Stock Companies And Mutual Funds

Takaful Company can also invest its funds in joint stock companies and earn return in form of dividends and capital gains. Principally the business of investments in common stocks of joint
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stock companies for long-term benefits or for short-term profit taking has been declared Halal by the majority of religious scholars, subject to certain basic conditions that are being elucidated in the following paragraphs.

It should be noted that preferred stocks, debentures and fixed return based redeemable capital securities are classified as Haram, irrespective of complying with the following rules and conditions.

Basic Rules

Following are the basic rules for investments in the common stocks of joint stock companies:

➢ The main business of the investee company does not violate Shariah. Therefore, it is not permissible to acquire the shares, debentures or certificates of the companies providing financial services like conventional banks or the companies involved in businesses prohibited by Shariah like Pork, Pornography, gambling or night club activities etc.;
➢ If the main business of the investee companies is Halal, like automobiles, textiles etc, but they deposit surplus amounts in interest bearing accounts or borrow money on interest, the investors (in this case the Takaful Company) must raise his voice in annual general meeting of the investee companies on ground of Islamic Shariah;
➢ If some income from interest bearing accounts or non-Halal activities is included in the income of the investee company, the proportion of such income should not be material (exceed 5% of the total income). If it is considered material (i.e. exceeds 5%), it is not permissible to invest in that company. However, if does not exceed 5%, it must be given in charity and must not be retained by the Takaful Company. The basic rationale of this limitation of 5% is not specifically derived from Quran or Sunnah, it is the collective consensus or Ijtihad of contemporary Shariah scholars. It is also worthwhile to be noted, that certain scholars are of the view that any capital gain income from the trading of shares of such a company also needs to be purified using any appropriate formula;
➢ The debt to equity ratio of the investee company should not exceed 30%. The rationale behind this condition is by the following Hadith of the Holy prophet(SAW), “One third is big or abundant” (Tirmizi). 30% is less than one third of the total assets of the company and not considered abundant as per above Hadith;
➢ The shares of a company are negotiable only if it owns illiquid assets i.e. the assets other than cash or cash equivalent. If all the assets a company are in liquid form i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the shares represent money only and the money cannot be traded in except at par;

1.5.1.3. Investments in Mutual Funds

A Takaful company can also make its portfolio investments through various mutual funds, instead of investing in its own developed portfolio in order to minimize the risks associated with these investments and / or in order to get the benefit of expertise of experienced fund and investment managers managing such mutual funds.
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It is pertinent to note that in the current regime of awareness regarding Halal investments, the concept of Islamic mutual funds has also been introduced that are being floated and managed by well-known financial institution and investment companies. These funds generally comply with the above referred basic rules regarding investments in joint stock companies, however, before making any investment therein it would be appropriate to get the procedures and practices being followed by such funds, be vetted by the Shariah advisors of the investors.

However, the management might also decide to make investments in normal mutual funds being operated subject to the conditions laid down earlier insofar as these are applicable to the investments in the shares of a normal joint stock company that might have some income from Haram sources.

Classification and Accounting Treatment

Investments in stocks and mutual funds is generally made with two basic motives as identified earlier and accordingly their classification and accounting treatment also depends on the same.

Investments for long-term profit taking are classified as “available for sale” and ‘held to maturity’ and capital gains and losses thereon are recognized either directly in equity or in profit and loss according to the accounting policy consistently applied.

Investments for short-term profit taking are classified as “held for trading” and any profit or loss thereon is immediately recognized.

1.5.1.4. Investments In Redeemable Capital

Musharika certificates, term finance certificates (TFCs) and participation term certificates (PTCs) are the options of redeemable capital issue available. In principal, these should not be based on interest and instead these are supposed to be issued on the profit and loss sharing basis according to the schemes of their issue. These certificates may or may not be listed on the stock exchange.

Basic Rules

For the purpose of investment in redeemable capital it needs to be ensured that these are issued in compliance with the Shariah conjunctions and in this respect it would be appropriate to get the scheme of their issue be vetted by the investor’s Shariah advisors. In this respect, the basic rules for musharika instruments area being discussed in the following paragraphs. If the basic instrument of redeemable capital is considered to be Halal, the takaful company may invest in the same subject to the basis conditions laid down earlier for investments in the common stock of joint stock companies.

Classification and Accounting Treatment

Investments in redeemable capital shall be classified according to the substance of the transaction as a loan or an investment. Returns thereon shall be recorded on accrual basis whereas, in case of increase or decrease in fair value of such investment or loan, it shall be accounted for in equity or in profit and loss account in accordance with the classification of such instrument, as well as, the accounting policy of the Company.
1.5.1.5. Placement Of Excess Funds With Banks And Islamic Financial Institutions

The most important question regarding investments is the investment of surplus funds on liquid or short notice basis in order to ensure the optimal usage of available funds and to maximize the returns such as for reserves. In this respect it should be kept in mind that even in case of surplus funds or losses, it is not considered Halal to invest in an interest based scheme. Accordingly, the takaful company should be vigilant regarding the investments in this area.

Following are the investment and placement opportunities in this respect:

➢ Investments in short-notice deposits schemes of Islamic banks or other Islamic financial institutions;
➢ Placements in PLS saving accounts of Islamic banks; and
➢ Placement in current accounts of traditional banks – without any return thereon.

Basic Rules

In case of return based investments, it is necessary that these should be made in an Islamic bank or Islamic financial intuition only, whereas it would also be appropriate that the practices and operations of such bank or institution are vetted by the Shariah advisors of the investor or it is ensured that such bank or institution has been audited for its Shariah compliance. In this respect it needs to be assured that the return on such placements or investments should be based on profit and loss sharing basis only. On the other hand, the investments and operations of such bank and financial institution should only be in the Shariah compliant avenues.

Classification and Accounting Treatment

These are classified as cash and cash equivalents and recorded at the fair value. Any returns and profits are recognized on accrual basis.

1.5.1.6. Direct Financing Under Islamic Modes

Financing Possibilities and Feasibility

In addition to the above mentioned investment opportunities, another avenue for maximizing return on investments for a takaful company is direct financing arrangements under the Shariah compliant schemes. However, such a matter would be highly sensitive as it is not directly related to the core business of such company, and also a risky business. Moreover, the matter of permissibility of these transactions under the prevailing insurance laws and rules framed thereunder, vests with the regulators. In this respect this also needs to be ensured before entering in a transaction as to whether the objects of the company as laid down in the memorandum of association allow such a transaction.

Nevertheless, in the ensuing paragraphs we wish to highlight the salient features of the few basic tools of Islamic financing. It is worthwhile to note that the same rules shall be applicable, on the other side of the picture also, whereby the takaful company would be obtaining financing facilities for its own operations from Islamic banks and financial institutions.

1.5.1.7. Musharika


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A Takaful Company may also choose the way of partnership in different businesses under Islamic Shariah to make its business prosperous and profitable. The description and basic rules for Musharika financing are presented below for guidance

Definition

The literal meaning of Musharika is sharing. The root of the word “Musharika” in Arabic is Shirkah, which means being a partner. Under Islamic jurisprudence, Musharika means a joint enterprise formed for conducting, some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest based financing with far reaching effects on both production and distribution. The Takaful Company can use Musharika in two forms namely:

- Permanent Musharika;
- Diminishing Musharika.

Permanent Musharika is the conventional form of partnership whereas Diminishing Musharika is an innovated mode. The basic difference between the two is the continuity of the contract. Permanent Musharika and its types are discussed in detail in this point and Diminishing Musharika will be discussed in the next point.

All these modes of “Sharing” or partnership are termed as “Shirkah” in the terminology of Islamic Fiqh, while the term “Musharika” is not found in the books of Fiqh. This term (i.e. Musharika) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of “Shirkah”, that is, the Shirkat-ul-Amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-Aamal also where partnership takes place in the business of services.

1.5.1.8. Diminishing Musharika

Another form of Musharika, developed in the near past, is Diminishing Musharika. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share until all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.
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Practical Steps of Musharika

Permanent Musharika

The Takaful Company tenders part of the capital required and authorizes the customer / partner to manage the project partner.

Partner tenders part of the capital required and acts as trustee for funds received from Takaful Company.

Results of project may be positive or negative.

Each partner bears part of the loss proportionate to its share in capital.

Profits are divided in accordance with the agreements between the two parties (the company and the customer).

Takaful Company tenders part of the capital required and agrees with the customer / partner on a specific method of selling its share in capital.

Partner tenders part of the capital required and acts as trustee for funds received from company.

Results of project may be positive or negative.

Each partner bears part of the loss proportionate to its share in capital.

Profits are divided in accordance with the agreements between the two parties (the company and the customer).

Bank expresses its readiness to sell a specific percentage of its share in capital.

Partner pays the price of the percentage of capital whose ownership is transferred to him.
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1.5.1.9. Common forms of Musharika

Permanent Musharika

This is considered to be the appropriate mode for collective investment in modern economic life. The Takaful Company can use this form of partnership by contributing capital to new or established projects.

The Takaful Company by using this method as a mode of investment make sufficient liquidity available to the customer in the long run. Equity investment in big projects through share capital is a form of this mode of Musharika.

Diminishing Musharika

This mode of Musharika can be used for various types of financing done by the Islamic banks. Following is a list of some of the uses of Diminishing Musharika:

- Project financing
- Short term financing
- Housing finance
- Fixed assets financing

Basic Rules

- In Musharika (Partnership) the capital is specific, existent and under disposal. It is invalid to establish a Musharika on non-existent fund or debt.
- That partners may have varying shares in capital subject to agreement.
- That the capital of the Musharika is money and valuable. It may consist of merchandize on condition that it is evaluated in the contract and the value is agreed upon.
- Profit for each partner must be known to avoid uncertainty and it must be a pro rate ratio to all partners and must not be a lump sum because this contravenes the requirement of partnership.
- Profit must be divided among partners in ratios as agreed at the inception of Musharika while each partner bears loss proportionate to its ratio in the capital.
- It is impermissible to impose condition forbidding one of the partners from work. However, it is permissible for one partner to singly work in the Musharika by mandate of other partners.
- A partner is a trustee on the funds in his hand from the Musharika and he guarantees only in case of trespass or negligence and it is permissible to take security for profit or capital.
- In principle, partnership is a permissible and not a binding contract, so it is admissible for any partner to rescind the contract whenever it wishes provided that this occurs with the knowledge of the other partner or partners, because rescinding the contract without the knowledge of other partners prejudices their interests. Some of the jurists are of the view that the partnership contract is binding up to the liquidation of capital or the accomplishment of the job accepted at the contract.
- In the case of a decreasing partnership, it shall not be a mere loan financing operation, but there must be real determination to participate and all the parties shall share profit or loss during the period of the partnership. The Takaful Company
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must completely own its share in the partnership and must have its complete right in management and disposal. In case the company authorizes its partner to perform the work, the company shall have the right of supervision and follow up.

➢ It is impermissible to include in the contract of decreasing partnership a condition that adjudges the partner to return to the Takaful Company the total of its shares in capital in addition to profits accruing from that share, because of resemblance to Riba (usury).

➢ It is permissible for the Takaful Company to offer a promise to sell its shares in the Musharika to the partner, if the partner pays the value of the share. The sale must be concluded as a separate deal with no connection to the contract of the Musharika.

➢ On the liability side of the Takaful Company, same principles have to be followed as in case of asset side. However, for making it practicable, pools and projects may be separately identified on which the profit sharing ratios may be determined to be different from each other.

Classification and Accounting Treatment

Investments in Musharika shall be classified as an investment or in certain circumstances as a loan on the basis of the nature and substance of the transaction. Takaful Company’s share in Musharika capital shall be recognized when it is paid or made available to the partner. Takaful Company’s share in Musharika capital shall be measured at cost. Takaful Company’s share in revenue or losses shall be recognized at the time of liquidation for Musharika transactions that commences and ends during the same financial period. In case of Permanent Musharika that continues for more than one financial period, Takaful Company’s share of profits shall be recognized to the extent of profits being distributed.

1.5.1.10. Murabaha

Murabaha sale is one kind of an absolute sale. It is selling the commodity for the purchase price plus a certain profit margin agreed upon. Murabaha is one of the most widely used modes of finance by the Islamic banks. It is suitable for partial financing to the investment activities of the customers, in industry, trade or other. It enables the customer / investor to obtain finished goods, raw material, machines or equipment from the local market or through import.
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The mode of Murabaha sale connected to a promise (Murabaha to a purchase orderer) is used by the Islamic banks which undertake the purchase of commodities according to the specifications requested by the customer and then resell them on murabaha to the one who promised to buy for its cost price plus a margin of profit agreed upon previously by the two parties.

Practical Steps of the Murabaha Sale

1. The purchaser determines its needs
2. The purchaser contacts the seller for determination of price
3. Seller sends a quotation to the purchaser valid for a certain period
4. The purchaser contacts the insurance company and shows intentions for purchasing the said product from the bank on Murabaha
5. The Takaful Company studies the request and determines the condition and securities required
6. The company communicates its approval to the buyer
7. The seller expresses its approval and sends the invoice
8. The company and the purchaser enters into a Murabaha sale agreement on agreed upon terms and conditions
9. The purchaser receives the commodity on behalf of the company from the seller
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1.5.1.11. Common forms of Murabaha

As mentioned earlier, Murabaha is the most widely used mode of financing used by the Islamic banks. It can be used in the following different ways for financing of different customer needs:

➢ Long term financing requirements for financing of fixed assets, stocks etc;
➢ Short term financing requirements for financing of working capital needs;
➢ As an alternative to running finance arrangements;
➢ Installment sale for financing of fixed assets or in some cases, for car financing;
➢ Normal Murabaha sale by the Takaful Company working as a trading house;
➢ House financing;
➢ Export financing (pre-shipment); and
➢ Import financing.

Basic Rules

❖ The mutual promise agreement shall contain various conditions agreed upon by the two parties, especially with respect to the place of delivery, the payment of an encashable security to guarantee the implementation of the operation and the method of paying the price.
❖ It is permissible to stipulate the binding nature of the promise to purchase. The effect of the promise being binding is determined either by the satisfaction of the promise or indemnifying the damages caused by breaking the promise without excuse.
❖ It is a condition that the company purchases the requested commodity before selling it to on Murabaha to the buyer. The contract in the first purchase must be settled, in principle, between the source seller and the Takaful Company.
❖ It is permissible for the Takaful Company to authorize a second party including the buyer to receive the commodity on its behalf. This authorization must be in a separate contract in case of the buyer for fear of giving false impression of connection between the authorization and the Murabaha Sale.
❖ After the Takaful Company purchases the commodity and before selling it on Murabaha to the buyer, the Takaful Company shall bear the consequences of any damages or defects (unless there is an agreement with the customer releasing the Takaful Company of the defects). That means if the commodity is damaged the Takaful Company is liable and if the commodity is defective, the Takaful Company bears the responsibility, thus it cannot deliver the commodity to the buyer and the buyer will not bear any risks or responsibilities.
❖ It is a condition that the Murabaha sale contract be drawn at the last phase. That is after the promise to purchase and the purchase of the commodity in the name of the Takaful Company and receipt of the commodity directly by through an agent.
❖ The legal rules of Murabaha must be observed in drawing the contract of Murabaha sale connected with a promise to purchase, especially the conditions of the transparency of the cost of the first purchase and the amount of profit because ignorance leads to dispute and invalidates the contract.
❖ It is permissible to document the debt resulting from Murabaha by a guarantor or a mortgage, like any other sale on credit.
❖ It is permissible that the mortgage accompanies the contract or be prior to it, because it is possible to take mortgage on actual debt as well as promised debt.
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before it is realized but the mortgage shall only be in effect if the debt goes into effect.

❖ Once entered into a Murabaha transaction, the price and other conditions cannot be changed, unless specifically approved by the Shari’a Supervisory Board.

Classification and Accounting Treatment

Receivables on account of Morabaha sales shall be classified as trade receivables. Assets acquired for Murabaha shall be measured at cost. Revenue shall be recognized by using either proportionate allocation of profits over the period of credit or as and when the installments are received.

1.5.1.12. Other Islamic Financing Modes

A Takaful Company may also use the following mode of financing modes to make their operations purely Islamic Shariah basis. Following is the list of those modes with their basic definitions for understanding purpose.

1.5.1.13. Ijara (Lease)

Lease is the employment of money in operations other than sale and purchase operations. That is the subject of operation is the sale of the benefit of the asset not the asset itself. These operations aim at obtaining the rentals and the proceeds by receiving the benefits of the assets through time.

There are two types of Ijara namely:

➢ Ijara (Operating lease); and
➢ Ijara Muntahia Bittamleek (Ijara wa iqṭina).

Assets acquired for Ijara shall be recognized at cost. Ijara income shall be recognized in on a straight-line basis over the Ijara term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

1.5.1.14. Salam

Salam is a sale of commodity whose delivery will be in a future date for a cash price. It is the financial transaction in which price is advanced in cash to the seller who abides the delivery of commodity of determined specification. Salam is treated as a futures derivatives contract but without the leverage aspect.

Assets acquired through Salam financing shall be measured at lower of cost and cash equivalent value and if cash equivalent value is lower the difference shall be recognized as loss. The difference between the amount paid by the client and cost of commodity shall be recognized as profit or loss.
Istisna is the purchase of commodity by ordering the manufacturer to manufacture the specific commodity to the purchaser. The manufacturer uses his own material to manufacture the required commodity and the price is fixed with the consent of the parties and necessary specification of the commodity to be manufactured is fully settled between them.

Istisna cost shall be recognized in an Istisna work-in-progress account. Istisna revenue shall be recognized according to either:

- Percentage of completion;
- Completed contract method; or
- Deferred profit using proportionate allocation of deferred profits over the future financial period of credit or as and when each installment is received.

1.5.1.16. An Important Note

It is noteworthy that the guidelines provided above have been included herein as a general guide for the benefit of the reader. Since these are only general comments, no final conclusion on any issue should be drawn without further consideration and professional consultations, particularly with regard to the matters relating to the permissibility or otherwise of various financial transactions. In this respect, it is strongly recommended that before taking any action in the light of the above guidelines, specific consultation with the relevant experts should be carried on.

As per IAIS report 2006 “Issues In Regulation And Supervision Of Takaful (Islamic Insurance)” the differences between Takaful and conventional insurance clearly have regulatory implications. For example:

- A Takaful operator has an obligation to ensure that all aspects of the insurance operations are compliant with Shari‘a rules and principles. To do so, it will draw on inhouse religious advisers, commonly known as a Shari‘a board.

- The Takaful operator will be representing to policyholders, either explicitly or implicitly, that its operations are in accordance with Shari‘a rules and principles. Some regulators would consider they had a responsibility to ensure that such representations are wellfounded.

- In a Family Takaful plan there are generally no guarantees (i.e. they operate on a ‘defined contribution’ rather than a ‘defined benefit’ basis). This implies that the risk profile is different from the standard insurance product, where guarantees are normally given in terms of maturity benefits, surrender benefits and death benefits. This has implications both for capital adequacy and for disclosure to consumers.

- The solvency regime needs to reflect the location of risk. For example, if there is a deficit in the underwriting fund, how strong is the obligation on the operator to give an interest free benevolent loan, and what account should be taken of this in the solvency regime. This raises the issue in practice of whether liability can be extended to policyholders’ investment accounts.
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- Because policyholders share in any surpluses and, in principle, meet any deficits in the underwriting pool, there is a need to determine how their shares should be determined. At present different companies follow different policies in this respect. • Because investments must be Shari’a compliant, a Takaful firm cannot invest in conventional interest-paying bonds, or in certain types of equity (brewers being an obvious example). There are also limitations on the use of derivatives, for example to hedge currency risk. The asset risk profile will therefore be different from that of a conventional insurer.

Moreover, General insurer in takaful cannot pay for business interruption causing loss of profits because this event has not occurred yet and is based on an estimate of an uncertain future.

### 1.6. Conclusion

The future of Takaful would depend largely on the Takaful operators as well as the users of this alternative to conventional finance. Whether Takaful would develop eventually become the real insurance alternative for the Muslims as well as others would depend on the commitment and political willingness of the Muslims at the individual, community, national and international levels. What is urgently needed is the practical translation of these commitments and political willingness by all.

If there is a commitment and strong political willingness plus the application of modern management practices in approach, Takaful operations have the potential to further grow then currently into a viable and profitable business venture.

The huge potential that exists in the market as well as the results of the financial projections indicate that the opportunity for a takaful operator can be immense. However, the key to success would be the ability to establish credible operations with a well-trained operational and marketing staff familiar with the Shariah aspects of Takaful.

With its generally superior features compared with conventional insurance policies, it provides boundless opportunities for takaful once the awareness and credibility are established.

For example, in Malaysia apart from individuals, more and more corporations and multinationals are using Takaful products including among the non-Muslims community.

A number of crucial issues have to be addressed to ensure credibility and acceptability and hence brighter future for Takaful. The single greatest challenge is how to compete against the giant conventional insurance companies and survive. Company should adopt multi-faceted strategy:

- Foremost is the natural affinity of the Muslim community.
- Religious endorsements and Shariah Scholars supports are equally important factors.
- Professionalism is critical and should not be underestimated.
- Price competitiveness in modern times is a necessity.
- Company must present a competitive product/service in terms of price, quality of coverage and delivery time.
- Company should also rely upon product innovation to set it apart from the competitors.

In summary, company should exert marketing power and promotion of Takaful program to create an image and portray values sensitive to the Islamic community.
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Among the future challenges takaful may face as a whole are:

- Shortage of skilled insurance manpower and dedicated to apply Takaful concepts in operational practices
- Lack of motivated Muslims familiar with Takaful operations
- Start-up risks of slow production, limited capital and other resources
- Regulatory changes
- Investment of Funds
- Managing explosive growth once it takes off