Islamic Insurance (Takaful) and conventional Insurance, Concept and challenges

التأمين التكافلي والتأمين التقليدي، المفهوم والتحديات

Sara Alouache& Sofiane Fikarcha

Faculty of Economic, Commercial and Management SciencesFaculty of Economic, Commercial and Management Sciences

University of Blida 2 – AlgeriaUniversity of Blida 2 – Algeria

Abstract:

Insurance plays an important and growing role in various economic and social activities. However, some Muslims have taken into consideration the practices of insurance companies that are contrary to their religious beliefs, and which can not be tolerated. Hence the thought of establishing insurance companies that are considered to be Shari'a-compliant. This was motivated by an obligation to engage in insurance activity in violation of Islamic law, on the one hand, and on the other, to respond to a gap in the insurance market. Takaful insurance companies began to emerge in the early 1970s in Saudi Arabia, Sudan, the Middle East and the Far East, based on solidarity and cooperation between individuals and organizations.**Keywords:** Takaful, conventional insurance, insurer.

الملخص:

يلعب التأمين دوراً هاماً ومتنامياً في مختلف النشاطات الاقتصادية والاجتماعية. إلا أن بعض المسلمين أخذ بالنظر إلى ممارسات شركات التأمين القائمة على أنها منافية لمعتقداتهم الدينية، وأمراً لا يمكن قبول التعامل به.ومن هنا ظهر التفكير بإنشاء شركات تأمين تُراعي اعتبارات الشريعة الإسلامية. فكان الدافع وراء ذلك الالتزام بممارسة نشاط التأمين بما لا يخالف الشريعة الإسلامية، هذا من جهة، ومن جهة أخرى الاستجابة لفجوة قائمة في سوق التأمين. فبدأت شركات التأمين التكافلي (الإسلامي) بالظهور في بدايات السبعينيات من القرن الماضي في المملكة العربية السعودية والسودان والشرق الأوسط والشرق الأقصى، وهي تقوم على أساس التضامن والتعاون بين الأفراد والمنظمات.

الكلمات المفتاحية: التأمين التكافلي، التأمين التقليدي، المؤمن له.

Introduction:

Islamic finance consists of Islamic banking, Islamic insurance and Islamic capital market. Being one of themajor elements, Takaful (Islamic insurance) does have a significant role in the industry. The concept of Takaful is where a group of people participate in a scheme that enables them to share the burden of anymisfortunes faced by any of the participants/policyholders, and where appropriate, compensation arepaid using the funds contributed by the participants.

The risk profile for Islamic finance can be categorized into general risks and unique risks. Islamic financewith its unique characteristics give rise to a set of risk management challenges namely; (1) credit risk; (2)liquidity risk; (3) legal and fiduciary risk; (4) financial supervision and transparency; and (5) shari'ahsupervision risk . Due to the rapid growth in Islamic finance, there is a need for a uniquerisk framework for Islamic institutions, particularly for Takaful operators. Therefore, this paper looks atthe basic of takaful industry.

Islamic insurance was first established in the early second century of the Islamic erea. This was the timewhen Muslim Arabs started to expand their trade to India, Malay and other countries inAsia. Due to the long journeys, they often had to incur huge losses because of mishaps along the way. Based on the Islamic principle of mutual help and cooperation in good andvirtu ous acts, they got together and mutually agreed to contribute to a fund before they started theirlong journey. The fund was used to compensate anyone in the group who suffered losses through anymishap. In fact the Europeans copied this, which was later known as marine insurance.

Objectives of the study:

Generally, the objective of the study is to review the prospects and challenges of takaful insurance . However, the specific objectives of the study are:

- To characterize the takaful insurance industry
- To assess the prospects and potentials of takaful insurance
- To draw comparative analysis between different markets
- To evaluate the key challenges.

To achieve these objectives, the following research question is formulated :

What are the characteristics that distinguish the takaful insurance industry to meet the challenges in the world insurance market ?

In order to simplify the main question, we divided it into the following sub-questions :

- What is the concept of the takaful insurance ?
- what is the differences between conventionnal and Takaful insurance ?
- What are the main challenges of the world Takaful insurance ?

This paper will look into the Shariah inconsistencies issue in the Takaful industry. The paper will start with the definition of the risk, the insurance concept followed with the elaboration on the Takaful industry. To increase our understanding on this issue, this paper will be continued by the industry examples of Takaful markets. Lastly, this paper will be ended with some recommendations and conclusions.

I-Risk definition:

Riskiseverywherearound us. Wherever one goes or whatever action one takes, thereis an element of “risk”. This isbecause the future, even the next few seconds of life, isunknowable. Hence, everythingwe do contains an element of risk and uncertainty.

One definition of risk points to “the possibility of lossoccurring in the future”[1]. The occurrence of such a lossismeasured by probability (likelihood) and impact (severity). Common understandingtakes a viewthatriskis “negative” and consists of twoparts:

- **Uncertainty**– an eventmay or may not happen
- **Loss**– an event has unwantedconsequences or causes loss. In insuranceterms, a lossis an unexpecteddecrease or disappearance of economic or monetary value

The Australia/New Zealand Standard for Risk Management definesrisk as “…the possibility of something happening that impacts on your objectives. It is the chance to eitherrmakea gain or aloss. It is measured in terms of likelihood and consequence.”

Traditionally, the concept of risk has been associatedwithuncertainty of events in future. In insurance, riskistheamount of lossassociatedwithproperty or life. Risk to propertycanbe a loss or damage to car, building, house, etc. Risk to life canbe described as poor health, premature death, bodily injuries as a result of accident etc.[2]

1- The Definition of Insurance:

Insurance is a risk-sharing arrangement between two parties. In this arrangement, one party (the insurer) agrees to indemnify another party (the insured) against certain losses specified by a contract (the policy). Insurance is an economic device by which individuals and organizations can transfer pure risks (that is, uncertainty about financial losses) to others.[3]

In other words, insurance is basically a mutual-help where people intend to help each other. However, we have to underline, that insurance here is to transfer a risk from one party to another party, which risk itself is pure risk and not speculative risk. Pure risk is different with speculative risk, where the outcome for the pure risk is only loss not gain. On the other hand, speculative risk is where there is probability to gain.

2- The Takaful Industry:

Takaful means ‘guaranteeing each other’ and is based on the principles of ‘Ta’awun’ (mutual co-operation) and ‘Tabarru’ (donation), where a group of Takaful participants (policyholders) agree between themselves to share the risk of a potential loss to any of them, by making a donation of all or part of their Takaful Contribution (premium) to compensate for a loss. Compared to conventional insurance's risk transfer, Takaful implies risk sharing framework where all the Takaful participants share the risks together.

The word "Takaful" originates from the Arabic word Kafalah, which means "guaranteeing each other" or "joint guarantee"[4]. In this modern world, Takaful is commonly referred to as Islamic insurance even some people claim it as not an insurance contract[5]., Takaful is based on principles of mutuality and co-operation, encompassing the elements of shared responsibility, joint indemnity, common interest and solidarity.

Bank Negara Malaysia, in its website has interpreted Takaful as follows;

"Takaful (Islamic insurance) is a concept whereby a group of participants mutually guarantee each other against loss or damage. Each participant fulfils his / her obligation by contributing a certain amount of donation (or tabarru) into a fund, which is managed by a third party - the Takaful operator."[6]

There are four underlying principles of Takaful, which are:

- Ta'awun: Taawun is mutual help of a group of people.
- Tabarru': Tabarru'at is willingly relinquishing individual rights over the contributions paid, for collective benefits.
- Losses are divided and liabilities spread according to the community pooling system.
- It does not seek to derive advantage at the cost of others.

3- Types of Takaful Products

There are basically two types of Takaful products in the market worldwide- General and Family Takaful. Let us analyze each type further.

3-1- General Takaful

General Takaful are Takaful policies that cover everything else except the family and health benefit. It usually a short term policy, as short as few days coverage only. Some of the examples of General Takaful products are as follows;

- Fire Takaful;
- Car Policy;
- House Coverage;

- House Content Coverage;
- Group Coverage;
- Travel Policy.

3-2- Family Takaful

Family Takaful is basically a Life Insurance's counterpart. It covers family, health and education benefits. It usually a long term policy, may up to 30 years. Some of the products are;

- Family Takaful;
- Health Benefit Takaful;
- Critical Illness Coverage;
- Education Benefit;
- Saving Benefit.

4- Features of takaful

Some of the characteristics of the takaful industry are [7]:

• The customers (policyholders) of the takaful business agree to pool their contributions and share the liability of each policyholder. So if one policyholder has to be paid a claim, this is paid out of the combined pool of the policyholders' contributions.

• As with mutual insurance, the policyholders share in the profit and loss of the takaful business, i.e. the policyholders all share the insurance risk – they do not give the risk to the takaful company (as occurs in a conventional shareholder insurance company) Consequently, if at the end of a financial year, the takaful business makes a surplus, this is shared between the takaful policyholders.

• If at the end of the financial year the policyholders' fund makes a loss, this deficit is funded by an interest-free loan from the shareholders' fund. The shareholders' fund is then repaid the loan from any future surpluses of the policyholders' fund. The shareholders cannot access the capital from the policyholders' fund except when the interest-free loan is being repaid.

• The assets of the takaful business have to be invested in Shariah compliant assets. For example, investments can't be made in gambling institutions, or businesses that make alcohol.

• The operators of the business are paid explicit fees for setting up and running the company on behalf of the policyholders. These fees should cover all the setting-up costs, running costs and profit loading of the shareholders and are the only way that the shareholders are remunerated. After the fees are deducted, any surplus arising from the takaful business is shared amongst the policyholders only. These explicit fees are in the takaful contract that each policyholder signs with the takaful company and are fully transparent.

5- Takaful Models

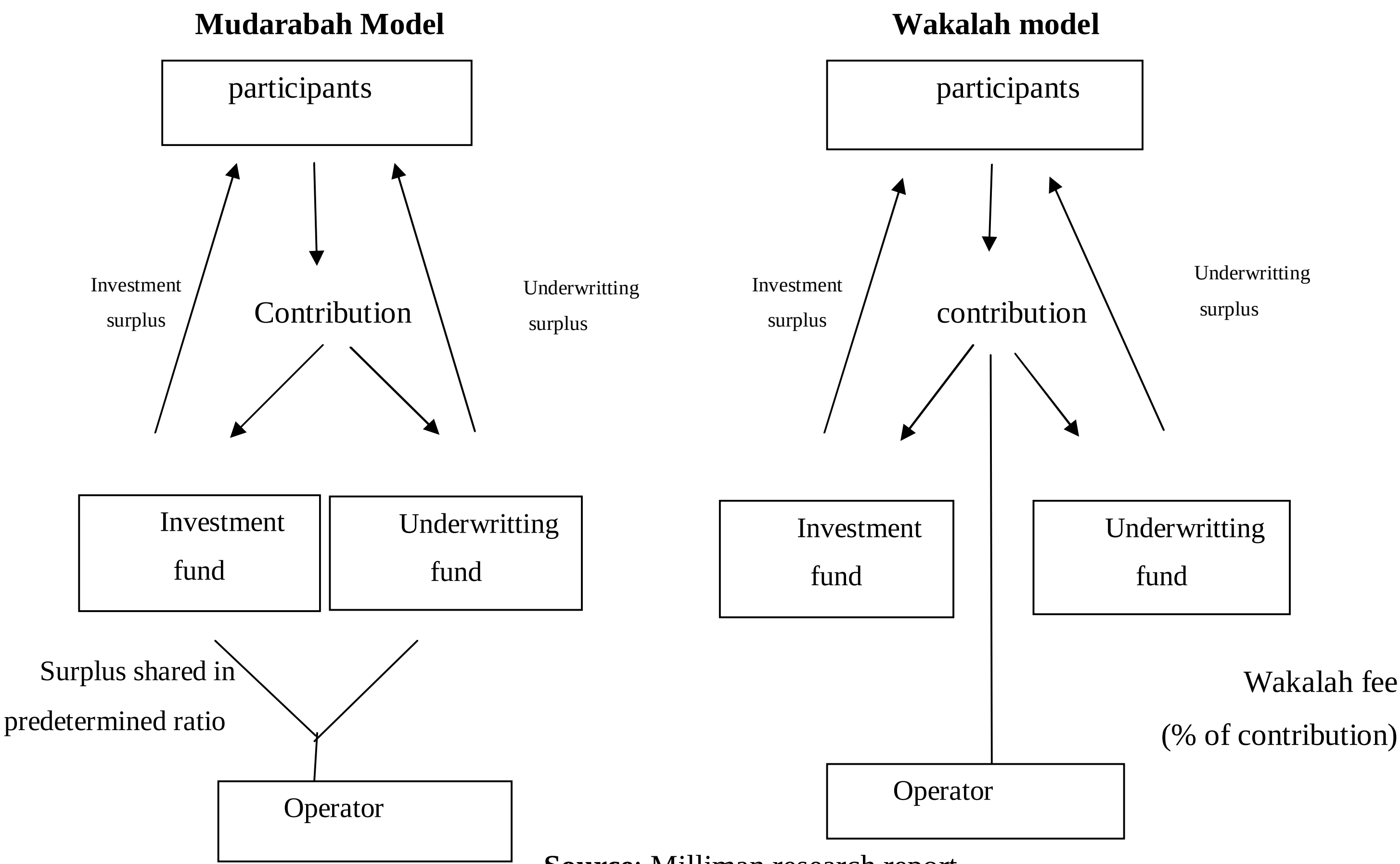
There are a few models used in Takaful which is Mudharabah, Wakalah and Tabarru-Based Takaful model.[8]

- **Mudarabah Model**: it describes that all policyholders must agree to share profits (or losses) from the undertaking. Under this model, the operators do not have to pay a commission but will receive a salary which will be paid from share of profits made by the company. These same conditions apply to the management. The sharing of profit and loss between the participant and operator is determined in advance and judged on the basis of company's developmental stage and earnings. The sharing ratio is approved by the Shariah committee on advance basis. Normally total expenses are charged to shareholder under Mudarabah.

- The second model is **Wakalah Model**. This model describes that the surplus of policyholders' funds investments – net of the management fee or expenses go to the policyholders. The participant pays the Wakalah fee from contributions that cover the total operator expenses of the business and operator salaries. The Wakalah fee is determined by the Shariah Advisory Board of the company one year advance basis. To give incentive to operator for good governance, management fee is paid as per the level of performance.

- The third model is **Tabarru-Based Takaful.** This financial structure or model of takaful assumes a non-profit nature of takaful business. Originally used in Sudan, this is also called the tabarru model of takaful. Under this model, there are no returns for the promoters, and for the policyholders. The initial contribution to organize the venture may come from the promoters as qard-hasan. Participants make donation or tabarru to the takaful fund, which is used to extend financial assistance to any member in the manner defined in the agreement

Figure 01: Comparision of Mudarabah and Wakala Models



Source: Milliman research report

II-The differences between conventional insurance and takaful insurance

Insurance in Islam is essentially a concept of mutual help. Insurance business under conventional system is based on uncertainty, which is prohibited in Islamic society under Islamic principles. So there is need to clear the difference between the conventional insurance and the Islamic insurance.

Similarities and differences of Takaful and Conventional Insurance

- Takaful is a co-operative institution based on the principles of contract for mutual co-operation (ta'awun). While conventional is a business institutions operated based on the principles of contract.

- In Takaful shareholder of the company, if any, are not entitled to participate in the profits generated by the insurance operators, while In the case of conventional insurance the primary motivation is to earn profit from the insurance transactions for the shareholders.

- In Islamic insurance companies these facilities are available to all members who pay a certain stipulated amount of premiums while the policy-holder in a conventional insurance company have no right to vote in the elections of the directors of the company or to see the annual accounts of the company.

- Takaful operation is based on the concepts of taawun (mutual help or co operation) solidarity, trusteeship, and brotherhood but conventional insurance is based on to take material gain on behalf of other.

- Takaful, the Islamic alternative to conventional insurance is based on the idea of social solidarity, cooperation and joint indemnification of losses of the members.

- The conceptual difference between Takaful and conventional insurance is that risk in Takaful is not exchanged by way of contribution payments made to operator which means operator is not selling and participant is not buying any risk coverage.

- In conventional insurance the contract is based on the principles of exchange of interest. The relationship is designed in such a way that the insured buys protection by payment of premium, and insurer provides protection against the insured risk. Under Islamic law insurance transaction cannot be concluded on this basis of buy and sale contract.

- Under Takaful contract every policy holder has the right to know how their money is used, how the surrender value is calculated, and Takaful policy holders must be certain that neither returns nor funds paid out in claim settlements, originate from unlawful means such as investments in stocks of companies producing non-halal goods but in conventional insurance policyholder have no right to know about this.

- If the holder of an Islamic insurance policy decides to terminate a policy in a manner that is not provided under terms of the contract, premiums are refundable along with any corresponding surrender value less administrative fees, but in conventional insurance insured forfeited his/her premiums on termination of a policy.

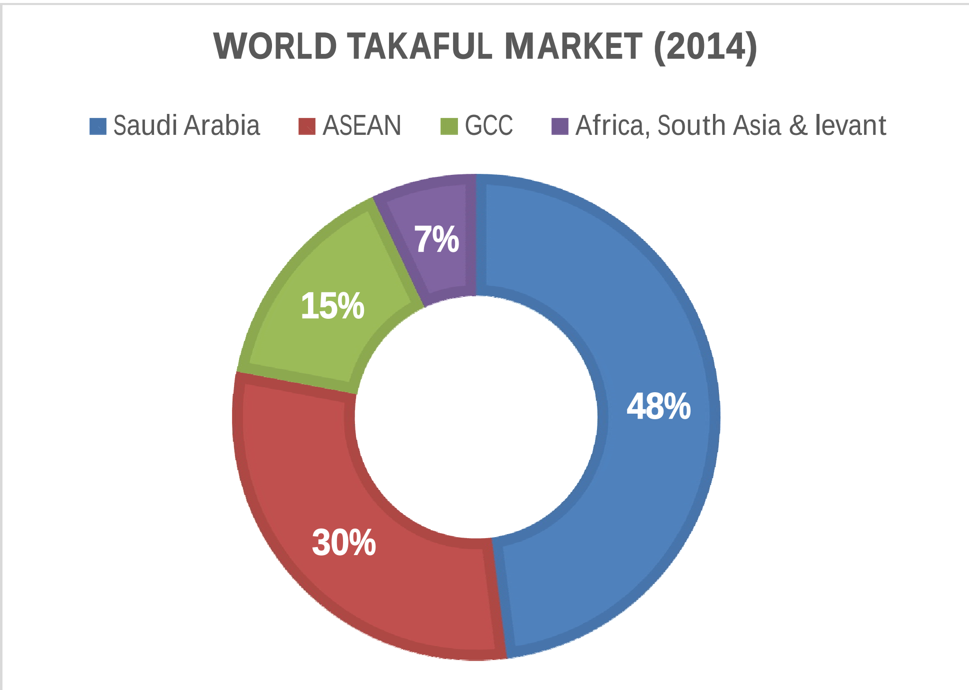
- Under Takaful contract every policyholder has the right to know how profits from different investments are divided among the participants but under conventional system there is no hard and fast rule for profit distribution, it is totally depends on company management.

III-Takaful Market

Takaful is an important growing sector in the Islamic finance industry, with continuous positive growth momentum in key markets and estimations of continued double-digit growth globally. While the GCC and ASEAN are expected to continue to lead the global takaful markets with their substantial growth, emerging markets within Europe and Africa are also showing significant growth potential.

Takaful has experienced a rapid growth in recent years. From 2014 to 2016, the industry worth almost doubled from USD 14 billion to USD 18 billion and the number of dedicated Takaful insurance companies mushroomed from 138 to 308. This growth in Takaful, however, has been primarily restricted to increased penetration in existing Muslim markets i.e. in the GCC, Far-east and Africa. In the Western economies, Takaful remains very much at the formative stage. This is primarily because of existing impediments at the regulatory and technical fronts coupled with resource constraints.

Figure 02: World Takaful market (2014)



Source: Report released at the 2015 Global Islamic Economic Summit in Dubai on 5th October 2015.

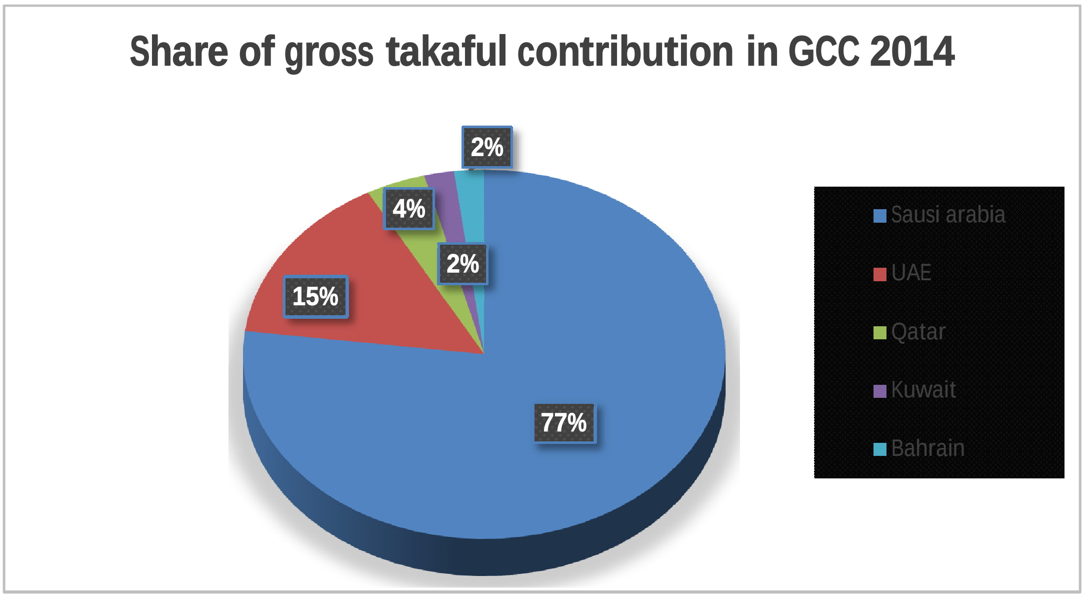
Developments in takaful are likely to accelerate in key domiciles such as the key GCC countries and Malaysia, as well as highly populated Muslim countries where takaful is gaining popularity such as Indonesia and Pakistan; new entrants to the takaful market are likely to orginate from African countries (Kenya, South Africa, Morocco, Nigeria) and Asia (Afghanistan, Kazakhstan, Thailand, Sri Lanka); these countries are currently either at exploration stage or have a handful of takaful players in the market. Total gross takaful contributions are expected increase to around USD 26 billion at end-2015 and USD 42 billion by 2020

1- GCC takaful Market:

Islamic insurers in the GCC saw gross premiums increase by around 20% from 2014 and 2015, while conventional insurance premiums grew by around 10%, according to S&P Global Ratings.[9]

In 2015, the combined gross premium income of Islamic insurers in the region exceeded $10 billion, beating the approximate $9 billion income generated by conventional insurers for the year in the GCC. More than 75% of the region's Islamic insurance premiums were written in Saudi Arabia, which has the largest Sharia-compliant market in the region.

Figure 03: Share of Gross Takaful contribution In GCC (2014)



Source: Global takaful insight,2014

Takaful contributions in The United Arab Emirates (UAE) rose by 55% to AED 121.9 million for the year 2016 compared to AED 78.6 million for the year 2015.

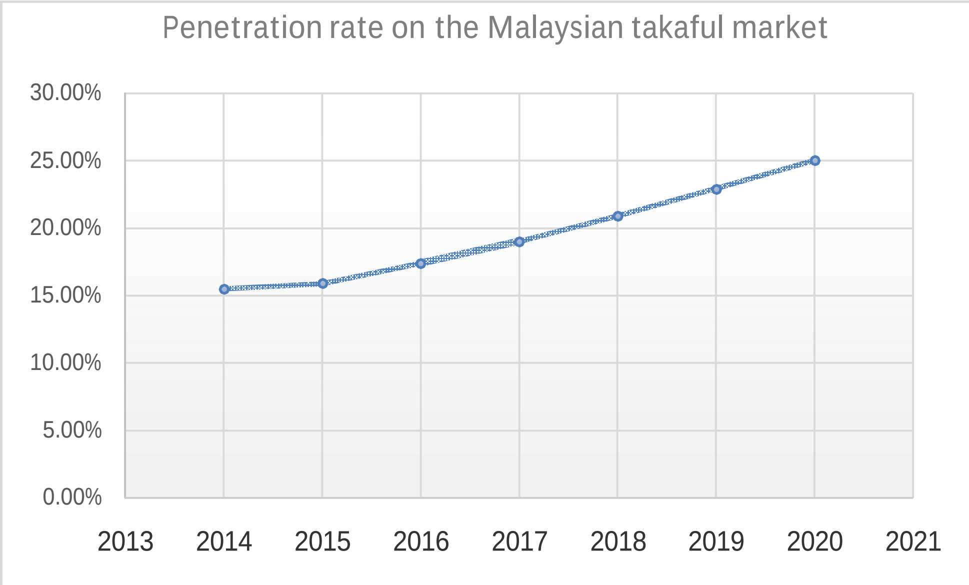
The United Arab Emirates (UAE) has the best depth and breadth of products, and offers the most diversified suite of family and general takaful products. The global takaful insight report noted that since 2008 the GCC region recorded a stable insurance and takaful industry growth with buoyant performance in some countries like the UAE (CAGR of 11.75% and 18.5% for the insurance and takaful sectors respectively) with the takaful industry witnessing a faster growth rate in the period 2008-2012. This is majorly attributed to the implementation of new regulations with compulsory health and motor insurance schemes. The global takaful insurance market has exhibited impressive double digit growth with gross takaful contributions reaching US$18.3 billion in the first half of 2013. A major challenge facing the Takaful industry going forward will be to boost top line growth levels while also focusing on technical profitability. The evolving regulatory landscape, pricing dynamics and technical profitability will be key factors that will shape the direction of the industry at this important juncture in 2015 and beyond.

2- The Malaysian Takaful Market:

There is a perception that while Malaysia has been able to form a vibrant Takaful industry, the Takaful sector is estimated to reach USD 20 billion by 2017.

According to the new report, “The Dynamics of Takaful Markets of the Middle East and Malaysia: Similar Models, Different Approaches, Contrasting Fortunes,” The report identifies one of the key drivers of the success of takaful in Malaysia is the balance of earnings between the shareholders’ and policyholders’ funds, demonstrated by the stronger returns experienced in their family and general takaful portfolios. Over the last three years, Malaysian operators have generated superior margins on their family takaful portfolio compared with Middle Eastern operators. On the other hand, Middle East companies have spent considerable time and money to develop family takaful products that have not translated into significant revenue to absorb these costs.”

Figure 04: Penetration rate on the Malaysian Takaful market



Source: strategic issues of Takaful operator, Cairo 2015

3- Africa Takaful market:

Takaful in Africa has largest presence in Sudan, Egypt, Tunisia, Algeria, Senegal and smaller presence in South Africa and Gambia.

In the African region, Sudan leads the Takaful market, recording gross Takaful contribution of 23.4 per cent during the period 2009-2013.

Family takaful contributed to 58% of the total takaful contribution in 2013. Currently, there are 15 takaful operators in Sudan offering both general and family takaful products with five of them providing micro takaful products.

East Africa is emerging as the region’s Islamic financial ser-vices hub, with fully-fledged Islamic banks and insurers offering takaful insurance services.

Morocco also is one of the main insurance markets in Africa, which saw revenues of MAD 28.4bn ($2.91bn) in 2014 and an annual growth rate of around 6%.

IV-The challenges of the takaful industry

Takaful industry continues to face numerous challenges and issues in many aspects, notably low penetration rate, shortage of human capital, inadequate technology capabilities, ineffective governance practices, and lack of innovation in business model for new market niches.

There are certain challenges for the takaful companies to tap their full potential. Some of the recurring challenges are following:

- General Issues: Takaful companies in different regions are practicing different operational, regulatory and accounting strategies. Only some of the countries have passed laws and regulations for takaful companies. So the takaful industry has still to cover a large distance to build globally acceptable operational and regulatory standards
- Scarcity of human resources with both insurance and sharia- expertise.
- Future growth may also be hampered by the currently narrow pool or professionals with sufficient takaful knowledge in areas such as law, sales, and actuarial services.
- Issues that are due to regional differences: There are significant regional differences in consumer attitudes and the extent of tolerance and innovation in the takaful industry. For example Malaysia is perceived to be more liberal and willing to embrace modern conventional concepts within the takaful framework. In contrast, the approach in the Middle East countries is more conservative, with less willingness to embrace modern conventions. This creates challenges in transferring solutions across regions[10].
- Drop in oil prices :The plunge in oil prices was cited to have a strong (and negative) impact on the takaful industry , more than a third of the total number of full-fledged takaful operators are based in the GCC, the largest economies of which are highly dependent on income from oil. Malaysia, another major player in terms of high contribution growth and number of takaful operators, is also a net oil exporter and has been hurt by a slide in oil prices. Thus, Takaful operators based in these jurisdictions are of the view that the drop in revenues of oil exporters will have a trickle-down effect via a contraction in the spending expenditure in those economies. The effect is likely to be most pronounced in the commercial sector with delays or cancellation of new projects. A stagnation in this area will lead to slower contribution growth in these regions.

Conclusion

Takaful is the second most important social institution to counter poverty and deprivation. This position shows that takaful is a way of dealing with poverty in any society, no matter how backward it is. If well implemented, takaful arrangements have the prospect of the societal regeneration for poverty alleviation, or even its elimination, and pave ways for sustainable economic development. It is second only to zakat (the poor due) as a social institution.

The key difference between Takaful and conventional insurance rests in the way the risk is assessed and handled, as well as how the Takaful fund is managed. Are as follows:

1. Conventional insurance involves the elements of excessive uncertainty (gharar) in the contract of insurance;
2. Gambling (maysir) as the consequences of the presence of excessive uncertainty that rely on future outcomes
3. Interest (riba) in the investment activities of the conventional insurance companies;
4. Conventional insurance companies are motivated by the desire for profit for the shareholders;
5. Conventional system of insurance can be subject to exploitation. For example, it is possible to charge high premium (especially in monopolistic situations) with the full benefit of such over-pricing going to the company.

At the conclusion figures issued several resolutions and recommendations of interest to insurers and re-Takaful insurance, which leads to action by the support of the industry in all markets and were as follows: -

1. Provide full support of insurance companies symbiotic companies Re-Takaful Practice of the activity itself.
2. Work out all legitimate fatwas concerning the activity of Takaful insurance in a single assembly reference.
3. Do Takaful insurance companies to work to raise the level of financial solvency to keep abreast of industry developments and meet the current and future challenges..

References:

[1]Omar Clark Fisher, **A TAKAFUL PRIMER: BASICS OF ISLAMIC INSURANCE,** Islamic Finance Gateway,Dubai, UAE, 2013, P 07.
[2]Rejda, G. **Principles of Risk Management and Insurance** (9thed.).Riadh, ArabicSaudi, P25
[3] Jacky Lim & Muhammad Fahmi Idris, **History, Progress and Future Challenge of Islamic Insurance (Takaful) In Malaysia,** Oxford Business & Economics Conference Program, Oxford University, UK,2010,P04
[4]S. Saaty, A., & Ahmad Ansari,**Takaful-An Islamic Way of Insurance-Developments, Growth, Challenges and Issues**. 2009, P09
[5]MohdAbd Hamid,**Shariah Issues in Takaful,** SHARIAH ISSUES IN ISLAMIC FINANCE, P 03
[6] Retrieved from BNM website on 14th Fabruary 2017. The URL is: http://www.bnm.gov.my/microsites/financial/0204_ib_*Takaful*.htm
[7] Maya Bhatti, **Takaful growth oppurtunities in a dynamic market**, Price waterhouse coopers, 2008, P07
[8]Maher Mushtaq Hussain and Ahmad Tisman Pasha**, CONCEPTUAL AND OPERATIONAL DIFFERENCES BETWEEN GENERAL TAKAFUL AND CONVENTIONAL INSURANCE,**Australian Journal of Business and Management Research, November-2011, P 24.
[9]http://www.insurancemena.com/sp-takaful-passes-conventional-premium-in-gcc/
[10]Safder Jaffer & others**, Takaful (Islamic insurance, Concept, Challenges and opportunities**.Milliman research report, 2010, P16