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Contemporary Issues in Takaful (Islamic Insurance)

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Abstract

Takaful business is a kind of insurance activity within the framework of *Shari'ah*. To be *Shari'ah* compliant Takaful operator, it needs to consider not only on the conventional aspect like conventional insurance, but also must take into account the *Shari'ah* requirement. Some of the *Shari'ah* requirement is avoiding interest, uncertainty, gambling and prohibited elements. Thus, the operating activities of Takaful operators are not straight forward and simple, compared to the conventional counterpart. Thus, the objectives of this paper are to highlight the current issues in Takaful industry and to provide the recommendation for future research. The contemporary issues in Takaful are due to the combined nature of profit-motivation and religious motive. The issues highlighted in this paper will be the interest of all the related parties, especially to the regulators for the development of future rules and regulation.

Keywords: insurance, Shari'ah and Takaful

1. Introduction

Nowadays, Takaful becomes a popular term in the insurance market all over the world. It has been acknowledged as an alternative to conventional insurance and is offered in both Muslim and non-Muslim countries. Takaful products can be offered in other different names such as Islamic insurance, Halal insurance, ethical insurance, Islamic mutual insurance, co-operative insurance and community insurance (Noordin et al., 2014). Similar to insurance companies, almost all of Takaful companies are business entities and they are offering similar products. Thus, they need to compete with the well-established insurance companies and have to be profit oriented entities while operating within the framework of *Shari'ah*. In other words, Takaful operators have two motives, i.e. earning profit and complying with *Shari'ah*. In reality, it is not easy to achieve both objectives ultimately. There is a tendency that Takaful operators might engage in the prohibited elements in order to maximize profit (Noordin et al., 2014).

Due the rapid growth of Takaful industry, regulations and guidelines are introduced as fast as the development of Takaful market. In addition, different schools of thought and variation in the opinions of *Shari'ah* scholars lead to non-standardization on the practices in Takaful industries (Noordin et al., 2014). For instance, sharing surplus is allowed in Malaysia while it is not allowed in Middle East. Consequently, there are some issues raised by the contemporary researchers regarding Takaful industry. This paper is presented in four sections. Second section explains Takaful. Third section discusses issues and the last section concludes.

2. Takaful

Insurance concept is very beneficial for us since it can provide financial assistance when we face misfortune. As rational decision makers, most of the people prefer to pay premium rather than taking unnecessary risks. In most of the developed countries, the insurance is already integrated in the daily life activities and it becomes unavoidable in most of the cases. Unfortunately, when the insurance practice is reviewed, it has Islamically prohibited elements such as interest, uncertainty and gambling. These items are strongly opposed from the Islamic teachings since the end results of involving in these elements will not provide the fairness to all the involved parties. There are three different views on the validity of insurance. First group believes that insurance is totally prohibited regardless of any circumstances. Second group supports that if insurance is necessary, it is allowable. Third group supports that conventional insurance needs modification in order to be in line with *Shari'ah* (Dikko, 2014).

Thus, Muslims scholars introduced Takaful as an alternative to conventional insurance. According to Dikko

(2014), Salman & Htay (2013) and Noordin (2014), *Takaful* is based on the concepts of *Tabarru* (i.e. voluntary donation) and *Ta'a wun* (i.e. mutual cooperation). Currently, these two concepts are premises on which contractual relationships between participants and Takaful operators are built. Currently, there are a few different Takaful models are adopted by Takaful operators and the most common Takaful models are Cooperative (*Taa'wuni*) Model, Pure *Wakalah* (Agency) Model, Modified Wakalah Model (*Wakalah* with Incentive Compensation), Pure *Mudarabah* (Investment Profit-Sharing) Model, Modified *Mudarabah* Model, Hybrid *Wakalah-Mudarabah* Model and *Waqf* Model. The available Takaful products are general Takaful products and family Takaful products. Examples of general Takaful products are for motor, fire and marine while that of family Takaful products are health, investment planned and education.

When the current development of global Takaful industry is reviewed, there are 174 Takaful operators in the key Takaful markets comprising of 34 in Saudi Arabia, 11 in Malaysia, 43 in GCC countries (excluding Saudi Arabia), 29 in ASEAN (excluding Malaysia), 12 in South Asia, 36 in Africa and 9 in the Levant. Among the Takaful products, family and medical Takaful are the main products because 80% in South Asia, 50% in ASEAN and 47% in MENA belongs to family and medical Takaful. In addition, it is predicted that Saudi Arabia, ASEAN, GCC, Africa, South Asia and Levant will be the key Takaful markets in 2014 and 2015 with the rapid growth (Ernst & Young, 2013).

3. Contemporary Issues in Takaful Literature

Prior researchers have conducted research in Takaful from various angles. This section discusses the issues raised by the prior researchers and provides the opinion on each issue.

3.1 Charity or Business Entity?

Altuntas et al. (2011) examine whether Takaful can be a business or charity since Takaful is based on the concept of mutual assistance and contribution. Based on the semi-structured interviews, they found that Takaful can be an alternative to insurance and it can be a business entity, not charity. Since Takaful can be a business entity, it is not immune to risks and risk management becomes part of its daily activities.

Takaful can be profit oriented as well as non-profit oriented entity. It depends on which type of Takaful model implemented by the entities. For instance, the models such as *Mudarabah*, *Wakalah* and Hybrid are intended for profit motive but the model like waqf can be for the non-profit oriented organization.

3.2 Risk

According to Aris and Tapsir (2012), the Takaful operators are facing risks, namely, credit risk, liquidity risk, legal and fiduciary risk, financial supervision and transparency and supervision risk. Thus, they suggest that the risk management strategies of Takaful operators should be able to protect the Takaful fund, to have enough funds to pay for claims, to maximize the investment return, to stand and create the backup plan for the possible liquidity problem and to sustain the business. Yusop et al. (2011) examine the risk management efficiency of conventional life insurers and Takaful operators. Data is collected from the annual reports of 22 industrial players for the period of 2003-2007. RAM-DEA is used as a frontier efficiency technique to assess the efficiency of risk management. They found that both life insurers and Takaful operators have high scores for risk management efficiency and it is hard to confirm whether there is a positive or negative relationship between firm size and risk management efficiency.

One of the fundamental concepts of Takaful is risk sharing, not risk transfer. In my opinion, regardless of risk sharing or risk transfer, Takaful operators cannot run away from the risk management. It is a known fact that the participants contributes to the Takaful operators to minimize the risks might be faced by them in the future. Similarly, Takaful operators are taking the risks imposed by the participants and consequently, they need to find the way to manage the risks. If they do not manage the risks in the prudent way, Takaful operators will be facing problems and finally, the public will lose confidence in the Takaful industry. Additional responsibility of Takaful operators is the *Shari'ah* non-compliant risk. *Shari'ah* compliance is the main distinguishing factor between Takaful and conventional insurance. Thus, in order not to impair the reputational risk, Takaful operators should have precautionary and preventing way of managing the risks, rather than making corrective actions after the damage has incurred.

3.3 Performance

Abdou, Ali and Lister (2014) look at the performance levels of Takaful and conventional insurance industries in Malaysia. They find that conventional insurers perform better than *Takaful* companies in terms of profitability and risk measurement but *Takaful* outperform conventional insurance when the ratio of premium to surplus is used. *Takaful* operators have prudent underwriting practices to reduce information asymmetry. Ratio of the net premiums to contributions as macro-economic variable does not have any impact on the growth of Takaful operators. However, net investment income has statistical significant impact on both industries. This is indicative of the fact that both industries efficiently utilize their funds to generate the desired return on their investments.

Miniaoui and Chaibi (2014) compare the technical efficiency of Takaful industry Malaysian and the Gulf Cooperation Council (GCC) countries. Data Envelopment Analysis (DEA) is used in their study for the period of 2006 until 2009. The sample includes three takaful operators in the UAE, two in Saudi Arabia, two in Qatar, one in Bahrain, and four in Malaysia. They find Takaful operators in GCC countries are more efficient than Malaysian Takaful operators.

Kader et al. (2010) examine the cost efficiency of Takaful insurance companies. Sample is obtained from the World Islamic Insurance Directory and it consists of a balanced panel data set of 78 firm-years for the period 2004-2006 comprising 26 Takaful non-life insurance companies. They use non-parametric data envelopment analysis to calculate cost efficiency scores and a second-stage logit transformation regression model is used to examine the impact of corporate governance variables on cost efficiency. Their findings show that non-executive directors and separating Chief Executive Officer and Chairman do not improve cost efficiency. However, board size, firm size and product specialisation have positive effects on the cost efficiency of Takaful operators. The regulatory environment is not significantly improving the cost efficiency.

Efficiency is one of the aspects to look at the performance of the company. It is excellent measurement of performance since Takaful operators are in the service industry. Due to the recommendation of the corporate governance codes, the companies have separate leadership structure and majority of the board with non-executive directors. However, in terms of board size, most of the guidelines do not specify the optimal number of board members. Hence, when the impact of corporate governance variables on cost efficiency is examined, only board size has significant impact, but separate leadership structure and the role of non-executive directors do not. Corporate governance guideline alone cannot encourage or force the companies for the better performance of the Takaful operators. It should be supported by the serious enforcement by the relevant authorities and other legal and regulatory frameworks.

3.4 Financial Accounting and Reporting

Annuar and Abu Bakar (2010) studied two Takaful companies, namely, Syarikat Takaful Malaysia Berhad and Takaful National Sdn. Bhd. regarding the choice of accounting practices. They found that the differences in the choice of accounting policies are due to Sharīʿah variation. According to the view of *Shāfi'ī*, management expenses should not be charged against the *mudarabah* capital or its realized profit because it will involve uncertainty. Consequently, uncertainty will render the *mudarabah* contract null and void. However, other schools of thoughts view that expense can be charged against *mudarabah* capital or its realized profit depending on the nature of expenses. *Hanafi* and *Maliki* schools confirm its permissibility to the case of journey where both lodging and food cost of the managers are covered. The *Hambali* school of thought says that it is not necessary to limit the manger's expense related to the journey only and he, as a *mudarib*, can deduct his management expenses such as food, cloth, lodging, salaries of the employees from the account even if he is staying in his home town. However, how much and which type of expenses should be according to the social or industry norms. Syarikat Takaful Malaysia Berhad follows the view of *Shāfi'ī* and thus, all the management expenses are born by the company. On the contrary, Takaful National Sdn. Bhd. deduct portion of management expenses which are directly related and traced to the Takaful funds and commission for agent from the Takaful fund and the rest which are not related to the Takaful funds are born by the company through shareholders' funds. In addition, its marketing strategy relies on the agents and hence, there is a tendency that its profit will be higher than Syarikat Takaful Malaysia Berhad. No uniform guideline on the deducting the amount allocated to the Takaful risk fund from the contribution creates another issue. Starting from the first month, Syarikat Takaful Malaysia Berhad deducts 15% for Takaful risk fund and the balance 85% for the participant account. Hence, when the participants surrender earlier, they can get 85% of their contribution. However, in the case of Takaful National Sdn. Bhd., for the first three years, more than 50% of the contribution goes to the Takaful risk fund and the balance is allocated to the participant account and after three years only, at least 25% of the contribution goes to Takaful risk fund and the balance goes to the participant account. Thus, if the participants surrender early, they are at the disadvantage compared to the participants of Syarikat Takaful Malaysia Berhad. In sum, they recommend to have standardization for accounting policy by passing the fatāwas so that it will be fair and just to the participants.

Financial reporting and accounting is the tool used by the management to discharge their fiduciary duty towards the shareholders and other stakeholders. Fairness and justice is required in Islam and all the participants should be treated fairly. Since Takaful operators have more knowledge in the operational aspect, compared to the participants, the operators should not take advantage on the Shari'ah variation. This is the time for the regulators to synchronise all the possible variations for the betterment of the whole industry.

3.5 Awareness on Compliance

The study conducted by Akhter and Hussain (2012) examines the compliance of Takaful standards by the Takaful operators in Pakistan. Takaful standards are risk assessment and management standards, corporate governance standards, reporting standards, internal controls, fraud detection and prevention standards, capital adequacy and solvency standards and Shari'ah compliance standards. From the questionnaire response of CEOs of three Takaful operators, the level of the observance of Takaful operators in Pakistan towards the reporting standards and internal control is very low.

Takaful has been offered widely all over the world including both Muslim and non-Muslim countries. Among the Muslim countries, Malaysia has come out with Shari'ah governance framework and Islamic Financial Services Act 2013 for Islamic financial institutions. And the Central Bank of Malaysia is regulating and monitoring the Takaful operators. One of the main reason for it is Malaysia is trying to be the hub of Islamic finance. Compliance with the prevailing rules and regulation is mandatory for the industry to improve to the next level and to get the confidence from the investors. There are Takaful operators which are operating in non-Muslim countries and in Muslim countries where no *Shari'ah* standards are available. In this kind of situation, Takaful operators should have their own *Shari'ah* advisory board at the company level. Compliance is essential regardless of where Takaful operators are operating. It is believed that strict enforcement from the regulators is the most effective mechanism to ensure that they are operating in line with *Shari'ah*. In addition, board of directors and the person-in-charge should be regularly updated the knowledge by sending them to the training. There should be some clauses in the Acts to penalize the Takaful operators if they do not comply with the regulatory requirement.

3.6 Shari'ah and Legal

Noordin (2014) and Dikko (2014) question the practices of Takaful are still in line with the concept of *Tabarru* and *Ta'a wun*. According to Dikko (2014), different Takaful models bring different issues that question the compliance with the fundamental Takaful concepts. Some of the issues are in *Mudarabah* model, it involves profit making and in all the models except pure *Wakalah* and pure *Mudarabah* models, surplus sharing is practised. Although participants make the contribution according to the concept of *Tabarru*, they can claim and get compensation. Under the concept of *Tabarru*, the contributors do not expect any return. The worst scenario is involvement with reinsurance companies due to the inadequacy of *Retakaful* operators. Noordin (2014) inserts that some of the *Shari'ah* scholars suggest a more specific Takaful contract which includes *Hiba* (gift), *Hiba Bi Shart'iwad* (gift with reward), *Al-Nahd* (co-operative partnership), *Waqf* (endowment) and *Sadaqa* (voluntary charity) to represent two main concepts of Takaful. The main issue of these models is due to the commercialization of Takaful industry and hence the profit becomes an important factor for the Takaful operators.

Shari'ah interpretations from various schools of thought bring variation not only in the accounting practices but also in the practices of nomination and *hibah*. According to Salman and Htay (2013), in the case of family Takaful, the participants can give the nominee and the purpose of nomination is that if the participant dies, the nominee will become the beneficiary and the Takaful benefits will be given to the nominee. Nominees can be anyone whom the participant chooses and it is not necessary that the nominee must be his or her legal heirs. Thus, the Takaful benefit might not be distributed according to *Fara'id* and it brings the attention of the *Shari'ah* scholars. One view supports that the nominee must be his or her heirs while the other view is that the nominee can be anyone and the Takaful benefit received by the nominee is the *Hibah* from the participant. The decision from court case like Re Ismail Binti Rentah in 1940, it has been decided that nominee is just an executor and the benefits must be distributed according to *Fara'id*. However, in other cases such as Re Man Bin Mihat in 1965 and Re Bahadun Bin Haji Hassan in 1974, the nominee is the sole beneficiary. In Malaysia, the majority of the Takaful operators prefer to treat the nominee as the executor. The *Shari'ah* Advisory Council from Bank Negara Malaysia makes a resolution that Takaful benefits can be given away as *Hibah* and the operators should provide the standardized form which is a clear contract to state the status of nominee as whether the nominee is the beneficiary or an executor. The distribution of the Takaful benefits should follow the contract. This resolution leads to other *Shari'ah* compliant issues since Takaful benefit treated as *Hibah* is a gift and it can be given away during the lifetime of the participants. In the case of Takaful benefits, it can be distributed after the participant passes away. One view believes that if the nominee is receiving the benefits, it is against the nature of *Hibah*.

Another view expresses their opinion that the distributed benefit should not be more than one third of the total wealth and the distribution to the nominee is in the form of *Wassiyah* (trust), not as *Hibah*. In addition, Takaful benefit given out of the participant risk fund brings another issue since it does not belong to the participant during his lifetime and hence, the benefit portion from that risk fund should be distributed according to *Fara'id*. So far, no clear-cut ruling on this matter has been reached. Thus, it is expected that *Shari'ah* scholars should examine all these issues for the betterment of all involved parties. The findings show that there are rooms to improve in order to have standardized resolutions.

Htay et al. (2013) examines the opinions of the *Shari'ah* scholars on the factors used in the underwriting process in Takaful operators. This study adopts the Delphi technique and the interview from the five *Shari'ah* scholars show that most of the *Shari'ah* scholars are not exposed to the underwriting and risk rating practices of family Takaful. However, they opine that the underwriting process is not against the *Shari'ah* but some of the determinants used in the process should be revisited.

Since the Takaful industry is relatively new compared to the conventional insurance industry, the adequacy of the Islamic laws governing the Takaful industry is sufficient to cater for all the issues in the Takaful industry. In addition, due to colonization, the common law is still influential in Malaysia to a certain extent. Lambak and Mohd Tahir (2013) explore the applicability of common law in Malaysia Takaful Act 1984 and their findings confirm that the common law is applicable as long as it does not contradict the *Shari'ah*.

Due to the rapid growth of the industry, the regulatory framework is relatively slow compared to the market growth. Hence, there is no choice except to speed up coming out with the relevant rules and guidelines to mould the industry.

3.7 Current Insurance Market

Htay and Salman (2014) examine the acceptability and possibility of offering Takaful in India and propose the most suitable Takaful model for the Takaful operators. Based on the findings from 216 Muslims and 117 non-Muslims respondents show that the acceptability of *Takaful* is very high regardless of Muslims or non-Muslims and it is possible to introduce it in India. From the interviews from 10 *Shari'ah* scholars, 7 Takaful operators and 5 consultants, hybrid model, i.e. combined concept of *Wakalah* and *Mudarabah* seems to be the best Takaful model in India.

The research conducted by Samad and Siddiqui (2014) has highlighted the prospects and challenges of *Takaful* in India. The interviews were conducted in Hyderabad, Bangalore, Chennai and Mumbai and the respondents chosen were mostly Muslims between the age group of 25 to 45 years old having the monthly income over INR 10,000 per family member, focusing on the people who are likely to pay for the insurance services. The findings show that 95% of Muslims are taking the insurance policy for vehicle due to the government rule and only 5% of Muslims are taking it willingly. Only 2% of the respondents are aware about *Takaful*. 20% of non-Muslim respondents are willingly to have *Takaful* products if they are similar to the mutual and cooperative insurance and if the *Takaful* products are not more expensive than conventional ones. However, in the case of Muslim respondents, 20% of them are willingly to go for *Takaful* products even if they are more expensive than conventional products. Some of the future *Takaful* products can be offered in India are general *Takaful*, motor *Takaful*, fire *Takaful*, fire consequential loss *Takaful*, burglary *Takaful*, family *Takaful* products and mortgage *Takaful*.

Rahman & Daud (2010) examine the behaviour of participants of medical and health Takaful in Malaysia. Based on 300 respondents, they found the existence of an adverse selection since most of the claims are rejected due to discoveries of some irregularities by the management care organizations.

When the history of Takaful is examined, it can be seen that the motivating factor to introduce Takaful is due to the religious factor. This is evidenced by the findings of Maysami and Williams (2006). Based on 84 Muslim respondents by using Chi-square test, they found that the awareness of Takaful is associated with belief about Islamic fundamentals on religious and social goals. They further suggest that in order to start offering Takaful, it is necessary to have a large Muslim population.

By reviewing the findings of prior research, it can be suggested to the Takaful operators that Muslim population should be the first step they should focus on promoting the product and then try to convince the non-Muslims by explaining the attributes of the product like ethicality, benefits. At the same time, awareness of Takaful should be created by the right marketing strategy.

3.8 Prospects and Challenges in Takaful Industry

Prospects of Takaful industry are rising in the oil price causes Muslim investors to think of investing in the

Middle East and South East Asia where the Islamic finance industry is booming, increasing awareness among educated Muslims and Muslim demand in Western countries and low level of penetration of density of conventional insurance. Moreover, the Muslim population in Europe is around 15 million and thus, they are the potential markets for Takaful. In addition, Takaful can be introduced if the Muslim population is 10 to 15% of the total population in the non-Muslim countries and then it can attract the non-Muslims later. Takaful products are ethical and hence, it can be accepted regardless of the religion (Alamasi, 2010; Maysami & Kwon, 1999; Ali (n. d.).

Although the Takaful industry has much potential, it does not mean that there is no challenge. Prior researchers have highlighted the possible challenges of the Takaful industry and some of them are uneasiness to compete with the well-established conventional insurance and reinsurance companies, limited experience and competent human resource, not having a framework for corporate governance, *Shari'ah* compliance, legal and regulatory, taxation and international accounting standards which suit with the Takaful industry, need heavy investment in research and development to innovate Takaful products which are competitive with conventional insurance products, limited number of *Shari'ah* advisors and industrial experts, limited number of Re-Takaful operators to support the Takaful industry, low level of awareness of Takaful and limited *Shari'ah* compliant investment (Hanif, 2014; Ahmad et al., 2010; Alamasi, 2010; Maysami & Kwon, 1999).

In sum, the prospect of *Takaful* is tremendous due to the raising of oil prices, awareness of Takaful among the educated Muslims in non-Muslim countries, acceptability of Takaful by non-Muslims and the population of the Muslims all over the world. It is also necessary for the Takaful operators to overcome the challenges.

4. Conclusion and Area for Future Research

This paper has provided the contemporary findings by the prior researchers. It can be summed that Takaful concept can be used for the profit and non-profit oriented entities. Takaful operators should have proper risk management system and performance assessment. To attract the investors and to gain their confidence, financial reporting should not be ignored and compliance with the prevailing standards is mandatory. In the case of market, awareness is very important and hence, marketing will play an important role for the success of the industry. Finally, this paper discusses the prospects and challenges of the Takaful operators.

Most of the prior research has raised the issues however, proper solution is not mentioned. Hence, the regulators should play the role to lead the research projects, survey and discuss with the industrial players and *Shari'ah* advisors to come out with new regulations or modify the existing ones to cater the current issues in Takaful industry.

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