Introduction

Takaful and Cooperative Finance are two subjects that have been highly debated in the recent past. Many conferences have been organized in various parts of the world bringing *takaful* operators, scholars, academicians and practitioners together to discuss and debate emerging issues. In parallel, many institutions are offering various products and services in different forms worldwide. Thus, with the rapid growth of the industry, literature on *takaful* has mushroomed over the years.

Initially, some thought that *takaful*, commonly referred to as Islamic insurance, would create more demand and crystallize its product offering earlier than other Islamic finance sectors because of its mutuality concept. But it appears this unique sector of the Islamic financial services industry has been the last to pick up the required momentum due from such an important sector. In essence, the underlying principles of *takaful* overlap with cooperative finance; hence, the need to address these two closely related concepts together in one book.

The Harvard University Forum on Islamic Finance was conceived in 1997 to engage scholars, practitioners and regulators in productive dialogue about the then nascent field. Although topics such as microfinance and *takaful* have always been part of the discussion at various Harvard forums, *takaful* as a major theme was overshadowed by other pressing topics while addressing the global economic crisis and its impact on Islamic finance. Finally, ‘*Takaful* and Alternative Cooperative Finance’ was selected as the main theme for the 11th Harvard University Forum on Islamic Finance organized at Harvard Law School from 25 to 27 April 2014. Overwhelmed by responses to call for papers, which were a result of huge enthusiasm from researchers and practitioners, additional sessions were organized during the Forum to accommodate more papers. In fact, for the first time in the history of Harvard University Forums on Islamic Finance, a pre-forum workshop was organized on the same theme.

The book contains a total of 15 carefully written chapters that have gone through a thorough peer review process. These chapters are grouped into four parts. Part I is an ‘Introduction to *Takaful*: Form, Function and Criticism.’ Part II deals with the ‘Regulatory Environment and Legal Aspects of *Takaful*.’ Part III, ‘*Takaful* Product Analysis,’ goes into the

wider aspects of *takaful* dealing with *re-takaful*, commercial credit and pension. Part IV, '*Takaful* as Social Finance', discusses some new paradigms and presents several case studies.

Contributors of these chapters come from highly rich and diverse academic and professional backgrounds including economics, law, *shari'ah*, insurance, regulations and field research.

INTRODUCTION TO *TAKAFUL*: FORM, FUNCTION AND CRITICISM

Part I contains chapters that describe *takaful*, its features and the underlying Islamic principles that govern it. It covers the journey *takaful* industry has covered over the years. It critically analyses various *takaful* models and products in the light of Islamic jurisprudence and chronicles various models developed to address one or other challenge.

Ajmal Bhatti and Shariq Nisar's chapter, '*Takaful* journey: the past, present and future,' sets the background and the context in which *takaful* came to fulfill the important requirement of *shari'ah* compliance. The authors describe *takaful* as that disruptive innovation in financial protection that unlocks huge potential around the globe. The chapter, after setting the context in which *takaful* was developed, goes on to chronicle the developments of various *takaful* models with their attendant features. The chapter while describing the current state of the *takaful* industry also focuses on various issues and challenges faced in real life practice. The chapter also highlights the areas that need serious consideration of scholars, practitioners and regulators.

Volker Neinhaus's chapter gives an important overview and introduction to the underlying principles and terms of *takaful*. He finds that despite the significant difference between the aims of *takaful* as compared to conventional insurance, the practices of both have the same economic substance. He finds the difference between the two 'only minor.' The deviations, according to Neinhaus, are mainly 'due to combination of market mechanics and exaggerated moral imperatives.' He calls *takaful* a mutual ideal and hybrid reality. He predicts greater potential for *takaful* in the life segment and micro-*takaful* area, which in his opinion has wider scope for financial inclusion.

Mahmoud El-Gamal is a well-known critique of most things offered in the name of Islamic finance. While Volker Neinhaus criticized lack of mutuality in Islamic insurance or *takaful*, El-Gamal criticizes the concept of mutuality itself on the grounds of its purported limitation in attracting large capital investment needed for growth and lack of efficiency in

comparison to stockholder-owned companies. He considers the mutual a potential for abuse and excessive risk taking. However, he has a word of praise for mutuals in their ability to serve those who are shunned by profit-seeking stockholders. Overall, he describes the Islamic finance industry based on legal arbitrage, which while focusing on the form/contract, has ended up replicating 'injustice' with greater 'inefficiency.' He uses strong words to call Islamic finance incoherent, potentially abusive and pseudo-religious. He concludes that the Islamic requirement of justice cannot be enforced through mere replication of contract and forms whether mutual or otherwise.

Abdullah Nana goes deeper into *takaful* operation based on *tabarru*. He analyses the concept of *tabarru* in *shari'ah* as unilateral and conditional and concludes that current *takaful* practices based on conditional *tabarru* make the contract commutative and hence invalid under *shari'ah*. He puts forward the characteristic of an ideal *takaful* model as one based on a true non-commutative contract and a true voluntary contribution. He then discusses the *waqf* model and concludes that the *waqf-wakal* model best meets this ideal. He concludes that implementing the model and fine-tuning it in practice is the way to move the industry forward. He also discusses the barriers to implementation of the *takaful* model in the United States, which have wide implications for the implementation of such principles-based insurance models in the western world.

Abdulazeem Abozaid raises several issues of *shari'ah* compliance of *takaful* models. He too analyses the model based on *tabarru* in addition to questioning *shari'ah* compliance of surplus distribution between donors and *takaful* operator (neither are actually the owner lest the contract becomes commutative), clubbing *mudaraba* and loan in the same agreement and utilization of corpus in the *waqf* model. He argues that even the *waqf*-based model does not really offer a solution to the mutual compensation (*mu'awadda*) problem raised against the *tabarru* model. Abozaid proposes a model based on *nihd* wherein an owner offers a consumable item for consumption by other(s) while maintaining ownership of it so that he may reclaim the leftovers. When analysing this model, he finds that it is better suited to neutralize *gharar*; it avoids the mutual compensation conundrum, and does not transfer ownership as long as the surplus remains the property of the participants and not the *takaful* operator. In addition, the *takaful* operator cannot be responsible for any deficits nor can it retain the surplus.

Thus, the chapters in Part I provide valuable insights of the *takaful* journey right from its start in the late 1970s to the present day. It provides different perspectives of their writers, regarding core questions concerning *shari'ah* validity of the different models of *takaful* as well

as the claims regarding distinctiveness and superiority of *takaful* over insurance.

REGULATORY ENVIRONMENT AND LEGAL ASPECTS OF *TAKAFUL*

In Part II the focus moves on to regulatory and legal environment in which *takaful* operates and products are offered. The regulatory environment, especially in the GCC region, dispute resolution mechanism and how certain *shari'ah*-related practices affect the whole market are covered in this part. Sara Carmody focuses her attention on *takaful* regulations in the Gulf Cooperation Council (GCC) countries, namely, Bahrain, Qatar, Kuwait, United Arab Emirates, Saudi Arabia and Oman. One common barrier she identifies across all countries in the GCC is the lack of recognition of the concept of trust, where one party holds assets for the benefit of another or for a specific purpose to benefit others. This in her opinion is due to the reason that the French Civil Code has no provision for segregating legal and beneficial ownership. She is of the view that *takaful* organizations have the biggest potential for growth in the region, followed by small and medium-sized enterprise (SME) financing. However, she finds that at present, licensing and regulatory requirements constrict the operation of a mutual or cooperative model.

Umar Oseni expands on Sara Carmody's findings, exploring the specific legal and regulatory challenges and dispute resolution issues surrounding *takaful*. He details the existing legislations in Middle Eastern, Asian and African countries, types of legislation and years of their enactment while making particular reference to the way and manner *takaful* disputes are being resolved. He then describes major *takaful* claims handled in Malaysia, pointing to confusion about *takaful* and problems in the *takaful* dispute resolution. He concludes that mediation and arbitration that work well in conventional insurance will also work well for *takaful*. Oseni notes that the flexibility of these less formal means of dispute resolution will allow for easier incorporation of Islamic law in the dispute resolution process.

Joe Bradford examines the role of *fatwa* in Islamic insurance. He calls *fatwa* a means for regulatory capture. He highlights the key obstacles preventing Islamic insurance from achieving true mutuality and cooperation. He poignantly raises the issue of conflict of interest between *Shari'ah* Board members appointed by the shareholders of a *takaful* company. According to Bradford, fatwas serve to eliminate competition and compel consumers to buy a product approved by a *Shari'ah* Board. In addition,

he cites the case of eliminating *shari'ah* competition by a select group of *shari'ah* scholars who hold the majority of the board positions. He concludes the Islamization of the industry weakens both the consumer and state. It allows the industry to be captured by *fatwa* and *fatwa* to be captured by big business. According to the author, what is needed is not more Islamization but better use of Islamic law to create equitable, just and fair markets for all stakeholders.

TAKAFUL PRODUCT ANALYSIS

Part III describes the specifics of implementing *takaful* products, including insurance for insurance companies (*re-takaful*), insurance for corporations and lifetime annuities for families. All three chapters in Part III deal with three different areas where the major focus is on deepening *takaful* offerings.

Abu Umar Faruq Ahmad, Ismail Bin Mahbob and Muhammad Ayub analyse *re-takaful* to determine if it is truly a risk sharing product or it involves transfer of risks. After discussing the definition, structure and usage of *re-takaful* as insurance for *takaful* companies, the chapter analyses the business model of Bank Negara Malaysia to ascertain the grounds for its legal permissibility under the *shari'ah*. This leads to a further discussion on the *shari'ah* issues of risk sharing, risk transfer and commission relating to *takaful*. The authors find that risk cannot be shifted to the *re-takaful* operator, but it can be shifted to the *re-takaful* fund itself. Interest-free loans (*qard*) are therefore necessary for the fund to remain solvent. While commission to operators is permissible, the amount to be paid requires further study. The chapter further finds that operators can provide a free indemnification for the fund, and can get a fee for managing the fund pool on behalf of the participants. Finally, the authors find that keeping risk pools separate is impractical and the same should be consolidated on the basis of the category of business and risks involved.

Muhammad Al Bashir Muhammad Al Amine discusses the need for *takaful* by corporations, highlighting its benefits for national trade development. The author pays particular attention to the development of trade credit *takaful* in protecting *sukuk* holders against the default of issuers or in enhancing the credit profile of some sovereigns to access the *sukuk* market. He finds that trade credit *takaful* in *sukuk* cannot be an extension of credit default swaps in the conventional market. His recommendations therefore include education initiatives for central banks, government-based trade credit agencies, *takaful* providers, *shari'ah* advisors and

consumers, as well as connectivity between *sukuk* and long-term *takaful* liabilities.

Further discussion on *takaful* product analysis centers on the family insurance product. Hiba Allam and Volker Nienhaus discuss how to structure a *shari'ah*-compliant family insurance product to meet the demand of Muslims for capital protected savings products. They find that there are four issues that need to be addressed to meet *shari'ah* compliance. The authors recommend providing capital protection through a guarantee of nominal amount paid in via risk-free fixed income instruments, while the remaining funds are invested in higher risk/higher return equity instruments. For options, they recommend non-speculative use of conventional options with high transparency and customer education to mitigate *shari'ah* non-compliance risk. The argument that a high watermark fund guarantee, which is problematic due to the fact that its value is only known at maturity, can be defended based on the fact that the calculation formula can be agreed upon, and regulation can ensure that excessive risk (*gharar*) is not involved and that minimum capital requirements ensure solvency in case of loss. Finally, lifetime annuity can be structured based on a cash *waqf* basis where annuities are self-financing.

TAKAFUL AS SOCIAL FINANCE

One of the critical differences between *takaful* and conventional finance, as pointed out in the previous chapters, is its ability to serve as social finance – finance that benefits the poor, fuels development at the lowest level of society and thereby alleviates poverty. Part IV details how this aspect of *takaful* can be strengthened by discussing models of social banking based on *takaful*, including microcredit, micro-insurance and developing case studies of the effect of the implementation of these models. The chapters in this part deal with the greater role for banking institutions in extending financial protection followed by some case studies from Pakistan, Indonesia and India on the role of cooperatives in offering microfinance and micro-*takaful*.

Hussam Sultan and Abdur-Rahman Syed lay out a *takaful*-based social banking model, positing that it can have an effect on socioeconomic development within the current market and regulatory environment. This is significant given the regulatory and structural changes raised in Part III. Elements of their suggestions include banks seeding the pool and being a contributor of a small monthly amount, a basic hardship protection for participants, in the form of a contribution to bank-run charitable activities, and *wakala* fee for the bank. This new dimension to *takaful* will act

to strategically introduce social banking as an opportunity for banks and spur growth in the industry.

Mian Farooq Haq and Bushra Shafiq develop a banking alternative they call the Commercial Islamic Cooperative Model by first looking at the types of cooperatives available globally and then focusing on Islamic finance cooperative models as providing the best option for poverty alleviation. The chapter offers share offering and relative dividend income with the flexibility of outsourcing professional management while maintaining a reserve fund. The authors develop their model based on the seven principles identified by the International Alliance of Cooperatives to offer voluntary and open membership, offer democratic member control, promote member economic participation, ensure autonomy and independence, offer value-added services, promote cooperation among cooperatives and be concerned for the community.

Tanvir Ahmed Uddin and Maaz Rahman analyse the microcredit and micro-insurance frameworks in Indonesia in order to ascertain to what extent they assist in the alleviation of poverty. They find that the institutions are underperforming due to lack of a holistic approach and recommend the combination of various socio-legal programs such as microcredit, micro-insurance, *waqf* and social funds, along with use of *zakat* and *sadaqah* funds. In addition, the government should support microfinance institutions through partnership with larger institutions that can publicize and conduct training, and incentivize larger Islamic banks to participate via corporate social responsibility programs. Overarching regulation needs to replace the disparate regulatory frameworks, and mutuality needs to be promoted as the means of overcoming poverty.

Finally, Mohammad Faisal, Asif Akhtar, Asad Rehman and M. Abdul Samad provide a case study and model for microfinance in India. Their literature review reveals that banks cannot be the sole drivers of financial inclusion, and that insurance is one of the main means of stability for vulnerable populations. Environmental and health risks mostly affect poor people. Because they are vulnerable to even minor shocks, micro-insurance has a great stabilizing influence. However, information asymmetries, enforcement issues and verification costs prevent the widespread use of even micro-insurance. *Takaful* is offered as a solution to remedy some of these barriers to access to financial protection. Survey data is used to determine customer needs and preferences regarding *takaful*. Findings include a need for sensitivity to a population, trust in financial services, concept of affordability and ethical implementation of micro-*takaful* schemes. These findings confirm *takaful* as a means of poverty alleviation and promote the poor as customers whose needs and desires should be catered for in any social finance schemes.

Overall, the book starts with the context and need for *shari'ah*-compliant insurance (*takaful*) and then thoroughly analyses various *takaful* models and their efficacy both in terms of *shari'ah* compliance and operations. Along with suggestions to improve *takaful* operation, some of the chapters also discuss the possibilities of increased product lines to further deepen the market.