1. *Takaful* journey: the past, present and future

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**INTRODUCTION**

Any phenomenon, idea or paradigm that helps to create a new market and value system, and eventually disrupts an existing market (over a long period), displacing the earlier status quo is a standard definition of Disruptive Innovation. *Takaful* is a disruptive innovation in financial protection to unlock huge potential that exists in so many markets around the globe. Its DNA is the natural phenomenon of ‘cooperation’ that itself is the basis of how everything around us grows and evolves; from cooperation of cells within living organisms to cooperation of people and businesses within societies, communities and economies. The system within which *takaful* works best is a holistic system that upholds values and ethics that are good for people, where economic fundamentals generate profits made in a fair manner and where in doing so, the environment and ecosystem is not harmed. This holistic system is the system of Islamic finance, good for People, Planet and Profit.

The aforementioned scenario is the ultimate goal of *takaful*’s journey into the future. Questions about the validity of conventional insurance in the context of *shari’ah* acceptability with regard to the prohibitions like *riba*, *gharar* and *maysir* have been raised since the early twentieth century and the modern debate of what should be the solution built on the ideals of ethical values started in the 1970s. It is not surprising that when a framework was agreed based on ‘cooperative principles’, *takaful* went through a rapid and dizzying pace of developments in the late 1980s as a disruptive innovation for the financial services industry. Today, however, *takaful* finds itself in a fragmented state as a result of this rapid development, going through a great deal of soul searching of how theory and

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practice could be brought together in sync and what should be done to get the takaful industry on track towards its ultimate goal to be effective in the People, Planet, Profit paradigm.1

This chapter provides a real life account of the journey the takaful industry has undertaken so far. It analyses the constraints faced by the practitioners of takaful and presents a snapshot of possible solutions being discussed and debated in the industry. The first section, ‘The Past’, sets out the background to the need and justification for takaful followed by discussion on the developments of various takaful models. The second section, ‘The Present’, analyses the arguments and difficulties faced by the takaful industry. The third section, ‘The Future’, discusses some solutions that are currently debated in the industry, followed by the conclusion.

Islamic prohibitions and other standard terms and definitions like riba, gharar, maysir and so on are deliberately not discussed in this chapter as these are adequately covered elsewhere in the book.

THE PAST

Financial protection has been an integral part of the Islamic thought process, emanating from the system practised by Arab tribes even before the advent of Islam.2 It was embraced and further improvised within the Islamic fold in various forms.3 It is therefore no surprise that the first modern experiment of takaful was based on the concept of cooperation (tawwun) among participants. Takaful, which comes from word kafala, is the modern form of mutual financial protection, mainly developed out of


2 Arab merchants had created a mutual risk fund called hilf to assist victims of natural disasters or hazards of trade journeys. Daman khatr al-tariq (a kind of surety) was placed on traders against losses suffered during a journey caused by bandits or pirates. Agilah was practised to prevent bloodshed among tribal members by extending compensation to ransom captives or to settle a claim from an accidental killing. Such practices from the pre-Islamic period were validated by Prophet Muhammad and incorporated into acceptable practices of the early Islamic state. http://www.takafulprimer.com/Resources/takaful_report_primer_2013.pdf

3 The concept of agilah (shared responsibility) was further improvised when Arab traders started contributing to a fund to help members confronted with mishaps or robberies along the numerous sea voyages.
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Some key milestones in the journey of insurance to takaful are set out below:

- **1700s and 1800s:** Conventional form of insurance was introduced in the Near and Far East by European companies. Egypt and Malaysia, the main precursors of the debate on questioning the validity of insurance, had conventional insurance introduced in 1835 (Malaysia) and 1845 (Egypt) by the British.
- **1900:** Muhammad Al Bashir, the Grand Mufti of Egypt and Shaikh Mohammad Abduh, issued two fatwas in favour of validity of insurance.
- **1906:** Mufti of Egypt, Shaikh Mohammad Baqit, issued a fatwa in favour of insurance.
- **1926:** Islamic Supreme Court of Egypt declared conventional life insurance unlawful.
- **1965:** Muslim League Conference declared conventional insurance unlawful followed by a similar prohibition by the Fatwa Committee of Al-Azhar in 1968.
- **1969:** Islamic Fiqh Academy of Muslim World League prohibited commercial insurance.
- **1972:** All forms of commercial insurance prohibited:
  - by Muslim scholars of more than 85 countries agreeing at a gathering organized by the Secretariat of Islamic Research Academy in Morocco
  - by shari’ah scholars and economists at the University of Libya Symposium
  - by the National Religious Council of Malaysia – this led to the set-up of a committee to study the Islamic insurance system and its implementation in the country.
- **1976–77:** The Higher Council of Saudi Ulema issued a fatwa in 1976 in favour of insurance to be based on Islamic cooperative principles, followed by the issue of a similar fatwa by Majma al-Fiqh of the Muslim World League.

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Takaful and Islamic cooperative finance

- 1985: The second conference of the International Council of Fiqh Academy of the Organization for Economic Cooperation (OIC) declared commercial insurance void and recommended cooperative insurance as the preferred alternative.5

Specific *takaful* regulations, rules and guidelines have been issued in various jurisdictions as listed below:

- 1984: Malaysia was first to come up with *takaful* regulations as the Takaful Act in 1984.
- 1992: Sudan issued insurance law requiring all insurance companies to operate on *shari’ah* principles. The regulations are being updated as of February 2016.
- 2004: Saudi Arabia introduced cooperative insurance regulations but these differ from *takaful* regulations in other jurisdictions.
- 2005: Pakistan introduced ‘*Takaful Rules 2005*’.
- 2006: Bahrain introduced the Rulebook on insurance, which included specific *takaful* rules. Updated *takaful* regulations are expected as of February 2016.
- 2010: United Arab Emirates (UAE) introduced *takaful* regulations. These were further revised in 2015.
- 2013: Nigeria introduced operational *takaful* guidelines.
- 2015: Kenya introduced operational *takaful* guidelines.
- 2015: Oman *takaful* regulations expected as of February 2016.

The early *fatwas* in 1900, 1901 and 1906 in favour of insurance were primarily on the basis of *shari’ah* upholding actions and deeds that save human beings from hardship.6 There was, however, an undercurrent of a more pressing *shari’ah* compliance concern culminating in the emergence of Islamic banking and *takaful* in the 1970s. The concern amongst Muslim scholars was about the use of money and how it was not being used for equitable and sustainable economic growth for the general welfare of mankind.7

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5 https://uaelaws.files.wordpress.com/2012/05/resolutions-and-recommendations-of-the-council-of-the-islamic-fiqh-academy.pdf
6 ‘Allah intends for you ease, and He does not want to make things difficult for you’ (*Qur’an*: 2: 185). And ‘Allah wishes to lighten the burden for you, and man was created weak’ (*Qur’an*: 4:28). The holy Prophet when he saw a person leaving his camel by the tent, asked ‘why don’t you tie down your camel?’ He answered: ‘I put my trust in Allah.’ The Prophet said: ‘Tie your camel first, then put your trust in Allah.’ Hadith At-Tirmidhi 2517.
7 Yusuf Ali, the eminent translator of the Holy *Qur’an* translated verse 2:275 as ‘Whereas legitimate trade or industry increases the prosperity and stability of men and nations,
The use of interest creates all sorts of possibilities of exploitation of those in need of money by those who have plenty of it. All revealed religions in fact prohibit interest, based on the premise that there can be no gain without sharing the underlying risk of a transaction or investment. Risk and reward must stack up together with an understanding that there could be profit or loss, each mutually shared by the parties involved.

The debate for the need for Islamic finance gained momentum in the 1960s, resulting in a number of initiatives: Tabung Haji was established in Malaysia in 1966, Mit Ghamr local savings bank in Egypt in 1967. Dubai Islamic Bank is the first Islamic commercial bank established in 1975, followed by Faisal Islamic Bank in 1977, Dar al Maal Al Islami in 1982 and Bank Islam Malaysia in 1983. Sudan attempted to Islamize its entire banking system in 1984.

As for takaful, the approach proposed at the Majma Al Fiqh in 1985 was to develop a system based on cooperative principles. This reflected the concept of shared responsibility within the system of agilah where payments by the whole tribe (the solidarity pool) covered the burden of a family in trouble (the mutual help). Thus, under takaful, the participating members contribute a sum of money to a common pool to indemnify those who suffer loss from defined perils. The cooperative principles are built on mutual cooperation, mutual help and mutual protection. As Al-Darir puts it, ‘the parties to this contract (Takaful) do not aim for profit in isolation. Their intention is to cooperate with the purpose of overcoming misfortunes in life.’

dependence over usury would merely encourage a race of idlers, cruel bloodsuckers and worthless fellows who do not know their own good and are akin to madmen.’

8 History and Development of Islamic Banking System, Astin College, Malaysia. http://www.slideshare.net/n_izzuddin/the-history-of-islamic-bank
9 The bank did not survive long and was eventually absorbed by the National Bank of Egypt in 1967.
10 Qur’an 5:2 and Prophet Muhammad is reported to have said, ‘When the people of the Ash’ari tribe ran short of food during the holy battles, or the food of their families in Medina ran short, they would collect all remaining food in one sheet and distribute it among themselves equally by measuring it with a bowl. So, these people are from me, and I am from them’ (Sahih Bukhari, Volume 3, Book 44, Number 666).
11 Prophet Muhammad: ‘A believer is like a brick for another believer, the one supporting the other.’ He also said, ‘The similitude of believers in regard to mutual love, affection, fellow-feeling is that of one body; when any limb of it aches, the whole body aches, because of sleeplessness and fever’ (Sahih Muslim).
12 Qur’an 3:2: ‘. . . and do good to parents, kinsfolk, orphans, those in need, neighbors who are near, neighbors who are strangers, the companion by your side, they wayfarer (you meet) and what your right hands possess: for Allah loves not the arrogant, the conceited’.
EVOLUTION OF TAKAFUL MODELS

Phase 1

This phase saw the development of Islamic financial services, driven by standard shari’ah-compliant contracts (mudaraba, wakala, murabaha, istisna and so on). The ‘practical application’ was based on what was known of how the conventional financial services products worked. There was heightened activity amongst the shari’ah scholars to find a best fit of shari’ah-compliant contracts to get the Islamic financial institutions working and competing in the largely conventional space of banking, finance and insurance. One big objection to conventional insurance was that insurance companies allegedly made huge profits out of policyholders because the magnitude of claims is normally not as large as the aggregate pool of premiums. This line of thinking mainly applied to retail personal lines such as life insurance, savings, motor, medical and so on. The focus on devising takaful structures was therefore not to be driven by the motive of profit but to fill a need to provide protection in a fair and transparent manner where the risk is shared amongst policyholders and the rights of policyholders and shareholders were clearly defined and segregated. Takaful models in this phase were therefore of the pure cooperative type. Surplus if any remained within the fund. The cost of running the operation was charged to the fund. The takaful operator was compensated from profits earned on investment of the fund. Examples of this phase are Islamic Insurance Company (promoted by Faisal Islamic Bank) in Sudan and Islamic Arab Insurance Company, Saudi Arabia promoted by Dallah Al-Barakah Group both in 1979.

![Diagram](image-url)

1. Tabarru contribution
2. Investments
   a. Share of profit to takaful operator
   b. Share of profit to the fund
3. Claims

**Note:** Expenses in this model are borne by the fund. Any surplus remains within the fund.

*Figure 1.1 Pure mudaraba model*
Phase 2

It was natural for *takaful* companies to offer products covering the needs of both persons and businesses and to seek distribution channels for greater market penetration. As Islamic banks had greater affinity with customers seeking *shari'ah*-compliant solutions, and by nature as people don’t go running to insurance companies in the same way they do to the banks, *takaful* distribution through banks became a major focus, leading to bank-*takaful* alliances. As more companies entered the market, the ‘pure’ *mudaraba* model came under scrutiny, especially on the point about very low returns to shareholders that were mainly derived from management of funds invested in *shari'ah*-compliant avenues. There was a question of both scale and liquidity of the available investment instruments resulting in low returns. The insurance liabilities usually require secure asset backing with a level of secure returns and a good level of liquidity for most products except for those that are savings and retirement driven. The pure *mudaraba* model generated low profits for the operator. The model was therefore modified to recognize the need for fair returns to the shareholders by allowing a share of the underwriting surplus of the funds. This would enable the *takaful* operator to cover operational cost and the balance available for shareholders. Syarikat Takaful Malaysia (STM), promoted by Bank Islam Malaysia, was a leader in applying this model, and through this institution, the model was applied to various other countries where STM was instrumental in promoting and developing *takaful*, such as Indonesia, Bangladesh and Sri Lanka.

![Diagram of Mudaraba modified](image)

**Figure 1.2 Mudaraba modified**

1. Business acquisition charges
2. *Tabarru* contribution
3. Investments
   a. Share of profit to *takaful* operator
   b. Share of profit to the fund
4. Claims
5. Operator’s share in underwriting surplus

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Phase 3

The modified *mudaraba* model soon came under scrutiny as other players entered the *takaful* space. This attracted criticism of the model on two fronts. Firstly, the capital coming into a *mudaraba* contract is never a donation, which conflicted with the concept of *tabarru*, this being a donation. Secondly, as the operator had to cover its operational cost out of underwriting surplus that could only be appropriated at the end of a business cycle, this resulted in a time delay between the incidence of expense and its payment. This gave rise to other models starting with pure *wakala*, then modified *wakala* (also known as the hybrid model), the *waqf* model and the *wadihah* model. Bahrain Islamic Insurance Company (the present-day Takaful International of Bahrain), Islamic Arab Insurance Company Dubai and Bank Al-Jazira Takaful of Saudi Arabia were amongst the early users of the *wakala* model.

In the pure *wakala* model (3-A), the *takaful* operator charged a fixed fee for operational expenses and a margin for shareholders, whereas underwriting surpluses belonged solely to the participants. As a high *wakala* charge would render the product more expensive for the customer, the margin for shareholders had to be kept small. The only way the shareholders could hope to increase their return on capital was by writing a lot of premiums, thus creating larger funds and generating a higher amount from fees for managing the investments. However, the classic practical conundrum for *takaful* companies has been unfortunately to attract more business by competing on price in order to break into the market not only dominated by established and strong conventional players but in markets that were already saturated by too many players chasing a finite number of customers. An underpriced risk on the books invariably results in underwriting losses. This triggers the statutory requirement for shareholders to provide *qard* (benevolent loan) to cover underwriting deficits, to be repaid out of future surpluses without interest. This model was similarly criticized as the modified *mudaraba* model for not being sufficient in meeting shareholders’ expectations of fair returns on their capital exposed to risks underwritten on behalf of participants.

This led to modification of pure *wakala* into a hybrid model (3-B) of *wakala* and *mudaraba* that resulted in improved revenue flows to the *takaful* operator and shareholders from *wakala* fees for managing underwriting activities and *mudaraba* profit for managing investments. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) supported this model as well as Bank Negara Malaysia and the Central Bank of Bahrain.

The *wakala-mudaraba* model (3-B) was criticized for allowing
1. *Tabarru* contribution
2. *Wakala* fee
3. Investments and returns
4. Claims

**Figure 1.3  Pure wakala model (3-A)**

1. *Tabarru* contribution
2. *Wakala* fee
3. Investments
   a. Share of profit to *takaful* operator
   b. Share of profit to the fund
4. Claims

**Figure 1.4  Wakala-mudaraba hybrid (3-B)**

1. *Tabarru* contribution
2. *Wakala* fee
3. Investments
   a. Share of profit to *takaful* operator
   b. Share of profit to the fund
4. Claims
5. *Takaful* operator gets performance fee for better management of underwriting account

**Figure 1.5  Wakala-mudaraba with performance fee (3-C)**
shareholders to receive returns out of the *wakala* fee related to the participants’ contributions instead of linking it to ‘underwriting’ results that affect the surplus emergence. A performance fee based on the *juala* concept levied on underwriting surplus was considered to be a more acceptable form of risk-reward return to the shareholders.

**Phase 4**

This brings us to the present phase where we have various *takaful* models being practised and modifications are still being sought from *shari’ah* scholars and practitioners. This is because the question of *tabarru* has been a subject of much debate. The ‘fund’ or ‘risk pool’ is built from insurance premiums, known as *takaful* contributions. In support of the cooperative mutual principles, these contributions are deemed donated for the collective benefit of participants in the pool. The point of debate\(^{14}\) is that the participant expects to be reimbursed in the event of loss. But the concept of *tabarru* is all about once a donation is made, there can be no expectation of return as it is unlawful for the donor to seek to derive any benefit from the donated property.\(^ {15}\)

One solution to overcome this challenge has been sought in the form of the *waqf* model, which primarily seeks to address the issue arising out of conditional *tabarru*. The *takaful* operator in this model first establishes a *waqf* with its own contribution and then all the contributions received from participants (as cash *waqf*) become part of the *waqf* fund, which is then used to support the participants’ insured needs. The *takaful* operator earns revenue out of the fee levied on managing the *waqf* fund. Surpluses, if any, remain with the fund, or are distributed among the participants or distributed for social and charitable purposes in the unlikely event of the fund being liquidated.

Some other modifications based on the concept of *nahd* or *wadiah* (safekeeping) are also under consideration but they are yet to be tested with actual practice. The *wadiah* model has a contractual basis of establishing a pool for the participants (like *waqf*), but additionally, *tabarru* comes after the insured event occurs and any payment from this pool is an act of *tabarru* on behalf of the mutual group. The fund has legal structure established within specific parameters such as participants waiving the


\(^{15}\) ‘Ibn’Abbas reported that the Messenger of Allah said: ‘He who takes his gift/donation back is like a dog which takes back its vomit.’ Mishkat-ul-Masabih, 316 (Al-Ha] Maulana Fazlul Karim trans., 1938).
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rights to their contributions, claims paid as donations and surplus paid to them out of good underwriting results provided the pool is secure, stable and solvent.

Qard

Another area of much debate has been the concept of qard, the benevolent loan, provided by the shareholders to cover underwriting deficits in the takaful fund when what is in the fund is insufficient to cover the liability of claims payable. This can happen for various reasons, such as inadequate pricing of the underwritten risks, poor underwriting, poor risk management including re-takaful programmes and inadequate reserving. All these areas are a function of policies of the management (the wakeel) and if these are sound, then qard would be manageable and sustainable out of the emerging surplus. The surplus of course varies and its volatility depends on the risk profile of the underlying takaful liabilities. The emerging surplus can also be quite stable, again depending on the product mix, market share and company’s ability to secure new business at the right price. Nevertheless, such deficits do occur and in conventional insurance these are absorbed out of shareholders’ reserves. From a regulatory point of view, qard is obligatory in order to protect the participants. From the shari’ah angle, however, qard is not obligatory. In fact, it has been criticized vehemently by some scholars who claim that in being fair to both participants and shareholders in upholding their rights, obligatory qard

Figure 1.6 Waqf-wakala model
impinges on the rights of the shareholders who are not supposed to be exposed to the risks pertaining to the participants. In their view this makes *takaful shari'ah* non-compliant, making the contract commutative. On the other hand, some researchers have greatly appreciated this arrangement, as this one:

The ability of the takaful risk pool to solicit an interest-free loan from the shareholders to cover occasional deficits is a wonderful innovation, as it enables a takaful fund to generate capital indirectly from future surpluses of the fund. Instead of participants having to pay up capital at the outset, shareholders will come up with any necessary capital should a deficit occur, and this would be financed (repaid) from future surpluses of the fund.16

In reference to the above observation, it should be noted that deficit correction is seen to be problematic in *takaful* because of the necessity to maintain a firewall between shareholder funds and participant funds in a system that is built on ‘risk sharing’ as opposed to ‘risk transfer’. For conventional mutual companies this is not a problem because these companies don’t have external shareholders, and any deficit that arises is corrected out of their contingency reserves or external funding. In the case of proprietary insurance companies, all funds belong to shareholders under the risk transfer mechanism. In all cases the regulatory requirement is for the deficits to be corrected out of accumulated reserves or fresh capital.

**THE PRESENT**

*Takaful* as an industry is only 37 years old as of 2016. It has been trying to find its place in markets dominated by the conventional insurance industry that is nearly 380 years old. There were a total of 224 *takaful* companies mainly spread around the Gulf Cooperation Council (GCC), Southeast Asia and Africa as of 2012, with 101 new companies established between 2006 and 2012.17 This number has substantially grown, as there have been a number of companies established, especially in Africa, since 2012. The global contributions are expected to grow to $25.5 billion by 2020. The estimated figure in 2014 was $20 billion. Even though the number of *takaful* companies has been growing, as well as the growth of *takaful* contributions, the overall size of the *takaful* industry is still very small.

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17 Hamdan Bin Mohammed Smart University, Dubai Center for Islamic Banking and Finance Launches Extensive Takaful Report at 3rd Global Islamic Economic Summit in Dubai. https://www.hbmsu.ac.ae/news/15311
Takaful is an integral part of the Islamic financial system, and yet its growth has not been commensurate with the growth of Islamic finance. The size of the global Islamic finance industry is estimated to be $2.1 trillion as of 2014.\textsuperscript{18}

In relative terms, the takaful industry has made tremendous progress over a short period of three and a half decades. Many in the industry however feel not enough has been done, keeping in mind that the takaful industry had a head start in technology, equipped with technical knowledge of managing insurance risk and backed by the disruptive innovation of ethical principles, all geared to what the customer needed. The following sketches a picture of possible reasons for this.

1. Mutual versus commercial. There is a conflict between mutuality of risk sharing in takaful with its existence as a commercial corporate entity. If takaful were to be set up on a purely mutual basis then qard would not be such an issue, tension between risk sharing and risk transfer would not exist, nor shareholders wanting to take a share of the underwriting surplus. In its truly mutual form, takaful however may still need the backing of a non-governmental organization (NGO) or government body to play the role of lender of last resort. Unless there are specific niche and large enough affinity groups needing takaful solutions, or a closed market with a level playing field for all players, it would be difficult even to set up a mutual company in this day and age, competing in fragmented and crowded markets of insurance and takaful companies. The fact of the matter is that takaful companies are not mutual companies and have to compete on commercial grounds, where shareholders expect returns commensurate with the business risks they undertake. It should also be borne in mind that many, if not most, takaful companies are publicly listed companies. This means investors buy equity stakes in these companies with an expectation of making decent returns on their investment. This has led to situations where shareholder revenues from wakala fees result in fees being excessive to increase investor margins, as income from investment returns is not sufficient. For the investors, this is like sharing in business risks but not in business rewards on a commensurate basis. If the business risk of deficit funding were to be removed from the shareholders then not sharing in the underwriting surplus would be justified as supported by shari’ah scholars.

The above emphasizes the fact that takaful business cannot exist without shareholder capital; rather it is essentially a basic requirement in all jurisdictions around the world for setting up a takaful company, even where specific takaful regulations exist.

Unless some unique solution is found, qard is a practical reality and takaful companies need to manage it. As to the commercial nature of takaful and shareholder expectations for a decent return, this remains a dilemma.

2. Takaful models. There has been considerable industry debate on takaful models, as each model has been found to be an imperfect fit in satisfying the expectations of participants and shareholders within the boundaries of cooperative principles. The important consideration is to have a takaful system that works at business, economic and cooperative levels for the long-term durability of the business supported by shareholders’ equity, customer centricity and mathematical (scientific) approach to surplus/deficit management.

In the wakala model, wakala fees are a direct source of revenue for the operator, with or without a margin for shareholders; this is open to exploitation albeit with a trap of obligatory qard later. For this very reason, in takaful companies the shareholder part of the financials may be healthier than the participant part. This is happening. The fee revenue is effectively a ‘risk free’ source of income out of participants’ contributions.

In the mudaraba model, on the other hand, revenue for operator and shareholder is out of the technical result if and when it is positive; this is effectively a reimbursement in the current period of expenses that were incurred in the previous period. There are other models also being experimented and debated such as waqf, wadiah and so on, but these are still being tested for possible limitations.

Where the risk is priced or underwritten incorrectly or reserved insufficiently, or claims experience is worse than expected (and the chances of this happening in general takaful are much more than in family takaful) then the overall outflow can exceed the available reserves, creating deficits; these deficits are then funded by the shareholders’ capital as qard – the benevolent loan. In practice, there is the imposition of arbitrary limits on wakala fees, on the mudaraba share of investment returns and on performance incentive fees (if allowed). The arbitrariness of these limits creates financial imbalances and impedes the ability of takaful companies to take on new business with different inherent risks.

Each company ends up with its unique risk profile driven by types of risks it is writing, impacted by the quality of its technical resource,
creating a specific burden of *qard* on shareholders. This raises a multitude of scenarios where shareholder capital is exposed. How can the burden of *qard* be minimized? At what level can *wakala* fees adequately service the business expense? The level of fees need to be commensurate with the degree of maturity of business, whether it is a new company or an old established company within the constraints of adequate price for acquiring new business.

The key questions therefore confronting the industry are:

a. Is there a solution for shareholders and participants to be inclusive within defined rules that can satisfy the concept of risk and reward within the principles of cooperation (risk sharing)?

b. Is there a better approach to fixing the percentage of fees for investment and underwriting returns, such as ‘actuarial cum management’ assessment instead of arbitrary ‘board cum shari‘ah’ considerations?

*Takaful* companies therefore need a clear technical approach to what is the right way of deciding how large the *wakala* fee should be, and for how long can the remainder of aggregate contributions continue to be put aside as reserves before some of it can be distributed back to eligible donors as a reward for risk sharing. There are several risk factors attached to this, related to expense levels and their control, claims experience, strategy for new business, underwriting philosophy and its control, the retention of risk and ceding the rest to re-*takaful* companies. The donation concept de-links the payment of contribution from the donor. If a surplus is distributed it may not necessarily go back to the ones who had contributed towards it as they may have left the scheme, but that would be within the spirit of mutuality between generations of participants.

3. The ethics. There is a wide consensus about the lack of understanding and awareness of the mutuality aspects of *takaful*. These are least known or understood. The customers don’t know much about this ethical dimension, the employees and management of *takaful* companies don’t seem to have done much about it and many times the board of directors don’t seem to care much about it. As a result, there is not enough to demonstrate how this system works for the good of society, how the companies are supposed to be socially active and the funds are supposed to be channelled in ways that are good for the economy and the environment. Companies have not done enough in marketing the unique brand value of *takaful*, which is its goodness for all, protecting the community and investing in it. A lot of this is to do
with the mind-set of practitioners who feel *takaful* is a niche business, appealing to certain sections of society only. We have seen this happening in the UK and some parts of the Middle East, but *takaful* needs to be part of the mainstream insurance industry, such as in Sudan and to some extent Malaysia.

The brand value of *takaful* essentially revolves around the following five pillars that define its ‘People, Planet, Profit’ paradigm:

i. *Takaful* ‘stakeholders’ are all part of a community benefiting from a mutual and cooperative system.

ii. *Takaful* enables channelling of wealth and capital with social conscience and responsibility, benefiting the communities and the environment.

iii. *Takaful* encourages the use of money with commensurate risk and reward for a sustainable system, good for all humanity.

iv. *Takaful* is built on principles of equity, justice and fair play, minimizing uncertainty of terms and ensuring one party does not exploit another.

v. The rights of stakeholders are clearly defined and transparent.

THE FUTURE

There are proponents and critics of Islamic finance and *takaful*, each holding a critical view of what the future holds for this industry, ranging from cautious optimism to outright pessimism.

Pessimism stems from what is observed of the current state of several institutions in the Islamic finance and *takaful* space, struggling to achieve financial stability, and in the absence of constructive measures and the presence of apathy, it would lead to contraction of market shares within the overall financial services industry.

Cautious optimism relates to the growing constructive criticism and debate on various issues such as those highlighted in this chapter that should lead to improvement in the effectiveness of reaching out to existing and prospective customers on an ethical financial footing.

Factors that contribute to this thinking are discussed below:

1. Rationalization and consolidation. This is needed in the *takaful* industry. The dizzying pace of development of the *takaful* industry has resulted in an over-supply of insurance offerings both from *takaful* and conventional companies. Whilst the conventional companies may
survive, *takaful* companies may struggle due to higher expense and claims ratios hurting their bottom lines. What is preventing *takaful* companies from merging has been the competitive element of their promoter shareholders, these being Islamic banks and family offices. The struggling companies thus far have been re-capitalized, but the cycle could very well repeat. If the founders of these initiatives have the vision to see the growth of the ethical system of Islamic finance and *takaful*, mergers between companies would be the way forward. This would create stronger companies better able to compete in the market. The sum of the parts will be positive, with lower expense ratios and improved profit margins.

2. Getting the message across. The promotion of *shari’ah*-compliant products should be on their ethical merit and value addition, highlighting the fact that these are good for everyone. Why would the Islamic finance industry want to segregate itself from the mainstream, especially in Muslim countries? However, to reach this dimension, the industry must improve its customer service and product terms and conditions. *Shari’ah*-compliant contracts and policies have not been easy to understand. Unless the customer is fully knowledgeable of the jargon, it would help to put these in simple language instead of legal nomenclature.

3. Not a niche but mainstream. The governments in Muslim countries ought to be more supportive and proactive for this industry to grow and even be the mainstream. This is beginning to gather momentum in the UAE. Saudi Arabia, by definition, has all financial dealings on a *shari’ah*-compliant basis, but insurance is structured quite differently from what we know of *takaful* in other markets. Sudan of course has had a *shari’ah*-compliant system since 1984. The OIC and Islamic Development Bank (IDB) would do a great service to this cause in building a consensus that would do wonders for enlarging the ethical system of Islamic finance.

4. Connecting the dots. Initiatives of *halal* industry\(^\text{19}\) on a global scale are shaping up where tens of thousands of projects should be financed by Islamic banks and insured by *takaful* companies.

5. Big brother support. Islamic banks and financial institutions need to support *takaful* companies much more in insuring assets under management of their clients, businesses and projects. However, *takaful* companies being new and still growing have had neither the scale nor financial wherewithal to insure the multitude of risks that are passing

into the conventional insurance space. Such leakage is likely to slow down or even stop going forward as takaful companies reach financial stability.

6. Enlarging re-takaful capacity. Re-takaful companies have been going through a rough patch, faced with internal challenges of technical resources, management and insufficient scale, on the one hand, and external challenges of low volumes of business, on the other. For takaful companies, the challenge has been firstly fewer numbers of re-takaful companies to select from, and as this affects their margins, they are driven to considering reinsurance companies either because particular risk coverage is not available from the re-takaful side or simply to have better margins. This includes ceding to conventional reinsurance companies with just the basic structures of the seemingly shari'ah-compliant facility. The industry needs more re-takaful capacity. Initiatives to establish re-takaful companies with a large capital base would be well placed for the future growth of the takaful industry both in general takaful lines and family takaful protection and savings side, especially in retirement planning and pensions.

7. Mass penetration. The takaful industry has so far not done much in the micro-takaful space with few exceptions in Africa and Malaysia. Conventional insurance has been active and 263 million people are covered by micro-insurance worldwide as of 2014. In Latin American and Caribbean countries\textsuperscript{20} micro-insurance has been growing in recent years at 33 per cent annually (excluding Mexico) compared to 23 per cent growth in traditional insurance. Micro-insurance in these countries is morphing into ‘mass’ insurance – low premiums, typically linked insurance cover – that is not necessarily designed particularly for the low-income market but can provide some value to any economic level. This expands the market for insurance more substantially into the middle economic ranges, which have also commonly had little or no access to insurance.

Institutions like the IDB can be the catalyst between the OIC countries and local and global NGOs in putting together programmes in micro-takaful in conjunction with micro-finance. This can benefit millions who are in desperate need for financial independence.

\textsuperscript{20} Network Annual Report 2014, 40pp. http://www.microinsurancenetwork.org/resources
CONCLUSION

The ethical dimension of the *takaful* system is what matters. It cannot however be promoted as such effectively if the issues highlighted in this chapter remain unresolved. The *takaful* industry is expected to have $25.5 billion worth of premiums in 2020. This number sounds large, but compared to the size of the insurance market it needs to be larger than this. After all, Islamic finance assets are expected to grow to $3.4 trillion in 2018 from $2.1 trillion in 2014. In countries where *takaful* is needed and life insurance penetration is very low, in places where it is less than one dollar per capita but the gross domestic product (GDP) per capita is high, there is huge potential. In general *takaful* there is a flow of business to the conventional side such as large risks in oil, chemicals, energy, aviation, engineering and so on. Finding solutions to the issues in this chapter should help to stop such leakage and unlock the potential. The providers of conventional insurance have not effectively penetrated 1.6 billion Muslims, but *takaful* can penetrate the market of 7 billion people on our planet.

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