CONCEPTUAL AND OPERATIONAL DIFFERENCES BETWEEN GENERAL TAKAFUL AND CONVENTIONAL INSURANCE

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ABSTRACT

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. A rich literature also describes such differences but the present article addresses the differences based on conceptual and operational framework.

Keywords: *Aqilah; Maisir; Mudarabah; Mudarabah Model; Tabarru; Takaful; Wakalah Model; Wakalah Waqf Model.*

1. INTRODUCTION

In this world, everyone is exposed to the possibility of risk and disasters such as death, losses and damages through fire, accident, and business etc. Despite this, all the Muslims believe in *Qadha-o-Qadr,* but Islam requires that one must find ways and means to keep away from such troubles and adversities whenever such things occur, and one should try to minimize his/her or his/her family financial losses. One possible way out is to buy an insurance cover. Dictionaries define the risk in different meaning like possibility of facing loss or threat. It is a common element of life. Risk can be defined as the variability or volatility in unexpected outcomes (Jorion and Khoury, 1995, p.2). It can be defined as the chance of events happening that could put an impact on the outcomes of the event. Johnson (1983) defines risk in insurance context and says, "risk is an element of uncertainty, as to whether an event occurs or not".

The basic idea of an insurance agreement is that it is a mutual co-operation between two parties to protect one of them from unexpected future financial loss. Under conventional setup the main viewpoint of insurance is to minimize the risk. Pfeffer (1956) defines as "insurance is a device for the reduction of risk of one party, called the insured, through the transfer of particular risks to another party, called the insurer, who offers a restoration, at least in part, of economic losses suffered by the insured".

An insurance contract minimizes the risk of loss due to accident or ill-fated situation. In conventional setup, this agreement is unproblematic; but, its acceptance to Islamic law, or Shariah, is debatable (Billah, 1993, 1996). Shariah scholars have different opinions about the status of conventional insurance from shariah point of view. One group of scholars has a perception that the actual lawful position of any matter is permissibility until there is a proof of its prohibition. They emphasize that there is no injunction against mutual insurance and it should be allowed (Billah, 1996, comments on Sheikh Al-Azhar's Fatwa). Muslims have to accept any catastrophe that befalls, as the will of Allah but they are also insisted to take positive steps to reduce unfortunate events. Other school of thought argues that insurance must be illegal due to the view that, each contract or agreement whose consequences are unknown is illegal. The result of an insurance contract is, by its nature, unknown, so it is illegal. The majority of the Shariah scholars believe that it is unlawful due to involvement of Maisir (*gambling*) and Gharar (*uncertainty*) (Ayub,2003). Moreover, when a person is purchasing an insurance policy, the policy holder is assured of promised fixed returns at the end of the insurance contract if premium installment payments are made. Once again, the outcome may contravene with the spirit of Islam, which prohibit a predetermined return or Riba (El-Gamal, 2000).

All the above discussions invite a question of clear differentiation between the Islamic Insurance and the Conventional Insurance. The present article addresses the same question. Many authors have already explained such difference, e.g., see Bt. Esman (2008) and Shahzad (2009) but we present here

conceptual and operational difference between these two types of insurances; the Islamic Insurance and the Conventional Insurance.

2. THE ISLAMIC INSURANCE (Takaful)

Takaful is the Islamic alternative to conventional insurance which is based on the idea of social solidarity, cooperation and joint indemnification of losses of the members. It is an agreement among a group of persons who agree to jointly indemnify the loss or damage that may inflict upon any of them out of the fund they donate collectively (Maysami et al., 1997).

The main purpose of *takaful* under the Islamic system, is to bring equity to all parties involved, and the objective of the contract is to help the policy holder through bad times. Profit earnings is not the main goal, while sharing any profits generated incidentally is acceptable (Maysami and Kwon, 1999).

The origin of Islamic insurance started before the era of the Holy Prophet Muhammad (S.A.W) which is based on "*Aqilah*" mutual co-operation (Klingmuller, 1969). Later such insurance transaction was steadily practiced and was even made mandatory in some cases during the period of the second Caliph, Saydina Omar (R. A .A). During the period of 14th to 17th century a Sufi Order of the Kazeeruniyya was very active especially in port cities in Malabar and in China. This order served as a kind of marine travel insurance company.

In 19th century, a Hanafi lawyer Ibn Abidin (1784 -1836) was the first Islamic scholar who came up with the meaning, concept and legal entity of insurance contract. He was also the first person, who repeated the word insurance in the context of a legal constitution, and not in a customary practice (Klingmuller, 1969). In 1906, Muhammad Baqit Mufti of Egypt approved the idea of insurance which was explained by Ibn Abidin. In the period of twentieth century, a well-known Islamic jurist, Muhammad Abduh issued two '*fatwas*' mentioning that an insurance transaction is like the transaction of '*al-mudaraba*' financing technique, while the other was that a transaction which is similar to endowment or life insurance are legal.

To consider insurance as Islamic mode of risk sharing efforts were made in late 1970s. The first Islamic insurance company, known simply as the Islamic Insurance Co. Ltd, was established in Sudan in 1979. This company was able to distribute profits to its shareholders at the rate of 5% in 1979, 8% in 1980 and 10% in 1981. Following the success of the insurance company in Sudan, other Islamic insurance (*takaful*) companies were established in Islamic and in non-Islamic countries. In Pakistan first Islamic insurance company was established in 2004 and now there are three Islamic insurance companies working.

2.1. Takaful Models

There are various models adopted in different Muslim countries, the one model is *Mudarabah Model* which describes that all policyholders must agree to share profits (or losses) from the undertaking (Maysami et al., 1997). 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 (Billah, 1996). 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 *Wakalah Waqf Model*. According to this model, a *Waqf* fund is created as separate legal entity with the contribution of the participant's amount and the amount deposited to this fund is considered as a "*tabarru"* donation. The aim of this fund is to provide relief to participants against defined losses according to the terms and condition of the *Waqf* fund. See Wahab (2006) and Wahab et al. (2007) for more details.

3. CONCEPTUAL FRAMEWORK OF TAKAFUL AND CONVENTIONAL INSURANCE

Literature on Takaful has considerably grown during the last three decades. Most of the literature emphasizes on Takaful concept and its difference with conventional insurance is frequently discussed topic (For example Ali 1989; Yusof, 1996; Aris, 2004; Maysami and Kwon 1999; Billah 2003a,b; Ghifari , 2003; Annuar et al., 2005; Ashraf, 2008). Following are the conceptual differences between Takaful and the conventional insurance:

3.1 Joint Guarantee/Taawun

Takaful is conceptually defined as an Islamic financial protection system which involves a joint guarantee scheme in providing possible indemnity or contingency but conventional insurance is based on compensation of loss in exchange of premium which is paid by insured (Billah, 2003a). 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 (Yusof, 1996; Azman 1997; Maysami and Kwon 1999; Billah 2003a,b).

In Islamic society Takaful system worked on the basis of *Taawun* and *Tabarru.* Participants mutually agree to help and guarantee each other by collecting contribution from individual, for the sake of mutual cooperation. Literally, insurance is worked on risk transferring process under which one protects themselves on behalf of others (Maysami and Kwon 1999; Omar and Dawood 2000; Billah 2003a; El-Gamal 2001).

The main purpose of Takaful under the Islamic system is to bring equity to all parties involved, and the objective of the contract is to help the policyholders through bad times. Profit earnings is not the main goal, while sharing any profit generated incidentally is acceptable but in conventional system business is started with the aim to earn profit (Maysami and Kwon 1999).

3.2 Social Solidarity/ Shared Responsibility

Takaful*,* the Islamic alternative to conventional insurance is based on the idea of social solidarity, cooperation and joint indemnification of losses of the members. It is an agreement among a group of persons who agree to jointly share responsibility of loss or damage that may inflict upon any of them; out of the fund they donate collectively but in conventional setup loss is indemnified by the insurance company according to the terms and condition of the policy (Maysami et al., 1997).

Takaful insurance has grown not only as an innovative financial instrument, but also on religious consideration (Maysami and Kwon, 1999). The contract of takaful provides solidarity in respect of any tragedy in human life and loss to business or property (Ayub, 2003). The Islamic model of insurance policy is based on the fundamental principle of mutual cooperation and solidarity, as ordained by Allah (SWT) mentioned to this effect in the Holy Quran (Maysami and Kwon, 1999).

But for conventional insurance there is no any religious boundaries and the purpose of insurance is to protect risk-averse from suffering the full cost of those actions on the part of nature which affect them unfavorably.

3.3 Concept of Aaqilah

Takaful is not a modern concept in Islamic commercial law. The current jurists acknowledge that the foundation of shared liability or Takaful was laid down in the system of '*Aaqilah'*, which was an arrangement of mutual help or indemnification customary in some tribes at the time of the Holy Prophet (S.A.W). In case of any natural disaster, every person used to contribute something until the loss was indemnified. Takaful is basically based on the idea of *Aaqilah* for the payment of blood money wherein payment was made by the whole tribe. Islam accepted this principle of mutual compensation and joint liability (Billah, 1998).

3.4 Risk Distribution

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 (Omar and Dawood 2000). Operator is playing the role of fund manager on behalf of the participant. So operator is not undertaking risk, the risk is however, distributed among the participants who agreed to jointly assume the risk (Yusof, 1996; Maysami and Kwon 1999; Billah 2003b).

Under conventional framework Insurance is a contract between two parties, whereby first party agrees to undertake the risk of other party in exchange of premium and the other party promises to pay fixed sum of money to the first party on the happening of uncertain event with in a specific duration (Spence and Zeckhauser,1971).

4. OPERATIONAL FRAMEWORK OF TAKAFUL AND CONVENTIONAL INSURANCE

The operational framework of conventional insurance is based on "risk assumption" but Takaful operate under mutual co-operation basis. The insurance system is based on following elements:

4.1 Gharar

Gharar means that a contract may be done in such a way that payment will be made on the occurrence of an uncertain event outcomes (Kamali, 1999). One may think of "selling the fish in the water" or the fruits on the trees at the beginning of the season. It may result in the unjustifiable loss of one party and equally undue enrichment of the other party. Gharar is forbidden to ensure full consent and satisfaction of the parties in a contractual agreement, because it is not showing the full knowledge, disclosure and transparency (Haberbeck, 1987). Other than *riba*, which makes any business transaction prohibited, it must be understood that uncertainty cannot be totally avoided in any business; it is excessive uncertainty that is prohibited (Khan, 2011).

The Islamic literature uses term *"Gharar"* to describe risk. It is generally described as risk of loss or promise to pay money upon the happening of specified event. A transaction under Islamic law should be held invalid, if it involves the element of Gharar but conventional insurance system is totally based on the theory of risk taking and uncertainty. (El-Gamal, 2000). *Gharar* can exist in insurance in four forms. *Gharar* in the out come, *Gharar* in the existence, *Gharar* in the results of the exchange and finally *Gharar* in the contract period (Billah, 2000).

4.2 Maisir

Maisir or gambling originates from Gharar and exists in insurance, since profit or loss to insurer very much depends on chances which is closely associated with claims level. Maisir, in insurance operation, resembles to a certain extent "risk taking" whereby insured got huge amount of money without an equivalent amount of input (Yusof, 1996; Maysami and Kwon 1999; Omar and Dawood 2000; El.Gamal 2000; Billah 2003a,b). However the rule of "large number" also plays its role i.e., uncertain with regards to an individual and it is also uncertain with regards to a very large number of individuals. As Gharar is eliminated, so also, Maisir which is due to Gharar is also avoided under Takaful system (Siddiqui 2000). But the conventional insurance is regarded as a kind of gambling as the insured makes a bet on the loss occurrence and the same applies vice versa for the insurer (Khan, 2011). It is also regarded as acquiring wealth on luck or by chance at the cost of others(Houston 1964).

4.3 Riba

Payment and collection of interest is not permissible under Islamic philosophy. Riba is strongly condemned by the Quran and Sunnah, because reward of money is not permissible in Islamic economy (Iqbal, 2007). Monetary capital is treated on par with production factors like land or labor, each being entitled to return regardless of profit or loss. But one has to understand that a key principle of the Islamic financial system is that any profit from trade and business has to come along with a liability or risk(Mahmood, 1991). Money capital in Islamic finance is seen as on par with an enterprise which comes with both risks and rewards (Siddiqi, 2004). Conventional insurance companies normally place insurance funds in Riba/interest bearing instruments such as bond and loans (El.Gamal, 2001).

4.4 Investment of Funds

The distinction between conventional insurance and Takaful business is more visible with respect to investment of funds. There is no hard and fast rule from investment point of view in insurance setup. Conventional insurers may invest in such type of assets that are strictly forbidden by the Shariah such as alcohol, gambling or pork are haram (Al Janahi and Weir, 2005; Gait and Worthington, 2008). While Takaful companies invest funds in interest free avenues and with the concept of Halal-o- Haram (Ayub, 2003; Thanasegaran, 2008; Khan, 2011).

4.5 Nature of Contract

By their nature, Takaful companies face additional risks as compared to conventional insurance. Conventional insurance companies invest large amount in fixed income securities on their balance sheet in order to minimize the risks and the variability associated with the equity. But in Takaful under Shariah law, interest is forbidden, which rules out the investment in fixed income securities.

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 can not be concluded on this basis of buy and sale contract (Ali, 2006).

Under Takaful contract every policyholder has the right to know how their money is used, how the surrender value is calculated, and Takaful policyholders 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 (Arbouna, 2000).

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 (Billah, 1997)

4.6 Profit Distribution

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.

5. CONCLUSION

The discussions on whether conventional insurance is in line with the Shariah have manifold but the widely accepted view is that conventional insurance is contrasting to Takaful. The major conceptual and operational paradigms are enough to define such contrasts.

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