

# APPLICATION OF ISLAMIC INSURANCE IN PAKISTAN & MALAYSIA, CHALLENGES AND PROSPECTS



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# **APPLICATION OF ISLAMIC INSURANCE IN PAKISTAN & MALAYSIA, CHALLENGES AND PROSPECTS**

By

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Thesis

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***Application of Islamic Insurance in  
Pakistan and Malaysia, Challenges and  
prospects***

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### **Acceptance by Viva Voce Committee**

The thesis on the topic; Application of Islamic Insurance in Pakistan and Malaysia, challenges and prospects, written and compiled by, Mian Muhammad Sheraz, Registration No. 32-SF/LLM-ICL/F08, is accepted by the Faculty of Shariah and Law, International Islamic University Islamabad, in partial fulfillment of the requirements for LLM in Islamic Commercial Law.

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# *Dedication*

*To my beloved late Mother*

*I miss thee, my Mother! Thy image is still  
the deepest impressed on my heart.*

*May ALLAH rest her soul in peace, Ameen*

## **Acknowledgments**

In the name of Allah, the most merciful, the beneficent

My sincere thanks and gratitude are extended to my Father, Brothers and sisters for their assistance in completing this work. It is in fact their prayers and best wishes which enabled me to complete such an assignment and also my studies with thoroughness and tranquility.

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The actual reward rests with ALLAH



### **Abstract**

Insurance is an essential feature of business in the modern economic culture. The concept of insurance emerges from the concept of risks hedging on the first part and risk buying on the other hand. Conceptually the insurance may be performed for literally each and every business, individuals, families and society may face. A person having a basic knowledge about the insurance system feels that this is a real benefit for the humanity because the insurance company hedges each individual's risks and support him in case of extra ordinary losses. We all know that in a civilized society, particularly in an Islamic society, it is the duty of the society in general and the government in particular to ensure to avoid losses for its citizens and in case of any extra ordinary loss, to try to compensate aggrieved one. The term insurance in its real sense is community pooling to alleviate the burden of the individual, least it should be ruinous to him. The simplest and most general concept of insurance is a provision made by a group of persons each singly in danger of some loss, the occurrence of which cannot be foreseen, that when such loss shall occur to any of them it shall be distributed over the whole group. The aim of all insurance is thus, to make provision against the dangers which beset human life and dealings. It is in fact the danger of loss which makes men seriously think of some safety devices to avoid it. Now considering the situation particularly for an environment whereby the government's attitude is particularly pathetic regarding efforts for saving the people's lives, properties and other assets, a number of people are of the view that it is a situation of compensation to obtain insurance policies to ensure that remedies are available in case of losses or potential losses. The contract of insurance is normally a contract of indemnity (cover) because it insures a compensation for loss to the insured. The life insurance and personal accidents insurance however are not contracts of indemnity (cover, protection) for in all such cases, the insurer has to pay compensation on the happening of an event without reference to loss.

The concept of Insurance is very much related to group life. In primitive society, people lived together in families or tribes in which their needs were fully met and protected through

co-operation and mutual help. They therefore did not feel the need for Insurance, because they were fully protected against all sorts of risks by the community. When this family or tribal life was replaced by the urban life in the ancient civilizations, the individuals found themselves open to multifarious perils and without the family and tribal protection.

Primitive people discovered no need for Insurance, finding their needs fully protected by the family or tribe in which mutuality such as is established by Insurance is a living reality. This was not true of the ancient civilizations of Egypt, Phoenician, Greece and Rome in which the individual found himself exposed to numerous risks without recourse against the family community. Under the circumstances, the individual was completely deprived of family or tribal protection and therefore, he looked for other kinds of safeguards. Thus insurance originated from the human need to find safeguards against the possible risks to himself and his property or interests. An early signs of modern insurance in a scientific form seems to appear in the European countries in middle of the thirteenth century. We find many examples of marine insurance in this century in many parts of Europe. The early practice of marine insurance in a scientific form, and on the "premium" basis, is undoubtedly associated with merchants of the city of Lombardy and notably Florence (A.D 1250) in Italy. In middle ages, trade was mainly centered in the Mediterranean, with well known trade routes to the east (Constantinople and India) and to the north. The Northern Italian cities, Florence, Greece and Venice became centers for banking, commerce and insurance. It is confirmed by Professor Grossmann Marcel that, the first precursors of Insurance institutions were the funeral association, which were formed during the period of the Roman Empire by Craftsman, Merchants and Actors<sup>1</sup>. Italy boasts the first known "Insurance agreement" which was executed at the Genoa on thirteenth October 1347. A second d agreement was signed in Palermo in 1350. In 1369, Marine Insurance was legally regulated in Genoa.

And we find marine insurance vague in Spain around the same period. The intensive trading by Barcelona for example, with Italy and the seaports of the Eastern Mediterranean since the end of the fourteenth century marine Insurance flourished early in Spain.

Then the marine Insurance spread to France, England and other countries of Europe, Marine Insurance was practiced in London in the early part of the fifteenth century, and the methods employed followed those used by Italians. France had experienced of marine insurance in fifteenth century at Rochelle and Marseilles. Literature on marine codes, sea Laws and marine insurance were first established in 1542. The earliest work treating of insurance in France is a publication known as *Le Guidon*. It treats mainly of Marine Insurance. It also mentioned life insurance, observing that while it was practiced in other nations, it was prohibited to insure the lives of persons in France. The first serious movement for life insurance was made in 1787.

This record of insurance practice is strong evidence that marine insurance did not exist in Europe before the thirteenth century. It also shows that the practice of marine insurance first began in Italy and Spain and then spread to other European nations, including France, England and Germany.

After marine insurance, Fire insurance developed in present form. It had been observed in Anglo- Section Guild form for the first time where the victims of fire hazards were given personal assistance by providing necessities of life. It had been originated in Germany in the beginning of sixteenth century. The fire insurance got momentum in England after the great fire in 1666 when the fire losses were tremendous. About 85 per cent of the houses were burnt to ashes and property worth of sterling ten crores were completely burnt off. Fire insurance Office was established in 1681 in England. With colonial development of England, the fire insurance spread all over the world in present form. 'Sun Fire Office' was successful fire insurance institution.

Life insurance made its first appearance in sixteenth century, the first recorded evidence in England being the policy on life insurance of William Gybbons on June 18<sup>th</sup>, 1653. Even before this date annuities had become quite common in England, and marine insurance had,

in fact, made its appearance three thousand years ago. The life insurance developed at 'Exchange Alley'. The first registered life office in England was Hand-in-Hand society established in 1696. The famous 'Amicable Society for a perpetual assurance Office' started its operation since 1706. Life insurance did prosper in United States during the 18<sup>th</sup> century, because serious fluctuations in death-rate, but soon after 1800 some active interest began to be shown in operation in this enterprise because of the application of level premium plan which had by then been in operation in U.K for more than a generation. It is difficult to determine when Insurance was first introduced into Islamic civilization as much as it is difficult to determine when Insurance was first introduced into world civilization.

Imam Ibn Abidin, a Hanfite jurist who died in 1836, is considered the first Muslim to introduce the Insurance by the name of 'Sukara' (Security) in Islamic civilization. It is hard to believe that Muslims did not practice Insurance before the 19<sup>th</sup> century. Muslims were involved in marine activities in the Mediterranean and the Indian Ocean from 17<sup>th</sup> century on, contacts between Islam and Christianity existed in Spain, Sicily, Italy, Cyprus and Malta. Thus Muslims must have been exposed at least to European marine (if not to other types of Insurance) which was part of the usual conduct of trade in middle ages. The modernist Afzalur Rahman claims that it was the Muslims of Spain who taught the Europeans what Insurance was and not vice versa.

It would be safe to presume that institutionalized insurance indeed started around the thirteenth 13<sup>th</sup> or fourteenth 14<sup>th</sup> centuries in the Italian cities. Muslims became acquainted with it not much later. However, just as the ancient and medieval civilizations devised methods to secure the individual against a major loss (which is the basic definition of all insurance) before insurance became an institution, Islamic civilizations too devised its own methods. In other words, the non existence of the terms "insurance" or "Ta'amin" prior to the 13<sup>th</sup> or 20<sup>th</sup> centuries, respectively, is not an indication that aspects of insurance. If general historians show signs of insurance in already in the third millennium B.C.E, modern Muslims writers eagerly show that several forms of insurance can be traced back to the beginning of Islam.

The charter which Muhammad (Peace be upon him,) prepared in Al Madina in 622 to establish the relations between the three groups which constituted His Ummah (Islamic Community) included certain elements of insurance 1) the Diya (Blood money) to ensure that every one's life should be considered inviolable, (2) fidya (ransom of prisoners of war) to ensure that one's freedom is always sought (3) joint action of the Ummah to aid the sick and poor) similarly to what is known as social security. If perceived as a means of insurance, these examples defiantly expand the types of insurance practiced by Muslims, already in the 7<sup>th</sup> century beyond marine insurance. The Shariah recognizes several transactions and institutions which function in a way similar to certain types of insurance. The most typical are: Daman (guarantee) is synonymous with Kafalah and is used of the risk or responsibility that one bears with regard to property of which one enjoys profit. Daman Khatir al tareeq (a guarantee against travel hazards) reminds one of travel insurance) Person "A" secures a sum of money with person "B" before leaving on a journey. If person A suffers any loss along the way person B would compensate him. Diya (Blood money) is according to the Qur'an compensation due to the victim or victim's family for unintentional killing or bodily injury. The party which pays the Diya is one's Aqila that is a group of people with a common interest in the defendant (either his male agnates (asaba) or fellow mawali or neighbors. Zakat means "growth and "purity". It is a religious levy and one of the five pillars of Islam. It is often mentioned as an equivalent to modern social insurance, and there have been modern attempts made in Islamic states such as Saudi Arabia (November 21, 1950; April 07 1951; April 01 1959; and in 1963) and Pakistan (June 06 1980) to apply Zakat and test it against the social insurance needs of each country. Jizya is the pool tax which is levied on non Muslims residing in the Islamic state and provides them with security for their live and property. Jizya is mentioned in Qur'an, Chapter 9:29. It was collected annually. As in world civilization, in the Islamic world first type of insurance to be used was marine insurance. At the end of 19<sup>th</sup> century the first insurance companies in the Islamic world were founded in 1890 in Egypt and in 1893 in Turkey. The 20<sup>th</sup> century development of insurance and insurance companies in Islamic and Arab world was influenced by European model, European legislation, and nationalism as well as by the ongoing Muslims theological debate whether insurance is at all legitimate transaction.

The history tells that the first form of Insurance which was practically applied in business world was the marine insurance scheme initiated by Muslims merchants. This scheme was based on the concept of Takaful which implies mutual cooperation and social security. In modern Islamic finance, takaful has emerged as an alternative to conventional insurance business. Takaful companies are now working in most parts of the world especially in Islamic world. Islamic Insurance (Takaful) is an alternative form of conventional insurance based on the concept of trusteeship and cooperation inspired by the beliefs of the followers of Islamic teaching. Muslim societies in different parts of the world are now practicing Takaful scheme as their own way of sharing financial responsibilities to assists each other. They have invented an Islamic way of mutual assistance to deal with uncertainties of life. Takaful is a social scheme based on the principles of brotherhood, solidarity and mutual assistance. It provides mutual financial aids and assistance to those who are members of the takaful scheme and voluntarily agree to contribute a certain amount of money for that purpose. It is a mutual agreement among the participants of the scheme. This has its origin from the concept of collective sharing of individual's loss. Takaful, is being practiced now as an alternate of conventional insurance system and is bounded by Islamic principles, rules and the laws of Islam (Shariah). Takaful has grown as a form of protection against the risk of loss. Takaful is now being operated in Muslim societies mainly because it is necessary to protect each and every member of the society from any unexpected negative change in life, and wealth that he has. This is also necessary to protect the members of the society from unforeseen losses arising from legal liability. The system of protecting one from an unforeseen loss or damage is not a new concept that people just learnt about. Islamic societies have always collectively assisted their members, both in cash and kind, and when they have been required to incur some usual or additional expenditure on deaths, births, marriages etc.

The Arabs even in the pre-Islamic days tied by blood relationship considered to meet the loss of any individual member, including his liability towards the payment of "blood money. They were obliged by custom and tradition to come to rescue of a fellow tribe and take suitable measure to cover losses or liabilities collectively. This took the form of mutuality and gave rise to the custom of losses being shared by the group as a whole.

Takaful has emerged as an alternate to insurance, because insurance and risk management are now being used in every sphere of human life and especially because of its tremendous importance to modern trade, commerce and industry. Because of the important role of insurance in the day today life and business ventures, the legal and contractual aspects has been the subject matter of detailed studies by Islamic scholars.

## INTRODUCTION

Islamic commercial Law refers to the law of sales, contracts and business transactions. This study is limited to the Contract of Insurance; there is difference of opinion between Muslims Scholars some of them are of the view that Contract of Insurance is invalid while other said that it is valid.

A contract of Insurance is one in which one party, i.e. Insurer promises in return for a money consideration, i.e. the premium to pay to the other party, i.e. the insured, a sum of money or provide him with some corresponding benefit, upon the occurrence of an event specified in the contract.

The concept of Insurance is very much popular in the whole world. As we know that, Islamic commercial law world. But there are some issues which are still not deeply discussed.

Many objections in the contract of insurance are raised by various Muslims Scholars from time to time, but still no conclusive statement has been made in this regard. There are different approaches to these objections in the contract of Insurance. Most of the Muslims jurists are of the view that commercial insurance is invalid and against the Injunctions of Islam and Shariah principles on the ground that Islamic law does not allow all unlawful means of business. (By which one party takes the property of other).

The other group of jurists says that the contract of Insurance does not contain prohibited elements (Gambling, Maysir and Gharar) these Scholars hold that in Insurance what a person buys when he seeks Insurance cover is not the amount of compensation he receives when something happens to him or property, but in fact, in Insurance he buys the peace of mind, which is not contrary to Shariah.



Whereas those who advocate reforms in Islamic banking and finance hold that it is permissible under Islamic law based on the arguments that *Gharar* implicated in the contract is only a minor one, which is always present in any kind of business transactions and such element of Uncertainty (*Gharar*) is negligible in the contract of Insurance, even if the *Gharar* that accompany commercial insurance seems excessive they are due to externalities of the contract thus becomes irrelevant.

So this research will be an attempt to resolve all these issues while analyzing the issues/objections in the contract of Insurance in the light of Islamic Law and Shariah principles.

## **STATEMENT OF RESEARCH PROBLEM/ THESIS STATEMENT**

- Conventional Insurance as practiced today is allowed on the grounds of Needs?
- Conventional Insurance as practiced is permissible or not?
- Can Islamic Insurance (*Takaful*) be a real Islamic Alternative of conventional Insurance?

## **HYPOTHESIS OF THE RESEARCH**

- 1- The contract of Insurance as practiced today is compliant with Shariah injunctions (Islamic Law).
- 2- The contract of Insurance as practiced today is not compliant with Islamic Law.
- 3- The contract of Insurance as practiced today is permissible on the basis of Needs.

4- Islamic Insurance is a real Alternative of conventional Insurance.

5- Uncertainty (Gharar) in the contract of Insurance is negligible.

## **OBEJETIVE OF THE RESEACH**

This research is aimed to:

- Explain the concept of Insurance contract and its validity.
- To analyze the concept of Conventional Insurance in the light of Islamic Law.
- To find out the bases of disapproval of the jurists on the subject.
- To discuss the concept of Islamic Insurance (Takaful) as an alternative to Conventional Insurance.
- How Islamic Insurance differs from Conventional Insurance.

## **LITRATURE REVIEW**

Throughout the history of Islamic law, there has been disagreement among scholars as to whether the insurance contract is prohibited or not? The centre of the arguments is based mainly on two grounds, that is, whether it pertains to the kind of contracts involving Gharar and Riba? Generally, these views can be summarized into two groups which are; those who view the contract as prohibited those who view it as permitted, The first group mainly consists of the traditional scholars of Islamic laws though some distinguished contemporary scholars like Zuhayli and Musleh-ud-Din also hold the same view The second view arises as early as late 19th and early 20<sup>th</sup> centuries. Among them are Siddiqi (1985) who argues that the contemporary insurance business is based on a Shariah-valid concept and is distinct from

*Maysir* and *Gharar*. Among works on the permissibility of insurance that examines quite critically on *Gharar* in the insurance contract is by Zarqa (1994). This work is an extension of his early works on Islamic view on insurance especially his '*Aqd al-Ta'min*'. He maintains that since insurance is a contract that has definitive objective upon its commencement, the contractual parties do not rely upon something that is uncertain and not clear. He introduces the concept of security or safety (*al-aman*) as the counter value for the premium paid by the insured which help lessen the uncertainty in the contract. Sharf al-Din (1991) examines the existence of *Gharar* in insurance in each of its form. He concludes that the *Gharar* in insurance in general, is excessive, though the extent of *Gharar* in different types of insurance is different. On discussing the uncertainty of the outcomes of the contract, he questions the 'security' as the counter value as proposed by Zarqii since it is only a motive of the contract and cannot be a subject matter (*ma'qud 'alayh*) due to its independency from the contract. Other works that bring out new forms of discussion on *Gharar* in insurance are of Rosly (1996), Siddiqi (2000) and Ma'sum Billah (2001). Siddiqi (2000) for the matter maintains that the uncertainty involved in the contract tends to disappear when large numbers are involved. Ma'sum Billah (2001) points out that the possibility of *Gharar* being involved in the subject matter of the contract is only through the 'happening of the risk' and this uncertainty is forever will be known by Allah only. The uncertainty comes in the form of pure risk which is implicated with fear of risk, for example the death of the policy holder or the incident insured is not vague and is identified before the commencement of a policy. Rosly (1996) in the meantime questioned the address of the *Gharar* pinpointed by the *fatwa* from the perspective of risks which are dealt by a commercial insurance contract. He suspected that the issue of *Gharar* contended by the *fatwa* is misplaced in certain parts that is in the uncertainty of the event, for example the occurring of death or injury. These uncertainties are pure risks that are transferred to the insurer companies by the insured through the payments of premiums and are beyond human control. Looking back at the literature, we notice that the permissibility of insurance from *Gharar* perspective depends on the extent of its existence in the contract. On the other hand, the scale of its existence depends on the accepted subject matter as well as consideration of pure risk as an internal or external factor of the contract. Thus, by trying to determine the precise subject matter as

well as resolving the issue of pure risk, the thesis may give a new light on the true extent of *Gharar* existence in an insurance contract.

## **RESEARCH METHODOLOGY**

- Historical methodology would be used to know about the history of Insurance.
- Methodology of classical Islamic law would also be used to know about the different views of Jurists on the subject.
- Similarities and differences between both Conventional and Islamic concept of Insurance would be stated, also the controversy on the issues between the contemporary scholars would be looked into and the bases of disapproval would be analyzed.
- With the help of early Fiqh literature basic principles of Islamic law regarding issues in the contract of Insurance would be extracted and on the basis of these principles the validity or invalidity of the contract of Insurance would be decided.
- This would be a descriptive but a comprehensive research based on library research.

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## ***Chapter No. 1***

### ***Introduction of the concept of Insurance***

## **1.0. Concept and Definition of Insurance**

Insurance is an essential feature of business in the modern economic culture. The concept of insurance emerges from the concept of risks hedging on the first part and risk buying on the other hand. Conceptually the insurance may be performed for literally each and every business, individuals, families and society may face. A person having a basic knowledge about the insurance system feels that this is a real benefit for the humanity because the insurance company hedges each individual's risks and support him in case of extra ordinary losses. We all know that in a civilized society, particularly in an Islamic society, it is the duty of the society in general and the government in particular to ensure to avoid losses for its citizens and in case of any extra ordinary loss, to try to compensate aggrieved one. The term insurance in its real sense is community pooling to alleviate the burden of the individual, least it should be ruinous to him. The simplest and most general concept of insurance is a provision made by a group of persons each singly in danger of some loss, the accidence of which cannot be foreseen, that when such loss shall occur to any of them it shall be distributed over the whole group<sup>1</sup>.

The aim of all insurance is thus, to make provision against the dangers which beset human life and dealings. It is in fact the danger of loss which makes men seriously think of some safely devices to avoid it. Now considering the situation particularly for an environment whereby the government's attitude is particularly pathetic regarding efforts for saving the people's lives, properties and other assets, a number of people are of the view that it is a situation of compensation to obtain insurance policies to ensure that remedies are available in case of losses or potential losses.

So insurance can be defined as "A contract whereby one party 'insurer' promises in return for a money consideration "the premium" to pay to the other party "the insured" a

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<sup>1</sup> Dr, Muslehuddin, Muhammad, (1982). Insurance and Islamic Law, Delhi: Markazi Maktaba Islami Sharif, pages 166-181

sum of money or provide him with some corresponding benefit, upon the occurrence of an event specified in the contract<sup>2</sup>.

The premium is a price of an insurance policy. It is the price at which the insurer i.e. the company is prepared to take risks and bear the burden of the probable loss involved in the contract of insurance. On the basis of law of average through experience the insurer finds a reasonable amount sufficient to cover his risks as well as other charges included his profit. An insurance policy aims at providing compensation for potential loss or damages that are specified in the contract. For example when a person insures his car with the insurance company he gets an undertaking from the company that it will undertake repairs of damages, which is caused to the car of insurance as a result of an accident.

The contract of insurance is normally a contract of indemnity (cover) because it insures a compensation for loss to the insured. The life insurance and personal accidents insurance however are not contracts of indemnity (cover, protection) for in all such cases, the insurer has to pay compensation on the happening of an event without reference to loss<sup>3</sup>.

### **1.1. Origin and Development of Insurance**

The concept of Insurance is very much related to group life. In primitive society, people lived together in families or tribes in which their needs were fully met and protected through co-operation and mutual help. They therefore did not feel the need for Insurance, because they were fully protected against all sorts of risks by the community. When this family or tribal life was replaced by the urban life in the ancient civilizations, the individuals found themselves open to multifarious perils and without the family and tribal protection<sup>4</sup>.

Primitive people discovered no need for Insurance, finding their needs fully protected by the family or tribe in which mutuality such as is established by Insurance is a living reality.

<sup>2</sup> Dr, Mansoori, Tahir, Muhammad, (2008), Islamic Law of contracts and conventional transactions. Shariah Academy, IIUI, Pakistan, page 103, Parkington and Anthony on Insurance Law, London: O'Dowd sweet and Maxwell 17<sup>th</sup> edition, 1981, page 3.

<sup>3</sup> Dr, Mansoori, Tahir, Muhammad, (2008), Islamic Law of contracts and conventional transactions. Shariah Academy, IIUI, Pakistan, page 104

<sup>4</sup> Clayton, G. British Insurance 1971, London, page no 13.

This was not true of the ancient civilizations of Egypt, Phoenician, Greece and Rome in which the individual found himself exposed to numerous risks without recourse against the family community<sup>5</sup>.

Under the circumstances, the individual was completely deprived of family or tribal protection and therefore, he looked for other kinds of safeguards. Thus insurance originated from the human need to find safeguards against the possible risks to himself and his property or interests<sup>6</sup>.

An early signs of modern insurance in a scientific form seems to appear in the European countries in middle of the thirteenth century. We find many examples of marine insurance in this century in many parts of Europe. The early practice of marine insurance in a scientific form, and on the "premium" basis, is undoubtedly associated with merchants of the city of Lombardy and notably Florence (A.D 1250) in Italy<sup>7</sup>. In middle ages, trade was mainly centered in the Mediterranean, with well known trade routes to the east (Constantinople and India) and to the north. The Northern Italian cities, Florence, Greece and Venice became centers for banking, commerce and insurance<sup>8</sup>.

It is confirmed by Professor Grossmann Marcel that, the first precursors of Insurance institutions were the funeral association, which were formed during the period of the Roman Empire by Craftsman, Merchants and Actors<sup>9</sup>. Italy boasts the first known "Insurance agreement" which was executed at the Genoa on thirteenth October 1347. A second agreement was signed in Palermo in 1350. In 1369, Marine Insurance was legally regulated in Genoa.

<sup>5</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, page 19

<sup>6</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, page, 20.

<sup>7</sup> W.A, Dinsdale Elements of Insurance, 1965, London, Page, 17

<sup>8</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, page, 20

<sup>9</sup> Gross Mann, Marcel, Insurance markets of the world 1964, Zürich, page, 89.

And we find marine insurance vague in Spain around the same period. The intensive trading by Barcelona for example, with Italy and the seaports of the Eastern Mediterranean since the end of the fourteenth century marine Insurance flourished early in Spain<sup>10</sup>.

Then the marine Insurance spread to France, England and other countries of Europe, Marine Insurance was practiced in London in the early part of the fifteenth century, and the methods employed followed those used by Italians. France had experienced of marine insurance in fifteenth century at Rochelle and Marseilles. Literature on marine codes, sea Laws and marine insurance were first established in 1542. The earliest work treating of insurance in France is a publication known as *Le Guidon*. It treats mainly of Marine Insurance. It also mentioned life insurance, observing that while it was practiced in other nations, it was prohibited to insure the lives of persons in France. The first serious movement for life insurance was made in 1787.<sup>11</sup>

This record of insurance practice is strong evidence that marine insurance did not exist in Europe before the thirteenth century. It also shows that the practice of marine insurance first began in Italy and Spain and then spread to other European nations, including France, England and Germany.

After marine insurance, Fire insurance developed in present form. It had been observed in Anglo- Section Guild form for the first time where the victims of fire hazards were given personal assistance by providing necessities of life. It had been originated in Germany in the beginning of sixteenth century. The fire insurance got momentum in England after the great fire in 1666 when the fire losses were tremendous. About 85 per cent of the houses were burnt to ashes and property worth of sterling ten crores were completely burnt off. Fire insurance Office was established in 1681 in England. With colonial development of England, the fire insurance spread all over the world in present form. 'Sun Fire Office' was successful fire insurance institution.<sup>12</sup>

Life insurance made its first appearance in sixteenth century, the first recorded evidence in England being the policy on life insurance of William Gybbons on June 18<sup>th</sup>, 1653. Even

<sup>10</sup> Gross Mann, Marcel, *Insurance markets of the world* 1964, Zürich, page, 89.

<sup>11</sup> Welford, Cornelius the encyclopedia of Insurance, vol .iv, London 1876, page 290-309.

<sup>12</sup> M.N, Mishra, *Modern concept of Insurance*, S. Chand & Company Ltd, New Delhi page 9.

before this date annuities had become quite common in England, and marine insurance had, in fact, made its appearance three thousand years ago. The life insurance developed at 'Exchange Alley'. The first registered life office in England was Hand-in-Hand society established in 1696<sup>13</sup>. The famous 'Amicable Society for a perpetual assurance Office started its operation since 1706. Life insurance did prosper in United States during the 18<sup>th</sup> century, because serious fluctuations in death- rate, but soon after 1800 some active interest began to be shown in operation in this enterprise because of the application of level premium plan which had by then been in operation in U.K for more than a generation

It is difficult to determine when Insurance was first introduced into Islamic civilization as much as it is difficult to determine when Insurance was first introduced into world civilization.

Imam Ibne Abidin, a Hanfi jurist who died in 1836, is considered the first Muslim to introduce the Insurance by the name of '*Sukara*' (Security) in Islamic civilization. It is hard to believe that Muslims did not practice Insurance before the 19<sup>th</sup> century. Muslims were involved in marine activities in the Mediterranean and the Indian Ocean from 17<sup>th</sup> century on, contacts between Islam and Christianity existed in Spain, Sicily, Italy Cyprus and Malta. Thus Muslims must have been exposed at least to European marine (if not to other types of Insurance) which was part of the usual conduct of trade in middle ages. The modernist Afzalur Rahman claims that it was the Muslims of Spain who taught the Europeans what Insurance was and not vice versa.<sup>14</sup>

It would be safe to presume that institutionalized insurance indeed started around the thirteenth 13<sup>th</sup> or fourteenth 14<sup>th</sup> centuries in the Italian cities. Muslims became acquainted with it not much later. However, just as the ancient and medieval civilizations devised methods to secure the individual against a major loss (which is the basic definition of all insurance) before insurance became an institution, Islamic civilizations too devised its own methods. In other words, the non existence of the terms "insurance" or "*Ta'amin*" prior to the 13<sup>th</sup> or 20<sup>th</sup> centuries, respectively, is not an indication that aspects of insurance. If

<sup>13</sup> M.N, Mishra, Modern concept of Insurance, S. Chand & Company ltd, New Delhi page 9.

<sup>14</sup> Concept and development of Insurance in Islamic countries, Islamic culture (Hyderabad) Jan 1969, page 30

general historians show signs of insurance in already in the third millennium B.C.E, modern Muslims writers eagerly show that several forms of insurance can be traced back to the beginning of Islam.

Afzalur Rahman relates that the merchants of *Makkah* used to form a mutual fund to help the victims or survivors of natural hazards during their conventional ventures into Syria, Iraq and other places. Muhammad (Peace be upon him) Himself while still trading with capital of *Khadija*, contributed to such a fund<sup>15</sup>. The description fits mutual insurance systems.

The charter which Muhammad (Peace be upon him,) prepared in *Al Madina* in 622 to establish the relations between the three groups which constituted His *Ummah* (Islamic Community) included certain elements of insurance 1) the *Diya* (Blood money) to ensure that every one's life should be considered inviolable, (2) *fidya* (ransom of prisoners of war) to ensure that one's freedom is always sought (3) joint action of the *Ummah* to aid the sick and poor) similarly to what is known as social security. If perceived as a means of insurance, these examples defiantly expand the types of insurance practiced by Muslims, already in the 7<sup>th</sup> century beyond marine insurance<sup>16</sup>. The Shariah recognizes several transactions and institutions which function in a way similar to certain types of insurance. The most typical are:

- (1) *Daman* (guarantee) is synonymous with *Kafalah* and is used of the risk or responsibility that one bears with regard to property of which one enjoys profit.
- (2) *Daman Khatir al tareeq* (a guarantee against travel hazards) reminds one of travel insurance)<sup>17</sup> Person "A" secures a sum of money with person "B" before leaving on a journey. If person A suffers any loss along the way person B would compensate him.

<sup>15</sup> Afzalur, Rahman, Banking and Insurance, vol-4 page 32, and Klingmuller, Concept and development of Insurance in Islamic countries, Islamic culture (Hyderabad) Jan 1969, page 30,

<sup>16</sup> Chaim, Vardit, Raspler Insurance and semi insurance Transactions in Islamic history until 19<sup>th</sup> century, PhD Thesis and paper, Pages 144, 145 and 146

<sup>17</sup> Zarqa, al Ahmad, Mustafa Aqd al ta'amin wa mawaqif al Shariah al Islamiya minhu, page 17.



- (3) *Diya* (Blood money) is according to the Qur'an compensation due to the victim or victim's family for unintentional killing or bodily injury<sup>18</sup>. The party which pays the *Diya* is one's *Aqila* that is a group of people with a common interest in the defendant (either his male agnates (*asaba*) or fellow *mawali* or neighbors).
- (4) *Zakat* means "growth and "purity". It is a religious levy and one of the five pillars of Islam. It is often mentioned as an equivalent to modern social insurance, and there have been modern attempts made in Islamic states such as Saudi Arabia (November 21, 1950; April 07 1951; April 01 1959; and in 1963) and Pakistan (June 06 1980) to apply *Zakat* and test it against the social insurance needs of each country.<sup>19</sup>
- (5) *Jizya* is the pool tax which is levied on non-Muslims residing in the Islamic state and provides them with security for their life and property. *Jizya* is mentioned in Qur'an, Chapter 9:29. It was collected annually.

As in world civilization, in the Islamic world first type of insurance to be used was marine insurance. At the end of 19<sup>th</sup> century the first insurance companies in the Islamic world were founded in 1890 in Egypt and in 1893 in Turkey. The 20<sup>th</sup> century development of insurance and insurance companies in Islamic and Arab world was influenced by European model, European legislation, and nationalism as well as by the on going Muslims theological debate whether insurance is at all legitimate transaction.

## 1.2. Types of Insurance

Following are the main types of Insurance;

### 1.2.1. Life Insurance

Life insurance is different from other insurance in the sense that, the subject matter of insurance is life of a human being. The insurer will pay the fixed amount of insurance at the time of death or at the time of certain period. At present, life insurance enjoys maximum

<sup>18</sup> Al Sarakhsi, *Al Mabsut*, vol- 26, page 58-104, Al Quran, Surah Al Nisa, 92

<sup>19</sup> Volker, Nienhaus, *Islam and modern Wirtschaft*, Graz, koln, wien 1982, page 2,3,4, for Pakistani experience, also Abidin, Ahmad, Salama, *Fiscal analysis of zakat with special reference to Saudi Arabia*, 1978, page 341-364.

scope because life is the most important property of the society or an individual. Each and every person requires the insurance<sup>20</sup>. This insurance provides protection to the family at the premature death or gives adequate amount at the old age when earning capacity are reduced. Under personal insurance a payment is made at the accident. The insurance is not a protection but is a sort of investment because a certain sum is returnable to the death or the insured at the expiry of a period. The objective of the life insurance is to provide financial help to the families of insured persons after the death so that in their absence the families do not become destitute and public charges.

### **1.2.2. General Insurance**

The general insurance includes property insurance, liability insurance and other forms of insurance. Fire and marine insurance are strictly called property insurance. Motor, theft, and machine insurances include the extent of liability insurance to a certain extent<sup>21</sup>. The strictest form of liability is fidelity insurance; whereby the insurer compensates the loss to the insured when he is under the liability of payment to the third party.

### **1.2.3. Social Insurance**

The social insurance is to provide protection to the weaker section of the society who is unable to pay the premium for the adequate insurance. Pension plans, disability benefits, unemployment benefits, sickness insurance and industrial insurance are the various forms of social insurance<sup>22</sup>. With the increase of socialistic ideas, the social insurance is an obligatory duty of the nation. The government of a country must provide social insurance to its masses.

<sup>20</sup> M.N, Mishra, *Modern concept of Insurance*, S. Chand & Company Ltd, New Delhi page, page 9.

<sup>21</sup> M.N, Mishra, *Modern concept of Insurance*, S. Chand & Company Ltd, New Delhi page, page 10. see, also Geroje, Rejda, *Principles of management and Insurance*, 5<sup>th</sup> edition, Harper Collins college publishers, page 165

<sup>22</sup> M.N, Mishra, *Modern concept of Insurance*, S. Chand & Company Ltd, New Delhi page, page 10.

#### **1.2.4. Property Insurance**

Under the property insurance property of a person or persons are insured against a certain specified risk. Property insurance policy provides compensation to the insured who suffered some losses or damage consequent upon occurrence of a catastrophe or disaster inflicted upon his property, assets and other belongings. The risk may be fire or marine perils, theft of property or goods, damage to property at accident<sup>23</sup>.

#### **1.2.5. Marine Insurance**

Marine insurance is a contract of indemnity between the insurer and the insured in which the insurer, against premium, promises to compensate the insured for loss caused by sea or perils within a specified time<sup>24</sup>. Marine insurance provides protection against loss of marine perils. The marine perils are collision with rocks, or ship, attacks by enemies, fire and capture by pirates, etc. So marine insurance insures ship, cargo and freight

#### **1.2.6. Fire Insurance**

Fire insurance covers risks of fire. Fire insurance is a contract of indemnity between the insurer and insured in which the insurer, against the premium, promises to compensate the insured against the loss caused to the subject matter due to within a specified time. In the absence of fire insurance, the fire waste will increase not only to the individual but to the society as well. With the help of fire insurance the losses arising due to fire are compensated and the society is not losing much. The individual is protected from such losses and his property or business or industry will remain approximately in the same position in which it was before the loss. The fire insurance does not protect only losses but it provides certain

<sup>23</sup> M.N, Mishra, Modern concept of Insurance, S. Chand & Company Ltd, New Delhi page, page 10.

<sup>24</sup> Ibid.

consequential losses also. War risk, turmoil, riots etc., can be insured under this insurance too<sup>25</sup>.

### **1.2.7. Miscellaneous insurance**

The property, goods, machine, furniture, automobile, valuable articles etc., can be insured against the damage or destruction due to accident or disappearance due to theft. There are different forms of insurance for each type of the said property whereby not only property insurance exists but liability insurance and personal injuries are also insured.

## **1.3. Liability Insurance**

The liability insurance covers the risks of third party, compensation to employees, liability of the automobile owners. This is also called third party insurance. It refers to a situation where a person or institution incurs some liability towards a third person. These policies cover a variety of business and professional liability exposures<sup>26</sup>. They protect people and organization against financial loss due to legal liability claim. In liability insurance the insurance company undertakes to compensate the effectee on behalf of insured person or institution.

## **1.4. The Insurance Act 1938**

Insurance Act 1938 is the regulating set of rules and provisions which governs the Insurance in Pakistan. Every insurance transaction or insurance related activity comes under its sphere, whether it relates to the rights and obligations of the insured party or the insuree etc. Insurance and its details will be discussed in the next chapter, i.e. why insurance is not considered to be in accordance with Islamic injunctions? And what are the main factors

<sup>25</sup> M.N, Mishra, *Modern concept of Insurance*, S. Chand & Company Ltd, New Delhi page, page 10.

<sup>26</sup> Khalid, Mehmood, Cheema, *Business Law*, revised edition 2008. See Also Mansoori, Muhammad, Tahir, *Islamic Law of contracts and business transactions*, Shariah academy, iiu Islamabad, Pakistan, page, 105.

which renders it prohibited in the eyes of Islamic Law. As far as the insurance act 1938 is concern, few sections i.e. (Section 3 b(1), Section 27(3), Section 29(8)(b)(c) (iii), section 47 (b) and 81(2)(d) were declared repugnant to the injunctions of Islamic law.<sup>27</sup>

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<sup>27</sup> Insurance act 1938,PLD 1992,page 153

## ***Chapter No.2***

### ***Defects in Contract of Insurance***

## 2.0. Defects in contract of insurance

Conventional Insurance does not conform to Rules of Shariah. Muslim Jurists had conducted a thorough and comprehensive study on the operation of the conventional insurance. Arising from these studies, the generally accepted view of the Muslim jurists is that the operation of the conventional insurance not in its present form conforms to the rules and requirements of the Shariah. Therefore, after deep and thorough studies carried out jointly by the Muslim jurisprudents and economists, the principles of Islamic Insurance has been formulated as an alternative form of cover, which strictly conforms to the tenets of Islam. Islamic Insurance is based on the Islamic concept of "Al-Takaful" which means "Joint Guarantee".<sup>28</sup> Under modern insurance terms this can also be termed as the concept of Mutuality. The practice of insurance presently follows the western style of management and therefore, not in line with the teachings of Islam in a number of ways. For example it is alleged that:

1. Insurance contracts may contain *Maysir* as it promises to pay more than the premium paid.
2. Insurance companies invest the premiums which they have collected, in interest bearing investment;
3. The conventional method of insurance is akin to gambling as one can lose the premium to insurance companies;
4. The western method of insurance may contain the element of *Gharar* as the contract is not transparent Insurance companies can earn profits or loss as a result of death or accident or risk to people.

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<sup>28</sup> Ali, Mortuza, K.M, Managing Director Prime Islami Life Insurance Limited,(thesis on: Introduction to Islamic Insurance), page 34-36

5. Insurance companies can earn profits or loss as a result of death or accident or risk to people.

What is objectionable to Muslims is the conventional insurance as being practiced and not the idea of insurance. This is because any transaction (including insurance) must be in conformity with the Divine Rules and Regulations. For example, both the Quran and the Sunnah prohibit interest (*Riba*). Generally the money collected through premium is invested in the interest bearing deposits and or dealings which are not being transacted in conformity with Islamic rules and regulations.

Therefore, it is necessary that an insurance contract should be based on the principle of *Mudharaba* and other financing techniques such as *Musharaka*, *Ijarah*, *Salam*, *Istisna* etc. Furthermore, the objective of an insurance contract should not be for a material gain nor to override the power and determination of ALLAH, but to achieve the pleasure of ALLAH. This has to be done through mutual help and cooperation with the object of providing assistance against unexpected future loss. This is why most Muslim jurists think that cooperative insurance system can be a basis of Islamic insurance system. The basic purpose of having an insurance cover should be to rescue helpless people from unexpected future loss. The Islamic Insurance schemes should be based on brotherhood, solidarity and mutual assistance, which provides for mutual financial assistance and aid, when it is needed. The objective of insurance contract should be the alleviation of hardship to ensure a comfortable life<sup>29</sup>.

The Quran says,

"ALLAH intends you to enjoy with an easy life. He does not wish you to face Hardship"<sup>30</sup>

Insurance is generally rejected by Muslim jurists, because of the presence of *Gharar*. But we find that the element of uncertainty is of minor nature at the individual level, while

<sup>29</sup> Ali, Mortuza, K.M, Managing Director Prime Islami Life Insurance Limited,(thesis on: Introduction to Islamic Insurance) page 36-38

<sup>30</sup> Al Quran 2:185.



at the collective level, they are scientifically determined by laws of large number, actuarial science and the theory of probability. Therefore, it is not justifiable to prohibit insurance due to *Gharar* at the individual level. Furthermore, the insurance contract as we see today was not exactly practiced during the time of the Prophet. But with the passage of time, we observe that there is an urgent need to find a way of providing material security for those who are suffering in the society due to unexpected loss. Insurance is necessary in the public interest so that the victims can be rescued from unexpected and undesired risks. This is justified in Islam by the Doctrine of *Masaleh al-Mursalah*, (Doctrine of Necessity). Insurance, though permissible as a necessity, should be operated with the principles laid down in the Quran and the Sunnah. It is alleged that insurance is *Maysir* (gambling) because the policyholders are paying premium on the condition that insurer will pay him on the happening of specific events. We have observed that insurance is a contract of indemnity which is completely different and opposite of a gambling and wagering contract. In a gambling contract on the happening of the specified event one of the parties must win or lose. In the case of insurance the specified event may or may not occur during the policy period<sup>31</sup>.

Moreover, the insured holds a specific financial interest (insurable) in the subject matter of insurance. The insured is supposed to get indemnity only if he suffers loss and indemnity is limited to actual loss or damage. While the act of gambling creates a new risk, insurance contract provides a mechanism for managing inherent and predictable risks to make losses bearable to the individuals susceptible to such risks. Insurance is a systematic pooling of individual resources to cover collectively the expected inherent risks of Loss that each and every person faces. The purpose of insurance is to protect, not to enhance the financial position of the insured. Therefore, it is not gambling. Obviously, if insurance is operated as contract of guarantee, rather than an exchange of money, then it is absolved of contractual *Riba* (interest) and *Maysir* (Gambling). The Quran ordains compensation including monetary benefits to the victim's family for killing someone by mistake. Therefore, in principle there is no harm in obtaining monetary helps against the death of a

<sup>31</sup> Ali, Mortuza, K.M, Managing Director Prime Islami Life Insurance Limited,(thesis on: Introduction to Islamic Insurance) page 39-40

family member which seemingly justifies conduct of life insurance. Despite all these positive factors, insurance remains a controversial matter within the Muslim communities.

For some time conventional insurance was considered to be incompatible with the Shariah that prohibit excessive uncertainty in dealings and investment in interest-bearing assets; both are inherent factors in conventional insurance business.

It is unanimously held by the Muslim jurists that presence of *Riba* (interest), *Maysir* (gambling) and *Gharar* (risk or uncertainty) in any business contract or transaction makes it unlawful. Whenever any of these elements is found in any transaction or agreement renders it void in the sight of Islam. If you analyze the contract of modern insurance, you will find that almost all these four unlawful elements are present in it in sufficient degree so as to make it illegal in Islam. Therefore, when Islamic economic system is enforced, modern conventional insurance will have no place in Islamic lands.

## 2.1. Conventional insurance contains

### 2.1.1. *Riba (interest)*

### 2.1.2. *Maysir (gambling) and*

### 2.1.3. *Gharar (risk or uncertainty)*

As we mentioned that conventional insurance contains the element of *Riba*, *Maysir* and *Ghârar*, so we will discuss these elements in details;

## 2.2. Element of Riba (Interest)

The first of the elements forbidden in Islam is Interest. Islam regards interest as an economic evil harmful to society, economically, socially and as well as morally. Therefore the Holy Qur'an forbids Muslims to give or take interest. In order to judge the legality or illegality of conventional insurance, we have to analyze the nature of certain elements which are forbidden in Islam. If any of these elements are found in conventional insurance, it will render the insurance contract illegal and invalid. Therefore, it is quite logical to analyze these elements before we can draw any conclusion on conventional insurance.

The Arabic word '*Riba*' literally means 'increase in' or 'addition to' anything. Technically, it means an increase over the principal in a loan transaction, over a debt or in exchange transactions, accrued to the lender/ creditor or a party to exchange without giving an equivalent counter value or recompense ('*iwad*') in return to the other party.<sup>32</sup>

Islam prohibits the lending of money for profit because it is often ruinous to the borrower and at the same time makes the lender greedy and selfish. Islam seeks to protect the weak from exploitation and to encourage partnership between investors and entrepreneurs on a

<sup>32</sup> Nyazee, Imran Ahsan khan, The concept of Riba and Islamic banking, first edition. Also, Marghinani, Hidayatullah, Kitabu'l-buyu, vol.3, page 67, also Al Sarakhsi, al Mubtasut, Kitabu'l-Buyu, vol.12, page 109.

more equitable basis such as Mudharaba. The law prohibiting *Riba* was introduced gradually. One of the commandments forbidding Muslims to earn interest form loan for example, was made through the Qur'anic verse:

ALLAH says: "Although Islam prohibits *Riba* it does not prohibit trade". The proof of this is that the Holy Prophet himself indulged in business. However some people were mixing trade with interest and insisting that there is no difference between the two.

The Qur'an however states: "they say 'trade is just like interest' whereas ALLAH has permitted trade and forbidden interest."<sup>33</sup>

Scholars generally agree that it is *Riba* if interest is charged for a loan given, whether it is on the principal (*Riba qard*) or as penalty for late payment (*Riba Jahilliyah*). In addition, the Holy Prophet on the authority of a Sunnah also considers it *Riba* to exchange the following goods, known as *ribawi* items, if there is any difference in terms of quantity, quality and/or time

- gold for gold;
- silver for silver;
- wheat for wheat;
- barley for barley;
- dates for dates: and
- Salt for salt.<sup>34</sup>

Some Scholars have by the process of analogy extended the above *ribai* items to include money and all types of foods. This is because gold and silver were used as a medium of exchange just like money is being used today.

The prohibition of '*Riba*' is accepted by all the Muslim jurists. It is an absolute prohibition which covers simple and compound interest, productive as well as non

<sup>33</sup> Al-Quran, 2:275

<sup>34</sup> Sananni, Subulu al salam, Muhammad ibne Ismail, sharha bulugh al maram, vol 3, 72, cairo 1987.

productive loans. Even in case of productive loans guaranteed return on capital is unjust and prohibitive. Both the Quran and Sunnah prohibit '*Riba*'. Those who disregard the prohibition of *Riba* are in direct conflict with ALLAH and His Prophet Muhammad (Peace be upon him). *Riba* is completely prohibited under Islamic Law; because Shariah does not consider money as commodity as such that there should be a price for its use. Islam does not permit gain from financial activity unless the beneficiary is also subject to risk of potential loss; and that Islam regards the accumulation of wealth through interest is selfish compared with that of accumulated through hard work.

*Riba* was commonly practiced in Arabia and other counties in the Era of ignorance (*Jahilliyah*).

There are a number of passages in the Qur'an whereby unjustified enrichment is prohibited. Islam permits trade and forbids *Riba* which is "a monetary advantage without a counter value which has been stipulated in favor of one the two contracting parties in an exchange of two monetary values.

At the beginning ALLAH discouraged its practice in Qur'an;

"Those which ye give for increase through the property of other people with have no increase with ALLAH".<sup>35</sup>

Then ALLAH condemns Jews for practicing it in Qur'an;<sup>36</sup>

Then its prohibition came along with justification that it had a bad effect of multiplying many folds.<sup>37</sup>

<sup>35</sup> Al-Quran 30:39

<sup>36</sup> Al-Quran 4:161

<sup>37</sup> Al-Quran 3:130

"O ye who believe devour not usury doubled and multiplied". Also in Verse 2:275-279 "But ALLAH has permitted trade and forbidden usury. Those after receiving direction from their Lord desist shall be pardoned for the past. Their case is for ALLAH to judge. But those who repeat the offence are the companions of the fire. They will be abiding therein forever. ALLAH deprives usury of all blessings, but will give increase for deed of charity...and give up what remains of Riba if ye are indeed believers, if ye do it not take notice of war from ALLAH and His Messenger, but if ye turn back ye shall have your principal, deal not unjustly and ye shall not be dealt with unjustly".<sup>38</sup>

Qur'an also says;

"O believers, fear God, and give up the Riba that remains outstanding if you are believer".<sup>39</sup>

With regard to Sunnah, the Prophet Muhammad (Peace be upon him) is reported to have said;

"Avoid the seven condemning sins, and He mentioned among them "taking Riba"<sup>40</sup>

Also Prophet Muhammad (Peace be upon him) said;

"The wrath of ALLAH is on the taker of *Riba*, its giver, its writer and its witnesses".<sup>41</sup>

The Holy Messenger of ALLAH, on His last Pilgrimage and in His last address declared the prohibition of interest in these words:

"Every form of *Riba* interest is cancelled; capital indeed is yours which you shall have. Wrong not and you shall not be wronged. ALLAH has given His commandment totally prohibiting *Riba* interest. I first start with the amount of interest which people owe to

<sup>38</sup> Al Quran 2:275, 279

<sup>39</sup> Al-Quran, 2:278

<sup>40</sup> Sahih Muslim, vol 1, English translation, Naseeru din ibne khatab, page 177, No 262, darrussalam 2007, Pakistan.

<sup>41</sup> Sahih Muslim, Kitabul Buyu, vol 1, page 469, Tirmidhi, Sahih, Abwabul Buyu, vol 1, page 227.

Abbas and declare it all cancelled". He then on behalf of His uncle Abbas cancelled the total amount of interest due to his loan capital from his debtor.<sup>42</sup>

The contract of insurance contains *Riba*; it is dependent for its profits on interest which is completely involved in its all stages of its business, from the calculation of the premiums to the payment of indemnity to the insured who has suffered a calamity. Most of the funds collected in premiums are invested in fixed earnings investments by the insurance companies and only a small portion of their monies is invested in other projects. This is because they consider it is safe and free from risk and since this is the policy of the insurance companies to protect their clients from risks and protect their interests, fixed earnings investments are most likely choice for them. The amount which is paid by the company to the insured under the name of bonus or profit or any other name is nothing but *Riba*. Premium is a loan given to the insurance company and according to the sayings of Prophet Mohammad (Peace be upon him) a loan which brings profit is unlawful.<sup>43</sup> The increase or excess without a counter value is *Riba* in a transaction where exchange of property (*ma'al*) takes place. *Riba* is prohibited according to the clear text of the Qur'an and there is no space for *ijtihad* too.

The condition in contract of insurance that the premiums paid will be forfeited in case the insured fails to pay further premiums is opposed to Islamic Law. The contract of insurance contains *Riba* in the shape that when the insured deposits the amount known as premiums to the company, and upon the occurrence of any accident to the insured he gets more or less what he has deposited in shape of premiums to the company, and hence this is known as *Rib-al fadal*. Similarly the insured gets profit from the company after non occurrence of any event so this is *Rib al Nisa*. These both forms of *Riba* are completely prohibited as we mentioned earlier.

<sup>42</sup> Mautta, Malik, Imam, Last sermon of Muhammad (Peace be upon him) given on 10<sup>th</sup>, Dhul Hajj, mentioned in all books of Hadiths.

<sup>43</sup> Muslehuddin, Dr, Muhammad, (1982). Insurance and Islamic Law, Delhi: Markazi maktaba Islami Sharif, page 166 -181

### 2.3. Riba in Contract of Insurance

As we mentioned above that the contract of insurance consists element of *Riba*, now we will discuss how *Riba* is found in Insurance contract?

The Insurance company which gathers capital (money) from different people, and gives that money to other companies or people on interest. After getting back that money along with its interest the Insurance Company divides the interest based money (which is taken from other companies or people) on the insured people and insurance company keeps the remaining money itself.<sup>44</sup>

Insurance company pays the insurance money to the insured person on the completion of insurance period or after occurring any incident to the insured person before the completion of insurance period. Now there are two situations,

- i) The insurance company pays to insured person his actual amount after the completion of insurance period (let's say Rs.60,000)
- ii) The insurance company pays more than the insured paid to insurance company in shape of premiums (let say Rs.80,000)

In the mentioned situations both forms of *Riba* is found, in the first situation, the company pays to insured person his actual amount which he deposited to the insurance company (deposited 60,000 and company pays back 60,000 after completion of insurance period) so it is known as *Riba al Nasi'ah* because the insured person paid money in installments and the insurance company returned to him his actual amount in money again after the completion of insurance period, so exchange of money with money with delay is prohibited in Islam

In second situation, if an incident occurred to the insured person and the insurance company pays to the insured person the insurance amount well before the insurance period

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<sup>44</sup> Profesor, Ghafari, M, Dr. Noor, the concept of Riba and Islamic banking, (Mojuda Nizam Insurance aur Islam ka Nizam-e takaful ejtimayee), shiekhul Hind academy Karachi, page 24,25



(Lets say the insurance amount is Rs. 80,000 and insured person paid only Rs.40, 000 to the insurance company and company pays Rs.40, 000 more than the insured paid to it). So the excess of Rs. 40, 000 is not justified to the Islamic scholars and they call it *Riba al fadl* which is prohibited by Quran and Sunnah<sup>45</sup>.

In the light of above discussion, we can say that the insured person gets his actual amount without any excess to it (on actual amount) it is return of money with money (with delay), this is *Riba Nasi'ah*, which is totally prohibited by Islam, we can also say e.g. "Mr. "A" will give to Mr. "B" 100 Dinars, which "B" will pay back without any increase after one year. There is no excess in this case that can be called *Riba Al fadl*, but there is a delay during which "B", the borrower, will be able to use the 100 Dinars. Thus an excess in the form of use of Dinars for one year is flowing towards "B". "The command in this case is:

"Do not exchange gold for gold, unless it is of the same quality, and unless it is exchanged at once".<sup>46</sup>

As for as the second situation is concerned, in which the insurance company pays profit or Bonus to the insured person on actual amount, (it is not a legitimate profit in the eyes of Islam rather it is excess on the actual amount paid by the insured person, which is interest. if in case the company says that the excess in terms of estimation, is the legitimate profit of the business, then can the company tell us about the legitimate status of that business? And if it is Partnership, then is it according to the Islamic rules of Partnership? The answer will be "No", so then why the capitalists do not agree that the conventional insurance is against the Injunctions of Islam. Some of them say that the excess over actual amount of the insured person is "*Tabarru*" and "*Ihsan*". We say to them why does this "*Tabarru*" and "*Ihsan*" is for insured persons only and not for the poor people of society? And then why this "*Tabarru*" and "*Ihsaan*" is on such a fixed ratio?<sup>47</sup>

<sup>45</sup> Profesor, Ghafari, M, Dr. Noor, the concept of Riba and Islamic banking, (Mojuda Nizam Insurance aur Islam ka Nizam-e takaful ejtimayee) shiekhul Hind academy Karachi, page, 24,25

<sup>46</sup> Bukhari, Sahih, Kitabul Buyu, vol 3, page 28, Muslim, Sahih, Kitabul Buyu, vol 1, page 464.

<sup>47</sup> Profesor, Ghafari, M, Dr. Noor, the concept of Riba and Islamic banking, (Mojuda Nizam Insurance aur Islam ka Nizam-e takaful ejtimayee) shiekhul Hind academy Karachi, page, 24,25

## 2.4. Element of Maysir

The second element forbidden by Islam is *Maysir*. All forms of gambling and betting are prohibited and are considered acts of impiety and abomination. The word *Maysir* means getting something for nothing, and when a person receives a profit or gain purely based on luck and without an effort, it is called *Maysir*. Islam prohibits all forms of business dealings where monetary gains come from chance, speculation and not from work. In the Quran the word *Maysir* has been used to denote games of chance.

The word *Maysir* has been derived from "Yusir" i.e. ease and convenience. This implies that a gambler seeks to amass wealth without effort. Methods of gambling prevalent in pre-Islamic Arabia fall into the modern category of games of chance<sup>48</sup>. *Maysir* or games of chance (gambling) is not accepted at all by Islam. A transaction involving gambling is one where a gambler hopes for a material gain. It is alleged that an insurance contract has the elements of *Maysir* as the insured pays the premiums with the hope or a chance of a material gain in the form of a large amount of money. Therefore, it is alleged that an insurance contract involves the unlawful element of gambling.

An element that plays an important role, especially for insurance Companies but also for the whole Islamic finance sector, is the prohibition of *Maysir* (or *Qimar*). Both these terms stand for gambling – in the Qur'an one can find the term *Maysir*, whereas in the Sunnah the expression *Maysir* is used.

"They will ask thee about intoxicants and games of chance. Say: In both There is great evil as well as some benefit for man; but the evil which they Cause is greater than the benefit which they bring." <sup>49</sup>

<sup>48</sup> Siddique, Nejatullah, Muhammad, Insurance in an Islamic Economy, Islamic foundation, 223 London Road Leicester, UK.

<sup>49</sup> Al-Quran, 5:90

"By means of intoxicants and games of chance Satan seeks only to sow Enmity and hatred among you, and to turn you away from the Remembrance of God and from prayer. Will you not, then, desist?"<sup>50</sup>

The key element in *Maysir* is found in a game in which two parties are involved with the sole intent to win at the cost of the opposing party. Not only is the profit made in such a game against the law, but the act itself is too. It is alleged that the gambler as well as the insured could receive huge amount of money, without equivalent input from their side. It is true that an insured may get a great deal of money than the premium he has paid<sup>51</sup>. It is to be noted that the very purpose of insurance is to eliminate risks, whereas gambling creates new risk. Insurance is a means of handling risk carefully. Insurance is considered as the most effective and economic way of dealing with risks.

The contract of insurance consist of *Maysir* (Gambling) because in this contract the insured party pays installments which is known as Premiums, but he does not know how long he will pay these installments and at the same time he does not know whether he will face an incident or a calamity, if he faces any calamity then he will be entitled to receive the compensation in return.

This could be a huge amount against a small and insignificant sum of money paid in the first premium installment, and on the other hand if nothing happened to him (accident or natural calamity) he will not receive anything from the company so that is the reason and point of concern to the Islamic scholars, and that's why they rate this contract of insurance similar to the Gambling, because in game of chance the person achieve profit without any effort and hard work same is the case in contract of insurance. Gambling is known as *Maysir* which is completely prohibited in Islam. Qur'an says in this regard;

"By means of intoxicants and games of chance Satan seeks only to sow Enmity and hatred among you, and to turn you away from the Remembrance of ALLAH and from prayer. Will you not, then, desist?"<sup>52</sup>

<sup>50</sup> Al-Quran, 5:90.

<sup>51</sup> Aichbichler, Eloana, Islamic Banking in Germany and Switzerland, paper, 2009

<sup>52</sup> Al-Quran, 5:90

## 2.5. Maysir in Contract of Insurance

Contract of Insurance contains *Maysir* (Gambling), it is in a sense if the insured person dies or insured property loss before the completion of insurance period, then the insured person or the owner of the insured property will get greater ratio of the bonus, and if the insured person remains alive or the insured property remains intact after the completion of insurance period then the ratio of the bonus will be less.<sup>53</sup>

In this case we find the element of *Maysir* in contract of insurance, because the time of death and the time of destruction of the property is not determined to the people, in other words we can say that the time of death is certain and determined but nobody knows when he is going to die, and same is the case of the destruction of property nobody knows when the calamity is going to happen to his property? So in this situation contract of insurance is similar to Gambling (*Maysir*), the reason is that in Gambling nobody knows that whether he will win or lose? And the person is always in confusion and uncertainty, and that is what the insurance companies do and the insured people are always in uncertainty because nobody knows how much bonus he will get by the end of the insurance period?<sup>54</sup>

Let's make it more clear, if the insured person dies before the completion of insurance period, he will get Rs.60, 000/- and if he remains alive he will get Rs. 50,000/- so there is always a chance of more and a chance of less bonus, and in Gambling the Gambler does not know the out come of his gambling whether he will return rich or poor (whether will gain money or lose money by the end of the day). The business or transaction which is conditional upon death or life is not allowed in Islam, because the time of death is determined but nobody knows the exact time when a person will die?

<sup>53</sup> Profesor, Ghafari, M, Dr. Noor, the concept of Riba and Islamic banking, (Mojuda Nizam Insurance aur Islam ka Nizam-e takaful ejtimayee) shiekhul Hind academy Karachi, page 28.

<sup>54</sup> Profesor, Ghafari, M, Dr. Noor, the concept of Riba and Islamic banking, (Mojuda Nizam Insurance aur Islam ka Nizam-e takaful ejtimayee) shiekhul Hind academy Karachi, page 28.

That's why ALLAH Says,<sup>55</sup>

ALLAH has forbidden Gambling, so it means all the related things to gambling is forbidden and almost all the Islamic scholars have declared the illegitimacy of conventional insurance because of the similarities of conventional insurance with Gambling.

## 2.6. Element of Gharar

The third issue or defect in contract of insurance is the issue of *Gharar*, most of the Islamic Scholars said that the contract of insurance include *Gharar*, now let's discuss this issue to know how contract of insurance contains *Gharar*.

The word *Gharar* comes from the root verb *Gharara* signifying to reveal oneself and one's property to destruction without being aware of it. Generally it means danger, peril, jeopardy, hazard or risk.

*Gharar* according to Islamic jurisprudence is "A contract which consists upon some risk to the compensation of one of the parties and this risk relates to actual ingredients of the contract"<sup>56</sup>.

*Gharar* is the uncertainty or indeterminacy involved in transactions where the quality and the quantity of the commodity on sale is not predetermined and known. Similarly, *Gharar* is involved when all sales or exchanges of services where the rights and obligations of each party are not known and certain<sup>57</sup>.

Looking at the Qur'an and Ahadith, there is no direct definition of *Gharar* but references of *Gharar* in them are plentiful from the examples of contract of sales that are prohibited because of the elements of *Gharar* in it. Some contemporary scholars have also

<sup>55</sup> Al-Quran, Surah Al Maida, Ayah, 90

<sup>56</sup> Samdani, Ahmad, Ejaz, Mualana, Dr, Islamic Banking and Uncertainty, Darul Isha'at Karachi Pakistan, page 18, 19

<sup>57</sup> As defined by Ibne-Tammiah, extracted from <http://www.islamiq.com/knowledgecenter/takaful>, page.4

defined *Gharar* such as *Mustafa al-Zarqa*, he says *Gharar* is the state of probable whose presence or characteristic are uncertain because of its risky nature<sup>58</sup>.

*Wahbah Zuhayli* also maintains that *Gharar* is danger whose existence is uncertain whether in its existence, quantity or deliverance which are due to wants of knowledge and lack of control over the time and place of delivery<sup>59</sup>.

## 2.7. Types of Gharar

Namely there are two types of *Gharar*, that are mostly referred to by scholars when classifying whether a contract becomes invalid or not due to the *Gharar* in it, namely, *Gharar Fahish* (major *Gharar*) and *Gharar yasir* (minor *Gharar*)<sup>60</sup>.

*Gharar Fahish*, which means excessive risk, is the one that can affect a contract, that is, nullifies it, and other is *Gharar yasir*, it is a *Gharar* but in small degree (the amount of *Gharar* is small) it is said that this type of *Gharar* is always present in every contract and its presence is acceptable. Scholars approach it from the *Gharar yasir* or tolerable risk perspective. For them, three conditions need to be fulfilled to identify the risk as tolerable ones. The risk should be negligible, in the sense that the probability of loss is small and its magnitude is limited. It also needs to be inevitable that is out of one's control and lastly, it should not be intentional<sup>61</sup>.

Looking from a different perspective of behavior, there are two types of *Gharar* or uncertainty in any contract. Firstly is uncertainty that happens naturally and the other is uncertainty that happens through deliberate act of parties involved in the contract. The former one which is a natural uncertainty is the uncertainty that will always preside in any contract. For example, the possibility of earning profits from the transaction or loss due to

<sup>58</sup> Zarqa, Mustafa, 1959, *al fiqh al Islami fi thawbih al jaded*, v.1 pp, 697-698.

<sup>59</sup> Zuhayli, al Wahbah, *Al fiq al Islami wa Adillatuh*, v.4, Damasheq, p.437.

<sup>60</sup> Maihaini wan, Ahmad, wan, journal, 2002, some issues of *Gharar* (Uncertainty) in insurance, page 66, 67.

<sup>61</sup> Ibid.

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lack of market for the seller is associated with market risk that remains outside the contract. Since this form of uncertainty is naturally Fixed (embedded) before a contract of sale and cannot be eliminated, it is thus negligible in affecting the contract. In this sense, it is similar to the *Gharar yasir*. The second type of *Gharar* is the uncertainty arising from *Zulm* actions since it is an uncertainty deliberated by one of the parties of the contract such as putting an uncertain terms<sup>62</sup>.

In this manner, many forms of *Gharar* will emerge arising from fraudulent acts, fraudulent statements fraud by concealment. In each of these activities, one of the contracting party or a third party will deceive the other party, thus inducing him to enter the contract. The deceived party is normally ignorant of the fraud and has no other means of knowing it.

## 2.8. Gharar in Insurance

As we know, *Gharar* emerges from two sources, either from doubts or deceit. Generally the doubt or deceit about the contract arises when one or both parties enter the contract without knowledge exact what will be the outcome of the contract. Neither the insurer nor the insured know the exact nature and extent of their rights and obligations until after the occurrence of the insured event or peril<sup>63</sup>. The second type of *Gharar* is also said to occur in insurance as in most cases the insured when entering into such contracts are not sure, if not totally ignorant of their terms. Most of the people do not read the policy while among those who read it; many do not understand its contents. *Gharar* in insurance emerges from doubts or deceptions take place in four ways, namely in the contract and compensation's existence, in the contract result (outcome), in the length of contract time period and in the amount of compensation and premium<sup>64</sup>.

<sup>62</sup> Yusuf, 1998 Defective contracts in Islamic conventional Law with special reference to Al Gharar, MCL, IIUM, pp 206-229.

<sup>63</sup> Ramalah, Nik, Mahmood, 1991, Takaful, The Islamic system of mutual Insurance, the Malaysian experience, Arab Law quarterly, pp, 283-284.

<sup>64</sup> Maihaini wan, Ahmad, wan, journal, 2002, some issues of Gharar (Uncertainty) in Insurance, page 70, 71. <http://www.insurance.com.my/zone-consumers/interactive-guide/takaful>. Muslehuddin, M.C 1982, pp. 143-165

On the bases of above observation we can say that insurance contract contain excessive *Gharar*. Firstly, because of the uncertainty of the subject-matter (the compensation has the possibility of non existence in future time), the compensation is unclear or uncertain because it is based upon the happening, which may or may not happen. Secondly, all of the uncertainties arise due to uncertainty of the happening of the insured event as well as the time of happening. Although the event or the time is beyond man's control, any contract attached with these conditions is not allowed due to want of knowledge. Want of knowledge itself shall result in the existence of *Gharar* in the contract.

## 2.9. Arguments in support and against the contract of insurance

The supporters of conventional insurance have argued that the latter is valid and lawful like any other business and there is nothing wrong in it. Their arguments are as below;

- 1) The insurance contract is reciprocal in the sense that the insurer will not pay the indemnity if the insure does not keep his part of the contract (which is payment of premium installment)<sup>65</sup>.

Reciprocity is only valid as far as the legal aspect of the contract of insurance is concerned, in practice it does not exist. It is the insured who always loses and suffers, where as the company (Insurance) loss is always uncertain and partial, in the end the company always wins. The insuree has always got to pay premium monies to get his loss repaired but in case of the non occurrence of a peril he gets nothing. Where is the reciprocity here?

- 2) Conventional insurance is like an ordinary business, in which risk is essential and indispensable for profit making in modern industrial world. Both the parties in the

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<sup>65</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, pages 126,127,129 130.



insurance contract are taking a risk voluntarily and knowingly. They are in a way co-operating to avoid danger and restore equality or balance through risk<sup>66</sup>.

This argument is totally false and misleading. The risk involved in a normal business contract is almost negligible and is quite different substance and nature from that in conventional insurance. The latter cannot be compared to the normal business risk, if any. There is practically no such risk in business in normal conditions, except in speculative enterprises which are any way unlawful in Islamic society. In insurance the risk is always one sided, it is the insuree who always bears the risk and company on average makes profit.

- 3) Conventional insurance is not like gambling because the insuree is paid his actual losses incurred from a peril and from his own savings paid earlier by premium installments. In fact the insuree put up their money together in form of premiums to pay off the claimants who have suffered a calamity or disastrous<sup>67</sup>.

It is misconception to call premium money paid by the insurees to the company (insurance company) as their savings. The insurees as individuals had no such intention at the time of the insurance contract, and there is nothing in the insurance contract to suggest that the insurees pay premium money to pay off the losses of those who have suffered a calamity. In fact each individual insuree pays premium money to the insurance company to secure his own interest against future losses.

- 4) The insurance company helps other people in peril and reduces their misery by making up their losses. Many calamities and hazards are compensated, removing the miseries and suffering of hundreds of families. There is co-operation between the two parties to achieve the above objectives.

<sup>66</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, pages 126,127,129 130.

<sup>67</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, pages 126,127,129 130.

We have already mentioned that insurance contract contains element of gambling. If people are prepared to pay the legal expenses of a thief that would not justify theft on the basis of cooperation by the people or make it lawful for the people to share the booty between them to ward off their poverty.

- 5) The insuree is paid his actual losses from a peril out of his own contribution to the company in the form of premium. Therefore the element of speculation and chance is very small in the insurance business.

It is not correct that the insuree is paid compensation out of his own contribution, firstly because the insuree is paid only on the occurrence of a calamity, if the perils does not occur he is paid nothing, thus the payment depends on mere chance and secondly because when the peril does occur the insuree is paid out of the funds accumulated from fixed earnings investment (out of the interest earned from insurance funds). There is not given or mentioned in contract of insurance that each insuree will be paid compensation out of his own savings. If for a little time we agree with the suggestion that each insuree is paid out of his own savings, then the further question arises in mind, is the amount of compensation paid to the insuree always equal to the amount of his premium contribution? If not then what is the relation between premium contributions of each insuree and his compensation? And in case of non occurrence of any peril what happens to the so called savings? Who gets or grabs the savings and why it is not paid to the insuree<sup>68</sup>.

- 6) Contract of insurance is Mudharāba contract, because the insured person pays the premium in shape of installment and company gets profit because of those payments and in case there is any peril or hazard occurred the company pays off compensation, and contract of Mudharaba is valid according to jurists<sup>69</sup>.

This is not true because in contract of Mudharaba the money does not out of the

<sup>68</sup> Rahman, Afzalur, Banking and insurance, vol4, 1st edition, 1979. The Muslim School Trust, London, pages 126,127,129 130

<sup>69</sup> Ibid.

ownership of the *Ra'abul ma'al* and in insurance once the insured person pays the installment then he has nothing to do with the money he paid, because he is no more the owner of the money. Secondly the profit in Mudharaba is divided on predetermined ratio but in insurance the insurance company takes all the profit and nothing is given to the insured person, so that's why it is not true to call insurance, a contract of Mudharaba.

Now from the arguments of both the parties we can now decide that the Contract of Insurance is not valid from Islamic point of view and we can take Islamic insurance (Takaful) as an alternative of conventional insurance, although Islamic insurance is in the stage of infancy here in Pakistan and many Islamic scholars have still some reservations on takaful, but in my view Concept of Takaful is relatively new to all people and specially to Muslims but yet we have to work hard to promote this concept and follow as an alternative of Insurance. Takaful can become a real alternative of insurance once we start following this concept and by following takaful we can remove and sorted out all the defects which are still found in concept of takaful, for removing the defects we should involved ourselves practically in this concept in order to draw the people towards Takaful and make it an alternative of insurance.

## 2.10. Gharar and Jihalah

*Gharar* means, uncertainty about the subject matter whether exists or not, Or uncertainty about the subject matter where the seller are not in position to hand over the things purchased; like sale of fish in the water, sale of birds in the air or sale of stray animal. In other words, *Gharar* arising due to non-existence of the subject matter of exchange, and the seller is not in a position to hand over the subject matter to the buyer, irrespective of whether this is in existence or not?

*Jihala* means, where the uncertainty may be caused by lack of adequate value relevant information or lack of knowledge. Like sale of fetus in the womb. In other words *Jihala* means that the person is unaware from adequate relevant information regarding the

subject matter of a contract. Scholars have described, that '*Jihal*' means want of knowledge with regard to the subject matter, the price or with regard to the characteristics of the price or of the subject matter, the date of settlement of contract, agreement of transaction. In my view so for the reason '*Jihala*' is a kind of *Gharar*. In other words, thus information is the central element to Islamic law of contracting; an absence of accurate information, (*Jihala*) want of knowledge and lack of information is a source of *Gharar*. *Imam Ibn Taymiyyah* also holds this view. We can say that '*Gharar*' is the uncertainty about the subject matter; price and the date of settlement of contract etc. whereas '*Jihala*' is the want of knowledge, lack of information about the features of the subject matter of a contract, agreement or transaction"<sup>70</sup>

### 2.11. Removal of Defects (*Riba*, *Maysir*, *Gharar*)

As we have discussed above that there are three defects in conventional insurance: *Riba*, *Maysir* and *Gharar*. In fact only one step has been taken in this regard which is a real change in the structure of insurance. As we know that the contract of insurance is based on sale and purchase contract which is the core reason of all the defects. The Islamic Insurance is based on a charitable contract (donation). So this source eliminated the defects of *Riba*, because *Riba* emerges in the exchange of two things through the contract of sale. If the contract is not based on compensation, there is no restriction on the parties to give something more as a gift; rather the action would be appreciable in Islamic Law. For example; if Mr. "A" has offered rupees one thousand to Mr. "B" and Mr. "B" after sometime gifted Mr. "A" rupees two thousand there is no prohibition in it and it would not be considered *Riba*. Because it was a gift and was free from a stipulation of increase and as

<sup>70</sup> Fazli Dayan, Thesis for LLM on "Effects of uncertainty on contracts and Islamic law", IIUI, p. 14 (as he quoted: Obaid Ullah, Muhammad, Islamic Financial Services, King Abdul Aziz University, Jeddah, Saudi Arabia, pp. 31, 32; Al Qarafi, Al Furuq, Dar Al Kutub Al Ilmiyyah, Beirut, 1986, vol. 3, p. 265; Ibn Taymiyyah Al Qawaid Al Nuraniyyah Al Fiqhiyyah, Damascus, 1951, p. 117; Darir, Siddiq Muhammad Amin, Al Gharar WA Atharuhu Fi Al Uqud, Cairo, 1967, p. 59.)

it is a *tabarru* contract and collection of funds on voluntary basis there is no involvement of *Riba*. So the defect of *Riba* is removed<sup>71</sup>.

As far as the defects of *Gharar* and *Maysir* are concerned it can be said there is an element of uncertainty in *Takaful* as happening of the loss for the cover of which the policy holder deposit the premium is not certain. But this kind of uncertainty in the contract of *Takaful* is not unlawful according to Islamic Law. Since the contract of *Takaful* is based on voluntary contract. Uncertainty is unapproved only in the contracts of compensation and in case of voluntary contracts it does not make any harm. For example; a man has some money in his bag and says to the shopkeeper that I have purchased this thing and that thing for the money available in this bag.

This contract of sale and purchase is not valid because the price in this juncture is unknown and unspecified, and it is necessary for a valid contract of sale that the price of the things sold must be identified and specified. But in case this man says to a student I will present you the money in this bag as a gift on your success in the examination, this contract of gift is valid and legal. Although the element of uncertainty exist in this contract as well but the uncertainty appearing in a voluntary contract is acceptable. Since the contract of insurance has been changed from a contract of sale to a voluntary contract this uncertainty has become acceptable<sup>72</sup>

## **(2.12.) Council of Islamic Ideology Council's Opinion about the current Insurance system**

The Council of Islamic Ideology gave a majority decision in December, 1983 that the well known and current forms of insurance are in conflict with Islamic Injunctions only one Member (Dr. Abdul Malik Irfanni) expressed the opinion in his note of dissent that the prevalent forms of insurance accord with the Shariah. The Council of Islamic Ideology

<sup>71</sup> Ansari, Mustafa, Omar, Managing Finance A Shariah Complaint way, time management club, page 187, 188. Murtaza, KM, Introduction to Islamic Insurance. Samadani, Dr. Ejaz, Islamic Banking and Uncertainty, page 18, 19.

<sup>72</sup> Ansari, Mustafa, Omar, Managing Finance A Shariah Complaint way, time management club, page 187, 188. Murtaza, KM, Introduction to Islamic Insurance. Samadani, Dr. Ejaz, Islamic Banking and Uncertainty, page 18, 19.

drew up its decision in a report in which it also expressed its opinion about different laws relating to insurance. This decision of the Council unambiguously expressed the opinion that:

"The contract of insurance in all its forms is unlawful, corrupt, false, prohibited and not promulgatable".<sup>73</sup>

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<sup>73</sup> Eleventh, Report of the Council of Islamic Ideology on Islamization of Laws page 12.

### ***Chapter No. 3***

### ***Islamic alternative (Takaful) to Insurance***

### **3.0. Alternative to conventional Insurance "Takaful"**

The history tells that the first form of Insurance which was practically applied in business world was the marine insurance scheme initiated by Muslims merchants. This scheme was based on the concept of Takaful which implies mutual cooperation and social security. In modern Islamic finance, takaful has emerged as an alternative to conventional insurance business. Takaful companies are now working in most parts of the world especially in Islamic world.

Islamic Insurance (Takaful) is an alternative form of conventional insurance based on the concept of trusteeship and cooperation inspired by the beliefs of the followers of Islamic teaching. Muslim societies in different parts of the world are now practicing Takaful scheme as their own way of sharing financial responsibilities to assist each other. They have invented an Islamic way of mutual assistance to deal with uncertainties of life. Takaful is a social scheme based on the principles of brotherhood, solidarity and mutual assistance. It provides mutual financial aids and assistance to those who are members of the takaful scheme and voluntarily agree to contribute a certain amount of money for that purpose. It is a mutual agreement among the participants of the scheme. This has its origin from the concept of collective sharing of individual's loss. Takaful, is being practiced now as an alternate of conventional insurance system and is bounded by Islamic principles, rules and the laws of Islam (Shariah).

Takaful has grown as a form of protection against the risk of loss. Takaful is now being operated in Muslim societies mainly because it is necessary to protect each and every member of the society from any unexpected negative change in life, and wealth that he has. This is also necessary to protect the members of the society from unforeseen losses arising from legal liability. The system of protecting one from an unforeseen loss or damage is not a new concept that people just learnt about. Islamic societies have always collectively assisted their members, both in cash and kind, and when they have been required to incur some usual or additional expenditure on deaths, births, marriages etc. The Arabs even in the pre-Islamic



days tied by blood relationship considered to meet the loss of any individual member, including his liability towards the payment of "blood money"<sup>74</sup>.

They were obliged by custom and tradition to come to rescue of a fellow tribe and take suitable measure to cover losses or liabilities collectively. This took the form of mutuality and gave rise to the custom of losses being shared by the group as a whole. Takaful has emerged as an alternate to insurance, because insurance and risk management are now being used in every sphere of human life and especially because of its tremendous importance to modern trade, commerce and industry. Because of the important role of insurance in the day today life and business ventures, the legal and contractual aspects has been the subject matter of detailed studies by Islamic scholars.

### 3.1. Concept of Takaful

The basic concept of takaful is the combination of both "*tabarru*" (donation) and Mudharaba (profit and loss sharing) contract. The primary contract which binds the participants is the contract of tabarru as they mutually agree to help each other financially when any one of the group suffers from defined risk. At the same time all the participants agree to invest the pool of fund thus collected. The main contract is the contract of tabarru<sup>75</sup>.

The elements of "*Gharar*" (uncertainty) and "*Jahala*" (lack of knowledge) are irrelevant as these two elements do not affect contracts which are gratuitous in nature. The basic aim of contributing to the common fund is to provide financial assistance to the one who suffers from defined risk. The profits are shared between the policy holders (participants) and the takaful operator as entrepreneur. While the conventional insurance basically is a contract of buying and selling, the takaful contract is based on the principle of Al-takaful and Al-Mudharaba. Al-takaful means the act of a group of people reciprocally

<sup>74</sup> Marghinani, vol 4, kitab al Ma'aqil, pp. 641-650. Rispler, Verdic, chain, journal, Insurance and semi insurance Transaction in Islamic history until 19<sup>th</sup> century PhD Thesis and paper. Page 144, 145 and 146.

<sup>75</sup> Mansoori, Dr, Tahir, Muhammad, Islamic Law contracts and conventional transactions. Shariah Academy, IIUI, Pakistan, 200, page 108-109

guaranteeing each other; Mudharaba is the conventional profit sharing contract between the providers of fund for a venture and the entrepreneur. Therefore, the distinct character of this form of insurance is that the contract is based on the virtues of co-operation, mutual help, shared responsibility and benefit. The basic motive of takaful under the Islamic value system, is to bring equity to all parties involved.

### 3.2. Proof of the concept of Takaful in Quran and Sunnah

There are numerous references to *Ta'awan* and Takaful in the Quran in the context of co operation and solidarity for the good of society. One widely quoted reference is from *Sura al-Maidah*, as follows:

"And help one another in righteousness and piety and do not help one another in evil deeds and enmity"<sup>76</sup>.

One of the approaches to social help and assistance practiced in Islam that relates to the first Constitution of Medina, stated that, "the emigrants from among the *Quraish* shall be responsible for their ward and shall pay the blood money in mutual collaboration and shall secure the release of their prisoners by paying their ransom themselves, so that the mutual dealings between the believers be in accordance with the principles of recognized goodness, justice and mutual responsibility".

Marghinani said that "Imam Malik Stated in his book *Al-Muwatta* Where a person inflicts bodily injury or homicide it becomes incumbent upon him or, as mutual responsibility, upon a group of people representing him, to compensate the injured party in cash or kind. This compensation is called "*Diya*". Where homicide is intentional, the *Diya* or blood money is payable by the person committing that act. A third party (*aqila*) pays blood money only where the act is unintentional or where it is offered by the *aqila* on voluntary basis".<sup>77</sup>

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<sup>76</sup> Al-Quran, Al Maidah.2

<sup>77</sup> Marghinani, vol 4, kitab al Ma'aqil, pp 641-50

Islam aims at establishing a social order under universal brotherhood. The underlying concept is that of mutual co-operation and help.

The Prophet (SAW) stressed:

"In mutual compassion, love and kindness you will find the faithful like a body, so that if one part feels pain, the whole body responds with wakefulness and fever."<sup>78</sup>

### **3.3. Other references to Ta'awan and Takaful in the Quran are as follows:**

#### **Protection and Co-operation**

"(ALLAH) who prepares nourishment to prevent the fear of hunger and saves / puts at peace those who fear"<sup>79</sup>

A Muslim is the brother of a fellow-Muslim. He should neither commit oppression upon him nor ruin him and he who meets the needs of a brother, ALLAH would meet his needs and he who relieves his brother from hardship, ALLAH will relieve him from the hardships to which he could be put on the Day of Resurrection.<sup>80</sup>

#### **Takaful - sharing of responsibility**

"A believer is like a brick for another believer, the one supporting the other".<sup>81</sup>

<sup>78</sup> Sunnah, Kitab al Usul al kafi, vol 2, page 164

<sup>79</sup> Al-Quran, Al Quraish, 106:4

<sup>80</sup> Sahih Muslim. No. 6260, Abdul Hamid, Siddiqi, vol 4, Sh.M.Ashraf publishers & bookseller, Lahore

<sup>81</sup> Sahih Muslim, No. 6258, Abdul Hamid, Siddiqi, vol 4, Sh.M.Ashraf publishers & bookseller, Lahore

"The similitude of believers in regard to mutual love, affection, fellow-feeling is like that of a body, when any limb of it aches, the whole body aches because of sleeplessness and fever"<sup>82</sup>

"And hold fast, all together, by the rope which ALLAH (stretches out for you), and be not divided among yourselves; and remember with gratitude ALLAH's favor on you; for you were enemies and He joined your hearts in love, so that by His grace you became brethren; and you were on the brink of the pit of fire, and he saved you from it thus does ALLAH make His signs clear to you; that you may be guided".<sup>83</sup>

"The believers are but a single brotherhood: so make peace and reconciliation between your two (contending) brothers; and fear ALLAH, that you may receive mercy"<sup>84</sup>

"(Their bearings) on this life and the hereafter they ask you concerning orphans. Say: the best thing to do is what is for their good; if you mix their affairs with yours, they are your brethren; but ALLAH knows the man who means mischief from the man who means good. And if ALLAH had wished He could have put you into difficulties: he is indeed exalted in power, wise."<sup>85</sup>

"But those who before them had homes (in Medina) and had adopted the faith, show their affection to such as come to them for refuge, and entertain no desire in their hearts for things given to the (latter), but give them preference over themselves, even though poverty was their (own lot) and those saved from the covetousness of their own souls; they are the ones that achieve prosperity"<sup>86</sup>

"Serve ALLAH and join not any partners with him and do good to parents, kinsfolk, orphans, those in need, neighbors who are near, neighbors who are strangers, the companion

<sup>82</sup> Sunnah, Sahih Muslim, No. 6257, Abdul Hamid, Siddiqi, vol 4, Sh.M.Ashraf publishers & bookseller, Lahore 1987.

<sup>83</sup> Al-Quran, Al Imran.103

<sup>84</sup> Al-Quran, Al Hujaraat.10

<sup>85</sup> Al-Quran, Al Baqara, 220

<sup>86</sup> Al-Quran, Al Hashr,9

by your side, the wayfarer (you meet) and what your right hands possess: for ALLAH loves not the arrogant, the conceited.”<sup>87</sup>

Given the Qur’anic admonition to “assist one another” and the words of the Prophet Muhammad (SAW) regarding mutual assistance, Takaful may be understood as an imperative upon Muslim believers:

“a system based on solidarity, peace of mind and mutual protection which provides mutual financial and other forms of aid to Members {of the group} in case of specific need, whereby Members mutually agree to contribute monies to support this common goal.”<sup>88</sup>

“Finally, although a believing Muslim is required to accept (destiny or pre-ordainment) which can incorporate misfortune, s/he is not a passive “victim” of circumstances. Conversely, the believing Muslim is exhorted by the injunctions of the Holy Quran to proactively take precautions in order to minimize potential misfortune, losses or injury from unfortunate events. One specific such instruction appears in Hadith to the owner of the camel to first tie your camel then rely upon the destiny ordained by ALLAH (SWT).<sup>89</sup> This Hadith implied a strategy to mitigate/reduce risk. It is one of the means of providing a material safeguard for offspring and is thus in line with the saying of the holy prophet SAW No human actions change the Will of ALLAH (SWT) for our destiny. Whether a person has insurance/Takaful or not has no effect on future events. However, we are instructed to take precautions and then fully trust and depend upon Almighty ALLAH (SWT):

<sup>87</sup> Al-Quran, Al Nisa. 39

<sup>88</sup> [www.takaful.com.pk](http://www.takaful.com.pk), Omar Fisher, Unicorn Investment Bank Bahrain.

<sup>89</sup> Sunnah, Al Tirmidhi, vol.4,p.668

### 3.4. Meaning and Definition of Takaful

#### 3.4.1. Meaning of Takaful

"Takaful comes from the Arabic root-word '*kafala*' — guarantee." Takaful means mutual protection and joint guarantee.

Operationally takaful refers to participants mutually contributing to a common fund with the purpose of having mutual indemnity in the case of peril or loss<sup>90</sup>.

#### 3.4.2. Definition of Takaful

Takaful refers an agreement among group of people called participant to guarantee jointly that, should any of them suffer catastrophe or disaster, he would receive certain sum of money to meet the loss or damage."<sup>91</sup> Thus it is a method of mutual help, the contribution are made on Mudharaba basis in Takaful business. It is also known as solidarity Mudharaba.

#### 3.4.3. Reference — Al Quran

"Help (*ta'awan*) one another in furthering virtue (*birr*) and ALLAH consciousness (*taqwa*) and do not help one another in furthering evil and enmity".<sup>92</sup>

#### 3.4.4. Reference – Ahadith

"Narrates *Hazrat Anas Bin Malik (R.A.)*, one day Prophet Muhammad (SAW) noticed a Bedouin leaving his camel without tying it. He (SAW) asked the Bedouin, "Why don't you tie down your camel?" The Bedouin answered, "I put my trust in

<sup>90</sup> <http://www.LearnIslamicfinance.com>. <http://www.pakqatar.com.pk>.

<sup>91</sup> Mansoori, Dr, Tahir, Muhammad, Islamic Law contracts and conventional transactions. Shariah Academy, IIUI, Pakistan, 2008, page 108

<sup>92</sup> Al-Quran Al Maidah: verse 2 (5:2)

ALLAH." The Prophet (SAW) then said, "Tie your camel first, and then put your trust in ALLAH".<sup>93</sup>

The Hadith Implied a strategy to mitigate/reduce risk. Takaful provides a strategy of risk mitigation/reduction by virtue of collective risk taking that distributes risks and losses to a large number of participants. This mitigates the otherwise very damaging losses, if borne individually.

The Prophet Muhammad said:

"Narrated by *Saad bin Abi Waqas* ® ... the Holy Prophet (SAW) said ..... It is better for you to leave your offspring wealthy than to leave them poor asking others for help".<sup>94</sup>

### 3.5. Mechanism of Takaful

Takaful put much emphasis on the issues of "Joint Benefit" and "Shared Responsibility". Accordingly, the distinct character of this form of insurance is that the contract is based on the virtues of co-operation, mutual help, shared responsibility and benefit, while all aspects of the contract must be transparent to all involved. The basic motive for Takaful under the Islamic value system, then, is to bring "equity" to all parties involved. Profit earning should not be the main goal, rather, helping other policyholders through bad times, sharing the misfortune while sharing the profits, if any, is the objective<sup>95</sup>.

The management of Takaful funds are therefore to exercise prudence when making investment decisions and must not subject such funds to potentially high return/high risk situations. To grasp the nature of Takaful fully, one should consider the element of *Tabarru*-the fact that in accordance with the principle of Joint Guarantee to help others, each policy

<sup>93</sup> Hadith, Sahih Buhkari, kitabul Adaab, vol. 8, no 725, p. 477.

<sup>94</sup> Sahih Bukhari, Kitabul diya, vol 8, No. 725, page 478

<sup>95</sup> Murtaza, Muhammad, kazi, the future of takaful business and its challenges, paper, January, 5, 2010.

holder willingly agrees to give a portion of his/her paid premium to other policy holders who are struck by a mishap and may be in need of financial assistance<sup>96</sup>.

In conventional insurance, insurance company takes guarantee to make the loss good and provide financial assistance to the insured against the sum which he has deposited as a premium. Contrary to Takaful, the customers upon their mutual agreement form a fund (pool) which is called takaful fund and this takaful fund provide mutual benefits to the participants, the Takaful company only manages to the fund (Takaful manager)<sup>97</sup>. Since the Takaful company only manages takaful fund and earns its management fee in different forms and in models, also become a partner in the takaful fund (pool).

All the contributions of the participants (customers) (premiums that's what the conventional insurance company call) which are deposited in Takaful fund and then those funds are invested in different Shariah investment sectors at the start of business the takaful company provides funds to the Takaful fund. These funds are provided as a cede money under the model used in Pakistan, and sometimes in other models these funds are provided in shape of Musharaka.

Similarly, the Takaful Company provides *Qard-e-Hasana* to the fund in case of losses and cash short fall. Takaful company also provides capital on Musharaka basis. The services of administration and marketing of the fund provided by takaful company and is therefore entitled to a *Wakalah* fee. In addition management fee (Mudharib share is paid to the takaful company out of the profits of the takaful fund (pool) according to the rates and proportion agreed upon). In certain models Takaful Company is also a partner. Musharik in the takaful pool its share of profit is paid according to the capital involved. All the remaining profits are attributable to the takaful pool<sup>98</sup>.

Whenever any losses are reported all the claims or losses are paid out of the fund and if after payment all the claims, there comes or arises any surplus, that surplus may be

<sup>96</sup> Murtaza, Muhammad, kazi, the future of takaful business and its challenges, paper, January, 5, 2010.

<sup>97</sup> Ansari, Mustafa, Omar, Managing Finance A Shariah Complaint way, time management club, page 189, 190.

<sup>98</sup> Ansari, Mustafa, Omar, Managing Finance A Shariah Complaint way, time management club, page 189, 190.



refunded to the contributors. The modeling of Takaful Company in general, particularly the determination of sharing ratios, contribution rate and takaful limits are determined with the help of actuary.

### 3.6. Difference between Takaful and conventional Insurance

The fundamental difference lies in the fact that in the Takaful concept, the premium is paid on the basis of *tabarru'*. This changes the contract because with *tabarru'*, it is the participants themselves who are carrying the risk and not the insurance company. The Takaful operator is clearly not the owner of the fund but truly its custodian. As such, the Takaful operator cannot use the contributions except as intended by the donors i.e. for mutual help.

By including the concept of *tabarru'*, the element of *Gharar* would be eliminated, which consequently eradicate *Maysir* from the transaction. This is because with *tabarru'*, the contract is no longer that of exchange, thus eliminating the problem of deliverability. In addition, the *tabarru'* factor also inculcates the spirit of solidarity, brotherhood and mutual help. Takaful companies invest their funds in financial instruments, which are not forbidden by Islam. General Takaful companies maintain two separate and distinct accounts - one known as the Participants Fund and other Shareholders Fund. Takaful companies must have Shariah Supervisory Council to monitor their operation to make sure they do not engage in forbidden practices such as *Riba*<sup>99</sup>.

The major points of difference between conventional and Islamic insurance may be enumerated in brief as under:

1. Conventional Insurance is based on profit-motive and aims to maximize returns to shareholders. The business of insurance is, in essence, "owned" by shareholders of the insurer company. Islamic insurance, on the other hand, is based on the motive of community welfare and protection. The business of

<sup>99</sup> Obaidullah, Muhammad, paper, Islamic financial services, and Islamic economics research center, King Abdul Aziz University Jeddah KSA.

insurance itself is non-profit. The insurer is now called the *takaful* operator who receives a fair compensation, either through a share in returns on investment of funds or through agency fees. The business of insurance is, in essence, "owned" by policyholders and the operator company acts as the agent manager<sup>100</sup>.

2. In case of conventional insurance, insurer's profits include underwriting surplus, which is the difference between total premiums received from and total claims and benefits paid to policyholders. Essentially, profit comprises underwriting surplus plus investment income. The distribution of profits or surplus is a managerial decision taken by the management of the insurer. As a result there is a conflict of interest between shareholders of the insurer company and the policyholders. In case of Islamic insurance, on the other hand, the operator has no claims in underwriting surplus. Further, it is the *takaful* contract, not the management of the operator company that specifies in advance how and when profit will be distributed. There is little room for conflict between interests of shareholders of the operator company and the policyholders. This point is further elaborated in the subsequent chapter dealing with alternative models of Islamic insurance.
3. In case of conventional insurance, the sources of laws & regulations are set by state and are man-made. In case of Islamic insurance, the laws and regulations are based on divine revelations. A manifestation of this is in the right of insurable interest that is vested in the Nominee absolutely in conventional life insurance. The same, however, is determined by Islamic principles of inheritance in case of Islamic insurance.
4. Just as in case of the insurer, the insured or policyholders may or may not be governed by the profit motive. For instance, in conventional insurance, the insured or policyholder may decide between original costs or replacement cost as the basis of valuation and claim accordingly - whether or not they chose to

<sup>100</sup> Obaidullah, Muhammad, paper, Islamic financial services, and Islamic economics research center, King Abdul Aziz University Jeddah KSA.

rebuild property. In Islamic insurance, however, the insured may not "profit" from insurance and are entitled to compensation only for repair or rebuild or replacement.

5. In conventional insurance the investment of premiums is entirely at the discretion of the insurer with no involvement by policyholders. As such, investment usually involves prohibited elements of *Riba* and *Maysir*. In Islamic insurance, on the other hand, the takaful contract specifies how and where the premiums would be invested. By definition such investment would exclude prohibited areas<sup>101</sup>.
6. In case of dissolution of the former, reserves and excess/surplus belong to the shareholders. In case of dissolution of the latter however, reserves and excess/surplus could be returned to participants, or donated to charity. Most scholars would prefer the latter course of action.
7. The Islamic insurance company has an additional obligation of annual payment of Zakat.

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<sup>101</sup> Obaidullah, Muhammad, paper, Islamic financial services, and Islamic economics research center, King Abdul Aziz University Jeddah KSA.

A comparison is made below in a shape to highlight the salient differences between conventional insurance (companies) and Takaful companies in a simple way or in short:

Conventional Insurers	Takaful Operators
Sources of laws & regulations are set by state and man-made.	Sources of laws are based upon Divine revelations (Holy Quran and Hadith)
Profit-motive, maximizing returns to shareholders.	Community well-being optimizing operations for affordable risk protection as well as fair profits for the operator.
Profits and/or Bonus units to be returned to policyholders as determined by managers and Board of insurer.	Takaful contract specifies in advance how and when profit/surplus and/or Bonus units will be distributed.
Initial capital supplied by shareholders.	Initial capital supplied by Rabb al Mal (Agent) or paid in via premiums from participants.
Separation of policyholder and insurer with differing interests.	Coincidence of interests between policyholder and operator as appointed by participants.
Transfer of losses among insurance pools and from policyholders to shareholders.	Losses retained within classes of business written and sole obligation of Participants.
Right of insurable interest is vested in the Nominee absolutely in Life insurance.	Right of insurable interest is determined by Islamic principles of (inheritance).

Insured may elect cost or replacement cost valuation and claim accordingly whether or not they chose to rebuild property.	Insured may not "profit" from insurance and entitled to compensation only for repair or rebuild or replacement.
Agents and Brokers are typically independent from insurer and paid a fee from the premium charged to policyholders that is not disclosed that is not disclosed.	Agents are employees of the Takaful and any sales commission should be disclosed.
Investment of premiums conducted by insurer with no involvement by policyholders.	Takaful contract specified under principles of al Mudharaba how premiums will be invested and how results are shared. Under al Wakalah, similar practice plus Participant can direct his investments into a range of unitized funds.
Insurer invests premiums consistent with profit-motive with no moral guidelines; hence co-existence of Al Riba and Al Maysir.	Takaful invests premiums in accordance with Islamic values and Shariah guidelines.
Benefits paid from general insurance account owned by insurer.	Benefits paid from contributions (Al tabarru) made by participants as mutual indemnification.

### 3.7. Shariah appraisal of Conventional Insurance and Takaful

Most of the contemporary Muslim jurists regard modern conventional insurance invalid and unsuited with the injunctions of Islamic Law. As Islamic law does not allow any *Gharar* transactions in which neither the seller knows what he has sold and nor the purchaser knows what he has purchased. In conventional insurance the buyer of policy does not know what he has bought by his premiums. The time of happening of an event is also uncertain for the parties. As such contract of insurance is contract of *Gharar*<sup>102</sup>.

The Takaful business is satisfactory from Shariah standpoint. It is based on the Islamic concepts of Mudharaba and *tabarru* and it is also free from *Riba* because the participant or the policy holder does not get a fixed return on participant Account (P.A). The capital is subject to loss and profit sharing and the deposited amount in P.A is invested in different forms of business (those businesses. The participant special account is the same fund which has been designated as Waqf by the *Ulama* of Pakistan. Since this is a *tabarru* contract any uncertainty with regard to the benefits of the participant or policy holder does not affect the validity of contract because uncertainty and *jahl* in contract of *tabarru* is allowed in Islamic law<sup>103</sup>.

### 3.8. Declaration by Shariah scholars rendering conventional insurance Un-Islamic

- Fatwa issued in Judicial Conference held in Makkah in Shaban 1398 AH.
- Verdict of Supreme Court of Egypt on Dec. 27, 1926.
- Unanimous resolutions and *fatwa* by Ulama in the Muslim League Conference in Cairo in 1965.

<sup>102</sup> Samadani, Ejaz, Dr, Islamic Banking and uncertainty, Darul Isha'at, Karachi, Pakistan, page 87-88

<sup>103</sup> Dr, Mansoori, Muhammad Tahir, Islamic Law contracts and conventional transactions. Shariah Academy, IIUI, Pakistan, 2008, page 109

- Unanimous decision by Muslim Scholars in seminar held in Morocco on May 6, 1972.<sup>104</sup>

### 3.9. Judicial Opinions and Fatwas confirming validity of Takaful

- Fatwa issued by Higher Council of Saudi Arabia in 1397 A.H.
- Fatwa Issued by the Fiqh Council of Muslim World League in 1398 A.H.
- Fatwa issued by the Fiqh Council of the OIC in 1405 A.H. (1985).

### 3.10. Fiqh Academy Resolution 1985

Islamic Fiqh (science of Shariah) Academy, emanating from the Organization of Islamic Conference, meeting in its Second Session in Jeddah, KSA, from 10 to 16 Rabi-ul- Thani, 1405 A.H. (Dec 1985) issued a Resolution which in summary stated the following:

- The conventional Insurance contract... is prohibited (*Haraam*) according to the Shariah.
- The alternative Takaful contract which conforms to the principles of Islamic dealings is *Halaal*, being the contract of cooperative insurance, which is founded on the basis of charitable donation and Shariah compliant dealings.<sup>105</sup>

### 3.11. Models of Takaful

Theoretically, Takaful is perceived as cooperative insurance, where members contribute a certain sum of money to a common pool. The purpose of this system is not profits but to uphold the principle of "bear ye one another's burden." The role of this practice indicates that the policyholders are in fact the managers of the fund and the ones in ultimate

<sup>104</sup> <http://www.islamonline.net>, Akhtar, Jamil, Muhammad khan, chief executive officer, Pakistan Takaful limited, delivered lecture on "Takaful introduction and types"

<sup>105</sup> <http://www.islamonline.net>, Akhtar, Jamil, Muhammad khan, chief executive officer, Pakistan Takaful limited, delivered lecture on "Takaful introduction and types"

control. However, the conventionalization of Takaful has produced several types of Islamic insurance, each reflecting a different experience, environment and perhaps a different school of thought. Although takaful is gaining widespread acceptance. Yet, there is great debate about the basics on what is right and what is wrong and the whole area of "grey" on the laws of tolerance and the rules of necessity. It is certainly in the process of evolution with differing views, concerns and interpretations expressed by various Shariah scholars. There is no single "best" model that exists for takaful. Shariah scholars worldwide agree on fundamental components that describe a takaful scheme, yet in their judicial opinions (Fatwas), operational differences are tolerated as long as they do not challenge essential religious code of belief.<sup>106</sup>

### 3.12. Mudharaba Model

Mudharaba is defined as the contract between one party, known as the capital provider (*Rabbul mal*), with another party known as the *mudharib* (entrepreneur) where the Rabbul mal provides the capital, and the mudharib provides the skills in a business enterprise. When there is revenue (profit), it is shared between the *Rabbul mal* and the mudharib in a pre-agreed way. In this case, the takaful operator is the mudharib, and the participants are the capital providers. The pure Mudharaba model conforms to this definition and is practiced mainly in the Asia-Pacific region.

In this Mudharaba model, the Shariah committee generally approves the sharing proportion (ratio) for each year in advance. Generally, these risk-sharing arrangements allow the takaful operator to share in the underwriting results from operations, as well as the favorable performance returns on invested premiums.<sup>107</sup>

According to Mr. Azman Bin Ismail, under the modified Mudharaba model, no profit from the venture is shared between the operator and the participants. Instead, what is shared under the modified Mudharaba model is the actual balance of the fund at the end of the

<sup>106</sup> <http://www.meinsurancereview.com>, August 2007

<sup>107</sup> <http://www.meinsurancereview.com>, August 2007



period (also called underwriting surplus), and not the surplus between the balance of the takaful fund at the end of the period (meaning the Mudharaba contract) and the balance of the takaful fund at the beginning of the period. In general takaful business, the balance (or underwriting surplus) of the fund at the end of the period is always less than the balance of the fund at the beginning of the period.<sup>108</sup>

Under a pure Mudharaba model, if there is a loss, the *Rabbul mal* loses (some of) his capital and the *mudharib* loses in terms of effort. Therefore, the modified Mudharaba model is not really Mudharaba, and that is why some scholars, especially in the Middle East do not condone it. It is important to note that under Mudharaba, the takaful fund belongs to the participants and not the takaful operator. The takaful operator therefore has no right to a share of the surplus.

### 3.12.1. Takaful in Malaysia

In the early eighties, Malaysia legitimized the operation of Takaful companies with enactment of the Takaful Act by the parliament, vesting with the Central Bank of Malaysia, Bank Negara, and the authority to regulate the Islamic insurance industry and to monitor the compliance of companies with the letter of the law. Syarikat Takaful Malaysia Sendirian Berhad, STMB, a subsidiary of Bank Islam Malaysia Berhad was the first to obtain a Takaful operation license in Malaysia under the new Act. It was incorporated on 29 November 1984 with an authorized capital of RM 100 million and a paid-up capital of RM 10 million, and commenced its operation 8 months after its incorporation. Since its establishment, STMB has been actively involved in Islamic Life Insurance-Family Takaful-and General Takaful, each with its own unique characteristics. The aim of the General Takaful Scheme is to provide compensation in case of accidents, much like any conventional insurance fund. The difference is the mutual nature of the fund where the source of funds for any claim settlement with an insured is the contributions made to the fund by other participants. Upon receipts of

<sup>108</sup> <http://www.meinsurancereview.com>, August 2007

premium payments, STMB acts as trustee to invest the moneys in acceptable opportunities and to channel back into the fund the returns on the investment less the operating costs. After settling all the claims, any residual amount will be distributed between STMB and the participants based on a previously agreed upon ratio. The coverage period under this scheme is shorter than the Family Takaful Plan<sup>109</sup>.

In attempts to promote greater competition possibly leading to a wider selection of Islamic insurance products as well as lower premiums. A second license was issued to MNI Takaful Sdn Berhad to operate Islamic Insurance in Malaysia. Eighty percent of the shares of the new company are owned by Malaysia National Insurance Sdn Berhad, the largest local insurance company. As the public may have the misconception that there are few differences between STMB and MNI Takaful, and since STMB has already been well established in the Takaful market, MNI had to find ways and means to highlight its uniqueness. The marketing strategies of MNI Takaful was to increase public awareness of Takaful, to make Takaful more accessible to its customer at "any time, any place, anywhere," to utilize the technological means in meeting their objectives faster, and to establish cooperative efforts with other financial institution in promoting Takaful. It has, assembled a strong marketing force and sales executives, as well as a highly motivated group of agents. The company has also explored other channels-banks and the posts offices, for example - to reach potential customers. At present there are several other takaful operators. They are basically following the Mudharaba model of Islamic Insurance. Some of these are practicing Takaful operation as Wakalah Model, where a reasonable service charges are being borne by the participants.

<sup>109</sup> Report on Islamic Insurance, Council of Islamic Ideology, Government of Pakistan Islamabad, page 35.

### 3.12.2. In Malaysia Mudharaba model

The first Takaful Operator in Malaysia is Syarikat Takaful Malaysia. It has a separately identified shareholders and policy holders (Takaful) fund. It follows the Mudharaba model on the basis of the following interpretation of the insurance process; The policyholders are nominated (designated) as the capital providers to the takaful fund. The shareholders are nominated (designated) as the entrepreneur whose task is managing the takaful fund.

Surplus arising from Takaful fund arises from both the underwriting of risk and the investment of assets and shared on a pre agreed profit sharing proportion. All management expenses are met by the shareholders fund. However all the deficits in the Takaful fund fall (accrue) to the policyholders only, not the shareholders.<sup>110</sup>

### 3.12.3. Problems with Mudharaba Model

Mudharaba model has many problems from Shariah point of view;

- 1) First problem in Mudharaba model from Shariah point of view is that, whether all takaful operators comply with recommendation to accept ta'awan as a basis for Islamic insurance. When people contribute money, they often expect something in the result of their contribution to takaful (profit or financial outcome). So therefore a question mark regarding the true nature of ta'awan. Is it really cooperative in true sense or in nature?
- 2) Second concern is that, the relationship of participants in Mudharaba model is of donation (*tabarru*) and not of Mudharaba (profit sharing). So Shariah scholars have concerned on it that a profit sharing contract should not be applied here, as a donation can not be Mudharaba capital at the same time.

<sup>110</sup> <http://www.mcinsurancereview.com>, August 2007

- 3) Third problem is that, in Mudharaba contract a profit is generated to be distributed. Essentially, an investment on a Mudharaba basis of 100% should at the end of the period give more than 100% to be termed as profit and for the operator to share in that. However profit is not the same as surplus, and in the context of insurance no profit can be generated by definition so the question of distribution of profit is of concern<sup>111</sup>.
- 4) The sharing in underwriting surplus makes the contract essentially the same as conventional contract, where the share holders become risk taker and therefore bear the risk and return from the underwriting results just as any ordinary business venture and not a contract for mutual assistance with a fee charged by the operation as risk managers.
- 5) The requirement to provide an interest free *Qard Hassan* (in case of a deficit) in a Mudharaba contract by definition is against the concept of mudharaba, which is a profit sharing contract and the mudharib, cannot be a guarantor.

### 3.13. Wakalah Model

The Wakalah model, commonly used in the Middle East, distinguishes between the operating company (*wakeel*) and the takaful fund. The operating company does not share in the underwriting result, but rather it is compensated by a fee deducted from contributions made by participants and/or investment profits generated by the takaful fund. The fee rate is fixed annually in advance in consultation with the Shariah committee of the company. In order to give incentive for good governance, the management fee is related to the level of performance.<sup>112</sup>

<sup>111</sup> Rahim Abdul, Wahab Abdul, Hassan, M.Kabir, Paper on, Islamic Takaful, Business Models, Shariah Concerns, and Proposed solutions

<sup>112</sup> Rahim Abdul, Wahab Abdul, Hassan, M.Kabir, Paper on, Islamic Takaful, Business Models, Shariah Concerns, and Proposed solutions

The surplus of the takaful fund belongs to the members; the operating company does not have a claim on it under any circumstances. If the takaful operator is to generate a profit from its efforts, it must manage the operations (including salaries, overhead, selling commissions, sales and marketing expenses, etc) entirely within the disclosed Wakalah fees.<sup>113</sup>

Since there is no other benefit to the takaful operator other than the declared Wakalah fees, the Wakalah model "demands" that all other charges/costs to the program be provided to the participants at the lowest possible cost level that can be negotiated by the operator on their behalf. The Wakalah model can be viewed as transparent as fees are clearly related to the operator's operational costs. Mudharaba practices are usually preferred for investment aspects of takaful, while Wakalah practices are favored for risk division/underwriting aspects of the operation.

### 3.13.1. Problems with Wakalah Model

Wakalah model has many issues from Islamic perspective;

Shariah scholars agree with the conceptual basis underlying the basic Wakalah model but they expressed some concerns also, which are;

- 1) Under this model the donation remains the property of the participants unless consumed, as they have the right to receive the surplus back and therefore it becomes a conditional gift. This feature in turn gives rise to issues such as inheritance and *Zakat*, in case of death of the person as the donation is a conditional gift. The relationship is between the participants and the operator and also among the participants (exchange of gift for gift). As such doubts are created about the contract becoming a contract of compensation.
- 2) Another problem with this model is, there are various generational matters. For example, contingency reserves may not be equitable between generations as the

<sup>113</sup> Rahim Abdul, Wahab Abdul, Hassan, M.Kabir, Paper on, Islamic Takaful, Business Models, Shariah Concerns, and Proposed solutions

operator is likely to hold higher proportionate reserves in early years for future contingencies. Since the participants keep changing on a regular basis, it leads to an intergenerational equity issue. In a pure pooling arrangement, one should be able to call on members to actually contribute more in the case of a deficit on a pro rata basis. This is not seen as practical in retail conventional insurance and therefore alternative solutions may need to be explored for takaful.<sup>114</sup>

- 3) Third issue is also generational arises from the *Qard Hassan* for deficits. This is an obligation on shareholders that would be returned by future generations and is different from those that may have given rise to the deficit, as the participants keep changing on a continuous basis. The *wakeel* should not be the guarantor of the participants he presents.

### 3.14.0. Waqf for the purpose of Insurance

Not only that we can utilize the institute of Waqf to achieve the objectives of insurance but also it can be very helpful and supportive in the remodeling of economic system on Islamic lines during the present times. Generally Waqf is taken to be a branch of personal law of Islam and limited, therefore to its religious activities. But the fact is that from the Golden time of Prophet (Peace be upon him) to the near past the institute of Waqf played a very vital and active role in economic, social, educational and cultural life of the Muslims. Before discussing the mutual link between the institution of Waqf and business of insurance it appears appropriate that the essential introduction of Waqf its fundamental laws and provision may be mentioned here.<sup>115</sup>

Literally Waqf means to withhold, to estop. But as a term it means to withhold some property for a noble purpose and to prevent others from its free use after bringing it out of the ownership of the owner. In this junction a slight juristic difference between Imam Abu

<sup>114</sup> Rahim Abdul, Wahab Abdul, Hassan, M.Kabir, Paper on, Islamic Takaful, Business Models, Shariah Concerns, and Proposed solutions

<sup>115</sup> Report on Islamic Insurance, Council of Islamic Ideology, Government of Pakistan Islamabad, pages 67, 68.

Hanifa and other jurists, this is merely theoretical. Abu Hanifa says The Waqf property does not out completely from the ownership of the owner, and ownership vested in original owner and he is free to end the Waqf property and take back his property. The other say including the most distinguish pupils of Imam Abu Hanifa differ with him. According to then the property passes out of the ownership of the owner on its endowment and its ownership goes to ALLAH. No one owns the property there after its position is like that of A Masjid which is attributed directly to ALLAH. This last opinion is always the foundation of religious verdicts and deduction of legal principles in Islamic law. However for if necessary for the implementation of the objectives and requirements of insurance business there is no harm in taking Abu Hanifa's views to the extent to which the aims of insurance demand.<sup>116</sup>

### 3.14. Wakalah-Waqf Model

The concerns related to the Wakalah model and the solutions to them that could be offered acceptable to Shariah scholars take the form of a Wakalah model with a separate legal entity of Waqf in between. A Waqf is a well recognised Shariah entity that has been in existence since the days of Prophet Peace be upon him. A Waqf may be set up as a separate Shariah entity that has the ability of accepting ownership or making someone the owner of any asset.<sup>117</sup>

The objective of Waqf fund is to provide relief to participants against defined losses as per the rules of the Waqf fund. Many examples of cash Waqf funds exist to give interest free loans or to handle monies given to manage where the returns may be used for social benefits. The fund may be managed on a conventional basis for a fee by a fund manager or an administrator appointed for this purpose. A conventional insurance contract is contract between two parties where there is an offer and acceptance, and therefore it is an *aqd-e-moawza*. The shareholders become the owner of the premiums against which they take on obligation to pay claims.

<sup>116</sup> Report on Islamic Insurance, Council of Islamic Ideology, Government of Pakistan Islamabad, pages 67, 68.

<sup>117</sup> Rahim Abdul, Wahab Abdul, Hassan, M.Kabir, Paper on, Islamic Takaful, Business Models, Shariah Concerns, and Proposed solutions

In Waqf, the donation becomes a part of the Waqf fund that becomes the owner and not the operator. With a typical Wakalah contract the donation or gift is not complete, as it is conditional on being used to pay claims, and there is an element of surplus that may come back to the participant. From Shariah point of view, proportionate ownership therefore remains with the participants to the extent of the funds utilised for claims. The shareholders will make a donation to establish a Waqf fund. The donation can be of any reasonable amount. After establishing Waqf fund the shareholders would lose their right ownership right on the fund. However they will have the right to administer and develop rules and regulations of the fund. The donation of Waqf fund requires to be invested in a very safe Shariah compliant investment and returns would be used for the benefit of the participants.<sup>118</sup>

The relationship of the participants and the operator is directly with the Waqf fund. The operator is the '*Wakeel*' of the fund and the participants pay contribution to the Waqf fund by way of *Tabarru*. The contributions received would also be a part of this fund and the pooled (combined) amount will be used for investment and the profits earned would again be deposited into the same fund which also eliminates the issue of *Gharar*. Losses to the participant are paid by the company from the same fund. Operational expenses that are incurred for providing Takaful services are also satisfied from the same fund.<sup>119</sup>

### 3.14.1 In Pakistan Wakalah-Waqf Model

While the Wakalah contract still applies between the Takaful Operator and the Takaful fund, Pakistan's Shariah scholars have raised certain issue with the accompanying Tabarru contributions which is considered as a conditional gift;

<sup>118</sup> Akhtar, Jamil, Muhammad Khan, chief executive officer, Pakistan Takaful limited, delivered lecture on "Takaful introduction and types"

<sup>119</sup> Ibid.



As a conditional gift, the contributors are specifically to be used to pay claims with any underwritings surplus still accruing to the *Tabarru* contributors, under this assumption there is a concern that the transaction has the characteristic of a contract of compensation. Under such conditions the underlying *Gharar* would have invalidated the transaction under Islamic Law. There is also the issue of the fairness of intergenerational subsidies between different generations of participants if such ownership links prevails.<sup>120</sup>

To avoid such doubts, the Shariah proposed the use of an Islamic Trust Fund, a Waqf. Under a Waqf any lingering ownership by the policyholders to the *Tabarru* contribution is legally detached (severed).

### 3.15. Challenges and Prospects of Islamic Insurance (Takaful)

Takaful is still unfamiliar (Alien) to some and vague to many people. Why such things happened to takaful industry has raised a lot of questions. Is takaful strategically positioned and strong enough to face the ever challenging financial environment? Are the marketing strategies presently adopted open enough to the general public? Are there constraints for non-Muslims to participate? Is the government commitment and political will together with legal framework effective enough for takaful industry to grow even more? Is takaful industry lack of calibre human capital and technical expertise so that they can compete effectively with conventional insurance? In this section we will examine some of the challenges that have to be faced by takaful operators.<sup>121</sup>

#### 3.15.1 Shariah acceptability

A related factor is the poor reputation of insurance among many Muslims. For generations, Muslims around the world have grown up with the doubt (suspicion) that insurance (life insurance especially) contravenes basic Islamic doctrine. Objections have

<sup>120</sup> Akhtar, Jamil, Muhammad Khan, chief executive officer, Pakistan Takaful limited, delivered lecture on "Takaful introduction and types

<sup>121</sup> Murtaza, Muhammad, kazi, the future of takaful business and its challenges, paper, January, 5, 2010.

been raised on the ground that taking out a family *takaful* policy is against *tawakkal*. The Shariah Control Board of the Faisal Islamic Bank in Sudan for example, thinks that insurance should be prohibited due to its innate (inherent) elements: a wagering contract of which the consequences are unidentified (unknown). Such a contract would possess the prohibited elements of uncertainty of outcome (*Gharar*) and gambling (*Maysir*), and is frowned (disapproved) upon by the Shariah law. However, as jurists have pointed out, they may seem to forget the Prophet Muhammad (peace be upon him)'s famous Hadith: "tie your camel, and then depend on ALLAH". Taking precautions in future planning for one's life is not against *tawakkal* but, on the contrary, is a perquisite, because it is a financial transaction for protecting widows, orphans and other dependants, rather than leaving them needy and having to ask others for help.

### 3.15.2 Supporting structures

A number of conditions need to be put in place to facilitate the development of *takaful* business. These include an organized regulatory and legal framework that emphasizes transparency and consumer protection, consistent (uniform) accounting standards and a higher degree of consensus on the interpretation of Shariah principles in the context of *takaful* operations. A few countries have special laws governing *takaful*, for example Malaysia has enacted *Takaful Act 1984* to provide procedure for the registration of *takaful* providers and to establish the conditions under which they operate. Although having a special *takaful* law seems appealing and appropriate, other Muslim countries have not followed Malaysia's lead. On the other hand, Bahrain does not have a specific *takaful* law, but the Bahrain Central Bank (formerly The Bahrain Monetary Agency) has introduced special regulations for *takaful* regulation. Bahrain can be regarded as an example of a light regulatory environment; the rules are specific where it matters, especially with regard to the disclosure of information to the policyholders. In some respects, the regulations in Bahrain are more developed than those in Malaysia, despite the latter having a long-established *takaful* law.<sup>122</sup>

<sup>122</sup> Murtaza, Muhammad, kazi, The future of *takaful* business and its challenges, paper, January, 5, 2010.

For the Mudharaba based takaful operator, their Shariah Supervisory Board should (persist) insist on a high level of transparency and accountability in the interests of policyholders because the policyholders certainly want to know where the takaful fund is invested and the (degree) extent of financial reporting on this. The takaful management company will need to have its own accounts audited, as this is a regulatory requirement in all jurisdictions. However, the primary purpose of the financial statements is to report to the shareholders, not the policyholders. Therefore takaful operators should have good corporate governance in order to induce confidence of public to them and to manage conflict of interest issues effectively.

### 3.15.3 Reward structure

A related factor is the reward structure to either Mudharaba based or Wakalah based takaful operators. This needs to be structured carefully to ensure suitable (appropriate) incentives and risk-sharing from the Shariah viewpoint. Most operators adopt Mudharaba approach, but at present there are some issues in regard to the approach: whether the mudharib or entrepreneur can deduct (subtract) operational expenses prior to the distribution of the surplus. Greater harmonization on the reward structure may aid to the industry development<sup>123</sup>.

### 3.15.4 Investment avenues

One of the other difficulties facing takaful operators is finding Riba-free investments. For conventional insurance companies, they hold significant proportion of their assets in bonds or floating rate notes, which in many respects are well suited to their needs, as the maturity value is known, the only risk being of default. They also have the availability to match the length to maturity of their assets with their (estimated) anticipated payments obligations<sup>124</sup>. The problem for takaful companies is that they cannot hold conventional bonds or notes due to *Riba* elements. Avenues of investment must be in accordance with

<sup>123</sup> Murtaza, Muhammad, kazi. The future of takaful business and its challenges, paper, January, 5, 2010.

<sup>124</sup> Ibid

Shariah principles and these can be limited. Widening the range of investment instruments and products that are Shariah acceptable remains a high priority, particularly in the area of Islamic project finance and infrastructure financing so important for Muslim countries. In Malaysia, the substitution of Sukuk for bonds and notes is not a problem. The position in the Gulf is very different, with relatively few Sukuk available until recently.

### 3.15.5. Competition

Another challenge for takaful operator is that they compete on a universal basis (Global basis) with conventional international insurance companies. The advantage they (conventional insurance) have would be the huge resources that they have and their brand strength that provides assurance to potential clients. The fact that they have been developed around the world for so many years, gives them the capacity (ability) to influence millions of customers worldwide with variety of products to sell. On the contrary, takaful players' lack of competence can be seen in the area of underwriting skills, quantitative analysis and also in developing the products. In order for takaful operators to optimize their capability and to be more competitive than its conventional counterparts, they must make a change through scientific approach. They also must emphasize on the qualitative factors apart from quantitative factors. One of the ways to achieve this is through learning from conventional insurers about its methods and operations. The system and procedure used in the process of takaful also need to be developed to ensure the smooth running of the operation<sup>125</sup>.

This includes processes and procedures that are in accordance with Shariah principles, integration of the IT system and the operator turnaround. Again, the smooth running of systems and operations can be benchmarked to the conventional counterparts. As mentioned above, the insurance companies have been here for so many years proved that they have achieved operational consistencies. Thus, takaful operators may put some studies on these operational issues. As a conclusion, the takaful operators' challenges in system and process challenges can be met with greater knowledge of its procedure and process from its conventional counterparts. Besides that, the operators must prepare themselves to achieve

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<sup>125</sup> Murtaza, Muhammad, kazi, the future of takaful business and its challenges, paper, January, 5, 2010.

higher financial strength, intense political will and greater cooperation with others. In fact, takaful operators may develop strategic alliances with conventional insurance counterparts in order to be at par, if not better than them.

### **3.15.6. Mutuality**

Islamic insurance is based on the principle of mutuality, in that members are both the insured and insurers themselves. The members themselves share all the losses and thus no transfer of risk involved. Unfortunately, some of the jurists have opined that most of the takaful companies established in Muslim countries are in fact similar in ownership structure to stock or proprietary insurance companies. This perception (view) may limit the acceptability of the concept of takaful in the Islamic community. Certainly, a mutual insurance company that invested its funds in Islamically acceptable ways would satisfy all of the conditions laid down by jurists as a valid alternative to conventional insurance<sup>126</sup>.

### **3.15.7. Human capital and technical expertise**

The lack of human resources dedicated to takaful is one of the major weaknesses of the industry. This is visible especially in the Middle East and North African region because of the recent development of takaful. The backgrounds of underwriting, accounting and marketing staff are in conventional insurance. Apart from lack of technical competence, shortage in Shariah competence also causes setbacks to the takaful industry. This tends to negatively affect their ability to develop an appropriate takaful profile needed for better service to the clients. The takaful industry must develop proper educational tools to ensure professionals within the industry are able to fully develop and market takaful products and the concept of takaful. Only then can differentiation develop within the industry. In addition, most Shariah advisors lack of operational knowledge and this results in the inability to develop the takaful industry to its full potentials. One of temporary solution would be to hire

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<sup>126</sup> Murtaza, Muhammad, kazi, The future of takaful business and its challenges, paper, January, 5, 2010.

staff with experience and skills in takaful for retakaful operators.<sup>127</sup> The skills required are in the area of underwriting and qualitative skills. In addition, more qualified staff with insurance background is still necessary. For investment department, there should be continuous training program to existing and new staff. Continuous training programs can upgrade their skills and update them with the current knowledge on the Shariah compliant investment avenues. In this connection, Malaysia (Pakistan to some extent) has taken initiative to establish the International Centre for Education in Islamic Finance (INCEIF) to nurture Islamic finance professionals and experts in order to address the human capital needs either in banking or takaful industry.

### 3.16.0. The Future Prospects of Takaful

Currently, there are about sixty "takaful" operators world-wide. During last twenty years Islamic Insurance (takaful) has developed mainly in Sudan, Saudi Arabia, Iran, Malaysia, Pakistan, Brunei, Indonesia, Singapore, Bahrain, Bangladesh, Bahamas, Belgium, Switzerland, and in the USA. On the other hand, there are at present 45 countries, in the world having some form of Islamic banking operations. Interestingly takaful is seen in the non-Muslim world as well. For example, in Singapore there are less than half a million (15% of total population) Muslims but at least two operators are now providing takaful scheme in Singapore. In non-Muslim countries, the scheme is also expected to grow if the operators can prove their worth in comparison to conventional insurance products. In Muslim countries, Malaysia seems to be the single most successful country in terms of takaful. In Singapore, about 22% of the present takaful policy holders are non-Muslims. Most of Islamic countries suffer from the common attitude that insurance is undesirable. There is mass non-awareness among the Muslim about risk management and insurance not to speak about takaful<sup>128</sup>.

In most of the Muslim dominated countries of the world insurance still accounts for less than only one percent of the country's G.D.P. However various surveys have shown that

<sup>127</sup> Murtaza, Muhammad, kazi, The future of takaful business and its challenges, paper, January, 5, 2010.

<sup>128</sup> Ibid.

life and general insurance market has large potential to be exploited in Muslim countries, and in countries where Muslim are at-least 10% to 15% of total population.<sup>129</sup> Takaful is likely to grow along with the conventional insurance schemes. But this is only when this new form of insurance should provide at least equal and better value, as compared to the existing conventional insurance policies. A dramatic rise in the demand for Takaful Insurance is being predicted by market observers, as the population of Islamic countries becomes more financially sophisticated and more determined to invest in Shariah compliant products. Moreover, due to the ethical nature of the products Takaful ought to be attractive to both Muslim and non-Muslims. It is obvious that the potential demand for Takaful products is very large and the Takaful Industry is now poised for a Global take off.

The Global Takaful Industry is small in comparison to Conventional Insurance counterpart. Therefore, the market needs to gain worldwide brand recognition and exceed performance standard set by the Conventional Insurance Industry<sup>130</sup>. It is nice to note that takaful operators are increasingly starting to understand that the ethical guidelines and transparency of their products underpin their offering appeal to both the Muslims and more importantly the larger non-Muslims communities. The Takaful Industry is fast evolving and entering a stable development phase. However, only a few National Regulators have enacted a Takaful framework for the industry. Malaysia and Bahrain are leading examples of having progressive Takaful Regulation. Recently, Saudi Arabia & Pakistan have also established Regulatory Framework for Takaful business<sup>131</sup>.

<sup>129</sup> Murtaza, Muhammad, kazi, The future of takaful business and its challenges, paper, January, 5, 2010.

<sup>130</sup> Ibid.

<sup>131</sup> Ibid.

### 3.17.0. Conclusion of the research

We have discussed Insurance and its demerits from Shariah point of view, we have mentioned the views of different scholars about its legality and non legality, and there is no doubt about the conventional insurance that it is totally against the injunctions of Shariah, although the followers of the conventional insurance system provide justifications to make it legal but the Islamic scholars have provided solid proofs to declare it illegal it can be legalized if we follow Islamic insurance system i.e. which is Takaful. Islamic insurance which is known as Takaful can be an alternative to insurance, because we can avoid those elements which render the conventional insurance illegal in the eyes of Shariah i.e. Elements of *Riba*, *Maysir* and *Gharar*, which is found in the contract of insurance and make it illegal islamically, morally and economically.

Conventional insurance is totally prohibited in Shariah because of *Riba*, *Maysir* and *Gharar*, Islamic scholars have introduced the concept of Takaful as we mentioned above, which is based on Co-operation (*Ta'awan*) and is considered to be a substitute of conventional insurance. The reason why Takaful is considered to be an alternative to conventional insurance is that, in Takaful system those elements (*Riba*, *Maysir* and *Gharar*) which render conventional insurance void and illegal from Shariah perspective can be avoided through Mudharaba and Musharaka. These two modes of Islamic finance are recognized by Shariah and also can eliminate the elements of *Riba* and other elements of conventional insurance.

Mudharaba is defined as the contract between one party, known as the capital provider (*rabul mal*), with another party known as the *mudharib* (entrepreneur) where the *rabul mal* provides the capital, and the *mudharib* provides the skills in a business enterprise. When there is revenue (profit), it is shared between the *rabul mal* and the *mudharib* in a pre-agreed way.

Mudharaba can be used in takaful scheme through Mudharaba model in this case, the takaful operator is the *mudharib*, and the participants are the capital providers. The pure Mudharaba



model conforms to this definition and is practiced mainly in the Asia-Pacific region. In this Mudharaba model, the Shariah committee generally approves the sharing proportion (ratio) for each year in advance. Generally, these risk-sharing arrangements allow the takaful operator to share in the underwriting results from operations, as well as the favorable performance returns on invested premiums.

If we follow those modes of finance which are recognized by Shariah we can manage Insurance system under the new tag of Takaful (Islamic insurance) as we mentioned one of the modes of finance i.e. Mudharaba is recognized by Shariah and can be used in takaful system to produce Riba free scheme to the people which can be followed across the world by the Muslims specially and others in general. In the light of these we can say that Takaful can be considered as an alternative of conventional Insurance.

The takaful system is still in the process of evolving, with a number of issues raised by various Shariah scholars. It is therefore desirable to encourage a process of discussion and advance alternative approaches with ideas that may come from anywhere around the world. The ultimate aim is to have a consensus takaful model addressing as many current as well as in future legal concerns as possible. Such a process seems to be a logical way to move forward and ensure that the takaful at some stage is governed by a uniform consensus based model. At global level, two basic models of takaful are currently in operation.

The Mudharaba model as long as the operator benefits only by sharing in investment returns of the funds. However this model has some reservation regarding underwriting surplus therefore most of the operators now adopt the Wakalah model. This model has much wider acceptance and is most suited to risk contracts, some Shariah concerns in a typical Wakalah model has been identified therefore a third model has been introduced Wakalah with Waqf fund. In this suggested approach the Shariah concerns relating to the Wakalah model are addressed creating a separate entity in between the participants and takaful company.

This alternative framework is offered here in the hope that the industry practitioners will consider with their Shariah advisors whether this proposed model better addresses the

concerns raised about the Wakalah system and whether the modifications are suitable in their setup and can contribute to the growth of the takaful industry.

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