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Towards a Better Model

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Abstract

Conventional (commercial) insurance involves an intolerable magnitude of gharar (uncertainty), and hence its prohibition in Shariah. In order to Islamize insurance, it needs to be reconstructed on different basis so that the inherent uncertainty associated with the concept of insurance will not invalidate its contracts. This is thought to be doable only if the commutative nature (mu'awada) of insurance is converted into donation (tabarru'); deeming the contributions of the policy holders as mutual donations, with the Takaful company being only responsible for the administration of the Takaful fund as well as the Takaful operations. Nevertheless, the existing Takaful structures, which supposedly adopt the said methodology, still have unresolved Fiqh issues. These issues pertain to the underlying concept of Takaful being genuinely of donation nature and also to the applications and practices of Takaful being capable of substantially ascertaining their differences from those of the conventional insurance. The paper comes to scrutinize the existing Takaful structures and highlight their shortcomings in an attempt to outline a new sound model, with a special emphasis on its practicalities and applications.

Keywords: Takaful, Gharar, Donation, Surplus, Ibaha.

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Introduction

Commercail insurance is a business with profit-maximization objective. Profit materializes when there is an underwriting Surplus, i.e. when the total premiums exceed the total claims. However, the total claims amount is left to uncontrollable and unmanageable factors, which renders the outcome of this business similar to gambling. If no loss occurs, the insurer pays nothing against the premium already paid by the policy holder, but if loss occurs the policy holder receives much larger payment compared with the small premium he has paid to the insurer. This uncertainty in insurance is called in Shariah terms "*gharar*", and *gharar*, when excessive, is prohibited in financial dealings and it leads to their invalidity. Although Shariah tolerates the minor *gharar*, the type of *gharar* involved in the commercial insurance is excessive and consequently, conventional insurance is banned by Shariah. The issue of what constitutes a major *gharar* is not free from debate in Fiqh literature, but the amount of *gharar* involved in insurance is beyond dispute, since it is big enough to render the insurance contract a gambling contract.

Takaful, as a Shariah-compliant alternative to conventional insurance[1], is not free from *gharar* either, but it is claimed that Takaful is based on the concept of donation, and *gharar*, big or small, does not invalidate contracts of *tabarru'* (donation). The second part of the claim is true, as it is commonly held in Shariah that *gharar* is tolerated in contracts of donations[2], but the claim that Takaful is based on donation is debatable from different aspects.

First, donation (*tabarru'*) implies that the thing donated cannot return, in whole or part, to the donor. Once one donates something it departs one's ownership and becomes the property of the beneficiary. However, the donor in Takaful will practically get his donation back when the loss befalls him, since he gets an unallocated amount from the Takaful fund.

Second, the intention of the participants is not practically that of donation. In fact, all policy holders contribute their premiums only to cover themselves, and they have no intention whatsoever of donating their premiums to any party.

Third, a donation is not a donation if it is in exchange of another donation, like "I donate to you if you donate to me", and this is the case with the existing models of Takaful where we have mutual commitments of donations; one from the policy holders and the other from the Takaful fund.

For the said reasons and some others, constructing Takaful on the notion of *tabarru'* harbors some controversies on which this paper elaborates in an attempt to set the outlines of what constitute a controversy-free Takaful model.

Concept and Structure of Takaful

Takaful, or Islamic Insurance, can be defined as a kind of cooperative insurance, which covers different types of risks, under the management of a specialized company that adheres to the rules and principles of Shariah.

In Takaful the participants (policy holders) contribute their premiums to a fund (the Takaful fund) to be managed and administered by the Takaful operator. The Takaful operator managing the fund is normally a joint stock company responsible for managing the Takaful operations as well as investing the assets of the fund against fees. The resources of this fund are used to indemnify any participant who suffers from the loss insured against. To sum up, the Takaful company does the following:

- Managing the Takaful (insurance) operations.
- Investing the assets of the fund.

Unlike in conventional insurance, the operator in Takaful does not own the fund, but rather it is entrusted with the job of administering it for the benefit of the participants. If the operator does not own the fund, then it does not own the surplus of the fund either, and it should dispose it according to the agreement with the policy holders. However, the Takaful operator in return of its administration of the Takaful operations and fund receives fees that can be determined upfront and hence the profit. On the other hand, the Takaful operator, being a mere agent, is not responsible for any shortfall in the fund; if the compensations exceed the premiums then it is not the responsibility of the operator to cover the fiscal deficit. In this case, the operator can demand further contributions from the participants or terminate the policies.

This is the structure of Takaful in brief, but although the above summary sounds simple and straightforward it contains many debatable Shariah issues to the extent that they may jeopardize the very legitimacy of Takaful if not resolved correctly. All issues will be discussed in this paper.

The Advantages of Takaful in Comparison with the Conventional Insurance

To the Takaful operator, the profit return of the Takaful business is guaranteed since the fees can be determined upfront, so the operator does not need to worry about the risk of not making profit let alone undergoing a loss. However, on the other hand, the operator may make more profit under conventional insurance if he was fortunate enough to be demanded less claims.
To the policy holders, Takaful grants them the chance of getting refunded some of their premiums at the end of the year through redistribution of the surplus. However, on the other hand, the operators is not responsible towards the policy holders for any deficit in the Takaful fund, which is not the case with the conventional insurance where the operator is committed to cover all claims despite the deficit.

Thus, each type of insurance has its advantages and disadvantages to its parties but Takaful remains in the final analysis more consistent with the norms of justice to all parties.

Shariah Analysis of Insurance

The following discussions highlight the Shariah issues in the insurance business in general for the objective of building a proper understanding of the Shariah principles governing insurance and then identifying the elements that need to be worked on to structure a sound Takaful model.

Insurance and Gharar

INSURANCE INVOLVES GAMBLING

Gharar, which is uncertainty in contract whether in its very execution or in any of its elements, is prohibited in Islam for a variety of reasons; it may cause dispute between the contracting parties and may lead to unjust enrichment of one contracting party at the expense of the other. Gambling is an obvious application and example of *gharar*; the winner in a gambling game seizes the other players' money in a game of luck. When trying his luck, the gambler pays an amount of money in exchange of an uncertain value. He may win and he may lose, so he may get the counter value he has put his money on or he may not. This is an intolerable uncertainty that invalidates contracts from Shariah perspective, not to mention the zero-sum-game nature of gambling where the gain of one is the loss of others. Undoubtedly, the concept of insurance in general, be it Islamic or conventional, is of the same nature of gambling; a group of people each contributs money against uncertain value, i.e. the compensation. The insurer, on the other hand, exchanges the premium against excessively uncertain counter value, i.e. the surplus. Although the compensation amount might be certain in some kinds of insurance but the very payment of the compensation remains probable and uncertain.[3] In fact, uncertainty is inherent in insurance in general, but it may be in the amount of the compensation, its very payment or the time of its payment. The only difference, however, between gambling and insurance is in the objective of the participants, in gambling it is basically enrichment while in insurance it is the protection against a possible loss.

THE GHARAR INVOLVED IN INSURANCE IS MAJOR

Shariah tolerates *gharar* in contracts as long as it is minor, like in selling one of two commodities without specifying which one exactly in the contract so long as the differences in their features is inconsequential and has no impact on the price, or when the asset is agreed to be delivered in the future during a short range of time without specifying an exact date. Another21
q2q1 obvious example of the minor *gharar* is in buying a buffet dinner; the amount of food customers/ may consume differs from one customer to anoth qnhdety8er, but yet the price payable by all customers is the same. Minor *gharar* is tolerated because it normally does not lead, as per commercial custom, to a dispute between the contracting parties, and because it has no relevance to gambling. However, unlike the minor gharar, major *gharar* invalidates contracts for it amounts to gambling as in selling of unknown contents of a sealed box or in buying a commodity with an identified price, like whatever is in buyer's wallet. It may also lead to dispute between the contracting parties due to the uncertaintly of some of the contract elements. Obviously, insurance harbors major *gharar* due to its relevance to gambling and the major uncertainty involved therein as described above.[4]

GHARAR IS TOLERATED IN CONTRACTS OF DONATION NATURE

It is one of the established Shariah rules, though not unanimously agreed upon, that *gharar* does not invalidate contracts of donations.[5] This is because contracts of donations do not involve exchange of counter values as one being the price of the other and therefore, the *gharar* that may be involved in donations does not normally cause dispute or potentially result in unjust appropriation of wealth. What the beneficiary obtains in these contracts comes free of charge leaving thus no room for dispute or exploitation.

RULES OF DONATIONS

In order for an act to be truly characterized as *tabarru'* some conditions need to be observed:

First, the intention of the giver must be *tabarru'*, i.e. commanding no request of a counter value. In fact, it is for this reason that some schools of Islamic law judge the gift on condition of reward as a sale contract. This is reflected in the Fiqh maxim "Contracts are judged by their essence and purposes, not by their form or structure" (العبرة في العقود للمقاصد والمعاني لا للألفاظ والمباني). [6]

Second, the donor cannot claim back what he has donated; if the donation was made on condition that he would be given the right to claim back his donation or part thereof, then this is not a real donation.[7]

Third, the donor cannot restrict the beneficiary in the way he uses or disposes of the donation, because once something has been donated it becomes the property of the beneficiary and consequently, he has the right to use it or dispose it as he may wish. [8]

The above rules of donation are of a special importance for judging the Takaful models which are said to be built on the basis of donation. If any donation-based Takaful fails to fulfill these rules then its basis is void.

Analysis of the Donation-Based Takaful Model

Most of the existing Takaful companies mention *donation* as basis for their structure following the model outlined in the AAOIFI Takaful standard. The following is a critical analysis of this structure.

The Contractual Relationships

There are three contractual relationships in the donation-based Takaful as per AAOIFI:

a) *Musharaka* (partnership) among the contributors to the fund.

b) *Wakala* (agency) between the company and the policy holders' fund for managing the Takaful fund and investing its assets against fixed fees. Investing the fund's assets, however, can be achieved through *Mudaraba* instead of *Wakala* according to AAOIFI.

c) Donation relationship between the policy holders and the fund which takes the form of donation commitment at the stage of making contributions, and indemnification commitment at the stage of providing compensation for injury as per regulations.

CRITICAL OBSERVATIONS ON THE CONTRACTUAL RELATIONSHIPS

- One can easily notice that this characterization of the contractual relationships in Takaful evades admitting any contractual relationship between the policy holders and the operating company, which is absurd. To the proponents of the *tabarru'* model, the participants cannot contract with the operating company because their conduct is of a donation nature, which has nothing to do with a commutative (*mu'awada*) contract like *Wakala* or *Mudaraba*. Once participants have made their donations, they lose all rights and control over their donations and therefore the Takaful operator needs to contract other party to manage the fund, and to the AAOIFI standard this party is the fund itself, which is really absurd. The fund practically does not have any legal entity here; it is not registered as legal entity so that it can contract with others or admit legal action taken against it in case of litigations. In fact giving it an independent character is purely hypothetical and is only meant to theoretically validate what would otherwise be invalid from Shariah point of view. Besides, the fund is controlled and administered by the operating company so the company will be effectively contracting with itself in *Wakala* or *Mudaraba* or in best scenario combining between two conflicting contractual capacities; a case which is not accepted in Shariah due to the occurrence of conflict of interests. [9]
- Unlike in any legal entity, there is no one in this described structure to stand for the fund's rights against the operating company, nor is there one to stand against the fund in fulfillment of its obligations, while legal entities have either shareholders, societies or the government, as in case of charities like *Waqf*, to stand for their rights and obligations. And since the fund manager (the company) benefits from the surplus via an incentive clause as in most Takaful structures, then it tends not to act in the interest of the participants when it comes to payment of the compensations, which renders the fund nondependent in its relationship with the participants, causes disputes and creates conflict of interests.
- *Gharar* in Shariah is tolerated in donations because its existence therein does not cause any harm to the beneficiaries. If one makes his donation conditional on an uncertain event like the occurrence of an accident, or he initiates a statement to the donation of an unknown amount of money, no harm will either way befall the beneficiary, because whatever donated is a bonus that comes free of charge. If this is the case, then characterizing the fund's commitment to pay compensations to the participants as a commitment to donation is invalid, because, unlike in the true donations, nonpayment of the compensation will inflict considerable harm upon the participants, for they have paid the premium only in expectation of receiving the compensation when needed. Thus, the *gharar* inherent in the payment of the compensations cannot be tolerated because these compensations cannot be regarded as donations in the first place.
- The indemnification commitment on the part of the fund towards the participants brings in the *Mu'awada* element which invalidates the structure, because a commitment to give

donation against a counter commitment to do the same is nothing but *Mu'awada*, and if this is the case then the resulting *gharar* would invalidate it as highlighted earlier.

- Finally, the characterization of any contract should always be reflective of the reality of this contract and the purpose of the contractors, and one cannot dictate a certain intention on the contractors then judge the contract accordingly just to invalidate what would otherwise be invalid. In fact, *tabarru'* is odd and irrelevant to the real intentions of the participants, so to dictate upon them such intention functions against the very objective of contracts in general- which is to translate intended purposes into deeds - and therefore it cannot be accepted. Furthermore, it is a common practice of Takaful institutions, similar to conventional insurance, that if a policy holder cancels his subscription he will be refunded an amount of his premium proportionate to the remaining policy period. In fact, this very action of matching the premium with policy period is a practical evidence for the reality of the premium being far from *tabarru'*, because if it was a donation then the policy holder would not be entitled to any refund in case of cancellation of policy.

THE CORE STRUCTURAL PROBLEM OF THE DONATION-BASED TAKAFUL MODEL

The main problem with the existing structure of Takaful lies basically with the legal characterization of the entity of the Takaful fund and its relationship with the participants. According to the dominant structure, which is based on AAOIFI standards, the participant commits him/herself to donate an amount (the premium) to the Takaful fund on condition that the fund in return undertakes to compensate the donor for specified losses.

This characterization of the relationship between the fund and the participants seems to be problematic from Shariah point of view. It is an agreement between the policy holders and the fund which takes the form of donation commitment at the stage of making contributions, and indemnification commitment at the stage of providing compensation for injury or loss. (AAOIFI Standards, No 26, Clause 4). The problem with this arrangement is that it results in bilateral obligations analogous to commercial contracts in which *gharar* is not permitted as explained earlier. In fact, establishing Takaful on *tabarru'* was intended to avoid the effect of gharar, but with this arrangement *gharar* will continue to invalidate the agreement since the agreement boils down to a commercial contract where two counter values are exchanged on *Mu'awada* basis: the premiums and the compensations. This is because Shariah judges contracts by its essence and spirit, not form and apparent structure, and the essence of this agreement is *Mu'awada* (mutual compensation) rather than *tabarru'*, and consequently the inherent *gharar* would render this Takaful structure invalid.

The Waqf-Based Takaful Model

The foregoing discussion shows that in order for the Shariah scholars to Islamize the notion of insurance, they had to strip it down then build it on *tabarru'* basis in order to prevent the *gharar* inherent in insurance contracts in general from invalidating the Takaful contracts, but this led to another caution which was the legal justification of the participants' right to the compensations. This was thought to be solved by giving the fund a legal capacity to accept the donations and give counter commitment to donations, but this did not solve the problem because the opposite commitments between the participants and the fund was effectively *Mu'awada*.

The *Waqf*-based Takaful model is an attempt to avoid the suspicion of *Mu'awada* resulting from the mutual commitments to donation between the Takaful fund and the policy holders. The concept and mechanism are as follows:

- The Takaful company establishes and independent *Waqf* fund by contributing part of its cash capital to this fund whereby the beneficiaries are the potential Takaful policy holders. The issue of establishing cash as Waqf should not raise a Shariah concern even though cash is consumable and *Waqf* is supposed to be permanent, because cash *Waqf* was accepted by some Fiqh schools,[10] and the same opinion was also adopted by AAOIFI standard on Waqf. (AAOIFI Standards, No 33, Clause 3/3/4/3). However, in case of cash *Waqf* the cash has to be invested and only its proceeds can be given to the beneficiaries; alternatively, the cash can be lent to the beneficiaries to be later paid back by them.
- The participants pay their premiums as donations to the *Waqf* fund and not as cash *Waqf*, and donating the *Waqf* should also not raise a Shariah concern because there are some *Fatawa* (Shariah legal opinions by scholars) in the classical literature of Islamic law allowing donation of cash to the *Waqf*, like donating Mosques some cash money to be spent in their maintenance.[11] The reason, however, to consider the premiums as donations to the *Waqf* and not as cash *Waqf* is to validate payment of the compensations from these donations, because what is *Waqf* cannot be donated since *Waqf* is supposed to be permanent, while the proceeds from investing the cash *Waqf* will not be enough to cover the compensations.
- The Takaful operator manages the *Waqf* fund (the Takaful fund) with respect to the Takaful operations on *Wakala* basis, and invests the fund's cash on *Wakala* or *Mudaraba* basis.
- Being the beneficiaries of the *Waqf* fund, the policy holders receive upon the occurrence of loss the compensations from the *Waqf* fund.

Apparently, *Waqf*-based Takaful model solves the problem of *Mu'awada* resulting from the mutual commitments to donation, because the policy holders are the beneficiaries of the fund so they are naturally entitled to its wealth and therefore, there is no need to obtain from the Takaful fund a counter commitment to donation to the policy holders.

This is simply the basic structure of the *Waqf*-based Takaful, and it is worth noting that some Takaful institutions were established on this basis, like TAKAFUL SA in South Africa.[12]

Critical Review of the Waqf-Based Takaful Model

Apart from the discourse on whether the structure of this model meets the objectives of the participants as well as the Takaful operators, it is obvious that the structure of this model overlooks one important point which relates to the policy holders getting their donations back through receipt of the compensations. Although the policy holders appear to be the beneficiaries of the *Waqf* fund but here they are donating money and then getting the donations back. *AbuGhudda*, a proponent of this model, attempts to refute this argument by claiming that "*what the participants get of compensations is not in exchange of their donations but rather an* *independent payment from the Waqf fund for they are the beneficiaries of this fund, and the Waqif (the founder of the Waqf) himself may become a beneficiary, while the compensations received are not in exchange of the Waqf they made*" (*AbuGhudda*, *Waqf*-based Takaful as substitute to the donation-based Takaful, p.10).

As a matter of fact, this argument is not in line with the very structure of the *Waqf* model, because the policy holders are not among the *Waqf* founders but rather donors to the *Waqf* as the same writer proclaims elsewhere "*The Waqf-based Takaful uses the principle of donating to the Waqf rather than paying the premium as Waqf*" (*AbuGhudda*, p.7). Considering the premiums as donations and not as cash Waqf is necessitated by the fact that what is *Waqf* is supposed to be permanent so deeming the premiums as *Waqf* then repaying the same as compensations will result in draining the *Waqf,* because regardless of how much profit these premiums can make in investment they fall short to cover the Takaful compensations.

Thus, the premiums have to be treated as donations and not as *Waqf*, otherwise they cannot be spent in payment of the compensations, and if this is the case then the policy holders will be getting back their donations, which breaches the rules of donations as detailed earlier. Besides, if what the policy holders receive does not effectively emanates from their capacity as *Waqf* beneficiaries, then what they get is a counter value in exchange of their contributions, and this triggers *Mu'awada* and thus renders this Takaful structure invalid due to the presence of *gharar*, which dominates the core of any insurance business. Therefore, the *Waqf*-based Takaful fails to offer a real solution to the *Mu'awada* problem as it reverts back to the same problematic point of the *tabarru'* model.

The Proposed Model for Takaful

The Structure and the Contractual Relationships

The past discussions show that the structures of the existing Takaful models have some unresolved Shariah issues and most importantly, they imply *Mu'awada* so that the *gharar* inherent in insurance business in general may invalidate them like it does to any other commercial contract.

What adds to the unacceptability of the aforementioned models is the intention of the participants being far from giving donations.

Thus, in order for any proposed structure to be valid it must not be of a commutative nature so that the inherent *gharar* in Takaful will not invalidate its contracts. Besides, it must be in line with the real intention and objective of the participants.

The alternative model this paper proposes is to construct Takaful on what is called in Fiqh terminology "*Ibaha".* With *Ibaha* one puts at the disposal of others something consumable and allows them to consume it. He, however, remains its owner so the leftover, if any, belongs to him. A simple example of *Ibaha* is in the practice of offering guests food or drinks by the host. By offering the food, the host permits his guest to eat it; however, doing so does not entail transferring the ownership of the food from the host to the guest, but rather the host remains its owner and has the right to take it away, share it with the guest and keep the leftover. Although *Ibaha* has some similarity with donation, it is still significantly different since the object of *Ibaha* remains the property of the *Mubih* (the doer of *Ibaha*), unlike donation where the donated object becomes no longer the property of the donor. This difference is of a particular importance if to apply *Ibaha* to Takaful as the participants will remain then the owners of the Takaful fund and so have access to the compensations without the need to justify it through a counter commitment from the fund and consequently, the arrangement remains beyond the scope of *Mu'awada*.

Hence, if the contributions made by the participants are constructed on *Ibaha* basis all Shariah legal problem of Takaful will be solved. The inherent *gharar* will not invalidate its contracts, the participants will remain the owners of the fund and the surplus will specifically belong to them.

Now in order for this arrangement to be sound and acceptable, three points need to be ascertained.

First, whether *ibaha* is similar to donation in its capability of neutralizing the effect of *gharar* on contracts like normal donation does.

Second, whether the reciprocal commitments of the participants to offer their contributions on *Ibaha* basis render the arrangement of a *Mu'awada* nature and consequently the inherent *gharar* invalidates it.

Third, whether the object given on *Ibaha* basis enters the ownership of the party to whom the *Ibaha* is made. This is because if it enters his ownership then the giver (participant) may not get what it gave and so cannot benefit from the compensation unless through a counter commitment, which again brings in the *Mu'awada* element.

To address the first point, it was reported by al-*Bukhari* that *Nihd*, which is the practice of *Ibaha* in travel whereby travelers contribute their foods on the start of the journey and share them together till the end of the journey as *Ibn Hajar* explained in his explanatory work on *Sahih al-Bukhari* [13], was commonly practiced by Muslims and it received no Shariah objection by the scholars.[14] This report shows that although *Nihd* involves *gharar* emerging from the unequal contribution and unequal consumption of food, it was accepted due to the purpose behind it being that of mutual cooperation. *Al-'ini* says: "Nothing wrong with it (*Nihd*), for it is based on *Ibaha* and meant for mutual cooperation". (*Al-'ini*, *Umdat al-Qari* 19/371)

With respect to the second point, it can be again said that the very permissibility of *Nihd*, as stated by *al-Bukhari, Ibn Hajra and Al-'ini* is clear evidence that the reciprocal *Ibaha* commitments of the participants do not render the agreement *Mu'awada*.

To address the Third point, *Al-'ini* in his explanatory work on *Sahih al-Bukhari* very clearly mentions that *Ibaha* does not involve transfer of ownership "This action (*Nihd*) cannot be regarded as donation, for donation involves transfer of ownership while this (*Nihd*) is *Ibaha* and *Ibaha* does not involve transfer of ownership". (Al-'ini 19/371)

However, to ensure that *Ibaha* in Takaful does not involve transfer of title and so avoid the occurrence of *Mu'awada*, the Takaful surplus must remain the property of the participants as discussed below.

The Insurance Surplus

The surplus can be defined as "the residual premiums of the participants in addition to the reserves and profits, after deducting all expenses and indemnity amounts" (AAOIFI Standards, No 26, P.488 Appendix c: Definitions)

Treatment of the Takaful surplus is the most important practical aspect of Takaful business that ascertains its difference from the conventional insurance. This is because, the legal characterization of the Takaful structure remains theoretical in essence and it is not normally observed by the participants when subscribing to Takaful, not to mention its debatable validity.

Treatment of the Surplus According to the Donation Model

According to the *Tabarru'* model neither the participants nor the Takaful operator own the surplus. This is because the participants have already donated the premiums so they do not own the fund and consequently, they do not own the surplus, which is the leftover of the premiums. The Takaful operator, on the other hand, cannot be given any ownership right over the surplus, because its owning the surplus entails prior ownership of the premiums, which in turn renders Takaful a Mu'awada business as justified earlier. "The managing company is not entitled to any share of the surplus" (AAOIFI Standards, No 26, 5/5).

So what to do with the surplus if the financial statement of a Takaful company shows any? According to AAOIFI Takaful Standard, which advocates the Tabarru' model, "disposal of the surplus should be in a way that serves the cause or common interest of the participants, such as accumulation of reserves, reduction of the contribution, charitable donations and partial/full distribution of the surplus among the participants. (AAOIFI Standards, No 26, 5/5).

One of the observations one may have over this AAOIFI clause is how can the charitable donation of the surplus serve the common interest of the participants?! As a matter of fact, Takaful operators do not consult the policy holders on how to dispose of the surplus, and the policy holders have no choice but to accept what is dictated on them in the Takaful policies, and their implicit objection to dispose of the surplus in a way that does not benefit them financially is very likely. Therefore, the very action of giving the company the right to dispose of the surplus according to its own discretion may function against the very interests of the participants, like when donating the surplus to charity despite the participants' implicit objection.

Besides, it has been noted from the actual practices of the Takaful companies that many of them seize the surplus or a significant part thereof under the pretext of incentive for good management.[15] The Saudi Arabia monetary agency, for example, has approved 10% of the Takaful surplus to be redistributed to the participants and 90% to the shareholders of the operating company as an incentive! Similarly, HSBC Amanah Takaful takes 80% of the surplus as incentive for its performance in managing the fund and distributes only 20% amongst eligible participants. (Gulf Region Takaful Report, 2011).

Treatment of the Surplus According to the Waqf Model

Treatment of the surplus according to this model is no different from that of the donation model "The Waqf fund may initiate any self-commitment with respect to the surplus, like to commit itself to keep the surplus as a reserve to cover possible deficit in next years or to distribute all or part of it among the policy holders" (AbuGhudda, p.11).

Treatment of the Surplus According to the Proposed Model

Since the participants in Takaful are deemed the owners of its fund, the residual of the fund after payment of compensations shall specifically belong to them. In fact, the Takaful surplus is just like the leftover in *Nihd*, and since the leftover in *Nihd* is redistributable among the participants, the participants in Takaful shall also have the right to redistribute the surplus among themselves or to instruct the Takaful operator to dispose it of according to their genuine will. Under no circumstances, however, can the Takaful operator be entitled to the surplus, for this will abolish the very concept of *Ibaha* and drag the Takaful arrangement into the sphere of *Mu'awada* as indicated earlier.

Hence, the Takaful operator should dispose the surplus as prescribed by the participants, but as an investment agent he may be given form the surplus a reasonable incentive for his good management of the Takaful fund if he was really found to be a good manager.

Possible Forms of Surplus Distribution among the Participants

Surplus distribution, which best serves the interest of the participants and best meets the non-*tabarru'* nature of Takaful arrangement, may upon the agreement of the participants take one of the following forms:[16]

1. Distribution of the surplus among the participants in proportion to their respective contributions, and regardless of whether the participant has received indemnity during the financial period or not.
2. Distribution of the surplus among participants after deducting the amounts of indemnity they receive during the same financial period.
3. Distribution of the surplus among the participants who have not received indemnity during the financial period.

It is possible too that every participant be given the choice to utilize his share in the surplus in getting a discount on the premium payable upon renewal of the Takaful policy.

Other Important Shariah Issues

Deficit in the Takaful Fund

According to AAOIFI, which adopts the *Tabarru'* model, "when the insurance assets along with indemnities received from re-insurance companies- if any- fall short of covering indemnity commitments, the Company may cover the deficit from *qard hasan* (interest-free or benevolent loan) debited to the account of the insurance fund. In this regard, the deficits resulting from commitments of the current year may be covered from the surpluses of the succeeding years. The Company may also claim settlement of the deficit from policy holders if they undertake to do so in the insurance policy". (AAOIFI Standards, No 26, 10/18).

This standard obviously allows Takaful companies to undertake to repeatedly lend the Takaful fund amounts needed to cover the deficit, and the lent amounts can be repaid from the surpluses of the succeeding years. Similar stand was taken by the proponents of the Waqf model.[17]

This matter, however, raises the following concerns:

- The widespread practice of allowing the Takaful operator to both seize the surplus through the incentive and cover all claims through the lending undertaking verily eliminates any practical difference from conventional insurance and drag the whole arrangement to the sphere of *Mu'awada*; the very reason for prohibiting conventional insurance. This is because what the company facilitates as supposedly a loan is not a loan in reality since the loan will not be effectively repaid. Seizing the surplus, or a significant part thereof, by the Takaful company (the lender) under the pretext of the incentive does not enable the company to effectively get its loan back, for it will be getting back what is already its and thus the loans remain unpaid. Besides, even in the absence of the incentive clause, Wakala fee becomes too high to leave behind any significant amount to repay the loan incurred in the previous year(s). In fact, Takaful operators cannot deny that their profit simply vanishes or turn into loss in cases of deficit, which should not be the case if the Takaful operator is merely a lender and an agent to administer the Takaful operations and fund.
- The policy holders change every year, so it is unfair and unaccepted from Shariah point of view that the policy holders of a given year be responsible for the loans incurred by the policy holders of the previous year and thus be denied the surplus, which is supposed to be distributed "in a way that serves the cause or common interest of the participants" as the very AAOIFI standard reads. (AAOIFI Standards, No 26, 5/5).
- Shariah prohibits combining together a loan with any commutative contract, like sale, *Wakala* or *Mudaraba* contract in one transaction.[18] The reason for this prohibition is the fear that one contractor may demand from the other a higher compensation in exchange of his undertaking to grant him a loan and thus the loan would involve then a hidden or indirect interest. Very clearly, Takaful structure involves *Wakala* and possibly *Mudaraba*, so adding a contract of loan to it should not be allowed either. In fact, this is the very reason why AAOIFI Sukuk standard disallows the sukuk manager, be him a *Mudarib* (Mudaraba manager) or a partner or an investment agent, to undertake to grant loans to the sukuk holders. (AAOIFI, Fatwa Council, Appendix 2). Therefore, AAOIFI's stand on the loan granting issue should be consistent in these two standards. The prohibition however remains, in the writer's opinion, purely technical if loans were not associated with any increase in the compensations of the other contracts.

Hence, the undertaking by the Takaful operator to give loans in case of deficit harbors some controversies and most importantly, it brings the structure of Takaful closer to *Mu'awada* which is embodied in the simple formula of 'premiums against claims'; the very reason for prohibiting the conventional commercial insurance.

TREATMENT OF DEFICIT ACCORDING TO THE PROPOSED MODEL

The status of the Takaful operator according to this model is basically no different; it is an agent responsible for managing the Takaful operations and administering the Takaful fund against the Wakala fees. Therefore, Takaful operator should have no responsibility whatsoever for any deficit in the Takaful fund due to excess in claims. If, however, the deficit has resulted from mismanagement in handling both or one responsibility then the operating company can be made liable towards the policy holders for the amount lost as a result of the mismanagement, and no liability beyond that can be assumed by the company. The fund on the other hand is owned by the policy holders according to this model, and so they should be responsible for the repercussions of having a shortfall. Therefore, upon the occurrence of a shortfall, the operator may ask the existing policy holders to top up their contributions or else he may terminate their policies. Alternatively, Takaful companies may subscribe to re-Takaful companies, which can also be structured on the same *Ibaha* basis, to meet deficit cases. Lending the Takaful fund remains an invalid option in this model for two reasons: the suspicion of combining between loan and *Mu'awada* contract, if to observe the outward prohibition, and the fact that the fund belongs to the policy holders according to this model, which means that they are the borrowers, and since they keep changing, the operator will not be possibly able to get the money back from the same borrowers.

Investing the Takaful Fund on *Wakala* or *Mudaraba* Basis

Managing the Takaful operations cannot be done on *Mudaraba* basis because the action of Takaful operations management is not of investment nature while *Mudaraba* is an investment contract; however, it can be achieved through *Wakala* against fixed fees. What could be potentially managed on *Mudaraba* basis is the investment of the Takaful fund. AAOIFI Takaful standard allows investment of the Takaful fund by the Takaful operator to be done on *Wakala* or *Mudaraba* basis. (AAOIFI Standards, No 26, Clause 4)

However, on the other hand, management of the Takaful fund is achievable through Wakala contract whereby the Takaful company gets a fixed fee in advance, and since managing the Takaful operations is supposed to be through Wakala as well, both actions can be achieved based on one Wakala agreement so that any Takaful company can demand for instance 20% of the premiums in return of managing the Takaful operations as well as investing the Takaful fund.

Conclusion: The Parameters for a Proper Islamic Insurance

Based on the above discussions the following parameters must be observed while structuring or outlining the rules of any valid Takaful model:

- The legal characterization of the relationship between the payers of the premiums and the payer of the compensations must reflect the real intentions of these parties, because contracts are supposed to reflect the real purposes of the contractors, instead of some devised purposes being dictated on contractors for sake of superficially validating the contract, and it must not result ultimately in *Mu'awada* as implied in the mutual commitment to donations.
- The Takaful fund cannot be owned by the Takaful company, otherwise the gharar-loaded *Mu'awada* between the premiums and the compensations will take effect. Hence, the Takaful fund must be financially as well as legally independent of the company.
- Since the Takaful company does not own the Takaful fund it consequently cannot seize its surplus in any way, and the surplus should rather be distributed among the participants

or disposed of according to their genuine will. Seizing the surplus by the Takaful company by any means renders the company the owner of the fund, which jeopardizes the very structure of Takaful and gives rise to the gharar-loaded *Mu'awada*.

- The Takaful company may not undertake to cover claims beyond the limit of the Takaful fund or to give loans to cover the deficit, because the company is merely an agent to manage the Takaful operations and invest the Takaful fund, so it cannot be responsible for any deficit in the Takaful fund except in case of mismanagement. Failure to observe this rule eliminates the real and practical differences between Takaful and the conventional insurance; especially that such a practice is normally accompanied with seizing the surplus, limiting thus the difference between the Islamic and the conventional insurance to the merely hypothetical characterization of the structure and contractual relationships.
- For managing the Takaful operations and investing the Takaful fund it is recommended to use one *Wakala* contract fot both actions.

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[1] Fiqh Academy issued a resolution introducing cooperative insurance, or one based on *Tabarru'*, as alternative to conventional insurance. See the resolution dated: December 22-28, 1985.

[2] Al-Qarafi, Al-*Forouq*, 1/151.

[3] Given the less probability of wining in gambling and the higher probability of getting the compensation in insurance, fortune seekers may use insurance illegally for sake of enrichment. Reports show that some insurance policy holders may fake an accident or death to get the compensation.

[4] For this reason Fiqh Academy issued a resolution prohibiting conventional insurance. Date of resolution is December 22-28, 1985.

[5] Al-Qarafi, Al-*Forouq*, 1/151.

[6] This Fiqh maxi is originally derived from the famous *Hadith* "matters are determined by intention" (إنما الأعمال بالنيات). (This *Hadith* was narrated by Omar bin Al-khattab (ra). See *Sahih al-Bokhari*, 1/3, *Hadith* No (1); *Sahih Muslim*, 3/1515, *Hadith* No (1907)-); Ibn Nujaim, Zainulddin, *Al-Ashbah Wal Naza'ir,* 1/34; Al-Seyoti, Jalaulddin, *Al-Ashbah Wal Naza'ir,* p.21; Al-Kurdi, Ahmad. *Al-Madkhil Al-Fiqhi*, p.33.

[7] Not to give the donor the right to demand back his gift or donation while it is still in the procession of the beneficiary is the opinion of the vast majority of Shariah schools. (Ibn Qudama, Al-*Mughni*, 5/175)

[8] Ibn Abedeen. *Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar*), 4/188.

[9] For details on the matter of combining between two conflicting contractual capacities in one contractor see Abozaid Abdulazeem*, Al-Murabaha and its Modern Applications in the Islamic Banks*, p 187.

[10] Ibn al-Humam, *Sharih Fat'h Al-Qadeer*, 6/203 .

[11] Al-Fatawa Al-Hindiyya mentions that "If a man donates a dirham to a mosque, whether to be spent in its renovation or maintenance, it is valid donation because the mosque has the capacity to own things". 2/460.

[12] Jakhhura, Bilal Ahmed, *The Application of Takaful Based on the Waqf Model in South Africa*, p. 2.

[13] Ibn Hajar, *Fat'h Al-Bari*, 5/129.

[14] Al-Bukharia, *Sahih al-Bukhari*, Chapter 47, Sub chapter 1, p. 436.

[15] For more details on this matter see Qaradaghi, "The Surplus in Takaful Companies" a paper presented during the second Takaful conference held in Riyadh, 6-7 October, 2010.

[16] This way of surplus distribution is similar to the one adopted by AAOIFI Standards (No 26, Clause 12).

[17] Jakhhura, Bilal Ahmed, *The Application of Takaful Based on the Waqf Model in South Africa*, p. 13.

[18] For more details on this issue see al-Dasuqi, *Hashiyah*, P.76; Abozaid, *Cotemporary Modes of Islamic Finance between Contractual Technicalities and Shariah Objectives*, P. 17.