

Comparative Analysis of Islamic and Prevailing Insurance Practices

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Abstract

***Purpose** – Islam is believed to provide guidance in every sphere of life. This guidance is not limited to the social aspects but also covers economic dimension of human life. Islamic economic system supports interest free financial system. This paper addresses insurance, a part and parcel of modern financial and economic system. We have compared prevailing insurance system with Islamic alternative, Takaful. We have attempted to highlight its main features and discussed its suitability.*

***Methodology** - Sources of Sharia (Islamic way of life) are sought to trace the roots of Takaful. A brief comparison between Islamic insurance and prevalent system is given to find out whether Islamic insurance can take over prevailing insurance system.*

***Findings** – After comparing Takaful with conventional insurance, it is indicated that Takaful is more suitable than insurance especially to the vast Muslim community of the world.*

***Value** – This article gives a comparative analysis of Islamic and conventional insurance system. In this way it is an addition to the scarce literature on the subject. It has a managerial implication in the shape of guidance to the potential buyer of the insurance.*

Keywords: Takaful, Islamic insurance, Islamicity of insurance, Difference between takaful and conventional insurance

Paper type Conceptual paper

1. Introduction

Islam is one of the greatest religions of the world, second largest in terms of number of believers. Nearly 1.3 billion of Muslims live in this planet. Islam deals with every social and non-social issue. For financial and economic systems it has given broader outlines. Takaful an Arabic word means “assuring each other” (Takaful, 2010). Takaful is the Islamic term used to denote Islamic insurance. Takaful is based on the principle that the pool of donations is created and is used to support each other. This is the principle of Tabarru. To fully understand Takaful one can see principles of waqf, Kafalah, Tabarru etc... (Usmani, 2007). Conventional insurance is Haram (forbidden) in Islam because it contains the element of Riba, Maisir and Gharar. The funds pooled from large no of policy holders are reinvested in interest bearing instruments etc.... As the translation of the verse of the Quran S-ii, 274 says "God hath permitted trade and forbidden usury". Usury means giving loan at high interest.

Similarly in Sura 2 verse 219, the Gharar is prohibited. Takaful is free from Riba and Gharar. So, it confirms to the Islamic principles. Moreover Takaful is a mutual agreement by large no of donors to protect those who are in great risk. The amount is distributed in accordance with the principles of Wasiah (Mirath) if the assured dies. It is given in Fatwa (Verdict by Islamic Scholars) by the National Council for Muslim Religious Affairs in Malaysia. This can be a solid ground for making distinction between Islamic and conventional insurance.

Concept of Takaful in Sharia

Takaful principles have their roots in Sharia. Sacred Orders of Allah in Quran, religious, social and commercial practices of The Holy Prophet (SAW), Qiyas (comparative arguments), and Ijma (the agreement of whole Islamic world on an issue) form the basis of Sharia. Sharia is the constitution of Islamic world. The basic principles of Sharia are necessary to be discussed before further discussion on Islamic insurance.

Takaful is an Islamic contract therefore requires acceptance of offer (Mohammad, 1988). The contract of Mudarabah (Islamic way of partnership) forms the basis of Takaful. In ancient Arab takaful was found in system of “Aaqilah” involve mutual assistance arrangement. As in takaful loss is covered by many people so this system is allowed in Islam. In Takaful policy holders share a specific percentage of profit and also pay a sum of money to assist or indemnify each other. Basis of takafal can be traced down in Sunnah of The Holy Prophet (SAW) and Sunnah of Companions. Then we find operational improvements in fourteenth to seventeenth century; in nineteenth century; and twentieth century (Billah, 1998). Takaful is originated from the Sharia principles especially those of Muamlatt (transactions between men) and purely is in compliance with the teachings of Islamic Sharia (Mohammad, 1988).

Models Governing Takaful

There are Mudarabah, Waqalah, and Waqf models of takaful. In Mudarabah model one person invests money seeking efforts from mudaharib. The profit sharing is based on the rate at which Sharia committee agrees. The participants are the money investors and takaful operators are mudaharibs (Takaful, 2007). In Waqalah model there is a distinction between effort making company and the participants. The efforts maker gets their salaries from the contribution of the participant and profits made by investing funds of takaful. The fees provided to operators for their efforts are set by Sharia committee which ensures compliance of company’s policies with Sharia (Takaful, 2007). On the other hand in Waqf model the donors donate money to the assured in need. In this way company works as a Governmental foundation not for profit. Unlike in Mudarabah and Waqalah models the funds in this model are not in the ownership of anybody. Mufti Mohammad Taqi Usmani (famous Islamic scholar) likes Waqf model the most and believes it as purely Islamic (Takaful, 2007).

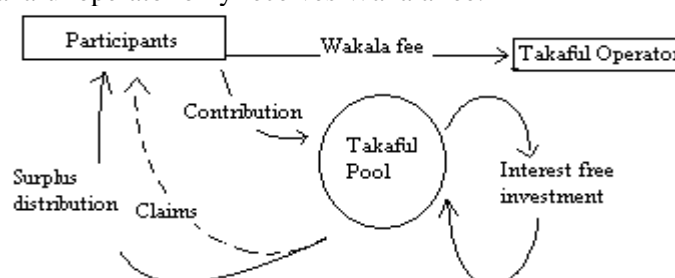
2. Why Islamic Sharia Prohibits Conventional Insurance?

An opinion was sought from a religious scholar Syed Ibn-Abdin about insurance related to sea. In his opinion it is not according to Islamic Sharia that a trader pays amount of premium to insurance company so that he may be indemnified (Mankabady, 1989). Conventional insurance include Riba, Maisir, and Gharar which are against Islamic Sharia. Riba is used in Arabic language which means excess or addition in something. In Islam loan without interest is allowed and if interest is charged then it is Haram and against Sharia however service charges are allowed (Mahmood, 1991). It is narrated by Hazrat Jabir (R.A), “The Holy Prophet (SAW) cursed the devourer of usury, its payer, its scribe and its two witnesses and they were equal (in sin)” (Karim).

Gharar is uncertainty in a contract in which one party is in benefit and loss is beard by other party. Gharar may be in case of any insurance contract in which there is no idea about payment as promised or there is no idea about how much amount should be paid at the time of its payment. Maisir in insurance is in which policy holders invest small amount premium with hope to gain large profit and some time due to losses they lose their premium invested and claims may be higher than contributions. Maisir refers to obtaining or acquiring something without any effort. This is done in gambling (Mohammad, 1988). In Holy Quran Allah has clearly declared Maisir (gambling) unlawful and there is no relaxation in it (Quran, 627 A.D). About 200 scholars participated in a conference in Makkah and concluded that insurance practiced in conventional insurance companies is against Sharia (First international conference on Islamic economics, 1976). In this conference it was also concluded that Islamic insurance system is different from conventional insurance system and is according to Sharia. Council of Islamic Ideology of Pakistan in 1983 rejected all the models of commercial insurance.

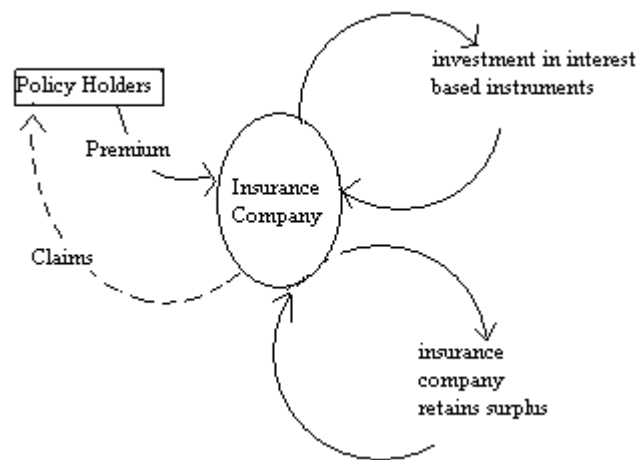
3. Differences in Takaful and Conventional Insurance

Takaful operate in such a way that the participants contribute their money and formulate a pool of money. This money is then invested to earn Halal profit in sharia compliant investments. The amount of profit earned is then added in money pool and is then distributed among the participants after satisfying any claim as a renewal discount. The takaful operator only receives Wakala fee.



Takaful Operations (Takaful and conventional insurance compared, 2009).

Conventional insurance operates in such a way that premium is paid by policy holders to insurance company and then this amount is invested by insurance company in interest bearing or non sharia compliant investing areas. Amount of interest and profit is received by insurance companies and then surplus is retained in the company without distributing it among policy holder and only claims are met with this surplus.



Conventional Insurance operations (Takaful and conventional insurance compared, 2009)

Islamic insurance companies invest in a number of Sharia compliant products. Governments of the countries in which Muslims are in majority have introduced a legal framework which helps in introduction of new Sharia compliant products. Mudaraba certificates are the instruments which are evolved from such legal framework. While a conventional insurance company invests in interest based instruments like treasury bills, certificates of deposits, interest bearing bonds etc....Table 3.0 shows some of the Islamic and non-Islamic instruments that attract the investments of Islamic insurance companies and conventional insurance companies (Hakim, 2007).

The present form of conventional insurance is Haraam and Takaful is according to Islamic Sharia is fully permissible because conventional insurance has elements of interest, gharar and gambling and takaful has not such type of elements as explained above (Islamic conference in jeddah , 1985). Insurance includes pure risk and speculative risk. In pure risk loss may occur or not while in speculative risk there may be loss, profit or no loss. Takaful applies the indemnification principle and compensate the loss of Takaful client. Takaful is only related with pure risk and not with speculative risk.

The goal of insurance is to maximize profit in favor of shareholders because they are stock companies and ignore client while in contrast takaful goal is well-being and self sustaining operation without earning high profit. In Takaful surplus is shared between shareholders and policy holder and also surplus is owned by participants and is reduced by performance fee for operators before dividing in to participant (Wakala model). Takaful helps people to accumulate their saving for goodness of whole community. An opportunity is provided by takaful scheme to people to practice Islamic way. The Holy Prophet (PBUH) saying is “whosever removes the hardship from believer, Allah will remove hardship from him one of the hardship of the Day of Judgment” (Sahih Muslim). Insurance is vice versa. Al tabarue is account in takaful which involves donations and it also involves al Mudarabah principles. While in conventional insurance general insurance and life insurance accounts are involved. In Takaful profit is divided between different participants in specific ratios on the basis of Al-Mudarabah principles. While in conventional insurance profit is not shared between members in a specific ratio and in some year bonus is provided and some time not.

Takaful fund is managed by operator but ownership is of participants. They have a complete right of contribution and benefits. In conventional insurance the policy holder purchase policy and there exist seller – purchaser relationship. Takaful company performs trustee and operator functions. In conventional insurance there exist one to one relationship between policy holder and company. Different elements like Riba, Gharar and Gambling are not involved in takaful and it is according to Islamic Sharia. Riba and Gharar are involved in conventional insurance system and do not fulfill sharia requirements and therefore it is not allowed (Haberbeck, 1987). Sharia Council determines where to invest funds so that interest factor may not involve while in conventional insurance funds are invested without guideline of Sharia Council usually in interest based businesses. Takaful operates on mutual assistance principle. Conventional insurance operate on business principle.

In insurance contract there is clause that insurer can forfeit the premium amount that is paid by the policy holders under certain circumstances. Islam does not allow the forfeiture of premium, wholly or partly, as the amount of premium is considered as loan by insured to insurer. In takaful there is no forfeiture of contributions and it is distributed among the participant in form of surplus (Mahmood D. N., 1991). Rules are made according to Holy Quran and Hadith in takaful system. In conventional insurance system rules are made according to human mind and thinking. All participants contribute fixed amount in Takaful. In conventional insurance amount of paid premium vary from one policy holder to others. In takaful the participant can receive all the benefit on the maturity of contract but if he died before maturity then amount is paid to the claimant without investigation and without letter of administration. The claimant is entitled to receive same benefits as it is to be paid to the participant on maturity and there is no deduction (Mahmood D. N., 1991). In conventional insurance if the policy holder is died then amount is not paid to the claimant without proper investigation of causes of death.

In Islamic insurance the agent (wakil) gets the salary for his services while in conventional insurance agent gets specific percentage from the amount paid by policy taker. In Islamic insurance agent is considered as employee of the takaful operator and only gets salaries for his services. In conventional life insurance the persons (not necessarily the heirs) can have the insurable interest of the policy holder whereas in Islamic life insurance the insurable interest is vested according to wasiyah principle (Billah, 1997).

Quran, Hadith and Fatwas Regarding Conventional Insurance

All kinds of insurance according Islamic Sharia is Haram and prohibited by The Holy Quran because it includes gharar and gambling. No doubt interest factors are included in every type of insurance which are riba-ul-nasiah and riba-ul-fadl and are prohibited in Islam (Noorzoy, 1982). God has prohibited gambling saying "O ye who believe! Strong drink and game of chance and idols and divining arrows are only an infamy of Satan's handiwork. Leave it a side in order to succeed" (Al-Ma'ida, 627 A.D). Gharar is included in all type of conventional insurance. Therefore Islam prohibits all type of conventional insurance as "O ye who believe! Eat not up your property among yourself in vanities" (Al Nisa). The Holy Prophet says, "Do not buy fish in the sea, for it is gharar" (Hanbal).

Ulamas (religious scholars) gave fatwas related to insurance. Hanfi (a religious school of thought) scholars considered that co-operative insurance is legal while other types of insurance are illegal because it includes the elements of riba and gharar. According to Maliki's (another school of thought) contract of life insurance is illegal while other insurance contracts are legal. Shafi's agree with Maliki's but in other contract of insurance they think are as well. According to the Hanbalis (a religious school of thought) contract of insurance is illegal (Mankabady, Insurance and Islamic Law, 1989). The contract of commercial insurance involves the element of risk which makes the contract void and therefore not allowed in Islam while the contract of mutual assistance (takaful) fulfill the sharia principles and is allowed. The pure Islamic nature of Takaful gets a solid support from Ulama's Fatwa. In Feb. 16, 2006 takaful approval was signed by Justice Taqi Usmani and other religious Ulama of Pakistan.

Conclusion

Britain is a Muslim minority country. A nationwide study in Britain revealed that 74% of Muslim participants considered their religion were very important in living their lives, and 21% considered it fairly important. Moreover, around 80% declared to visit mosque once or more than once in a week (Modood, et al., 1997). Muslims represent a large portion of world population and are increasing at a greater pace than other religious communities. Muslims are 20% of the world population and are expected to be 30% by 2025 (Shafie & Othman, 2006). Fifty seven Islamic countries are regular members of the Organization of Islamic Conference's (OIC).

The Muslims all around the world wish to go side by side with modern commerce. They are not willing to follow non- Islamic practices. They are looking for Islamic alternatives to prevailing financial instruments and practices. Islamic banking is a great success not only in Muslim majority but also in Muslim minority countries. Major international banks are today offering Sharia compliant products. In the similar manner akafal presents an Islamic alternative to insurance.

The Interpretations made by Scholars provide a complete framework governing Islamic Insurance. In this article the suitability of Islamic insurance over conventional one along with its applicability in Muslim world is discussed. Ahmed (2010) reported that the Islamic principles can prohibit the global crisis to occur. Islamic insurance funds are invested in interest free securities which reduce the chances of the crisis in this industry. Resultantly it provides a solid support for Islamic insurance.

To maintain his Homo-Islamicus behaviors a Muslim may adapt his practices to and comply with Sharia principles. The models of Takaful are helpful in categorizing it. Tawakal concept best deals with takaful because firm belief in the God is compulsory but taking due care is also necessary. Takaful and conventional insurance models are different because of their permissibility in Islam. Conventional mode is based on Riba which is prohibited in Islam.

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Table 3.0 Islamic and non-Islamic instruments

Islamic instruments	Non-Islamic instruments
Mudaraba certificates	Treasury bills
Musharaka certificates	Certificates of deposits
Musharaka term finance certificates	Call money market
Sukuk	Asset-backed securities
Mudaraba inter-bank investment	Negotiable certificates of deposits