THE CONCEPTUAL FRAMEWORK FOR ISLAMIC INSURANCE

by

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PREFACE

There is incisive debate amongst contemporary Shariah experts in relation to the correct Shariah characterization of Islamic insurance, sometimes referred to as takaful.

The Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) has now published a Shariah Standard on Islamic Insurance namely Shariah Standard 26, which is based on the separate legal entity model only (and not the Waqf model).

The purpose of this booklet is to simply summarize the Shariah conceptual framework of Islamic insurance, for the benefit of interested persons, institutions and practitioners in the field of Islamic Finance, including those who do not have access to authoritative Islamic sources of reference.

The practical application of the principles will depend on the relevant local regulatory environment, its flexibility and constraints.

May the Almighty Allah accept this humble endeavour for His Exclusive Pleasure. Please remember this humble being in your pious prayers.

M.S OMAR
12 March 2009
Durban, South Africa

IN THE NAME OF ALLAH THE ALL-COMPASSIONATE AND THE MOST BENEFICIENT

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INTRODUCTION TO THE AUTHOR

This is to confirm that I personally know Sheikh Muhammad Shoaib Omar. Apart from being a competent lawyer, he has traveled twice to Darul Uloom Karachi and had privately studied the Arabic language, literature, fiqh, usul-fiqh, mantiq, tafsir and usul al ifta from competent and experienced teachers here at Darul Uloom Karachi. He thereafter continued to study higher books of hadith such as Sahih-ul-Bukhari under Mufti Jalil Qasemi Saheb in South Africa. All his efforts has enabled him to benefit and draw from original authentic Arabic authorities and works in the Islamic Sciences. Despite his work engagements in the legal field, he has authored and published a number of useful and beneficial Islamic texts, which have been well-received by scholars and the general public. May Allah give him tawfiq to serve the Muslims according to the way of pious elders of the Ummah.

(Ret) Justice Mufti Muhammad Taqi Usmani
Ex-Member Shariat Appellate Bench
Supreme Court of Pakistan
Vice President Darul Uloom Karachi
Chairperson of Shariah Panel of (AAOIFI)
Accounting and Auditing Organization
For Islamic Financial Institutions

THE IMPERMISSIBILITY OF CONVENTIONAL INSURANCE

Conventional insurance for profit is a bilateral contract comprising the following three essential elements[1]:

(a) the payment by the insurer of a sum of money or money's worth to the insured or for his benefit;
(b) such payment being contingent upon the happening or occurrence of a future uncertain event, which may or may not happen. (or will happen in the future but the time at which it will happen is uncertain, as in the case of death);
(c) the insurer's undertaking to make such payment is assumed in return for the payment of a premium by the insured.

The question that arises, in the light of the above definition, is why a conventional insurance contract is prohibited in the Shariah. The reasons may be summarised as follows:

Firstly, an insurance contract is a commercial contract of gain or profit, which is described as *muawadah*[2] *(معاوضة)* .In essence, insurance represents the sale of a chance or risk for a price. The payment by the insurer is dependent on an uncertain event which may or may not occur. This uncertainty of outcome or result based upon a contingent event is known as *gharar (غرر)* . In the case where *gharar* permeates a commercial contract of gain (muawadah) it renders such a contract void. The Holy Prophet (SAW) forbade a sale based on *gharar*[3] . This prohibition has been extended by consensus to all commercial contracts, which are based on *gharar*. A conventional insurance contract is accordingly invalid by reason of *gharar*, which goes to the root of the contract, and is not incidental thereto[4].

[1] For a definition of a contract of insurance, see generally the analysis in the early English case of Prudential Insurance Company v Commissioner of Inland Revenue (1904) 2KB 658.

[2] Sale and lease are classical examples of muawadah or contracts of exchange of consideration, the one for the other. They should be contrasted with benevolent contracts of tabarru (such as donation) in terms of which there is no reciprocity of exchange.

[3] See for example, Sahih Muslim, hadith number 3786. Sheikh Siddiq Dharir has collected nine separate narrations (see Al Gharar p78- p80). The generally accepted view of the overwhelming majority of jurists is that a prohibition (nahy) renders the underlying contract null and void, with no consequences (see, Al- Gazzali, Al Mustasfa, vol 2, p24 - p31).

[4] Incidental gharar is tolerated on grounds of genuine need because it cannot be avoided except with difficulty. For example, ignorance relating to the strength of the foundation of a house. In this case, the gharar may also be said to be minor or insignificant (see Al-Nawawi, commentary to Sahih Muslim, on hadith no 3786).

Secondly, dealing in commercial contracts of interest is prohibited in Shariah. In the context of insurance, in the event that an uncertain hazard occurs, there is no equality between the amount of the indemnity and the total premiums paid by the insured. The indemnity may exceed the total premiums or vice versa. It is an established principle of the Shariah that the exchange of money in a commercial contract must be equal on both sides, with no excess passing to a contracting party. For example, R100 cannot be exchanged for R120 either at spot or on a deferred credit basis. Money is simply regarded as a medium of exchange, and not a commodity. This was pointed out by the great thinker Al Ghazzali (see Ihya, kitab al shukr).

Thirdly, an insurance contract for profit is essentially a wager *(qimar - قمار).* The one party (the insurer) gains absolutely and the other party's (insured's) potential hope of gain is dependent on a chance event (which may or may not occur). The insurer receives the premium but the insured will only receive the indemnity if the unforeseen future chance event occurs. The fact that the insured is termed to have an 'insurable interest' in the insured subject matter, does not detract from the fact that the conventional insurance contract is essentially a wager or bet. Wagers and betting transactions are absolutely prohibited in the Shariah.

Fourthly, the sources of entitlement to profit in Shariah are three[5]: capital, services and risk. The insurer's contractual claim to the premiums is not covered by any of these three categories. The insurer contributes no capital or money on which it can claim a legitimate recognised return. The insurer contributes no recognised services in exchange for the premium. As for risk, this refers to the risk of destruction or deterioration of an asset (and the resultant entitlement of profit thereon) as a result of ownership and possession of the asset in question[6]. The so-called risk under a policy of insurance (the burden of the insured's potential loss, which is transferred to the insurer, in consideration for the premium) is not a risk recognised by the Shariah.

Finally, a conventional profit insurance contract must be distinguished from a suretyship *(kaffalah - كفالة)*. The latter is an accessory contract which secures a recognised principal obligation, such as a valid debt.

[5] See for example, article 1347 of the Ottoman code of Islamic Commercial Law, known as majallah.

[6] For example, the purchaser of a defective commodity is entitled to the profits generated by that commodity, until the article or commodity is returned to the seller. The reason is that if the commodity were destroyed prior to its return to the seller, the purchaser would bear the burden loss (see article 85 of the Majallah).

On the other hand, a conventional insurance contract gives rise to a principal obligation to indemnify the insured for a potential loss, if the future uncertain event occurs, in exchange for a premium. Suretyship in relation to the creditor is essentially a benevolent contract *(tabarru -* تبرع). The surety's right of recourse is limited to the principal debtor, if the surety bound himself to the creditor in that capacity, on the instructions of the principal debtor. It is also established in Shariah that a third party cannot guarantee the loss of another. This would apply equally to the situation where the loss is contingent upon a chance event, which may or may not occur[7].

[7]The main purpose of conventional insurance is to transfer the risk of loss to the insurer.

MAIN PRINCIPLES OF ISLAMIC INSURANCE

Islamic insurance or *takaful* is true insurance because it is based on mutual assistance, solidarity, benevolence, cross-subsidisation and non-profit making.

The essential elements of Islamic Insurance are as follows:

(a) the payment by a participant of a gratuitous contribution to a fund or portfolio, which contribution is owned by the portfolio[8];
(b) the portfolio is a separate, legal, juristic, person with the requisite powers, including the power to own and dispose of property, to enter into transactions for the promotion of its objects (of mutual assistance and the provision of defined benefits);
(c) the payment of a surplus or part thereof (excess of contributions over claims, reserves and expenses) back to the participants on an equitable basis, pro rata to contributions;
(d) the payment of compensation by the portfolio to a participant solely in accordance with the rules of the portfolio , upon the occurrence of a risk event, and not in accordance with a bilateral contract[9].

In view of the aforegoing, Islamic Insurance or *takaful* may be distinguished from conventional profit insurance on the following basis:

(i) Conventional insurance is a commercial bilateral contract for profit. The premiums paid by the insured are owned by the insurer and invested ultimately for the benefit of its shareholders. All profits arising from the insurance business accrue to the insurer. The insured has no claims to any surpluses or profit. The rights and obligations of the parties (insurer and insured) arise from the insurance contract, its proper interpretation and application. The indemnity is paid pursuant to and as a result of the bilateral contract, which is the legal basis for such payment.

(ii) On the other hand , in the case of Islamic Insurance, the gratuitous contributions paid by the participants are owned by the portfolio as a separate legal person. There is no contract for profit entered into

[8] The portfolio may be a waqf fund (see the chapter on the waqf model of Islamic Insurance) or, a separate juristic person.

[9] This requirement is critical. Any reciprocity of exchange in terms of a bilateral contract would convert the arrangement into one of muawadah, with the result that it is hit by gharar.

between the participants and the portfolio. The compensation or benefits are paid by the portfolio solely in accordance with its rules[10], and not in accordance with any bilateral contract. In terms of these rules, all surpluses accrue for the ultimate benefit of the participants. The payment of compensation under the rules of the portfolio is gratuitous but such gratuitous payment is enforceable[11].The enforceability of a gratuitous obligation is dealt with in a separate chapter. Upon winding up of the portfolio, the net surplus is paid to charity.
It may be argued that the compensation paid by a portfolio is in essence a return on, or an exchange for, the payment of a contribution by a participant. In other words, the objection is that in substance the 'transaction' between a participant and the portfolio is reciprocal, and in this sense bilateral falling within the ambit of a contract of exchange on both sides (mu`awadah) with the result that the arrangement is hit by gharar (as in the case of a conventional insurance contract).

The answer to the objection is that the compensation that is paid by a portfolio is not so paid in exchange for the gratuitous contribution. On the contrary, the compensation is paid exclusively on the basis of the rules of the portfolio, which is the source of entitlement, and not a bilateral contract. At the same time, the participant qualifies because he falls within the category of entitled beneficiaries in terms of the rules of the portfolio.

[10]For the promotion of its main object of mutual assistance and non-profit making.

[11] In the case where the portfolio is a separate juristic person. In the case of a waqf portfolio, the compensation is paid in accordance with the rules of the waqf. There is no question of the enforceability of a gratuitous obligation.

THE IMPACT OF *GHARAR* ON BENEVOLENT CONTRACTS

We have stated previously that *gharar* (uncertainty of outcome or result) which permeates a commercial contract of profit or gain renders such contract void ab initio.

The word *gharar* itself is a wide term and encompasses a number of situations of manifest uncertainty within the contractual field, including uncertainty relating to the subject matter of a contract, and the consideration payable.

The sale of birds in the air, or the sale of a deserted slave are examples from classical juristic literature. In both these cases, the seller receives the full contractual consideration, but the buyer remains under the risk or hazard of receiving delivery of the purchased commodity. For this reason, the great thinker Ibn Taymiyyah regarded this category of *gharar* as equivalent to a pure wager (see Al Dharir on *Gharar*: p.62).

Similarly, in the insurance context, the insurer certainly receives the premiums (the full contractual measure due to the one party). However, the insured's contractual entitlement to the indemnity (in exchange for the premium) is premised on fundamental uncertainty, namely the occurrence of a specified future event or peril which is outside the control of the parties, and which may or may not occur (with the result that the insured may lose absolutely).

On the other hand, the Maliki School tolerates *gharar* in benevolent contracts of tabarru[12]. The great Maliki jurist Al- Qarafi states that in benevolent contracts of non-profit making, *gharar* is permitted because the recipient suffers no prejudice or harm, if the contingent event does not occur. For example, a person donates a deserted slave or the fruits of his tree which are still to mature. The donee suffers no harm, if the slave is not located or the fruits do not mature, for whatever reason. The donee has paid no consideration, the contract being purely benevolent (see Al Qarafi, Furuq distinction: 24).

The aforegoing demonstrates that the principle of gharar has no application to Islamic Insurance or takaful because it is a benevolent arrangement of non-profit making based on mutual assistance and cross-subsidization.

[12] This is a general principle of the Maliki School. It is followed by most contemporary Shariah experts. The Maliki view that gharar does not apply to benevolent contracts of tabarru is most appropriate to contemporary circumstances. For example, the great Maliki jurist Ibn Rushd states that the donation of an unknown thing (majhul) or a thing which may exist in the future is valid. He states that the donation of a thing, whose sale is otherwise vitiated by gharar,is a valid donation (See, Bidayat al Mujtahid: vol 2 p329) (See also, Al Dharir on Gharar at p525 to p527).

THE CHARACTERISATION OF CONTRIBUTIONS AND PAYMENT OF INDEMNITY

The correct Shariah characterisation of the contributions made by participants is critical. As stated previously, the contribution of a participant is unconditional and gratuitous (tabarru). On this basis, the contribution represents a unilateral gratuitous transfer of ownership of the amount of the contribution from the participant to the portfolio, as a separate legal person, with capacity to own and dispose of property.

If the contributions are paid under a contract in exchange for an indemnity, then the contract is characterised in the Shariah as a commercial contract of mu`awadah, with the result that it is vitiated by gharar (as stated previously).

Similarly, the indemnity, which is paid by the portfolio as a separate legal person in accordance with its own rules, and not in terms of a bilateral contract, is unilateral in the form of a benevolent payment.

The question then arises: what is the Shariah basis for the enforcement of the indemnity or the contributions (as the case may be), which are characterised as gratuitous (tabarru) payments. In other words, is there a basis in the Shariah for enforcing what are essentially unilateral gratuitous or benevolent undertakings, outside of contracts? This problem does not arise if the Waqf model of Islamic insurance is applied (see next chapter).

There is a difference of opinion amongst the classical jurists on this issue. The Maliki School however regards gratuitous undertakings as being legally enforceable. This is expressed in a well-known statement:

'a person who assumes upon himself a legitimate obligation , becomes bound thereto (with the result that it is enforceable)'

The great Maliki jurist Al Hattab has categorised gratuitous obligations and has explained their enforceability (See his well-known work, Tahreer al Kalam fi Masaail al Iltizaam).
Contemporary Shariah experts have applied the principle of the enforceability of gratuitous undertakings or obligations in the context of Islamic Insurance or takaful (See for example , the AAOIFI Shariah Standard no. 26 on Islamic Insurance which in articles 2 and 3 states

That the contributions are paid by participants on the basis of the enforceability of a gratuitous tabarru obligation)[13].

[13] Article 2 states that the contributions of participants are made on the basis of enforceable gratuitous obligations, which in essence comprise a portfolio of insurance, with separate legal personality and the requisite power and responsibilities. On this basis, Article 4 (3) states that the "contractual" relationship between the participants (policy holders) and the portfolio is a relationship premised on the enforceability of gratuitous obligations (for the purposes of participation as a member of the portfolio). On the other hand, the relationship between the portfolio and the beneficiary, at the time of payment of compensation, or indemnity to cover the relevant loss is governed exclusively by the rules of the portfolio (and not a bilateral contract).

THE WAQF MODEL OF ISLAMIC INSURANCE

Waqf is a benevolent arrangement in terms of which the founder *(waqif)* relinquishes ownership of specific property *(waqf)*, to be held in perpetuity, with the profits generated thereon to be used for the benefit of the beneficiaries specified by the founder, and in accordance with the terms and conditions stipulated by the founder[14].

The following principles governing a *waqf* are relevant:

(a) A *waqf* is a separate legal person, with the power to own property and to dispose of property, and otherwise to enter into transactions to promote or further its objects. A *waqf* may similarly incur obligations as a separate legal person[15].

(b) A *waqf* is managed and administered by trustees (nazir ناظر - or mutawalli -متولي) who are appointed by the founder.

(c) The *waqf* of money is permissible according to most jurists, with the profits utilised for the promotion of the waqf objects.

(d) The founder of a *waqf* may also benefit therefrom if he or she stipulates accordingly, or otherwise falls within the ambit of specified entitled beneficiaries.

(e) Donations made by third parties to the waqf, do not form part of the *waqf* (to be held in perpetuity) but are owned by the *waqf*[16] and may be utilised for the objects and purposes of the waqf including for the benefit of the beneficiaries.

[14] This definition has been formulated to take into account the different juristic definitions based on the famous prophetic statement: “hold the capital and distribute the profits”. (see for example, Sahih Muslim, Hadith no: 4200).

[15] For example, a Waqf may sue or be sued in its own name. A waqf acquires rights and incurs obligations as a separate legal person. It has the capacity to own property, to be a creditor and a debtor. The founder has a broad latitude to fix the terms and conditions of the waqf, the identity of the beneficiaries, and the circumstances under which they qualify to take a benefit.

[16] This is important because the contributions of participants do not form part of the waqf (founding 'donation') but are owned by the waqf and may accordingly be used for the purposes of the waqf. The authoritative juristic work, Fataawa Hindiyah states: “A person donates money (dirhams) for the purposes of the edifice of a mosque, its maintainence or welfare, such donation is valid. Although such donation cannot be construed as waqf, it may be treated as constituing a transfer of ownership (from the donor) to the mosque. Such transfer of ownership to the mosque is valid, and is completed by possession (of the donated amount by the trustees) See: Fataawa Hindiyyah, book on Waqf.

(f) A *waqf* is perpetual in the sense that the ultimate category of beneficiaries are the poor and needy. (charity)

In the light of the aforementioned principles, a *waqf* portfolio may be established to implement an Islamic Insurance arrangement. The main points are as follows:

(1) the founder creates a *waqf* by setting aside in perpetuity a cash amount.

(2) The objects of the *waqf* are to compensate beneficiaries upon the occurrence of defined events.

(3) The waqf portfolio will be a separate legal person with all the requisite powers and responsibilites.

(4) Participants will be required to make benevolent contributions as specified in the waqf deed.

(5) Such contributions will be owned by the *waqf* portfolio and will be invested and utilised for the benefit of the *waqf*.

(6) The total contributions together with the returns thereon will be used to pay the operating expenses and benefits due to beneficiaries in accordance with the terms of the *waqf.*

(7) The payment of benefits to beneficiaries will be determined by the terms of the *waqf* deed, on the basis that the participant qualifies by virtue of his or her entitlement under the *waqf* deed (as a beneficiary), and not in exchange for any contributions.

(8) The regulation of operating surpluses will be governed by the *waqf* deed. A portion may be retained as a reserve; a portion may be distributed to participants, and a portion may also be paid to charity.

(9) Upon a winding-up of the *waqf* portfolio, for any reason, the net surpluses must be distributed to charitable causes.

(10) The portfolio will be managed by a fund manager who will be entitled to charge a fee in terms of a separate management contract. The fee will be part of the operating expenses of the *waqf* portfolio.

THE MANAGEMENT OF THE PORTFOLIO

The Islamic Insurance Portfolio may be managed by a fund manager ("the manager"). The manager is entitled to charge a fee for its services relating to the management of the portfolio. The relationship between the portfolio and the manager is governed by a separate management contract, creating a principal and agent relationship for reward (which has the effect of a contract of hire of services). The contract should specify the material terms of the appointment including the amount of the remuneration, which may be fixed as a percentage of contributions. The obligations of the manager may include the management of risk and the settlement of claims. The assets of the manager must at all times be kept distinct and separate from the portfolio. The portfolio is a separate legal person, and is distinct from the manager[17].

There must be paid into the portfolio all contributions and receipts properly attributable to the portfolio and its operations. The assets of the portfolio shall be used to meet its liabilities and operating expenses arising from its day to day operations, including the remuneration payable to the manager, and any retakaful contributions.

It is critical to note that no portion of any surplus (assets over liabilities) realized in the portfolio may be paid to the manager, directly or indirectly. The surplus may be retained as a reserve to cover future claims, and a portion may even be paid to participants according to the rules of the portfolio, pro rata to contributions. In the case of a deficit in the portfolio, the same may be discharged by way of a loan (qard hasan- قرض حسن) advanced by the manager or operator to be recovered from future surpluses.

The manager may in addition charge a fee for managing the investments of the assets of the portfolio. This arrangement may also be structured as a contract of mudaraba : the portfolio provides the capital and the manager the labour, the profits to be shared in an agreed ratio upfront.

The manager would be liable for loss caused to the portfolio arising from negligence, reckless management or material breach of contract (taaddi).

[17]Under the Malaysian legislation, Takaful Act 1984, the operator is a company which carries on "takaful business". The operating company itself establishes a takaful fund under the Act. Whilst the assets of the takaful fund must be kept separate from the assets of the operator in terms of section 17 (1), the takaful fund itself is not a separate legal entity, apart from the portfolio. The situation appears to be similar under the Sudanese Islamic Insurance founding charter enacted in 1978 (under its company law of 1925). The AAOIFI standard on Islamic Insurance (No. 26) appears to recognize in article 4 (1) that there is a separate contractual relationship between the portfolio and the manager, as distinct separate entities. However, in article 5 (2), the standard refers to two separate accounts (hisab).

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