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S. Nazim Ali and Shariq Nisar

Takaful and Islamic Cooperative Finance: Challenges and Opportunities

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Reviewed by: Umar Farooq
Rizvi Institute of Management Studies and Research
Mumbai, India

The Geneva Association, an international think tank of insurance in its November 2014 report "*The Global Insurance Protection Gap: Assessment and Recommendations*" highlights the extent of global underinsurance and the root causes for the same. According to the report, approximately four billion people or nearly 55 percent of the global population is still uninsured owing to multiple factors including low levels of risk awareness and risk culture, affordability for lower income households and small and medium enterprises, immature regulatory and legal framework especially in developing and emerging economies, cultural and religious reservations towards the concept of insurance (especially among the followers of Islam) among others.

Takāful (insurance based on Islamic Sharīʿah principles) and Islamic cooperative finance, based upon the principles of mutuality and risk sharing, has the potential to play a pivotal role in providing insurance cover to both un-served and underserved sections of the society. The book titled "*Takaful and Islamic Cooperative Finance: Challenges and Opportunities*" provides a critical assessment of various *takāful* models and the current practices of Islamic cooperative finance. It further touches upon the key role cooperative finance can play in efficiency and stability of the broader financial system.

The book is a compilation of select papers presented on the subject at the 11th Harvard University Forum on Islamic Finance, Harvard University, USA. It is edited by S. Nazim Ali and Shariq Nisar. Dr. Nazim Ali, the Founder of Islamic Finance Project at Harvard University, is currently Director at the Center for Islamic Economics and Finance, Hamad bin Khalifa University, Qatar and Dr. Shariq Nisar, the former Sr. Visiting Fellow at Harvard Law School, USA, is currently Professor at the Rizvi Institute of Management Studies and Research, India.

The book is broadly classified into four parts. Part I consists of five chapters, dealing with introduction to *takāful*: Its form, function, and criticism. Part II spread over chapters six, seven and eight focuses on the regulatory environment and legal aspects of *takāful*. Part III analyses *takāful* products in chapters 9 to 11 whereas chapters 12 to 15 make up for the last and fourth part of the book which focuses upon *takāful* as a social finance. In addition, the book has seven tables and a number of figures. It also has a glossary of Arabic terms and an index of topics.

Reasonably, in the first chapter "*Takaful* Journey: the Past, Present and Future" Ajmal Bhatty and Shariq Nisar chronicle the development of *takāful* right from the era of modern insurance being introduced in the Muslim world to the emergence of various *takāful* models and their evaluation. Referring to some internet sources they hold that it was in the early 18th century that conventional insurance was introduced in the Near and Far East by European companies. In the opinion of this reviewer, one should be very careful while quoting something from the internet because there is "no barrier to entry, no need to be an expert, anyone can publish anything they want" (Ali, 2008, p. 227). According to the authors, in 1900, Muhammad Al-Bashir, and the Grand Mufti of Egypt Shaikh Mohammed Abduh, issued their opinions in favor of the validity of conventional insurance.

It has not been mentioned who was Muhammad Al-Bashir? As far Mufti Muhammad Abduh is concerned, it has been frequently attributed to him that he permitted insurance and the interest offered by the post office on investment deposits. But many contemporary writers refute this claim (Badawi, 1964, pp. 223-39, Islahi, 2015, pp. 72-6) because no such statements are traced in Abduh's own writings. In fact, this unsubstantiated report is based on an ambiguous statement of Muhammad Rashid Rida (d. 1935) that needs to be corrected.

The authors further report that in 1906, the Mufti of Egypt, Shaikh Mohammad Baqit [Bakhit] also issued a *fatwá* favoring insurance. It may be noted that the tenure of Shaikh Mohammad Bakhit as the Grand Mufti of Egypt was 1915-1920. The authors note that these allowances were primarily on the basis of the Sharīʿah upholding those actions and deeds that save human beings from hardship. However, there were undercurrents of a need for Sharīʿah compliance from Muslim scholars for an equitable protection and sustainable economic growth for the general welfare of mankind. In 1926, Islamic Supreme Court of Egypt declared conventional life insurance unlawful. In 1965, the Muslim League Conference declared conventional insurance unlawful, followed by a similar prohibition declared by the *fatwá* Committee of Al-Azhar in 1968. In 1969, the Islamic Fiqh Academy of the Muslim World League also joined to prohibit conventional insurance. By the early 1970s, almost all forms of commercial insurance were declared prohibited.

The authors note that in the Muslim Scholars conferences held in Cairo in the year 1965 and 1972 scholars started debating alternatives to insurance in the form of mutual and cooperative insurance. These alternatives were later approved by the first international conference on Islamic economics organized by the King Abdulaziz University at Makkah al-Mukarramah in 1976 (Saqr, 1980, pp. 553-54). This was also confirmed by *fatwás* from the Higher Council of Saudi Ulama and Majma al-Fiqh al-Islami of the Muslim World League. In the meanwhile, in 1972, the National Religious Council of Malaysia set up a committee to study the Islamic insurance system and its implementation in the country. Consequently, in 1984 Malaysia became the first nation to come up with the *takāful* Act.

Over the years, *takāful* model has undergone several changes. For example, owing to the rise in the number of companies offering *takāful* and limited avenues for investments, the profits generated by pure *muḍārabah* model were very low for the operator. Thus, it was modified to allow shareholders a share in the underwriting surplus. But this too soon faced operational challenges on two counts: firstly, the capital coming into a *muḍārabah* contract, not being a donation, in fact, conflicted with the concept of *tabarruʿ*. Secondly, as the operator had to cover its operational costs out of underwriting surplus but this could only be apportioned at the end of the financial year. This resulted in a delay in the incidence of expense and its payment. This challenge eventually gave rise to other models like *wakālah*, modified *wakālah* (hybrid model) and *waqf*. But the hybrid model also faced criticism for allowing shareholders to receive returns out of the *wakālah* fee related to the participants' contributions, which affected the generation of surplus.

Volker Nienhaus in his paper "Solidarity, Cooperation and Mutuality in Takaful" remarks that *takāful* is very similar to mutual insurance except for the fact that participants are not the owners of the *takāful* operator, which is governed by a board of directors. In his opinion, this is a contentious issue in operations of *takāful* as there can be a conflict of interest between participants and the governing board. He calls *takāful* a 'mutual ideal and hybrid model'. He further points out that there are only 'two minor' differences between *takāful* practice and conventional insurance. In his opinion, in life insurance products if interest bearing bonds are replaced by investment portfolio with Sharīʿah compliant assets, then the conventional insurance and *takāful* are same. He does not agree with those Sharīʿah scholars who call conventional insurance as gambling. To him, insurance is not a game of chance but based on statistics and empirical data. The element of uncertainty in insurance is in the occurrence of the event not in the contract, as it is widely proclaimed by various Sharīʿah scholars.

Nienhaus further states that Sharīʿah scholars and Islamic economists overstate the risk transfer in conventional insurance but ignore the similar risk transfer in *takāful* practice. According to him, there are deviations in *takāful* in the way it is practiced from what it is ideally perceived to be but these are not due to negligence or ill-will of the practitioners. These are due to a combination of market mechanics and exaggerated moral imperatives. According to him, *takāful* may need a different institutional set up for better implementation of its spiritual and socio-economic qualities.

As early as 1946, Dr. Muhammad Hamidullah (1951) advocated 'mutuality' as the basis of Islamic insurance. The idea was not advanced much after him. In the work under review, Mahmoud El-Gamal through his paper "Mutuality, Reciprocity and Justice" takes this debate forward when he says that profit or loss sharing or partnership firms, which are suggested as the ideal Islamic alternative to *ribā*, may itself involve grave injustice. According to him, mutual financial structures are potentially subject to abuse and excessive risk taking as is known from the savings and loans crisis in the Unites States in the 1980s and 1990s. He criticizes the proponents of Islamic finance for invoking the ideas of mutual finance with focus on profit sharing. In his opinion, merely treating a depositor in an Islamic bank as investment account holder when they don't own a bank, or marketing Islamic insurance products as *takāful* when the policyholders don't own the company's assets or receive dividends doesn't make the products Sharīʿah compliant. He says the belief that the working structure of Islamic finance organization should be like those of mutual cooperatives will not yield results. In fact, by doing this, the focus is merely on form and not on the substance of these products, which may result in injustice to the users.

Abdullah Nana claims that *waqf-wakālah* model of *takāful* is the most Sharīʿah compliant and is best suited to serve as a viable Islamic alternative to conventional insurance. In his paper "Introduction to the *Waqf-Wakala* Model of *Takaful*", he asserts that the basic premise of the *waqf-wakālah* model is endowments. This should be more acceptable than the other models as the endowments, as he claims, have a proven track record for successfully financing and maintaining a myriad of socio-economic services vitally important for the society, such as education and health. This model offers the participants an opportunity to make a perpetual endowment that will benefit their dependents after they pass away and also help the poor directly while at the same time protecting the participants in case of unforeseen events in the future. However, the *waqf-wakālah* model also has its share of criticism as according to Mufti A.S. Desai it is just like conventional insurance and hence unlawful. But Nana says that there is more leeway in Islamic law of endowments than in normal transactions and hence this is better suited to benefit the needy and poor.

Continuing with the discussion on the emergence of several *takāful* models and the Sharīʿah issues in them, Abdulazeem Abozaid does a critical Sharīʿah review of *takāful* structures in his paper "A Critical Shari'ah Review of Takaful Structures: Toward a Better Model". According to Abozaid, donation based *takāful* model outlined in the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) and *waqf* based *takāful* model have Sharīʿah compliance issues. He proposes another model of *takāful* based on the concept of "*ibāḥah*" which is a real example of mutual cooperation. He explains that in *ibāḥah* one puts at the disposal of others something consumable and allows consuming it. However, since there is no transfer of ownership in this, the element of *gharar* relating to the use of donations doesn't arise here, thus making it more acceptable as per Sharīʿah laws.

Moving on to the regulatory environment and legal aspects of *takāful*, Sara Carmodycon tends that the Gulf Cooperation Council (GCC), which offers the most ideal conditions for establishing mutual and cooperative organizations, do not allow the *waqf-wakālah* structure for setting up a financial services company. For example, in the Kingdom of Bahrain, to carry out banking activities, it is necessary to be incorporated as either a Bahraini Joint Stock Company or be a Bahraini branch of a bank. Till 2011, in the Sultanate of Oman, there was a public policy decision not to encourage or promote Islamic finance. According to Sara, though the progress has been slow, the rising demand for insurance products and financing requirements of small and medium enterprises (SME) along with legislation for financial zones like Qatar Financial Centre, Dubai International Financial Centre and Abu Dhabi Global Market will drive the legal and regulatory change in the GCC region.

Umar Oseni in his paper "Towards a Watershed in Takaful Dispute Resolution: From Litigation to Effective Dispute Management" emphasizes the need and importance of a dispute settlement mechanism for increasing the acceptance and reach of *takāful*. He highlights the case of how consolidation of legal and regulatory aspects of Islamic finance has strengthened and expanded the reach of its products and services in Malaysia. He points out that when it comes to settling disputes and claims, *takāful* is no different from conventional insurance and experts should not resist in taking a leaf out of the successful practices like the creation of an arbitration process and ombudsman scheme among others. He cites the example of Pakistan and Malaysia in creating successful ombudsman schemes for dispute settlement.

Today, there are growing concerns the world over about the actions of regulators which seem to be crossing their mandate and instead of promoting the growth of the businesses they regulate, they end up choking them. Joe Bradford in his paper highlights how *fatwá* is restraining Islamic finance from achieving its true potential. There is often a conflict of interest between Sharīʿah Board members appointed by the shareholders of a *takāful* company and the participants. According to him, Islamization of the industry weakens both the consumer and the state. In his opinion, what is required is not more Islamization but better use of Islamic law to create equitable, just and fair markets for all stakeholders.

Abu Umar Farooq, et al., through their paper "The Nature of Re-takaful: Risk Sharing or Transferring Risks?" analyze the nature of *re-takāful*; whether it is sharing risk in compliance with the Sharīʿah principles or it is transferring risk like conventional insurance. They state that both *takāful* and *re-takāful* theoretically operate on a risk sharing model but they appear to be transferring risk as their operators become liable for meeting participants' claims underpinning the contracts and if there is any shortfall, the operators have no option but to provide an undertaking for rendering a loan. In principle, this application for a loan violates the envisaged risk sharing model of *takāful* and *re-takāful*. The authors argue that loan provision is crucial in the system as *takāful* and *re-takāful* operators have to maintain solvency of the respective portfolios as per business practice.

Taking stock of recent slowdown in the growth of *takāful* which has raised concerns among the industry practitioners, Muhammad Al-Bashir in his article "Commercial Credit Takaful" argues that the industry needs bold and strong measures to beat this slowdown. He suggests that the *takāful* industry should develop new products to meet the requirement of businesses including small and medium enterprises to compete with the conventional insurance industry. According to him, credit *takāful* should be one of the priorities of the industry in the coming years due to its enormous economic benefits, potential for growth, and increasing global importance following the recent financial and economic crisis. The credit *takāful* market should be structured to help protect businesses, traders, and financial institutions against the financial consequences of default, insolvency and bankruptcy of their trading partners. He cites the experiences of institutions such as Islamic Corporation for Insurance of Investment and Export Credit (ICIEC), EXIM Bank of Malaysia, and Shiekan Insurance and Reinsurance Company. These organizations have shown that credit *takāful* is a viable alternative and can solve many financial risks, particularly of SMEs, and can also assist in extending microfinance facilities to farmers and other poor segments of the society.

The rising global economic uncertainty has shifted focus towards financial products which safeguard the capital along with capital appreciation. The unit linked insurance product of the conventional insurance industry meets this requirement. But for the ones looking at an added element of Sharīʿah compliance along with capital protection and appreciation, there is no alternative to meet this requirement. Hiba Allam and Volker Nienhaus discuss the possibilities of a Sharīʿah-compliant family insurance product in their chapter "Shariah-Compliant High Watermark Protected Lifetime Annuity in Family Takaful". According to them, there are four major concerns that need to be addressed to meet the requirement of this segment of the population. These concerns can be met through providing capital protection via risk-free fixed income products and investing the remaining funds in high return (high risk) equity instruments to meet the requirement of capital appreciation. They also recommend the use of non-speculative conventional options with increased transparency and information sharing with customers to meet the Sharīʿah compliance. Lastly, they argue that high water mark fund can be defended by pre-deciding the calculation formula and putting in place stringent regulations to avoid excessive risks being taken.

The very premise of Islamic finance is the promotion of social welfare and justice in financial transactions. Stressing on this fact, Hussam Sultan and Abdur Rahman Syed through their paper "Reimagining Takaful: A new model for Social Banking" argue that by calling *takāful* as an *Islamic* alternative to conventional insurance, the practitioners are not harnessing its potential completely. They highlight three important aspects to further its use for social development. Firstly, the structure of *takāful* is similar to mutual insurance. Secondly, since it is a form of *mushārakah*, the *takāful* can be easily set up for shared investment opportunities as it is for risk sharing. Lastly, the contemporary practice of *takāful* has forgotten the social welfare element which is the crux of the term *takāful*. According to them, crowd funding, which is witnessing a sharp rise since the past decade, is an ideal fit for *takāful*. Initially, *takāful* funds can be leveraged for social causes and based on the experience, can be extended to a wider gamut of financial services offerings.

In spite of the sharp global economic growth since the 1990s, the benefits of the same have not percolated to the lower strata of the society. Approximately a billion people around the world continue to reel under extreme poverty. While there are multiple causes of extreme poverty, financial exclusion is one of the most important amongst them. The United Nation's (UN) Millennium Development Goals (2000) and the subsequent Sustainable Development Goals (2015) continue to prioritize poverty elimination in all its forms. International organizations have appreciated the role of Micro Finance Institutions (MFIs) in providing access to capital to micro and small enterprises and farmers alike and thus reducing the incidence of financial exclusion. The UN declared the year 2012 as the International Year of Cooperatives. In their paper "Islamic Co-operatives: A Route to Poverty Alleviation and Economic Development" Mian Farooq and Bushra Shafiq assert that *takāful* based on its mutual cooperation model can help in furthering the cause of poverty alleviation. They propose a Commercial Islamic Cooperative (CIC) which combines the principles of cooperative models of Schulze and Raifeen and the principles of Islamic finance. The CIC model will have its members classified into three segments viz. Group I or lowest income group, Group II or the middle income group and Group III or the highest income group. The key strength of the CIC model will be its double bottom line objective of social welfare and commercial success, social welfare for the members of Group I and commercial success for the members of Group II and III. The model will have its share of challenges in designing products suited for all three groups, yet maintaining the homogeneity in the purpose of its existence.

While Islamic finance institutions have shown potential, however, when it comes to scalability and impact on poverty reduction, their performance has been abysmal. Nations with large-scale Muslim population continue to remain amongst the poorest and least educated. Tanvir Ahmeduddin and Muhammad Maaz in their article "Scaling Poverty Reduction in Indonesia: Enhancing the Institutional Effectiveness of Islamic Microfinance Institutions" discuss the importance of Islamic finance in Indonesia, which has the largest Muslim population. Firstly, people demand Islamic financial services over the conventional medium as Sharīʿah compliant banks continue to be more accessible and responsive to the growing needs of micro, small and medium enterprises (MSMEs). Second, Sharīʿah compliant funds can address the shortfall in MSME funding. There are over 50 million MSMEs in Indonesia which contributed nearly 30 percent of the gross domestic product in 2012, however, the majority still lack access to formal banking. Islamic microfinance institutions (IMFIs) can play a significant role in the growth and development of these MSMEs provided government policies integrate IMFIs into the national poverty reduction framework and these organizations manage to work efficiently within the existing socio-religious and socio-legal structures in the country.

Similarly, India, which has at least a third of the global poor population and is also grappling with the incidence of financial exclusion of the marginalized sections of the society, can look at the possibility of micro-*takāful* to achieve its goal of financial inclusion as well as creating sustainable development. Reserve Bank of India acknowledges insurance as an effective tool of financial inclusion but the insurance penetration in India is still very low and much lower amongst the economically backward segments of the society. Mohammed Faisal, et al., find a huge gap in the market for an affordable Sharīʿah compliant insurance product accompanied by educational initiatives to build people's trust in mutual financial services. In their paper "Micro-*takaful* in India: A Path Toward Financial Inclusion and Sustainable Development" they assert that micro-*takāful* can bring the marginalized population of both Muslims and non-Muslims into the financial mainstream and open doors to sustainable development.

To summarize we can state that even after over four decades since its inception, the growth of the *takāful* industry is slower than expected. It accounts for only around one per cent of the global Islamic finance industry which is estimated at $2.1 trillion. The key issues plaguing the growth of *takāful* are the structure of mutual companies, *takāful* models, and business ethics. Going forward, the industry needs consolidation to better its product offering and maximize the returns to make it more attractive. There is a huge potential for *takāful* to grow especially in places where per capita income is low but GDP growth is higher as Volker Nienhaus points out that it is ideal for life and micro-*takāful* which can help reduce the incidence of financial exclusion. Like commercial insurance, even *takāful* needs to increase its penetration to enhance the operational feasibilities. Partnerships with Islamic banks like conventional bancassurance and other financial institutions can help to increase the penetration.

Overall, the book is a valuable addition to the literature on *takāful*. The most important contribution it makes is through the discussion on the Sharīʿah compliance aspect of various *takāful* models. It would have been very pertinent to see some more case studies from economically poor Muslim countries. Nevertheless, the contributors to *Takaful and Islamic Cooperative Finance: Challenges and Opportunities* have made serious attempts to analyze Sharīʿah compliance of the industry and that is the beauty of this book for common readers and researchers.

The editors have provided at the end of the book a glossary of all the Arabic terms used. However, it may not always be easy for a reader who does not know Arabic to keep referring to the glossary. This may affect professionals such as insurance practitioners (and others) to comprehend or co-relate the Arabic terms. As a suggestion, mainstream English words should replace the Arabic terms (they can be framed in brackets) for ease of understanding. This will help in comfortable reading and understanding of the subject and garner a wider readership audience.

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Umar Farooq is currently an Assistant Professor with Rizvi Institute of Management Studies and Research (RIMSR), Mumbai. He specializes in cost management, financial aspects of marketing and management control systems. His research area ranges from Islamic finance to government policies and regulations. Besides RIMSR, Umar Farooq is also associated as a Senior Economic Researcher with Deutsches Asienforschungszentrum (DAfz), a German public policy research firm where he undertakes economic assessment of public policy initiatives of various countries across Asia. In the past, he has worked with the Centre for Monitoring Indian Economy as an Industry Analyst. He was also associated as a Consultant with the Economic Risk Division of Dun & Bradstreet Financial Services. He holds a Masters in Management Studies from the University of Mumbai, specializing in Finance and is pursuing his Doctoral Studies on the key benefits of Islamic Finance in India.

E-mail: umarfarooq@rmi.rizvi.edu.in