



***Takaful Business Models, Opportunities, Obstacles and
Practical Recommendations
for
Islamisation of Insurance System in Pakistan***

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The concept of Takaful is becoming popular in the country with a number of existing as well as new players seriously considering entering into this area. This is the beginning of signs of a great change where Shariah compliant insurance solutions could finally be available to over 145 million Muslims in the country.

The scope of this paper is to cover the potential Opportunities as well as Obstacles in setting up a Takaful based Insurance company in Pakistan. Further different takaful models prevalent amongst the International Takaful operators have been discussed and the approach evolved in the country by Shariah scholars has also been presented. Finally some practical recommendations have been made which should go a long way in encouraging the effective development of Takaful based insurance system in the country.

The current trend in the financial sector is towards introduction of Islamic financial products. A number of such instruments require that the assets be insured through an Islamic Insurance company if one is available. Moreover there is a large potential market which does not insure its assets or take personal life insurance for religious reasons. At the moment all insurance companies are based on Conventional Insurance practices and there is a real need for a few Islamic Insurance companies in the market.

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1. THE COUNTRY

- 1.1 Pakistan is a very large country with a population of over 148 million people of which almost 98% are Muslims. Its economic indicators have shown improvements over the last couple of years and the insurance industry has been showing fairly healthy growth.

2. THE INSURANCE MARKET

- 2.1 The Insurance sector in general is highly underdeveloped in the country in terms of market penetration. Less than 2% of the population is covered under any kind of life insurance plan. On the General Insurance side it is felt that other than the large public sector or private sector listed companies who insure their assets, most small businesses are not insured (other than where mandated by law such as Marine business). Personal lines insurance such as for personal property, motor vehicles, family health etc hardly exist barring where required by law (for instance in the case of leased cars which has become a very fast growing market) or where provided by the employer such as Group life and Health insurance. There could be a number of reasons for this low penetration in the Insurance sector. These may include:

- (i) Lack of efforts by the Insurance companies to expand their services in a wider context, most companies concentrating on core businesses in major cities only.
- (ii) Lack of Trust on the Insurance sector in terms of their claim paying practices
- (iii) Low level of awareness amongst the masses of the concept of insurance.
- (iv) Religious reasons as all insurance companies are based on conventional principles
- (v) Cost reasons, as businesses cannot afford the extra costs related to insurance
- (vi) Low level of savings in general resulting in less people buying life insurance.
- (vii) Low returns by Life Insurance companies resulting in other financial instruments being used for savings.
- (viii) Lack of tax incentives
- (ix) Lack of demanding consumers

3. OPPORTUNITIES

General Takaful

- 3.1 The business figures for the industry for 2002 indicate a total market premium of about Rs. 11.5 billion with 42 companies operating. Of this amount almost 92% is written by the top ten companies. The growth in the industry premium has been around 12 to 15% p.a. in the last three years. A 5% switch of the existing insured to takaful companies could mean a premium income of over Rs. 600 million. Achieving this would naturally take time as the concept of takaful is new and it may take some time before people start becoming aware of this alternative and accept this alternative system.
- 3.2 Besides, National Insurance Company Limited (NICL) underwrites government business with premium of around Rs. 2.5 billion. With pressure on the government to permit this business to open competition, this represents another potential market which takaful operators can explore with government support.

- 3.3 Reinsurance terms have become tighter due to worldwide events resulting in higher premiums for the industry and ultimately the consumers. Consumers are concerned and look for alternative solutions for commercial reasons as well.
- 3.4 A fairly significant portion of businesses and individuals do not insure themselves due to non-compliance of the conventional insurance contracts to Shariah principles. More importantly a Takaful company may cater to the needs of Islamic financial institutions, which have currently no option but to insure through conventional means. Further demand is likely to arise from commercial banks, which have been permitted to operate Islamic finance windows. Also leasing companies (especially Car Ijarah contracts) may also provide potential customers who would like to insure on a Takaful basis. A takaful company will thus complete a vital link in the development of the Islamic financial system.
- 3.5 There is no hard basis to determine the size of the untapped insurance market which would like to insure if a Shariah compliant insurance alternative is available. A crude way of looking at this may be that even if 10% of the existing insured market is without insurance for religious reasons, it represents a very large potential of over Rs. 1.2 billion in premium income for just General Insurance needs. Personal lines business such as health, motor, homeowners, personal accident may have more potential to grow as individuals may have more religious concerns when insuring their personal losses (which are not required and the need is not felt) as opposed to business losses.
- 3.6 A international takaful study indicated market potential for takaful in Pakistan to be US\$ 76 million (Rs. 4.5 billion) for 2015. To achieve this would certainly require a great deal of effort and dedication in promoting the concept and implementation in spirit.
- 3.7 The return of surplus for the consumers under takaful contracts is a big attraction for consumers in other countries. Consumers in many cases are attracted to the takaful system because of its fairness and not just for religious reasons. This has been seen in Malaysia where lots of non-Muslims are takaful clients.
- 3.8 The above indicates a sizeable market for General Takaful companies to come up with Shariah compliant solutions for the masses and which should also be commercially viable for those who decide to offer these solutions.

Family Takaful (Life Insurance)

- 3.7 The Life Insurance market has also grown fairly rapidly over the past five years with private sector life insurance companies being allowed to operate in the country. There are six life insurance companies in the country with a total premium income for 2002 of about Rs. 11.2 billion. Of this individual life policies account for over 175,000 new policies being issued each year with a annual premium income of Rs. 1.9 billion. Renewal of old policies for over 1.8 million policyholders accounted for Rs. 7.2 billion in annual premium income. Further more than 7.2 million individuals were covered under Group life contracts through their employers paying a annual premium of Rs. 2.1 billion.

- 3.8 The above figures may seem impressive but indicate a vast potential market where only a very small segment of the market is insured under individual policies. A large segment of the market remains untapped due to religious concerns relating to insurance. Family takaful based on Shariah compliant principles can fill this gap to some extent.
- 3.9 Group Life and Health insurance contracts are widely used by employers to cover their employees losses related to death, disability and medical expenses. Such contracts covering more than 7.5 million individuals can very easily be offered on a Takaful basis.
- 3.10 The success of Islamic banks in terms of attracting large amounts of funds on a Shariah compliant basis, clearly indicates a thirst for financial rewards (savings) and protection (insurance) on a Shariah compliant basis. Both these objectives can be achieved through Family Takaful plans.
- 3.11 **Need is the mother of Invention. Like any other products, product innovation generally takes place when there is pressure from consumers on the industry to provide alternative solutions. It is therefore the responsibility of the consumer to demand Shariah compliant products if they wish insurance companies to come up with such products.**

4. OBSTACLES

General Takaful

Legal (Takaful Rules / Shariah Board) Aspects

- 4.1 As per the Insurance Ordinance 2000, "Takaful" means a scheme based on mutual assistance in compliance with the provisions of Islamic shariah, and which provides for mutual financial aid and assistance to the participants in case of occurrence of certain contingencies and whereby the participants mutually agree to contribute to the common fund for that purpose.
- 4.2 There are at this stage legal obstacles in the establishment of a takaful operator. Takaful Rules need to be developed so that a takaful operator can be given permission to operate under the guidelines of those rules.
- 4.3 There would also be a need to have a central Shariah Advisory Board with which SECP would need to take approval/advice prior to approval of products and other documentation filed by insurance companies.

Consumer Mindset

- 4.4 Consumers mindset has become such that they have the tendency to try to recover the premium that they have paid to an insurance company. A number of malpractices have crept into the system because of this mindset. Changing this mindset can become a major challenge for a takaful operator. It would need to ensure that like the conventional system, compromises do not creep into the system due to pressures from clients. It may be important for a takaful operator to avoid insuring such consumers as they can effect the credibility of the takaful system and ensure that operational controls are not compromised.

Malpractices

- 4.5 Insurance industry is plagued with a number of malpractices in its operational practices. The reasoning for this as mentioned above has to do a lot with consumers mindset. However the insurance industry has also adopted / accepted lots of compromises as a matter of routine business practices in the thirst to protect its business. This includes settlement of false or ex-gratia claims, kickbacks, back dating of policies and many others. All of this implies that the cost of protection ultimately becomes more expensive to the consumers. It is a standard practice of the industry to more leniently look at claims when it relates to a large client (or clients with favourable loss experience) and more strictly when it comes to a small individual client. Ex-gratia claims are similarly settled for business considerations (under pressure by clients) resulting in higher loss ratios than otherwise would be the case. A senior executive related to the insurance industry indicated that claims ratio could be lowered by at least 10% (if not more) if such practices are controlled. **Once insured, the claims process should be independent of the loss ratios or business interests as insurance by definition is for contingent events.**
- 4.6 It needs to be understood that under a Conventional Insurance company the underwriting surplus / deficit goes to the shareholders as such a company is run as a normal business entity with profits and losses being the basic objective. However, settlement of ex-gratia claims still results in higher premiums being charged as the overall experience of the portfolio worsens.
- 4.7 Under a Takaful company however, it needs to be remembered that a takaful operator is effectively **a trustee on behalf of the participants** and is managing the pool on their behalf. In such a case, therefore, if claims are settled which are not payable as per the contract terms or different practices are followed for different people for business considerations, it amounts to breaking the trust. **A takaful approach if implemented in spirit would ultimately benefit the consumer by lowering the cost of protection on a takaful basis by way of reduction in upfront cost (premium) as well as by way of return of surplus to the consumers.**

Window Products

- 4.8 A major obstacle that may be faced by a takaful operator may be by conventional companies naturally trying to protect their business from switching to a takaful basis. It is likely that conventional companies would come up with Takaful based products to protect their business interests especially if they see takaful becoming successful. For all these years, the major industry players never introduced takaful based products but it now appears that there is a degree of concern and companies are considering developing window products to be available should there clients require such a product due to the awareness of takaful system.
- 4.9 It is desirable that the regulators should ensure that takaful industry is given a chance to establish itself and grow. It is therefore suggested that **at least for a period of three to five years, General takaful products should only be permitted by takaful operators**

established as separate companies only. I believe that it would be extremely difficult (if not impossible) to be able to implement a true takaful operational system if it is operated as a window operation within existing conventional companies. This is unlike Islamic banking where the changes primarily relate to documentation and windows may be able to operate with strict guidelines, the implementation of which is yet to be seen. **What is at stake here is hurting the credibility of the takaful system by non-serious operators bringing in products to protect their business interests but not being able to follow and apply the takaful concept of mutuality.**

- 4.10 A takaful operator with a dedicated operation would hopefully be seen by the public as a better alternative than a conventional insurer having both products. International experience indicates less than 5% of takaful business is from window operations. Rest is all from dedicated takaful operations. **Further it may be noted that countries like Malaysia and in Middle East have also not allowed conventional insurers to introduce takaful products and require a separate takaful company.**
- 4.11 In either case, very strict and detailed guidelines and operational practices would need to be set-out for takaful operators so that the system is used to get more people to protect themselves from various commercial and personal risk exposures which they are unable to in the absence of a takaful operator. This would only happen if they really see this alternative as different and credible.

Investment Aspects

- 4.12 The Investment Rules would need to be framed to allow for Shariah compliant investment options but with limitations to protect the takaful funds from being invested in highly risky alternatives.
- 4.13 Investment Avenues in Shariah compliant investments are still limited. With more Islamic banks and window products likely to be available in the future, it is hoped that this critical obstacle may be overcome. State Bank would soon need to come up with Shariah compliant bonds or other instruments so that takaful operators are able to apply the funds generated by their operations. For the State bank deposit requirement, State Bank may consider, a takaful operator investing in an approved and reasonably secure Islamic financial institution with a lien to State Bank, unless it comes up with its own instruments.
- 4.14 For a Takaful company, it is all the more essential to ensure that within Shariah compliant investments, a takaful operator acts prudently in investing in different Shariah compliant investments. It would therefore be essential to ensure that suitable percentages are defined as limits on each type of investment considering the risk profile of various Shariah compliant instruments.

Family Takaful

- 4.15 Some of the obstacles covered above are equally applicable to Family Takaful plans. The issues which deserve separate attention have been discussed here.

Investments

- 4.16 Investment issues are all the more relevant to a Family takaful operator as more funds accumulate due to renewal premiums on long term plans and consumer expectations of better returns on their investments. Different guidelines for these funds would also need to be adopted which should reflect the product features and the statutory funds to which the assets would belong.

Window Products

- 4.17 It is suggested that window products for Family Takaful plans should be permitted. The reason for this being that it is much more difficult to develop a Family takaful business in terms of its infrastructure needs such as distribution capacity as well as creating a large enough need due to the stronger public perception of Life insurance being unIslamic. It may therefore be relatively difficult for a new company to come in with family takaful plans as its only business especially with a larger capital requirement.
- 4.18 Further, the issues related to malpractices etc especially on the claims side would not be a major obstacle on the life side (as the event primarily insured is death of a person). It is therefore suggested to **allow Family Takaful products to be launched by existing life insurance companies** with strict guidelines defined in terms of operational practices and surplus distribution policies.

5. TAKAFUL BUSINESS MODELS

- 5.1 Presently different takaful models are prevalent in different countries. The basic models being two i.e. Mudaraba based (Malaysian Model) and Wakalah Model (Middle Eastern model). However there are a number of finer issues and combinations of models that exist in practice which have been discussed briefly in Annex 1.
- 5.2 Discussions with scholars in the country show a clear preference for the Wakalah model due to less serious Shariah related concerns with this approach as opposed to the Mudaraba model where scholars have a number of serious concerns. A refinement of the Wakalah model has also been made which is called Wakalah with WAQF Fund that has been evolved by Darool Uloom, Karachi. I had the opportunity of assisting in this process and a model has taken shape which still needs to be discussed on a larger platform before it can be considered as being ready for implementation by Takaful operators.
- 5.3 The general perception also is that people would be more comfortable with the approach acceptable to Middle Eastern Shariah scholars compared to the Malaysian approach which is generally considered as more liberal even in Islamic banking.

- 5.4 **A final consensus needs to be developed and decision taken on the model that we wish to adopt for Pakistan. It is hoped that urgent discussions take place on the model issue and consultations are done with Shariah scholars from other countries to arrive at a consensus approach. A central Shariah Board would also be required to advice SECP on the approval of specific products that would later be submitted to SECP by different companies.**
- 5.5 **Once a consensus has been reached, it is equally important to emphasize that the Takaful Rules should specify the specific model to be adopted to avoid confusing the public at large with different models and further different variations of models being adopted by different companies. The Rules may however allow for some flexibility in certain aspects which may be left to the Individual Shariah Boards. This step would go a long way in ensuring public faith and acceptability of the takaful system and avoid creating confusion and interpretations of different models.**

6 PRACTICAL RECOMMENDATIONS FOR ISLAMISATION OF INSURANCE SYSTEM

- 6.1 **The approach of the Government in the case of Islamic banking has been to allow a parallel development, perhaps due to the practical difficulties in implementation of a full Islamic system such as existing long term debts servicing. In the case of Insurance, the difficulties would certainly be much less and it would be possible and perhaps more practical to implement a Takaful based system for the country as a whole.**

General Takaful, Group Life and Group Health

- 6.2 **General Insurance contracts are mostly of one year or less and contract terms can be changed at the time of renewal each year. Similarly Group Life and Health Insurance contracts are also of one year duration and can be changed easily to a takaful basis.**

Individual Life

- 6.3 **Under Individual Life Insurance, contracts are of longer duration. Also these have elements of guaranteed return and may be difficult to change unless reasonably secure Islamic investment vehicles are available and requires willingness to shift from a interest based system to a Islamic system of returns on part of the Government, the industry and the consumers.**
- 6.4 **The advantages of such a transformation could be enormous, starting with the real possibility of getting away from lots of malpractices and waste in the conventional insurance system, which would directly benefit the consumers and ultimately the country's economy.**
- 6.5 **There is obviously a need to have the will to transform any system and than to lay out specific steps with a timeline to implement the changes. This naturally requires detailed planning and commitment with all stakeholders taking part in an extensive review of the overall issues involved. Some of the steps which may be taken in this direction may include:**

Encourage setting up of separate General Takaful Companies

- 6.6 To start with regulations need to encourage the establishment of separate takaful companies instead of allowing window operations which may simply try to crush a takaful operator before it can establish itself for pure commercial interests as any business entity would do to protect itself.
- 6.7 It needs to be ensured that regulatory limitations which may be set-out are not penalizing a takaful operator on account of two sets of rules being applied to it in terms of compliance etc – one from the regulators and the other from Shariah perspective. Regulation needs to ensure that there is at least a level playing field for takaful operators so that they are able to operate and establish themselves and the compliance and other costs do not unduly disadvantage them but perhaps some incentives are offered to encourage companies to set-up separate takaful operations.

Representation by Participants

- 6.8 Participants interest on the Board of a Takaful operator may be considered to protect the interest of consumers and develop a sense of belonging. This may for example be a representative of employers or employees association. A mechanism for this would need to be thought through.

Regulatory Changes

- 6.9 It is important to realize that a takaful operator also needs to be financially viable. One should not expect a capital investment of Rs. 80 million or more on part of shareholders for the sake of introducing a Shariah compliant company. I do not believe there is anything wrong with earning rewards on the effort that you make as long as the compensation basis is defined in advance and is acceptable to both parties. Sharing in underwriting profits does not appear to be acceptable under Shariah given the objective of mutuality in sharing risks but a fee based approach is acceptable.
- 6.10 It is important that Takaful Rules are framed keeping in view the protection for the consumer in terms of controls in operational practices and penalizing operators not adhering to strict guidelines. On the other hand, limitations should not be such that the operator is at a disadvantage from day one and is therefore not able to compete with conventional operators on at least equal footing.
- 6.11 Regulations would need to ensure that proper and adequate measures are implemented and there is a strict monitoring system in place to control malpractices with strict penalties for any violations.

Composite Companies

- 6.12 Under the new Insurance Ordinance, General insurance companies require a capital of Rs. 80 million and Life Insurance companies Rs. 150 million. Separate licenses are required for both lines of business and composite companies are not permitted. One of the reasoning behind perhaps was the earlier malpractices (when composite companies were allowed prior to Nationalisation) related to proper allocation of expenses and segregation of funds and

accounts which suggested that composite companies should not be permitted. These led to issues related to equity for Life Insurance policyholders of composite companies in the form of bonuses that they received. In General Insurance the concept of bonus is not there and all the profits belonged to shareholders.

- 6.13 Under a takaful system following the Wakalah model, the takaful operators fees is pre-defined as per the contract. All expenses may be charged from this fees and any excess gets charged to the shareholders account. Expenses less than the fee is the source of profits for the shareholders. Further the underwriting surplus is to be passed on to the policyholders. In view of this, **it is suggested that to encourage companies to launch family takaful plans as well, a composite license (to operate both General and Family Takaful with limitations) may be granted to takaful operators.** The paid-up capital should be related to the types of products and the distribution network that the operator wishes to use.

- (i) **Additional paid up capital of Rs.70 million (i.e. total of Rs.150 million).** It is suggested that with this additional capital (separately identified) General takaful operators may be allowed to market life assurance risk products through certain distribution channels suggested as through banks and directly to employers (as a Group contract). This would imply lower distribution costs (with lower expense limits also to be applicable by Takaful rules) for the takaful operator to establish and maintain a distribution network and ultimately lower costs to the consumer. With the above limitations, **a General takaful operator should be permitted to write life risk business (group life and bank assurance risk products) with a total paid up capital of Rs. 150 million** (instead of Rs. 80 million for General business only). Risk products may also be co-branded with savings products of Islamic banks to offer a one window cost effective solution to consumers.
- (ii) In case a takaful operator wishes to also write Individual life business through the usual agency distribution channels than the normal capital requirement of **additional Rs. 150 million** would be applicable.
- (iii) In addition to encouraging takaful operators to write family takaful risk business, this would also provide an opportunity to employers to spread there risk over a larger takaful pool with assets as well as employee related risks. There could be a possibility of surplus determination and/or distribution based on the overall pool and the share of an employer/participant may be on the combined portfolio of risks passed on to the pool.

Retakaful Pool

- 6.14 Government needs to encourage establishment of a Retakaful pool for takaful operators. Such a pool is highly desirable for the takaful industry to grow not just in Pakistan but also internationally takaful operators have a need for risk sharing pools. NICL and PRCL may be considered suitable to establish such pools for General Takaful business given their portfolio size. However it needs to be ensured that these are managed on a professional basis and able to attract takaful operators within Pakistan and possibly from other regional countries takaful

operators as well. Such a pool has been established in Malaysia and caters to about six different takaful operators. Similarly State Life Insurance may be encouraged to form a Retakful pool for Family takaful business given its huge capacity to retain risks.

Transformation to Islamic Insurance system

- 6.15 A complete transformation would obviously require Government intervention by way of incentives to encourage both consumers to move to a takaful based company and also to insurers to offer takaful based products to their clients. For e.g. if premium is paid to a takaful operator, it is a 100% deductible expense whereas if its paid to a conventional insurer it may be 90% tax deductible. This is to gradually change the consumers mindset as a lot of malpractices do take place in the conventional industry due to consumer pressures. If such an incentive is offered, then it would be necessary to allow window products by conventional companies as otherwise it would provide an undue advantage to a takaful operator which is not the objective, which is to gradually transform the system.
- 6.16 Similarly for the insurer, on its takaful business income it may be charged a lower tax rate to encourage it to switch clients to takaful based products. The incentive aspect really needs to be thought through after discussions on the practical issues which can arise in its implementation.
- 6.17 The objective may be set to transform the conventional insurance industry into a takaful based industry in a predefined period of 5 to 10 years time. The cost to the consumer would decrease as elimination of elements of malpractices would bring in more than the required savings to offset the temporary tax cost.
- 6.18 It is important that such a transformation is seen positively by the conventional insurance industry. **Such a transformation would mean that the industry would then compete on its service levels and the fee it charges for the service. Also it should be noted that its ability to do better risk management would not go unrewarded.** On the risk part it manages the risk professionally but does not derive any direct income for its shareholders on this account. The incentive to pay ex-gratia claims for business reasons also is minimized for two reasons:
- (i) by controlling such practices and having better overall underwriting results it is able to distribute more surplus to its participants which itself would attract more customers to its portfolio. This would mean it would have a larger pool to manage, thereby reducing its costs which implies higher profits for shareholders and/or reducing fee levels further to attract even more business.
 - (ii) it may over time loose its credibility if the market which wishes to insure on a takaful basis realises that the company is not following the spirit of takaful. Further regulatory controls and participants representation would make it more difficult to settle such claims.

- 6.19 A complete transformation could rid the insurance industry of a lot of evils which are unlikely to go away with a parallel system. A Shariah compliant takaful system does not prohibit any insurer from making profits it wishes to derive. For instance the takaful operator fee may be kept as 40% if market accepts this level of fees (although it is likely that regulation would limit the level of fee). For the shareholders, the risk of underwriting losses would be passed on to the policyholders (other than giving a Qard Hasnah recoverable from future surplus) although risk management techniques would try to ensure that deficits do not arise in a takaful fund by way of retakaful/reinsurance (as may be permissible).
- 6.20 A complete transformation or incentives to takaful would mean more and more security can be available on a takaful basis. This would ease the creation of a ratakaful pool amongst the takaful operators and make this much needed service available at our doorsteps. A larger retakaful pool can also better negotiate with international reinsurers and with expansion increase its capacity to retain risks within the pool. This would over time reduce our reliance on foreign reinsurance which is difficult to obtain these days in any case. The ultimate objective should be to have large enough pools to eliminate/minimize the need for foreign reinsurers.
- 6.21 The implementation of such reforms would have its own hurdles which would need to be thought through and solutions discussed at length with the industry as well as with consumers. A change in the consumers mindset is an essential element in any kind of market reforms and a sense of trust needs to be established for reforms to succeed. To make a beginning though it would be essential to first of all lay down the issues which may be faced and create multiple platforms to discuss the issues at length before a implementation plan can be evolved.
- 6.22 The issue here is to provide financial protection at a reasonably fair price to all who wish to protect themselves from unforeseen events respecting the Shariah requirements which are very much aligned with the objectives of the community at large. **Takaful could provide the opportunity to reduce the costs of protection and ensure that if a surplus arises in the pool there is a return of surplus available to participants.** Shareholders earnings potential may not get impacted as what is changing is the sources of profits being from fees rather than from underwriting results to follow the mutuality concept. **Takaful could become like a insurance program being encouraged by Government but financed by individuals and managed by private companies who wish to join in on a voluntary basis. This could result in substantial overall economic benefits as well as resolution of moral issues related to the industry.**
- 6.23 I hope this discussion paper would serve as a useful documentation of the issues that need to be digested, discussed and concluded. This may enable the industry as a whole and the potential sponsors who intend to introduce the Takaful concept and set-up a company along these lines may need to think through together with consumers and regulators so that all aspects of this huge industry and its equally large untapped potential could be explored to its fullest.

- 6.24 The opportunity to offer an alternative to conventional insurance system to the population at large is a great opportunity which should be utilized in its true spirit.

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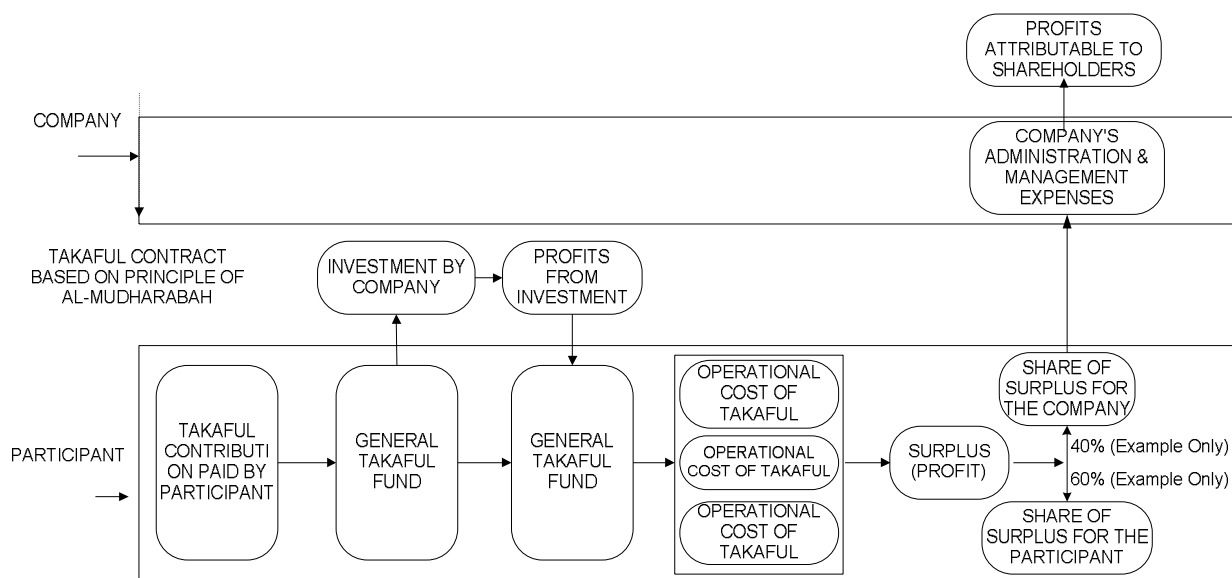
Annex 1

1. *Takaful Business Model Alternatives*

- 1.1 There is enough material available related to the basic takaful concepts and differences with conventional insurance. It is equally important to try to differentiate between the different alternative models being followed in different parts of the world.
- 1.2 The basic concept of mutuality and shared responsibility being permissible by way of “tabarru” (donation) should be kept in mind in differentiating between the different models.
- 1.3 Also it is important to note that the basic variations relate to the application of the model to the **risk portion** and not the investment portion where a Mudaraba approach is generally applied under all models. The models discussed below are from the perspective of General Takaful business, although the same models are applicable to Family Takaful as well with different variations.

2. Mudaraba Model

- 2.1 A flow chart showing the Mudaraba model (also known as the Malaysian Model) is given below for ease of explanation:



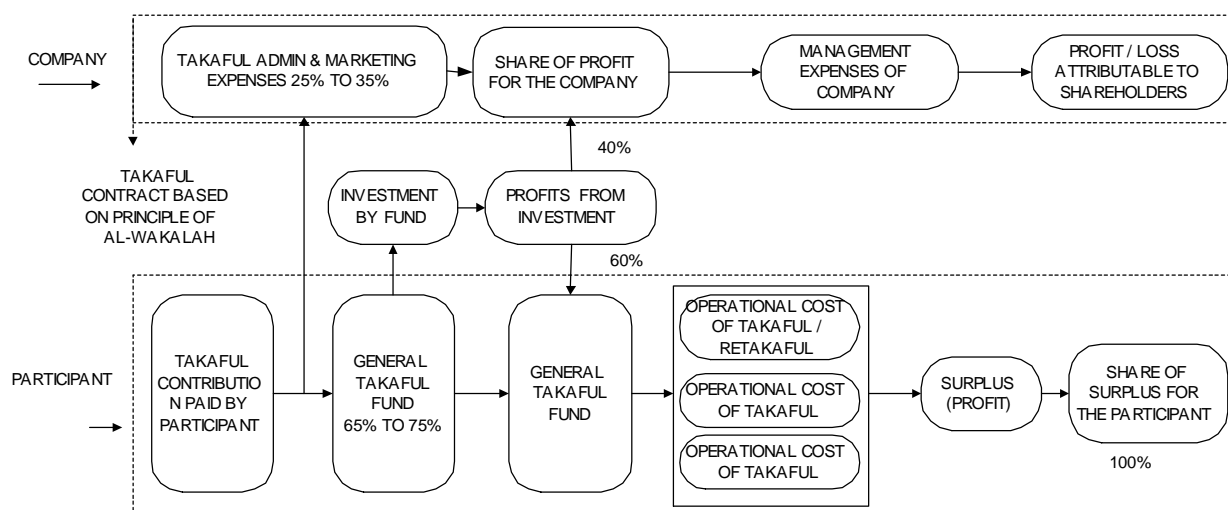
- 2.2 It may be seen here that the participants contributions and investment income is being used to pay for claims, retakaful/reinsurance costs and other claims related expenses from the General Takaful Fund. The remaining surplus in the takaful fund is than shared between the participants and the Shareholders in a defined proportion (60:40 here). The Shareholders are responsible to meet all management related expenses from their share and any remaining amount would be the shareholders profits.

Concerns:

- 2.3 A basic concern which also is the most contentious one is the application of Mudaraba or “Profit Sharing” contract to a takaful operation and the sharing of surplus by the operator. First the relation between the participants is that of tabarru and not Mudaraba. Second, in a Mudaraba contract, a profit is to be generated to be distributed. Profit is not the same as “Surplus” (excess of premiums over claims, reserves and expenses) and in the insurance context no profit can be generated by definition. Third, the sharing in surplus itself is something which is similar to making this into a business venture and not a mutual contract for assistance. Fourth the requirement to provide Qard Hasnah (in case of a deficit) in a Mudaraba contract in itself is against the concept of Mudaraba which is a profit sharing contract and a Mudarib cannot be a guarantor.

3. Wakalah Model

- 3.1 The model is common in the Middle Eastern countries as approved by their Shariah scholars. The basic concept here is that the takaful operator acts as a Wakeel for the participants. His role being to manage the affairs of the pool for a defined fee. The flow chart is shown below:



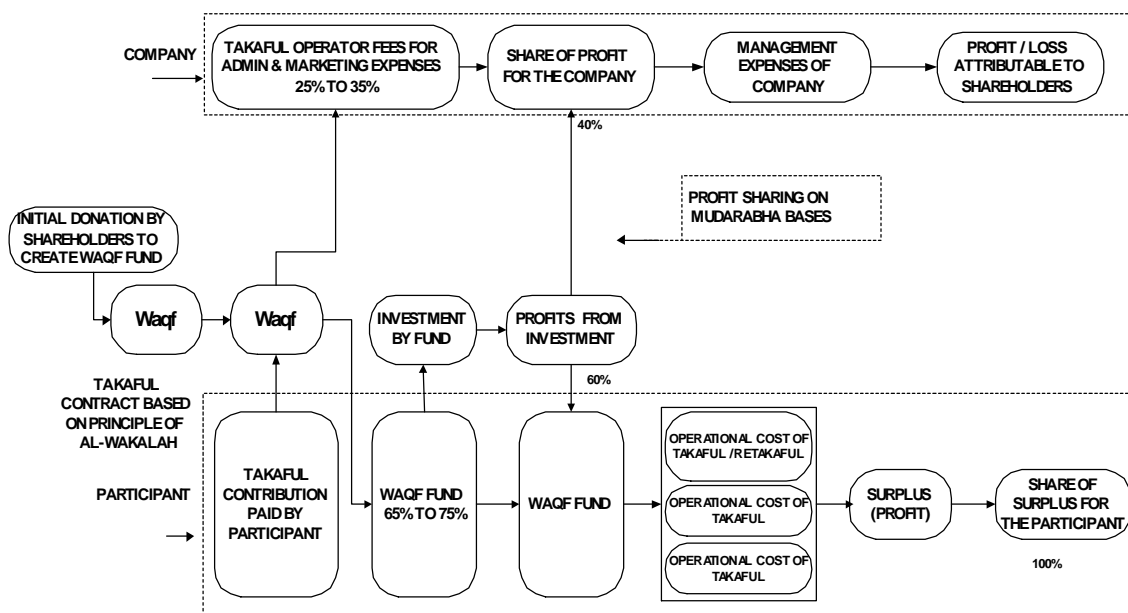
- 3.2 The Wakala fee may be defined upfront (generally in the range of 30 to 35% of the contributions) which may be transferred to the Shareholders account. The remaining portion of the contributions may be transferred to the Takaful account which is used to pay claims, retakaful costs etc. The surplus which remains may then be allocated 100% for the benefit of the participants. Generally a portion of the surplus may be retained as a contingency reserve and the balance may be distributed to participants in proportion to their contributions (to those who have not had a claim). The shareholders would be responsible for all expenses of management and marketing etc and their earnings would come from expenses being less than the fee and the investment income share as a Mudarib for the takaful fund and investment income on the Shareholders funds.

Concerns:

- 3.3 A Wakala model is more acceptable as the concerns related to a Mudaraba model above are resolved under a Wakalah model. Some of the concerns related to the Wakalah model are: (i) Under a Wakalah model, the tabarru (donation) remains in the property of the participant as he has the right to receive the surplus back and therefore becomes conditional (ii) Further this gives rise to issues such as inheritance in the case of death of the person as the donation is a conditional gift. (iii) The relationship is between the participants and the operator and also amongst the participants which gives rise to a contract of compensation. (iv) Qard Hasnah is an obligation on Shareholders which would be returned by future generations which would be different. These concerns are less serious and it was required to find solutions to these issues within the Wakalah model as in principle this model was seen as more acceptable by scholars as the issues within Mudaraba model are much more serious from a Shariah perspective.

4. Wakalah with Waqf Fund

- 4.1 A discussion on the Wakalah model lead to the concerns related to the Wakalah model and solutions were offered by Darool Uloom Karachi in the form of a Wakalah Model with a separate legal entity of WAQF in between.
- 4.2 A Waqf Fund would basically be a separate legal entity to which the Shareholders would initially make a donation to establish the Waqf Fund. The donation can be of any reasonable amount (Shariah scholars may specify such an amount). The objectives of the Waqf fund would be to provide relief to participants against defined losses as per the rules of the Waqf fund. A WAQF based model flow has been illustrated below:



- 4.3 In this modified Wakala Model with Waqf, the relationship of the participants and of the operator is directly with the Waqf fund. The Operator is the Wakeel of the Waqf Fund and the participants pay one sided donation to the WAQF fund (not conditional) which also eliminates the issue of Gharar. The WAQF fund rules may define the sharing of surplus and other rules under which it would operate but there is no obligation to distribute surplus. Further the Qard would be given by the shareholders to the WAQF entity and not to individuals as in the typical Wakalah model.
- 4.4 The donations received from the participants, seeking takaful protection, would also be a part of this fund and the combined amount will be used for investment and the profits earned would again be deposited into the same fund. The company on the basis of set rules and regulations would pay the losses of participants of the fund from this same fund as per its rules. Besides this, all operational expenses that would be incurred for providing takaful services e.g. arrangements of Re-takaful and building-up of Reserves will also be met from the same fund.
- 4.5 The sources of income here would be the same as under the Wakala model covered above. The only differences here mainly relate to the separate WAQF entity being created which resolves a number of Shariah related issues and makes it a acceptable model for the local Shariah scholars at Darool Uloom, Karachi, an institution with a high level of credibility amongst the general public and a reputation.

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