

# An Analysis of the Implementation of Shari'ah Principles in the Management of Takaful

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**Abstract**— This study was conducted to establish the level of knowledge of the management of takaful providers in Nigeria of Islamic financial principles relating to takaful and to determine whether the management operations of the takaful providers are in complete compliance with Islamic financial principles relating to their chosen takaful model. Using qualitative research techniques, the study discovered that the majority of persons chosen to run takaful units were inadequately educated concerning takaful. It was also discovered that some takaful providers had issues with *shari'ah* compliance to conditions for the validity in Islamic law of their chosen mode of financing. The paper concluded with recommendations to ensure persons dealing in the provision of takaful are adequately educated and mechanisms put in place to regulate takaful operations particularly those pertaining to modes of financing

**Keywords**— Takaful principles, Islamic modes of financing, *mudarabah* financing, takaful models, *shari'ah* compliance.

## Introduction

Takaful is “A type of Islamic insurance, where members contribute money into a pooling system in order to guarantee each other against loss or damage. The term derived from the Arabic root word *kafala* (which means guarantee), refers to a system of insurance which provides risk protection within Islamic parameters (Bekkin, 2007; Usman, 2000). The basic principle which provides the foundation for takaful insurance is risk protection based on mutual help and brotherhood where it is the responsibility of individuals facing the same type of risk to cooperate and protect each other (Ahmed & Ahmed. nd; Maysami & Williakims, 2006). Thus it is “a scheme that is based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose (1984 Malaysian Takaful Act).

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This system of contribution itself is based on a concept referred to as the principle of ‘*Tabarru*’ (donation/charity). Therefore, while under conventional insurance risk protection is provided by the insurance company in exchange for premium payments, in takaful, the insured persons provide this protection for each other as the risk is distributed and managed based on *taawun* (solidarity and mutual assistance). Furthermore, with conventional insurance, all premium payments and the risk fund from which claims are satisfied belongs to the company with the company aiming to make profits by paying out, as claims, less than it collects. (Rejda, 2011). With takaful, on the other hand, the risk pool belongs to the contributors (usually referred to as takaful participants) who hand it over to a manager (referred to as the takaful operator) to oversee contributions and claims payments. The common practice is to invest the fund and the takaful operator is paid by for its services via an arrangement with the participants (operating model) using either one of the various Islamic modes of financing. This paper presents the results of a study into the Nigerian takaful practice and management against the backdrop of Islamic financial laws.

In Nigeria, takaful services are provided by three conventional insurers. Two of which is do so via window operations while the third as a subsidiary of the parent company. For the purpose of this research, three research questions were raised:

- i. What is the extent of the knowledge of the basic principles underlying takaful of the heads of takaful units of the companies?
- ii. What is the extent of the knowledge of Islamic modes of financing of the heads of takaful units of the companies?
- iii. To what extent do the companies implement and follow the guidelines and the conditions relating to their choice of mode of financing in the takaful model?

These questions are hoped to achieve the research objectives

- i. To establish the extent of the knowledge of the basic principles underlying takaful of the heads of takaful units of the companies?
- ii. To determine the level of understanding and exposure of heads of takaful units of the takaful providers to the laws and regulations pertaining to the mode of financing chosen by their company
- iii. To determine the extent to which the management of takaful companies in Nigeria comply with Islamic laws and regulations governing their chosen mode of finance for takaful model

The paper is divided into six sections. After the introduction, an outline is presented of the different modes of financing available in Islamic financial law particularly those relevant to takaful operations. The next section looks at the preferred takaful operating models while explaining how they work to incorporate the modes of financing and the fourth section provides data collection and sampling method used to answer the research questions. The fifth section presents analysis, observations and recommendations.

### I. Modes of Financing, Takaful Operating Models and the Laws Relating Thereto

This refers to the methods used by Islamic financial intermediaries to generate income for themselves within the confines of ethics, guidelines and prohibitions of Islamic financial law. It indicates a situation where financing is provided for a venture, usually in partnership with others, with the aim of making a profit which profit is usually shared amongst the partners. (Usmani, 1999; Khaf, 2006). The different modes of financing in Islamic law include *mudarabah*, *murabaha*, *musharakah*, *ijarah*, *salam* and *istisna*. Other additional modes of financing include *wakala* and *waqf*. However, in relation to takaful, the important modes are *mudarabah*, *wakala* and *waqf*.

A *takaful* operating model, on the other hand, refers to the arrangement between the *takaful* operator (TO) and the participants of the *takaful* fund regarding the system of provision of the *takaful* operator's remuneration for the service of the management of the takaful fund (Archer et al, 2009; Bakar, 2009; Hussain, 2009; Htay & Zaharin, 2012; Kwon, 2007). An operating model utilizes one or a combination of the *mudarabah*, *wakalah* or *waqf* modes of financing as contracts of compensation to regulate the arrangement for the payment of the TO (Dusuki & Abdullah, 2007).

#### A. Mudarabah

This is an equity based financing model where one party, referred to as the *rabb al mal*, provides funds for a business venture while another party, referred to as the *mudarib*, provides the managerial skill. Profits realized from the venture are then shared according to a predetermined ratio, losses, on the other hand, are borne by the *rabb al mal* alone while the *mudarib* takes nothing in the event of the loss (Quraishi, 1947; Sadique, 2009; Gamal, 2006; Obaidullah, 2005; Siddiqui, 2010; Khaf & Khan, 1992). In effect, the entrepreneur gets a share of the profit in return for his skill and services but gets nothing where he fails to achieve a successful venture.

Before a valid *mudarabah* can be constituted, the investment fund must be explicitly stated at the inception of the arrangement (Sadique, 2009; Alwosabi, nd), the sharing of profit must be in a predetermined ratio not a percentage of investment (Sadique, 2009; Nadeem, 2010) and the *rabb al mal*, though not permitted to be involved in the day to day management of the venture, may have a say as to the nature of investments the fund can be involved in (Alwosabi, nd). Furthermore, while profit is shared between the *rabb al mal* and the *mudarib*, any loss should be borne by the *rabb al mal* alone. And finally, at the termination of the arrangement, the *rabb al mal* is entitled to a return of his capital contribution

When *mudarabah* is used as an operating model, takaful contributors are considered to be the *rabb al mal* and the *takaful* operator is the *mudarib* with the *takaful* fund being the capital for investment in shari'ah compliant ventures. Therefore, the *takaful* operator as manager is expected to provide entrepreneurial skills to manage the fund and in return he becomes entitled to a share of the profits and any surplus from underwriting on a predetermined ratio (Kasim, 2005). Any loss, whether from investments or underwriting, should be absorbed by the participants just as is the rule with *mudarabah* financing (Htay & Zaharin, 2012) but the TO may be required to provide a *qard hasan* to the takaful fund in cases of deficit which will be repaid from future surplus (Abdul Rahim et al, 2007).

In a pure *mudarabah* model, the TO is responsible for its own management expenses from its share of profits and may not deduct same from the fund. However, a modified *mudarabah* model has evolved where the TO is also entitled to a share of any underwriting surplus based on a pre-agreed ratio.

#### B. Wakala

The *wakalah* contract is technically not a model for financing but a service contract where one person, referred to as the *wakeel* (agent), is employed to perform particular service(s) on behalf of another the *muwakkeel* (principal) for which the former will be provided remuneration (Ayub, 2007). The *wakalah* agreement can be used for a multitude of purposes and in conjunction with other modes of financing and in this type of contract, all risks, profits and loss are born by the principal. The remuneration of the *wakeel* is usually based on the agreement between the principal and the agent which may be a percentage of the amount or it could be an up-front fixed amount irrespective of the funds with the *wakeel*.

The *wakalah* takaful model places the TO in the position of an agent employed by the participants to manage the *takaful* fund in exchange for a fixed agency fee. In this model therefore, the complete ownership of the fund and all benefits accruing to it remains with the participants and in a pure *wakalah* model, the TO as *wakeel* merely manages the underwriting activities of the fund and handles the investment of what is left over from the fund after deduction of its *wakala* fee (which is paid annually) and other expenses attached to the fund. According to Tolefat and Asutay (2013), the TO earns a fee for both services but is not entitled to share in the investment profits (Dusuki & Abdullah, 2007; Kasim, 2005; Hamid et al, 2010). With the more commonly used model, referred to as the modified *wakalah* model (Odierno & Ismail, 2008) or *wakalah* with incentive fee (Frenz & Soualhi, 2010) however, in addition to this fee, the TO may also take a share of the surplus of the fund, after claims and expenses, based on a predetermined ratio as performance incentive fee (Dusuki & Abdullah, 2007; Bhatti, 2007; Zukifli et al, 2012; Tolefat & Asutay, 2013; Salman & Htay, 2014).

#### C. Waqf (Endowment)

The Arabic word literally means 'hold', 'confinement' or 'prohibition'. Under Islamic law, it refers to the irrevocable setting aside and designation of particular property (which can exist in perpetuity), either as a religious, charitable or

pious donation whether real (Cizaka, 2009) or in cash (Chowdhury, Gazali & Ibrahim, 2011) by way of endowment to be used for the benefit of persons who may not be the owners of the property (Khaf, 1999; Muhammad, Iman, Hamid & Omar, 2005). A manager(s) is usually appointed to manage the *waqf* property (safeguard and invest) and is paid a salary for the job as *wakeel* and the terms of his duties may be general or specific (Ibrahim & Ibrahim, 2013).

As a *takaful* model, a *waqf* fund is initially created by shareholders of the TO for the purpose of providing protection against risk to others and such persons (the *takaful* participants) become entitled to this protection by applying for membership and paying subscription to the fund. This fund is then handed over to the TO to manage under its choice of *mudarabah* or *wakalah* contracts or a combination of the two. However, according to Htay & Zaharin (2012) unlike other models, any profits from investments belong to the pool and not the participants. Therefore, profits are subsumed back into the *waqf takaful* fund and cannot be shared amongst the participants as surplus.

## II. Methodology

This study used semi structured interviews as a qualitative data collection tool. According to Robson (2002), the use of the semi structured interview in one-on-one interviews allows for the collection of data on subject areas which the researcher already has some knowledge using a flexible list of open-ended questions which allows for flexibility within each interview so that optimal information is obtained from participants (Wallace, 1998).

The interviews were conducted with members of the *takaful* units of each of the two insurance companies providing *takaful* services via window operations and the third company which does so through a subsidiary. Interviews were also conducted with users of *takaful* products of each of the providers. In particular, heads of each of the *takaful* units and participants of each of the providers in three geo-political zones of the country were interviewed so as to ensure adequate coverage and representation of the entire country. The purpose of obtaining data from both providers and users is to provide triangulation of information by collecting data on the same phenomenon from different sources so as to establish mutual confirmation of data and validation of findings (Berg, 2001). Goetz and LeCompte (1984) view it as a method of strengthening the connections between links in data which allows researchers, particularly in qualitative research, to obtain other perspectives on data apart from their own (Boman, LeCompte & Goetz, 1996).

To obtain access to *takaful* participants (also referred to as users), heads of *takaful* units and members of marketing staff were asked to provide introductions to at least one user of *takaful* products. Using the snowball sampling technique (Handcock & Gile, 2011), each user was then asked to provide an introduction to another user. The participants in this study included 10 members of *takaful* units of which five (5) were from the first *Takaful* Operator (hereinafter referred to as Company one), (3) from the second (Company two) and two (2) from the third (Company three). Of the 10 users interviewed three (3) were customers of Company one,

four (4) were those of Company two and (three) 3 from Company three.

## III. Results, Analysis and Observations

All of the *takaful* providers indicated that they used the *mudarabah* model for *takaful* operations and this was supported by the policy documents which the researcher was given access to. Therefore, the aim of the research became to ascertain whether the heads of *takaful* units had adequate working knowledge of the rules governing the *mudarabah* model. The research also hoped to determine whether the *takaful* providers were complying with the conditions for the validity of using *mudarabah* as a mode of financing. This section presents the key findings obtained from the interviews conducted. Following is a discussion of the findings with details that support each finding.

The first major finding was that only four of the heads of *takaful* units interviewed had a satisfactory understanding of the fundamental principles underlying *takaful*. The majority of the heads seemed to view *takaful* as a system of investment or savings based on a profit and loss sharing system. This is evidenced from the excerpts of the interviews conducted;

Head of unit #1: “I know *takaful* works with the Qur’anic principles of no usury (interest). That is we don’t talk about interest but about profit”

Head of unit #2: “My understanding of *takaful* is that it does not believe in interest”.

Head of unit #3: “the *takaful* man told us that *takaful* is a non interest yielding policy, that’s the major thing”

Head of unit #5: “what I understand about *takaful* is that it is like gathering your money, giving to the beggar...”

The second major finding was that the majority of the unit heads interviewed also had misconceptions about the modalities for the lawful implementation of *mudarabah*. From the interviews, it became obvious that some believed *mudarabah* was meant for profit sharing alone and had no idea that the participants, as *rabb al mal*, would be required to bear any losses that befell the *takaful* fund while others believed it was a profit and loss sharing system.

Head of unit #4: “the returns do not come in a usury form. The returns come in a profit or loss sharing form”

Head of unit #4: “when I asked whether they had ever realized a loss, they told me that whatever they generate every year, they always keep a reserve. When the money from their investment is not forthcoming, they fall back on this reserve so that they keep their customers. Because in Nigeria, no matter their cadre, nobody will like to be associated with loss”

These two findings are probably due to the fact that of the 10 heads interviewed, only three had any formal education in Islamic finance as answers given to questions about



educational qualifications showed most had foundations in non-related fields ranging from Agriculture to Business Administration. All others had their exposure to Islamic finance principles, particularly takaful principles limited to the odd ‘one day training’ in takaful products with particular emphasis on how best to sell those products while some had no training at all.

The third major finding was that the management of two of the takaful companies had areas in which they were not in complete compliance with the Islamic financial laws regulating *mudarabah* as a mode of financing. Lack of compliance ranged from failure to share profits in a predetermined ratio with participants instead being given a fixed percentage of their investment to the allocation of profits to the participants even when investments have not yielded any. In effect, the takaful operator was not only absorbing losses but paying out profits from its own coffers. This was also observed from excerpts of the interviews;

Head of unit #1: “initially when we started we were giving 10% of your investment at the end of the year but the economy changed and .....so presently we give 1% which is subject to review by the board”

Head of unit #1: “from the discussion we have had with management the company is not really making much from takaful. It is running at a loss.... I can tell you that we pay out more than what we collect.....Nigerian populace doesn’t want to hear about loss”

Takaful user #3: “when they bring the money the excess that will be on top will not be much. As I did contribution of N20, 000 for a year at the end of it what is on top is only N2,400”

Head of unit #4: “when I asked whether they had ever realized a loss, they told me that whatever they generate every year, they always keep a reserve. When the money from their investment is not forthcoming, they fall back on this reserve so that they keep their customers. Because in Nigeria, no matter their cadre, nobody will like to be associated with loss”

This failure to adhere to rules of financing relating to *mudarabah* may be attributed to the fact that takaful products are provided by a conventional insurer which is accustomed to paying out a fixed return on its conventional products and so extends this system into its takaful products. This would also imply that there may be lapses in the oversight functions of the regulator as indications of payment of a fixed return were clearly indicated in the policy documents of some the providers.

#### IV. Summary and Recommendations

This study gave an insight to the level of exposure to and knowledge of Islamic financial laws and principles, of the

management of takaful providers in Nigeria. It also provided an analysis of the shari’ah compliance by management regarding the chosen mode of financing of these takaful providers. In essence, the study discovered that knowledge of Islamic financial principles, particularly those relating to takaful, were generally inadequate or inaccurate amongst the majority of those involved with takaful units of the takaful providers in Nigeria. The study also determined that the takaful providers were in one way or the other, failing to comply strictly with the conditions for the validity under Islamic law of their chosen mode of financing.

From the foregoing, recommendations include the following;

- i. Appointment to the positions relating to the provision of takaful services should be based on the possession of necessary knowledge, qualifications and/or experience with Islamic financial law. This could be done by either ensuring they have the necessary qualifications before employment or by providing in-depth training.
- ii. Regulators must not only enact laws specifying strict compliance with Islamic financial principles in all facets of takaful operations particularly the mode of financing, a supervisory mechanism should also put in place to ensure compliance.

Finally, though this study is limited to the Nigerian takaful industry, future research may extend the same research questions to other jurisdictions where takaful is also provided.

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