Takaful articles

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MIXED MODEL IS BEST APPROACH

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Existing takaful companies can be differentiated according to their objectives. While some companies are established as non profit entities and merely aimed to provide the participants (policy holders) with low cost insurance similar to mutual companies, others are based on profit basis. The former plan is widely adopted in Sudan and follows mutual plan whereby the board of directors and managements are elected by the participants. In the latter plan, companies located in the countries other than Sudan, are established to maximize profit for shareholders.

However, the structure of takaful companies on profit basis is totally different than conventional commercial insurers as will be discussed later. The most dominant models that have currently been adopted by takaful companies on profit basis are pure Al-Wakala, pure Al-Mudarba and a combination of the two models whereby the Al-Wakala contract is adopted for underwriting activities and Al-Mudarba contract for investment activities. The third option is recognized and recommended by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to be adopted by takaful companies. Furthermore, the Bahrain Monetary Agency (BMA) has only allowed Al-Wakala and mixed models to be adopted by takaful companies operating in the Kingdom. It should be noted that a new model, known as Al-Waqf, has been introduced to the market by Pakistani scholars and it has been adopted by a takaful company in South Africa.

Mixed Model

The mixed model of Al-Wakala/Al-Mudaraba is the dominant model in the Middle East market and it is widely practised by takaful companies worldwide. In fact, the central idea for all Islamic insurance models is the segregation between participants and shareholders funds as the company role is only to manage participants' funds on their behalf. For this reason, any takaful company is usually called a 'takaful operator' instead of insurer.

The second principle for all Islamic models is that contributions (premiums) should be paid on donation (tabarra) basis in order to remove the element of gharar from the takaful contract. This is because the gharar has not affected the gratuitous contracts according to Malikki School. These two principles are considered essential elements, from the Shari'a point of view, and all Islamic models have to comply with these principles.

As for the structure of the mixed model, as has already been indicated, the takaful company has two funds, one for the shareholders and the other for participants (policyholders). In the mixed model, Al-Wakala contract is used for underwriting activities while Al-Mudarba contract is adopted for investment activities. With regard to underwriting activities, the shareholders act as the Wakeel (agent) on behalf of participants to manage their funds whereby the takaful company (shareholders) receive contributions, pay claims, arrange retakaful and all other necessary actions related to takaful business. In exchange for performing these tasks, the company charges each participant a fee known as a wakala fee, which is usually a percentage of the contribution paid by each participant.

This fee should be approved by the company's Shari'a Supervisory Board (SSB) and disclosed to participants in a very transparent manner. Although this fee is considered as the main source of income for the takaful company, special attention should be given to determination of this fee. This is due to the fact that this fee is fixed and cannot be changed after it is approved by the SSB and disclosed to participants. If the company fails to precisely calculate the level of the wakala fee, then it may incur a loss and lose its main income source.

Furthermore, the takaful company is also entitled to earn a fee if there is a surplus in the participants fund as an incentive for the effort that has been done to manage the fund effectively. This fee is called the 'incentive fee' and usually it is determined as a percentage of the surplus in the participants' fund. As a matter of fact, scholars are in dispute regarding the legitimacy of such a fee as, many of them have stated, any surplus arising from the participants' fund is owned by the participants. Accordingly, this fee is only charged by a few takaful companies, such as Bank Al-Jazeera in Saudi Arabia.

On the investment side, the company invests the surplus contributions in different Islamic instruments based on Al-Mudaraba contract, whereby the company acts as Mudarib on behalf of participants 'Rab almaal'(capital provider). However, in order to satisfy the Shari'a requirement for Al-Mudaraba contract, the ratio of profit is fixed and agreed upon between the two parties, at the inception of the contract.

As we seen, the adoption of Al-Wakala contract in underwriting activities is more transparent and reduces elements of conflict of interest between the two parties. Moreover, the company has several sources of income under this model, which are Wakala fee, incentive fee and its profit share from investment activities. It can, thus, be concluded that a unified approach by all takaful companies is crucial to the development of the takaful industry and to enhance confidence and understanding of consumers as well as conventional insurers. As Bahrain has taken the initiative towards a unified takaful model, it is hoped that other countries will follow.

If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.