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AN EXAMINATION OF SHARI'AH COMPLIANCE IN TAKAFUL WINDOW OPERATIONS

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Abstract

This paper conducts a study into takaful window operations with a view to ascertaining the existence or non-existence of issues of compliance with the principles of shari'ah relating to takaful. The study therefore highlights areas necessary for shari'ah compliance in takaful and then proceeds to review window operations against the backdrop of these identified areas. The research established that there are facets of window operation which may result in a deviation from shari'ah compliance and concludes with recommendations for streamlining the windows to establish complete compliance.

Keywords: Takaful, Takaful Windows, Shari'ah Compliance, Islamic Finance, Islamic Insurance

INTRODUCTION

Takaful, is a risk protection mechanism based on Islamic principles which is built on a system that seeks to avoid the illegal elements of *riba* (interest), *gharar* (uncertainty) and *maysir* (gambling or unjust enrichment) (Billah, 1996). Persons who share a common need to be protected against loss come together and pool their resources into a common fund from which they indemnify each other. Thus it is a system modeled on the framework of mutual insurance or *ta'awun* (solidarity or brotherhood) (Maysami & Kwon, 1999; Kwon, 2007; Fisher, 2013; Yazid et al 2012; Dusuki & Buheraoua, 2011; Arifin et al, 2013). This pool is usually managed by a company referred to as the *takaful* operator which is remunerated for its services.

The *takaful* operator may be a company specifically incorporated for that purpose and will offer only Islamic compliant (*takaful*) products and services or, as it permitted in some jurisdictions, *takaful* may be provided by a conventional insurer through the use of window operations. This implies that the conventional insurer should have a unit specially dedicated to the provision of *takaful* products and services. The objective of this paper was to examine the practices of such window operations for *shari'ah* compliance based on aspects of *takaful* operations that must be established to ensure *shari'ah* compliance as identified in previous studies.

Therefore this paper is divided into five sections. After this introduction comes a review of literature which highlights facets of *shari'ah* compliance in *takaful* operations. The next section presents the basic set-up of *takaful* window operations and analyzes same against these identified facets while the fourth section presents observations. The last section provides a summary, recommendations and avenues for further research.

LITERATURE REVIEW

The *takaful* contract presents a special relationship between the contributors (participants) to the *takaful* pool on the one hand and the manager (*takaful* operator) of the pool on the other. While the participants mutually contribute to the fund which will provide indemnity to members in the even to of a loss, the *takaful* operator receives the contributions and manages same, with utmost good faith, in such a manner that the fund adequately takes care of claims from participants. In return for this service, the *takaful* operator becomes entitled to be remunerated by the fund. There must be compliance with the provisions of Islamic law regulating every aspect of *takaful* operations from investment of funds to the contract of indemnity and the position of all parties to the contract (Ahmad, 2012).

First, the method of remuneration of the *takaful* provider is determined by the operating model chosen to regulate the contract between the *takaful* provider and the participants. The *takaful* fund is usually managed by the operator who is paid for the service based on one of the modes of financing applicable in Islamic law which are mudarabah (profit sharing), murabaha (profit and loss sharing), wakala (agency) or through the establishment of a waqf (endowment fund).However, in either of these situations there must be conformity with the basic principles of Islamic financial law which are the avoidance of *riba* (interest) (Kazi and Halabi (2006; Qur'an 3:130; 2:275-281; (Ahmad & Hassan, nd; Obaidullah, 2005; Khan, 2007; Ayub, 2007; Anwar, 2003), *maysir* (gambling, speculation) and *gharar* (uncertainty) (Saleh, 1992; Ayub, 2007; Gamal, 2000) in investments. The *takaful* fund must also be invested in *shari'ah* complaint avenues and must avoid areas that are considered out-rightly unlawful such as alcohol or pork or questionable such as the supply of arms and drug trafficking (Hussein, 2011).

Secondly, because Islamic financing is based in the concept of risk sharing, the investor gets a return on his investment only when funds are used productively in the economic environment (Obaidullah, 2005) and is only entitled to a return if he is also ready to share in the risks of the enterprise (Askari, 2011). This means that the *takaful* operator must also comply with the provisions of Islamic law regulating its mode of financing. One important feature of this concept is that the exact amount or return is not predetermined. Rather, what is fixed is the sharing ratio or percentage (Errico & Farrahbaksh, 2001: Gamal, 2006; Iqbal & Mirakhor, 2007).

To ensure this compliance regulation must be created which caters to the special requirements of *takaful* separate from those of conventional insurance (Dikko, 2014). *Takaful* must also be provided by persons who have adequate knowledge of both the basic underlying principles and substantive laws regulating such transactions (Dikko, 2011). Such persons include management, marketing, product development and *shari'ah* supervisory staff.

Also, due to the fact that the ownership of the *takaful* fund remains with the participants regulations require a strict segregation of *takaful* funds from the assets of the TO (Bank Negara Malaysia; Ahmad & Auzzir, 2012). The *takaful* fund is used for the settlement of claims but where this proves to be insufficient, the TO is required to provide a *qardhasan* (benevolent loan) to the fund which will be paid back from future surplus (Archer et al, 2009; Kwon 2007; Bakar, 2009). This loan is given form the shareholders' funds of the *takaful* operator (Ismail, 2010).

Daud (2012) argues that *shari'ah* compliance for a *takaful* operator entails ensuring that core Islamic values are reflected in every facet of *takaful* operations. This can be achieved by ensuring workers in the industry approach the provision of *takaful* as ibadah (worship) to God and should advance and educate others in the religion of Islam. In essence, they must through marketing, work values, products and services create a good reflection of the religion itself.

Finally, *shari'ah* compliance has to extend to re*takaful*. This means that the *takaful* operator must ensure that it obtains reinsurance from a re*takaful* provider which has also established *shari'ah* compliance in its activities, products and services (Billah, 2011).

Takaful Window Operations and Shari'ah Compliance

Window operations are obtained where *takaful* products and services are provided via a subordinate office of a parent conventional company which office remains attached and answers to the parent. In the global *takaful* industry, there are over 80 *takaful* operators and over 200 window operators (Abdul Rahman, 2009). Countries which allow window operations include, among others, Pakistan, Indonesia, the United Kingdom, Nigeria and Thailand. This section examines window operations against the backdrop of facets of *shari'ah* compliance already identified

In the first place, funds for the establishment of the windows are provided by shareholders of the parent company (Section 24 Pakistani *Takaful* Rules, 2012).These funds do not have to pass the test of *shari'ah* compliance relating to investment avenues and the avoidance of *riba*, *gharar* or *maysir* (Abdul Rahim, 2006; Jaffer et al 2010). This in itself may not be a problem if the *takaful* fund itself continues to observe *shari'ah* compliance but where the *takaful* fund runs into a deficit and there is the need to provide a *qardhasan* (benevolent loan), this will be done from the same shareholders' fund thus possibly infusing non *shari'ah* compliant funds into the *takaful* pool.

In addition, though most jurisdictions where *takaful* windows are allowed insist on the segregation of the *takaful* funds from those of the conventional business (for example section 3.27 Nigerian *Takaful* Guidelines), this may not always be the practically possible as most companies usually retain and share accountants, auditors and investment managers(Dikko, 2016).

Also, to establish window operations, most conventional insurers co-opt staff already within their payroll to into their *takaful* units. These staff may not necessarily have knowledge of and/or experience in Islamic finance particularly as it relates to *takaful* as it one of the problems already facing the industry is the dearth of suitably qualified personnel. In fact, even where specific persons are allocated as management of the *takaful* unit, this may not be so for marketing staff (Ali, 2006). Therefore *takaful* products may be marketed alongside conventional products by any and all marketers. This is further compounded by the fact that while legislation in some countries insists on minimum educational requirements and training for eligibility to engage in *takaful* management and marketing (section 28 Pakistan *Takaful* Rules, 2012) others are silent.

Lastly, an important aspect of the *shari'ah* compliance of *takaful* is the establishment of adequate re*takaful*. This must be done with an equally *shari'ah* compliant re*takaful* provider. However, due to the lack of sufficient re*takaful* providers in many jurisdictions, scholars have allowed for the use of conventional reinsurers though they are encouraged to first look for a re*takaful* company (AbRahman, 2015).*Takaful* window operators, based on this concession, may be inclined to use the same reinsurer for both conventional and *takaful* products particularly where the *takaful* business has not achieved a lot of retention.

SUMMARY, OBSERVATIONS AND RECOMMENDATIONS

Islamic financial services differentiate themselves from the conventional mainly because they are grounded and inseparable from the principles of Islamic law. In fact, the success of an Islamic financial product is in its ability to provide a desired service without deviating from the fundamental and basic principles of the law. This paper, while highlighting aspects of establishing *shari'ah* compliance in *takaful* operations also identified areas of possible deviation from compliance where *takaful* is provided via window operations.

In essence it was observed that strict compliance with Islamic financial law in investments may be difficult where a company is also involved in conventional investments and is using the same personnel to oversee both sides of its operations. Also, to achieve *shari'ah* compliance, persons involved in all aspects of *takaful* operations must have adequate knowledge in the basic underlying of Islamic financial law relating to *takaful* and the provisions of any and all regulations relevant to *takaful*. This knowledge may be obtained through formal education of through sustained in-depth training for personnel. Obtaining this may also be difficult to where members of staff are merely co'opted into managing and/or marketing *takaful*.
Furthermore, a reflection of Islamic values in both management and marketing can be lost where conventional products and *takaful* are sold by the same marketer. Where a potential customer shows the slightest disinterest in *takaful*, he is in a position to promptly whip out and offer a conventional counterpart. This may create confusion as to the difference and exclusivity of *takaful*

In addition, though scholars have agreed that the source of initial funding to begin a *takaful* operation need not be shari'ah compliant, they are unanimous that the funds must from that time henceforth be compliant in investments and the avoidance of those elements which are considered unlawful vis. *riba*, *maysir* and *gharar*. In fact, scholars have devised various formulae for the purification of Islamic wealth where unavoidable investments are made in non-compliant avenues. The shareholders' funds of a *takaful* operator are not subjected to any test of *shari'ah* compliance therefore the acceptance of a *qardhasan* from a parent conventional insurer may effectively be a deviation from *shari'ah* compliance for the *takaful* fund.

Therefore, while the reasons given for the adoption of window operations are acknowledged as cogent, as windows more often than not allow for faster and wider reach for *takaful* products due to leverage on the already existing network of the conventional insurer. Also, capital requirements for full-fledged (stand-alone) companies may be high thus making it difficult to establish and in some cases, there is reluctance to venture into *takaful* based on the fact that *takaful* is majorly an Islamic product and companies may be afraid to go out on their own if their target customers are not predominantly *Muslim*s or the industry has not been tried previously. However, it is still recommended that window operations be considered merely as the first step towards the provision of *takaful* and should gradually be phased out form the industry completely.

Moreover, though *takaful* is an Islamic based product, its underlying principles of brotherhood and communal help make it also an ethical product which appeals to persons of other religions. But this can only be obtained if it distinguishes itself from conventional insurance and this is only possible through complete *shari'ah* compliance.

Therefore, it is humbly recommended that first, there should be clear demarcation of members of staff from management to marketing and product development between the conventional and *takaful* business. This should also extend to accounting auditing and investment advisers

Also, regulators should insist on strict minimum formal educational and training requirements for all *takaful* personnel where windows are permitted.

Furthermore, regulators must insist on presentation of proof of a *retakaful* arrangement with a *shari'ah* compliant re*takaful* provider before license is issued to commence window *takaful*.

Finally possible areas for further research may include investigation into how to purify funds that are to be used for the provision of *qardhasan* before passing it in to the *takaful* pool.

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