



## An Exploratory Study of Shari'ah Issues in the Application of Tabarru' for Takaful

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**Abstract:** Takaful industry has witnessed an exponential growth across the world over the last decade, demonstrating an enormous demand for *takaful* products ranging from short-term general *takaful* to long-term family *takaful*. It has attracted considerable attention not only from the Muslim countries, but also from the non-Muslim countries. Despite its promising growth, however, the *takaful* industry continues to face numerous contentious *Shari'ah* issues. The present study aims to discuss some of the most fundamental *Shari'ah* issues in *takaful*, namely the issue of applying *tabarru'* concept in *takaful* and the issue of underwriting surplus of *tabarru'* fund.

**Keywords:** *Takaful, tabarru', surplus, underwriting.*

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### Introduction

The demarcation between conventional insurance and Islamic insurance (hereafter referred to as *takaful*) lies in the underlying concepts and contracts employed. While the former applies the concept of *tabarru'* (donation) as the underlying concept, the former uses the contract of exchange thus the issue of *riba*, *gharar* (uncertainty) and *maysir* (gambling) emerge.

The element of *riba* in conventional insurance exists in two ways. Firstly, money is exchanged for money whereby policyholders pay sum of money in the form of premium with the exchange of money in the form of claim in the future. The issue of *riba* takes place because the exchange is not made on spot and the amount received by policyholders is usually higher than the actual amount paid. Secondly, the premium paid by policyholders are invested in interest bearing instruments such as treasury bills and fixed deposits in conventional banks. Furthermore, the issue of *gharar* arises in conventional insurance practices due to the uncertainty of the subject matter. For example, both the policy and premium are uncertain as the actual value is very much dependent upon the occurrence of catastrophe which is uncertain (Adawiyah, 2010). In addition, the element of *maysir* in conventional insurance takes place as a consequence of the existence of *gharar*. *Maysir* is a form of *gharar* and zero sum game that is prohibited by *Shari'ah*, as the profit or loss is contingent to the occurrence or otherwise of claims. In other words, the profit of one party is determined by the loss of another party.

With that, the concept of *takaful* is introduced so as to eliminate such intolerable elements. It is achieved by changing the underlying contract of insurance from an exchange contract to the concept of donation (*tabarru'*). *Tabarru'* means a voluntary contribution given by a person during his lifetime to another person, without expecting any compensation in return,

which results in the ownership transfer of the subject matter from the donor to the recipient (Parid, 2009). From Shari'ah perspective, *tabarru'* is charitable contract which is normally unilateral in nature as opposed to contract of exchange; and that in the unilateral contract the application of the rule of uncertainty is more flexible. Thus, even though the element of *gharar* and *maysir* may persist in *takaful* operation, the concept of *tabarru'* tolerates such uncertainty as the *tabarru'* contribution is not used for profit making activities rather for mutual assistance purposes only. If the participant were to face unforeseen events in the future, the group of people will then aim to create both mutual indemnity and mutual assistance for the participant. Meanwhile, the element of interest (*riba*) is also eliminated in the *takaful* operation as all of the funds are invested in *Shari'ah* compliant activities only. In this sense, the *tabarru'* concept removes the non-permissible elements in insurance (Adawiyah, 2010).

However, although the concept of *tabarru'* has been widely accepted to serve as an alternative solution from the existing conventional system, many contentious Shari'ah issues still arise in the application of *tabarru'* for *takaful*. The present study therefore aims to examine the issues surrounding the use of *tabarru'* in *takaful* industry.

Following the introduction, the next section discusses the overview of *takaful* concept, covering its definitions from the various international organizations such as Accounting and Auditing Organization for Islamic Financial Institutions (hereafter referred to as AAOIFI) and Islamic Financial Services Board (hereafter referred to as IFSB). The next part in this section explains in greater detail the various contracts and models of *takaful*, such as the *mudharabah* model, *wakalah* model and hybrid model. Section 3 delineates the key *Shari'ah* issues related to use of *tabarru'* concept in *takaful*, reflected in Participant Risk Fund (PRF). Section 4 provides the concluding thoughts on the subject matters discussed.

## Concept of Takaful

### Definition of Takaful

The word "*Takaful*" is derived from a root word *kafala* which means guarantee or indemnity. Technically, *takaful* is a mutual insurance whereby a group of participants agree to contribute sum of donation to assist each other from a defined financial loss in the future arising from either catastrophe or misfortune. Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) standards (2004:05) defined *takaful* as "a system through which the participants donate part or all of their contributions which are used to pay claims for damages suffered by some of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions". On the other hand, the Islamic Financial Services Board (IFSB) defined it as "the Islamic counterpart of conventional insurance, and exists in both life (and family) and general forms, whereby it is based on the concept of mutual solidarity, and a typical *takaful* undertaking will consist of a two tier structure - hybrid of a mutual and a commercial form of company". In the same context, Islamic Financial Services Act 2013 defines *takaful* as "an arrangement based on mutual assistance under which *takaful* participants agree to contribute to a common fund providing for mutual financial benefits payable to the *takaful* participants or their beneficiaries on the occurrence of a pre-agreed events." The concept of *takaful* in Islam is based on the notion of mutual assistance (*ta'awun*), mutual security and responsibility (*tadhamun*), and mutual protection and assurance, incorporated into the concept of *tabarru'* (donation).

The principle of mutual assistance is deduced from the verse of the Holy Quran which reads: '*Help one another in al-Birr and in al-Taqwa (virtue, righteousness and piety): but do not help one another in sin and transgression*' (Al-Ma'idah 5: 2). It is also supported by a hadith that states: "*Allah will always help His servant for as long as he helps others.*" (Narrated by Imam Ahmad bin Hanbal and Imam Abu Daud). The principle of mutual security and

responsibility is evidenced by a hadith of the Prophet (pbuh) which reads: *The place of relationships and feelings of people with faith, between each other, is just like the body; when one of its parts is afflicted with pain, then the rest of the body will be affected (Narrated by Imam al-Bukhari and Imam Muslim)*. Meanwhile, the spirit of mutual protection and assurance is substantially supported by a hadith narrated by Imam Ahmad bin Hambal which states: *"By my life, which is in Allah's power, nobody will enter Paradise if he does not protect his neighbor who is in distress."*

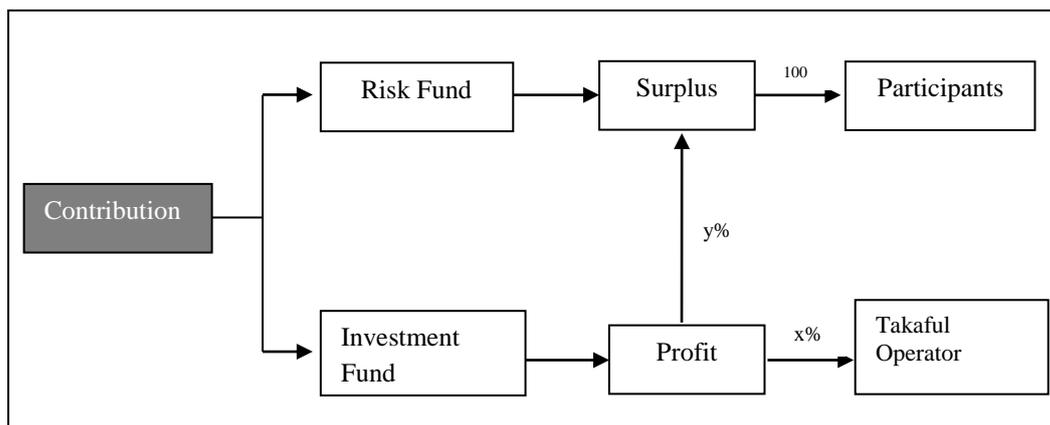
### Contracts and Models of Takaful

As indicated earlier, the primary feature of *takaful* that distinguishes it from conventional insurance is the application of *tabarru'* concept. The concept of *tabarru'* is applied in *takaful* operations so as to indicate the relationships among the participants. Under this concept, each participant donates a sum of contribution amount to mutually assist and indemnify each other in the event of misfortune. The fund is placed into namely a participant risk fund (PRF) and treated as a "common ownership" and will be utilized when helping the participant who suffers from catastrophe. In current practice, however, the purpose is not skewed for merely mutual protection only but has also grown to include both investments and savings. This is particularly true in the case of family *takaful* product. Therefore, instead of a single fund, *takaful* operator divides the fund into two separate funds: Participant Risk Fund (PRF) and Participant Investment Fund (PIF). The position of *takaful* company in this context is being the agent or investment manager of the participants. Thus, the underlying contracts that are mainly utilised to indicate the relationship between *takaful* operator and participants are mainly *mudharabah* contract and *wakalah* contract. Both are further explained below.

### Mudharabah Model

*Mudharabah* is a partnership contract whereby one party provides a capital while another party offers skill and entrepreneurship. A profit, if any, will be shared based on the pre agreed ratio. Any financial loss will be borne solely by the capital provider (*rabb maal*) while the fund manager (*mudharib*) will bear the loss of effort and labor.

Figure 1: Mudharabah Model

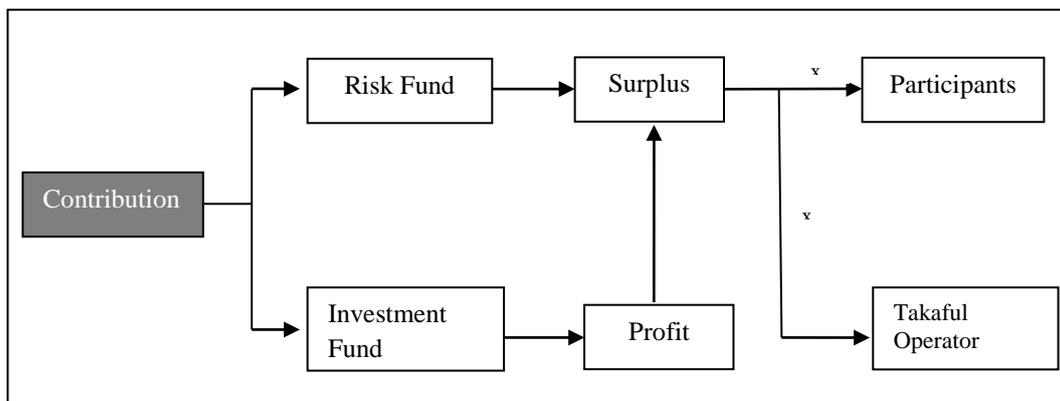


In regard to *takaful* operation, the capital providers are known as the participants while the fund managers are the *takaful* operators. Under this contract, the *takaful* operator will accept the contributions from the participants. The contribution is deemed as a capital (*ra'sul maal*) that will be managed and invested in a *Shari'ah* compliant manner. The contract specifies that any profit from managing the fund will be shared between the *takaful* operator and participant

based on the ratio agreed upfront. In the event of loss in the Participant's Risk Fund (PRF), however, *takaful* operator shall provide an interest free loan (*qard*) that should be repaid when the PRF generates profit (Dusuki (ed), 2011). The underwriting surplus, if any, will be distributed to the participants since it is not part of the profit. Figure 1 above depicts the process flow of *mudharabah* model.

As depicted above, the pure *mudharabah* model allows *takaful* operator to only enjoy profit sharing based on agreed ratio, and not an underwriting surplus. The underwriting surplus in this model should be fully distributed to the participants as it is part of the principle, and not the profit. However, this condition is not preferred by most *takaful* operator. Thus, the *takaful* operator constructs a modified *mudharabah* model whereby the underwriting surplus is construed as "*mudharabah* profit" to be shared between the participants and the *takaful* operator (Adawiyah and Odierno, 2008). Figure 2 below shows the operational flow of this modified *mudharabah* model.

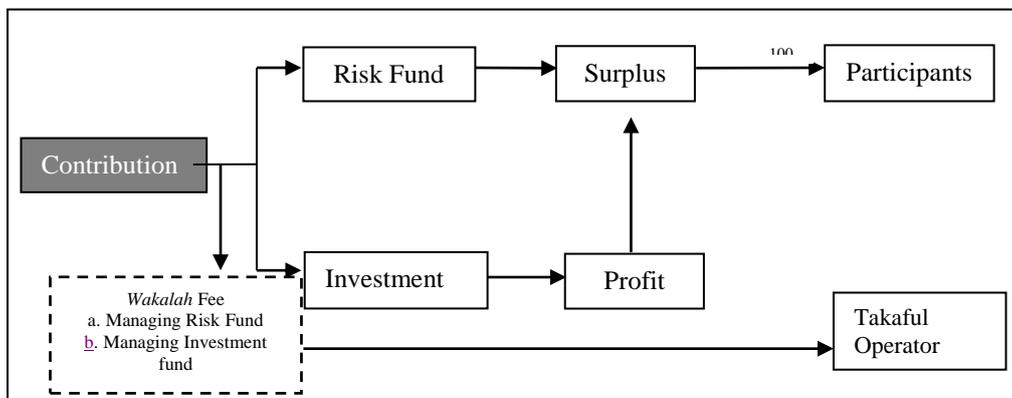
Figure 2: Modified Mudharabah Model



**Wakalah Model**

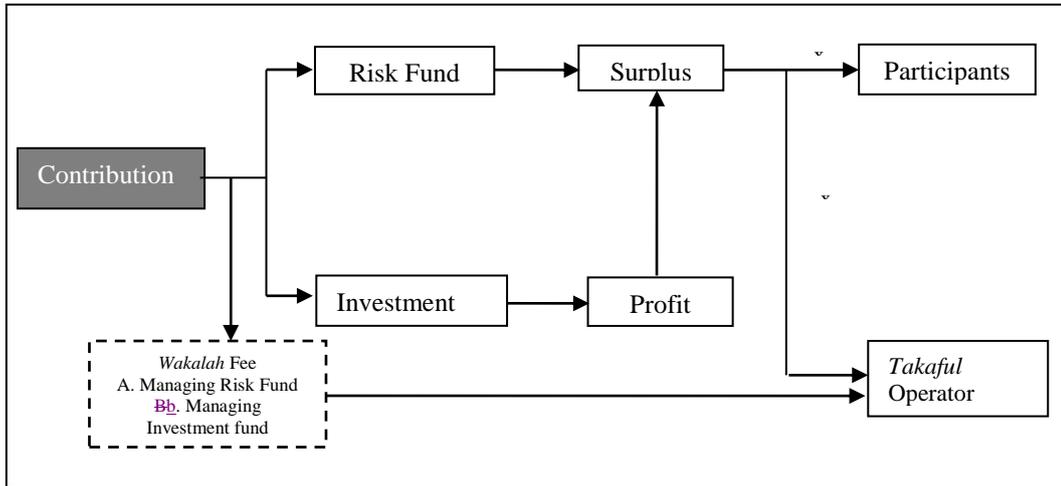
In the case of *wakalah*, it is an agency contract whereby party mandates another party as his agent to perform a particular task. Adopting this in the *takaful* practice, the principal (*muwakkil*) is known as the participant while the agent (*wakil*) is regarded as the *takaful* operator. The participant appoints the *takaful* operator as an agent to manage the fund. As compensation, the *takaful* operator is entitled to attain a pre-determined agreed fee. *Takaful* operator then invests the fund in *Shari'ah* compliant investments. Any profit or surplus will be fully distributed to the participants. Figure 3 below illustrates the operational flow of this model.

Figure 3: Wakalah Model



The absent of surplus sharing in the Wakalah model calls for the takaful operator to reconsider this above-mentioned model. With that, some of the *takaful* operators then proposed the application of a modified *wakalah*. In this model, the *takaful* operator are entitled to attain a pre agreed fee based on the principle of *wakalah* and concurrently a portion of surplus, called as performance fee. Figure 4 below shows the process flow of the modified *wakalah* model.

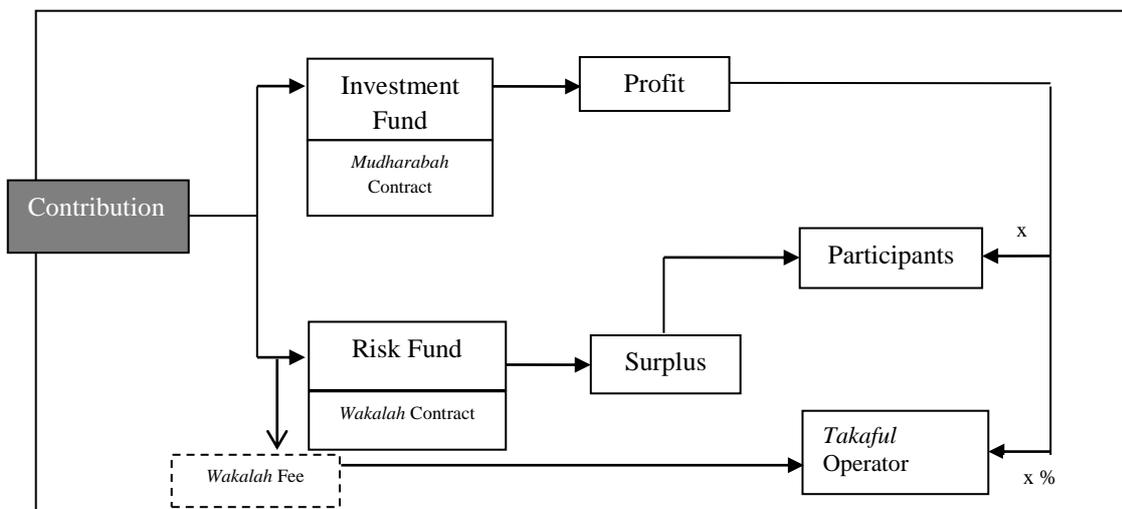
**Figure 4. Modified *wakalah* model**



**Hybrid Model**

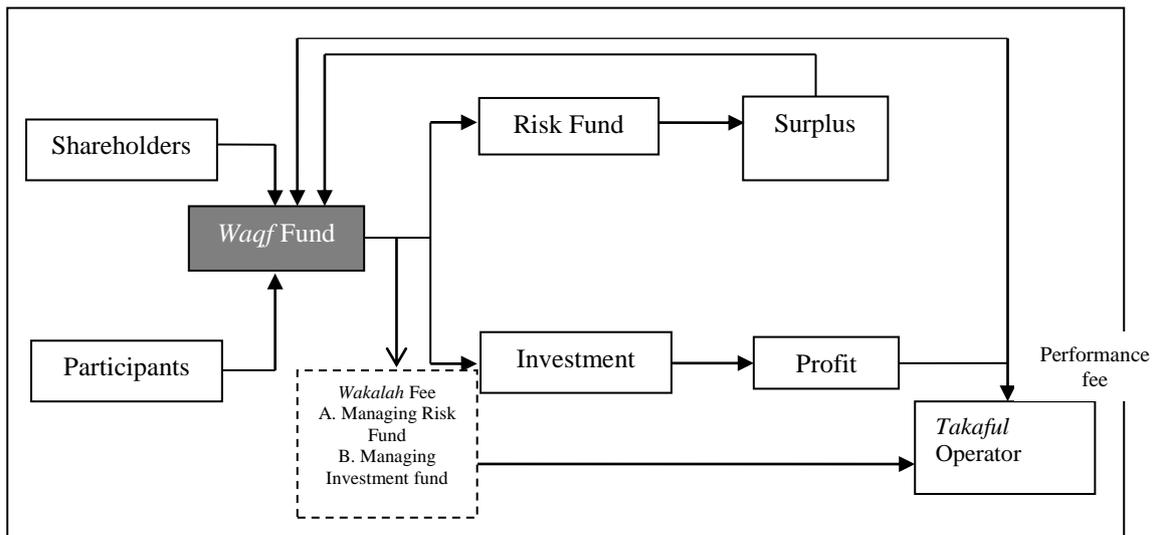
The hybrid model is basically formulated using the combination of *mudharabah* and *wakalah* or the combination of *wakalah* and *waqf*. Under the former combination, the *mudharabah* contract is applied to indicate the position of *takaful* operator as the manager of the participants' investment fund, while the *wakalah* contract is used to justify the position of *takaful* operator as an underwriter of the participants' risk fund. As a manager, the *takaful* operator will enjoy the portion of profit based on an agreed ratio for investing the fund, while as an underwriter the *takaful* operator are entitled to a pre-determined fee (Dusuki,(ed) 2011). Figure 5 below depicts the illustration of the hybrid model of *mudharabah* and *wakalah* in *takaful*.

**Figure 5: Hybrid of *Wakalah* and *Mudharabah* Model**



In the case of the combination of *wakalah* and *waqf* model, it has been introduced by Sheikh Taqi Uthmani and it has successfully been developed in Pakistan (Dusuki,(ed) 2011). The general idea of this model is to enable any individual to assist each other in the event of catastrophe using the *waqf* fund. Using this model, the shareholders of *takaful* operator initially place donation in establishing the *waqf* fund. Simultaneously, participants also contribute sum of the donations to be put in the *waqf* fund. In this sense, the *waqf* fund consists of namely two sources; the shareholders' fund and the participants' fund. The pool of fund is then invested in *Shari'ah* compliant business activities. If any of the participants were to experience misfortune, the profit generated from the *waqf* fund will be used to assist each of the participants (Dusuki, (ed), 2011).

**Figure 6: Hybrid of Wakalah and Waqf Model**



*Takaful* operator in this model serves as an agent (*wakil*) of both the shareholders and participants. It administers the fund, including the claim payment. Simultaneously, it acts as an investment agent to help invest the fund in a *Shari'ah* approved business activities. *Takaful* operator will then be compensated by a certain percentage of the predetermined fee and performance fee (Dusuki, (ed), 2011). Figure 6 above indicates the process flow of this particular hybrid of *wakalah* and *waqf* model.

### Shari'ah Issues in Tabarru' Concept

After deliberating on the various contracts in *takaful*, the paper will now tackle one of the most important issue in *takaful* which is the issue of applying *tabarru'* concept in *takaful*.

### Issues in the Application of Tabarru' Concept for Takaful

According to Shariah Advisory Council (SAC) of Bank Negara Malaysia, the definition of *tabarru'* is known as the contract of gratuity or charity, i.e. to relinquish a portion from the contribution as a donation to fulfill the obligation of mutual help, and to use it to pay claim submitted by eligible claimants. The *tabarru'* concept is applied in *takaful* operation to indicate the relationship among participants (SAC BNM, 2010).

While all jurists agree that *tabarru'* concept is very noble in Islam, the implementation of *tabarru'* in *takaful*, however, remains a matter of debate and unresolved contentious *Shari'ah* issue, arising from the fact that the contributions paid by the participants may not be a donation

in a pure sense. Rather, the donation is created conditionally: each participant in *takaful* should donate a particular amount so as to cover an unexpected financial loss in the future. The contribution (donation) is imposed in order to get a future compensation. The amount of donation, in addition, is determined by the level of probability of risk. The rate of donation is adjusted in accordance to the participants' risk whereby the higher the risk exposure, the higher is the contribution charged. This raises *Shari'ah* issue among the scholars as the concept of *tabarru'* is supposed to be accomplished voluntarily rather than on a compulsory basis. Furthermore, it is also argued that if the participant is entitled to make a claim as the compensation of contribution paid, it will change the overall structure of the *takaful* concept into a bilateral contract (*mu'awadah*) whereby money in the form of donation is exchanged with money in the form of claim. In this juncture, the issue of *gharar* and *maysir*, like the conventional counterpart, does take place due to uncertainty of the subject matters exchanged.

Some scholars upheld that the principle of making something that is voluntary into an obligation is substantially supported by the Maliki school of thought. Based on this point of view, the contribution made by the participant is considered as an *iltizam bi al-tabarru'* (self-commitment to donate) which is approved by *Shari'ah*. Under this principle, one who commits himself to do good things is obliged to do so. Some scholars, however, disagree with this concept as it comprises of two commitments - donation and indemnification which leads to bilateral contract. This condemnation is, however, being rebutted that although the concept has two commitments - donation and indemnification, the latter (indemnification) is not definite because it is tied upon the occurrence of catastrophe (Muhammad, 2010). Hence, it does not simply equivalent with the exchange or bilateral contract.

On the other hand, the fact that the contribution made serves as a "price" for indemnification is viewed by some scholar that the *tabarru'* in *takaful* is reflected in the form of *hibah bi thawab* (a gift with expected compensation). Sharh Al-Kharshi defines *hibah bi thawab* as a donation given for the purpose of attaining financial compensation in the future. Majority of the jurists, except for Imam Shafii, are of the view that the donation given with the expectation of getting compensation in exchanged is permissible (Raudhatul Thalibin, 5/384-387).

#### Box 1: AAOIFI, 2010

##### AAOIFI Shari'ah standard No. 26 Article 3

"Islamic insurance is based on the commitment of the participant to make donations for the sake of their own interest. The participants, therefore, protect their group by payment of contribution that constitute the resources of the insurance fund, and assign the management of that fund to a committee of policyholders or to a joint stock company that possesses the license of practicing insurance business. In the latter case, the company assumes this job on the basis of a remunerated wakala (agency) contract. In addition to managing the insurance operations, the committee policyholders or the company also assumes the responsibility of investing the assets of the fund through mudharabah or investment agency"

##### AAOIFI, 2010. In No 26 article 4 (c)

AAOIFI stated that the relationship between the policy holder and the fund takes the form of donation commitment at the stage of making contribution, and indemnification commitment at the stage of providing compensation for injury as per regulations and underlying constituent documents.

Nevertheless, the application of *hibah bi thawab*, according to jurists, will change the nature of *tabarru'* from the unilateral contract to the bilateral contract. In other words, if the gift is made in exchange for claim received in the future, the ruling of gift equates to the ruling of sale (Muhammad, 2010). In this sense, the *takaful* contract constitutes an exchange contract in which the issue of *gharar* and *maysir* is then applied. However some jurists, on the other hand,

are of view that *hibah bi thawab* is considered as unilateral contract such as pure gift with all its rulings and implications (Qurrah Daghi, 2004). Some other scholars, instead of use of *iltizam bit tabarru'* or *hibah bi thawab*, proposed the application of *waqf* model as the underlying *tabarru'* concept.

In the current standard, the *iltizam bi al-tabarru'* concept proposed by the Maliki school of thought seems to be the most internationally accepted concept. It is further evidenced in the boxes above.

### **Issues on Underwriting Surplus**

The use of *tabarru'* concept in *takaful* creates another subsequent issue, namely the issue of underwriting surplus from *tabarru'* fund. The main issue in this perspective is whether the *takaful* operator is entitled to have a share in the underwriting surplus or whether the surplus is exclusively owned by the participants only, thus it should be redistributed back to them. To comprehend this further, the research will now provide the definition of underwriting surplus from two separate Islamic bodies, namely AAOIFI and Islamic Financial Services Board (IFSB). It is further explained in Box 2 below.

#### **Box 2: AAOIFI, 2010 & IFSB, Takaful Governance Standard**

<b>AAOIFI Accounting Standard No.13</b>
...“the excess of the total premium/contributions paid by policyholders during the financial period over the total indemnities paid in respect of claims incurred during the period, net of reinsurance and after deducting expenses and changes in technical provisions.”
<b>Takaful Governance Standard, IFSB 8</b>
...“the <i>takaful</i> fund’s financial outturn from the risk elements of its business, being the balance after deducting expenses and claims (including any movement in provisions for outstanding claims) from the contributions income and adding the investment returns (income and gains on investment assets).”

It is noteworthy to point that there are two main divergent views over the distribution of underwriting surplus. The first view treats the surplus as the participants’ exclusive right hence should be entirely distributed to them. The second view believes in sharing the underwriting surplus between the participants and the *takaful* operators. The former is adopted and implemented by most GCC countries while the latter is practiced by Malaysian *takaful* companies (Ali, 2012).

The first view is held by AAOIFI and IFSB standards as well as several international resolutions and fatwas. In Fatawa Ta'min, Dallah al-Barakah, 1986, it stated that the underwriting surplus is the exclusive right of the participants and thus it should be returned to them. The *takaful* operator has no entitlement to enjoy a portion of surplus. The AAOIFI Standard on *takaful* states: “the underwriting surplus and its returns, less expenses, and payment of claims, remain the property (*milk*) of the policyholders, which is the distributable surplus. This is not applied in commercial insurance, where the premiums become the property of the (insurance) company, by virtue of contract and acquisition, which would make its revenue and a profit for commercial insurance (AAOIFI Standard on Takaful, p.437).

The AAOIFI position over the surplus distribution is premised upon the origin of surplus. It is clear that the surplus is produced from the contributions paid by the participants. The participants paid the contributions to enjoy a financial benefit in the event of hazard or peril. In addition, they also expect to enjoy a portion of an excess over claim. In addition, the AAOIFI's position over surplus is also grounded on the underlying contract that governs the contribution agreement. It is assumed that there is no explicit agreement to offer the surplus to the *takaful*

operator. Hence, implicitly, the surplus should go back to the one from whom the surplus is collected (Musa, 2010).

However the opposing view is upheld by *Shari'ah* Advisory Council Bank Negara Malaysia. It is stated in the resolution (ref. no. 09/07/07) on the distribution of underwriting surplus that: "The Shariah Advisory Council of Bank Negara Malaysia (the Council) has made the resolution that the distribution of surplus from the *tabarru'* fund in *takaful* scheme is permissible from *Shari'ah* perspective. The council's resolution in allowing the distribution of surplus from the *tabarru'* fund (for both family and general *takaful* plans) to the participants/certificate holders and *takaful* operator is based on the premise that *takaful* contract is generally established on the *Shari'ah* principles of *tabarru'* (donation) and *ta'awun* (mutual cooperation), apart from the agreement among the contracting parties. In the formulation of *takaful* product, the principle of *tabarru'* has been the main underlying *Shari'ah* principle, although the application of other principles such as *wakalah* and *mudharabah* also complement the *takaful* operational structure. The council's resolution to allow such distribution is also based on the permissibility of performance fee for the *takaful* company".

Thus, it is clear that the AAOIFI justification over distribution of surplus relies on the origin of surplus while the resolution of SAC BNM premises on the nature of *tabarru'* contract in which the participants have relinquished any claim over what they have already donated as *tabarru'*.

On the contrary, in the case of Indonesia, the treatment of underwriting surplus tends to adopt a more moderate approach. The fatwa issued by National *Shari'ah* Council - Indonesian Ulama Council on the distribution of surplus tries to accommodate both the GCC and Malaysian practices. It is further explained in Box 3 below.

### Box 3: Indonesian Ulama Council, 2006

#### Indonesian Ulama Council Fatwa no. 53/DSN-MUI/III/2006

The *takaful* operator may treat the underwriting surplus based on the three choices below:

1. All underwriting surplus is placed into the reserve fund.
2. The underwriting surplus is divided into two portions: One portion is for reserve and the other portion is for participants
3. Certain percentage is allocated for reserve. The remaining is shared between participants and *takaful* operator. However, it is subject to the consent from the participants.

The following issue arises in regard to the ownership of surplus from the *Shari'ah* perspective. AAOIFI undoubtedly ascertained that the surplus still belong to the participants as it is derived from the contribution paid by them. However, the participant has donated the premium as *tabarru'*, hence loses title over it, as prescribed by the rules of *hibah* in the *Shari'ah*.

The juristic ruling over *tabarru'* is obvious that it requires relinquishing the ownership over the subject matter of *tabarru'*. The majority jurists upheld that *hibah* will cause the donor to lose the ownership of donated subject matter. The donation is transferred to the donee. Ibn Qudamah pointed out that *hibah* requires donor to enable the beneficiary to own the object of *hibah*. Based on these premises, it is argued that the donor (participant) basically does not have any right or claim over the contribution unless it is stipulated in the agreement that the surplus from the contribution should be exclusively given to them. Otherwise, the distribution of the surplus will be decided based upon the agreement and condition agreed in the contract (Frenz & Soulhi, 2010).

To solve the ownership issue in the underwriting surplus, some scholars propose the application of "conditional contribution" to the *takaful* fund. Under this concept, a participant will contribute some amount of fund for mutual assistance on the condition if there is any surplus in the fund, it should be redistributed back to the participant. The concept allows the participant to retain ownership over the contribution (Frenz & Soulhi, 2010). Bouheraoua & Ahmad, 2011 proposed the concept of *wadiyah yad dhamanah* (safekeeping with guarantee) to be applied in *takaful* operation. Under this contract, the *takaful* operator will act as custodian or depository institution whereby the participant will place their fund as deposit, coupled with a waiver clause to release some amount of the deposit for the purpose of indemnifying other participant. Under this concept, the funds still belong to the participants and the issue of surplus distribution is thus resolved.

## CONCLUSION

The paper found that the main issue in the application of *tabarru'* concept in *takaful* operation lies in the aspects that the applied *tabarru'* departs from the original nature of *tabarru'* upon which the concept is legislated by Lawgiver. Many view that *tabarru'* is supposed to be accomplished voluntarily without expecting any compensation in return rather than on compulsory basis. It is argued that if the participant is entitled to make a claim as the compensation from contribution paid, it will change the whole structure of *takaful* concept into a bilateral contract (*mu'awadhah*) whereby money in the form of donation is exchanged with money in the form of claim. In this juncture, the issue of *gharar* and *maysir*, like the conventional counterpart, does take place. Another issue is the distribution of surplus resulting from the management of *tabarru'* fund. Some view that the surplus is the exclusive right of participants while other upheld that participants has donated the contribution as *tabarru'*, hence losing title over it.

In a nutshell, the progression of *takaful* industry has been a long journey. Many contentious Shariah issues need to be settled. Finding an ideal *takaful* concept is 'the homework' of scholars, researchers, and industry players. Extensive research and deep study are essential in order to arrive at an ideal model as a basis for the *operationalization* of *takaful*, a model that serves as a bridge to the achievement of the noble objectives of the Shariah.

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