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A Primer on Takaful

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Background

The recent spike in oil prices has created an explosion of new wealth in the Middle East. Combined with rising devoutness throughout the Muslim world, the result is a mushrooming market for Islamic finance, currently estimated at $500 billion. In the last couple of years alone, numerous Middle Eastern countries have enacted legislation for Islamic law-observant Takaful insurance and issued new licenses for Takaful insurance companies. At the same time, opportunities for Shari'ah-compliant investment are emerging across the financial services sector.

Takaful is a form of cooperative insurance in which members contribute money to a common pool. The system observes the rules of Islamic law and is based on mutual responsibility and cooperation among the participants.

An industry still in its infancy compared to conventional insurance, the first Takaful company was formed in Sudan in 1979. But the industry only developed and grew after Malaysia adopted Takaful-specific regulations in l984. Today, there are about two dozen such insurers—all of them mid-size (average premiums: $1 billion). Yet with an estimated 1.5 billion Muslims worldwide, the opportunity is golden. The untapped Takaful market (life and general) in Asia and the Middle East is estimated at 23.4 million potential new buyers for $11 billion USD of new annual premiums.

Although Muslim beliefs often differ from those held by Westerners, the Islamic form of insurance can be so attractive that even many non-Muslims in Southeast Asia have opted to buy it.

Takaful is not that foreign as an insurance concept. It encompasses what is often referred to as ethical investing—along with a healthy dose of high-quality corporate governance. The key elements are explained below.

Profit-Sharing

In Arabic, "Takaful" means "guaranteeing each other." Based on cooperation, a Takaful company is similar to a mutual insurer; policyholders share profits with shareholders. There is, however, a wide range in terms of what is acceptable. Some Muslims read the Qur'an (the Islamic holy book) literally while others interpret it. As a result, there are 12 or 13 Takaful models. In some conservative Muslim countries, policyholders can expect 90 percent of the profits; in more liberal Muslim countries, they may expect as little as 10 percent. That said, the company cannot make a profit at the expense of policyholders—nor can policyholders profit at the expense of the company.

Shari'ah Compliant

Islam's sacred law is Shari'ah. Its principles are based primarily on the Qur'an (the Islamic holy book) and the Sunnah of Muhammad (the collected words and actions of Muhammad outside revelation). In general, those principles, which have a strong societal aspect, dictate that investments must better mankind. As a result, certain industries are forbidden, including weaponry and the military, gambling, alcohol (Muslim law forbids drinking), and Western-style banking (Muslim law forbids usury, or the charging of interest for the use of money).

A Takaful company's suppliers must also comply with Shari'ah law. As a basic example, take the office coffee supply. Starbucks is a well-known coffee company that also happens to sell (as a tiny percentage of sales) a coffee liqueur as one of its many product offerings. Therefore, in the true sense of the word, a Takaful company would not be allowed to buy Starbucks coffee for its offices.

What about reinsurance? Technically, a Takaful company that reinsures with a non-Takaful reinsurer is not Shari'ah compliant. The problem is that there are very few Retakaful insurers (reinsurers that are Takaful)—something that has no doubt stunted the industry's growth. But there are many gray areas in Takaful, and due to the lack of options, this is one of them.

One other note: When a traditional insurance company has a separate line of business dedicated to Takaful, this is called a "Takaful window." The purpose is to have Muslim operations, but this approach is not always permitted. For example, the new Saudi Takaful Insurance Act prohibits any insurance other than Takaful.

Shari'ah Board

Another key component of a Takaful company is a Shari'ah board consisting of at least three clerics that are experts in the Shari'ah law. Separate from the insurer's governing board of directors, its purpose is to make sure the company and its products comply with the Shari'ah. This is not easy. Human affairs are complicated and constantly changing, and religious texts simply do not cover every possible ethical issue that could arise. Specifically, there are many gray areas in Takaful—so many that some Muslims were unable to access insurance at all. The ideal board members are well-respected religious and legal scholars—and can understand economics and the increasingly complex world of finance.

Note that the concept of a Shari'ah board is not really that foreign. The fraternal societies in the United States more than 100 years ago—many of them offshoots of a church—included a priest, doctor and lawyer on their boards of directors. Based on English common law (where an insurable interest in one person was required in order to have life insurance), the idea was to maintain the organization's morality—and approve or disapprove of applications for life insurance to prevent abuses.

Full Disclosure

Perhaps the most attractive feature of Takaful from a policyholder's perspective is its transparency: the requirement for 100 percent disclosure in an insurance contract. You must disclose not just how the profit will be divided among policyholders and shareholders, but also how you made it: the investments you made; how you arrived at your pricing; sales commissions; the cost of computer, marketing and actuarial services; administrative costs, etc. In other words, who gets what. In effect, the formula to derive policyholders' and shareholders' profits must be clearly spelled out so that one would in theory be able to calculate the distribution of profits. These same principles of full disclosure also apply to the partnership between a Takaful company and its Retakaful company. ☐

Takaful Products

It is no easy task developing investment products that are Shari'ah-compliant. To begin with, since the Qur'an specifically prohibits usury (the charging of interest for the use of money), products cannot be based upon a rate of return. That means no universal life products that offer guaranteed minimum return, no preferred shares investment with a fixed dividend rate, and no bonds with fixed coupon rate. Instead, insurance products should be based upon a mutual fund model—something that incorporates capital gains, not rate of return. To put it another way: Dividends are indeed allowed—if they are expressed as a proportion of earnings, not as a fixed return.

Also prohibited are windfall profits. For this reason, a traditional North American-style term insurance policy may be problematic unless it has a return-of-premium aspect. If you pay $300 per year for a premium and then die the following year, thus garnering your heirs a windfall of $500,000, that is seen as gambling about the timing of your death. Because this is another issue that is gray, it requires the assessment of a Shari'ah Board.

Such a return of premium certainly can be applied to a retirement product. Let's say that a single premium is $100,000, which provides an annuity of $1,000 per month. If the person received 54 months of payments worth $54,000 before dying, the heirs will receive a lump sum payment of $46,000. An alternative to that is an installment refund annuity, whereby the annuity payments will continue for 100 months until the outstanding amount reaches zero.