Chartered Insurance Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

February 2022 Examination Guide

SPECIAL NOTICES

Candidates entered for the September 2022 examination should study this examination guide carefully in order to prepare themselves for the examination.

Practice in answering the questions is highly desirable and should be considered a critical part of a properly planned programme of examination preparation.

590 – Principles of Takaful

Contents

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IMPORTANT GUIDANCE FOR CANDIDATES

Introduction

The purpose of this Examination Guide is to help you understand how examiners seek to assess the knowledge and skill of candidates. You can then use this understanding to help you in your preparation for this examination.

Before the examination

Study the syllabus carefully
This is available online at www.cii.co.uk. All the questions in the examination are based directly on the syllabus. *You will be tested on the syllabus alone,* so it is vital that you are familiar with it.

There are books specifically produced to support your studies that provide coverage of all the syllabus areas; however, you should be prepared to read around the subject. This is important particularly if you feel that further information is required to fully understand a topic, or an alternative viewpoint is sought. The reading list which can be found with the syllabus provides valuable suggestions.

Note the assumed knowledge
For the Advanced Diploma in General Insurance, candidates are assumed to have studied the relevant units of the Diploma in General Insurance or the equivalent. This knowledge is set out on the relevant syllabus.

Read widely
It is vital that your knowledge is widened beyond the scope of one book. *It is quite unrealistic to expect that the study of a single textbook will be sufficient to meet all your requirements.* While books specifically produced to support your studies will provide coverage of all the syllabus areas, you should be prepared to read around the subject. This is important, particularly if you feel that further information is required to fully understand a topic or an alternative viewpoint is sought. The reading list which can be found with the syllabus provides valuable suggestions.

Make full use of the Examination Guide
This Examination Guide contains a full examination paper and model answers. The model answers show the types of responses the examiners are looking for and which would achieve maximum marks. *However, you should note that there are alternative answers to some question parts which would also gain high marks.* For the sake of clarity and brevity not all of these alternative answers are shown.

This guide and previous Examination Guides can be treated as 'mock' examination papers. Attempting them under examination conditions as far as possible, and then comparing your answers to the model ones, should be seen as an essential part of your exam preparation. The examiner's comments on candidates' actual performance in each question provide further valuable guidance. You can obtain copies of the two most recent examination guides free of charge at www.cii.co.uk.

Know the structure of the examination
Assessment is by means of a three-hour written paper.

Part I consists of 8 compulsory questions, worth a total of 48 marks.

Part 2 consists of 1 compulsory question, worth a total of 38 marks.

Part 3 consists of 3 questions selected from 5, worth a total of 114 marks.

Each question part will clearly show the maximum marks which can be earned.

Read the Advanced Diploma in General Insurance information for candidates and important notes for candidates
Details of administrative arrangements and the regulations which form the basis of your examination entry are to be found in the current Advanced Diploma in General Insurance information for candidates and important notes for candidates, which is *essential reading* for all candidates. It is available online at www.cii.co.uk

In the examination

The following will help:

Spend your time in accordance with the allocation of marks:

- The marks allocated to each question part are shown on the paper.
- if a question has just two marks allocated, there are likely to be only one or two points for which the examiner is looking for, so a long answer is wasting valuable time.
- Conversely, if a question has 12 marks allocated, a couple of lines will not be an adequate answer. Always remember that if the paper is not completed, your chances of passing will be reduced considerably.
- Do not spend excessive time on any one question; if the time allocation for that question has been used up, leave some space, go on to the next question and return to the incomplete question after you have completed the rest of the paper, if you have time.

Take great care to answer the question that has been set.

- Many candidates leave the examination room confident that they have written a 'good' paper, only to be surprised when they receive a disappointing result. Often, the explanation for this lies in a failure to think carefully about what the examiner requires before putting pen to paper.
- Highlighting key words and phrases is a technique many candidates find useful.
- The model answers provided in this Examination Guide would gain full marks. Alternative answers that cover the same points and therefore answer the question that has been asked would also gain full marks.

Tackling questions

Tackle the questions in whatever order feels most comfortable. Generally, it is better to leave any questions which you find challenging until you have attempted the questions you are confident about. Candidates should avoid mixing question parts, (for example, 1(a)(i) and (ii) followed by 2(b)(ii) followed by 1(e)(i)) as this often leads to candidates unintentionally failing to fully complete the examination paper. This can make the difference between achieving a pass or a narrow fail.

It is vital to label all parts of your answer correctly as many questions have multiple parts to them (for example, question 1(a) may have parts (i), (ii) and (iii)). Failure to fully distinguish between the separate question parts may mean that full credit cannot be awarded. It is also important to note a full answer must be given to each question part and candidates should not include notes such as 'refer to answer given in 1(b)(i)'.

Answer format

Unless the question requires you to produce an answer in a particular format, such as a letter or a report, *you should use 'bullet points' or short paragraphs,* as this allows you to communicate your thoughts in the most effective way in the least time. The model answers indicate what is acceptable for the different types of question.

Where you are asked to perform a calculation, it is important to show **all** the steps in your answer. The majority of the marks will be allocated for demonstrating the correct method of calculation.

Provided handwriting is legible, candidates will **not** lose marks if it is 'untidy'. Similarly, marks are not lost due to poor spelling or grammar.

Calculators

If you bring a calculator into the examination room, it must be a silent, battery or solar-powered, **non-programmable** calculator. The use of electronic equipment capable of being programmed to hold alphabetical or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements. The majority of the marks will be allocated for demonstrating the correct method of calculation.

EXAMINER COMMENTS

Candidates overall performance

When studying for the 590 *Takaful* examination, it is recommended that candidate's study past Examination Guides in preparation for sitting this examination. In doing so this should aid candidates in identifying areas of the syllabus which require further study.

Reference to previous question papers will assist candidates in understanding the expectations of essay style questions contained within the latter parts of this paper.

Question 1

This topical question asked candidates to provide the reasons that enabled the *Takaful* industry to escape the worst effects of the global financial crisis. It was generally well answered.

Question 2

Explanations of *Diya* and the methods by which it can be collected was well answered by most candidates.

Question 3

Varied responses were seen in this question asking candidates to explain the main *Shariah* objections to conventional insurance provision.

Question 4

Explanations of the primary sources of *Shariah* were well articulated by most candidates.

Question 5

This question posed candidates with listing six of the pivotal roles of *Takaful* Operators.

Question 6

Identification of the risks associated with the segregation of Takaful funds into Participants' risk fund (PRF), Participants' investment fund (PIF) and Shareholders' fund were excellently answered by candidates.

Question 7

Explanations of the six objectives of Islamic Insurance standardisation were well answered by most candidates.

Question 8

Explanations of the main feature of concern for *Takaful* companies in relation to the implications of Solvency II were well poorly answered by most candidates.

Question 9

This essay question tasked candidates with explaining the major asset classes available to the investment managers of *Takaful* companies and saw mixed responses.

Question 10

Explanations of the basic *Mudharabah* model and compare it with the *modified Mudharabah* model were well provided by candidates.

Question 11

Discussions of the objectives of Islamic Finance was poorly answered.

Question 12

For this question candidates were asked to debate the contractual steps of establishing a *Shariah*-compliant insurance solution.

Question 13

Good discussion points were provided around the factors that a *Takaful* Operator should consider in order to manage and mitigate risks.

Question 14

Discussions of the the issues arising in the specific context of *reTakaful* that require attention from a *Shariah* perspective required further detailed explanations.

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

February 2022 examination

Instructions

- Three hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

Unit 590 – Principles of Takaful

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 200 marks as follows.

Part I	8 compulsory questions	48 marks
Part II	1 compulsory question	38 marks
Part III	3 questions selected from 5	114 marks

- You should answer **all** questions in Part I, the compulsory question in Part II and three out of the five questions in Part III. The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.

- You are advised to spend no more than 45 minutes on Part I.

- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.

- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.

- It is important to show all steps in a calculation, even if you have used a calculator.

- If you bring a calculator into the examination room, it must be a silent, battery or solar-powered, non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.

- Answer each question on a new page and leave six lines blank after each question part.

PART I

Answer ALL questions in Part I
Each question is worth six marks

Note form is acceptable where this conveys all the necessary information

1. Explain briefly the reasons that enabled the *Takaful* industry to escape the worst effects of the global financial crisis. **(6)**

2. Explain briefly Diya and the methods by which it can be collected. **(6)**

3. Discuss briefly the main *Shariah* objections to conventional insurance provision. **(6)**

4. Discuss briefly the primary sources of *Shariah*. **(6)**

5. List **six** of the pivotal roles of *Takaful* Operators. **(6)**

6. Explain briefly the risks associated with the segregation of *Takaful* funds into Participants' risk fund (PRF), Participants' investment fund (PIF) and Shareholders' fund. **(6)**

7. Outline **six** objectives of Islamic Insurance standardisation. **(6)**

8. Explain the main feature of concern for *Takaful* companies in relation to the implications of Solvency II. **(6)**

Part II
Compulsory question
This question is worth 38 marks

9. The *Takaful* industry must manage the funds in participants' pools with a view of securing liquidity needs, enabling efficient asset–liability matching (ALM) and maximise investment returns.

Explain the major asset classes available to the investment managers of *Takaful* companies. **(38)**

Part III

Answer THREE of the following FIVE questions
Each question is worth 38 marks

10. Explain the basic *Mudharabah* model and compare it with the *modified Mudharabah* model. **(38)**

11. Discuss the objectives of Islamic Finance. **(38)**

12. Discuss the contractual steps of establishing a *Shariah*-compliant insurance solution. **(38)**

13. Discuss the factors that a *Takaful* Operator should consider in order to manage and mitigate risks. **(38)**

14. Discuss the issues arising in the specific context of *reTakaful* that require attention from a *Shariah* perspective. **(38)**

NOTE ON MODEL ANSWERS
The model answers given are those which would achieve maximum marks. However, there are alternative answers to some question parts which would also gain high marks. For the sake of clarity and brevity not all of these alternative answers are shown. An oblique (/) indicates an equally acceptable alternative answer.

Model answer for Question 1

The Takaful sector was able to escape the worst effects of the financial crisis partly because of its small size; the sector accounts for less than 3% of the global insurance industry. In addition, the key Takaful markets, such as Malaysia, were not affected by the crisis to the same degree as those where Takaful is less prevalent, for example, across Europe.

Model answer for Question 2

According to Islamic law a person guilty of manslaughter, or of causing serious or grievous bodily harm, is obligated to pay Diya, blood money. The amount of compensation would be determined by experts on a case-by-case basis; often it would be set too high for an ordinary person to afford. The problem was persistent because accidental death was common. As a solution a co-operative insurance system was established so that Diya could be paid from the contributions of the community as a whole and not by the guilty party alone. That is, it would be paid from collective contributions.

There are two methods by which Diya can be collected:

• Aqila (supportive clan): if the offender is known, compensation money is collected from the offender's immediate family or tribe.

• Qasama (oath): in situations where the offender has not been identified or there is insufficient evidence to charge the suspect, an oath process called Qasama takes place. The victim's heirs testify that they believe the defendant killed the victim by swearing a religious oath a total of 50 times. Compensation money is then collected from the suspect's extended family or tribe.

Model answer for Question 3

For a contract of exchange to be valid in Shariah, it must be free from any element that may compromise the Shariah objectives of fairness and justice. The contract must not include elements such as:
• Gharar (uncertainty);
• Maysir (speculation); and
• Riba (usury).

This is in addition to requiring the fulfilment of the more familiar conditions of a contract: offer, acceptance and consideration.

The main basis for the Shariah objections to conventional insurance provision is due to the presence of Gharar, Maysir or Riba elements in proprietary and mutual insurance contracts and in the operations of the providers.

Model answer for Question 4

The Quran
Muslims regard the Quran as the foremost source for Islamic knowledge and guidance. They believe that the Quran is the final revelation of God to mankind. It was revealed to Muhammad (PBUH), the final messenger and prophet of God, over a period of 23 years.

For Muslims, the Quran is the literal word of God, both immutable and infallible. It is concise yet comprehensive in meaning, and the use of Arabic language is impeccable and excels in eloquence.

The Sunnah
The Sunnah (plural: Sunan) refers to the traditions of the Prophet Muhammad (PBUH). It includes his authentic sayings, reported actions, tacit approvals and physical attributes.

Hadith (plural: Ahadith) literally means narrative. It was once used to refer exclusively to sayings of the Prophet (PBUH), but is now synonymous with the Sunnah.

The Hadith supplements the Quran. It allows a person to understand the message from Allah through the actions and sayings of the Prophet (PBUH). The Hadith sometimes provides additional information to the rules already stated in the Quran.

Model answer for Question 5

Candidates would have scored full marks for any six of the following:

Pivotal role of the TO involves:
• obtaining the operating licence and regulatory approvals;
• provision of adequate capital to meet regulatory requirements and maintain solvency;
• establishment of effective governance processes;
• controls to protect the interests of the participants;
• controls to secure compliance with Shariah and relevant regulations;
• designing and marketing the products;
• managing the assets and liabilities; and
• administering the business.

Model answer for Question 6

• risk of incorrect attribution of transactions to a fund;
• risk of the PRF requiring financial support from shareholders' fund due to inability to meet its solvency and/or liquidity needs;
• risk of shareholders' fund having to provide an interest-free loan (Qardh-al- Hasan);
• risk of the loan not being repaid and resulting in the loss of capital for the shareholders' fund; and
• risk that fees and investments profits transferred from the PRF to the shareholders' fund are inadequate to meet the expenses of the TO in carrying out its obligations and commitments stipulated in the contract.

Model answer for Question 7

Candidates would have scored full marks for any six of the following:

The objectives of standardisation are to:
1. Harmonise the accounting and financial reporting policies and procedures adopted by Takaful companies.
2. Improve the quality and uniformity of accounting and financial reporting.
3. Promote good ethical practices within the Takaful industry.
4. To improve transparency and disclosure.
5. To establish a robust framework for accountability.
6. Achieve conformity or similarity as much as possible in applications of Shariah rules for investment, financing and insurance and to avoid contradictions and inconsistencies.
7. To ensure financial reporting and accounting meet the Shariah requirements and comply with the principles of Shariah.

Model answer for Question 8

A key feature of concern for Takaful companies will be the separation of Takaful pools (participants' contribution pools) from the TO's funds and resources. Under Solvency II such separation would constitute 'ring-fenced funds', for which capital requirements are calculated separately but may be covered by central funds, though surplus within a ring-fenced fund cannot cover capital adequacy requirements elsewhere in the company. If the Takaful company fails to build up surplus in the pool to meet capital adequacy, the burden of capital adequacy will fall entirely on the TO. Therefore, Solvency II provides an incentive for separately maintaining the capital adequacy of the Takaful pool as well.

There is an argument to be made that instead of focusing on short-term surplus distribution, Takaful companies should be using any 'surpluses' primarily to build the capital adequacy of the participants' pool itself. Again, this is a relatively new area for Takaful and is expected to evolve as the industry grows.

Model answer for Question 9

Major asset classes available to the investment managers of *Takaful* companies include:

Cash
Holding cash does not present any **Shariah** challenges to the Islamic investment manager; however, just holding cash does not produce any returns. Therefore, investment managers usually look to minimize cash holdings in order to maximise returns.

Short-term debt and money market instruments
Instead of holding cash, insurance companies often hold short-term debt and money market instruments which are traded on the stock exchanges. The money market is a subsection of the fixed income market. Money market instruments are short term, low risk, fixed-income financial securities with a relatively high degree of safety because their issuers have the highest credit ratings.

These bring some return without compromising liquidity and generally account for a significant proportion of an insurance company's asset portfolio.

However, Takaful companies find it difficult to source such securities as they tend to be interest-bearing in nature. The Central Bank of Malaysia has encouraged the development of an Islamic money market; currently only TOs in Malaysia have access to an adequate supply of these Islamic instruments.

Bonds

Bonds are a way that governments borrow money, typically over a long term, in return for a regular payment of interest. They offer relatively stable returns and are generally considered to be lower risk than shares, though they often have lower returns as well. Bonds are a type of fixed-income security and are often referred to as debt instruments.

Some sovereign bonds, such as US Treasury Bills or UK Gilts, provide a very liquid and robust market for placing funds. This means that they can be turned into cash relatively quickly, although potentially at the cost of a capital loss.

Where there is a deep and liquid market, regulators may allow holdings of high quality bonds to be treated as near cash and eligible for liquidity requirements. In some countries, regulators have gone so far as to prescribe minimum levels of government debt in insurance companies' portfolios, but this practice appears to be on the decline.

Other bonds are not so liquid. Corporate bonds are issued by corporations and used by a lot of insurance companies. These are long-term securities and are attractive to long-term (i.e. life) insurers as they allow for asset–liability matching. Bonds generally account for the majority of a conventional insurance company's investment holdings.

Bonds and debt securities present a major challenge to the Islamic investment manager. This is because their interest-bearing nature renders them ineligible for Shariah-compliant investment pools.

However, in the last few decades Islamic financial institutions and several governments in Muslim and non-Muslim countries have started to issue Sukuk. These produce bond-type returns and are Shariah compliant.

Presently, the number of high-quality Sukuk issued in most jurisdictions is very limited. This prevents Islamic investment managers from meeting their asset–liability matching requirement for this asset class. As a result, they must seek other ways of achieving an appropriate balance of assets if they are to have similar investment performances to their conventional peers.

Since bond holdings form a major proportion of insurance companies' asset holdings, the lack of availability of an adequate Islamic bond-equivalent class has a major impact on Takaful pool investments.

Bonds, short-term debt and money market instruments are referred to as debt securities, in contrast to cash or equity.

Equity

An equity represents part ownership of a company's capital and is an alternative name for an ordinary share. Until recently, investment in equities was often regarded as being more profitable over the long term than investment in bonds. However, listed equity prices are cyclical, which means their liquidity can be compromised and losses may occur if there is a need to sell the shares in a market downturn. As a result, insurance companies tend to keep a low proportion of their funds in equities. This enables them to capture the long-term returns produced, without compromising the liquidity of their funds by holding rather than trading their securities.

In a similar manner to ethical investors, the equities that Shariah-compliant Takaful companies may invest in reflect their underlying beliefs and ethics. This restricts the types of equities available to Takaful companies when compared to those that the general investor may choose from. For example, Takaful companies should not invest in forbidden industries such as gambling and interest-based financial institutions, or highly geared companies. Gearing, or leverage, refers to the level of a company's debt related to its equity capital.

However, according to research published in Investing In Islamic Funds: A Practitioner's Perspective (Noripah Kamso, 2013), the returns generated by Shariah-screened investment portfolios are not compromised when compared to those generated by conventional investment portfolios. This indicates that Takaful companies' adherence to Shariah-screened portfolios does not generally cause them to suffer any penalties on their returns.

Real estate
Investments in real estate (property) generate returns as a result of rental income and capital appreciation, although they are exposed to capital depreciation during downturns. However, such investments offer insurance companies limited liquidity when they need to sell/release funds. The limited liquidity means that insurance companies will use direct investment into real estate sparingly or as part of their alternative asset investments.

Alternative assets
This asset class comprises of high-risk and high-return investments. These consist of investments in private equity funds, commodity funds, hedge funds, derivatives and real estate (property). In contrast to REITS, ownership of property is considered an alternative asset. Increasingly private equity and commodity funds have become highly geared tools so are not suitable for Takaful funds. Conventional insurers make extensive use of derivatives to manage investment risk.

For Islamic investment managers, investment in private equity funds, commodity funds and some derivatives is possible subject to the limitations on gearing mentioned above. Many derivatives and hedging instruments remain outside the Shariah-permissible framework. Takaful companies have found it difficult to meet their desired level of exposure to this asset class.

Model answer for Question 10

The Mudharabah model is a risk-sharing partnership arrangement pioneered in Malaysia in the 1980s. It was the first model intended for commercial implementation with an incentive for the operator. The Mudharabah contract has two parties: the capital provider (Rab al Maal) and the entrepreneur or expertise/service provider (Mudharib).

The Mudharabah contract creates a Shariah-compliant relationship between the pool funded by the participants' contributions – which acts as the Rab al Maal – and the insurance company (the TO) – which acts as the Mudharib.

• participants contribute via Tabarru (donation) to a common pool – they are the capital provider;
• the TO enters into a Mudharabah contract with the contribution pool to manage the business – the TO is the expertise provider;

• the pool's funds are invested by the TO pending any claims;
• the funds of the contribution pool and the funds of the TO are segregated;
• the TO's remuneration comes exclusively from a share of any investment profits;
• the profit-sharing arrangement means that the key driver for the TO is maximising investment profits in order to optimise their remuneration; and
• participants ultimately own any surplus in excess of capital adequacy requirements, and are ultimately responsible for making good any deficit.

Treatment of deficit and surplus – As mentioned previously, in practice most regulators will require the TO to fund any deficit and this is done through Qardh-al-Hasan to absolve the participant of additional injection of funds. The Qardh-al-Hasan loan has a first charge on any future surpluses. In most cases, the effect of having to repay the loan is that participants would be unlikely to receive a share of any future surplus. However, the model may provide for any surplus in excess of capital needs to be returned to participants directly or indirectly, or to be applied to charitable purposes.

Incentive – Unless the contributions pool is very large, a share of the investment returns will not provide sufficient incentive for the TO to undertake the venture. This is even more the case if there is a mandatory obligation to provide Qardh-al-Hasan to tide over any deficit.

Commercially challenging – The basic Mudharabah model has proved commercially challenging to operate, in that it is difficult to generate sufficient investment income share to adequately reward the TO.

The modified Mudharabah model operates in a similar manner to the basic Mudharabah model. The difference is that instead of sharing only the investment profits, the TO also shares in any overall surplus including underwriting profits. This is clearly more aligned to commercial realities but is open to Shariah objections. It is argued that the TO should not in principle share in the underwriting surplus as this belongs to the participants only. The obligation for the TO to inject Qardh-al-Hasan in the event of a deficit still remains.

Controversy – There is a difference of opinion amongst Shariah scholars as to the validity of allowing the TO to share in the underwriting surplus, which in Shariah terms is attributable only to the participants. Some Malaysian Shariah scholars have historically allowed this. However, scholars in the Gulf Cooperation Council (GCC) countries have not always endorsed the acceptance of the model and have encouraged operators to look for other ways to remunerate the TO.

Commercially challenging – In practice, even the modified Mudharabah model has proved commercially challenging to operate.

Model answer for Question 11

The three objectives of Islamic finance are:

Economic and social fairness and justice
Islam encourages trade and business activities to be carried out for the purpose of creating a healthy and vibrant society in which people can be happy and flourish despite their inherent differences. Some people are stronger, healthier and richer than others. However, Shariah seeks to set a level economic and social playing field, in which those who are at a disadvantage do not get exploited, and the rich and powerful do not impose their supremacy unfairly.

Shariah attempts to extinguish any opportunity for abuse of power and position which may cause imbalances in society. Islam forbids the exploitation of unhealthy human instincts and making money through immoral and injurious products. It ensures reward for those who deserve it and that loss is shared by all participants. Islam rejects any dealing that establishes an unwarranted enrichment without a justified effort.

Equitable distribution of wealth
Shariah disapproves of the concentration of wealth in the hands of the few. A common feature of economic societies that are interest based is that the majority of the capital is possessed by very few wealthy individuals. Their lending and borrowing system is influenced and motivated by interest rates, which result in the 'rich getting richer and poor getting poorer'.

The wealthy lender is generally not interested in why the money has been borrowed, but focuses instead on collateral possessed by the borrower which can be exercised in the event of the borrower's default. The lender's objective is to make more money through the use of money, without any effort or work on their part. If the loan is not repaid, the lender has the option to repossess the borrower's assets and recover the initial loan, plus any payable interest and charges for defaulting repayments. The borrower, whose business venture did not go as planned, becomes poorer as a result.

Shariah forbids making money out of money. If an individual lends money to a friend, then all that is due back is the amount that was loaned and not a penny more. The lender cannot generate a return through a loan, but must put their capital at some sort of risk.

The capital owner is encouraged to invest their wealth instead. This means they have a vested interest in the business venture, as they are entitled to any profits generated and must also bear the burden of any resulting losses. The business owner, who is less wealthy, shares the profit with the capital provider as agreed and does not have to bear any losses alone.

The middle path
Shariah strives to achieve a balanced and tolerable society. It restricts human behaviour from becoming too extreme either through application or due to a complete lack of activity. The following verse from the Quran demonstrates how Islam prefers moderation, known as the 'middle path'.

Here, Islam is described as the 'straight path'. This is understood as being the middle path because God immediately mentions the following alternative paths which are present on each end of the spectrum:
• 'The path of those who have earned Allah's anger '– This is the path of rejection as it is for those who have angered Allah by rejecting his commands.
• 'The path of those who have gone astray'– This is the path of extremism, implying that it is for those who have misunderstood Allah's commands and taken them beyond acceptance.

Islam accepts the benefits of certain activities, such as trade, but also has restrictions in place to ensure that they are not used as tools for manipulating and bringing harm to others. For example, Islam adopts the middle path with regards to capitalism; it recognises the benefits that capitalism brings in its aim to reward individual enterprises, but limits its influence where it threatens society's collective interests.

Model answer for Question 12

Step 1. Tabarru – In the first of the contractual steps, participants or interested groups and individuals make a donation towards a fund with the intention of helping others should they suffer a loss. This is the principle of Tabarru, which we translate as 'donation' in this study text. Tabarru serves as the foundation for Takaful. It also serves to mitigate or remove the main elements prohibited by Shariah of Gharar and Maysir from insurance.

In Shariah the prohibition of Gharar does not strictly apply to charitable and unilateral contracts and generally does not render the arrangement void or voidable. The main reason for the tolerance of Gharar is the charitable and gratuitous nature of the contract where no counter-value is expected in return. A risk-transfer contract, such as the contracts offered by conventional insurance providers, is neither charitable nor unilateral so will not be able to mitigate this kind of Gharar. However, a risk-pooling arrangement – where the participants make a contribution to a common pool – reduces the inherent Gharar in insurance to minor Gharar. Minor Gharar would then not make the insurance arrangement void or voidable in Shariah. With suitable modifications to asset management policies of the conventional mutual insurance provision arrangement, a risk-sharing mutual insurer could become acceptable through Takaful.

Just like a mutual or a co-operative, the Takaful model adopts the principle of every participant making a contribution – or donation – to the common pool. Tabarru allows the 'contract of donation with a condition of compensation' to be adopted. Even though the element of Gharar still persists in a Takaful operation, the donation or Tabarru contract allows the uncertainty to be tolerated without affecting the validity of the Takaful arrangement. In the Shariah context this arrangement reduces the Gharar to the category of minor or tolerable (Gharar yasir). The reasoning is that those paying the Tabarru are not aiming to profit from the uncertainty inherent in the provision of any insurance. Instead, they intend to raise a pool of mutual donations that will be used for mutual indemnity to compensate those of the participants who suffer from defined perils.

Step 2. Promise to indemnify – A Wa'ad is translated as 'promise', and is a commitment made by one person or company to another person or company to undertake something to their benefit. This is a unilateral contract and obligates the offeror only.

In the second contractual step of Takaful, the group of participants makes a Wa'ad to each individual participant that they will be indemnified from the Takaful fund if a particular event occurs and they suffer a prescribed loss. According to most Shariah scholars, a Wa'ad is legally binding.

This promise of indemnity is similar to the promise made by a conventional insurer to the insured that they will indemnify them and provide compensation. However, the difference in Takaful is that the promise is made after the participant has made a donation to the Takaful fund, whereas in conventional insurance the promise is made in consideration and on condition that a premium is paid.

Once the second step is complete, a common understanding exists amongst all the participants that the contributions will be used to indemnify any participant who has suffered a particular loss.

Step 3. Takaful – We have now established a basic form of Takaful, which fulfils the requirements of the cooperative model prevalent in countries such as Saudi Arabia. We have the participants who have made contributions or donations towards a common fund, establishing a Takaful fund as a result. In return, the group of participants has made a Wa'ad to use the fund to indemnify any participant who suffers a prescribed loss.

This model is similar to propriety and mutual insurance provision models and that this basic form of Takaful is comparable to how Lloyd's of London first began.

Step 4. Takaful contracts – Company or individual is appointed to manage the fund on behalf of the participants. This arrangement can be secured through various Islamic contractual structures, such as Wakalah or Mudharabah.

In this contractual step, arrangements are made for an individual or company to manage the Takaful fund, effectively removing this burden from its participants.

There is a range of contractual structures through which an individual or company can be appointed to manage the fund and look after the participants' interests. The contractual structures used to supplement Takaful today are known as Takaful models, but, in reality, they only describe the contractual relationship between the participants and the appointed manager of the fund.

Model answer for Question 13

Factors that a TO should consider in order to manage and mitigate risks.

Principles of Shariah – A Takaful company must ensure that the risks underwritten comply with the principles of Shariah. For example, a Takaful company cannot provide coverage for a casino or a conventional bank that operates on interest. It is the responsibility of the Takaful company to ensure the assets that are the subject of the insurance contract meet the principles of Shariah. The participant does not have to be Muslim. For example, an individual who believes in the Hindu gods wishes to insure his car using Takaful – a car does not contravene the principles of Shariah.

Equitable and fair operations – A TO is required to run its operations in an equitable and fair manner for all participants. It has to ensure that the contribution charged is reasonable, adequate, equitable and fair among participants. In this respect, underwriters play a pivotal role in ensuring that only appropriate risks are selected and the rates charged commensurate with the risk accepted. This means that a higher than average risk should attract a higher contribution charge.

Shariah-compliant underwriting – The underwriting process of the TO must ensure the treatment of the contributions fulfils all applicable Shariah requirements.

Trends and changes – The TO needs to identify elements that contribute to changes in the expected and actual claims experience of the policies covered by a PRF, including mortality and morbidity in the case of family (life) Takaful. Underwriting management and the actuaries need to be aware of trends in claims and claim settlement costs so that underwriting standards, policy wordings and pricing can be modified on a timely basis.

Shariah-compliance training – The TO must have Shariah compliance embedded in all its activities in relation the Takaful fund. They should endeavour to provide Shariah-compliance training to its employees and ensure there is a regular and constant contact with the Shariah advisors and supervisors.

Operational policies and procedures – The TO should try to identify potential causes for operational failures of the Takaful fund, including incompetent and fraudulent activities within its system. The operator should create policies and establish procedures and provide training to ensure these risks are mitigated.

Legal risks and third party liability insurance – The TO should take out the relevant Shariah-compliant insurance policy to insure the TO, its officers, directors, employees, the Takaful fund and its business against legal risks and third party liabilities.

Financial crime policies and procedures – The TO should adopt policies and procedures to identify, prevent and report money laundering, fraud and other financial crime. It is important to establish and maintain a compliance function that would oversee and monitor all compliance related issues, including compliance with Shariah.

Model answer for Question 14

The four issues are:

Recoveries claimed
If the TO becomes eligible to recover from the RTO, then any proceeds claimed as recoveries from the RTO should be credited to the PRF because:
• the claims were paid out from the PRF;
• the purpose of reTakaful was to assist with claims and strengthen the PRF;
• there is a potential conflict of interest: if the recoveries are not paid into the PRF, it could be viewed as a covert stratagem to divert the contributions from the PRF into other accounts.

Under certain specific circumstances – for example, in the absence of reTakaful availability – a TO may have used conventional reinsurance out of necessity. In effect, in the event of a claim:
•the source of recoveries will not be Shariah compliant; and
• the funds in the PRF will be commingled with recoveries obtained from non-Shariah compliant sources.

Bearing in mind the principle of segregation of funds requires the fund to remain pure, if any recoveries are claimed from the conventional reinsurance company and deposited into the PRF, will it affect the Shariah-compliance of the PRF?

In response, Shariah scholars have agreed that the recoveries claimed from a conventional reinsurance company should be credited into the PRF as though the recoveries were from a reTakaful company, for the same reasons that recoveries from an RTO are deposited into the PRF. This will have no effect on the fund's purity or Shariah compliance.

Ceding commission
The TO will be offered or will be in receipt of a ceding commission for placing the business with the RTO or conventional reinsurance company.

Under Shariah rules and AAOIFI Shariah Standard 41, it is not permissible for the TO receive ceding commission. When TOs seek reinsurance or reTakaful solutions, they must ensure that they are quoted net contributions as opposed to gross contributions. Gross contributions include the ceding commission which is then returned to the TO. If the ceding commission is received by the TO, then the TO must return the commission to the PRF.

Profit commission
An RTO would not issue a profit commission. Instead, an RTO would distribute the surplus at the end of the underwriting year in accordance with the reTakaful agreement.

However, under a conventional reinsurance programme the TO may be awarded or offered a profit commission based on the reinsurer's profitability under the reinsurance contract, calculated in accordance with the terms and conditions of the contract. The aim of a profit commission is to provide the TO with an incentive to manage the performance of the business that is ceded. A profit commission differs from a distribution of surplus in that the profit commission is a contractual entitlement, rather than a discretionary distribution, and is specific to the performance of a contract.

The TO may accept any surplus distribution from the RTO and deposit the amount into its own PRF. Under Shariah rules, any profit commission received from a conventional reinsurer should not generally be accepted by the TO because the source of the income may be a non-Shariah complaint source. However, if profit commission is received, then there are two options.
1. Accept the profit commission and then use it to renew the conventional reinsurance policy; or
2. Leave it with the conventional reinsurer and seek a discount from the renewal.

Interest receivable
There is the potential presence of interest/usury in other aspects of reinsurance contracts entered into. For example, it is common practice under proportional treaties for cedants to retain a part of the premiums on account of possible future claims; in the conventional insurance market such 'retentions' are typically interest-bearing.

As long as the TO or the RTO ensures that all investments are Shariah compliant, then they will not be in receipt of any interest. However, if the operators were to receive any interest, then this must be isolated and donated to charity as a purification process.