



Chartered
Insurance
Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

September 2022 Examination Guide

SPECIAL NOTICES

Candidates entered for the March 2023 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

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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 1 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 question asked candidates to explain the three primary functions of insurance. It was generally well answered.

Question 2

Discussions of conventional insurance and Shariah perspectives of misrepresentation were generally well answered by most candidates.

Question 3

Varied responses were seen for this question asking for protection and indemnity (P&I) clubs. Candidates are reminded to pay close attention to the study text.

Question 4

Answers relating to Shariah objections to conventional insurance provision were generally provided in close alignment to the study text.

Question 5

This question was generally well answered by most candidates.

Question 6

This question tasked candidates with comparing a bilateral contract with unilateral contract in *Shariah* context.

Question 7

Explanations of the *Waqf* arrangement and its application in *Takaful* were well answered by most candidates.

Question 8

Discussions of the term *Dharurah* in *Shariah* context were carried out well by numerous candidates.

Question 9

Part (a) of this essay question tasked candidates with explaining segregated funds. Part (b) asked candidates to discuss the key specifics that make *Takaful* different from conventional insurers in terms of financial reporting. Candidates performed well in both parts of the question.

Question 10

Explanations of the key features of a proprietary insurance arrangement were well provided by candidates.

Question 11

Discussions of secondary sources of *Shariah* were well answered by most candidates.

Question 12

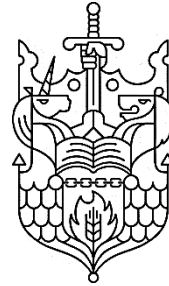
For this question candidates were asked to discuss the core principles of Islamic finance.

Question 13

Good discussion points were provided around the *Takaful* windows and debate of their benefits, criticisms and how they are strengthened.

Question 14

Discussions of the remaining five challenges and limitations and how they are being addressed by *Takaful* companies required further detailed explanations. Lots of candidates did not attempt the question and those that did provided very good answers.



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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

September 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 **three** primary functions of insurance? (6)

2. Discuss briefly conventional insurance and Shariah perspectives of misrepresentation. (6)

3. Discuss briefly protection and indemnity (P&I) clubs. (6)

4. Explain briefly Shariah objections to conventional insurance provision. (6)

5. Discuss briefly the term *Jahalah* in Shariah context. (6)

6. Compare bilateral contract with unilateral contract in Shariah context. (6)

7. Explain briefly Waqf arrangement and its application in Takaful. (6)

8. Discuss briefly the term Dharurah in Shariah context. (6)

Part II

Compulsory question

This question is worth 38 marks

9. Once the contributions have been received by the *Takaful Operator*, they are deposited into segregated and appropriate funds.
- (a) Explain each of these funds. **(19)**
- (b) Discuss the key specifics that make *Takaful* different from conventional insurers in terms of financial reporting. **(19)**

Part III

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

10. Explain the key features of a proprietary insurance arrangement. (38)
11. Explain the secondary sources of *Shariah*. (38)
12. Discuss the core principles of Islamic finance. (38)
13. Explain *Takaful* windows and discuss their benefits, criticisms and how they are strengthened. (38)
14. The challenges and limitations of the *Takaful* industry include, but not limited to, shortage of skills, knowledge and experience, the focus on agency-based distribution, the low levels of family *Takaful* and the perception that surplus distribution is a key feature of a risk-sharing *Takaful* model.
- Discuss and explain the remaining **five** challenges and limitations and how they are being addressed by *Takaful* companies. (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**Primary functions of insurance:**

- **To mitigate risks:** Individuals and organisations should consider the risks that they are exposed to and decide whether they can eliminate them altogether, whether they can be mitigated to an acceptable level or whether they can be transferred or shared.
- **Provide relative certainty and peace of mind:** In exchange for the premium, and subject to any limitations in the insurance itself, the insured swaps the uncertainty of loss for the relative certainty provided by the insurance protection and peace of mind.
- **Spread the risk:** By transferring the risk to insurers then sharing the risk between themselves either as co-insurance or reinsurance the risk is spread far wider than it would be if it were retained by the insured.

Model answer for Question 2

In conventional insurance, the test to be applied for misrepresentation is whether or not the customer has acted reasonably in providing the information. To avoid misrepresentation, the proposer needs only to provide answers to the best of their knowledge or belief. However, where a proposer deliberately or recklessly answers wrongly, the insurer will be entitled to avoid the policy from the beginning; that is, to decline all claims and return the premium. The misrepresentation must concern a fact not an opinion, and must otherwise meet the conditions outlined above relating to non-disclosure.

From a Shariah perspective, a transaction is not valid if it takes place under duress or is accompanied by fraud or misrepresentation by any party. Misrepresentation must be avoided and no false declarations should be made regarding the goods or trader's own standing and ownership. Islamic law insists that the contract is only legitimate if there is mutual consent of the parties.

Model answer for Question 3

The **protection and indemnity (P&I) club** is a particular type of mutual arrangement, which is still used in the shipping industry for marine liability risks. A P&I club reports only to its members. At the primary level it is a pure risk-sharing arrangement with club members sharing **surpluses** and funding **deficits** in a **risk pool**. Instead of paying a premium, a P&I club member pays a 'call'. This is a sum of money that is put into the club's risk pool fund.

Unlike many other mutual arrangements, P&I club members have to pay a further 'call' to replenish the fund if the pool might go into deficit. In addition, P&I clubs pool their risks in international associations of clubs.

P&I clubs show that for a set of defined **participants** with an affinity to each other, a risk-sharing arrangement can provide a viable form of insurance in contemporary societies. However, P&I clubs are not purely mutual as they protect their exposures with conventional reinsurance.

Model answer for Question 4

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.

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 5

Jahalah refers to ignorance or obscurity regarding the object for sale or its price. Jahalah is a consequence or effect of Gharar and its meaning is more specific; everything that contains ignorance is uncertain, but not all things become uncertain due to ignorance.

The prohibitions for Gharar given in the Quran and the Sunnah also apply to Jahalah. This is because uncertainty encompasses ignorance.

Jahalah occurs when an individual lacks knowledge about the specifics of an object, event or action, despite knowing about its occurrence or existence. Similarly to Gharar, Shariah only excuses minor Jahalah that does not have the potential to lead to disputes between contracting parties. However, major Jahalah is prohibited and renders contracts of exchange void or defective.

Gharar and Jahalah are often used interchangeably to describe uncertainty in contracts of exchange because they both involve speculation as to the result of an action or event. However, while Jahalah relates to precise details, such as the quantitative and qualitative aspects of an item, Gharar concerns more general information, such as the existence or non-existence of the item itself.

Model answer for Question 6

Bilateral contracts	Unilateral contracts
Two parties or more involved	Single party
Parties make a promise to each other	Only one party makes a promise
Actions are obligated to all parties involved	Actions are obligated to one party
Offer, acceptance and consideration	Offer is made; acceptance does not need to be communicated; and the offeree’s performance is regarded as the consideration
Must adhere to principles such as transparency, fairness and no uncertainty in the context of Islamic finance	The terms of the contract are at the offeror’s discretion, and no rules such as transparency and uncertainty are attached

Model answer for Question 7

Waqf is designed for the purpose of creating a trust fund. The owner of this particular trust fund is God alone. Waqf is a religious charity and everything owned by this charity is 'as if it were owned by God'. The proceeds in the fund exist to benefit the wider community.

The application of Waqf in Takaful is as follows:

- TO establishes a Waqf fund through initial donations;
- the TO cannot own the fund, so appoints itself as the Wakil of the Waqf fund instead. Thereafter, it is entitled to remuneration (agency fees);
- participants pay Tabarru towards the Waqf fund and become members; and
- participants are entitled to compensation when required on the basis that they are beneficiaries and not in consideration of their donations.

In a separate contract, the TO may also take the role of Mudharib while the Waqf fund acts as Rab al Maal. Investment profits are shared between the TO and the Waqf fund. If any surplus arises from the operations of the Waqf fund, this remains in the ownership of the Waqf fund.

Model answer for Question 8

Although the list of Haram products is extensive, a general exception applies to these; this is referred to as Dharurah, or the 'principle of necessity'.

Dharurah may be implemented when someone is in an extreme situation which could endanger them, their family, their wealth or their religion, and the solution lies in something that is prohibited or restricted by Shariah. Out of necessity, the Haram product temporarily becomes Halal, until the individual either recovers from danger or an alternative Halal solution is made available.

Model answer for Question 9

Shareholders' fund

The TO's Wakalah or Mudharabah fees, depending on what model is adopted, are placed in a shareholders' fund or a TO's expense fund – sometimes directly from the participants' contributions and sometimes transferred from the participants' risk fund.

The shareholders' fund also holds the following assets:

- paid-up capital and reserves attributable to shareholders;
- profit on the investment of capital and shareholders' reserves;
- such proportion of the investment profit generated by the investment of the policyholders' fund and technical and other reserves as is attributable to them; and
- performance fee (if agreed).

The administrative expenses of the investment department are deducted from the shareholders' fund according to the contract: that is, depending on whether or not the shareholders bear specific expenses in exchange for a Mudharabah fee.

Participants' risk fund (PRF)

The remaining contribution received from the participants is transferred into the PRF, also known as the policyholders' fund. The assets of the PRF consist of:

- contributions received;
- recoveries received from reinsurers;
- the proportion of the investment profits attributable to participants as agreed by contract; and
- consultancy and other receipts.

All the claims payable to the participants shall be met out of the PRF. The contract specifies which other expenses are borne out of the PRF and which borne by the operator; for example: reinsurance costs, technical reserves, administrative expenses and fees that relate to insurance activities, loss adjuster's fees and so on.

Participants' investment fund (PIF)

Many Takaful companies – especially those that provide coverage for homogenous risks, such as family (life) Takaful – divide the PRF into two distinctive funds:

- one fund to manage claims; and
- one fund other solely for investment purposes.

Any investment profit gained would be deposited into the investment account and all investment losses would be borne by this participants' investment fund (PIF).

Other funds

Some TOs will segregate family Takaful business into two funds:

- Takaful protection fund; and
- Takaful annuity fund.

Some Takaful companies also segregate the surplus into a surplus fund or a Takaful reserve fund. As regards life insurance facilities, Islamic insurance companies have developed Islamic trust funds for social solidarity, mortgage protection, student protection and employers' protection.

According to research by the International Shariah Research Academy for Islamic Finance (ISRA) there are three key issues related to Takaful that IFRS does not directly address:

1. definition of Takaful;
2. classification of the Qardh-al-Hasan provided by the TO; and
3. the nature of financial statement reporting in Takaful companies.

Elham Hassan and Andre Rohayem in *Takaful Islamic Insurance Concepts and Regulatory Issues* (2009) provide a list specificity as follows:

1. Takaful companies have an additional responsibility to comply with the relevant and applicable Shariah rules in addition to the laws, regulations and principles applicable to all insurance companies.
2. Contributions from the Takaful fund must be invested in assets that comply with the principles of Shariah.
3. The surplus must not be used to cover the deficits in other pools within the company.
4. Participants share in the surpluses and in some cases, may be requested to make further contributions in case there is a deficit in the pool. In other cases, the TO may be asked to provide an interest-free loan to cover for the deficit. Future surpluses will be used to repay the loan.

5. The shareholders' (operator's) fund and the participant's fund are kept segregated and investments and segregated between them both. Segregation of funds is imperative in Islamic insurance.
6. The TOs are responsible for the management of the Takaful fund and they are remunerated for their efforts. In Wakalah contracts, it can be agreed that the TO acting as an agent can be entitled to a sum of the surplus as performance incentive.
7. Islamic financial reporting is more specific to participants' balances and transactions (segregation of funds). In contrast, financial reporting in conventional insurance focuses more on the shareholders and markets, including customers and creditors.
8. Islamic insurance have numerous stakeholders and therefore have an increasing need for financial reporting. The stakeholders in Islamic insurance consist of:
 - participants;
 - operators
 - shareholders of the company;
 - Shariah supervisors; and
 - regulators.
9. Takaful is about risk sharing amongst the insured and not about risk transfer between the insured and the insurer.
10. The premiums coming from the participants are donations based on the contract of donation. Payment of premium in conventional insurance are based on contract of exchange.
11. In Takaful, the process is supplemented by operational models (such as Mudharabah and Wakalah) whereas no such models exist in conventional insurance.

Model answer for Question 10

Proprietary insurance company

A proprietary insurance company is owned by its shareholders. Managers appointed by shareholders run the company. All risks of the operation are borne by the company. Ownership in a proprietary insurance company is transferable. Shareholders can transfer or sell their shares to third parties.

Policyholders' premiums

All premiums become part of the company's funds and claims are managed from these funds. The policyholders have no say in how their premiums are used.

Risk-transfer contract of insurance

The policyholders of a proprietary insurance company have a contract of indemnity in return for the payment of a premium. They expect all valid claims to be paid.

Treatment of surplus or deficits in policyholders' fund

Surplus arising from the operations of the insurance company belongs solely to the company. The policyholders have no share in it except in contracts, which provide for discretionary participation. Conversely, any deficit arising from operations, however incurred, is the sole responsibility of the insurance company. The policyholders have no liability apart from the timely payment of premiums for the provision of the specified insurance cover and a duty to abide by conditions and warranties set out in the contract.

Capital provision and regulatory burden

The company is responsible for meeting all capital and regulatory requirements for the operations. The policyholders have no role in this.

Stakeholder interests

Shareholders of a proprietary insurance operation seek to make a return on the capital that they invest in the company. This forms their key motivation. Policyholders are mainly concerned to ensure that any claims arising can be met in a timely manner. Their only interest in the profitability of the company is to get satisfaction in its ability to meet claims as and when they become due.

Investment of assets

Funds are invested at the company's discretion. The only restrictions on investments are those required by the regulators. These mainly relate to segregation of some funds or investment in sound assets bearing in mind the solvency and liquidity needs to meet any claims in a timely manner.

Accounting treatment

As policyholder's premiums become part of a proprietary insurance company's funds, only a single set of accounts is prepared to reflect the status of its finances. There is no segregation between policyholders' premium payments and other funds of the company.

Corporate governance

The company is run ultimately for the benefit of its shareholders and their interests provide the main focus for operations. The company must also comply with regulators' and ratings agencies' requirements, and ensure adequacy and stability of solvency. Policyholders' interests feature in the operations in as much as they are aligned to shareholders' interests. Thus, competitive pricing and timely payment of claims are key features of proprietary insurance operations.

Model answer for Question 11**Ijma (consensus)**

The rules of Shariah may result from Ijma (consensus); this refers to the consolidated opinions of all the Shariah jurists after the demise of the Prophet Muhammad (PBUH). The opinions must have been formulated from at least one of the primary sources and must not contradict either the Quran or Hadith.

Opinions differ over whether the Ijma should be that of:

- the companions of the Prophet Muhammad (PBUH);
- the first three generations of Muslims (the predecessors);
- all the jurists and scholars of the Muslim world (i.e. scholarly consensus); or
- all the Muslim world, scholars and laymen alike.

However, contemporary Islamic finance jurists have argued that it should be the consensus of the jurists and Shariah scholars.

Qiyas (analogical deduction)

Qiyas (analogical deduction) refers to the application of an original rule, which was established through the sources of Shariah on an earlier case, to a current issue for which no relevant Shariah rule exists. There is a set of strict rules and conditions on how logic can be used to deduce new Shariah laws from established laws.

Ijtihad (legal reasoning)

Ijtihad (legal reasoning) is the exertion of maximum intellectual effort in order to find a conclusion to a matter related to the Shariah. It is an important source of Islamic law.

Mujtahid (competent scholars) only use Ijtihad in the absence of any clear ruling from the sources previously discussed, either due to a lack of clear textual evidence or because there is no definite interpretation of a text. Ijtihad is an important instrument for interpreting the divine message, and relating it to the changing conditions of the Muslim community and its aspirations to attain justice, salvation and truth.

There are strict conditions which must be met before a Shariah jurist or scholar can practice legal reasoning, such as:

- the attainment of a high level of intellectual competence;
- expertise in the Arabic language;
- thorough knowledge of the Quran and Sunnah;
- performance of religious duties; and
- knowledge in the various disciplines of religious learning.

Istihsan (juristic preference)

Istihsan (juristic preference) is a method of exercising personal opinion to give preference to one rule over an existing rule. This is done for the purposes of fairness, public justice and public interest.

A jurist may resort to Istihsan for the following reasons:

- The existing law is either too general, or too specific and inflexible.
- Its literal enforcement may cause unfairness and be detrimental to many people in certain situations.
- Departure from the existing law is the only way of attaining a fair solution to a problem.
- Another rule offers a means of avoiding hardship and generates a solution that is harmonious with the higher objectives of Shariah.

Istislah/Maslahah (public interest)

Istislah/Maslahah (public interest) involves the prohibition or permissance of something either because it does or does not serve the public by securing their welfare or protecting them against harm.

The use of Maslahah as a source of Shariah law is very limited because the ways and means for bringing benefit to the public are endless. Some scholars do not even recognise Maslahah as a source for law.

Those that argue in favour of Maslahah restrict its application to cases that are not related to religious observances, necessities and clear injunctions. Furthermore, its application must not contradict the principles of Shariah.

Al-Ghazali gives the following definition of Maslahah:

Maslahah consists of considerations which secure a benefit or prevent a harm but which are, simultaneously, harmonious with the objectives (Maqasid) of the Shariah. These objectives consist of protecting the five 'essential values', namely religion, life, intellect, lineage and property. Any measure which secures these values falls within the scope of Maslahah, and anything which violates them is Mafsadah (evil), and preventing the latter is also Maslahah.

Source: Al-Mustasfa Min 'Im al-Usul by Al-Ghazali, 1/174

Urf (custom)

Urf (custom) is defined by Mohammad Hashim Kamali as 'recurring practices which are acceptable to people of sound nature' (Kamali 2002, p.369). Whether general or specific, Urf is that which: is practised by reasonable people with sound mind; does not contravene the principles of Shariah; and is observed and upheld by a court of law; is valid and can form the basis for legal and judicial decisions in Shariah.

Source: Principles of Islamic Jurisprudence by Mohammad Hashim Kamali, The Islamic Texts Society, 2002.

For a custom to be used as a source of Shariah law, it must also:

- represent a common and recurrent phenomenon;
- be in existence at the time a transaction is concluded;
- not contravene the clear stipulation of an agreement; and
- not violate the definitive principle of the law.

Model answer for Question 12

Principles of Islamic finance

To achieve the three objectives of Islamic finance, Shariah has prescribed core principles for Muamalaat. These relate to:

Fairness

One of the main principles of Islamic finance is fairness to contract. Parties to a transaction must be free to agree any terms and conditions as they wish. This is provided that those agreed do not contravene the other core principles of Shariah and are not in conflict with the prohibitions of Shariah. Parties to the contract must then abide by the rules set out in the contract.

For example, parties may agree on how profit is to be shared, its method of delivery, a detailed description of how the agent is to perform and the conditions of remuneration.

Contracts are given great importance in the Quran. Allah says: O' you who believe, fulfil all your covenants. (Quran, 5:1)

Fulfil (every) engagement, for (every) engagement will be enquired into (on the Day of Reckoning). (Quran, 17:34)

Ethical investment

There is a strong link between Shariah and ethical standards. The ultimate objective of Shariah is the wellbeing of mankind and so any ethical standard which conforms to this objective is supported by Shariah, as long as it does not contravene its principles.

Muslims must apply ethical standards to investments. They should review the business they are investing in, taking into account:

- its policies;
- the products it produces;
- the services it provides; and
- its impact on society and the environment.

A Shariah-compliant insurance company must also look carefully at the risk before considering whether to underwrite it. For example, a Takaful company should not provide coverage for a weapons manufacturer or a company that abuses human rights.

Use of capital

In accordance with Shariah principles, capital should not be left idle and should be put to use instead. Islam encourages the investment of capital and profit.

All Islamic financial structures generate some form of return in a manner that is compliant with the rules and principles of Shariah. For example, this may be through rent from a leased property or profit from the sale of goods.

Transparency

Islam stresses transparency in financial dealings. All Islamic institutions, including Takaful companies, must show transparency in operational practices and financial performances.

Financial transactions must be conducted in such a manner that all the parties are clear about the important facts, including the terms and conditions. A contract will be rendered void if the seller does not fully disclose all material information relating to the product, or the seller intentionally or negligently misrepresents the goods.

In addition to the participant's duty to disclose all material information to the insurer, it is equally important for the insurer to make all material and reliable information available to both clients and shareholders in a timely and accessible manner. Nothing must be hidden; all commissions and fees should be disclosed.

Write and record

It is preferable to write and record all transactions for clarity, certainty and to avoid any future disputes. Should any dispute arise among the contracting parties, a written contract may be used as evidence and can be extremely useful in reaching a resolution.

Allah advises:

O' you who believe! When you contract a debt for a fixed period, write it down. (Quran, 2:282)

You should not become weary to write it (your contract), whether it be small or great, with (record of) the term thereof. That is more equitable in the sight of Allah and more solid for testimony, and the best way of avoiding doubt between you. (Quran, 2:282)

Participation

In Islamic finance and insurance, risk participation is an important aspect of a financial structure that generates profit and surplus. All parties to an agreement should share in the risk and profit of any endeavour.

To be entitled to a return, a provider of finance must either accept business risk or provide a service, such as supplying an asset. This principle is derived from a saying of the Prophet Mohammed (PBUH) that 'profit comes with liability.' (Sunan Abu Dawood, 24:3502) This means that entitlement to profit only occurs when one bears the liability or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.

In Takaful, participation comes in different forms:

- The policyholders are called the 'participants' because they engage in a participants' risk fund (PRF) towards which they have made a contribution.
- All the participants share the risk via the PRF and it will provide compensation to any participant who suffers a loss.
- The PRF is entitled to any returns generated from investments in its funds.
- The participants are eligible to receive a share of the surplus accumulated at the end of the underwriting year.

Tangible assets

One of the most important characteristics of Islamic financing is that it is asset backed. Financing in Islam is always based on illiquid assets which create real assets and inventories. Profit can only be generated when something with intrinsic value is being exchanged for money. Therefore, all transactions must involve either the use of tangible assets, usufructs or services.

Usufruct

The term 'usufruct' refers to the legal right to use an asset belonging to another person.

Historically, banks had tangible physical assets in their vaults over which ownership rights were granted in the form of paper money. In consequence, each and every bank note represented an underlying asset held in a bank's vaults. However, modern day banking practices do not involve underlying assets.

Existence and ownership

Assets should be in existence before sale. The seller must legally own and have actual possession of the asset before making an offer for its sale. For example, an individual may not insure a house promised to them after the death of their grandfather.

Money is a medium for exchange

From an Islamic perspective, money itself has no intrinsic value and is only a medium of exchange. This means that no charge should be made for its use.

Money is not a commodity and certainly not tradable, unless it is traded in a different currency. It simply acts as the payment mechanism to affect the transfer.

Each unit of money is equal to another unit of the same denomination. Therefore, it is not possible for different parties to generate any profit by exchanging these units with each other (inter se).

Model answer for Question 13

In many jurisdictions not all Takaful providers are fully fledged Islamic finance institutions. In such cases Shariah-compliant services may be provided by Islamic finance windows of conventional institutions. These are ring-fenced entities, within the larger financial institution, which operate in compliance with Shariah requirements. In a similar way, a conventional insurance company can provide Takaful by creating a Shariah-compliant window.

A Takaful window is defined as:

... a department, division, facility, or setup within a conventional insurance entity that provides insurance products and services in compliance with the Islamic principles and rules of finance.

The business, assets and operations of a Takaful window are segregated from the operations of the conventional insurance company which established it, and the operation is run as ring-fenced section of the company. In order to provide this segregation the company may designate separate management personnel to run the window.

An exclusively Shariah-compliant financial organisation (insurance company or bank) is based on foundations that comply with the principles of Shariah. This means the objective of such an institution would be to protect faith, life, intellect, posterity and property. The structure of the institution, ownership, management, objectives and articles or memorandum of association of the institution would be required to comply with the principles and rules of Shariah. The funding, capital, all expenses, all income, all its business activities, all third party contracts, all business associations – even down to behaviour of its employees whilst carrying out their responsibilities – would have to be in compliance with the principles of Shariah.

In comparison, a Takaful window is part of a conventional insurer. The conventional insurer itself is not required to comply with or carry out activities in compliance with the principles of Islamic finance and trade. However, the following must comply:

- all business activities within the window;
- associated third party contracts with the window;
- services provided through the window; and
- all income and expenses of the window.

Benefits of Takaful windows

A significant advantage of an Islamic insurance window is that it would continue trading using the brand, rating and resources of its 'host' company – the conventional insurance company. The window may benefit from its host's capital, security, credibility, reputation, authority, management and business relations. In particular, the window may have access to a deeper pool of capital from the host company.

Criticism of Takaful windows

- Commitment – A conventional insurer's incorporation and statutes do not comply with Shariah. For some jurists this raises a question over the insurer's commitment to comply with the Shariah in their Takaful windows.
- Supervision – Concern that lack of Islamic expertise or commitment could lead to weak supervision of Islamic windows, resulting in potential violations of Shariah.
- Segregation – Division between conventional operations and the Takaful window can be problematic. Concern that the window's funds could be diverted to finance activities of the conventional operation which are not permissible in Shariah.
- Unfair advantage – Concern that conventional financial institutions operating Takaful windows could compete unfairly with newly established Islamic financial institutions due to their wealth of experience, expertise and a strong presence in the market.
- Risk of conflict of interest – Concern that a conventional company may prefer transacting through its conventional operations over its Takaful window operations.

There are a few guidelines provided by scholars to enable the establishment of reliable and effective Takaful windows.

- Complete segregation of funds – It is widely held by scholars that, if a window is permitted, there must be a clear segregation between Shariah-compliant funds and the funds of the conventional entity. There should be clear evidence that the segregation is genuine and does exist, such as bank

account and computer records.

- Shariah supervisory board (SSB) – The Islamic window should be supervised by an SSB. The window should be managed according to the same principles and standards of corporate and Shariah governance as would be required if it were a standalone Takaful undertaking.
- Managerial commitment – The financial institution's management, which is undertaking the business activities of the window, should be fully committed to it. They should have knowledge of its objectives, principles and prohibitions and ensure the window's activities do not contravene the principles of Shariah. A sign of commitment would be to employ an in-house Shariah scholar to oversee the activities of the Islamic window.
- Safeguarding participants' funds – The contributions in the fund are primarily to pay claims to participants. Management must ensure that the fund is kept pure, that claims are paid on time and unauthorised payments do not enter or leave the fund. If a separate fund is created for investment purposes, management must ensure Shariah rules pertaining to investment are applied.
- Reference to established Shariah standards – Takaful windows should comply with established Shariah-based accounting and auditing standards such as AAOIFI and IFSB.

Another possible way to provide window segregation is to 'outsource' the management of the window operation to another party, a managing general agent, in order to provide a more complete segregation of the operation.

Model answer for Question 14

Availability of appropriate reTakaful

ReTakaful fulfils a similar function to reinsurance in conventional operations and is considered key to increasing the capacity to accept risk. Several reTakaful companies have launched in recent years. Many of them are relatively young and deal with a limited class of business. Some such as Hanover Re (Bahrain), Munich Re (Malaysia) and Swiss Re (Malaysia) are owned by global reinsurance companies and can service a larger class of business. However, the scale and sophistication of reTakaful companies is still lagging behind the growth of the Takaful industry; it is not only the availability of reTakaful capacity that matters, but the availability of sufficiently diversified capacity of high quality. As a result many Takaful companies cede business to conventional reinsurance companies when appropriate reTakaful is not available.

The use of conventional reinsurance is an area of concern for Shariah scholars and has an impact on the credibility of Takaful in its target markets. Shariah scholars have encouraged the use of reTakaful rather than reinsurance. However, they also recognise the limitations of the present reTakaful provision and have allowed Takaful companies to use reinsurance providers under the principle of 'necessity' (Dharurah) until appropriate reTakaful capacity becomes available. ReTakaful and reinsurance is frequently placed on a subscription basis, raising the possibility of gradual increase of the share of any one cover that is placed on a Shariah-compliant basis. The IIFA and IFSB recommend that reTakaful availability and specific Dharurah permission is reviewed regularly.

Reinsurance is an international business with hubs in several key jurisdictions, including London and Bermuda, where risks are placed on a syndicated basis. Recent developments in the provision of Shariah-compliant capacity by conventional insurers operating in the London Market offer scope for greater Shariah-compliant capacity in this market over time. This has the potential to increase the share of Takaful contributions ceded to RTOs rather than conventional reinsurance providers.

Linkage with international standards and practices

International co-operation among professional bodies and regulators has led to the development of global standards setting minimum requirements for many businesses. In the insurance industry, the standards of the International Association of Insurance Supervisors (IAIS) are relevant and the IFSB has sought to develop guidance for supervisors on how to reflect the characteristics of Takaful in relation to these standards. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has also developed Shariah standards, though different understandings and practices of Shariah in member countries have impeded standardisation. In many countries in which Takaful companies operate the use of International Financial Reporting Standards (IFRS) is mandatory. The relevant standard for insurance is IFRS-4 Insurance Contracts. IFRS-4 requires insurance operations – including Takaful – to be treated as one reporting entity. Thus the AAOIFI requirement for separate reporting of the interests of the participants' pool from those of the TO can be challenging to implement.

As we have seen, in practice a Takaful operation generally takes the form of a single legal entity, internally divided into segments that are attributable to the participants' interests on the one hand and the shareholders' interests on the other. Segmental reporting within a single legal entity provides a potential resolution to the Shariah requirement for separation of participants' and shareholders' interests in a Takaful operation. This may also provide a way to implement IFRS-4 for Takaful accounting which is in keeping with Shariah requirements.

The International Accounting Standards Board (IASB) – which issues the IFRS – and AAOIFI have formed a liaison committee to explore these issues and some agreed treatment is expected to emerge in the future.

Rating agency treatment

As the Takaful industry matures, it will need more companies with high credit ratings to inspire confidence in its clients. An issuer credit rating (ICR) is a credit rating agency's independent opinion of an entity's ability to meet its ongoing financial obligations. In general, reTakaful/Takaful operators which are part of bigger insurance and reinsurance groups tend to attract a high rating.

The key challenge rating agencies face is to determine the exact status of the relationship between the participants' pool and the TO. The rights and obligations of each party are sometimes ambiguous and lack of clarity in the legal relationships can create confusion in determining the strength of the TO. Two key considerations are whether Qardh-al-Hasan is mandatory and whether it is subordinated. If either is not the case, and surplus has not been accumulated in the fund, then financial strength ratings will suffer.

As Takaful companies mature and further precedents are established for the treatment of the different categories of assets, rating agencies have been able to establish more robust criteria for evaluations of these companies. Also as suggested earlier, if Takaful companies build more robust reserves beyond those required by capital adequacy or prudential concerns, the participants' pools themselves will achieve their own standalone capital adequacy. Such a scenario will attract much better ratings from the agencies. This will, in turn, attract a larger client base to use Takaful.

Solvency II implications for Takaful operations

Solvency II is a European regulatory regime for determining capital adequacy for insurance operations. Though not directly applicable to the Takaful markets in Asia and the Middle East, Solvency II will apply to any Takaful operations that are established in the EU and to EU groups into which Takaful operations are consolidated. 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 focussing 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. The IFSB has issued guidance and standards on the solvency requirements of Takaful companies including IFSB-11 Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings, December 2010.

Different interpretations of Shariah requirements

Different interpretations of relevant Shariah requirements have emerged as the Islamic finance industry has developed. Some of these variations have resulted from the presence of different jurisprudential schools of thought amongst Muslims. Others have been a result of the positions of leading jurists.

Surplus – For the Takaful industry there have been different positions on the allocation of any part of the surplus to the TO. There have also been variations on the centrality, or otherwise, of surplus distribution itself.

Islamic debt market – In investment management, the development of the key short-term Islamic debt market is also subject to Shariah interpretations. Thus the adoption of this market has been possible in Malaysia but not in the GCC countries.

Standardisation – Due to the varying Shariah interpretations, standardised regulations and cross-border alliances have also become more challenging. The IFSB has issued a number of standards and guidance notes for the Takaful industry. These have the potential to provide a building block for some key standardisation of treatment of Takaful operations on a global scale. Any such development will greatly aid the further development of the industry.