Chartered Insurance Institute

590

Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

April 2018 Examination Guide

SPECIAL NOTICES

Candidates entered for the April 2018 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 or from Customer Service. 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 purchase copies of the most recent Examination Guides online at www.cii.co.uk. CII members can download free copies of older Examination Guides online at www.cii.co.uk/knowledge.

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 or from Customer Service.

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.

EXAMINERS' COMMENTS

Candidates overall performance

In general candidates' overall performance was good, with significantly improved responses in the three sections compared to the October 2017 sitting. More detailed answers and in-depth knowledge of concepts were required from candidates to achieve high marks, in particular in Part III.

Question 1
Many candidates scored well in this question.

Question 2
In this question, candidates were required to apply knowledge and explain the risks arising from segregation of Takaful funds. While many candidates performed well, some could not meet the requirements examiners were looking for.

Question 3
A direct question where many candidates scored well.

Question 4
A question testing the core concepts and many candidates scored well.

Question 5
This question tested the fundamental knowledge under the core concepts of Takaful and candidates scored well in this area.

Question 6
Many candidates scored well in this question which asked candidates to Identify six responsibilities that fall within the role of a *Takaful* operator in a *Takaful* operational model.

Question 7
Candidates were expected to outline the responsibilities of the *Shariah* supervisory board. Most candidates scored well in this question.

Question 8
The answer to this question from many candidates did not meet the required standard.

Question 9
Relative to October 2017, many candidates fared well in question 9 with most scoring highly.

Question 10
For this question, where candidates were required to explain the types of insurable risk under a Takaful operation model, most candidates who answered it could not explain the concepts in sufficient detail required for an essay question.

Question 11

This was a question which required candidates to apply the core concepts under Takaful and offered an excellent scoring opportunity for candidates, many of whom answered this question and received reasonably good marks.

Question 12

This question asked candidates to explain the *Wakalah* models used in general *Takaful* and compare them to the *Wakalah-Mudharabah* hybrid model and the *Waqf* model. Candidates scored fairly well.

Question 13

Although this question offered a good opportunity to score marks, many candidates did not attempt this question and those who did, could not provide sufficient depth in their answers.

Question 14

The candidates who answered this question could not elaborate on the key concepts.

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Advanced Diploma in Insurance

Unit 590 – Principles of Takaful

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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. Identify **three** unique selling points to *Takaful* target customers to brand *Takaful* as a value driven product. **(6)**

2. Explain the risks arising from the segregation of *Takaful* funds. **(6)**

3. Identify and explain **three** guidelines provided by *Shariah* scholars to enable the establishment of effective *Takaful* windows. **(6)**

4. Explain briefly *Ijma* and *Qiyas*. **(6)**

5. Explain briefly when an action or object may be classified to be *Haram*. **(6)**

6. Identify **six** responsibilities that fall within the role of a *Takaful* operator in a *Takaful* operational model. **(6)**

7. Outline **six** responsibilities that fall within the role of a *Shariah* supervisory board in a *Takaful* operational model. **(6)**

8. Explain the reasons behind the relatively less significant impact of the financial crisis on the *Takaful* sector, when compared to the conventional insurance sector. **(6)**

Part II

Compulsory question
This question is worth 38 marks

9. A newly appointed accountant in ABC *Takaful* firm, which uses *Wakala-Mudharaba* model, has prepared the Statement of Participants' Revenues and Expenses and the Income Statement for ABC Takaful firm for the year 2017, as shown below.

Statement of Participants' Revenues and Expenses for the year 2017

Insurance Revenues	
Fixed Assets	10,000,000
Remuneration for managing investments	500,000
Wakala Fee	9,600,000
Gross Contribution	48,000,000
Total Insurance Revenues	**68,100,000**
Total Expenses	
Paid Claims	30,000,000
Reinsurer's Share of Contribution	19,200,000
Reinsurance Commissions Income	10,000
Total Insurance Expenses	**49,210,000**
Net Surplus from insurance operations	**117,310,000**
Investment Income for Shareholders	**3,000,000**
Surplus of revenue over expenses	**114,310,000**

Income Statement for ABC Takaful firm for the year 2017

Revenues	
Paid Up Capital	100,000,000
General & Administrative Expenses	6,000,000
Recovered Claims from Reinsurers	16,000,000
Total Revenues	**122,000,000**
Total Expenses	
Gross Investment Income for Participants	3,500,000
Acquisition Cost	75,000
Amortisation of Development Costs	2,000
Total Expenses	**3,577,000**
Net Incomes	**118,423,000**

(a) After reviewing the statement prepared by the accountant, ABC *Takaful* firm's chief financial officer and the Shariah liaison officer discovered that it was not properly prepared and presented. Using the information shown in the statement above, prepare the following statements covering the year 2016 (*after correcting the accountant's errors*). **(29)**

(b)) The newly appointed board members of the firm requested you to coordinate with the Shariah Liaison Officer and advise them on different segregated funds in *Takaful.*

Prepare a response to the Board of Directors. **(9)**

Part III

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

10. Explain the types of insurable risk under a *Takaful* operational model. **(38)**

11. Explain the concept and prohibition of *Gharar, Riba and Jahalah in a Takaful* operational model. **(38)**

12. Explain the *Wakalah* models used in general *Takaful* and compare them to the *Wakalah-Mudharabah* hybrid model and the *Waqf* model. **(38)**

13. Explain the major asset classes available to the Islamic investment managers of *Takaful* companies and the challenges they present to Islamic investment managers. **(38)**

14. Explain the re*Takaful* model and the associated *Shariah* issues which 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

Candidates would have gained full marks for any three of the following:
- Shariah-compliant risk mitigation provided by risk-sharing pools;
- Shariah-compliant and ethical management of participants' pool assets;
- participants' pool assets provide for capital adequacy and organic growth, and are not used to distribute dividends to shareholders; and
- The potential to share any excess surplus amongst participants.

Model answer for Question 2

The segregation of Takaful funds into PRF, PIF and shareholders' fund brings a set of risks that are unique to Takaful, including:

Candidates would have gained full marks for any three of the following:
- 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 3

Candidates would have gained full marks for any three of the following:

- **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.

Model answer for Question 4

Ijma

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

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.

Model answer for Question 5

An action or object may be Haram because:

- Allah forbids it. As the creator, he knows best what is good and bad for his creation, and would never forbid anything that is beneficial to mankind;
- it results in harm; or
- it contravenes the higher objectives of Shariah, i.e. the preservation of life and wellbeing of mankind.

Model answer for Question 6

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

The TO's role involves:

- obtaining the operating license 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 7

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

- Reviewing all Takaful contracts, clauses and reTakaful (reinsurance) treaties used by the company to ensure that they comply with Shariah. Often the SSB makes recommendations for modifications to ensure Shariah compliance.
- Reviewing all Takaful contracts used by the company to ensure that they comply with national or international standards; for example, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB).
- Reviewing all investment transactions for Shariah conformity and ensuring that they are free of Riba, Gharar and Maysir.
- Responding to queries or requests for clarification by the board of directors or the company's authorised employees in relation to Shariah matters.
- Monitoring the company's compliance with the relevant Shariah standards and requirements.
- Reviewing new rulings concerning Takaful issued by recognised industry councils or academies and advising the company on the impact on its products and operations.
- Carrying out regular audits/reviews of the Takaful company's operations to determine if they have been carried out in a Shariah-compliant manner and in accordance with international standards. Shariah audits take place a minimum of once a year.
- Issuing a Shariah-compliance report to the Takaful company on completion of audit.
- Members of the SSB often participate in the product development cycle to facilitate its design in compliance with Shariah requirements.

Model answer for Question 8

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. These factors have helped Takaful to compete more effectively with conventional insurance companies.

Model answer for Question 9

(a) ABC Takaful Firm

Statement of Participants' Revenues and Expenses for the year 2017

Insurance Revenues	
Gross Contributions	48,000,000
Less: Reinsurer's Share of Contribution	19,200,000
Net Retained Contributions	28,800,000
Reinsurance Commissions Income	10,000
Total Insurance Revenues	**28,810,000**
Insurance Expenses	
Paid Claims	30,000,000
Recovered Claims from reinsurers	16,000,000
Net Paid Claims	14,000,000
Wakala Fee	9,600,000
	75,000
Acquisition Cost	
Total Insurance Expenses	**23,675,000**
Net Surplus from insurance operations	**5,135,000**
Gross Investment Income for Participants	3,500,000
Less: Remuneration for managing investments	500,000
Net Investment Income	**3,000,000**
Surplus of Revenues over Expenses	**8,135,000**

Income Statement for ABC Takaful firm for the year 2017

Revenues	
Investment Income for Shareholders	3,000,000
Wakala Fee	9,600,000
Remuneration for managing investments	500,000
Total Revenues	**13,100,000**
Expenses	
General & Administrative Expenses	6,000,000
Amortisation of Development Costs	2,000
Total Expenses	**6,002,000**
Net Income	**7,098,000**

Model answer for Question 9 continues

(b) 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.

The 'other funds' are mainly subdivisions of the PRF or policyholders' fund.

Model answer for Question 10

In addition to being financial, pure and (generally speaking) particular, the following features must also apply for a risk to be insurable:

Fortuitous event
To be insurable, the happening of the event must be fortuitous. In the other words, it must be accidental or unexpected and not inevitable, for the insured. It must certainly not be deliberate on the part of the insured. An example of a non-fortuitous loss is an insured setting fire to their property. In contrast however, a theft may have required careful planning by the thieves, but still be unexpected for the insured and therefore fortuitous.

Insurable interest
Insurable interest is the legally recognised financial relationship between the insured and the object or liability that is being insured. Insurable interest may be simply defined as:
The legal right to insure arising out of a financial relationship recognised at law, between the insured and the subject matter of insurance.
For example, you can insure against the theft of your own car because you suffer financial loss if it is stolen; your neighbour cannot insure your car as they will not suffer financially if anything happens to it.
Other examples of insurable interest not necessarily based on ownership would be having:
• responsibility for someone else's goods because they are stored in your warehouse;
• responsibility for maintaining the pavement, where you might have a legal liability should anyone fall over and damage themselves; and
• dependents who rely on you to provide for them and in your absence, they would suffer financially.

The following features of insurable interest may help to clarify the definition:

Feature	Subject
Subject-matter	• **Subject-matter of insurance** is the item or event insured. For example, cars and factories, or the potential to be held legally liable for loss or damage to someone else or their property • **Subject-matter of the contract** is the name given to the financial interest the insured has in the subject-matter of insurance. For example, Tom owns a car. The ownership is the financial interest, the subject-matter of the contract.
Legal relationship	The relationship between the insured and the subject-matter of insurance must be recognised in law. For example, ownership is a legal relationship.
Financial value	The insurable interest in the subject-matter of insurance must have a financial value.
Insurer's insurable interest	Insurers have insurable interest in the risks that they have assumed. They reinsure part or all of the risk with other insurers; the subject-matter of the contract being the insurer's financial interest in the original insurance.
Timing of insurable interest	When must insurable interest exist? The answer depends on the class of insurance business. However, the expectation of acquiring an insurable interest in the future is not enough to create insurable interest in general non-marine insurances. For example, Harry will inherit his grandfather's house in the future but does not yet own it so does not have an insurable interest.

Public policy
It is commonly recognised in law that contracts must not be against public policy or go against what society considers to be the right or moral thing to do. Insurers should not, therefore, cover risks that are against public policy.
For example, it would be against public policy to insure the risk of incurring a fine for a criminal offence.
The risk may appear to have all the features of an insurable risk, as the event may be considered fortuitous (accidental) and the insured has an insurable interest, since they suffer financial loss as a result of the fine. However, it is clearly unacceptable to be able to insure against paying a fine, because the fine's purpose is to punish the individual. Providing insurance for this type of risk may encourage people to break the law.

Shariah compliance
In Takaful, there is an additional requirement in order for the risk to be insurable: the risk must not in nature be something which is prohibited or forbidden according to Shariah. In addition, the risk should not promote something which is prohibited in Shariah.

This requirement is similar to the conventional public policy requirement, except the requirement only applies to Takaful and acts as an additional restriction to the public policy consideration. So a risk may be insurable and not against public policy, however, the nature of the business is prohibited under Shariah and therefore uninsurable. For example, a Takaful provider will not be able to insure a conventional bank because the nature of its business involves usury and interest which is prohibited in Islam.

Homogeneous exposures
Let us consider the importance of homogeneous exposures – similar risks – to insurers in contrast to one-off risks.
A sufficient number of exposures to similar risks, historical patterns and trends will enable an insurer to forecast the expected extent of future losses. We could call such risks 'objective risks'.
In the absence of a large number of similar risks the task is harder, as a pattern is more difficult to determine. In extreme cases where there is no historical data, the risk becomes a subjective one from an insurer's point of view.
Whereas fortuitous loss, insurable interest and not being against public policy (and Shariah compliance in the case of Takaful) are absolute requirements, the concept of homogeneous exposures is an ideal.
There are occasions when an insurer will need to use less than fully reliable historical data when fixing premiums, such as:
• a completely new risk (e.g. new technology); and
• risk in parts of the world not previously open to that insurer.
For example, insurance is available for satellite launches, even though instances of such launches are fairly infrequent and any failure generally catastrophic. However, wherever possible, an insurer looks for homogenous exposures in order to utilise as fully as possible the law of large numbers. The greater the number of similar risks to insure, the closer the actual outcome will be to what was expected in terms of losses.

Model answer for Question 11

Gharar

Gharar is defined as:
Uncertainty over the existence of the subject matter of sale.
The term generally refers to uncertainty, but also includes a range of negative connotations, such as risk, hazard and ignorance.

In Islamic law, Gharar can be of two degrees, major or minor. Gharar Fahish (major or excessive) affects validity of exchange contract and generally render exchange contract void or voidable. Gharar yasir (minor or tolerable) does not generally affect the validity of the exchange contract.

Prohibition
The word ‘uncertainty’ is not explicitly mentioned in the Quran. However, the activities described in the following verses are believed to be uncertain:

O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you Traffic and trade by mutual good-will: Nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful! (Quran, 4:29)

And their charging of interest, although indeed they have been forbidden from it, and their devouring of peoples’ properties falsely, and We have prepared for the disbelieving amongst them, a painful chastisement. (Quran, 4:161)

Commentators have agreed that the word ‘falsely’, used in the latter verse, implies gross uncertainty. Furthermore, there is a Hadith narrated by Abu Huraira (may Allah be pleased with him, MABPWH) in which he states, ‘Muhammad (PBUH) has forbidden sales that contain uncertainty’. (Muslim, 10:3614).

Explanation
When the contract is being agreed, both parties must be aware of the item or service that is being sold and the consideration moving the opposite direction. The description that is given of the items being exchanged must be certain.
If there is Gharar fahish (gross uncertainty) surrounding the item, the transaction becomes void or voidable because it will result in an unfair outcome for the parties involved.

Riba

Riba (usury) can be defined as:
An increase in one good for another in an exchange, without any form of consideration for the increase.

Shariah regards all forms of interest as Riba and impermissible. This prohibition is prominent because interest plays a central role in modern banking, economics and finance.

Prohibition
Riba is probably the most well known prohibition in Islamic finance; it is mentioned several times in the Quran, where it is equated to particularly damning acts, and is also reported by many companions of the Prophet Muhammad (PBUH) in the Sunnah. For example, the Quran includes the following text:

Those who devour Usury will not stand except as one whom has been driven to madness by the touch of the Evil One (Satan). That is because they say: 'Surely trade is like Usury' but Allah has permitted trade and forbidden Usury.
(Quran, 2:275)

O you who believe, Fear Allah and give up what remains of your demand for interest, if you are indeed believers. If you do not (give up usury), then take notice of war from Allah and his Apostle.
(Quran, 2:278–9)

A Hadith is narrated by Abu Huraira (MABPWH) in which the Prophet Muhammad (PBUH) includes the devouring of interest as one of the seven grave sins. (Muslim, 1:161)

In another Hadith, the Prophet (PBUH) condemns the one who takes Riba, the one who pays it, the one who writes the agreement for it and the witnesses to the agreement. (Nasai, 48:5107)

Explanation
There are many types of interest and there have been various attempts to encompass these under one definition. It is sufficient for us to understand that in a contract of exchange where goods are passed from one individual to another, something equivalent in value or service must be exchanged in consideration or as compensation; nothing more or nothing less. Ibn 'Arabi states 'all excess over that justified by consideration' is interest. Any excess exchanged is construed as interest because the increase does not represent any value. Benefitting and allowing others to benefit from this excess are also forbidden.

In contrast to Gharar and perhaps Maysir, the prohibition on Riba is not necessarily a matter of the insurance transaction but instead relates to the operations of the insurer. Riba in an operation of an insurer can arise in several ways.

One of the key ways is the investment of the insurer's reserve funds to earn a return until claims actually materialise. The funds are invested in a range of asset classes including cash, bonds, equities, real estate and alternative assets. All these asset classes have features which may violate the requirements of Shariah. For example, a common feature of insurance assets is that a large proportion of the funds are invested in interest-bearing bonds; interest is considered Riba, so the investments become impermissible. Investment managers have devised investment strategies that avoid Riba. These make it possible to overcome this particular Shariah objection to conventional modes of insurance provision.

Jahalah (ignorance)

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.

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

Explanation
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 12

The basic Wakalah model

A completely different way of remunerating the TO was pioneered in the GCC countries. The Wakalah model is based on the Wakalah (agency) fees contract. The TO receives an upfront fee or commission from every participant that signs up. The commission is paid from the contribution pool to the TO for managing the operation. The TO does not receive any other remuneration.
Therefore, the key financial driver for the TO in the Wakalah model is the number of participants.

Like the other arrangements, any surplus is attributable solely to the participants. In a similar way to the Mudharabah models, the TO normally has a regulatory or commercial obligation to fund any deficit in the claims pool by injecting Qardh-al-Hasan. The funds of the contribution pool and the funds of the TO are segregated.

The key difference from the *Mudharabah* model is that with the *Wakalah* model the TO receives an upfront fee for every contribution and does **not** have to take the risk of only sharing a part of the investment profit or total surplus when it arises. Unlike the modified *Mudharabah* contract there is no provision for sharing of any surplus in a pure *Wakalah* contract.

Incentive risk and conflict of interest – A little reflection will show that the pure Wakalah contract does not incentivise the TO to maximise investment returns or underwriting efficiency as it has little to gain from it. The TO needs only to avoid the claims fund falling below the prescribed level of regulatory capital and triggering the obligation to inject Qardh-al-Hasan. Perversely, because the more contributions are received the bigger the Wakalah fee will be, there is a risk of an incentive to accept bad business purely to get the upfront fee. There may even be a motivation to underprice products in order to gain market share; by the time any Qardh-al-Hasan obligation is triggered the damage would have been done.

Commercially challenging – The Wakalah model has also proven commercially challenging to operate. There is a tendency to charge high Wakalah fees in order to award adequate remuneration for the TO. However, this can impair the quality of the whole operation by potentially compromising its capital adequacy. This issue is specifically addressed in the modified Wakalah model.

The modified Wakalah model

In order to appropriately incentivise the TO, a modified Wakalah model has also been used. The modified model allows the TO to benefit from a performance fee in addition to the Wakalah fee for sourcing the contribution. The performance fee is paid as a pre-agreed ratio from any underwriting surplus.

The TO would now receive a Wakalah fee for sourcing the contribution plus an additional performance fee. In contrast, in a basic Wakalah structure the TO would receive one Wakalah fee.

Controversy
Some Shariah scholars object to any sharing of the surplus with the TO and so have reservations about granting a performance fee from the surplus.

The TO's obligation to tide over any deficit by injection of a Qardh-al-Hasan loan remains the same as in all other models.

The Wakalah–Mudharabah hybrid model
The Wakalah–Mudharabah hybrid model has evolved as the preferred model used in most countries. This because it captures the upfront revenues from sales commissions and also rewards the TO for performance. This, in turn, makes the Takaful operation commercially viable.

Incentive – The TO is incentivised in two ways:
• an upfront Wakalah fee for every contribution sourced; and
• an operator's performance fee (sometimes called a success fee) from any overall surplus.
The obligation to fund any deficit via Qardh-al-Hasan still remains. The proponents of the Wakalah–Mudharabah model feel that it provides an appropriate application of Shariah principles in a commercial environment.

Controversy – Some scholars remain unhappy with any sharing of underwriting surplus, albeit in the form of an incentive fee, and have looked for other ways to implement Takaful. One of these alternatives is the Waqf model.

The Waqf model
The **Waqf** (endowment/trust) **model** has evolved to address some of the concerns with the Wakalah and Mudharabah models. It is argued that a Waqf structure captures the underlying intentions of Takaful in a more satisfactory way than Tabarru to the contribution pool in other models. This is because the contribution to the Waqf does not have the implied conditionality of the Tabarru

'donation'. A settlor can also be a beneficiary in a Waqf under appropriate provisions. The Waqf model is primarily used in Pakistan.

Workflow of Waqf model

- a Waqf (Takaful fund) is initially established as the recipient of bequests/donations from the shareholders of the TO;
- the Waqf is supplemented by further donations by participants;
- fees are paid from the Waqf to a TO to manage the business;
- the Waqf and TO may share any profits on investments on a Mudharabah basis; and
- any surplus is treated in accordance with the Waqf deed and the TO has no share in it.

Commercially challenging – The position of funding deficits by injection of Qardh-al-Hasan by the shareholders of the TO company is unclear in the Waqf model. The issues are similar to those in the basic co-operative model in terms of commercial viability. To overcome these difficulties, Waqf–Wakalah–Mudharabah hybrid models have been developed. Even so, the use of the Waqf model remains limited.

Model answer for Question 13

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

- cash;
- short-term debt and money market instruments;
- bonds (sovereign, corporate);
- equity (shares and real estate investment trusts); and
- alternative assets (private equity, hedge funds, loans, derivatives, real estate).

The term 'debt securities' is used to refer to the combined classes of bonds and short-term debt and money market instruments.

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.

Sukuk

Sukuk (singular: Sakk) are investment certificates which represent the holder's ownership of a proportion of an underlying asset. They show that the holder assumes all rights and obligations of the asset. In practice, there are two
broad categories of Sukuk:

• Asset-based Sukuk are the most widely issued Sukuk; they share many of the risk and return characteristics of
bonds.

• Asset-backed Sukuk are more similar to covered bonds; they have exposure to specific asset risk.

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.

Real estate investment trusts (REITS)
Some of the desired exposure that comes with investing in real estate can also be achieved through investments in real estate investment trusts (REITS). REITS are classed as equities.
Islamic real estate investment trusts (IREITS) also exist, mostly in Malaysia. An IREIT can only invest in properties in which the property tenants operate in businesses that comply with *Shariah* principles and the REIT fund itself must also be structured and run in a manner that is consistent with *Shariah*.

Real estate investments are often highly geared so not suitable for Shariah-compliant investments due to their interest-bearing nature. However, there are enough real estate assets which are Shariah compliant to allow the Takaful investment manager to meet any required exposure to this asset class.

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 14

The contractual relationship between the TO and the RTO is similar to the relationship between the TO and its participants.

The TO makes a contribution under the principles of donation (Tabarru). The contributions are pooled together to form a fund. The RTO is then appointed to manage the fund and offered the relevant operating contract, such as an Wakalah (agency) contract or a Mudharabah (risk-sharing) contract.

Just like Takaful, reTakaful is commonly viewed as divided into two categories: family (life) reTakaful and general reTakaful. An RTO that carries both forms is referred to as a composite RTO.

• Family reTakaful covers the TO for claims paid by it arising from Takaful contracts covering death, disability, accident or illness of the TO's participants, or survival to an age specified or determined in the contract.
• A particular feature of family reTakaful is that, in almost all cases, the participants' investment fund (PIF) is not reinsured, since the PIF is typically a pure investment fund, and the related investment risks are fully borne by the Takaful participants. Thus, only the participants' risk fund (PRF) is reinsured.
• General reTakaful covers the TO for claims paid by it arising from Takaful contracts covering loss or damage inflicted upon real estate, assets, and belongings or liability of the TO's participants.

Basic Structure:

- The TO makes a Tabarru donation from the PRF to the RTO.
- The donations go into a reTakaful risk fund (RRF). A percentage of the TO's contribution goes to the RTO as a Wakalah fee.
- The reTakaful fund has an investment pool. This pool is invested by the RTO. Under the Mudharabah arrangement of the contract, profits are shared between the reTakaful fund and the RTO. Any investment profit or underwriting surplus normally accrues to the TO less the agreed share for the RTO. The share of the investment profit received by the TO from the RTO must be deposited into the PRF.
- Finally, the principle of segregation is carried out by having two separate funds: one for the RTO (shareholder's fund) and one for the reTakaful fund.

Shariah Issues in reTakaful

Four issues arise in the specific context of reTakaful that require attention from a Shariah perspective:

1. recoveries claimed;
2. ceding commission;
3. profit commission; and
4. interest receivable.

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; and
• 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 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.