

# ***Takaaful Operation: Appraisal of the Existing Models and Exploration of a Possible Alternative, the Wadi'ah Model***

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## ***Abstract:***

*Practice differs regarding the underlying Islamic financial contracts used in various takaaful operational models. However, the current takaaful operational models have been subject to several criticisms from both operational and Shariah compliance viewpoints. This paper examines the fundamental and modus operandi of the existing takaaful models. It highlights area of strengths and weaknesses. The paper then explores takaaful model based on wadi'ah. It evaluates the extent to which the wadi'ah yad Damaanah contract can be used as an alternative for takaaful operational functions. The viability of takaaful companies implementing the wadi'ah model is assessed. The aim of this paper is to have an in-depth understanding of the existing models and open horizons for possible alternative models.*

**Key Terms:** Takaaful - Participants -Takaaful Operators - Tabaru' - Wakaalah – Mudaraba - Ju'alah- *Wadi'ah*

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## **1. Introduction**

Despite the fact that *takaaful* (Islamic insurance) is a product which has only recently been introduced in Islamic countries, Islamic insurance operations on a commercial basis have grown remarkably. Gross *takaaful* contributions have grown from US\$1.4 billion in 2004 to over US\$3.4 billion in 2007. There still exists a large, expanding and untapped Muslim population on almost every continent. Based on research interviews and estimates, the likely size of the global *takaaful* market could be as high as US\$7.7 billion by the end of 2012.<sup>1</sup> However, the promotion of *takaaful* has been impeded by unresolved *fiqh* questions regarding the nature of the *takaaful* contract, the ownership of the *takaaful* fund, and the nature of the contractual relationship between the participants and the *takaaful* companies, i.e., characterizing it as agency (*wakaalah*), silent partnership (*mudaarabah*), agency for investment (*wakaalah bil-istithmaar*), or a promise of reward for a stipulated achievement (*juaalah*). All of these unanswered questions have played a role in limiting the number of *takaaful* companies, in slowing their development and their expansion on an international level, and in earning them low [credit] ratings. On the other hand, conventional insurance companies have been handed the opportunity to seize market share by opening *takaaful* windows.

In response to the ongoing Shari'ah issues related to *takaaful* and re-*takaaful* companies, the International Shari'ah Research Academy for Islamic finance (ISRA) decided to evaluate the contractual bases for the relationship between the participants and the *takaaful* and re-*takaaful* companies and to propose an alternative to them that may avoid Shari'ah problems as much as possible. It intends to participate in providing a precise and effective legal framework for the relationships between Islamic *takaaful* companies and their international counterparts, especially since the activities of these companies have already transcended the local level and gone international.

The plan of the paper is as follows: first, it reviews the conceptual issues related to the existing *takaaful* models. Then the overview of *wadi'ah* principles is described. Next, the new model of *wadi'ah* is discussed and clarified. The paper concludes with the implication of this model and directions for further research. It is hoped that this research will provide more understanding of the *wadi'ah* model and help the industry ascertain the most appropriate basis for *takaaful* and re-*takaaful* operations.

## **2. Preliminary Comments**

- The paper is not intended to investigate or evaluate the contractual relationship between the participants or to suggest a replacement for it.
- The project for a *takaaful* contract on the basis of *wadi'ah* does not seek to eliminate or undermine other contractual forms; rather, it represents one of a

number of possible alternatives for regulating the contractual relationship between the participants and the *takaaful* companies.

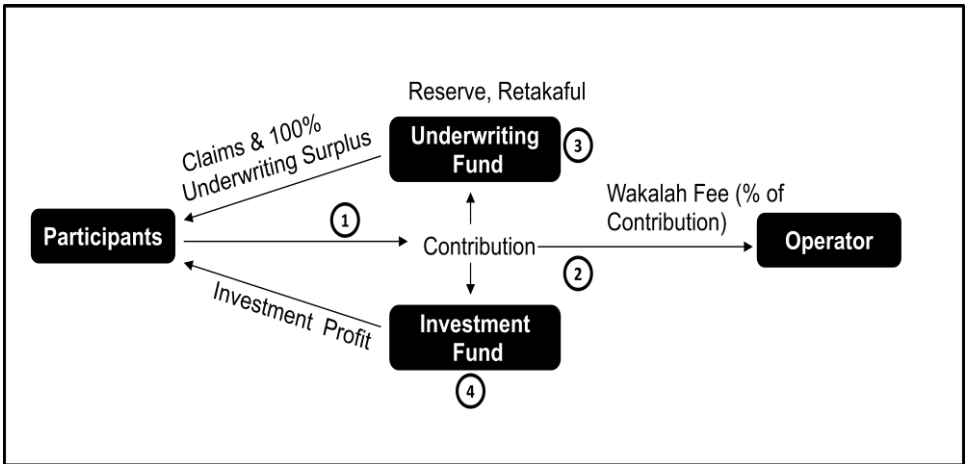
### 3. Appraisal of the Existing Contractual Relationships between the Participants and the Takaaful Companies

There are four major contractual forms currently being used as the bases for the relationship between the participants and the *takaaful* companies namely *wakaalah* model, modified *wakaalah* model, hybrid model and *waqf* model:

#### 3.1 Form One: Takaaful on a Pure Agency Basis (Wakaalah)

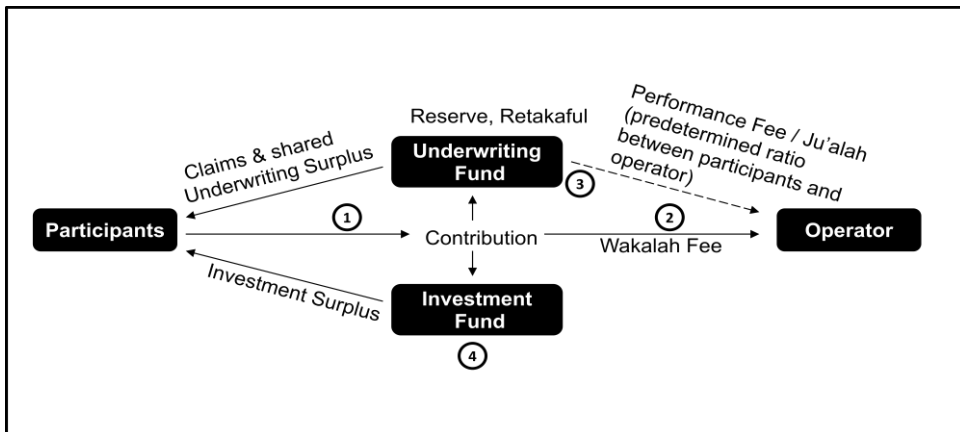
In a pure *wakaalah* model, *takaaful* participants contribute to the *takaaful* fund on the basis of voluntary charitable contributions (*tabarru'*) to cooperate in mitigating [certain] risks. The *takaaful* companies manage the *tabarru'* fund, processing claims and paying compensation, on the basis of agency for a fee (*wakaalah bil-ajr*). The *takaaful* company is authorized to invest a portion of the *takaaful* fund. By doing so it becomes entitled to a fee for acting as the agent for investment. With respect to the investment, the *takaaful* company does not bear any liability for losses unless it has been negligent or has violated its mandate; conversely, it does not participate with the *takaaful* participants in any profits.

**Diagram 1: Pure Wakaalah Model**



### 3.2 Form Two: Takaaful on a Modified Agency Basis (Modified Wakaalah)

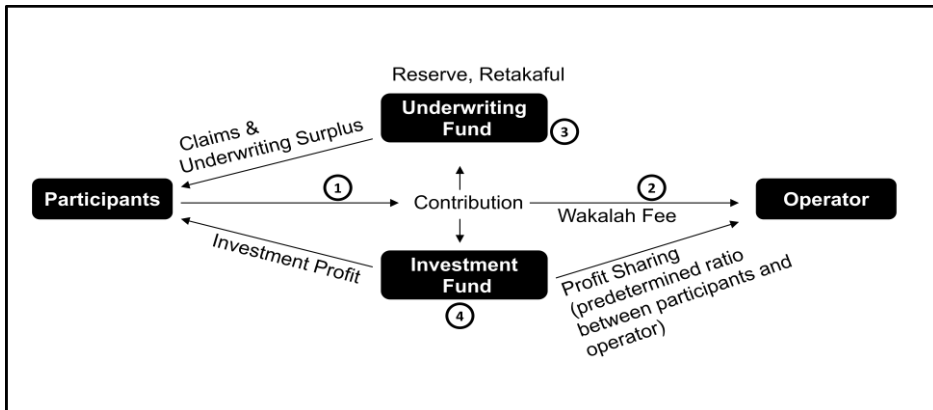
Diagram 2: Modified Wakaalah Model



In a modified *wakaalah* model, takaaful participants contribute to the *takaaful* fund on the basis of donation (*tabarru'*) to cooperate in mitigating [certain] risks. The *takaaful* companies manage the *tabarru'* fund, processing claims and paying compensation, on the basis of agency for a fee (*wakaalah bil-ajr*). The main difference between pure agency and modified agency is that, in modified agency, the *takaaful* company shares with the *takaaful* participants in the surplus in the fund—if there is any—on the basis of an incentive, or what is called a “performance fee”.

### 3.3 Form Three: Takaaful on the Basis of Agency and Silent Partnership (Hybrid)

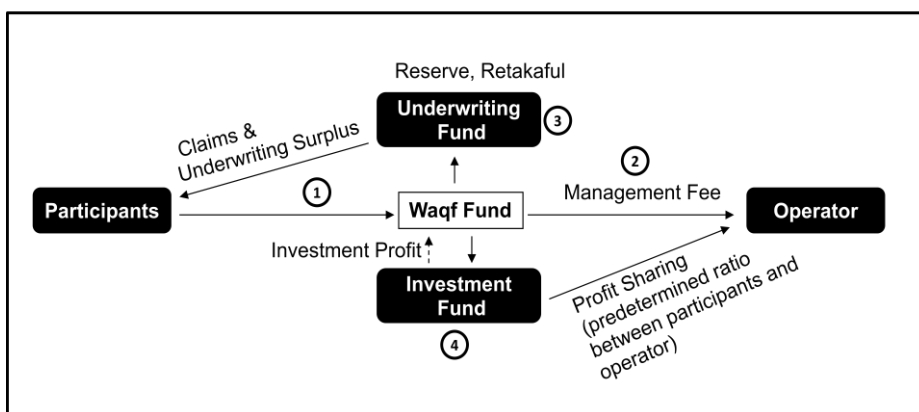
Diagram 3: Hybrid Model



In this model, the contractual relationship is similar with the pure agency with regards to the company commissioned to manage the underwriting activities, for which it receives a fee. It differs from it in the second area of activity (investment). The first form adopts agency for investment while this form adopts silent partnership (*mudaarabah*). The *takaaful* company still does not bear any liability for losses unless it has been negligent or has violated its mandate; however, it does not take a fixed fee for its activities; rather, it shares with the fund in any profits accrued, its share being that of the *mudaarib* (entrepreneur) in a *mudaarabah* contract.

### 3.4 Form Three: Takaaful on the Basis of Waqf

**Diagram 4: Waqf Model**



In *waqf* model, a *waqf* fund is established by the shareholders and the participants will contribute to the *waqf* fund. The operator will received a pre-agreed management fee for underwriting services and share the *mudarabah* investment profits based on a pre-agreed profit sharing ratio. In this model, *takaaful* operator will play two different roles, as a manager and as a *mudaarib*. The *waqf* fund will be used for claims, *retakaaful* and reserves. Any surplus in the *waqf* fund will be distributed as per the *waqf* deed which normally distributed to the participant, kept as a reserve or utilized for charitable purposes.

#### 4. Issues Raised in the Existing Takaaful Models

A general *takaaful* scheme essentially involves the relationship of two parties: the *takaaful* operator and a group of participants. The relationship between participants is governed by the contracts of *takaaful* and *tabarru'* as adopted by most countries, or *waqf* as practiced by Pakistan and South Africa, or cooperative partnership (*mushaarakah ta'awuniyyah*) as recently endorsed by many scholars in several conferences, while the relationship between participants and the *takaaful* operator is

governed by the contract of *wakaalah* (agency), whereby the *takaaful* operator is appointed to manage the scheme. Nevertheless, other Islamic contracts may also be combined with *wakaalah*,

Although Shari'ah scholars agree with the conceptual basis underlying the *wakaalah* model, they have raised some questions related to the current practice. One major issue still under deliberation involves the distinction between pure *wakaalah* and the modified approaches in which, besides a *wakaalah* fee, a percentage share of the underwriting surplus is paid as a performance incentive to the operator, while the participants remain the actual owners of fund. Another issue is: how to measure the exact share of the participants with regard to inheritance and *zakaah*? The intergenerational issue is also being raised, as the contingency reserves may not be equitable between generations, as the operator is likely to hold higher proportionate reserves in the early years for future contingencies.

There is also a strong trend for the operational model to move towards a hybrid *wakaalah*-based model, as it has been argued that the pure *wakaalah* business model puts *takaaful* at a pricing disadvantage when competing for business that does not require Shari'ah-compliant coverage. It is argued that the reason is that *wakaalah*-based operators are unable to use retained underwriting surplus to discount. As a result, it has been argued that *takaaful* pricing for group and commercial cover is often uncompetitive. This lack of competitiveness reduces an operator's ability to use brokerage as a "cost-effective mechanism" to source business.<sup>2</sup>

In addition, it is argued that the current *wakaalah* model is not robust enough and will fail when the industry matures; the supply value chain of the *takaaful/re-takaaful* industry involves many parties (agents or direct brokers / TO / re-*takaaful* broker / RTO / retrocession broker / retrocessionnaires) who are entitled to their respective service/*wakaalah* fees, and the funds get progressively depleted after each party takes its fees. The balance of the fund will be too small to respond to claims, thus undermining the purpose of *takaaful/re-takaaful*.<sup>3</sup>

Under the *mudaarabah* concept, two parties, basically the capital provider (*rabb al-mal*), i.e., the participant, and the entrepreneur (*mudaarib*), i.e., the *takaaful* operator, operate on a joint-venture basis. The advantage of the *mudaarabah* model is that operators have a bigger incentive to engage in efficient underwriting and strategically invest, as they will receive a portion of the surplus.<sup>4</sup> A number of issues arise from the current practice of *mudaarabah* model, however.

- Is the *mudaarabah* model really cooperative in nature?
- Can the donation be considered *mudaarabah* capital?
- Is the *mudaarabah* profit the same as surplus?

- Can the shareholder share the underwriting surplus, as is the common practice in conventional insurance?
- In case of a fund shortfall, is the requirement of *qarī* (interest-free loan) from the *mudaarib* in accord with the principle of *mudaarabah*?<sup>5</sup>

The issues and concerns about the applicability of *mudaarabah* as an approach of risk sharing have driven some *takaaful* operators to adopt the *wakaalah* model. Under the *wakaalah* model, the participants remain the actual owners of the fund into which the contribution is pooled. This fund is managed by the *wakil* (agent) on the principles of agency for investment (*wakaalah bil-istithmaar*). Before the agent starts managing the fund, it will first deduct out a predefined amount as a *wakaalah* fee/operator fee for management and service expenses. This model is commonly used in the Gulf and Southeast Asian countries. One of the advantages of the *wakaalah* model is that, when starting a new fund, operators know how much revenue they will generate because they receive a fixed share of the contributions.<sup>6</sup>

In a nutshell, each of these models has its own strong and weak points, and none can be exceptionally distinctive from the others as each meets the needs of a particular market. It is difficult to judge the relative merits of each of these models, which all serve their purpose in their own way. None of them are perfect, and there must be concerted efforts to fine-tune them to solve the problems in each of the models.<sup>7</sup> Therefore, the conceptual issues related to the *mudaarabah* and *wakaalah* models have led to the exploration of other contracts which can serve as bases for *takaaful* operations.

### **5. Exploring the Takaaful Operational Model Based on Wadi'ah**

Before we proceed to the discussion of the proposed new model, it is necessary to examine the underlying contract in the *wadi'ah* model as it will determine the Islamic rule for the activities that take place within it.

#### **5.1 Definition of Wadi'ah**

Definitions of *wadi'ah* have been provided by different schools of Islamic jurisprudence. Some *hanafi* scholars have defined the contract as an implicit or explicit empowerment of another for safekeeping of one's property.<sup>8</sup> The *Shafi'is* and *Maalikis* have defined it as granting another person agency (*tawkiil*) for safekeeping of one's property or legal possession.<sup>9</sup> In general, these definitions signifies *wadi'ah* as an instrument that allows a person to keep the wealth or items belonging to oneself with another person for safe keeping purposes.

The *wadi'ah* contract is permissible and recommended with evidence for it in the Qur'aan, the Sunnah and consensus. For example, Allah says in the Qur'aan:

إِنَّ اللَّهَ يَأْمُرُكُمْ أَنْ تُؤَدُّوا الْأَمَانَاتِ إِلَىٰ أَهْلِهَا

“Allah commands you to return trusts to those to whom they are due.”<sup>10</sup>

In the above verse, Allah SWT commands the believers to render trusts their rightful owners. Trust can covers all the wealth that is given like the wealth in mudarabah contract, asset for the lease contract and wealth that is given to another person as al-wadi'ah. The word trust has been used in the above verse indicate the importance of fulfilling all types of trust including safe keeping (al-wadi'ah). The word amanah (trust) is more general than al-wadi'ah because al-wadi'ah is a type of amanah (trust)<sup>11</sup>.

فَإِنْ أَمِنَ بَعْضُكُم بَعْضًا فَلْيُؤَدِّ الَّذِي أُؤْتِمِنَ أَمَانَتَهُ وَلْيَتَّقِ اللَّهَ رَبَّهُ<sup>12</sup>

“And if one of you entrusts another, then let him who is entrusted discharge his trust [faithfully] and let him fear Allah”

The above verse indicates that when you decide to trust one another, and then let the one who is trusted fulfill his trust, and let him fear Allah. It is therefore understood that trust is important before you can leave your wealth to someone else for the purpose of safe keeping and the trusted person must fear to Allah for this trust. Although the word wadi'ah is not specifically mentioned in the Qur'aan, Muslim scholars understand it to be included in the term *amaanah* (trust), which the abovementioned Qur'aanic verses require be discharged.

The proof on the legality of wadi'ah contract is also supported by the Sunnah, for instance:

عَنْ عَائِشَةَ فِي هِجْرَةِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَتْ: " وَأَمَرَ , تَعْنِي رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ , عَلِيًّا رَضِيَ اللَّهُ عَنْهُ أَنْ يَتَخَلَّفَ عَنْهُ بِمَكَّةَ حَتَّى يُؤَدِّيَ عَنْ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ الْوَدَائِعَ الَّتِي كَانَتْ عِنْدَهُ لِلنَّاسِ " <sup>13</sup>

A'ishah mentioned, regarding the Hijrah of the Prophet (peace be upon him), that he ordered 'Ali (may Allah be pleased with him) to remain behind in Makkah in order to return the items that people had entrusted for safekeeping with Allah's

Messenger (peace be upon him) back to their owners.

From this hadith, it is clear that The Prophet used to keep the wealth of Meccan people and when he was ordered to migrate to Madinah, he asked Ali to return the assets that were kept with him to their owners. In addition to the recommendation from the Qur'an and Sunnah on the concept of *amanah* and *al-wadi'ah*, jurists both the past and present also have consistently supported on the permissibility of *al-wadi'ah*.

There is a further precedent in the practice of the Prophet's companions for the form of wadi'ah practiced today. The most significant example is the safekeeping service offered by Zubayr ibn al-Awwaam. Because of his reputation for trustworthiness, people would ask Zubayr to hold their money and valuable items in his custody for safekeeping. The large sums of money were a burden to Zubayr, for he worried that he would not be able to protect and safeguard the money from danger or loss, and at the



same time he could not use it. Upon reflection, he decided to ask depositors permission to use their money and consider it as a loan. Thus, whenever a depositor come asking for safekeeping, he would refuse and say,

لا , وَلَكِنْ هُوَ سَلْفٌ؛ إِنِّي أَخْشَى عَلَيْهِ الضَّيْعَةَ<sup>14</sup>

“No, but make it a loan; I fear it will be lost.”

Through this action Zubayr changed the basic concept that the depositary would only keep people's trusts without use. This enabled borrowing to invest while at the same time ensuring the safety of the money.

## 5.2 The Concept of Wadi'ah Yad Damaanah

The jurists of all schools of law agree that *wadi'ah* is a form of trust contract, i.e., the property placed in the possession of the depositary (*mustawda'*) is regarded as trust. Therefore, the *mustawda'* is not obliged to guarantee the property except in case of negligence or *ta'addii* (breach of trust). However, jurists agree that the custodian becomes liable (*daamin*) for the deposit if he utilizes it.<sup>15</sup> In addition, an opinion of Imaam A'Imad has been transmitted that the depositary (*mustawda'*) is responsible in the event that the property is damaged. This opinion is based on an opinion of Umar ibn al-Khattaab, who held Anas ibn Maalik liable for assets lost while being held for safekeeping.

لَمَّا رُوِيَ " عَنْ عُمَرَ بْنِ الْخَطَّابِ رَضِيَ اللَّهُ عَنْهُ أَنَّهُ ضَمَّنَ أَنَسَ بْنَ مَالِكٍ وَدِيْعَةً ذَهَبَتْ مِنْ بَيْنِ مَالِهِ<sup>16</sup>

It is narrated that Umar ibn al-Khattaab had ordered Anas bin Malik to replace the property under his safe keeping.

From the above story, it appears that Umar has allowed the contract of safe keeping with guarantee (*yad damaanah*). Although this story might not be a strong justification on the concept of safe keeping with guarantee, the majority of jurist's share the same view that if the custodian utilizes the *al-wadi'ah* or the wealth, then it will be considered as *I'arah* (simple loan) that must be guaranteed. The hanafi jurist al-Kaasaani opined that if the property held by the depositary is in form of cash, whether dinars or dirhams, and the depositor has given permission to use it, then it is no longer a deposit but a loan (*qard*).<sup>17</sup> The hanbali jurist al-Buhuuti also stated that a *wadi'ah* contract in which the depositor consents that the depositary can utilize the goods is no longer *wadi'ah* but a loan for which the depositary is liable.<sup>18</sup>

Until now, the view of contemporary scholars with regard to money deposited in Islamic banking institutions is in line with the views of scholars of the past. For example, the Islamic Fiqh Academy of the OIC, in the proceedings of its 9th session, April 1-6, 1995 issued a resolution which states, “Deposits in current accounts, whether placed with Islamic banks or conventional banks, are, from a *fiqh* perspective, loans.

The bank in accepting the deposit assumes liability for it (*yad al-Damaanah*), and it must return the deposit when requested.”

### **5.3 The Current Practice of Wadi'ah Yad al-Damaanah**

*Wadi'ah yad al-Damaanah*, is a type of *wadi'ah* that combines two contracts: deposit (*wadi'ah*) and guarantee (*Damaanah*). A *Damaanah* contract, when attached to the *wadi'ah* contract, converts the concept of *wadi'ah* to guaranteed safe custody. Such a combination will facilitate wider participation in the Islamic banking system, where the deposits are the source of funds for the bank. These funds are used for banking investment activities. The bank that accepts the deposits is liable and has to guarantee their return to the depositor upon request. Therefore, they are considered as loans to the bank.

The salient features of this type of *wadi'ah* can be summarised as follows:

**One:** the deposited asset need not be segregated, as long as the custodian can differentiate between his own asset and the asset of the depositor.

**Two:** the custodian is entitled to use the deposited item for trading or other purposes, irrespective of the consent of the depositor, as he is guaranteeing the deposit and is liable for any damage or loss. The risk taken by the custodian permits him to utilise the deposit, as gain comes with the corresponding risk.

**Three:** the custodian has a right to any income derived from the utilisation of the deposited asset. This is based on the Islamic legal maxims: *al-kharaaj bi al-damaan* “profit [from a thing] is in return for liability [for loss from it]”, and *al-ghunm bil-ghurm* “liability is in return for benefit”.

**Four:** the owner of the deposit (depositor) can withdraw the deposit at any time, and it is the obligation of the custodian thereof to give him the asset upon request.

**Five:** the *wadi'ah yad al-Damaanah* contract is similar to *qard* (a loan). This is because when the depositor deposits his asset with the custodian, he is assumed to have loaned it to him. Therefore, all principles of a loan would be applicable to this contract.

**Six:** since this contract is similar to a loan, it cannot generate any pre-agreed benefit/income to the depositor over and above the principal amount of deposit. Failure to ensure the above will be tantamount to *riba*.

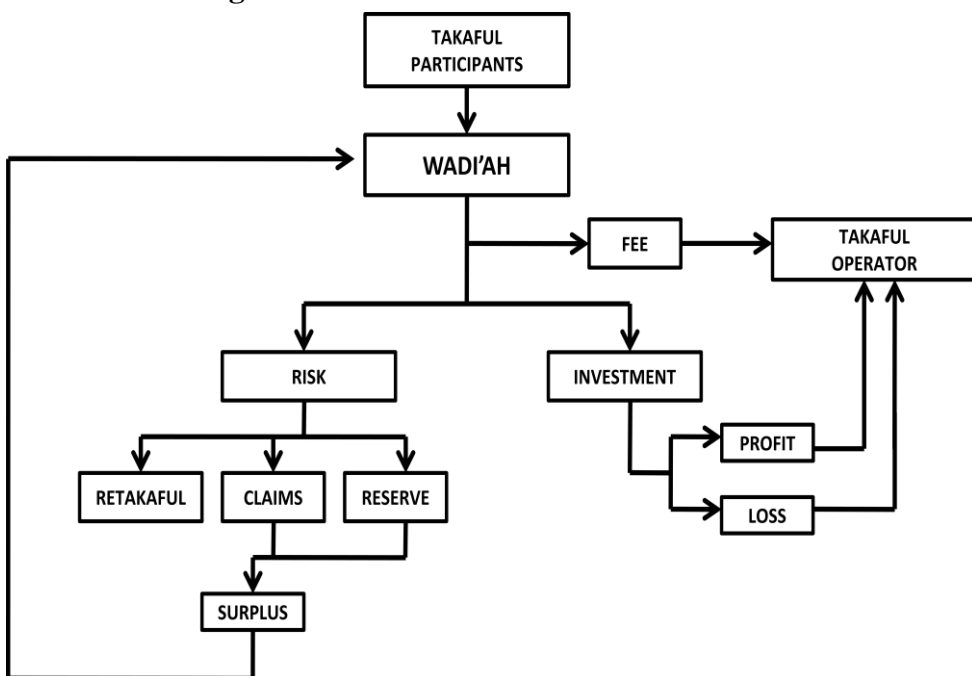
## **6. Exploring the New Takaaful Model Based on Wadi'ah**

The *wadi'ah* operational model in *takaaful* has been suggested by some researchers and scholars as an alternative model, but a feasibility study never been conducted to test its viability for the *takaaful* operation.<sup>19</sup> An enhanced version of this model was presented at the International Islamic Fiqh Academy conference held in Jordan in April 2010, and the feedback from the scholars was positive and encouraging.

### 6.1 The Mechanism of the Wadi'ah Model in Takaaful Operations

Under the proposed *wadi'ah* model, *takaaful* participants agree to deposit their money for the purpose of mutual help in case misfortune occurs to some of the participants. In the context of *takaaful* operations, the *takaaful* participants as a group appoint the *takaaful* operator to manage and safe-keep the money deposited in the *wadi'ah* fund in return for a *wakaalah* fee. In this model, the money pooled by the *takaaful* participants is considered a guaranteed deposit. However, if any claims are made or expenses incurred in managing the scheme, the *wadi'ah* fund will be treated as *tabarru'* (donation), based on the agreement of mutual assistance between the participants. With regard to the *wadi'ah* fund, the *takaaful* operator is authorized to invest the fund but will bear the risk of any losses to the fund as it is considered *wadi'ah yad al-Damaanah*. On the other hand, any investment return will belong solely to the *takaaful* operator. The *takaaful* participants are the owner of the entire *wadi'ah* fund, including the principal and any underwriting surplus.

**Diagram 5: Takaaful model based on Wadi'ah**



Significant Islamic banking experience is available in the implementation of the *wadi'ah* contract for its deposit instruments. There has, however, been no experience in doing so for *takaaful*. It should be noted that the nature of *wadi'ah* in Islamic banking is slightly different from the nature of *wadi'ah* in *takaaful*. To put it

simply, people deposit their money in a bank for two main purposes, namely transactions and investment; but in *takaaful*, people deposit their money for risk-sharing purposes. Thus, the *wadi'ah* mechanism in *takaaful* must be adapted to the existing *takaaful* institutional structure and market, and it must accommodate the concept of risk-sharing in *takaaful*. Therefore, the participants must understand that the money that is being deposited is their commitment for mutual assistance and donation. Therefore, the amount of deposited money will inevitably decrease as it is intended to be used to cover the *takaaful* expenses and the claims filed by the participants.

Furthermore, the validity of Islamic insurance, according to Islamic jurisprudence, is based on the commitment of the participants to make donations for their collective interest. In the *wadi'ah* model, the contribution is regarded as a deposit, and donation will only be exercised when the risk or claim happened. In other words, if any claims are made or expenses incurred by the *takaaful* operator, the *wadi'ah* fund will be tapped and treated as *tabarru'* (donation), based on the principle of mutual assistance. If claims are not made, the fund will remain as a *wadi'ah* under the safe-keeping of the *takaaful* operator.

In this *wadi'ah* model, the relationship between the participants is governed by the concept of *tabarru'* or cooperative partnership (*musharakah ta'awuniyyah*). The relationship between the operator and participant is governed by *wakaalah* and safe-keeping. The relationship between the participant and the risk fund is *iltizam bil-tabarru'*. In this model, the money pooled by the participants in the *takaaful* fund is considered as a deposit and not as a donation. The *wadi'ah* fund is jointly owned by all participants as opposed to the shareholders in a conventional insurance company. The *takaaful* operator only has the mandate given by the owners to administer the fund as per the contract agreement.

Surplus, defined as assets minus liabilities, is an important component in *takaaful*. Some Regulatory authorities have determined that the managing company (*takaaful* operator) is not entitled to any share of it in line with the remunerated *wakaalah* (agency) contract between it and the participants. In the *wadi'ah* model, the participants enjoy a fully guaranteed right to the entire *wadi'ah* fund, including any net underwriting surplus,

The *takaaful* operator is authorized by participants to manage the risk, and this comprises all operational areas such as pricing, valuation, distribution, acquisition, underwriting, claims handling, and asset management. For carrying out these administrative tasks, the *takaaful* operator receives fee-based compensation. With regard to the fund and since it is considered as *wadi'ah yad dhaman*, the *takaaful* operator can invest the fund but will bear the risk of any losses to the fund. On the other hand, any investment profit will belong to the *takaaful* operator.

The *wadi'ah yad al-Damaanah* contract allows the *takaaful* operator to invest the fund money in return for deposit protection. But the *takaaful* operator has no legal obligation to pay depositors a *hibah* or a fixed return. As the *takaaful* operator only manages but does not own the *takaaful* fund, the shareholders consequently cannot be held responsible for any deficits (unless the deficit is due to the negligence or misconduct of the operator). It has to be noted that a *qard* is not explicitly mandated by the Shari'ah. The loan will be repaid out of arising surplus in the future, though both timing and amount are uncertain. In addition to the usual technical reserves, the *wadi'ah* fund would be considered as a contingency reserve fund for future situations from the deposits received.

### **7. Rationale for the Wadi'ah Model**

Research is being done on this new model. The initial findings are that the *wadi'ah* model has many advantages over the existing models in that it creates fairness, transparency and a trust relationship between the *takaaful* operator and the participants. While a global standard and convergence of *takaaful* models seem not to be imminent, the harmonization of *takaaful* practices between regions is vital. One of the most controversial issues discussed within the *takaaful* industry is the question of surplus distribution, i.e., whether the *takaaful* operator is allowed to share in the underwriting surplus. The *wadi'ah* model provides clarity on this issue by retaining the ownership of the surplus to the participants. This model will concur with the practice of surplus distribution in the Middle East.

In the *mudaarabah* arrangement, the cooperative nature of the contract is undermined. The relationship between the participants should be based on *tabarru'* and not *mudaarabah*. Under a typical *wakaalah* model, the *tabarru'* (donation) remains the property of the participants unless consumed, as they have the right to receive the surplus back, and therefore, it becomes a conditional gift. This feature in turn gives rise to issues such as inheritance (it is not possible to measure the share of the surplus in the pool at the time of death) and *zakaah* in the case of the death of the persons, as the donation is a conditional gift. Also, the relationship is between the participants and the operator and also among the participants (exchange of gift for a gift). As such, doubts are created that the contract has become a contract of compensation. Furthermore, the modified *wakaalah* and *mudaarabah* models have departed from the pure models of *wakaalah* and *mudaarabah*. A consistent business model and transparency are required in order to better reflect a globally accepted structure of the *takaaful* operators. The *wadi'ah* model resolves the ambiguities surrounding the ownership of *takaaful* funds: the participants are the owners of the funds; they do not lose their ownership of the funds and thus have the exclusive right to the surplus. This is better than the current

model of applying the *wakaalah* concept whereby participants lose a considerable portion of the surplus.

Sharing of investment profits is well accepted in *takaaful*. However, sharing profits in the case of surplus and not sharing losses as they give only loan (*qard*) will burden the *takaaful* participant and put the scheme in risk. The relationship between the participants and the *takaaful* operator should be based on a more secure and transparent model. The *wadi'ah* model secures the participants' fund and guarantees the transparency of the relationship between the participants and the *takaaful* operator. The *wadi'ah* model is more equitable between the participants and *takaaful* operator, as the participants have a fully guaranteed right to the entire *wadi'ah* fund, including any net underwriting surplus, while the *takaaful* operator has a full right to management fees and the profits of investments earned if they opt to invest. Finally, the most important feature of the *wadi'ah* model is that it is Shari'ah compliant. The concept of *wadi'ah yad Damaanah* has been successfully implemented in Islamic banking institutions. The *wadi'ah* model is able to mitigate many unresolved issues in the *takaaful* market and become an alternative as the existing models are criticized for not meeting certain requirements of Islamic law.

### **8. Issues and Challenges of the Takaaful Model Based on Wadi'ah**

There are a number of challenges to be overcome to ensure the viability of the *wadi'ah* model in the market. The main challenge is whether it complies with the legal and regulatory framework in Malaysia and other jurisdictions. In this respect, this model can be considered as a deposit-taking activity which may not be in line with the Banking and Financial Institution Act (BAFIA), the Islamic Banking Act (IBA) or any act of different jurisdiction.

Among the important Shari'ah issues related to *wadi'ah* is the giving of *hibah* by the custodian to the depositors. The *hibah* given to the depositors is solely at the discretion of the *takaaful* operator, and it should not be promised upfront to the participants. Should there be a promise, then this may be akin to *riba*. Furthermore, the element of uncertainty in the system of *hibah* remains a setback in mobilization of Islamic deposits, given that contractual interest income has been the norm in the market for deposits. Nevertheless, this should not present a huge challenge with regards to the *takaaful* product as it is a nonprofit contribution.

Another possible Shari'ah issue relates to insufficient funds. If there is a deficit in the *takaaful* fund, the *takaaful* operator is required to provide a *qard* (loan) to the fund and recover it from the participants in the future. However, some Shari'ah scholars may question how it is that the *wadi'ah yad Damaanah*, which is essentially a *qard* from the participants, may be counterbalanced by a *qard* from the *takaaful* operator (shareholders) for the fund deficit.

Some regulators might allow under certain circumstances that no immediate cash injection is done, sufficing with a mere assignment of assets from the shareholders' fund to the *takaaful* fund. One obvious advantage for the operator is that it continues to earn investment profit on the earmarked assets, as they remain in the shareholders' fund. Such exemption is only likely to be granted if the operator can show that the deficit in the *takaaful* fund is only short-term and that the overall solvency of the operator is not affected.

The main challenge of this model is in maintaining the solvency of the *wadi'ah* fund as it will be reduced by claims and other expenses. Furthermore, the participants' full ownership of the surplus will not attract the *takaaful* operator to adopt this model as the bulk of *takaaful* profits are generated from underwriting surplus, namely the amount of premium collected and the amount paid out as compensations.

## 9. Conclusion

The concept of this new *takaaful* model is based on the contract of *wadi'ah yad dhamanah* (guaranteed safe custody). In the context of *takaaful* operation, the participants as a group appoint the *takaaful* operator to manage and safe-keep the money deposited in the *wadi'ah* fund in return for *wakaalah* fee. The distinctive of this model is that the money pooled by the participants is considered as a deposit and not as a donation. Participants will be the owner of the entire *takaaful* fund, including any net underwriting surplus. The *wadi'ah* fund will be deducted and channeled as *tabarru'* (donation) if there any claims were made or expenses incurred by the *takaaful* operators, and this is based on the principle of *ta'awun* (mutual assistance) between the participants. *Takaaful* participants also authorized the *takaaful* operator to use and invest the fund but will bear the risk of any losses to the fund. In return, the investment profit will exclusively belong to the *takaaful* operator. Thus, the source of income for the *takaaful* operator is from the *wakaalah* fee and the investment profit. It is found that the *wadi'ah* model has many advantages over the existing models; it creates fairness, transparency and a trust relationship between the *takaaful* operator and the participants. It is more equitable, as the participants enjoy a fully guaranteed right to the entire *wadi'ah* fund, including any net underwriting surplus, while the *takaaful* operator enjoys management fees and the profits of investments from the fund. The *wadi'ah* model is also more transparent than the existing model as it clearly determines the ownership of the fund and the ownership of the underwriting surplus. It mitigates several issues by treating the contribution from the participant as a deposit money and not as *tabarru'*, hence the participants will not lose on the ownership of the fund, as it is required by the rules of *tabarru'* in the Shari'ah. It is also more compliant to the shari'ah in that the modified *wakaalah* and *mudharabah* models have departed from the pure models of *wakaalah* and *mudharabah*.

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<sup>1</sup> The World Takaful Report 2009, Ernst and Young, page 39.

<sup>2</sup> Ernst and Young, *The World Takaful Report 2009*, p. 34.

<sup>3</sup> Interview with Mr. Ismail Mahbob of MNRB Retakaful.

<sup>4</sup> Swiss Re, Sigma No 5/2008 "Insurance in the Emerging Markets: Overview and Prospects for Islamic Insurance", p.24

<sup>5</sup> Abdul Rahim Abdul Wahab, Mervyn K. Lewis & M. Kabir Hassan, "Islamic Takaful: Business Models, Shariah Concerns, and Proposed Solutions", *Thunderbird International Business Review*, Vol. 49, May-June 2007, pp. 371-396.

<sup>6</sup> Swiss Re, Sigma No 5/2008 "Insurance in the emerging markets: overview and prospects for Islamic insurance", page Sigma page 24

<sup>7</sup> Billah, M.M. "Different Models of Takaful in the Global Sound Market". Retrieved from [http://www.takaful.coop/doc\\_store/takaful/differentModels.pdf](http://www.takaful.coop/doc_store/takaful/differentModels.pdf)

<sup>8</sup> Ibn Aabidiin, 4:515.

<sup>9</sup> Al-Khatib Al-Shirbini, vol.3 p.79. Hashiyat Al-Dusuqi, vol. 3, p.419.

<sup>10</sup> Al-Nisa', 58

<sup>11</sup> Ibn Abidin, *Rad Al-Muhtar ala Al-Dur Al-Mukhtar*, vol.5, p.662, Darul Fikir, Beirut.

<sup>12</sup> Al-Baqarah, 283

<sup>13</sup> Al-Baihaqi, *Sunan Al-Kubro*, vol.6, p.472, Darul Kutub Ilmiyyah, Beirut.

<sup>14</sup> Al-Baihaqi, *Al-Sunan Al-Kubro*, vol.6, p.467, 3<sup>rd</sup> Edition, 2003, Dar Al-Kutub Al-Ilmiyyah, Beirut. Al-Nawawi, *Riyaadu Al-Solihin*, vol.1, p. 77, Dar Al-Rayyan.

<sup>15</sup> Zuhayli, W, *Fiqh Al-Islami wa Adillatuhu*, p.4026

<sup>16</sup> Al-Maqdisi, *Al-Uddah Syarh Al-Umdah*, vol.1, p.293, Darul Hadis, Al-Kaherah.

<sup>17</sup> Al-Kasani, *Badaai' al-Sanaai'*, vol.8, p. 3899

<sup>18</sup> Al-Buhuti, *Kasyaf al-Qina'*, vol.4, p. 1414

<sup>19</sup> Frenz, T. Takaful and Retakaful, Principles and Practices, Munich RE Retakaful, p. 68. Engku Ali, E.R and Odierno, H.S (2008). *Essential Guide to Takaful (Islamic Insurance)* CERT Publication, p. 36