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Factors Driving the Islamic Insurance System in Pakistan, a Social Perspective Approach

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Abstract

The aim of this paper is identify those factors which are making conventional insurance system prohibited in Islam. The study examines the differences between the conventional and Islamic insurance contracts (Takaful).Conventional insurance is based solely on commercial factors and are only subject to the governing laws whereas Takaful is based on mutual cooperation and are subject to the governing law as well as a Shariah Supervisory Board.. The three main objections on conventional insurance are also being highlighted which are Gharar, Misir and Riba. It also includes those steps which can help in making the conventional insurance contract free of Islamic allegations.

Keywords: Insurance, Takaful, Gharar, Maisir, Riba, Allegation, Shariah.

1. Introduction

For a long time insurance companies are being working in our society and being criticized by many Islamic scholars. The main issue was that they were violating the rules of Islamic financial system due to which it has been considered Haram by many Islamic jurist and scholars. Later on in twentieth century the substitute or alternative to insurance company came into being that is Takaful, It was considered a viable concept which is well suited with the Islamic law (Akhter,2010).

If we talk about the Pakistan then for the first time the conversion of insurance company was done by Council of Islamic ideology 1983 followed by circulation of *Shariat* Ordinance 1988 and enforcement of *Shariah* Act 1991 (CIIP Report, 1992; Mehmood, 2002; p.686). In 1938 Insurance Act the Federal *Shari' at* Court give its view regarding ban of interest factor in it. After that in 1992 the council of Islamic ideology presented its complete report which included all those rules of insurance companies which are against the Islamic law. But still the output of this report was not fruitful due to the multipart political condition of the country (Abdel Karim & Archer, 2002; p. 39). In 2005 the implementation of takaful rules came into being which was the biggest development regarding this issue due to which five takaful companies are working in our country(SECP, 2009)but still they are at the preliminary stage in our country as compare to rest of the muslim world.

In this research paper we will discuss mainly those issues which are the main reason for the violation of Islamic rules regarding the insurance company and would like to share some new innovative ideas by which we can remove these violating rules from the operations of insurance company and will try to convert it in a new structure which are acceptable by Islamic financial system.

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2. Difference between Islamic and Conventional Insurance

The major points of difference (Obaidullah, 2005a; Billah, 2003a)between conventional insurance and Islamic(Takaful contract) may be enumerated in brief as under:

Nature of Business

Conventional Insurance business is based on profit-motive and aims to maximize returns to shareholders. Islamic on the other hand, is based on the motive of community welfare and protection. The business of Islamic itself is non-profit where operator only charges a fee for the services rendered and aims at increasing benefits to the participants.

Nature of Contact

In conventional insurance, customers are the policyholders who pay premium to the insurance company in return for the coverage of risk that may be inflicted upon them. It is a buy-sale contract where insurer guarantees to cover the risk for the paid premiums. Islamic contact, on the other hand, is a risk sharing agreement among members (participants) to pay a fixed amount in a joint fund to help each other in case of loss or risk. Here, operator merely acts as a manager of funds.

Disclosure and Transparency

In conventional insurance, there is uncertainty about the subject matter of the contract. The insurer guarantees to cover a certain loss but neither the insurer nor the insured exactly knows from where and how the loss is to be recovered in future if it occurs to many or all of policyholders. So there is a lack of disclosure and transparency in conventional insurance. In Islamic contract, on the other hand, participants agree to contribute in a joint fund (Takaful fund) and agree to help each other from that fund if a loss occurs to any or all of them. Here, Shareholders provide interest free loan if amount of claim payments exceed the amount of contribution. This makes the contract more transparent as all the relevant information is fully disclosed to participants. This is the system that is based on Islamic principles of mutual cooperation and brotherhood and compatible with Shariah guidelines.

Treatment of Funds

Conventional insurance company has separate account for each policy. Premiums received from policyholders for general insurance policy go to general insurance account. Whereas premium received for life insurance policy goes to life insurance account. In general Islamic contract, entire contribution received from participants is treated as tabarru and goes to risk fund account. In family Takaful contract, a portion of contribution is treated as tabarru that goes to risk fund account whereas remaining major portion is kept in a separate account called participant's account (PA) that belongs to the participant.

Investment of Funds

In conventional insurance, funds from general and life insurance accounts are invested in interest based instruments involving fixed returns. Moreover, some funds may be invested in Shariah prohibited schemes or projects like casino, liquor or some other illegal business. In Takaful business, all the funds from risk account and participants' accounts are invested in Shariah compliant instruments on the basis of Mudharabah where profit is shared according to agreed ratios. Moreover, in Takaful business, funds cannot be invested in Shariah prohibited or illegal business.

Claims and Benefits

In conventional insurance, policyholders have the right to claim the whole amount (or maturity value) stated in the policy in case of risk. But in case of no loss, policyholder is entitled to the policy value at the end of maturity period together with interest if any. In family Takaful contract, participants have right to claim the amount of loss from risk fund besides the entire amount from PA together with the share of profit earned till that period. But if participant survives till the maturity period without any loss or claim, he will get the amount only accumulated in PA together with the share of profit earned.

Surrender Value

In conventional insurance, if policyholder wants to withdraw his policy before the maturity period, he will get some compensation known as surrender value. Usually, surrender value is less than total amount paid as premium till that period. Insurance company deducts his management and operating expenses and also bonus, interest payments or any other benefits received by policyholder during that period. In Takaful contract, if participant wants to withdraw a Takaful plan, he will receive his entire amount accumulated in PA together with his share of profit from investment till that period. Takaful operator, however, may charge a small fee for drawing funds.

Extra Risk Premiums

In conventional insurance, extra risk premium is charged to the policyholder if he is prone to exceptional risk owing to his poor health or strenuous job. In Takaful contract, usually, contribution amount is fixed and no one is discriminated by extra foreseeable future risk. However, if underwriter thinks that a participant is expected to pose a higher risk to the company in future based on initial underwriting screening process, he may increase his share of tabarru in his contribution with his due consent. This will definitely decrease his share in PA than generally his share would be.

Limit of Damages Covered

In Takaful contract, participant is entitled to cover a limited number of damages and risks as specified in the contract. Underwriter clearly explains and discloses to the participant what damages will be cover under this contract. In conventional insurance, there is no limit on the number of damages cover under certain policy and Court of justice, in some cases, may be authorized to charge unlimited losses to the insurer based on the claim and insurance guarantee provided to the insured.

Nominee/Beneficiary in Insurance

Nominee is a person who is designated to collect policy benefits in case of sudden accident or death of policyholder. In conventional life insurance, nominee is absolute beneficiary who is expected to receive benefits of policy and no other person (even the legal heir) has right to claim the all or part of benefits disbursed to the nominee. In Takaful contract, nominee is not the absolute beneficiary rather he acts as a trustee who main responsibility is to receive benefits from operator and distribute them to the legal heirs of the deceased according to the Islamic principles of inheritance (al-mirath and al-wasiyah).

Distribution of Profit and Surplus

In general insurance, policyholders have no share in surplus and any surplus left goes to shareholders' fund. In life insurance, policyholders are entitled to the interest payments received from investments that add toward the policy value of the insurance contract. In life insurance, distribution of profits or surplus is a managerial decision taken by the management of the insurer. As a result there is a conflict of interest between shareholders and the policy holders. In Takaful contract, participants have not only their share in the surplus but also in the profit from investments according to their proportion in the investment. However, Takaful Company may retain a portion of profit or surplus in a contingency reserve for future risks. Further, it is the Takaful contract, not the management of the operator company that specifies in advance how and when profit will be distributed.

Accounting and Auditing Treatment

In conventional insurance, accounting and auditing procedure is based on international accounting standards and principles. Auditing is done by independent external auditor on yearly basis. In Takaful business, accounting and auditing mechanism generally follows AAOIFI[3] guidelines where Shariah Review and Internal Shariah Audit are considered essential part of auditing process.

[3]AAOIFI is Accounting and Auditing Organization for Islamic Financial Institutions established in 1991, based on Manama, Bahrain to cater the needs of Islamic Financial Institutions (IFIs) including *Takāful* companies.

Payment of Zakat

In conventional insurance, there is no concept of payment of Zakat from operating income of the company. On the other hand, in case of Takaful business, payment of Zakat is considered an integral part of Islamic financial system. That's why Takaful company has an additional obligation of Zakat as compared to conventional insurance system.

Sources of Regulations

Conventional insurance laws and regulations are man-made that are based on business experience, human thoughts and legal literature as well as statutes and culture of the country. Takaful regulations, on the other hand, are based on Islamic principles (Quran and Sunnah) and decisions and fatwas of Shariah supervisory board. Regulatory authorities may seek guidance from the experience of conventional insurance and certain regulations might be adopted or modified for Takaful system that are justified and compatible with Shariah.

3. Objections in Conventional Insurance

Conventional insurance contains three essentials contradictory to Islamic rules.

Gharar
Maisir
Riba

Gharar

It is Arabic word which means uncertainty in contract. And in insurance contract uncertainty exist because the amount paid is not known, the time when it will occur also not known and whether the payment will be accepted as promise. It is illegal in Islam due to its two illegal aspects (Obaidullah, 2005a; pp.29-33), first is uncertainty and second is dishonesty which leads to injustice, fraud and exploitation of other party by taking unfair advantage of ignorance of other party.When a claim is not made the insurance company may acquire all the profits whilst the participant may not obtain any profit whatsoever. The loss of premiums on cancellation of a life insurance policy by the policyholder, or the "double standard" condition of charging a customary short period in general insurance, whilst only a proportional refund is made if the insurance company terminates the cover is also considered as unjust. Quran has forbidden such transactions that involve gharar and deceit to any party by hiding some facts or providing inaccurate information:

"Woe to those who deal in fraud, who when they take their measure from others take it fully, and when they measure or weigh for them give less than what is due." Al-Quran (83:1-3)

Maisir

The meaning of the word Maisir is gambling .It is said that insurance contract contains the element of gambling because the participant contributes a small amount of premium in hope to gain a large sum, he loses the money paid for the premium when the insured event does not occur and the company will be in deficit if claims are higher than contributions. Especially in case of life insurance policy when policyholder dies after only paying part of the premium his dependants receive a certain some of money which the policyholder has not been informed of and has no knowledge as to how and from where it has been derived.Quran has warned against all such transactions which involves gambling and called it akin to Devil's job and great sin.

"Ye who believe! Intoxicants and gambling, sacrificing to stones and divination by arrows, are an abomination, - of Satan's handiwork: eschew such (abomination), that ye may prosper." Al-Quran (3:90)

"Satan's plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer: will ye not then abstain?" Al-Quran (3:91)

Riba

Riba means interest and it has been observed that in conventional insurance contract there is a practice of interest carrying activities. An element of interest exists in conventional life insurance products - as the insured, on his death, is entitled to get much more than he has paid. Insurance funds invested in financial instruments such as bonds and stocks contain and element of Riba. And in islam all those activities are prohibited which includes interest as it is clear by the verus of Quran.

"O' Muslims, Do not devour riba, doubling and redoubling it and fear (the punishment of) Allah that you may be successful." Al-Quran (3:130)

"O' believers, fear Allah and forgo the interest that is owing, if you really believe. If you do not, beware of war on the part of Allah and His Apostle. But if you repent, you shall keep your principal. Oppress none and no one will oppress you." Al-Quran (2:278-279)

"What you provide with the prospect of an increase through the property of (other) people, will have no increase with Allah; yet what you give in alms and charity, seeking the countenance of Allah, (will increase): it is these who will get a recompense multiplied." Al-Quran (30:39)

These verses evidently specify that every such commerce contract which contains uncertainty, gambling and interest are illegitimate under Islamic law. Being Muslim we should go without involving ourselves in such activities in our business which has no value in front of God. The studies of most of the Islamic scholars and economists proved this that these unlawful activities are responsible in destroying the society and keeping the wealth in the hands of some specific groups. In addition they are also the cause of unemployment and inflation in the country.

4. Steps in Making Conventional Insurance According To Islamic Rules

This section discusses all those steps which will help in making conventional insurance system in accordance to the rules of Islam (Anwar, 1994; Abdul Wahab, 2006).

- Isolation of shareholders and participant funds
- Removal of brutal tools from the conventional system
- Introduction of new arrangements
- Training of staff
- Regularity changes
- Renewing the insurance policies
- Support in the emergence of separate takaful companies

5. Conclusion

The current Conventional has the base motive to increase the profit and maintain high return to equity ratio where as Islamic contract (Takaful) is based on the principal of society safety and wellbeing. The premium is paid to conventionalinsurance companies and is owned by them in exchange for bearing all expected risks. Where as in Takaful all or part of the contribution paid by the Participant is a donation to the Takaful Fund, which helps other Participants by providing protection against potential risks. In conventional insurance there is no concept of zakat payment from operating income whereas in Takaful contract zakat payment is an important part of the business.

The different steps are being mentioned which should be adopted by the current insurance companies so that their working should be considered hilal according to Islamic rules. It was suggested that general insurance policies can be converted into general *Takaful* in one year after expiration of contract. Due to longer maturity period, life insurance policies could be continued under conventional insurance till their maturity while fresh policies can be started under family *Takaful* contract.

In spite of following these steps by conventional insurance, there survive is also ominous need to devise strategies to overcome challenges and create awareness of *Takaful* so that its benefits could reach at nasty root level of the economy.

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