How can takaful deliver on its promise?
A proposal for broadening its range and reach

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1 A historical paradox

“For most periods of its history, Islamic society was characterised by its internal balance and its capacity for self-administration. It was a self-organising society, since it contained many institutions, corporative bodies and formations that enabled it to execute its functions and its independence from the state in satisfying most of its needs. That is the concept of civil society which we want to revive … to be a pro-active, productive and mutually supportive (mutakafili) society…”

Ever since I read these words twenty years ago in the programme of the Yemeni Islah party, I kept them in mind. Not because it was probably the first time in my life that I encountered the Arabic root of “takaful”, which was to gain quite some importance for my personal life later on. But because words such as “corporative” and “cooperative” were not what Westerners usually connect with Islamic societies, not to mention the expression “civil society”. And so I kept looking for these cooperative, mutual and corporative structures wherever I went in the Middle East, Pakistan or South East Asia. And I found the spirit of cooperation and mutuality everywhere. People are deeply influenced by the value of cooperation, they are sociable and helpful, they support each other in families, neighbourhoods, villages, tribes, etc. But, these are networks, informal and rather unprofessional. One finds cooperative, but not corporative structures.

What has this to do with our topic? How can takaful deliver on its promise? First, we should define what this promise was. The word one kept hearing was: Growth. Profitable growth, of course, from a shareholder’s point of view. The next was: Offering an alternative to insurance for the vast, largely uninsured (and supposedly religious) strata of society. The two criteria were actually a tautology, since by successfully offering such an alternative, growth would come automatically. That did not happen, at least not compared to the high – possibly exaggerated – expectations, and where it happened it was, as it appears, usually not profitable.

The aim of this essay is not to further analyse and deduce the reasons for this failure to meet expectations, although it is interesting and even necessary to differentiate between lines of business and markets. We start here by boldly (and, I admit, probably oversimply) stating without further proof what in our opinion is the reason for this unsatisfactory situation, namely that takaful was simply not perceived by large portions of the target community as a real and attractive alternative to insurance.

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1 Barnamaj al-'amal as-siyasi, p. 36: The original Arabic text of the whole paragraph is as follows: ittasama l-mujtama’ l-islami fi mu’zam fatatratiha l-ta’rikhiyya bi-tawazunhi d-dakhili wa-maqdaratihi ‘ala idarat nafsihi, fa-kana mujtama’an munazziman dhatiyan, haithu htawa ‘ala l-adid mina l-mu’assasat wa-l-hal’at wa-t-takwinat allati tumakkinuhu mina l-qiyam bi-waza’ilhi wa-l-istiqlal ‘ana s-sulta bi-ishba’ mu’zam hajatiha. Translation by the author.

2 Ta’awuniyyat are described in the same text from page 38.
And this, again, for two reasons:
(a) It was not perceived as different from insurance because in fact it was not (very) different;
(b) It was to a great extent ignored by the target group (the uninsured masses) simply because the takaful companies to a great extent ignored the target group before offering unidentifiable products to the existing markets via the existing distribution channels. No wonder the outcome was unsatisfactory.

Wisdom comes from Yemen, as the hadith says\(^3\). And so we finally come back to the question of what the quote from the Yemeni party programme at the beginning of this essay has to do with the undelivered promise of takaful: It showed the historic paradox that there is a spirit of cooperation everywhere but hardly any corporations that implement this spirit in a professional way. And takaful operators (or takaful funds) could deliver their promise by seeking their rightful place there as part of these still lacking cooperative institutions.

All this has been said before by others (and my humble self) more or less often. Discussions on a microeconomic level of how cash flows, expense ratios or service quality can be improved have already been going on for some time. The starting point of this essay is even more generic and strategic. It is to use a historical perspective and methods to evaluate the strategic chances of takaful to create and become a new, strong segment of the economy.

2 Searching for a cooperative segment

The difficulties of developing a cooperative economy can be seen as having two roots: A legal/historical and an economic/logical one.

Let us first consider the historical one. In the European experience of the spreading of insurance – a history slow and rocky in itself – there were three starting points:
1. The trade centres for commercial insurance, starting usually with marine;
2. Semi-public societies for (sometimes obligatory) fire insurance, which later developed into other types of business, as e.g. third party liability in Germany\(^4\);
3. Professional associations from which mutuals developed to cover insurances of the person, namely life and health. Social insurance schemes only developed afterwards\(^5\).

Takaful operators have had problems behaving and being perceived as mutual insurers because that is not what they are. They are, as often mentioned, formally a hybrid of mutual and shareholders’ companies, but in fact they are

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\(^3\) Al-hikma yamiyya. Sahih Muslim, 1, 84 et al.

\(^4\) General liability accounts for more than 12 % of the non-Life market, which shows the potential of personal lines, if marketed intensively. Munich Re market figure.

\(^5\) In the rest of the essay, the issue of public or semi-public solutions will not be pursued, but we concentrate here on the private and corporate sector solutions
mostly simply run like any stock company. And the reason possibly lies in a historical peculiarity. The Islamic state started in a trade-based economy, characterised by equity financing and bilateral contracts. Then, with the first wave of the Islamic conquests, large agricultural areas of the Byzantine and Persian empires were occupied. But adopting the Roman practice, lands were considered the property of the state on which taxes were to be paid. The first comprehensive fiqh work on public law was, interestingly, named after this tax, the Kharaj. The cooperative segment of the economy in this early period, where shari’a rulings (in particular the contract types) took form, was the tribal and family segment. This could have provided the ground for cooperative structures, as in Europe. But since the tribes, where they needed rules for their cooperation, had (and still have) their own tribal law, their dealings did not become part of shari’a canons, and thus the cooperative society of which our Yemeni text above speaks has hardly any clear legal form in fiqh literature. It could be said that the set of economic forms was canonised as a snapshot of a time when a private and a state sector were reflected in these rules, but no cooperative sector. Here we can find a sort of historical feedback loop from form to content: because the treaty types, like mudharaba, musharaka, etc., made only capital-based partnerships possible, only such partnerships developed, and mutual contracts were not experienced. And now, again, because legal concepts such as joint ownership were not within the experience of the Muslim people for centuries, it appears so difficult for them to imagine pure mutuals and so easy and natural to adopt the behaviour of stock companies. This also seems to be the fundamental reason why modern cooperatives in the Arab world are often not self-governed private organisations, but “state parasatalists”. Owing to a millennium-old habit, Muslims – legislators, businessmen and consumers alike – can imagine production either as private-individual or state-owned. There is nothing in between, in particular no mutual.

This difficulty and “habitual stock-company behaviour” on the one hand, despite the importance and acceptance of the value of cooperation on the other hand, is the core of the above-mentioned historical paradox, which must be overcome if a cooperative and mutual segment of the economy is to be created.

Takaful would not only be part of such a mutual segment of the economy. It might also feed and thrive on it, covering insurable interests of cooperatives in production. And it might at the same time enable the creation of such cooperatives by offering this cover. Can such a segment develop and where? This is the second, the logical and economic question, mentioned above.

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6 Koch, Geschichte, p. 6.
7 Name of author and title: Ibn Ya’qub, Abu Yusuf Kitab al-Kharaj.
8 Muhammad 2010, p 11/2: reports that the Fiqh Academy of the OIC had discussed in 2010 to create such a contract type “musharaka ta’awuniya”, although its application would be limited to insurance and alike (i.e. it would not be applicable for sales contracts).
10 Which is in fact a habit and not a requirement of Islamic Law, or even against its basic intentions, as the text from the Islah party suggests.
3 Islamic fiqh and Oppenheimer’s transformation law

The idea of creating a new mutual sector seems audacious in a world where demutualisation is a widespread word but the opposite is hardly heard. A quarter of the world’s insurance premiums are still produced by mutuals, but the figure is in retreat. Tens of thousands of cooperatives exist across Europe and the USA\(^{11}\), but they are usually limited to consumption or service (e.g. financial service). Their common denominator is that the participants act in the role of the buyer. Even in agricultural cooperatives, which usually use, say, machines or distribution channels together, the participants cooperate in the role of the buyers of these factors of production, not in the production and the seller’s role itself. Outright self-governed (and not state-driven) production cooperatives are rare. So, is there wisdom in the shari’a’s neglect of cooperative societies, because this sector can only optimise distribution and minimise losses, but cannot originally create value on its own? Which means for our question: Does a possible mutual takaful industry not have a feeding ground on its own? Let us briefly examine this in the light of a German theory that is rarely discussed in the English-speaking literature: Oppenheimer’s transformation law.

In the historical context of Europe’s rapid industrialisation in the second half of the 19th century, cooperatives were created with the intention of providing a third way between Manchester capitalism and socialism, and the motivation often came from Christian values (virtually congruent with the Islamic ones when it comes to economic behaviour). In fact, the Roman popes themselves encouraged and accompanied the cooperative movement in their encyclicals\(^{12}\). Franz Oppenheimer (1864–1943) observed the development and analysed the experience along the lines of economic interest and rational (i.e. opportunistic) behaviour. To summarise this very briefly, he states that buyers’ cooperatives (Käufergenossenschaften) will flourish while sellers’ cooperatives (Verkäufergenossenschaften) will with the force of a mathematical law be closed for future entrants\(^{13}\) and thus lose their cooperative character. Buyers’ cooperatives, he argues, work better the more members they have, taking advantage of discounts, etc. An additional member is always an economic advantage for the group as a whole and for every individual participant. For sellers’ cooperatives, additional members entail ceteris paribus an economic disadvantage, because the volume of products to be sold remains the same and thus profits per participant are reduced\(^{14}\).

The parallel between this theory and the few known bases for mutual behaviour in Islamic fiqh tradition is striking. In the hadith of the Ash’ariyin, quoted e.g. by the Islamic Fiqh Academy’s fatwa on takaful\(^{15}\), the problem dealt with is the pooling and sharing of food provisions. In other words, this was a consumption

\(^{11}\) 5,436 in Germany. See www.dgrv.de.

\(^{12}\) Namely Rerum Novarum 1891, Quadragesimo Anno, 1931.

\(^{13}\) Kruck, Transformationsgesetz, p. 6/7. Oppenheimer himself is quoted to have called it an “iron” (in German “ehern”) law.

\(^{14}\) See Kruck 1992, p. 7

\(^{15}\) Muhammad 2010, p. 11
(buyers’) cooperative. The constitution (sahifa) of the first Muslim community in Medina deals to a great extent with defining sub-groups (tribes and clans) that share losses, ‘aqila, together. A loss-sharing cooperative is, again, a sort of buyers’ cooperative; it gets more efficient with every additional member and it is certainly not productive. Apart from those possibilities, the traditional tools of risk management are on the one hand Zakat, which is close to the state sector and social insurance and, on the other hand, the risk-sharing mechanisms built into the contract forms of the private sector, like mudharaba.

Should we thus draw, for the moment, a janus-headed conclusion? That firstly takaful-funds, being loss-carrying cooperatives, are as such a form of cooperative that makes sense under Islamic tradition and also has a chance of success according to the transformation law. But that, secondly, they will not be able to count on the development of a vast productive cooperative sector which would be of their kind and where they are the insurer of choice. They would, according to this preliminary conclusion, be an “orphaned” industry, forced to seek their business solely from the private-individual sector, where they remain in direct competition with the stock company insurers and are subject to constraints to behave like the latter. And that would, again, perpetuate the situation that they are not distinguishable from the conventional insurers, a situation we have identified as the main reason for the relative failure in delivering on their promise so far.

But, as has already been indicated, this is not the end of the story. Oppenheimer saw of course the condition under which the transformation law functioned: rational, opportunistic behaviour. But this is not the only way people act. Education, information and coordination can change people’s behaviour. And, again, there is a striking parallel to Islamic beliefs. The Islamic cultures are deeply based on confidence in the value and effect of education. In fact, the very basis of religious teachings and prophethood is the idea that people can be changed by telling them the truth, and the Qur’an mentions in dozens of places that its verses are “signs for those who use their reason”\textsuperscript{16}.

This idea of the feasibility of betterment of people by teaching also has a logical basis in game theory\textsuperscript{17}. Members of a group who are informed, coordinated and confident that the other members will act according to their defined role achieve a better result, overall and per individual, than under uncoordinated opportunistic behaviour. In the end, every ship’s crew or fire brigade only functions and survives because the members do not minimise their individual risks, but fulfil their defined roles, sometimes at the cost of their lives.

There is also evidence for the success of a coordinated cooperative approach in economic reality. The Spanish cooperative group of Mondragón, created in 1955, is often quoted as an example of a successful production cooperative and now

\textsuperscript{16} The formulations are e.g.: ayat li-qaumin ya’quluna: 2,164; 13,4; 5,103 (with negation); yatafakkaruna 10,24; 13,3; 10,11 or yaqahunna 6,98 or 8,65

\textsuperscript{17} Namely in the prisoner dilemma. For a description, see e.g. http://plato.stanford.edu/entries/prisoner-dilemma/
employs 20,000 people\textsuperscript{18}. The Kibbutz movement is another example. Both were methodically started after an education phase and deliberately built on cooperative values\textsuperscript{19}.

We thus propose accepting that there is space for the functioning of a cooperative segment including primary production, based on a cooperative (or Islamic) mindset. The questions are now where and how it can be created, how large it can be, and how far the takaful industry can contribute to its creation and benefit from its existence.

4 Overcoming legal and operational obstacles – a road map

It would go beyond the scope of this essay to attempt an analysis of market potential across the region, but in a quite generic way, there is agreement that there is a lack of insurance penetration in particular in personal lines and in countries with large populations and only basic social insurance. For health insurance, registered “out of pocket” payments are an indicator of the existence of strata that have an insurable interest and could afford to pay contributions. These figures go into the hundreds of millions for North Africa alone\textsuperscript{20}.

The takaful companies, restricted in their legal form and company strategy by the historical limitations explained above, are hardly geared yet to target these strata. Let us remember the three origins of insurance in the West: trade centres for commercial, associations for mutuals and states for (semi-) public insurance and apply this to the structure of takaful companies today; the latter, as we know, mainly compete with the commercial companies in the commercial field, where their hybrid nature seems to be more an obstacle than a help. This very hybrid nature could be turned into an advantage, however, allowing them to change their form flexibly according to the environment. Those deciding to go for the commercial markets, where risk transfer is required, could do so, since they are already behaving like a stock company. Those targeting the market of small mass risks could do so more easily in the form of fully-fledged mutuals\textsuperscript{21}, doing away with the shareholders’ fund and the requirements of shareholder value, quarterly profit statements, etc.

\textsuperscript{18} Kruck 1992, p. 12/3
\textsuperscript{19} Dto.
\textsuperscript{21} See for details: Stiftl, Transformation, p. 28/9
Of course, this would require a new sort of company and, on the legal/shari’a side as mentioned, the creation of a new contract type, the cooperative musharaka. Existing takaful companies would, nevertheless, not lose out in the medium term. The cooperative takaful funds to be created could at the beginning outsource many functions to existing operators. This is after all the very idea of wakala. The only difference to today’s practice is that one operator would run several funds of the same line of business, one which it provides with qard hasan, thus being in a risk carrier role, and one (or more) which it provides with shared services, full or in part.

Let us assume that the two first obstacles can and will be removed: that the fully mutual form or the “participant fund without shareholders’ fund” will be approved by the scholars and that the operators continue to strengthen operational abilities to manage the fund. Then the last and main question remains: how can the operators approach the masses?

The answer we propose leads us back to the quote at the beginning: “It was a self-organising society, since it contained many institutions, corporative bodies and formations that enabled it to execute its functions…in satisfying most of its needs.”

We suggest seeking out these local communities and networks, however informal, and formalising them by making them, with the help of international expertise and global retakaful operators, a takaful pool – a separate, decentralised one if possible. Or help “privatise” existing cooperatives that are virtually still run by the state. Giving such groups “their” fund should have an effect on commitment and moral hazard and support distribution. Loyalty and identity are strong and economically influential powers. As the hadith of the Ash’ariyin says: “They are from me, and I am from them.”

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22 Fa-humu minni wa-ana minhum” Bukhari, 2354. See Muhammad 2010, p.10
It also does not need to be called “takaful fund” if that word is perceived in the narrow sense of the existing companies and their structure. What it should probably be in order to be acceptable, particularly in rural areas, is shari’a-compliant.

And if there were not (yet) much insurable interest to be covered in the fund, the takafulisation of the community could trigger the creation of insurable interests. This could be done by systematically scrutinising the informal cooperative structures, e.g. lending schemes or unused production synergies. Examples can be found in the marketing of local products or involvement in renewable energy activities The takaful companies will need help and guidance in this, but there are a number of concepts developed and organisations that would probably gladly coordinate and use synergies.

5 Summary and outlook

Looking back at a decade of very intensive activities in the takaful sector, it is interesting to see how close the experiences still are to each other. It appears that only a fraction of the range of possible set-ups for Islamic insurance have yet been used. But that is quite understandable. The industry has started with the model described by the scholars as the model of choice, which is the hybrid model of participants’ and shareholders’ fund. And it started – as far as the Arab world is concerned – mainly in the GCC countries, where trade and service are important, capital is available in large quantities, where the size of population is (except for KSA) moderate to small, and poverty is virtually unknown. When comparing this to the origins of insurance in Europe described above, GCC is the equivalent of the trade centres, the origin of commercial insurance. In the GCC region, this was the logical thing to do and it could be put in place very swiftly, given the decision processes and GCC decision-making.

Since the GCC countries account for about 10% of the population of the region and the population giants such as Egypt, Iraq, Morocco are just starting to develop a takaful industry, it is little wonder that takaful has not reached the uninsured masses yet. But obviously in these countries, the circumstances are different from GCC. The rural population and agricultural economy are important, capital is scarce, and incomes are much lower. It would make sense to use a different approach for these markets, a more mutual and more synergetic one, since costs are even more difficult to manage with the smaller volumes.

But there is one important question: Who has an interest in setting this up? Mutual insurers can have an investor, for a limited period of 5-10 years and with limited expectations regarding return. But they are by definition not an asset for venture capital. Development banks have their requirements for getting involved;

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23 See also the example of the first interest-free bank in Mit Ghamr in the Nile delta, which helped the local handicraft community. Cf. J.KAU: Islamic Econ., Vol. 18, No. 2, pp. 3-25 (2005 A.D/1426 A.H), p 16

24 For International Labour Association see Polat. P. 45/6

25 The long history of Islamic insurance in Sudan should by no means be forgotten, but it is very special and deserves a separate discussion.
whether an untested new sort of Islamic insurance fits these requirements needs to be seen, but it may well be of interest to them²⁶.

Let us finally assume that all this becomes reality, large strata of these societies get access to insurance and become acquainted with insurance. This would in our opinion have an inestimable impact on the awareness and thus on the long-term development and stability of the insurance markets and economies in the region. From the point of view of joint-stock companies, that advantage should by far outweigh the additional competition. From the point of view of the Middle Eastern societies and their ability to manage risks and uncertainty, it would be a huge achievement. And wasn't that, after all, the promise of takaful?

²⁶ Cf. the recent activities of the international community and Gönülal, 2012
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