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Takaful

Islamic finance is based on the principles of *shariah* (Islamic law). This entails the removal of interest (*riba*), excessive uncertainty (*gharar*), gambling (*maysir*) and the trade of prohibited items, such as alcohol, within the contracts and structuring and application of financial products when compared to conventional financial products. Parties must share the risks and rewards of a business or transaction, the transaction should have a real economic purpose without unnecessary speculation and not involve any exploitation of either party.

Internationally, the industries which have had exposure to this specialised field of financing have been the banking, insurance, equity and the bond markets.

Various types of Islamic finance products have been available for a number of years, but it is only within the last ten to fifteen years that the Islamic finance market has gained its momentum. Islamic finance products in the Far and Middle East, which have been available for a number of years, are at an advanced stage of development.

Products that are compliant with *shariah* are gaining wider understanding and acceptance and are slowly making their way into the mainstream market of financial products. To further elaborate, according to shariah the following are prohibited:

- The charging and receipt of interest (*riba*);
- Excessive uncertainty or deception (*gharar*), for example an ambiguity or lack of clarity in the terms of a contract that can give rise to speculation like short-selling;
- Gambling (*maysir*) or speculation, for example any transaction undertaken for purely speculative purposes; and
- Unethical investments, for example dealing in commodities that include, for example, alcohol, pork, pornography, conventional financial services and tobacco.

Consequently, financial institutions offering *shariah* compliant products observe five distinguishing features. All products:

- are interest free;
- are multi-purpose and not purely commercial;
- are based on risk sharing and strongly equity orientated;
- prohibit speculative behaviours and uncertain transactions; and
- limit transactions to *shariah* compliant activities.

This is achieved by having a *shariah* board approving and overseeing the *shariah* compliance of products.

Coming back to our shores, South Africa is home to almost two million Muslims (of the 60 million population) scattered across the various provinces. The Islamic finance market is dynamic and becoming more appealing not only to Muslims, but to non-Muslims too.

Islamic finance and the insurance sector

An industry that has shown immense growth across many countries in the world is the Islamic insurance industry. Islamic insurance, which is better known as *takaful*, is the way in which risk is managed in accordance with Islamic principles.

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According to the International Market Analysis Research and Consulting (IMARC) Group, the global *takaful* market reached a value of US$ 27.6 billion in 2021. Looking forward, it expects the market to reach US$ 49.8 billion by 2027.[1]

The difficulty with conventional insurance products is that there are a number of uncertainties within the underlying contract. In addition, there is an element of gambling ("you win, I lose" *or vice versa*) which results in these products not being *shariah* compliant and therefore not open to the Muslim community.

How is *takaful* different to conventional insurance?

Insurance is an agreement between the insured and the insurer. The insurer bears the risk, and in order to be insured, a fee, also known as a premium, is paid by the insured to the insurer (this is often referred to as the transfer of risk). These premiums are invested by insurers in businesses which may not be *shariah* compliant, including those with elements of *riba*, *maysir*, *gharar* and other investments (considered to be unethical for *shariah* compliance purposes).

Takaful companies are required to follow Islamic finance principles, such as producing *shariah*-compliant contracts for clients and appointing a board of *shariah* scholars to ensure that both the products and the operations of the company comply with *shariah*. Furthermore, *takaful* insurers are required to invest in *shariah*-compliant investment products, where possible. *Takaful* arrangements can be used to pool either non-life or life (known as family *takaful*) risks.

The main difference between conventional insurance and *takaful* lies in how each deal with risks and profits (the "uncertainties" and the "gambling"). Whereas conventional insurers take and retain insurance risk, *takaful* businesses are risk managers, because *takaful* operates on a risk-sharing model. The operator manages a pool of funds on behalf of the policyholders who benefit from the investment income and in return the operator earns only a management fee.

As there are no *takaful* regulations, *takaful* insurers would still be governed by the Insurance Act, as well as the supporting regulations set out by the Prudential Authority.

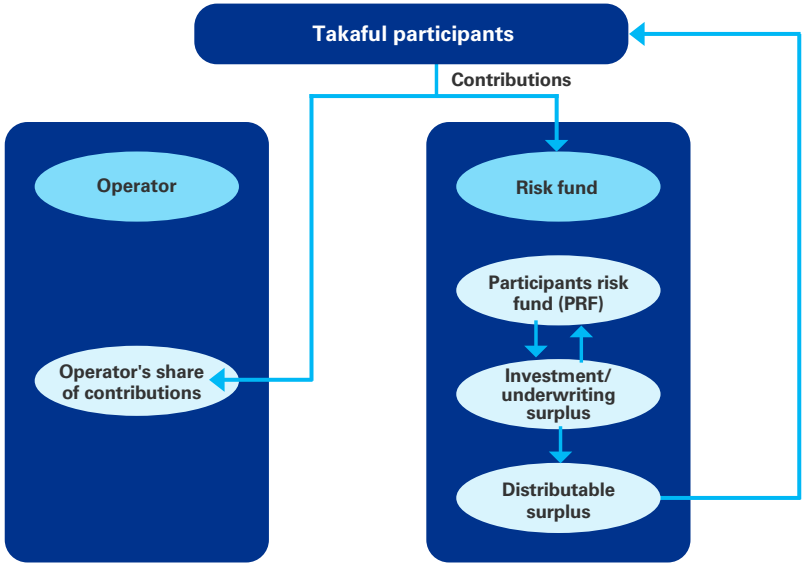
The transparency of contracts used in *takaful* and the avoidance of industries such as alcohol, gambling and tobacco in the investment portfolios of *takaful* companies potentially appeals to a wider category of non-Muslim customers seeking ethical financial services.

What *takaful* models are available?

With the establishment of a number of *takaful* models by Islamic scholars, there are now products available that assist in the mitigation of risk in accordance with Islamic principles. These can be found in the *wakala* (agency) model, *mudarabah* (profit and loss sharing) model as well as a hybrid *mudarabah* model, amongst others. The structuring of these products is based on models whereby every party to the fund contributes for the purpose of assisting other members of that fund who have undergone a loss.

While there are a number of models that are used globally and approved by Islamic scholars, for the purposes of this article we focus on the *wakala* model, which is essentially a pure arm's length concept and the most preferred model used locally.

***Wakala* (agency model)**



[1] https://www.imarcgroup.com/takaful-market

In the *wakala* model, the operator (insurer) acts as an agent of the participants and does not participate in the profits/losses of the business. The operator is paid a pre-agreed proportion of the contributions paid by the participants (policyholders), in return for running the insurance operations of the *takaful* business, on behalf of the policyholders. If the policyholders' fund makes a loss, the operator provides an interest-free loan to the policyholders' fund that is repaid out of future surpluses in the fund. This interest-free loan is known as a *qard hassan* and is extended by the lender to the borrower on the basis of benevolence.

Essentially the policyholder contributes to the pool of funds towards a common good. Further, reinsurance is permitted and conventional reinsurers can be used if suitable re-*takaful* insurers are not available, which will be done through guidance from the *shariah* board. This principle is known as *durura*, and finds application when there is an overriding necessity.

This structure may be operated through a division or 'window' within a business, similar to how some of the mainstream banking operations offer *shariah* compliant banking options. These divisions are typically aggregated as part of a statutory legal entity.

What further opportunities are there for *takaful* in South Africa?

There remains a misconception that Islamic finance products, and *takaful* by implication, is only available to the Muslim community.

With the rise of the ethical investor who seeks out ethically viable investment opportunities, *takaful* is an appealing alternative to consider owing to the nature in which the business is conducted and in how investments are made, the competitive pricing and the ability to participate in any surplus distributions. In addition, *takaful* operators are able to offer most conventional life and non-life insurance products (e.g. funeral cover, family insurance, property and casual insurance). Currently in South Africa there are only a few companies that offer *takaful* products, and this creates an opportunity for businesses to think of expanding into a niche market.

In more recent times, we have seen large South African medical aid insurers offer *shariah* compliant medical aid products. This is certainly an indication that the market recognises the opportunity and value in offering these products. With ESG currently being front and foremost on the minds of many a company executive, the ethical aspect underpinning *shariah* compliant products should increase their appeal to a broader audience.

From a tax perspective, we understand that *takaful* entities as operated under the *wakala* model are subject to existing tax legislation. However, should anomalies arise where for example a different model is used, we expect that National Treasury will amend legislation to put *takaful* on a similar playing field as conventional insurers. We saw this happen in 2010 when specific changes were made to the income tax legislation, the effect of which was to put Islamic finance, and conventional finance, on a similar footing. Since then, there has been little to no change from a legislative perspective on the tax treatment of Islamic finance.

** With thanks to Mahomed Akoob, who kindly assisted by sharing his time and experience for purposes of drafting this article. Mahomed Akoob is a non-executive director at Credit Guarantee Insurance Corporation of Africa Limited and Chedid Capital Holding, and the Chairman of the Bryte Insurance Company Takaful Committee.

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