Shari'ah and Ethical Issues in the Practice of Modified Wakalah Model in Family Takaful

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Abstract

Takaful has been acknowledged as insurance which is in line with Shari'ah principles. Due to the prohibited elements such as interest, uncertainty and gambling in the insurance practices, Takaful has been introduced by the Muslim scholars. Takaful is one of the fast growing industries in Islamic finance and it widely spreads into both Muslim and non-Muslim countries. The rapid growth of the industry does not mean that it is free from undesirable issues related to the Shari'ah and ethics. Therefore, the purpose of this paper is to highlight the Shari'ah and ethical issues in the practice of modified Wakalah model in family Takaful. This paper focuses on the issues arisen from the concept of Tabaru', surplus distribution and agency problem. These issues might be the mismatch of the original concept of Islamic principles and the current needs of the contracts. This paper does not intent to provide the solution for the issues and hence, future research should focus on it.

Keywords: Ethical, Family, Shari'ah, Wakalah, Takaful and Malaysia

1. Introduction

Takaful is one of the fast growing industries in Islamic finance. The span of Islamic finance and *Takaful* is growing remarkably fast not only in Gulf but also in non -Muslim countries. According to Keat (2009), expansion in the *Takaful* business has been robust in recent times. World Takaful Report (2010) also shows that the total amount of Takaful contribution has gradually increased from US$3.0 billion in year 2007 to US$8.9 billion in year 2010. Thus, it can be considered that Takaful is one of the fastest growing areas of International finance. The global Takaful industry with its modest beginnings in the early eighties with less than 10 players worldwide is now churning a multi-billion dollar business spanning across South-East Asia, Middle East, Africa, Central Asia and Europe with more than 200 players.

Hence, Islamic Insurance (Takaful) business has enormously growing and emerging continuously; nevertheless, there are still complications, difficulties and questions that impede the expansion and extension of Takaful industry. In order to address these challenges, obstacles and disputes and to accomplish further development and enlargement, we have to resolve the Shari'ah and ethical issues and problems.

A critical analysis of the modified Wakalah Family*Takaful* model described above will generate some ethical and Shari'ah issues which might cast disbelief in our mind as regards the permissibility from either Shari'ah or ethical (Adab) - which is also a component of Shari'ah. Although Shari'ah scholars are still debating on those issues, in the best interest of one's religion and honor, any form of unethical dealings or ambiguity in business transaction should be avoided. A Muslim whether individual or corporate does only avoid illegitimate means in the course of seeking his livelihood and provisions but also keeps a long distance from dubious and doubtful matters.

This paper is organized in five sections. The second section discusses Wakalah model in Family Takaful. The third section elaborates on the modified Wakalah model. The fourth section presents the Shari'ah and ethical issues in modified Wakalah model and the last section concludes.

2. Wakalah Model in Family Takaful

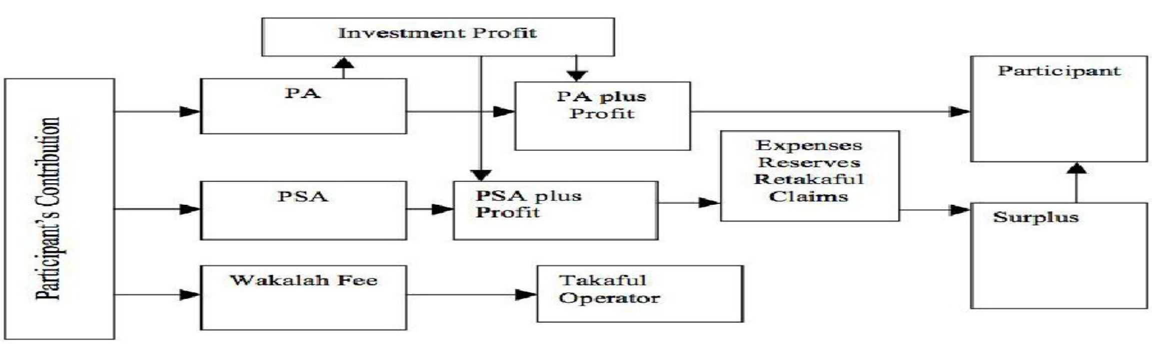
The term "*wakalah*" is a noun of the word '*wakala*' which means performing tasks on behalf of others, delegation of a task or job to another, and in English it generally means agency (Htay and Salman, 2013). The AAOIFI *Shari'ah* Standard No. 23 defines *wakalah* as "The act of one party delegating the other to act on its behalf in what can be the subject matter of delegation". Thus, *Wakalah* is a contract of agencywhere a person delegates his right or business to a second party to act as his representative in a financial transaction. The appointee is the agent or *Wakil* while the one whoappoints is called the principal.

Zainal (2008) gives a crystal-clear definition of *Wakalah* as when an entrepreneur is paid an agreed fee for applying his expertise in conducting a commercial activity but he will not share in the profit or loss which shall be returned to the providers of capital. The entrepreneur, in this case, must fully bear his own expenses. The definition given by Zainal (2008) is the one which has been used in Takaful practice. In applying this model to Takaful, the Takaful operator acts as an agent on behalf of the participants. In return for the services rendered, the operator is paid an agreed-upon predetermined fee. This fee can be a percentage of the contribution of total premium or an absolute amount. This is a fee on the portion of the contribution a general management fee and a fee on the investment of the contribution from the combination of general management fee and asset management fee (Warde, 2000; Jack et al., 2010). Generally, in Takaful scheme, there are essentially relationship that exists between two parties; i.e. Takaful operator and a group of participants. The relationship between participants is governed by the contracts of Takaful and Tabarru as obtainable in most countries while the relationship between participants and the Takaful operator is governed by the contract of *Wakalah* (agency), whereby the Takaful operator is appointed to manage the scheme. Nonetheless, it should be mentioned at this juncture that other Islamic contracts may also be combined with *Wakalah*.

3. Modified Wakalah Model in Family Takaful

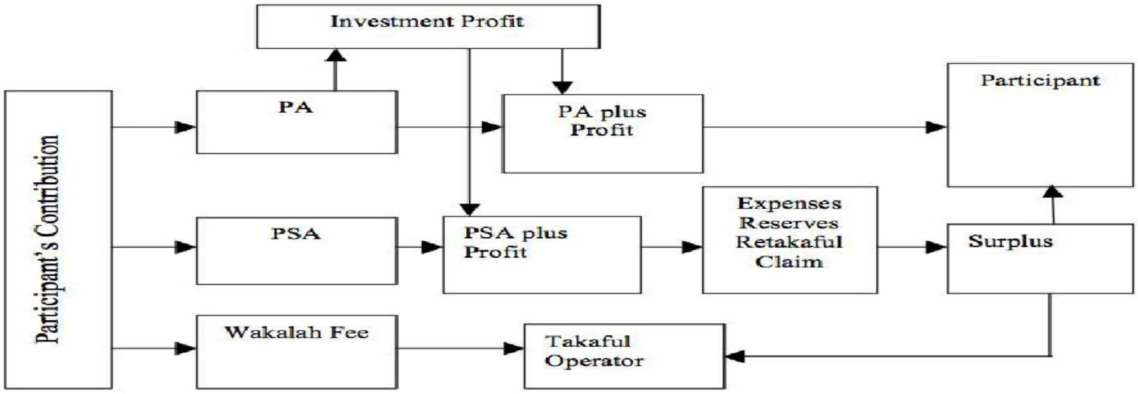
There are basically two forms of *Wakalah* model, namely pure *Wakalah* model and modified *Wakalah* model. In a pure *Wakalah* model, Takaful participants contribute to the Takaful fund on the basis of voluntary charitable contributions (Tabarru) to cooperate in mitigating (certain) risks suffered by members. The Takaful companies manage the Tabarru' fund, process claims and pay compensation, on the basis of agency contract by receiving the agent fee (*Wakalahbil-ajr*). The Takaful operator is authorized to invest a portion of the Takaful fund and thus is entitled to a fee for acting as the agent for investment. By virtue of the principle of *Wakalah*, the Takaful operator does not bear any liability for losses unless it has been negligent or misconduct; conversely, it does not participate with the Takaful participants in any profits.

Figure 1: Pure Wakalah Model



However, in a modified *Wakalah* model, participant contributes to the Takaful fund on the basis of donation (*Tabarru)* to cooperate in mitigating certain risks. The Takaful operator, as usual, manages the *Tabarru* fund, process claims and pay compensation, on the basis of agency contract by accepting the agent fee (*Wakalahbil-ajr*). The main difference between pure agency and modified agency is that, in modified agency, the Takaful operator shares with the participant in the surplus in the fund, if there is any. This is justified on the basis of an incentive, or what is called *Ju'ala* (performance fee) for a job well done.

Figure 2, Modified Wakalah Model



4. Shari'ah and Ethical Issues in Modified Wakalah Model

4.1 Issues in the Implication of the Concept of Tabarru'

Tabarru could carry so many meanings such as contribution, gift, donation or charity. In technical sense, it is a unilateral declaration of intent, which is a contract with a particular nature in Islamic commercial law. *Tabarru*is basically to give a favor to the recipient without any specific consideration in return. By definition, according to Dusuki at el., (2012) Tabarru' is essentially a contribution or donation which entails no return but rather a reward from Allah alone. As regards this, two important pillars of *Tabarru* are identified; namely the intention to perform Tabarru and the absence of counter-value. If any of or both of the two are absent it is no longer considered*Tabarru*. For instance, if a donor contributes with an expectation of a counter-value from the donation given, then the whole transaction will be perceived as an exchange (*muawadah*) rather than *Tabarru* contract (Dusuki at el., 2012). The Prophet (s.a.w) said: "He who retracts his hibah is like the one who swallows what he vomits". Thus, it makes it forbidden to retract the gift on whatever grounds or even to benefit from it in one way or the other. Thus, the concept of *Tabarru'* seems to apply that the moment a donor gives out his asset as *Tabarru*, he relinquishes his ownership to the second party who now takes full ownership and possession of the property or asset.

However, the current practice in modified *Wakalah*model, a donor or a participant can still be entitling to claim in the case of misfortune. Thus, it becomes a major controversial issue among the Shari'ah scholars on who actually owns the *Tabarru* fund, i.e., whether it is owned by the participants, the Takaful operator or jointly owned by both. One of the leading scholars in this contemporary era, Yusuf Qaradawipoints out that in order for Tabarru' based Takaful to be legitimate, the member who contributes forTabarru' should not entitle to receive a pre-determined amount in the event of an unforeseen calamity. Rather, he will be paid an amount which will compensate his loss or part of it, depending on the availability ofthe pooled fund.This opinion gives a picture that once *Tabarru* has been made; one has relinquished one's ownership of the asset and so should not expect any fixed amount of gains or returns there from. This issue has been a great debate among *Shari'ah* scholars until now.

4.2 Issues in Sharing of Underwriting Surplus

The current practice in modified Wakalah model is that surplus from Tabarru' risk fund is shared between the participants and Takaful operators. There are three different opinions on this issue (YounesSoualhi, 2008; Vijalapuram, 2012)and they are as follows:

- **(a)** Since the Takaful Operator is paid the agent fee as management compensation and the Takaful risk fund belongs to the participants, the surplus from the risk fund should belong to the participants only. Thus, Takaful operator should not share the surplus.
- **(b)** The surplus earned is borne out of the Takaful operator's sound risk management, thus, a portion of the surplus should be distributed to the Takaful operator as a reward or incentive (*Ju'ala*) for a job well done.
- **(c)** None of the parties (Takaful Operator and participants) should benefit from the underwriting surplus since favourable underwriting experience is deemed to be made possible by Allah. Hence, all such surpluses should be given out as charity in the true spirit of Takaful.

If the ownership issue is resolved from the line of argument of the Quran and Sunnah, the issue of surplus sharing will be permanently laid to rest.The opposition of the first opinion believes that the Takaful operator has deducted agent fee upfront from the fund and again the operator is going to share the surplus, it seems not to be in line with Islamic ethics. It will lead to unjust to the participants. In the same token, Allah also encourages in the Quranic verse (4:29) as follows: *"Do not devour another's property wrongfully – unless it be by trade based on mutual consent"*.Hence, all earnings that are not established on justice and fairness are forbidden. Furthermore, the Holy Prophet (s.a.w) was asked one day: *"What form of gain is the best? He replied, A man's work with his hands, and every legitimate sale"* (Ahmad, No: 1576). If a man actually earns from what he has not worked for in terms of business dealings or contract, he has succeeded in eating haram (Forbidden).

4.3 Agency Problem

In addition to the issues above, the agency problem can be another issue that might arise in the modified *Wakalah* model. According to Jensen and Meckling (1976), the agency relationship is defined as a contract under which one party (the principal) engages another party (the agent) to perform some services on the principal's behalf. The principal will delegate some decision-making authority to the agent. According to the agency theory relationship, the Takaful operators (as agents), are delegated the authority by the participants (as principals) to manage the Takaful fund. Therefore, the Takaful operators are supposed to perform according to the interests of the participants. However, due to the separation of ownership and control, agency problems, i.e. moral hazard and adverse selection could occur and Takaful operators might maximize their own interests at the expense of the participants (Millson& Ward, 2005). Thus, the main issue from the agency theory is the existence of agency cost, i.e. the difference in value of the firms between hundred percent owner managed and not hundred percent owner managed firms (Mueller, 2006; Williams et al., 2006). In Takaful, the principal of *Wakalah* is a contract between Takaful operator and participants. This contract enables the agent to render services and be paid a fee. The basic principles of *Wakalah* include (a) an agency contract between an agent and principal, (b) a facility to enable transactions to take place and (c) a fee earned by the agent for service rendered.

Based on the above, the Takaful operator can only earn the fees for services rendered. From the Shari'ah perspective, the *Wakil* (agent) cannot share the profit and is not responsible for any losses, except in cases of negligence and misconduct. Thus the agent might not be motivated to perform better since he cannot share the profit. In some cases, however, the agent is promised performance fee for any sound management of the fund, this leads to another problem of personal aggrandizement. This promise makes him place his personal interest over any other interest. Thus, in this situation, the agent might try to maximise profit at minimum expenses by denying the participant who suffers loss from being adequately indemnified. It will result in unethical practice and it is not permissible in Islam. The Prophet (s.a.w) is reported to have said: "*Each one of you has a responsibility and each one of you is responsible towards those under your responsibility"* (Reported by Bukhari and Muslim).

In another tradition reported by Bukhari, the Prophet (s. a.w) said *"One is not judged as righteous until he cares for his brother as much as he cares for himself"*. Similarly, the Prophet (s. a.w) said: "*If any one does not have compassion toward others then, he does not get compassion from Allah"* (Reported by Bukhari and Muslim). Therefore, it is clear that Islam requires every believer to cleanse his soul and reduce selfishness as much as possible.Moreover, information asymmetry is another issue in Wakalah contract. The agent, usually, has more information and uses it to his advantage. The agent, i.e. the Takaful operator receives an upfront fee which is a percentage of the contribution or premium and solely determined by him. He does the underwriting, determines the contribution rates, hires and trains sales agent, if any, and sets the fee structure with the participant. The situation becomes worse when the participants do not have representation in the board of directors and do not have any legal right to retain and fire a director. All of these are ethically unfair to the participants who have little or no information about the Takaful operator The Holy Prophet Peace be upon him has not only disapproved of certain forms of business transactions, but has also stipulated certain conditions that must be fulfilled in every transaction to make it lawful. Islam tries to be fair to both parties to a transaction. Any step on the part of one, that is advantageous to him and disadvantageous to the other, is not permissible.

5. Conclusion

The progress of the Takaful industry is indeed impressive and this will attract more market players in the form of Takaful windows or full-fledged Takaful operators. However, the most important factors for successful Takaful operations are the transparency of operations, the establishment of Shari'ah-compliant products as well as a robust Shari'ah supervisory board that ensures complete adherence to Shari'ah principles in both form and substance. However, this paper aims to highlight the Shari'ah and ethical issues in the practice of modified wakalah model for family takaful products in Malaysia. We suggest the unfavorable Shari'ah and ethical issues should be resolved as soon as possible and the regulators should improve the existing model or introduce or recommend the new model to reflect the concept of donation and mutual help.

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