

## **Notes on Islamic Finance and Insurance**

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## ISLAMIC FINANCE: AN ETHICAL ALTERNATIVE TO CONVENTIONAL FINANCE

By H Abdur Raqeeb

Robert E Michael, the Head of Islamic Finance at the New York City Bar, when asked whether Islamic Finance is a viable alternative in the current crisis, responded saying: *"The answer is clearly yes, but for two mutually exclusive reasons. On the one hand, it is clear that, properly employed, Quranic restrictions would have prevented the excesses of leverage and gambling on derivatives that lead to the current collapse; on the other hand, however, those same restrictions would have prevented our western economies from reaching anywhere near the levels of size and complexity we enjoy that make it possible for such enormous problems to occur"*

*"The global Islamic finance industry, valued by the Asian Development Bank at US \$ 1 trillion, has been regarded by some investors as a safer alternative as the shariah forbids complex, opaque financing structures similar to sub-prime loans that triggered the US housing collapse"* Bank Negara governor Tan Sri Dr. Zeti Aziz said in a speech at a SHARIAH BANKING CONFERENCE in Boston.

*"The current global market conditions has given Islamic finance a great opportunity to show what it can do-help to fill the liquidity gap"*, said David Testa, chief executive of Gatehouse Bank Plc which began operations as Britain's fifth Islamic bank. Testa said that Islamic finance practices were fiscally conservative, with genuine end-investor participation that did not involve parking of assets in off-balance sheet vehicles.

The former British Prime Minister, Gordon Brown, said at the G20 meet that:*"It is time for a value based market which is premised on a shared global ethics. A market with morals is possible based on demanding responsibility from all and fairness to all"*.

*"As trust in conventional markets continues to erode, Islamic finance as an industry is rapidly evolving into a viable alternative to conventional sources and forms of capital for Muslims and non-Muslims business. To describe Islamic finance as simply a system of finance that happens to be devoid of interest understates the true nature of the Islamic ideal, namely the fair and equitable exchange between two parties. Islamic finance is the execution of financial transaction through a trusted third party that acts to balance risk and return between parties. Corporations such as Tesco (UK) and Toyota (Japan) have used Islamic financial instruments to meet their capital requirements"* writes Joseph Divanna & Antoine Sreih in their new book: A New Financial Dawn, the rise of Islamic Finance

### 1. PRINCIPLES OF ISLAMIC FINANCE

The most important principles on which the modern Islamic finance framework rests on:

- **Prohibition of the payment or receipt of interest:** Money itself is considered to have no intrinsic value-it is merely a store of wealth and medium of exchange.
- **Prohibition of uncertainty or speculation:** Everybody participating in a financial transaction must be adequately informed and not cheated or misled. Derivatives and debt financing is prohibited.

- **Prohibition of financing certain economic sectors:** Investment is forbidden in what are considered to be socially detrimental activities like gambling, pornography, alcohol, armaments, etc.
- **Importance of profit and loss sharing:** The investor and investee must share the risk of all financial transactions; and
- **Asset-backing principle:** Financial transactions should be unpinned by an identifiable and tangible underlying asset.

## 2. COMMON INSTRUMENTS OF ISLAMIC FINANCE

Some common financial instruments currently being utilised in Islamic finance in various forms are as follows.

- **For financing working capital and liquidity management**

**Murabaha:** This is effectively cost-plus financing, as used for trade and asset finance, allowing deferred payment by customers rather than lending money as in conventional loan. The bank purchases the requested commodity (thereby taking it on risk) and sells it to the customer at the agreed mark-up price. In recent times, murabaha contracts have been the instrument of choice for many financial products, be it trade and asset finance or the provision of working capital facilities.

**Istisna'a:** Along with murabaha products, it is one of two types of finance which allows the sale of a commodity prior to production. Istisna'a contracts are clearly aimed at long-term projects, and are frequently used to finance the construction of real estate developments and large assets such as ships.

- **For asset finance**

**Ijara:** This is a quasi-debt instrument, essentially equivalent to leasing. Often used in the context of home purchasing, most aspects of an ijara are the same as those of conventional leasing, whereby the investor (lessor) purchases and leases the underlying asset to the prospective borrower (lessee) for a specified rent and term. Ijara are frequently used to finance the acquisition of real estate and equipment, although they have also been utilised to affect leveraged buy-outs in private equity transactions.

**Diminishing musharakah:** Recent times have witnessed a shift in emphasis away from ijara towards diminishing musharakah (DM) as a mode of financing Islamic mortgages. Many of the major Islamic mortgage providers have either already switched to DM (HSBC Amanah uses DM) or are planning to do so imminently. DM is a hybrid financing technique involving both ijara and musharakah. It appeals to Islamic investors because it is based on the fundamental principle of sharing risk. The attraction for financiers is twofold, in that it can incorporate a variable rate of return and has a credit profile that would be acceptable to most conventional institutions.

- **Equity based instruments**

**Musharakah:** This is akin to a joint venture arrangement, through an equity participation contract. Ownership is distributed according to each partner's share in the financing, and profit and loss is shared by the partners. Such contracts are often used in connection with large project finance and private equity funds. Despite it being a preferred option by many Islamic scholars, musharakah captures only a tiny portion of all Islamic finance.

**Mudarabah:** This is essentially an investment fund where one party provides the entire capital, and the other party provides the management (usually the bank, but can be the reverse). Profit sharing is agreed up-front, although the loss is borne by the provider of the funds alone.

- **Fixed income investment**

**Sukuk:** This is an investment certificate (bond) that represents a proportionate interest in a well-defined pool of assets that yield income and capital returns. Usually setup through the conventional securitisation process, with a special purpose vehicle acquiring the assets, the returns from the assets are passed to sukuk holders (investors). Nowadays popular asset classes have included real estate. This method has been a popular way for many governments to raise funds for infrastructure, and accounts for the largest portion of Islamic finance.

### 3. TWO IMPORTANT CHARACTERISTICS

- **Distribution of Wealth**

The wealth produced in a society must be distributed in a just and fair manner, so that it may not be concentrated in the hands of a few people. The Holy Quran says: 'so that it may not circulate only among the rich among you' (Holy Quran 59:7)

20 richest Indians earn as much as what 30 crores poorest people are earning, writes Bimal Jalan, former RBI Governor. While GDP growth is nearly 9%, Aam Aadmi, the 860 million marginalised Indians earn only Rs 20 per day. The system has created two sections in our societies: super rich and super poor.

The study by specialists at Oxford University based on an innovatory 'multidimensional poverty index' or MPI, more than 410 millions people live in poverty in the Indian states. The study's conclusions reinforce claims that distribution of wealth generated by India's rapid economic growth (10 percent in one year, recently) is deeply unequal. Even though after Prime Minister Dr. Manmohan Singh's repeated statement that he wants to see 'inclusive' development.

Islamic finance set values and principles that may remove this disparity and provide justice and equity for all.

- **Financial Economy Vs Real Economy**

The real economy consists of land and agriculture, factories and manufacturing goods etc. These are the tangible goods which can be traded, leased and sold. They are physical goods which are produced, and people are employed to make them. But financial economy consists of tradable paper with financial values that rise and fall based upon the value. People give them without backing real assets, which is beautifully termed as 'Financial Engineering'.

Sustainable economic growth needs to go through a proper development process

a) Develop agriculture

b) Develop Industry

c) Develop services

Real economy has to avoid temptation to copy western developed economies in their promotion of developing the services sector, while forgetting to develop the two underlying primary sectors. Also there is a challenge in finding and financing tomorrow's technology which will have direct implication and application today.

#### **4. ECONOMICS AND FINANCIAL INSTITUTIONS TO BE STRENGTHENED**

- **Zakah**

Collective system of zakah and its proper distribution has to be strengthened as it was prevalent in the days of the prophet and up to the seventh century hijra, till the invasion of the Tatars Conceptually. Zakah is supposed to be a major instrument for social security, eradicating poverty, curbing excessive economic disparities and stimulating economic activity by transferring substantial purchasing power to the have-nots.

In Malaysia and South Africa a system is evolved with a rehabilitative mechanism is successfully evolved categorising the poor into two categories i.e., Productive Poor and Unproductive Poor and treating them separately.

To begin with, in towns and villages, each mohalla with a mosque should form an NGO wherein a committee of 4-5 persons with skills and spirits is formed to collect zakath and sadaqat. Based on the survey of the area, the basic needs of the marginalised and needy sections can be addressed.

- **Waqf**

The institution of waqf provides a foundation set up by keeping a property in perpetual existence and making its income available for specified beneficiaries which plays an important social and economic role. The waqf properties have traditionally financed expenditure on mosques, schools, research,

hospitals, social services, etc. Today it can support microfinance institutions that can provide interest free loans to the needy and marginalised sections of the society.

- **Insurance**

The conventional insurance system is based on gharar (speculation) and maysar (gambling) and the investments are made on unethical businesses, a new system has been evolved called Takaful based on Islamic principles.

- **Microfinance**

Based on the successful experiments of Prof. Yunus of Bangladesh Grameen Banks, similar institutions are the need of the hour. Self Help Group (SHG) formed, finance collected and guidance provided to earn the decent livelihood to the needy has to be evolved. Finance provided has to be interest free and the development should focus on the family instead of only women folk.

- **Islamic Banks**

Almost non-existent 30 years ago, modern Islamic finance has risen to become a trillion dollar industry. The sector, though small in global terms, appears to have held up well in the crisis, with the Asian Development Bank putting annual growth at more than 15% over the next 5-10 years. Long focused on a potential global market of 1.5 billion Muslims, Islamic banking is now drawing attention from players the world over. Nowadays, major establishments such as Al Rajhi Bank of Saudi Arabia, the Kuwait Finance House, and Malaysia's Islamic bank may compete with western financial institutions such as Barclays, HSBC and Deutsche Bank.

Several banks have set up separate Islamic financial services departments in their home markets as well. In the UK, the Financial Services Authority has introduced regulatory standards for Islamic financial products and has a separate department dealing with Islamic financial institutions. Moreover, non-Muslims make up as much as half of Islamic bank customers in some cases. Similar developments have taken place in Singapore, Japan, Hong Kong and France. If London, Singapore, Hong Kong, Tokyo and Paris can become hub and house of Islamic finance and banking why not Mumbai and Kochin?

Committee on Financial Sector Reforms (CFSR) of the Planning Commission of India headed by Dr Raghuram Rajan has recommended interest free finance in the main banking sector of the country for inclusive growth with innovation.

Recently Dr. MS Swaminathan, father of green revolution has suggested Islamic Banking with zero interest to be the solution to the crisis of the farmers' suicide deaths in Vidharba and even Vatican has offered Islamic finance principles to Western banks as a solution for worldwide economic crisis.

## **CONCLUSION**

The challenge of the 21st century lies in inventing and implementing a mechanism that would be able to unshackle humanity from the bonds of money-an era of human supremacy over money rather than money over human beings. Although interest on finance has been denounced by all religions, a serious effort has to be made to find out a practical mechanism to provide institutional finance on an interest free basis.

We need to offer an alternative in the form of Islamic finance free from interest, speculation, financial engineering and concentration of wealth in the hands of a few in this 21st century and develop a practical mechanism to make finance available free of cost. All other strategies to promote world prosperity and peace are likely to fail if adequate finance is not available .Therefore, firstly, we should try to overcome the most insurmountable of all obstacles. It would be an era of prosperity for all.

The suggestion may seem to be utopian to some. But history gives us hope and courage. There was a time when ideas like abolition of slavery, the introduction of adult suffrage, education for all, and equality between men and women were wild dreams of visionaries. Few decades back, the vision of an interest -free world was considered as impractical concept. Given the ingenuity and will of man, however, this dream can come true. It would make the 21st century worth living. It would virtually transform the whole earth into a heaven.

## **CORPORATE FINANCE IN ISLAMIC PERSPECTIVE**

By Dr. Waquar Anwar

At the outset it is felt necessary to delineate the topic and its parlance so that its purpose and contour may be appreciated in their proper perspectives.

The topic may be translated into other words as the management of finance for corporate bodies. Management of finance encompasses arrangement, maintenance and application of funds. In this write-up we shall dwell upon only some aspects of the first part; i.e. arrangement of finance.

Corporate bodies would mean organisations that are formed under a statute or those which attract legal obligation. Such an organisation may be a Sole Proprietorship, a Partnership, a Company, an Association of Person (AOP), a Body of Individuals (BOI) or any other organisation with any other name under any legal system. The legal system may not require prior registration under an act of law but such entities entail legal obligations like payment of tax on income. In other words, organisations which have distinct legal identity may be called corporate entities.

Our concern in this paper is primarily finance of a typical business corporation. Literally, the word “corporate” would cover legal entities of both charitable and business-related establishments. But when the connotation “Corporate Finance” is used, the former activity gets lost! It is production and service activity that remains relevant. Similar is the case of funds required for consumption or contingencies of humanitarian nature; the term finance is a misnomer when used in these cases. We are using the expression finance or financing solely for production and service based business activities.

Another aspect which needs mention here is that we are considering the subject from the angle of production/service units and are relatively less concerned with the angle of fund providers, be they banks or other financial institutions. The overwhelming majority, if not entire, of literature on Islamic finance and research work being done or “standard” developed during the last three to four decades is from the angle of fund providers. That is why even the funding of consumption needs like purchase of cars and houses has been understood as financing. Obviously, for fund providers, that too is business; and it is their business to earn profit therefrom. A basic reason of that lopsided development in Islamic finance is

that the environment in which these so-called Islamic financing activities have developed has been of rentier-economy instead of production-based economy.

## ISLAMIC PERSPECTIVE

Islam, as such, is not the author of business systems like “*shirkat*” or “*mudharabat*.” These systems of business were in vogue at the time of Prophet Muhammad (peace and blessings of Allah be to him). He either maintained silence about them (*taqreer*) or corrected wrong practices (*naha an rasoolullah*). Both the silence of the holy Prophet on a practice in his times and the corrections in practices done by him are part of his traditions (*sunnah*). Further the Qur’ān provides certain specific commandments. So we find that business practices like “*shirkat*” and “*mudharabat*” were in practice from earlier times and the commandments of the Qur’ān and the traditions of the Prophet (peace and blessings of Allah be to him) let them continue with certain amendments. Silence was maintained on practices which were in order and corrections were done only where required. The Qur’ān and traditions of the Prophet provide the bases on which corrections in practices can be done wherever required in any period, including our time, the present.

Islamic scholars have opined that the purpose of the corrections done in prevalent business practices was to check any one or more of the following abhorring and harmful activities:

1. *Riba* – Interest (Increase in debt)
2. *Maysir/Qimar* - Gambling
3. *Gharar* - Misleading the other party
4. *Dharar* - Causing harm or getting harmed
5. *Jihl mufdhi ilan-niza* - Lack of material information leading to dispute
6. *Tadlees* - Misrepresentation and causing wrong impression about the product
7. *Taghreer* - False description of goods
8. *Ghaban* – Check on excessive profiteering
9. *Khulaba* - Impressing buyers by gestures and sales talk/ art of deceit
10. *Ihtikar* - Hoarding of food grains and essential items
11. *Baiatain fil bai* - Two-in-one transaction / Conditional deal

12. *Kharaj* without *dhaman* – Earning profit without corresponding risk/authority/possession.
13. *Bai madoom* – Dealing in non-existing product
14. *Malikil ghair* – Transaction in products that are in the possession of any other person
15. *La khilabah wa Khayarat* – No fraud and the right (option) of revisiting transactions

[Waqar Anwar, *Business Transactions in Islam*, Markazi Maktaba Islami Publishers, New Delhi, pp. 47-48]

Islam stands for welfare of human beings and the above mentioned provisions are meant to ensure justice for all so that the desired prosperity in human society may be achieved. The ingrained principle of business transactions in Islam may be summed up as JUSTICE, EQUITY, GROWTH AND WELFARE. Eradication of corruptions is required to ensure achievement of these goals. This can be done by ensuring that the higher objectives of Islamic law are adhered to. Islamic scholars have described these higher objectives of Islamic law as Protection of Life, Religion, Reason, Progeny and Property, as also preservation of dignity and freedom. (*maslaha & maqasid al-shari'ah*)

[Mohammad Nijatullah Siddiqi, *Riba, Bank Interest and the Rationale of Its Prohibition*, Markazi Maktaba Islami Publishers, New Delhi, p. 20]

## **THE COURSE OF ACTION TODAY**

The road ahead today is the same. We do not have to re-create any old system, as such. The approach should be to study the prevalent business systems and carry on corrections based on the cardinal principle of ensuring Justice, Equity, Growth and Welfare. One has to keep in mind the relevant provisions of the Qur'ān and Sunnah and the valuable works done by Islamic scholars in finding and describing the principles emanating therefrom. That is the basis of further works on the subject. One need not (as he cannot) recreate the past.

The discussion above can be elaborated with the help of one example. Take the case of a joint-stock company. It is a new development and its issues cannot be based on old business practices. This writer approached different sources to understand the relationship between shareholders and a joint stock company and got following replies.

- It is *shirkat* because all the shareholders are joint owners;
- It is *mudharabat* because individual shareholders simply provide funds and sit back and the business is done by the promoters of the company;
- It is *shirkat* because *mudharabat* is nothing but an extension of the former; and
- The concept of limited liability is a fraud on society so the whole thing needs to be abolished and an entirely new system akin to those in the past are required to be recreated.

As regards the last mentioned opinion, it is simply a denial mode. It appears simple to say that anything is wrong *ab intio* so we need to abolish it altogether and create an entirely new system or re-create the past. Life does not move like this. Further development of Islamic thought too has not been in such a renunciation fashion. The other positions, as above, taken by the scholars of the present have far reaching consequences as they tend to apply the principles delineated by the scholars of the past severally about them.

The correct position is that it is none of the above. It is an entirely new phenomenon; so one need not apply an old parlance for this new phenomenon. There is the need to analyse afresh this new situation and take new positions in the light of the provisions of our basic source and the principles developed by our past scholars.

Further, one should look into the deliberations of contemporary scholars and checks and balances developed to combat ill practices. For example, a worthwhile literature is available on the issue of corporate governance or on ensuring rights of minority shareholders or on lifting corporate veil or on disclosure requirements with Balance Sheets. Many of these are concerned with checking monetary and other frauds being perpetuated by mighty few on the hapless majority of shareholders.

## **PROFIT SHARING AND LOSS BEARING**

There is a basic difference affecting corporate finance between *shirkat* and *mudharabat*. Scholars agree that distribution of profit in both the formats shall be done on the ratios agreed between them. Loss will, however, be borne by them on the ratios of their respective capital in the business. As in *mudharabat* capital is provided by the passive partner and active partner does not provide any capital,

the burden of loss shall entirely be on the former. [Siddiqi, *Shirkat-o-Mudharabat ke Shara'i Usool*, Markazi Maktaba Islami Publishers, New Delhi, pp. 14-15]

This issue needs to be examined afresh in view of the contemporary situations. The case of an active partner with no capital is an uncommon event. In the case of a passive partner joining in a running business, some amount of capital is always invested. That capital may also include goodwill of the business which may be accounted for on some agreed basis. The only possibility of nil capital of the active partner is in the case of a new business. That too is not common these days. Fund providers insist on margin money of the active partner and this makes the venture a *shirkat*. One may safely conclude that the contemporary corporate finance scenario is more akin to active partnership (*shirkat*). Pure passive partnership (*mudharabat*) is an exceptional, if not far-fetched, situation. Even in banking business the position that our scholars have taken that it is *mudharabat* between the depositors and the banks can be challenged as no financial institutions can be allowed to begin business without seed money/initial capital. So the funds of the banks too are involved. The opinion that losses in an Islamic banking business shall be borne only by the depositors needs reconsideration.

### **IN THE CASE OF LOSS**

Loss, according to Islamic scholars is erosion of capital and will be borne by the partners on the basis of their respective capital. This principle of distribution of loss on capital ratio has been recognised in the contemporary accountancy practice and referred to as Garner vs. Murray rule. However, that rule relates to insolvency stage of a partnership business whereas the stand of the Islamic scholars is that it should be applied as a matter of routine.

This is a basic requirement in financing under Islamic perspective that all the parties should mutually agree on the quantum of their capitals and the method for accounting of capital. The prospective partners should agree at least on following two issues:

1. Accounting or otherwise of goodwill of the older partner, where a new one is joining at a later stage.
2. Basis of accounting of capital; either on Fixed Capital or Fluctuating Capital systems. This is particularly relevant for sharing of interim losses.

For short term financing arrangements, either in the beginning of any venture or project financing in later periods, it is advisable to opt for Fixed Capital system considering the initial share in finance as the basis on which losses would be borne.

## **SHORT TERM FINANCING**

The object of this paper is to initiate a discussion on corporate finance. One such aspect for discussion is the case of financing in following two situations.

1. Short term partnership in the initial period of business
2. Project financing in the interim period

As against the practice of business partnership for long periods, the practice of short term financial arrangement in the initial period of a business has very good potential. This has resulted in enormous growth in Silicon Valley in the USA. This type of finance is provided by venture capitalists or angel financiers on equity basis. Venture capitalists arrange their own fund on mutual fund basis and invest in prospective businesses. Angel financiers, on the other hand, are individuals with surplus fund who enter into such arrangements. Such finance providers remain partners for few years and then take back their capital and accumulated profits and let the business continue as usual. So the issue that has to be resolved by Islamic scholars is that of ascertainment of profit or loss in the period of association and the accounting at the close of the venture without closing the business.

The margin required to be invested by the entrepreneur is his share of capital and the investment by the venture/angel capitalists is their share. Thus if the funding is done on a margin of 15% the capital ratio between entrepreneur and financier is 15:85.

An ongoing business may need short term financial arrangement to finance a particular project. This is the case of a business continuing before this arrangement and which shall continue in future after the expiry of this. A method for profit sharing by short term partners is proposed with the help of following computation.

### A TYPICAL PROFIT AND LOSS ACCOUNT

Particulars	Rs.	Rs.
Sales		200,000
Add: Closing Stock		20,000
		220,000
Less: Opening Stock	30,000	
Purchase	60,000	
Wages	15,000	
Other Direct manufacturing expenses	10,000	(115,000)
Gross Profit (GP)		105,000
Less: Salaries	15,000	
Other Overheads	25,000	(40,000)
Profit before tax and depreciation (PBDT)		65,000
Less: Depreciation		(12,000)
Profit before tax (PBT)		53,000
Less: Tax		(13,000)
Net Profit (NP)		40,000

The parties may agree to share profitability on the basis of Gross Profit (GP), or on Profit Before Depreciation and Tax (PBDT) or at Profit Before Tax (PBT) or at Net Profit (NP).

This system is advantageous to the entrepreneur because he need not share his total business accounting and, may be, trade secrets with the project financier. Sharing information up to the stage agreed for profit sharing shall suffice. However, this system has the disadvantage that the entrepreneur may actually suffer loss after full accounting although he might have provided share of 'profit' to the project financier earlier!

The advantage described in the above paragraph may be ensured while avoiding the disadvantage by adopting marginal costing method; bifurcating expenses into fixed and variable. In that case profitability may be shared at 'contribution' which is computed by deducting variable expenses from gross income/sales. This system is justified where fixed expenses are recovered by the business as usual. So the marginal increase in profit on account of the new project may be shared between the entrepreneur and the project financier.

Computations in the following table have been done in order to elaborate the proposal as above.

**A TYPICAL PROFIT AND LOSS ACCOUNT PREPARED ON MARGINAL COSTING METHOD**

Particulars	Rs.
Gross Income	900,000
less: Variable expenses	(550,000)
Contribution	350,000
Less: Fixed expenses	(100,000)
Profit before tax and depreciation	250,000
Depreciation	(30,000)
Profit before tax	220,000
Tax	(2,100)
Net Profit	217,900

The data as above has been used from the final account of a software professional. He has negotiated for a software development job which will yield an additional income of Rs.500,000 and the additional expenses estimated by him is Rs. 225,000 as the cost of engaging/outsourcing professional for completing the job.

He envisages no further fixed expenses because the existing business will take care of his expenses like office rent and other office establishment expenses. He needs fund for executing this job and a friend is ready to finance up to Rs.400,000. So based on this the real time data the entrepreneur wants to know the basis of sharing profit with his friend without sharing his existing business details.

Contribution from this project is Rs.500,000 minus Rs.225,000 = Rs.275,000

However, he will require one computer with proper systems to execute the job which will cost him further Rs.100,000. As this new asset will remain with him even after the project period it will not be justified to charge this cost in total on the project. He can at best charge depreciation on this asset for the period of the project. Considering the project period to be 9 months and rate of depreciation

on computer and its software as 60% the share of chargeable depreciation on the project shall be 60% of Rs. 100,000\*9/12 = Rs. 45,000.

Thus profit may finally be shared on the differential gain as under  
 = Contribution minus depreciation  
 = Rs.275,000 – Rs.45,000  
 = Rs.230,000

This gain can be shared by them on any agreed ratio. However, ratio for sharing loss between the entrepreneur and the financier shall be 1:4.

The final account of the entrepreneur after executing this arrangement may be as under:

Particulars	Rs.
Gross Income	1400,000
less: Variable expenses	(775,000)
Contribution	625,000
Less: Fixed expenses	(100,000)
Profit before tax and depreciation	525,000
Depreciation	(90,000)
Profit before tax	435,000
Tax	(24,200)
Net Profit	410,800

Thus we may conclude that issues relating to corporate finance in Islamic perspective may be resolved on case to case basis.

## A PRIMER ON ISLAMIC INSURANCE (TAKAFUL)

By Dr. Shariq Nisar

### Introduction:

The word Takaful comes from Arabic word (k.f.l.) which means guarantee. Takaful works on the principle of cooperation and mutual help among the members of a defined group. In other words Takaful is a method of joint guarantee among a group of members or participants against loss or damage that may inflict upon any of them. The members of the group by pooling their contributions agree to guarantee jointly that should any of them suffer a catastrophe or disaster, he would receive certain sum of money to meet the loss or damage. Currently there are about 150 Takaful companies operating in about 40 countries. Business of Takaful is growing at 20 % per annum. Currently Takaful premiums are estimated at USD 3 billion of which 60% is in Genral Takaful and remaining 40% in family Takaful. Largest market of Takaful is in South East Asia followed by Middle East, Africa, Europe and others.

Actually Takaful or Islamic insurance is an alternate form of insurance which works in accordance with Shariah. Shariah basically is an understanding of Islamic Law. The codified form of Islamic law is known as Islamic *Fiqh* (jurisprudence). In that sense Shariah is a wider term denoting an abstract form of law capable of adaptation, development and further interpretation. Most important source o Shariah is Muslims' holy book (i.e. *Quran*) and recorded traditions of the Prophet (*Sunnah*). There are some secondary sources of the Shariah as well which includes analogical deduction, reasoning, consensus of scholars, customs which are not contrary to Islamic ethos and aim of public welfare (of course all these secondary drive their authority from the primary sources. Contrary to the public perception shariah has the capacity of adapting and developing itself in the light of emerging situation. However there are few fundamental things which are unalterable and these includes those things which are prohibited in Quran and *Sunnah*. Prohibitions of *Riba* (or interest), contractual ambiguity (*Gharar*) and gambling

(*Maysir*) are few of those which are of special interest in financial matters as well as insurance.

Let me also clarify here that Islamic laws are not against insurance per se but the way these activities are conducted by the insurance companies are such that puts a believer in awkward position from his religious point of view. This is the reason why Islamic insurance is growing at such a faster rate in Muslim dominated countries and regions.

With this brief prologue we now move to the subject at hand.

### **Shariah Objection against Insurance:**

As mentioned above prohibition of *Riba* (interest) is a crucial aspect that makes conventional insurance non-shariah compliant. Proceeds from the policy holders are invariably invested in interest bearing/earning instruments. Second important prohibition is contractual ambiguity which in Arabic is known as *Gharar*. *Gharar* implies in a situation in which certain key information of a contract are not fully disclosed, clarified or left un-agreed or undecided. Let me give an specific example; in insurance contract (say life) policy holder (who is subject matter of the contract) is paying a premium for an event which is his death and which is uncertain. In other words policy holder is paying a price for an item which he is not sure to get. On the other side insurance company is receiving a price for something which it is not sure to deliver. Often the relationship between the insurer and the insured becomes hazardous wherein one's loss becomes another's gain (and vice versa) and thus leading to a conflict of interest like situation. This in Islamic term is known as gambling (*Maysir*) which is also prohibited.

Complying with all the above prohibitions Takaful aims at meeting the same socially and economically desired objective of financial protection and wellbeing of the deceased's family which is likely to suffer due to unexpected or undesired death of their bread winner.

Another consequential result of a conventional insurance policy that directly contradicts with another Islamic law is the nominee clause. Nominee in the

insurance policy is the sole beneficiary in the event of death of the policy holder whereas under Islamic law anything left by the deceased would be required to be distributed in accordance with the inheritance law. Thus a nominee in an Islamic insurance policy is a trustee designated to receive the benefits on behalf of all the inheritors of the deceased.

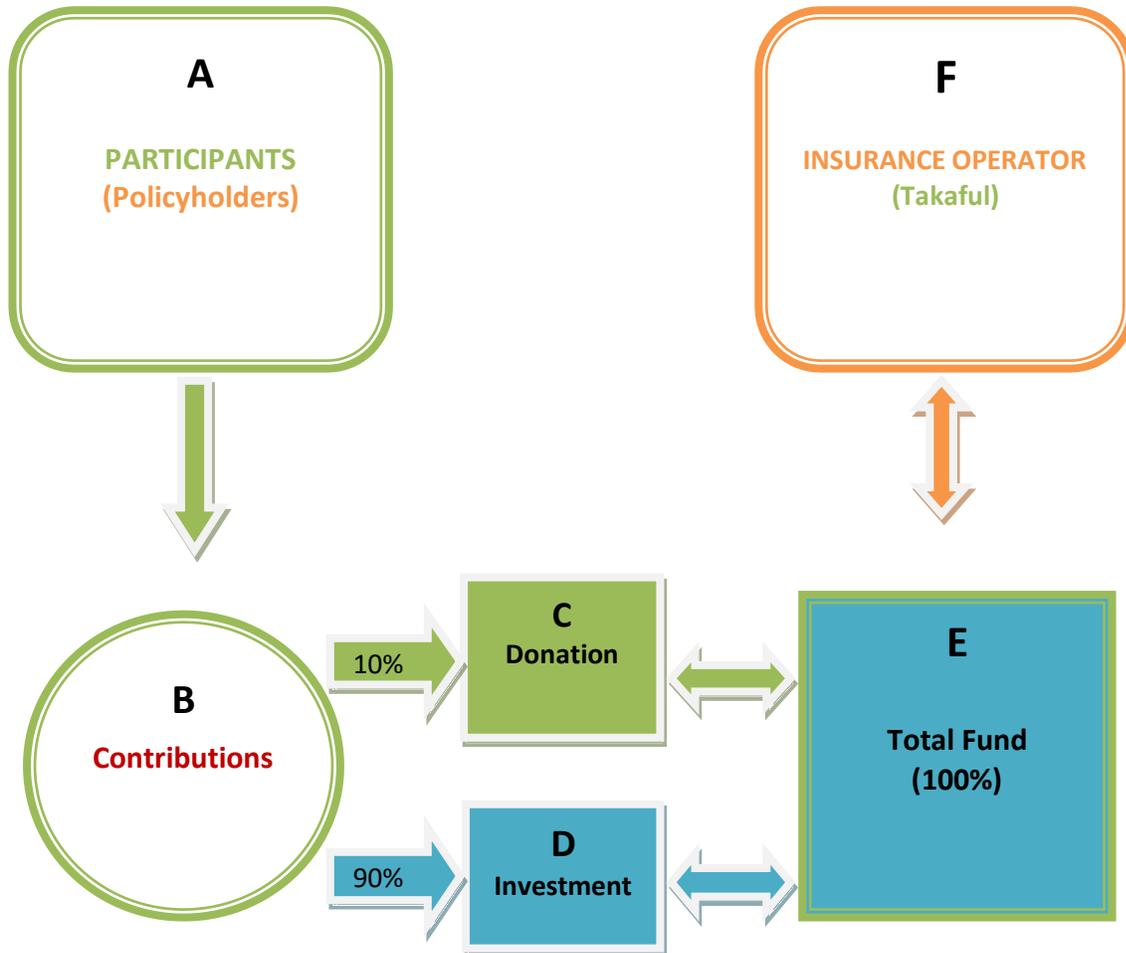
### **Major Differences Between Insurance and Takaful:**

There are some glaring differences between Islamic and conventional insurance. Few major of them are given below:

- In the conventional insurance protection is bought by paying a price to the insurer whereas in Islamic system mutual protection is sought by pooling resources from participants.
- Under the conventional insurance insurer is the owner of the fund contributed by the policy holders for protection whereas in Islamic insurance insurer is a trustee managing the fund on behalf of the policy holders. Policyholders in Islamic insurance remain owner of the fund.
- Under conventional insurance risk is traded whereas in Islamically compliant insurance risk is mutually shared by the participants.
- In conventional insurance insurer is the guarantor who is legally bound to compensate for the losses on occurrence of the event whereas in Islamic insurance insurer's role is of the wakil (manager). Any loss to deceased's family in Islamic insurance is compensated from the pool created by all the policy holders.
- In conventional insurance proceeds from policyholders are invested across various assets. The primary concern of a conventional insurer is safety, security and return from those investments. Whereas in Islamic insurance the primary concern before investing those proceeds is shariah compliance. Hence an Islamic insurance company will not invest any of its amounts in interest earning instruments or use it for financing activities that are

shariah non-compliant or proven to be injurious to the society such as alcohol, gambling, tobacco, armament, pornography etc.

### How Islamic Insurance (Takaful) Works?



## Notes:

### Life Insurance (Family Takaful)

- A are the policyholders contributing premium B
- B the total contributions is bifurcated into two C & D.
- C is the amount contributed (as donation) by each participant towards the pool for any eventuality on the members. Policyholders forfeit any claim on this in case they survive till the maturity of the policy.
- D, the amount which goes into investment account of each policyholder. Any return from this account is returned to the policyholder.
- E, the total amount (investable funds) comprising C&D to be managed by the insurance operator.
- F, the insurance operator, who for managing the fund (E) will charge a fee (in case of Wakala Model) or share in the profit (in case of Mudaraba model). Losses (prorate) in both the models are borne by the Fund E.
- Small portion of E (to the extent of risk covered under C) is paid towards contribution for Re-insurance.

### General (non-life) Insurance:

- In the case of General (non-life) insurance the whole contribution (B, without being bi-furcated) goes into a common pool (E) from which the risks are met.
- Claims are met by disinvesting E to the extent of requirement.
- As in the case of Life insurance, in general insurance too contributions towards re-insurance (Re-takaful) are paid from E.

- Operator F here too manages the fund either on Wakala or Mudaraba basis for which it is remunerated in accordance with the respective agreement.

**General Observation:**

- Cost of managing the operations is billed to the fund (E) in case of Wakala model whereas in Mudaraba model it is borne by the operator (F). This is the reason why Mudaraba model is not so popular.
- Based on the actuarial calculation operator (F) aims at keeping some surplus amount over and above the expected requirement of claims (C) in the case of life policy and (E) in case of general.
- Surplus over and above that expectation is either distributed back to the policyholders or they are rewarded in the form of lower contributions in the future.
- Any shortfall in (C, Life) and (E, General) is met through interest-free loan from the operator (F) which is recoverable in future years.