<u>The concept of Takaful and the structure of a Takaful program:</u>

Insurance, no matter what kind, is pooling of risks and applying the law of large numbers. The peril will only affect a small portion of those whose risks are polled. Hence, if our probability calculation is accurate, a small premium from every one in the pool will be sufficient to compensate fully the small portion who will suffer during the term of the policy[1].

The problem with conventional insurance is that it creates an "exchange contract" between the insurance company and the insured in the form of "policy". It simply says: you pay a premium of $ 100, and you will be covered from the specified risk (fire for example). If your house is destroyed by fire, the company will pay, say $500,000 as a compensation. This is problematic from Shari'ah point of view.

An exchange contract (such as sale contract) must be free from Gharar (contractual uncertainty). This means that the rights and obligations of the two parties must not be uncertain. If they are only probable, the contract is void. If we look at the conventional insurance contract we see that the insured will pay a "certain" premium in exchange from a "probable" payoff. Hence, the contract is void.

It is an established rule in Shari'ah that "Gharar" will only void exchange contracts and not benevolent contracts such as "Takaful". In other words. If I sell a sealed box the content of which is not known, then such sale contract may be void for the content may turn out to be equal, much more, or much less than the paid price. This is Gharar, for one party has received a "certain" price, the other bought an "uncertain" stuff. However, it would be O.K from Shari'ah point of view to give that same box as a gift or as an altruistic contribution or donation even though the Gharar remains but it will not void the contract (in Shari'ah a gift is also considered a contract).

The whole concept of Takaful is based on the idea of moving the insurance program from the realm of exchange contracts to that of benevolent giving.

The proposed structure does include that same idea of pooling risks and applying the law of larger numbers.

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[1] The major (and may be only) source of income for Insurance Company is profit generated from investing funds.

However, the form of contract is different. The insurance company will now manage this pool, and the insurance policy is simply a certificate through which the holder participates in the pool. What he pays is not a price but a contribution which may be considered a donation to this Takaful scheme. As a manager, the insurance company needs to manage the pool for the benefit of the participants. Insurance Company is only an agent and not an owner of the pool. It is compensated either by a charge on the net asset value of the pool, or a portion of profit generated from investing the same (or both). Hence, we have two contractual arrangements. One between the insurance company and the totality of the participants represented by this pool. This is an agency contract. The other between the insured themselves being partners in the pool and this is the Takaful contract.

Contributions are collected by the manager (insurance company), compensations are paid to those who are victims of the peril and then at the end of every year the manager will see the pool. If there is extra money, it should be paid back to the participants for this is their pool. If funds are not sufficient, then the manager should re-asses these basic contributions and go back to all participants for payment of more in the pool.

Because going back to the participants is not easy especially on our countries (although it is well known and practiced in the U.S.A). Takaful companies do two things to avoid these eventualities:

1- They purposely increase the donation rate (the equivalent of premium) so that they are saved from shortage.
2- They extend an interest free loan to the pool that can be collected at a late stage from donations.

This Takaful program is capable of serving every insurance need. It can be a substitute for life, auto, and fire … etc insurance. It can also be part of saving-cum-life, or disability insurance program. This is now marketed by some Islamic banks and Takaful companies in Saudi Arabia and in other Muslim countries.

And this is what referred to as Islamic Insurance.