

THE SHARIA (LEGAL) FOUNDATION OF RISK SHARING IN TAKAFUL (INSURANCE) OPERATIONS

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Abstract

Takaful, the Islamic alternative to conventional insurance, is founded on the principles of mutual cooperation, responsibility, and risk sharing in accordance with Shariah (Islamic law). Unlike conventional insurance, which often involves elements of gharar (uncertainty), maisir (gambling), and riba (interest), Takaful is structured around the concepts of ta'awun (mutual assistance) and tabarru' (donation). This article explores the Shariah foundations of risk sharing in Takaful operations, tracing historical origins, reviewing key literature, detailing methodological approaches in implementation, and offering conclusions and policy recommendations for strengthening Takaful's global viability.

Keyword: Shariah, Takaful, Risk Sharing.

Introduction

Takaful is derived from the Arabic root word *kafala*, meaning “to guarantee” or “to take care of.” It represents a system where participants mutually contribute to a pool to cover losses suffered by any of the members. Takaful replaces the risk-transfer model of conventional insurance with a risk-sharing framework. This model aligns with Islamic legal principles, ensuring ethical financial protection mechanisms that promote social solidarity and equity. Takaful finds its roots in the provisions of the Holy Quran (5:2), “Cooperate with one another in goodness and righteousness” that, in essence, represents an innovative and alternative approach to insurance, with the emphasis on shared accountability and mutual support that is reflected and deeply rooted in Islamic finance principles. Tabbaru (contribution) and Ta'awun (cooperation) are the fundamentals of Takaful on which the whole framework has been established, thereby upholding the values of cooperation, solidarity, and social responsibility that are deep-rooted in the Islamic injunctions pertaining to financial matters (Zulkifli et al., 2012). In contrast to conventional insurance, which may involve practices that conflict with Islamic principles, Takaful aligns insurance operations with Shari'ah-compliant guidelines, emphasizing fairness, transparency, and inclusivity.

Background to Takaful

Takaful is the Islamic counterpart of conventional insurance, and exists in both life or family and general forms. It is based on concepts of mutual solidarity, and a typical Takaful undertaking will consist of a two-tier structure that is a hybrid of a mutual and a commercial form of company. This in itself poses significant issues for regulation and supervision. In addition, all the functions of a Takaful undertaking should conform fully to Islamic law (Shari'a), and this has implications in other areas of regulation and supervision. This section sets out the background.

Islamic Religious Law (Shari'a)

To the Muslims society, Islamic law, called the Shari'a, is a divinely revealed law that dictates the way of life for mankind. It is all-embracing and covers not only the practice of religious worship but also how Muslims should live their lives and, by extension, conduct commerce. The authority of the Shari'a is drawn primarily from the Qur'an and the Sunna. The Qur'an is the holy book which Muslims believe contains God's word as

directly revealed to the Prophet Muhammad. The Sunna refers to the spoken advice, acts and tacit approvals of the Prophet Muhammad. Where a new situation arises which requires an interpretation of the law, qualified Shari'a scholars engage in *ijtihad*, which is a method of legal reasoning by analogy from the sources of the law to explore possible solutions to the problem. It may take some time for the scholars to arrive at a consensus, and there is no body that can impose an interpretation, though there are some bodies of scholars whose collective view carries great weight.

Takaful in Islam is not against the concept of insurance itself but against some of the means and methods that are currently used in conventional insurance. In fact, the concept of mitigation of risks by adopting the law of large numbers was widely used in Islam and especially in the practice of "al-aqilah" described below. However, to be acceptable to Islam, any form of insurance should avoid the elements of *riba* (interest), *maisir* (gambling) and *gharar* (uncertainty), though elements of *gharar* may be forgivable depending on the circumstances.

History of Takaful

Takaful is a system of mutual cooperation amongst policyholders whereby they reimburse each other in the event of a loss out of the contribution pool or fund to which they have agreed to contribute a regular amount, managed by a Takaful operator (Omar and Dawood, 2000). Takaful finds its origins in the early Islamic era in 622 when Muslims of Makkah and Madina established the practice of shared responsibility and mutual assistance to indemnify the members of any loss. This method of insurance came into practice in various forms in the backdrop of a growing need to be insured against the losses one bears in the case of a major financial setback, but conventional methods of insurance were disallowed by the people of faith due to *Al-Gharar* (uncertainty), *Al-Maysir* (Gambling), and *Riba* (Interest) (Al-Amri & Hossain, 2015). This pool serves as a fund to help those who experience losses or face unexpected circumstances, adhering to the Islamic principle of aiding one another during times of difficulty. (Adawiyah and Scott, 2008). The concept of Takaful is based on mutual assistance, solidarity, and shared responsibility among the participants. Unlike conventional insurance, where the insurer and the insured are two distinct entities, Takaful insurance is structured around a collective pool where all participants contribute to help one another in times of need. The key Islamic principles of Takaful are:

- i. **Mutual Assistance (Ta'awun):** Participants agree to help each other by pooling their resources together.
- ii. **Shared Responsibility (Kafalah):** The risk is collectively borne by the participants.
- iii. **Prohibition of Interest (Riba), Uncertainty (Gharar), and Gambling (Maisir):** Takaful avoids elements that are not permissible under Shariah law.

The concept of mutual assistance is deeply embedded in Islamic history. Early forms of cooperative risk-sharing were practiced in:

- i. **Pre-Islamic Arabia:** Tribal systems of blood money (*diya*) where compensation was collectively provided by the tribe.
- ii. **Islamic Era:** The Prophet Muhammad (PBUH) endorsed cooperative practices such as *aqilah*, where a group shared responsibility for accidental harm or death.

- iii. **Fuqaha Consensus:** Classical scholars, including Imam Malik and Imam Shafi'i, approved of cooperative risk mitigation through collective contributions.

Modern Takaful emerged in **Sudan (1979)**, with the establishment of the Islamic Insurance Company. Malaysia followed with the **Takaful Act of 1984**, becoming a model for the Southeast Asian market.

Risk-Sharing Model

The risk-sharing model in Takaful is fundamentally different from the risk-transfer model seen in conventional insurance. The Takaful shows:

- i. **Pooling of Contributions:** In Takaful, participants contribute a sum of money (called “tabarru”) into a common fund. This contribution is not a premium paid to an insurer, but rather a donation to a mutual fund that will be used to assist participants who suffer a loss. The amount contributed is determined based on the type of coverage and the expected risks.
- ii. **Collective Ownership of the Fund:** The Takaful fund is collectively owned by all participants. The operator of the Takaful scheme, often referred to as the “Takaful Operator,” manages the fund on behalf of the participants but does not own the fund itself. The Takaful Operator is compensated for its management services through a fee (Wakalah) or a share of the investment profits (Mudarabah).
- iii. **Risk-Sharing among Participants:** When a participant experiences a covered loss, compensation is paid out from the collective fund. This means that all participants share the risk together. If the fund accumulates a surplus after all claims and expenses are paid, it can either be redistributed among the participants or retained to reduce future contributions.
- iv. **Surplus and Deficit Management:** If there is a surplus in the Takaful fund, it is typically shared among the participants or rolled over to the next period to reduce future contributions. In the event of a deficit, the Takaful Operator may provide an interest-free loan (Qard al-Hasan) to cover the shortfall, which will be repaid from future surpluses.
- v. **Takaful’s Risk-Sharing VS Conventional Insurance’s Risk-Transfer**

The risk-sharing model of Takaful contrasts sharply with the risk-transfer model of conventional insurance, where the insurer takes on the financial risk in exchange for a premium. Here’s a comparison in terms of:

- i. **Risk Ownership:** In Takaful risk is shared collectively among participants while in conventional insurance risk is transferred from the insured to the insurer.
- ii. **Fund Ownership:** In Takaful the fund is owned by the participants while in conventional insurance the fund is owned by the insurance company.
- iii. **Profit Distribution:** In Takaful Surpluses are shared among participants or used for charitable purposes while in conventional insurance profits are retained by the insurer and distributed to shareholders.
- iv. **Ethical Considerations:** Takaful investments are made in Shariah-compliant assets, avoiding interest, gambling, and excessive uncertainty while conventional insurance there is no restrictions on how the premiums are invested.

The Role of the Takaful Operator

The Takaful Operator plays a crucial role in managing the Takaful fund, but it does so as a trustee rather than an owner. Depending on the model, the operator is compensated in one of two ways. The first way is the Wakalah Model which operator charges a management fee (Wakalah fee) for administering the fund. The fee is agreed upon upfront and is used to cover the operational costs of managing the Takaful scheme and the second way is Mudarabah Model which the operator shares in the profits generated from the investment of the Takaful fund. The profit-sharing ratio is pre-agreed, ensuring transparency and fairness.

In both models, the operator is responsible for managing the fund prudently, ensuring that claims are paid promptly and investments are made in accordance with Shariah principles.

Benefits of the Risk-Sharing Model in Takaful

The risk-sharing model in Takaful offers several advantages that make it an attractive option for individuals and businesses alike:

- i. **Ethical and Shariah-Compliant:** Takaful provides an insurance solution that is fully compliant with Islamic law, making it an ethical choice for Muslims and non-Muslims who prefer ethical investments and financial practices.
- ii. **Community-Centric Approach:** By pooling resources, participants in a Takaful scheme contribute to a system that supports each other. This fosters a sense of community and mutual support, which is particularly appealing in times of crisis.
- iii. **Transparency and Accountability:** The Takaful model is governed by strict Shariah guidelines, ensuring that operations are transparent and that participants are aware of how their contributions are used.
- iv. **Profit Sharing:** Participants may receive a share of the surplus, providing an additional financial benefit. Unlike conventional insurance, where profits go to shareholders, Takaful returns profits to the participants, aligning with the cooperative nature of the model.
- v. **Social Responsibility:** Any surplus not distributed among participants can be used for charitable purposes, enhancing the social responsibility aspect of Takaful.

Challenges in the Risk-Sharing Model

While the Takaful model offers many benefits, it also faces challenges:

- i. **Managing Surplus and Deficit:** Balancing the fund to ensure there are no deficits while maintaining sufficient reserves to pay claims can be challenging, particularly in markets with limited actuarial data for Takaful products.
- ii. **Awareness and Understanding:** Takaful is still a relatively new concept in many parts of the world, and there is a need for greater awareness and education to help potential participants understand how it works.
- iii. **Regulatory Frameworks:** As Takaful grows, there is a need for clear and consistent regulatory frameworks to ensure that the risk-sharing model is maintained and that participants' interests are protected

Literature Review

The development of Takaful has been supported by scholarly work in Islamic jurisprudence and finance. Muhammad Nejatullah Siddiqi (1985) Advocated for ethical alternatives to interest-based insurance. Prof. Muhammad Taqi Usmani emphasized that risk must be shared and not transferred for Shariah compliance.

Umar Chapra (2000) analyzed the socio-economic benefits of mutual risk-sharing over commercial insurance. These works converge on the premise that Shariah-compliant insurance must be based on risk sharing, mutuality, and the prohibition of uncertainty and gambling. The article on Risk and Risk Management of Takaful Industry in the Journal of Global Business and Economics, in which the research was carried out to identify the management of risk by takaful operators and the direct relationship between Shariah compliance and risk management (Abdul Aris, 2012).

In another journal, Enterprise Risk Management, the article Risk Management in Takaful explained the various types of risks associated with takaful business and the challenges that need to be addressed for enhancement of risk management practices among Takaful operators (Akhter, 2010). The article Achieving Maqasid al Shariah through Takaful explained maqasid al Shariah and the concept of takaful in general. Fiqh Awlawiyyat in Retakaful between RBC Standard and Islamic Institutions discussed the development of both fiqh awlawiyat and risk-based capital (RBC) and the application of the former in retakaful in the context of the latter and Islamic financial institutions (Ismail, 2009). There is also a recent report on takaful, DOME International Takaful Report 2012-2013 that presents Shariah and legal analysis for establishing takaful and retakaful in the Gulf Cooperation Council (GCC) countries (Khan, 2012).

Islamic financing is based in the concept of risk sharing, the investor gets a return on his investment only when funds are used productively in the economic environment (Obaidullah, 2005) and is only entitled to a return if he is also ready to share in the risks of the enterprise (Askari, 2011). This means that the takaful operator must also comply with the provisions of Islamic law regulating its mode of financing. One important feature of this concept is that the exact amount or return is not predetermined. Rather, what is fixed is the sharing ratio or percentage (Errico & Farrahbaksh, 2001; Gamal, 2006 ;). To ensure this compliance regulation must be created which caters to the special requirements of takaful separate from those of conventional insurance (Dikko, 2014). Takaful must also be provided by persons who have adequate knowledge of both the basic underlying principles and substantive laws regulating such transactions (Dikko, 2011). Such persons include management, marketing, product development and shari'ah supervisory staff. Also, due to the fact that the ownership of the takaful fund remains with the participants regulations require a strict segregation of takaful funds from the assets of the). The takaful fund is used for the settlement of claims but where this proves to be insufficient, the TO is required to provide a qard al hasan (benevolent loan) to the fund which will be paid back from future surplus (Archer et al, 2009; Kwon 2007; Bakar, 2009). This loan is given from the shareholders' funds of the takaful operator (Ismail, 2010).

Daud (2012) argues that shari'ah compliance for a takaful operator entails ensuring that core Islamic values are reflected in every facet of takaful operations. This can be achieved by ensuring workers in the industry approach the provision of takaful as ibadah (worship) to God and should advance and educate others in the religion of Islam. In essence, they must through marketing, work values, products and services create a good reflection of the religion itself. Finally, shari'ah compliance has to extend to retakaful. This means that the takaful operator must ensure that it obtains reinsurance from a retakaful provider which has also established shari'ah compliance in its activities, products and services (Billah, 2011)

Theoretical framework

The Shariah foundation of risk sharing in Takaful operations is grounded in several classical and contemporary Islamic legal and economic theories. These theories justify the permissibility of Takaful and its

core principle of mutual risk sharing as an ethical alternative to conventional insurance, which often involves prohibited elements like *gharar* (excessive uncertainty), *riba* (interest), and *maysir* (gambling).

Below are the main Shariah theories underpinning the risk-sharing model in Takaful:

i. Theory of *Ta'awun* (Mutual Cooperation and Solidarity): *Ta'awun* refers to mutual help and cooperation among individuals, especially in times of need. A quote from the Qur'anic Basis which says:

“Help one another in righteousness and piety, and do not help one another in sin and transgression...”
(Surah Al-Ma'idah: 2)

Takaful participants cooperate by contributing to a common fund to help any member who suffers a loss. This solidarity reflects the spirit of *ummah* (community) and social responsibility.

- ii. Theory of *Tabarru'* (Voluntary Contribution):** *Tabarru'* is a voluntary donation given without expectation of return. On the basis of Fiqh, it is permissible under all schools of Islamic jurisprudence, especially when intended for charitable or mutual aid purposes. In Takaful, each participant donates part of their contribution to a pool used for mutual indemnification. This transforms the relationship from a commercial transaction (as in conventional insurance) to one of shared responsibility.
- iii. Theory of *Takāful* (Mutual Guarantee):** It implies a system where participants mutually guarantee each other against defined losses. The practice of *'aqilah* in early Islamic society involved the collective payment of blood money (*diya*) by the tribe of the perpetrator. Participants jointly guarantee that if any of them suffers a specified loss, compensation will be provided from the collective fund.
- iv. Theory of *Maslahah Mursalah* (Public Interest and Welfare):** A principle in *Usul al-Fiqh* (Islamic legal theory) that permits actions if they are beneficial to society and do not contradict the Qur'an or Sunnah. Takaful fulfills societal needs for financial security and social protection in a Shariah-compliant way, thus considered in the public interest.
- v. Theory of *Al-Gharar* (Prohibition of Excessive Uncertainty):** Contracts that involve major uncertainty or ambiguity about the subject matter or outcome are prohibited. In conventional insurance, the contract may be void due to *gharar* in the timing, amount of payout, and occurrence of the insured event. Takaful overcomes this by basing participation on donation (*tabarru'*), not a commutative exchange, which mitigates *gharar*.

Other theories like the theory of *Al-Maysir* (Prohibition of Gambling) and theory of *Uqud* (Contracts and Obligations) are theories that also explain how Takaful is been carried out Islamically which is judicious by nature in Islam. Takaful's legitimacy and operational framework are firmly rooted in classical Islamic jurisprudence. These theories, taken together, construct a robust ethical and legal foundation for mutual risk sharing that aligns with Islamic values. They distinguish Takaful from conventional insurance and serve as a model for ethical finance globally

Table 1: Summary Table: Theories of Risk Sharing in Takaful

Theory	Main Concept	Role of risk sharing
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Mutual Guarantee (<i>Takāful</i>)	Mutual financial protection among members	Members guarantee each other's risks collectively
Voluntary Contribution (<i>Tabarru'</i>)	Donations made for mutual help	Contributions form the risk pool; not for personal gain
Cooperative Risk Sharing (<i>Ta'awun</i>)	Mutual support in adversity	Ethical justification for collective risk bearing
Risk Pooling	Economic sharing of risk among many	Distributes losses across a group
Wakalah & Mudarabah Models	Agency or profit-sharing contracts for fund management	Enables non-commercial, Shariah-compliant fund operation
Prohibition of Risk Transfer	Shariah restricts selling or transferring uncertain risk	Necessitates a shared model rather than transferred-risk insurance
Maslahah (Public Interest)	Actions beneficial to society are encouraged in Shariah	Supports Takaful as a morally and socially responsible risk-sharing tool

Takaful is supported by a network of interrelated theories that prioritize ethical, communal, and Shariah-compliant management of risk. Unlike conventional insurance, which isolates and transfers risk to a third party, Takaful promotes shared responsibility, mutual help, and social solidarity, reflecting both Islamic legal values and sound economic principles.

Methodology

This paper focuses exploratory research method in discussing takaful as an effective risk management tool using theories from quran and sunnah. Precisely, this study employed two stages procedure to analyse takaful and its relation to maqasid of Shariah and risk sharing. Firstly, the literature on risk management, takaful and maqasid Shariah are obtained from secondary data that included academic journals, books, conference papers and other periodicals. These information are then reviewed and analysed for its relevancy, adequacy and significance of the study. The study also did close and informal interviews with respective Shariah scholars in understanding the objectives of Shariah and its relevance to takaful. While the analysis of risk management in takaful is carried out by highlighting the main protections provided in takaful.

Findings

- Takaful offers a morally and ethically grounded alternative to conventional insurance.

Its foundations in Islamic jurisprudence and social responsibility emphasize mutual help and risk sharing.

- As the Takaful industry matures, it demonstrates resilience, especially in Muslim-majority countries and among ethically conscious consumers.
- Family takaful focuses on providing participants with both takaful coverage and investment or savings opportunities.
- Takaful businesses have good risk management techniques to limit the risks inherent in family takaful.
- The risks associated with family takaful products are substantially distinct from those related to general takaful goods.
- Whereas the claims in available takaful goods are often of short duration,

Recommendations

- i. **Strengthen Shariah Governance:** Establish unified global Shariah standards to minimize divergence and increase consumer trust.
- ii. **Enhance Public Awareness:** Educate communities about the benefits and values of Takaful, especially the concept of collective risk sharing.
- iii. **Encourage Regulatory Innovation:** Develop supportive legal frameworks to accommodate hybrid Takaful models and ensure competitiveness with conventional insurance.
- iv. **Boost Cross-Border Operations:** Harmonize regulations to facilitate international Takaful operations and risk pooling.
- v. **Promote Product Diversification:** Encourage innovation in Takaful products (e.g., micro-Takaful, health Takaful) to meet diverse needs.

The Future of Risk-Sharing in Takaful

The future of Takaful looks promising, especially as more people seek ethical financial solutions that align with their values. With advancements in technology, such as block chain and artificial intelligence, Takaful operators can enhance transparency, streamline operations, and improve risk management. Moreover, as the global Muslim population grows and becomes more financially empowered, the demand for Shariah-compliant financial products, including Takaful, is expected to increase. This will likely lead to more innovative Takaful products and greater market penetration.

Takaful insurance offers a unique and ethical alternative to conventional insurance through its risk-sharing model. By pooling resources and sharing risks, Takaful participants contribute to a system that is not only financially protective but also aligned with their ethical and religious beliefs. As more people become aware of the benefits of Takaful, it is likely to become an increasingly popular choice for those seeking a more cooperative and community-oriented approach to insurance.

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