> ungrateful for the favours of God, so He made it taste hunger and terror [closing in on it] like a garment [from every side] because of the evil [its people] wrought.
>
> (16:112)

This turning away from God by the people of Mecca through the rejection of Mohammed ensured their punishment instead of God's blessings, hunger instead of sustenance, unease instead of security (Al-Tabari 1978: 4:125; *Al-Jalalin* 1980: 231; Ibn Kathir 1981: 2:349).

> Which of us [two] parties has more right to security [*aman*]? Tell me if you know. It is those who believe and confuse not their beliefs with wrong that are truly in security, for they are in receipt of the right guidance.
>
> (6:81–2)

The above verses highlight the recourse to polytheism at a time of burgeoning Islam (Al-Tabari 1978: 4:227). Abd Allah Ibn Masud recounted that on learning such verses Muslims trembled, and asked Mohammed for an explanation, whereupon he repeated the words of Luqman to his son: 'Do not worship false idols for that is the greatest abomination' (31:13).

Therefore, in Islamic belief, to worship false idols incurs the wrath of God and disaster, but to follow the righteous path leads to deliverance and safety.

### *Faith as insurance against fear and sadness*

Pain, sadness and fear are the antithesis of security (*aman*) (Al-Saboni 1981:607), an axiom which endures for the Muslim not only in this world but also in the next. These negative states of mind can only lead to the deterioration of the sinner's stability and henceforth his or her future becomes unbearable and his or her past rendered devoid of happy memories (Al-Qurtabi 1952: 1:329). Being in a constant state of fear and sadness is to experience deprivation and loss (*Al-Manar* 1980: 1:237).

The spectre of sadness and fear is invoked many times in the Quran, in which it is made clear that the believer, so long as he or she continues to perform good acts and abide by the religious duties of Islam, will avoid such afflictions:

> Those who believe and do deeds of righteousness, and establish regular prayers and regular charity, will have their reward with their Lord. On them shall be no fear, nor shall they grieve.
>
> (2:277)

Thus, the Muslim, on account of his faith, is protected against loss, fear and sadness, and his obtaining of the good things in life is facilitated by his faith in God (*Al-Manar* 1980: 1:237, 352; Al-Saboni 1981: 1:169).

Likewise, faithful observance of Islam removes fear of the resurrection assuring the protection of the believer. This is insurance (*Ta'min*) for the faithful:

> Resurrection, the sound of trumpets, is heard by all living on earth and those of other galaxies and sky except those who will be relieved from the trumpet sound and those who died in war for God [the Martyr]. The mountains will be flattened, the earth will shake, the pregnant will deliver prematurely, the children will age, the people will run lost calling each other for direction; only those God will exempt will be relieved from that fear and terror.
>
> (Al-Qurtabi 1952: 13:344)

In other words, those who do not fear the resurrection are insured against fear.

### *Prayer as insurance*

Time and time again in Islamic messages to the people, prayer is presented as a form of insurance, i.e. a commitment to prayer is rewarded by God's protection. According to Islamic principles, Man's instinct is to avoid danger and escape from fear and sadness, blights which can be alleviated only by taking refuge in God. When God sends down floods, famine, pestilence, earthquakes and storms as a warning, man is powerless to prevent them (ibid.):

> Say, He has power to send calamities on you from above and below, or cover you with confusion in party strife, giving you a taste of mutual vengeance, each from the other. See how We explain the signs by various [symbols], that they may understand.
>
> (6:65)

It is in the power of God alone to offer his people protection (Al-Saboni 1981: 1:397):

> Say: who is it that delivers you from the darkest recesses of land and sea, when you call [*tadu*] upon Him in humility and silent terror. If He only delivers us from these [dangers] we vow we shall truly show our gratitude. Say: It is God that delivers you from these and all [other] distresses, and yet you worship false gods.
>
> (6:63–4)

Thus God is all powerful, providing sustenance and protection where merited, and punishment where called for.

The good Muslim who observes his religious duties and who supplicates (*yadu*) himself before God, will in turn receive an answer: 'And your Lord says

"Call on Me. I will answer your prayers"' (40:60). On this point, Ibn al-Abbas remarks:

> Each Muslim who prays receives an answer from his Lord. If he asks for sustenance he receives it, providing his daily acts are in accordance with the *Shari'a*.
>
> (Al-Qurtabi 1952: 2:311)

Thus we note here the link between commitment to prayer on the part of the Muslim and his protection (*Ta'min*) under God's wing:

> For who listens to the distressed [soul] when it calls on Him, and who relieves its suffering?
>
> (27:62)

God answers the calls of distressed travellers and seafarers enabling them to reach safe ground (Al-Qurtabi 1952: 13:233):

> He it is who enables you to travel the land and sea, so that you even board ships, then sail with them, with a favourable wind and they rejoice thereat.
>
> (10:22)

When they think they are being overwhelmed by storms, they cry to God, begging for their deliverance in return for carrying out their duty to Him:

> '. . . If you deliver us from this, we shall truly show our gratitude.' But when He delivers them, Behold, they transgress insolently through the earth in defiance of right.
>
> (10:22–3)

The Muslim not only prays to God for protection and his livelihood in the present world, but in the next world also, so as to ensure he enters Paradise.

> If any do wish for the Hereafter and strive therefore, with all due striving, and have faith, they are the ones whose striving is acceptable to God.
>
> (17:18–19)

Thus to pray to God is to secure the protection (*Ta'min*) of God from misery in this world and Hellfire in the next, but the supplication in the material world must be genuine, supported by lawful (*halal*) conduct befitting a Muslim:

> There are men who say 'Our Lord, give us your bounties in this world.' But they will have no portion in the Hereafter.
>
> (2:200)

Thus, according to the Muslim faith, prayer is an insurance against fear and sadness on the one hand, and against damnation and suffering in the next life on the other.

In relation to this concept of *Ta'min* in Islam, on the authority of Aiysha it is told that the Prophet said, 'If the Jew envies the Muslim for anything, it is surely for the security and protection he enjoys under Islam' (Al-Qurtabi 152: 1:130–1).

To sum up the argument about the role of *Ta'min* in Islam, we can see from the Quranic verses and *Hadith* that pious Muslims secure God's protection in the material world against fear, poverty and sadness (and against Hellfire in the next world) through their good deeds and their performance of religious duties, whilst the neglectful Muslim or the unbeliever forfeits this protection.

## Insuring the hereafter (*Al-Ta'min Al-Akhrawi*)

The origin of the Islamic principle is the belief in life after death and the resurrection of the body and soul. Life after death is thus everlasting – the end of death. Human performance during our existing life will determine our fate in the afterlife, whether in Heaven or in Hell.

The only insurance against going to Hell is living everyday life according to Islamic principles:

> The ultimate aim for man is to avoid Hell; those who obeyed God's requests and obeyed God's forbidding are the ones insured not to end up in Hell. The link between man's day to day work and his relationship with others, and his faith in God, is the route away from Hell.
>
> (Al-Tabari 1978: 24:276)

Heaven is visualized as a beautiful and peaceful place where security is guaranteed:

> The righteous [will be] amid gardens and fountains [of clear-flowing water]. [Their greeting will be]: enter ye here in peace and security. And we shall remove from their hearts any lurking sense of injury. [They will be] brothers [joyfully] facing each other on thrones [of dignity]. There no sense of fatigue shall touch them, nor shall they [ever] be asked to leave.
>
> (15:45–8)

However, Heaven is the destination only of:

> Those who obeyed God's rules [those having accepted God's blessing and his beneficence, having been wary of God's revenge, and having avoided God's prohibitions are in the light of God's grace, which protects them not only from active wrong but also from straying into paths of temptation or carelessness], who did good things towards each other, those people will receive God's blessings, utmost peace, no fear of death as their judgement

> will be light [who showed], no hatred nor malice neither malevolent nor ill will towards others, theirs will be love, friendliness, brotherhood, bosom friends, quintessence, sincerity. There will be no illness, tiredness, boredom – all happiness in the everlasting Heaven.
> (Al-Tabari 1978: 14:25; Al-Qurtabi 1952: 10:32; Al-Saboni 1981: 2:110)

### *Assurance of the higher levels in Heaven*

> It is not your wealth nor your sons that will bring you nearer to us in degree; but only those who believe and work righteousness, these are the ones for whom there is a multiplied reward for their deeds, while secure they [reside] in the dwellings on high.
> (34:37)

> All worldly goods are but a shadow that will pass away. Their intrinsic and eternal value is small, but those who work righteousness in faith are on the true path of self development, the reward they will get, infinitely more than their merits entitle to them, for they will partake of the boundless bounties of God.
> (Al-Qurtabi 1952: 14:306; Al-Tabari 1978: 22:68, Al-Saboni 1981: 2:557)

There will be no uncertainty as there is living on earth, no danger of discontinuity, no possibility of their satisfaction being terminated; everything will be open and in social companionship. All the petty feelings of jealousy or exclusiveness will have passed away and the purity, beauty, truth and goodwill will pertain. As in the Buddha's doctrine, the highest object of this life is to obtain salvation for sorrow, pain and the other incidents which make of it a constant struggle. Islam teaches that this is not possible by unaided efforts. Certainly, striving is an indispensable condition, but it is the mercy of God which comes to the aid of Muslims and keeps them from the fire of eternal punishment. This is mentioned last as the foundation on which eternal felicity and positive spiritual joys are built (Al-Tabari 1978: 25:83).

Given the above extracts and opinions, it can be considered that Muslims view good deeds in life as the insurance premium for everlasting life in the hereafter and at a higher level in Heaven. Human beings are in need of this type of insurance to protect themselves from terror at the day of resurrection, the day of judgement and humiliation and suffering in Hell (Al-Qurtabi 1952: 16:150). The real insurance is the grace of God for everlasting life, the only profitable investment human beings can enjoy forever.

## Worldly insurance (*Al-Ta'min Al-Dunyawi*)

The basis of worldly or material insurance and its principle in Islam is the insurance given by faith. Insuring the Muslim during his life is a constituent of his faith, his work, his good deeds, his relationship with others, his worship of God. To embrace good deeds, God made faith available to human beings to give them peace of mind, and to remove fear of the unknown. This type of insurance is connected to the 'insurance for the hereafter', as both lead to the same fate – Heaven (Al-Qurtabi 1952: 16:151–5). The need for peace, security and peace of mind in life are universal ambitions (ibid.: 81–3). They are fulfilled in Islam by faith, which brings its own, non-financial, rewards, and its means of compensation for life's vicissitudes.

### *Insuring livelihood*

The Quran states:

> God sets forth a parable: a city enjoying security and quiet, abundantly supplied with sustenance from every place, yet was it ungrateful of the favours of God, so God made it taste hunger and terror [in extremes], like a garment [from every side], because of the [evil] which [its people] wrought.
>
> (16:112)

The reference could be made to any of the cities or populations of ancient or modern times, which were favoured with security and other blessings by God, but which rebelled against God's law and were therefore punished. There are several metaphors: the experience of hunger and terror after abundant supplies and the full security which it had enjoyed, and the complete enfolding of the city as with a garment by the two scourges of hunger and a state of subjective alarm. If the reference is to Mecca shortly before its fall to the Muslims, the hunger was the seven years of severe famine which afflicted it, and the alarm was the constant fear in the pagans' minds that their day was nearing an end. Peace and prosperity were restored only after the re-entry of the Prophet.

### *Insuring against fear and poverty: the Quraysh*

In the Quran we read:

> For the covenants [of security enjoyed] by the *Quraysh*, their covenants [covering] journeys by winter and summer, let them adore the Lord of his house, who provides them with food against hunger, and with security against fear [of danger].
>
> (106:1–4)

The *Quraysh* were an important tribe of Arabia, who had the custody of the *Ka'ba*, the central shrine of Arabia. They had a commanding influence over other tribes, their central position facilitating trade and profit. The Mecca territory being by Arabian custom inviolable from the ravages of war and private feuds, they had a secure position, free from fear of danger. The honour and advantage from their position as servants of the sacred shrine of the *Ka'ba* they owed to God. In those days of general insecurity, their prestige as custodians of Mecca enabled them to obtain covenants of security and safeguard from the rulers of neighbouring countries on all sides – Syria, Persia, Yemen, and Abyssinia – protecting their trade journeys in all seasons.

Their journeys to the warmth of Yemen in the winter and the cooler regions of Syria and the North in the summer made them practised travellers and merchants, who acquired much knowledge of the world and many arts, and perfected their language as a polished medium of literary expression. Those experiences compensated the unfortunate losers for their losses. The *Quraysh* did not appreciate that God preferred them, particularly as he had chosen his Prophet from amongst them. They witnessed how God protected the *Ka'ba* from invasion by Abraha (Quran: 'Surat El-Fil': 105:1–5) and his elephants, even though they ran away and did not have the courage to stand up and defend their families, homes or wealth. The *Quraysh* tribe believed that God was the only insurance they could ever have, but they defied the injunction to worship the one God and continued to worship a man-made god of stones and clay (Al-Qurtabi 1952: 2:504; Al-Tabari 1978: 3:198).

### *Insuring against sadness and grief*

We are reminded of two Quranic verses:

> After [the excitement] of the distress, He sent down calm on a band of you overcome with slumber while another band was stirred to anxiety.
>
> (3:154)

and

> Remember he covered you with a sort of drowsiness, to give you calm as from himself.
>
> (8:11)

Calm (peace of mind) is essential in battle and in all situations of danger. If the mind is in a state of overexcitement, it cannot carry out a well-considered or concerted plan of action. This spirit of calm confidence on the part of Muslims won against the blustering violence of the *Quraysh* (Al-Qurtabi 1952: 3:242).

When a mother's eyes had become scalded with tears at the separation from her baby, they were 'cooled' – her heart was comforted:

> So We brought thee back to thy mother, that her eye might be cooled and she should not grieve.
>
> (20:40)

Avoiding sadness and grief is an intention to embrace the logic of God's guidance (Ibn Al-Arabi **1957**: 1:125).

### *Insuring against illness (Al-Marad)*

> And when ye are in peaceful conditions [again] if anyone wishes to continue *Umrah* [visit *Ka'ba* not at the time of *Hajj*] on to the *Hajj*, it is permissible.
>
> (2:196)

The peaceful condition is either free from illness or from enemies. The Prophet Mohammed said, 'Cold symptoms are an insurance from Leprosy' (Al-Qurtabi 1952: 2:372).

### *Insuring protection (Himaya) and asylum*

The Quran offers asylum to those who are drawn to religious belief

> If one amongst the pagans ask thee for asylum, so that he may hear the words of God; and then escort him to where he can be secure, that is because they are men without knowledge.
>
> (9:6)

Even those who are in battle with Islamic forces are entitled to seek asylum and to gain protection, even if they do not convert and accept the word of Allah:

> Even among the enemies of Islam, actively fighting against Islam, there may be individuals who may be in a position to require protection, full asylum to be given to them and opportunities provided for hearing the words of God. If they accept the words, they become Muslims and brothers, if they do not see their way to accept Islam, they will require double protection either from Islamic forces openly fighting against their people, or from their own people, as they detached themselves from them; both kinds of protection should be ensured for them from any harm (*Moaman*).
>
> (Al-Qurtabi 1952: 8:75)

### *Insuring the path (Ta'min Al-Tariq) – free passage*

> Between them and the cities on which We had poured Our blessings, We had placed cities in prominent positions, and between them We had appointed stages of journey in due proportion: travel therein, secure by night and day.
>
> (34:18)

The old frankincense route was the great highway between Arabia and Syria (Al-Tabari 1978: 22:58). Through Syria it connected with the great and flourishing kingdoms of the Euphrates and Tigris valleys on the one hand, and Egypt on the other – and with the great Roman Empire around the Mediterranean. At the other end, through the Yemen coast, the road connected by sea transport with India, Malaya and China. The Yemen–Syria road was much frequented. Syria was the land on which God 'had poured His blessings', being a rich, fertile country where Abraham had lived, and including the Holy Land of Jerusalem in Palestine. The route, on which merchants could travel with ease and safety by night and by day, was in the days of its prosperity studded by many closely-situated stations, or cities. The close proximity of stations prevented the encroachment of highwaymen (Al-Qurtabi 1952: 14:289).

### *Insuring against God's punishment during Worldly Life (Al-Dunya)*

> God has promised, to those among you who believe and work righteous deeds, that He will, of a surety, grant them in the land inheritance of power as He granted it to those before them; that He will establish in authority their religion, the one which He has chosen for them; and that He will change [their state], after the fear in which they [lived], to one of security and peace.
> (24:55)

Three things are promised here to those who have faith and obey God's law: 1 that they will inherit power and authority in the land, not for any selfish purposes of theirs, nor by way of favouritism, but in order that they may maintain God's law; 2 that the religion of right, which God has chosen for them, will be openly established, and will suppress all wrong and oppression; and 3 that the righteous will live in peace and security, instead of having to suffer persecution, or leave their homes for the cause of God, or practise the rites of their faith in secret (Yousuf 1938: 914). The verse was revealed about the time of the battle of the Ditch (*Khandaq*), also called the Battle of the Confederates (*Ahzab*) AH 4–5. We can imagine the comfort it gave to the Muslims who were besieged in Madina by a force ten times their number (ibid.: 914).

To those who do not follow Islamic law and are defined as evil, there is no security or peace, only the unpredictable threat of divine punishment, although God is just and merciful:

> Do then those who devise evil feel secure that God will not cause the earth to swallow them up? Or that the wrath will not seize them from directions they little perceive? Or that he may not call them to account in the midst of their goings to and fro, without a chance of their frustrating him? Or that he may not call them to account by a process of slow wastage? For thy Lord is indeed full of kindness and mercy.
> (16:45–7)

### *Pilgrim insurance in Mecca (Ta'min Al Bayt al-Haram)*

Islamic writings elaborate on the concepts of insurance or performance of the pilgrimage. It is an Islamic requirement to attempt, if possible, one pilgrimage in a lifetime. The Prophet Abraham asked God to make Mecca a secure and peaceful place, and God acceded to his request and it is therefore Abraham's shrine (Ibn Al-Arabi 1972: 1:38, 39). These verses from the Quran remind Muslims of the function of Mecca (ibid.: 73):

> Remember, We made the house a place of assembly for men and a place for safety.
>
> (2:127)

> The first house [of worship] appointed for men was that at Bocca: full of blessing and of guidance for all kinds of beings. In it are signs manifest: [for example], the station of Abraham; whoever enters it attains security (*Amn*).
>
> (3:96, 97)

It is in another form, as *Amn* from God's revenge in the hereafter, that Prophet Mohammed said:

> Who went for pilgrimage to Mecca and did not do obscenity nor act unlawfully, returned home as he was just born.
>
> (Ibn Al-Arabi 1972: 1:39)

### *Insuring peace and salutation to strangers*

The humble who had sincere faith were not sent away to humour the wealthy, but were honoured and given a special salutation, which has become the characteristic salutation in Islam: '*Salaam*' ('Peace be on you'). The word *Salaam* has a special affinity with the word 'Islam'. In words people are given the salutation, and in life they are promised mercy by the special grace of God (*Al-Manar* 1980: 5:282). When a courteous greeting is offered, it is met with a still more courteous greeting, or one of at least equal courtesy. This is considered important as all creatures derive from the one God, and are brought together before him (ibid.: 374).

> Ye who believe! When ye go abroad in the cause of God, investigate carefully, and say not to anyone who offers you a salutation: 'Thou are none of a believer.'
>
> (4:94)

> When those come to thee who believe in our signs, say: 'Peace be on you'.
>
> (6:54)

The attributes of God, summed up in the human concept of the 'Sovereign', imply the one undisputed authority who is entitled to give commands and receive obedience – the power that enforces law and justice. *Salaam* embodies not only the idea of peace as opposed to conflict, but also wholeness as opposed to defects, hence the paraphrase 'source of peace and perfection' (Yousuf 1938).

## Conclusions

Insurance is by no means a new concept, nor is it exclusively commercial. It has altruistic uses beyond the boardroom and the stockbroker, providing social bonding and collaborative environment in which whole societies can prosper. Few Muslims would disagree with insurance in its purest sense, as in its own way it reinforces the social responsibilities laid down to Muslims in the Quran. The majority of its detractors cite the commercial aspects of 'modern' insurance as reason enough to disallow it; many of their views are indeed justified and Islamically valid, while some choose to err on the side of caution because of the lack of specific mention of insurance in Mohammed's teachings, written of course when the industry was not extant anywhere in the world.

The Quran's and *Shari'a*'s prohibition of usury is similar to that of pre-reformation Christianity, except that the only permissible form of financial risks involves gaining returns from a partnership and allowing a penalty if a borrower fails to pay a debt in time. Insurance seems to have a place in a generic human solidarity, and forms of it have been traced back to 2500 BC; it was practised by the Chinese, the ancient Egyptians, the Greeks and the Romans. Insurance to Muslims is not a financial transaction, but is an everyday act, performed whether at work or at home. Worship can be considered as insurance for the ultimate place in Heaven, the destination for those who obey God's rules and avoid God's prohibitions. Muslims believe that Islam provides a legal safeguard, a moral system, and love of God. In return, God has promised Heaven and peace forever.

Apart from commercial insurance, there are other kinds of insurance such as State-established social security, where the State plays the role of the insurer. However, the social security is not a normal contract and cannot be directly compared with commercial insurance; it is a system set by the State for the help of certain categories whose financial resources are not sufficient for the confrontation of daily life risks. Many *Shari'a jurists* are in favour of insurance contracts as long as they are free from *riba*, gambling and *gharar*. Their opinions are generally in favour of cooperative or mutual insurance. In view of that, it is believed beyond doubt that the cooperative system should replace the commercial system, as the cooperative system is the only one that complies with Muslim teachings while satisfying the genuine purpose of insurance.

# 4

# THE DEVELOPMENT OF MUTUAL INSURANCE IN THE WEST

## Introduction

Insurance has a crucial role to play in social and economic development of Muslim countries, which is why it is necessary to study relevant insurance schemes that have been developed and practised with a history of success. The application of mutual insurance, the most successful form of insurance in the West and, as discussed in earlier chapters, acceptable to most Muslim scholars, is suitable to Muslim countries. This chapter outlines the mutual insurance structure and practice in several Western countries, each of which has a different structure, approach, and framework of legislation. From selected components of all the Western countries' insurance schemes compared in this chapter, we are able to construct an acceptable mutual form.

It is noted that all Muslim countries are also developing countries that suffer from an excessive growth of population relative to economic capacity and, as a result, national income dose not rise at rates commensurate with growth. Also, since capital formation is a very slow process, developing markets are usually small, being based on a relatively undiversified economy and lacking both financial and technical experience, particularly in mutual insurance activity.

As insurance expands with industrial and economic growth, the problem of insurance will differ from one country to another, according to each country's economic stage of development and political environment. It is known that establishing a mutual insurance market in developing countries often suffers from a lack of sufficient numbers of similar risks, and more time is required to develop the insurance market.

## The organization of mutual insurance

The concept of mutual insurance can be traced back in history to the eighteenth century when shipowners' dissatisfaction with the terms available from the underwriters at Lloyd's led them to form mutual insurance associations to meet their needs at lower cost. 'Mutual' appears in the names of those associations, now known as 'protecting and indemnity clubs'. Since the start, mutual insurance has steadily been developed in all countries, whether industrial or agricultural, and in all social and economic strata, whether urban or rural (Raynes 1948: 71). Mutual insurance is organized either by large companies and international organizations or by small firms. Its policyholders can be from one or several countries or from a single region or town. There are also mutual insurance companies that cater solely for members of a single profession (Carter 1973: 11). Mutual insurance occupies a strong position and even dominates the market of some countries, often grouped at a national level into a specific professional organization (Insurance Annual Report 1991: appendix 1).

Insurance is by its nature a mutual activity. It serves to compensate a group of persons, organized in accordance with statistical laws, from a hazard, so it is in no way surprising to find that people who incur the same risks create mutual insurance companies in order to be able to control the organization and functioning of their group. Members of such a company compose the social body and determine its powers. They constitute the General Meeting of the company, appointing from amongst themselves the directors. A mutual insurance company is a company that belongs to its insured members and is owned by its policyholders or their representatives – professionals or trade associations. An example of such a group at a national level is the UK's national association (Mutual Insurance Companies Association). This comprises a group of mutual insurance companies, together some nine company members and eight company associate members.

At an international level, another example is the International Association of Mutual Insurance Companies, AISAM (*Association Internationale des Sociétés d'Assurance Mutuelle*), which covers over 220 companies from 26 countries from its principal office in Amsterdam. The corporate purposes of the AISAM are defined in its by-laws:

1 to establish relations and links of confraternity between its members and to watch over the general interests of private insurance organizations based on the mutual principle of non-profit making;
2 to facilitate the exchange of information and experience between members, in matters of legal, fiscal, economic, political or other problems affecting mutual insurance in the different countries;
3 to draw its members' attention to problems of a general nature which arise in one or more countries and which seem to warrant study in the general interest of mutual insurance companies;
4 to study the origins of mutuality and investigate future possibilities of disseminating its principles;
5 to obtain recognition as a representative of insurance institutions based on the mutual principle in all international organizations; and
6 to maintain regular contact with the national federations of mutual insurance companies.

## Mutual value

The value of insurance is implicitly acknowledged but rarely made explicit. In practice, insurance eliminates uncertainty and risk and so allows commercial risk-taking. It helps place small groups on a more competitive footing with larger rivals, so stimulating new growth. Insurance develops financial security and reduces economic wastage.

The value of non-life insurance premiums rose from some US$38.5 billion in 1965 to some US$265.1 billion in 1985 throughout the OECD (Organization for Economic Co-operation and Development) countries (Sanders 1987: 3), matching the growth in GNP over the same period. The insurance industry was thus able to consolidate its overall economic position worldwide and occupy a position of growth. But like all commercial markets, the non-life insurance industry is not perfect. It suffers from alternate oversupply of its capacity, and volatility in current risk creates disequilibrium in pricing. When premiums become almost as unpredictable as losses, the insurance buyer is forced to turn to risk-financing solutions that are not based on conventional insurance. Thus, today no organization can depend solely on commercial insurance and the development of mutual dependence, and indemnification by means of a private pooling of risks is also a growth sector, receiving encouragement from national and world trade authorities.

Some US$10 billion of annual premiums have been identified in insurance organizations, which are the subject of this study. This sum received a considerable boost in 1986, when major US corporations sought liability insurance capacity to the value of some $1 billion, the subject of cyclical withdrawal by established American and European insurers and re-insurers (ibid.).

## Mutual stock

Mutual stock insurance organizations operate on an advance premium basis and are generally capitalized on the lines of a stock corporation. The stockholders or shareholders enjoy a return on their investment represented by the capital stock. Some of these may issue assessable or non-assessable contracts (where they have a system of 'calls' for premium post loss), but the assessment liability is typically limited (Klock 1974: 379). These mutual practices have in the past been designed to serve the requirements of a particular class of insured persons in the same trade or profession, frequently under the aegis of a trade or professional body. More recently hybrid mutual operations have emerged as a matter of necessity to replace insurance capacity vacated by commercial insurers after a buyers' market in the insurance trade cycle.

## Mutual assessment

There are mutual insurance organizations that operate on an assessment basis. For the smaller mutual of this class, contributions may be sought from the policyholders, in most cases, after a loss has occurred. Frequently for the larger and more established mutual, sufficient funds and expertise will have been accumulated to make advance calls that will generally be sufficient to cater for all losses in that financial year. These mutuals are usually non-profit making, without share capital, and are used by insurers of a particular class, with or without the involvement of the trade or professional body concerned (ibid.).

An example of this kind of mutual is the 'Protection and Indemnity Club' (Carter 1973: 59). This largely owes its origin to the reluctance of London underwriters to associate themselves with the liability risks that emerged in shipping around the turn of the nineteenth century. The clubs, as they became known (*The National Mutual Life with Profits Guide* August 1993: 5) also provided advice and services. Some have become involved in physical damage insurance to the hulls, others in war and strike risks. More recently, they have been used to solve professional liability problems.

## Other registered societies and clubs

Called 'fraternal' in the US, certain organizations provide mutual aid and self-help (Peffer 1974: 411). Examples are:

1 friendly societies, which began over 200 years ago, performing functions largely taken over by the Welfare State, but which still provide for those areas where the services of the State or other agencies are either non-existent, inadequate or need supplementing. In addition to life assurance and relief or maintenance during sickness, unemployment and retirement, friendly societies are able to provide other insurance that is of a more personal nature;
2 non-profit-making organizations helping with private health care and the effects of hospitalization;
3 the insurance cooperative which is most frequently used for agricultural insurance; and
4 in Third World countries, 'reciprocals'. Reciprocal exchanges operate in the areas of property damage and liability protection. They are unincorporated associations of the insured, each insured person, in effect, being a part owner of the enterprise and assuming a definitely established underwriting liability, which is shared. Reciprocal exchanges have also been used in the US as a way of providing insurance capacity where commercial insurance may not exist, for example, malpractice insurance for physicians.

By pooling risk through a mutual, the members of these organizations obtain considerable advantages in their attempts to finance their fortuitous risks. Principally, they will be able to achieve the ability to insure and manage risks in circumstances and at times when commercial insurance is neither available nor affordable (Klock 1974: 379).

The use of a wide and homogeneous database enables such organizations to create a rating structure more accurate than might otherwise have been the case. Also, the element of self-interest enables the members to discipline themselves in a way that does not obtain in the commercial insurance market. This, in turn, will allow reductions in loss costs to be made and broader covers to be granted. Smaller members may also enjoy the possibility of purchasing insurance with discounts similar to those that larger companies enjoy in the commercial market. This way, all the values of insurance are further enhanced.

The ultimate purpose of mutual insurance companies is to serve the objectives of risk management, by providing a mechanism to reduce losses (Housell 1987: 4). The opportunities for reductions in the cost of financing insurable losses through the mutual are considerable and, in some instances, this route is the only one available. However, in seeking to minimize the overall risk for the organization looking to establish a mutual, the insurance, legal and tax implications are considerable.

## Risk management

Organizations today undertake such a wide variety of tasks that their corporate objectives differ greatly. For any commercial organization the financial objectives can be simple, expressed as: *revenue – costs = profit* (*or loss*) (Sanders 1987).

This equation states the obvious, but it helps to emphasize that any decision, which affects one variable must affect at least one of the others. Thus, if a corporation wishes to improve its profits, it can do so by increasing its revenue, reducing its costs or by doing both (Lalley 1992: 37). Some organizations do not have the freedom to alter every one of these variables.

The cost of risk to any organization must represent a significant part of the total costs and it can vary drastically from year to year. The object of risk management is to plan, organize and control, to bring down the cost of risk to the lowest possible level tempered only by other corporate objectives voluntarily adopted or imposed by legislation.

## Applications of mutual insurance to risk management

Many insurable risks are in fact difficult to insure. This is particularly true of the kind of risks emerging from today's economic and political uncertainties. For example, negligence has become a wholly abstract and uncertain concept. Judgement is frequently based on the insurance principle of 'which can pay?'

As a result, in some cases and at certain times, conventional insurance is very restricted and may disappear completely at short notice. Conventional insurance for professional indemnity, in particular, is becoming increasingly expensive. However, the commercial insurance market is not to blame for this unsatisfactory situation. Fundamentally, any risk is insurable (Handsell 1987: 7) and at stable premiums, if it is static, clearly identified, precisely defined and quantified in terms of probability of incidence and severity of costs.

There are other requirements, which enable the insurer to apply 'the law of large numbers', namely that there must be a sufficient 'spread' of risk, over which to make a 'book' of underwriting probabilities, and thus secure the average and expected result. Apart from the unpredictability of many of today's risks, the insurance market is also faced with unpredictability of demand from their customers from year to year (Wise 1993: 4).

It becomes very difficult for an insurance underwriter to obtain the broad spread of risk he needs, both in terms of good and bad risks, as well as in terms of geographical spread, without some kind of group scheme to which members voluntarily commit themselves for a reasonable period of time.

How can the insurance industry succeed in the quantification of probability and severity? Too much uncertainty produces volatility in terms of insurance and many of the risks that threaten the trade or the current insurance market are not catered for by professional association members. As soon as volatility enters the scene, insurability disappears in the eyes of the insurers (Lalley 1992: 42).

Volatile risk comes to be equated with business risk, and insurance can therefore only perform with the greatest difficulty, as insurance premiums will always be volatile. Much of the volatility described can be controlled, if not entirely eliminated, by measures that recognize the problems encountered. Many trade and professional associations have attempted to reward their members for the cost of the administration and management. To a large extent, such schemes can help to establish the acceptance of uniformity and make the cost of risk reduction worthwhile. There is also the problem that commercial underwriters can never know as much about the risks of any given group of organizations as the people within those organizations.

Outside life assurance, insurance is a trading market and, in common with other commodity markets, is subject to trade cycles. The fluctuations in the insurance trade cycle are of a similar nature. Capital flows into the industry in times of profitability, pushing down insurance rates. This leads to some forms of insurance, particularly the more volatile risks, at any time becoming affordable or unavailable, or only available at inadequate levels of indemnity, as investors leave the market.

After a period of shortage, the rates rise, tempting capital back into the industry. This eventually leads to competition for market share, and the whole process repeats itself. Over recent years the fluctuations have become more acute. In the ten-year cycle leading to the turn of the twenty-first century, the downturn in the market was delayed by high interest rates, and in the previous cycle it was precipitated by a 'bear' market, which depressed insurance funds. Thus, interaction with general economic developments may distort the insurance cycle further (Volkswagebwerk 1972: 12).

An example of how self-interest and self-help can operate in mutual trading in insurance is that of the lawyers' mutual for professional negligence risks (Yorrow 1990: 37). This is one of the most volatile of risks to insure against. Often, and depending on the state of the insurance cycle, this form of cover is difficult or unavailable to buy and there are massive price fluctuations. Yet the members of this mutual have enjoyed consistent cover at reasonable premiums for many years. Furthermore, if one is paying for one's own claims, the essential elements of risk management are reinforced, through the principle of mutuality. There is a very strong incentive to make sure that claims are kept to a minimum.

There is also a systematic method of dealing with all circumstances that might lead to a claim. Once these are notified, a full-time lawyer retained for the purpose constantly monitors individual members' claims experience and suggests remedial action. In such situations, a return to the more primitive forms of mutual protection may not only be a better alternative to conventional insurance; it may be the only form of insurance available.

In the case of difficult risks, and when the commercial insurance market is not able to provide affordable protection (ibid.: 48), the ability of an adversely affected organization to manage its risks better is the key to regaining the advantages of protection by combination. A return to the original principle of sharing the risk, inherent in the mutual form, is the key to improved risk management.

At present, there are over 500 mutuals in the USA and their number is growing (American Insurance Association 1992: 2:33). The members, certainly from the most successful operations, will find it beneficial to draw up their own 'rules of the club', in the form of a members' agreement (ibid.). The agreement spells out the terms of acceptance into, and continuing membership of, 'the club'. The vital elements of self-interest and consequent insurability at affordable terms are restored via the incorporation of beneficial codes of conduct, risk management procedures, loss reduction (pre- and post-claim), disciplinary codes and the methods of transacting business, policy terms and rates, re-insurance procedures and requirements, method of cost, premium and surplus allocation.

## Re-insurance and foreign exchange

Insurance markets in developing markets often lack a sufficient number of similar risks. The risks insured are generally few, but they are larger relative to the total exposure and cannot be balanced in the same market; therefore, it will require re-insurance in another market or foreign country, leaving a relatively small and manageable risk for the local market. Hence the outflow of re-insurance remittance constitutes a substantial amount of foreign exchange, which may have an effect on the cash flow and balance of payment.

In addition, the technical reserve funds (savings by insurance for the policyholders) can be effected, and immediate payment of these funds represents a further drain of cash flow. The excessive dependence by the developing countries on foreign re-insurance facilities is likely to lead to unfavourable terms and conditions.

The establishment of national and regional re-insurance schemes has embraced a number of mutual insurance companies, as is the case in Great Britain (ibid.:35). National Insurance institutions are beneficial both to mutual insurance companies in the local and national markets and to the economy of the country, particularly in the area of foreign exchange requirements.

## Investment of mutual insurance

Investment of mutual insurance funds constitutes an important issue of paramount importance; such funds need spread in diversity of investments as well as an adequacy of safety and yield. Stock exchange investments combine these advantages, and accordingly a large portion of mutual insurance reserve funds is usually invested in stock exchange bonds. Obtaining the maximum economic progress, notably when the market is restricted in developing countries, is a particularly sensitive issue.

Another area of investment is real estate, which can also be restricted if an imposition of rent control by the government is in force. However difficult the investment problems seem, there will always be a determination on the part of the mutual insurance company to provide an adequate formulation to help growth.

## State regulation of insurance and re-insurance

The British regulatory philosophy used to be one of voluntary disclosure, under which successive governments relied very much on the publication by insurance companies of accounting information to assist in the operation of the self-regulatory pressures of a competitive market. The American tradition, which mirrored European principles, is highly regulated and codified by statute. It extends, beyond concerns that the insurance company can pay its claims, to other consumer protection matters, such as policy wording and the control of premium rates.

In 1977 the United Nations Conference on Trade and Development encouraged developing countries[1] to establish insurance cooperatives in order to provide better insurance protection. At least 20 developing countries, and most developed countries implemented this. The EU also introduced the concept of the minimum guarantee fund, in place of earlier minimum capital requirements. This provides a new inner benchmark of solvency. This fund must be maintained at a specified amount, depending on the class of business transacted, or one-third of the calculated solvency margin, whichever is greater.

The EU's approach to the calculation of the non-life solvency margin in fact requires two calculations, the first on a premium basis and the second on a claims basis, whereas traditionally only the premiums were used. Sole use of premiums as a means to calculate the solvency margin can result in the margin being reduced by inadequate premium levels. A second calculation using the claims results overcomes this potential flaw by substituting the claims basis for the premiums if the claims ratio exceeds 69.6 per cent. An insurance organization's current growth in written premiums would run the risk of being overlooked if the claims result were the only method used.[2]

Another innovation is a system whereby the amount by which gross premiums in the calculation are reduced to the net retained is measured by the relationship of re-insurance losses recovered to total losses suffered. This compares with the traditional method that uses amounts of re-insurance premiums paid out, but which might not reflect the end result. Moreover, the calculation gives a maximum credit for re-insurance of 50 per cent, which materially affects the smaller organization that may re-insure a substantial proportion of its risks.

In the case of mutual or mutual-type associations, which may seek to assess premium contributions from members after the loss is incurred, that is, with variable contributions, there are two important concessions under the EU regulations that are being used as models elsewhere.[3]

First, it is possible to reduce the appropriate minimum guarantee fund by 25 per cent, thereby allowing relatively low initial funding. Second, it is possible to include in the solvency margin calculation up to 50 per cent as an 'unmade call'. Any claim that the mutual has against its members by way of a call for supplementary contribution within the financial year can be allowed. This can be up to one-half of the difference between the maximum contributions and the contributions actually called in, provided that the limits of liability are kept to a reasonable level. But whilst the EU regulations pertaining to mutuals are held to be an improvement on the more traditional methods of control, defects remain.

The solvency margin calculation treats all re-insurers alike, and does not discriminate against the less fortunate (Anderson and Thompson 1921: 333). Neither does the solvency margin guard against potential ruin from investment depreciation: foreign exchange and claims are somewhat arbitrary, and no evaluation is made of the profitability of any given line of business, or adequacy of loss reserves.

The EU regulations provide the manager of a mutual with a better set of 'ground rules' than previously existed in law. The EU has yet to harmonize accounting standards within the Community and relies upon the existing accounting standards of the individual member States. Whilst this remains a weakness, the Community has recognized the need for special accounting rules for insurance enterprises, and is preparing a separate insurance accounting directive.

The mutual structure is, in fact, intended to contain substantial elements of equity having regard to the members of each policy-year (Cooper 1995: 35), although the directors of the mutual retain the power to move reserves or parts of reserves from one year to the next. Thus, a mutual can involve capital, although it may not have to provide immediate paid-up capital at the commencement of trading. In such cases the capital is, in effect, with the members of the mutual to be provided where necessary. Most on-shore and offshore supervisory authorities will control a mutual in a most flexible manner.

Although rarely put into practice, the form of incorporation may be on the purest mutual basis, where claims are apportioned and collected from members without any deposit or advance payment. Alternatively, they could go to the other extreme, whereby advance deposits are unlikely to be exceeded, or a ceiling is placed on supplementary calls. For budgeting purposes, a supplementary possible call may be indicated at the beginning of the policy year, to be called or not as circumstances dictate with the progress of the year. Initial funding may consist of gifts, loans, bank guarantees, premiums in advance (that is, more than one year's premium is paid in at the start), or part equity. Ongoing funding can be supplied by drawing on accumulated reserves, advance calls, supplementary calls, and equity raising or loan capital. Whilst unusual, it has been found possible to mitigate supplementary calls for new, non-marine mutual, by the use of re-insurance.

For the modern mutual, flexibility of cover can be given to pay claims excluded or not covered, or to provide for additional insurance to be underwritten beyond that contemplated at the inception of the mutual. Equity is achieved by matching calls against claims payments and the cost of providing services over a period of years. That is, there is self-insurance at cost. Service to members has always been a strong feature of mutual operations with the provision of claims mitigation and loss prevention as well as general risk management.

Whilst the operation of the mutual has followed a specialized path, recently this structure has been used, successfully, to solve risk-financing problems in such diverse areas as professional indemnity insurance, workmen's compensation, social security, employee benefits, and space satellite insurance.

## Mutual insurance in the USA

All insurance companies in the 50 States of the United States are subject to the General Corporation and Insurance laws of the States in which they are authorized to operate. With limited exceptions, all companies writing property are regulated under Department of Insurance casualty, life and marine insurance regulations, according to the local State needs.

Unlike a stock company, a mutual insurance company is a corporation owned and operated by its policyholders (Mason 1992). It is a form of insurance whereby each insured person, by payment of a specified amount into a common fund, engages collectively with other insured persons in indemnifying all others against loss. An insured person is entitled to attend policyholders' meetings and to vote on all questions that arise including the election of members of the company's board of directors.

The first successful mutual insurance company in the USA was a fire insurance company organized in Philadelphia, Pennsylvania, in 1752. It continues in operation to this day as an exceptionally strong institution (Noniewicz 1986). At that time insurance premiums were paid by insured persons in the form of periodic assessments, calculated to cover the actual amount of losses and expenses incurred by the company. Some of the small mutual companies continue to operate today on the assessment basis. Most mutual companies in the country, however, now charge a fixed premium, usually payable in advance. Rates are classified by type of structure, construction, protection and occupancy, or use. Each mutual insurance company is authorized, under a charter issued by the State in which it is domiciled, to provide insurance against various and specific hazards as set out in the company's articles of incorporation. Mutual life insurance companies are limited to classes of cover they can underwrite, namely, life, medical and hospital insurance. They cannot issue policies covering property (National Association of Independent Insurers 1993).

Likewise, mutual property and casualty insurance companies cannot issue life insurance policies, but are specifically limited by their articles to underwriting insurance against damage from such perils as fire, lightning, wind, hail, etc. Additional perils insured against are explosion, riot or civil commotion, aircraft, vehicles, vandalism or malicious mischief, theft and numerous extensions of such basic coverage.

As a mutual insurance company improves its financial position, it may gain the authorization to underwrite additional lines of insurance. Many of these companies have now become 'multiple line' writers, although there are still 'speciality' companies underwriting insurance against such single hazards as hail damage, growing crops or damage to property caused solely by hurricanes, tornadoes, cyclones, windstorms or hail (Holtom 1973).

Regulation by a State Department of Insurance can be extensive. Insurance departments approve rates, forms and policy wordings that are filed by each company. They license agents and supervise their activities; they supervise mandatory deposits of assets by companies operating within the State's boundaries, holding such deposits as a protection for the policyholders in the State. Each department maintains a staff of qualified accountants who periodically examine all records of companies doing business in its jurisdiction. The laws governing insurance company operations are established by the legislature of each State and are administered by the Insurance Department (Shilberg 1987). Although this procedure may result in variations from State to State, little difficulty is experienced by the companies.

Almost all mutual insurance companies are required to file an annual statement each year-end with the Department of Insurance in each State where they are authorized to issue policies (Noniewicz 1986). Whilst certain small companies submit simple forms containing limited information, most insurance companies, mutual and stock, are required to file an annual statement form designed and approved by the National Association of Insurance Commissioners (NAIC), which is made up of each State's Commissioner of Insurance.

The NAIC is a powerful organization that strives for uniformity in regulatory decisions and forms, as well as in laws governing the insurance industry in the United States. The 'convention form' annual statement is a complex 55-page document requiring detailed information relative to a company's premium income, losses, expenses, investments, reserves and assets during the year for which it is filed (Mason 1992). The annual statement is useful in determining the success or failure of a company and its financial condition and forms the basis for the periodically scheduled examinations conducted by the Insurance Departments.

Currently the United States government does little in the way of regulating the insurance industry. Instead, federal guidelines governing many areas of the insurance business have been established. It is ordinarily up to the various State governments to follow these guidelines. In order to maintain State control and regulation of insurance, each legislature establishes procedures in accordance with federal directives (National Association of Insurance Commissioners 1992).

Feeling that its insurance is unable to provide adequate facilities, the federal government does not offer insurance cover in catastrophic areas such as flood, crime, all risk damage to crops, medical protection for the aged or life insurance for members of the armed services. In addition, all insurance companies are subject to the rules and regulations of the Internal Revenue Service, which has certain specific procedures applicable to the payment of federal income by mutual insurance companies.

The 'farm mutual' comprises an important segment of the mutual insurance industry in the United States today. These companies were organized by groups of farmers striving to protect themselves in their rural environment, mostly during the latter part of the nineteenth century. Such companies usually operate in the limited area of a political sub-division, such as a township (36 square miles). They originally provided insurance to farm dwellings and out-buildings, rural churches and meeting halls and, later on to chattels against only two hazards: fire and lightning. In many States insurance departments did not regulate such companies under federal corporate laws, but received authority under the corporate laws of that State. They operated strictly upon an assessment basis with the number and amount of assessments being limited only by the amount of loss suffered by company members (Noniewicz 1986). Many farm mutuals still operate on this basis. Thus limitations have been established, and they continue to insure only against the hazards of fire, lightning and offer limited extended coverage. These companies, through arrangements with larger mutuals underwriting windstorm and hail, third party liability and other extensions, are able to continue serving their rural policyholders.

Over the years, however, other mutual companies, once classified as farm mutuals and providing insurance in rural areas only, have grown and now underwrite most property and casualty lines. The insurance laws of many States are still quite limited in regard to regulation of small, rural underwriters (Mason 1992). As a given mutual company's assets increased it became necessary for it to operate under a different chapter of the insurance law and then submit to departmental regulation.

All mutual insurance companies operating in the United States, with some definitive exceptions, produce business under the system of independent agents or 'captive' agents (Shilberg 1987). The exceptions are:

1 direct underwriters that sell insurance through their employees direct to the public and not, therefore, through independent agents or brokers;
2 those farm mutual companies that depend upon the members of their boards of directors for the production and service of the business; and
3 in those cases where the manager underwrites all the policies for the company.

As the various States enact laws requiring licensing of agents, however, these exceptions become fewer and fewer, resulting in more knowledgeable professional agents.

As the needs of the insuring public become greater it becomes more difficult for the smaller mutual insurance company to provide the necessary coverage. In some areas the powers of the regulatory agencies, the insurance departments, have waned, but in other areas of the business they are more extensive. Through mergers, re-insurance and assurance of combination policies, mutual insurance has maintained a strong position in the United States. Currently there are approximately 1,800 mutual insurance companies operating in the United States, many of which are more than 100 years old (Noniewicz 1986).

## Mutual insurance: the European approach

In the UK and in Europe generally, the conventional market and the insurance brokers are less conversant with the concept of 'self-insurance', and less obliged to seek that route. Thus other criteria for mutual insurance success can be examined, namely the ability to launch the mutual or association captive, without upsetting the conventional insurers or the brokers (Britten 1989).[4] A typical approach in the difficult market of professional indemnity insurance, for example, might be as follows (Akhurst and Watson 1990):

1 To exert influence against current market trends to narrow cover by imposing aggregate limits and excluding broader elements of cover currently available.
2 To improve negligence defence techniques by involvement in 'underwriting' and 'risk bearing' (with profit potential) – pre- and post-loss.

3 To become involved in claims settlement.
4 To 'capture' any excess profits that might be made by the conventional insurance market.
5 To provide a smoothing mechanism to even out the peaks and troughs of the traditional insurance trade cycle.

A purely funding approach may be made that relies on actuarial projections, and does not seek any support from the conventional insurance industry. Such an approach would be based on a company limited by guarantee and the fund would be structured so as not to constitute an insurance contract requiring statutory approval.

The mechanics of such an approach are demonstrated by the first proposals of the Law Society, in the Law Society's Gazette, and Bacon and Woodrow Consulting Actuaries, who made the projections. These proposals were made possible by the following special features (European Commission 1989: 29–39).

1 Under the Solicitors Act 1974, lawyers can establish a fund and grant statutory indemnity to solicitors, employees, etc. (past and present) and oblige solicitors to make contributions to the fund. Thus obligations to make payments into the fund and rights to recover from that fund are established without any contract of insurance ever being in force.
2 Claimants against a solicitor would have statutory rights (under the Solicitors Act) to be compensated by the fund for any claim sustainable against a solicitor. To give the Council some idea of the financial consequences of self-insurance, a limited number of products are set out below (Philips and Drew 1990). When considering them a number of facts must be borne in mind, namely that:

   a actuaries have assumed that the Department of Trade and Industry would not demand that the fund meet the EU solvency margin. Even if it is desired that the fund should be able to operate within the EU solvency margin in the longer term, that margin could be built up over a number of years and, moreover, any incidental losses could be recovered over a period;
   b the projections take into account a 15 per cent year-on-year increase in premiums and claims settlement. The figures take into account increases in the size of the number of claims and the amount of claims, which tend to run ahead of the general level of inflation in the economy;
   c tax is allowed at a rate of 35 per cent and interest at 10 per cent shown at a net rate of 6.5 per cent;
   d reserves are discounted to a figure which, including the additional interest credited thereto, would amount to the sum necessary on settlement, at the projected time that the settlement would be made;
   e claims incurred are claims reserved;

f management expenses are the costs of setting up the venture. Costs of defence are included in the claims and claims reserve figures. Costs of underwriting, claims handling, etc. would be met, from a sum equal to current brokerage;

g the total net investment income is split between net discounted reserves and the profit and loss account;

h the results of each projection can most readily be seen from the balance sheet. The liabilities are made up as follows:
  - i insurance funds – the total of discounted reserves carried forward for prior years and the current year;
  - ii accumulated profits – the profit carried each year to the profit and loss account accumulated to the end of the balance sheet year;
  - iii total liabilities – the sum of insurance funds and accumulated profits.

Under total liabilities is shown the solvency of the fund. The minimum EU solvency margin is compared with the net assets available to cover that margin, where 'net assets' are equal to 'accumulated profits', since no capital contribution is required.

The Law Society Council has approved the Solicitors Indemnity Rules 1987 (Laheac 1993), which will bring into effect a statutory fund providing the same indemnity as was previously given by the master policies, placed earlier in the insurance market.

## Technical personnel and exchange of information

Established mutual insurance needs adequate trained personnel, who are of utmost importance in managing successful mutual insurance. Recruitment of knowledgeable staff in a new mutual insurance scheme can be a difficult task, as the recruitment of experienced staff will need help from larger insurance companies and cooperation between other mutuals. As in the case of the AISM, the aim is to:

1 establish relations between members and to watch over the general interests of private insurance organizations based on the mutual principle of non-profit making;
2 facilitate the exchange of information in legal, fiscal, economic and political matters affecting mutual insurance in different countries;
3 draw members' attention to problems that arise of a general nature in one or more countries, for other members' interests;
4 obtain recognition as a representative of insurance institutions in all international organizations; and
5 keep its members updated on changes and relevant information from around the globe.

## Conclusion

Mutual insurance practised in the West has been established for many years and operates within the framework of the insurance industry. Insurance is based on statistical experience, the main difference between mutual insurance and commercial insurance being that the owner of the mutual insurance is the policyholder, whereas in commercial insurance the owners are normally the shareholders, and are not necessarily policyholders. In mutual insurance, a non-profit making organization, the management loyalty is focused on the policyholders; in commercial insurance, a profit making organization, the management are loyal to the shareholders.

Taking into account the highly technical and complex nature of insurance, mutual insurance requires to be in cooperation with other similar mutual insurance schemes either in the same country or abroad. This cooperation brings the law of large numbers to the small company, and information, problems encountered and up-to-date knowledge become available to mutual organizations large and small.

In developing countries, where the volume of insurance transactions is still small, international corporations can provide practical opportunities for development of the insurance industry. National, or international, re-insurance in these emerging countries is an important backup to mutual insurance; it is a good sign that an efficient service is provided to the mutual insurance organization. The goodwill that is traditionally associated with mutual insurance brings the benefits of security and prosperity.

# 5

# THE DEVELOPMENT OF ISLAMIC BANKING AND INSURANCE IN MALAYSIA

## A case study

### Introduction

Malaysia is a relatively small country of Southeast Asia, whose population is mainly Muslim. Natural resources such as crude oil and gas are the main sources of income, and the economy is dependent on private and foreign investment. With the *Takaful* Act, 1984, the government of Malaysia is considered to be one of the first to adopt Islamic banking and insurance systems parallel to their conventional counterparts.

### The development of Islamic banking in Malaysia

Since the 1970s, Islamic banking has emerged as a new reality on the international financial scene. Its philosophy and principles are, however, not new, having been outlined in the Quran and the *Sunna* of the Prophet Mohammed. The emergence of Islamic banking is often related to a revival of Islam and a desire of Muslims to live all aspects of their lives in accordance with the teachings of Islam.

In Malaysia, separate Islamic legal provisions and banking regulations exist side by side with those for the conventional banking system. The legal basis for the introduction of banking products along Islamic principles was the Islamic Banking Act, 1983, which came into effect on 7 April 1987. The Act provides the Central Bank with powers to supervise and regulate Islamic banks, similar to the cases of other licensed banks. The Government Investment Act, 1983 was also enacted at the same time to empower the government to issue Government Investment Certificates, (GICs) which are government bonds issued on an Islamic basis. As the Certificates are regarded as liquid assets, Islamic banks could invest in them to comply with the prescribed liquidity requirements as well as to park their temporary idle funds. Malaysia was the first country in the world to issue government bonds of an Islamic character.

The first Islamic bank established in the country, namely the Bank Islam Malaysia Berhard, commenced operations on 1 July 1983, with a branch in Kuala Lumpur. Bank Islam was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992 and by the end of 1993 it had a network of 52 branches. In line with its aims, the activities of the bank are based on Islamic principles of banking and credit conforming to the *Shari'a*. On the basis of these principles, Bank Islam offers all the conventional banking services, such as accepting deposits, granting credit facilities, providing safekeeping facilities and fund transfers. The bank accepts savings and demand deposits from members of the public under the principles of *wadi'ah* (deposits). It also accepts term deposits in the form of general investment deposits and special investment deposits under the principles of *Mudaraba*. General investment deposits and special investment deposits are similar to the fixed deposits commonly accepted by commercial banks, merchant banks and finance companies. However, the special investment deposits allow the depositors to specify the manner in which the deposits are to be utilized by the bank.

Service charges are levied on demand deposits, which do not bring any return to the depositors, and savings account holders are not entitled to a share of any return to the depositors or to a share of the bank's profits; but the bank, at its absolute discretion, may reward such savers as a token of its appreciation for the deposit of money with the bank. Profits are paid to the general investment account holders out of the bank's revenue from its financing and investment activities, while the special investment account holders are paid profits or made to bear losses from the manner in which their deposits are utilized.

The bank grants financing facilities such as project finance under the principles of *Mudaraba* and *Musharaka*, lease financing under the principles of *al ijara* and *tatinaa*, hire purchase financing under the principles of *al bai bithaman ajil*, trade financing (including bill financing and letter of credit) under such principles as *murabaha*, *Musharaka* and *wakalah*, guarantees under the principles of *al-kafala* and benevolent loans under the principles of *qard hassan*. In 1991, two new Islamic instruments were introduced, namely Islamic Accepted Bills and Islamic Export Credit Refinancing. Another important development in the evolution of Islamic banking is the securitization of debts and the trading of such debt instruments. After more than a decade in operation, Bank Islam Malaysia Berhard has proved to be a viable banking institution with its activity expanding rapidly throughout the country.

On the prudential front, Bank Islam has to adhere to the same regulatory rules as other banks offering conventional banking products. It is also required to maintain a statutory reserve account with the Central Bank. The long-term objective of the Central Bank has been to create an Islamic banking system which functions on a parallel basis with the conventional system. A single Islamic bank does not constitute a system. A banking system, whether Islamic or conventional, requires three vital ingredients to qualify as a system. These are:

1 a large number of players (there must be an adequate number of different types of institutions participating in the system. This is required to provide depth to the system);
2 a broad variety of instruments (a large variety and range of different types of instruments must be available to meet the various needs of financial institutions and customers); and
3 an Islamic inter-bank market (there must be an efficient and effective inter-bank money market to link the players (institutions) and the instruments).

In addition to the above requirements, which apply to all systems, it must be Islamic in substance and not merely in name (You 1991: Vol. 6: No. 1).

### *A wide variety of instruments*

By the beginning of 1993, a total of 21 Islamic banking products were successfully developed by the Central Bank and, therefore, one of the three requirements for a fully fledged Islamic financial system was achieved, namely the requirement for a large number and wide variety of Islamic financial instruments to meet the various needs of financial institutions and customers. This section deals with each instrument.

#### *Al-wadi'ah yad dhamanah (safekeeping with guarantee)*

*Al-wadi'ah yad dhamanah* refers to deposits which have been deposited with another person who is not the owner for safekeeping. As a *wadi'ah* is a trust, the depositee becomes the guarantor and therefore guarantees repayment of the whole amount of deposits, or any part thereof, outstanding in the account of the depositors when demanded. The depositors are not entitled to any share of the profits but the depositee may provide returns as a gift (*al-hiba*) to the depositors as a token of appreciation.

#### *Al-mudaraba (profit-sharing)*

Profit-sharing, or *al-mudaraba*, refers to an agreement made between two parties: one who provides the capital and the other, the entrepreneur, to effect business projects on a profit-sharing basis, according to pre-agreed ratios. In the case of losses, these are borne by the provider of the funds.

#### *Al-musharaka (joint venture)*

A partnership or joint venture for a specific business with a profit motive, whereby the distribution of profits is apportioned according to an agreed ratio is termed *al-musharaka*. In the event of losses, both parties will share the losses on the basis of their equity participation.

### *Al-murabaha (cost-plus financing)*

*Al-murabaha* refers to the sale of goods at a price which includes a profit margin as agreed by both parties. In *al-murabaha* contracts, the price, other costs and the profit margin of the seller must be stated at the time of the agreement of sale.

### *Bai' bithaman ajil (deferred payment sale)*

The concept of *bai'bithaman ajil* is similar to that of *al-murabaha*, except that in this case the sale of goods is on a deferred payment basis.

### *Bai' al-dayn (debt-trading)*

Debt financing, *bai' al-dayn*, is the provision of financial resources required for production, commerce and services by way of sale, or purchase, of trade documents and papers. It is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from bona fide commercial transactions can be traded.

### *Al-ijara (leasing)*

An arrangement under which the lessor leases equipment, building or other facilities to a client at an agreed rental is referred to as *al-ijara*.

### *Al-ijara thumma al-bai' (hiring followed by sale and purchase)*

*Al-ijara thumma al-bai'* refers to two contracts undertaken separately and consequentially, as follows.

1 *Al ijara* contract (hiring or renting).
2 *Al bai'* contract (sale and purchase).

Under the first contract, the hirer hires the goods from the owner at an agreed rental over a specified period. Upon expiry of the hiring period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price. This concept is applicable to financing the purchase of consumer goods and durables.

### *Al-qard al-hassan (benevolent loan)*

*Al-qard al-hassan* is an interest-free loan given mainly for welfare purposes. The borrower is only required to repay the principal sum borrowed, but may pay an extra amount as a gift (*al-hiba*) at his or her absolute discretion, as a token of appreciation.

*Al-wakala (agency)*

The system of *al-wakala* refers to a situation where a person nominates another person to act on his or her behalf.

*Al-kafala (guarantee)*

The guarantee provided by a person to the owner of goods who had placed or deposited goods with a third party is covered by *al-kafala*. Any subsequent claim by the owner with regard to these goods must be met by the guarantor if it is not met by the third party.

*Al-rahn (borrowing with collateral)*

The concept of *al-rahn* refers to an arrangement whereby a valuable asset is placed as a collateral for a debt. The collateral may be disposed in the event of default.

*Al-hiwala (remittance)*

*Al-hiwala* refers to a transfer-of-funds debt from the depositor's or the debtor's account to the receiver's or the creditor's account where a commission or fee (*al-ujr*) may be charged for such service.

*Al-ujr (fee)*

*Al-ujr* is the commissions or fee charged for services.

## Malaysia and the *Takaful* Act

The Malaysian *Takaful* Act (1984)[1] is certainly one of the most (if not *the* most) developed and comprehensive legislative frameworks aimed at establishing an insurance scheme in compliance with the *Shari'a*. The Act does not prejudice conventional insurance legislation, in that commercial insurance is still allowed and is governed by its own regulations. The *Takaful* Act exists concurrently with conventional insurance laws and offers an insurance scheme in which Muslims can take part.

*Takaful* (Arabic for 'mutual guarantee') is defined in Section 2 of the Act as meaning 'a scheme based on brotherhood, solidarity and mutual assistance, providing for mutual financial aid and assistance to the participants, in cases of need, where the participants mutually agree to contribute for that purpose'. The same section states that the aims and operations of *Takaful* 'do not involve elements which are not approved by the *Shari'a*'.

The Malaysian *Takaful* system can be summarized as follows. *Takaful* business which includes life insurance ('family solidarity business') and non-life insurance ('general business') can be undertaken by a Malaysian company as defined by the Companies Act 1965, or by a society constituted under the Co-operative Societies Act. There is, therefore, no specific company form devised or required to undertake *Takaful* business. Premiums are called contributions in order to imply the notion of gratuitous payment made in order to contribute towards a mutual help scheme. Therefore, the premium is, legally speaking, a donation which is supposed to be to a certain extent disinterested and directed to other insured persons (called participants).

Life insurance companies offer three main types of policy:

1. whole life policy, which involves payment of a fixed sum by the insurance company on death or permanent disability of the policyholder. The premium charged is based on the age and health of the policyholder. On death a lump sum equivalent to the sum insured plus the profits or bonuses accrued is paid to the beneficiary of the policyholder;
2. endowment policy which, in addition to its function of providing death coverage within stipulated periods, also acts as a means of savings for the policyholder. The policy involves the purchase of a policy with a fixed lump sum, or annuity, payable on maturity or death of the policyholder. Part of the premium on this policy constitutes the payment for protection, while the balance constitutes savings; and
3. 'term assurance', where the sum insured of the term policy is payable only in the event of the death or permanent disability of the life insured within the stipulated term. This type of policy does not have surrender value. The premium payable is relatively lower than with whole life, or endowment, assurance.

The office of the Director General was established for implementing the *Takaful* Act. The latter, who is appointed by the Minister of Finance, enjoys very extensive powers and is attached to the general administration of the *Takaful* Act.[2] In particular, the Director General is responsible for whether the operator is carrying out business in a manner 'which is not approved' by the *Shari'a*. The powers of the Director General include the right to refuse to register an operator, or to cancel its registration – thus putting it out of business, where there is evidence of breaches of the *Shari'a*.[3]

Two of the 13 grounds available to the Director General to cancel the registration of an operator are very broad indeed. Because of the very nature of his or her authority, the Director General is given great power of discretion. There are cases where the Director General concludes that the *Takaful* activities of the operator are possibly detrimental to the interests of its participants and where public interest requires the cancellation of the registration.[4] The Director General exercises control on the forms of proposals, policies and brochures (issued by the operator) and may order that a form be discontinued if it is considered in contravention of the *Takaful* Act, or if it appears to be misleading.

In Sections 33, 46(1)(g) and 47, all books, accounts, other documents and information held by the operator may be inspected or investigated at will by the Director General who can also issue directions to the operator if there is suspicion that the latter is carrying out business 'in a manner likely to be detrimental to the public interest, the interests of the participants or the interests of the operator'. In this respect the operator may be asked by the Director to cease the category of business conducted.

The Director General is the licensing authority for *Takaful* brokers and adjusters.[5] The *Takaful* Act also imposes the establishment of a *Shari'a* supervisory council, to control the legality of the business conducted by the operator.[6] Such control would affect the business on many levels, be it investment,[7] or the terms of the policies, or other levels. Such supervisory organs have already been set up by the 'Islamic' insurance companies operating at the time of the enactment of the *Takaful* Act. They represent the only guarantee of the legality of the operations effected by the insuring body.

The Act enjoins the operator to make a deposit, determined by the Minister, with the Accountant General of Malaysia. What is of importance here is that such deposits are to be invested in compliance with Islamic law. The importance of this point highlights the fact, expressed earlier, that in countries where no appropriate legislation is enacted for 'Islamic' institutions, the latter may be obliged to contravene the *Shari'a* in order to comply with the legal prescriptions applicable to them, which are intended to regulate conventional commercial entities. The above-mentioned prescription constitutes an example of remedy in this respect.

Section 18 of the Act places restrictions on the payment of dividends to the shareholders. No dividend shall be paid until all the capitalized expenditure of the operator has been written off. Capitalized expenditure, according to the Act, is meant to include 'preliminary expenses, organizational expenses, share selling commission, brokerage, amounts of losses incurred and any other items of expenditure not represented by tangible assets'. From this section it appears that the insuring body, under the *Takaful* Act, is normally a company with shareholders, and thus the mutual concept is not adopted. As will be argued later, in practice insurance remains, under the Act, an activity promoted and conducted for profit, but being a form of commercial insurance does not automatically make the scheme unlawful in the light of Islamic law.

The *Takaful*, or indemnity fund, is maintained by operators in respect of each of the classes of business engaged in.[8] *Takaful* guarantee scheme funds are established by the Director General, by means of levies paid by the operator.[9] Such funds, if available for investment, must be fully in compliance with Islamic law. Re-insurance, named Re-*Takaful*, is compulsory, by virtue of Section 23 of the Act.

The insurance industry is regulated by analysing periodic returns as well as by on-site inspection. The primary objectives of on-site inspections are to ensure that insurance companies and insurance intermediaries are solvent, that they operate in accordance with the requirements of the Insurance Act, 1963 (and other relevant regulations) and that they adopt sound business practices and are managed by competent persons.

The *Takaful* Act is a set of protective measures to benefit those insured. The rules in this regard are not new or particular to *Takaful*, for example the deposit requirement, the lodging of statements of accounts with the relevant authority,[10] licensing of brokers,[11] actuarial investigation[12] and other such measures aimed at regulating the business and safeguarding, as efficiently as possible, the interests of those in weaker bargaining positions.

It should be emphasized that the *Takaful* Act has, in many respects, been inspired by, and is framed according to, the Malaysian Insurance Act, 1963[13] and the UK Insurance Companies Act of 1982.[14] A significant part of the protective measures adopted by the *Takaful* Act has been adapted from the above: *f*or example, the powers and prerogatives of the Minister in charge of *Takaful* supervision and of the Director General of *Takaful*, which is borrowed from the UK Insurance Companies Act, 1982, as regards the duties of the Secretary of State. From those powers come:

- the duty of the insurer to deposit accounts and other statements with the Director General/Secretary of State;[15]
- the power to obtain information and require production of documents;[16]
- the power of the Minister/Secretary of State to require an insurer not to make investments of a specified class or description and to realize the whole or a specified proportion of investments of a specified class or description;[17]
- the entitlement of the Director General/Secretary of State to petition to wind up the company;[18] and
- the duty to notify change of director, controller or manager to the Director General/Secretary of State.[19]

Such safeguards for the protection of policyholders are more extensive in the case of the Director General under the *Takaful* Act: for example, the power to direct the insurance company, restricting its freedom to dispose of its assets, is much wider in the *Takaful* Act than in the UK Insurance Companies Act, 1982.[20] There are other similar prescriptions in the two Acts, such as the right of policyholders to receive copies of documents and statements deposited with the Director General/Secretary of State, periodic actuarial investigation for life insurance business and establishment of a separate insurance fund for assets and liabilities attributable to long-term business, or to industrial assurance business under the 1982 Act and to all classes of business according to the *Takaful* Act.[21]

The margin of solvency condition placed on payment of dividends in Section 18 of the *Takaful* Act is restricted to long-term business in the 1982 Act,[22] but in all cases there is a requirement of permanent solvency margin in both Acts.[23] Finally, two identical provisions, which should be underlined, are the prescriptions pertaining to misleading statements and to intermediaries. Section 28 of the *Takaful* Act, which adopts exactly the same wording as Section 73 of the 1982 Act, renders any person who misleadingly induces persons to enter into a contract of insurance guilty of an offence. Section 36-1 of the *Takaful* Act, also similar to Section 74 of the 1982 Act,[24] requires any person connected with an insurer to 'give the prescribed information with respect to his connection with the operator insurer to the person to whom the invitation is issued'. A comparison of the two Acts demonstrates that the *Takaful* Act contains major provisions which are similar to other legislation dealing mainly with commercial insurance.

The safeguards introduced by the *Takaful* Act in order to afford protection to the insured are not restricted to 'Islamic' insurance. Indeed, there are many regulations in force in the context of commercial insurance that are interventionist in favour of the insured, where commercial insurance presents no more likelihood of inequality than the *Takaful* system.[25] It remains, therefore, to question the rationale behind rendering the *Takaful* Islamically permissible, whilst rejecting conventional insurance unacceptable under the *Shari'a*. It is particularly remarkable that the *Takaful* Act has no special structure imposed on the insuring body. Moreover, there has been no attempt to introduce the mutual concept, much acclaimed by those opposing conventional insurance, as the only lawful structure. This cannot but be approved, since it was concluded earlier.

The mutual form does not, by itself, validate insurance since it has no bearing on the forbidden elements supposedly involved in commercial insurance. The *Takaful* Act, by allowing *Takaful* to be conducted by 'a company, as defined in the Companies Act 1965, or by a society registered under the Co-operative Societies Act'[26] acknowledges the commercial character of *Takaful*. *Takaful* is viewed as a commercial activity operated by the insuring body as a business, that is, as an activity generating profit. Yet, despite the fact that this source of profit is implicitly viewed as such, the *Takaful* Act presents *Takaful* as a scheme based on brotherhood, solidarity and other disinterested moral values,[27] and it colours its terminology in that vein, using words and expressions such as 'family solidarity' for life insurance and 'contribution' for premiums.

The Act presumes that the insured persons are animated by a will to assist each other financially and also that, by virtue of the *Takaful* scheme, financial aid and assistance will be available 'to the participants in case of need'.[28] This feature, which is meant to be the basis of the distinction between *Takaful* and conventional insurance, is more an idealistic supposition than a fact. The reality is that the participant usually has the same motivations as any other insured contracting conventional insurance. The sum insured is payable in compliance with the conditions contained in the policy (*Takaful* certificate) when the event insured against occurs without regard to the need of the participant. As a result, there is an evident contradiction between the intrinsically commercial nature of the scheme and the charitable and benevolent aspect of it.

This inconsistency stems from the desire to give to the scheme a humanitarian character which, it is thought, would bring it in line with the requirements of the *Shari'a*. The fact is that this dressing up of the scheme carries no real significance, since it lacks a genuine basis. In addition to this, the majority of protective measures contained in the Act are, as has been demonstrated, common to all kinds of insurance. However, there are no grounds on which to infer that *Takaful* is identical to commercial insurance due to the specific requirement that *Takaful* operations be in compliance with the *Shari'a*. Consequently there are provisions in the Act which require that the investment of deposits and *Takaful* guarantee scheme funds be carried out in a way not contrary to the *Shari'a*.[29]

This characteristic forms the distinction between *Takaful* and other insurance schemes. The rest is a matter of terminology and theoretical assumptions, so that in reality the *Takaful* Act, in view of its similarities with commercial insurance, is an implied acknowledgment of the validity of this latter provided that the investment policies adopted are not in breach of Islamic law.[30]

This latter issue falls within the competence of the Islamic supervisory board appointed by the insuring body. The Islamic and moral nature of the Act is also apparent in the proposal forms and policies circulated by *Takaful* companies. One example is the following explanatory paragraph contained in the 'Proposal for Participation in the Family *Takaful* Plan and *Takaful* Mortgage Plan':[31]

> In essence therefore the operation of *Takaful* can be summarized as a venture which embodies the virtues of co-operation, mutual help and shared responsibility among the participants. The embodiment of the principles among members of the community is in line with the injunction of the religion of Islam.

While such an interpretation may be applicable to most insurance operations, it contradicts other clauses of the same document, serving to negate the presumed disinterested and charitable elements in the scheme. One example of such clauses is that fixing the maximum maturity date for any participant to their 60th birthday is something that would normally be found in a conventional life insurance policy, but not in a scheme aimed at supporting humanitarian considerations. These, and other, contradictions are caused by an attempt to find in the *Shari'a* positive justification for insurance whilst, in reality, the contractual freedom afforded by Islamic law is sufficient to validate insurance and renders this unrealistic exercise superfluous.

The use of *Mudaraba* comes as a striking illustration of the endeavour to 'Islamicize' the insurance contract at the expense of applying *Mudaraba* rules incorrectly. In the proposal cited above, *Mudaraba* is reduced to a mere method of apportioning profits. The surplus remaining in the indemnity funds after payment of compensation and deduction of operational and re-insurance costs is shared between the participants and the company, provided the participants have not incurred any claims and no *Takaful* benefits have been paid to them. This sharing of the surplus is in a ratio agreed to, in accordance with the principle of *Al Mudaraba*.

Despite the inconsistencies cited above, the *Takaful* system set up in Malaysia has the merit of being both comprehensive and properly regulated by law. It constitutes an undeniable step towards freeing insurance from elements contravening Islamic law pertaining to the investment policies followed by insurance companies.

With the introduction of the Islamic inter-bank money market on 3 January 1994, all the three vital ingredients that are required for a comprehensive, vigorous and vibrant Islamic banking system were set in place which enabled the Islamic banking system in Malaysia to take off on a path of sustained growth.

## Overview of Islamic banking in Malaysia (BNM report)[32]

Since the 1970s, Islamic banking has emerged as a new reality in the international financial scene. Its philosophies and principles are, however, not new, having been outlined in the Holy Quran and the *Sunna* of Prophet Mohammed more than 1,400 years ago. The emergence of Islamic banking is often related to the revival of Islam and the desire of Muslims to live all aspects of their lives in accordance with the teachings of Islam.

In Malaysia, separate Islamic legislation and banking regulations exist side-by-side with those for the conventional banking system. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) which came into effect on 7 April 1983. The IBA provides BNM with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the government of Malaysia to issue Government Investment Certificates (GIC), which are government securities issued based on *Shari'a* principles. As the GIC are regarded as liquid assets, the Islamic banks could invest in the GIC to meet the prescribed liquidity requirements as well as to invent their surplus funds.

The first Islamic bank established in the country was Bank Islam Malaysia Berhard (BIMB) which commenced operations on 1 July 1983. In line with its objectives, the banking activities of the bank are based on *Shari'a* principles. After more than a decade in operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992.

The long-term objective of BNM is to create an Islamic banking system operating on a parallel basis with the conventional banking system. However, similar to any banking system, an Islamic banking system requires three vital elements to qualify as a viable system, i.e.:

- a large number of players;
- a broad variety of instruments; and
- an Islamic money market.

In addition, an Islamic banking system must also reflect the socio-economic values in Islam, and must be Islamic in both substance and form.

Recognizing the above, BNM adopted a step-by-step approach to achieve the above objective. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as *Skim Perbankan Tanpa Faedah* (Interest-free Banking Scheme) or SPTF in short.

In terms of products and services, there are more than 40 Islamic financial products and services that may be offered by the banks using various Islamic concepts such as *Mudaraba*, *Musharaka*, *Murabaha*, *Bai' Bithaman Ajil* (*Bai' Muajjal*), *Ijara*, *Qardhul Hasan*, *Istisna'* and *Ijara Thumma Al-Bai'*. To link the institutions and the instruments, the Islamic Inter-bank Money Market (IIMM) was introduced on 4 January 1994.

In October 1996, BNM issued a model financial statement for the banking institutions participating in the SPI requiring the banks to disclose the Islamic banking operations (balance sheet and profit and loss account) as an additional item under the Notes to the Accounts.

As part of the effort to streamline and harmonize the *Shari'a* interpretations among banks and *Takaful* companies, BNM established the National *Shari'a* Advisory Council on Islamic Banking and *Takaful* (NSAC) on 1 May 1997 as the highest *Shari'a* authority on Islamic banking and *Takaful* in Malaysia.

On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhard (BMMB), commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhard (BBMB) and Bank of Commerce (Malaysia) Berhard (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhard (BBMBK) were transferred to BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB accordingly. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia and a staff workforce of 1,000, migrated from BBMB, BOCB and BBMBK.

### *Islamic Inter-bank Money Market*

The Islamic Inter-bank Money Market (IIMM) was introduced on 3 January 1994 as a short-term intermediary to provide a ready source of short-term investment outlets based on *Shari'a* principles. Through the IIMM, the Islamic banks and banks participating in the SPI would be able to match their funding requirements effectively and efficiently. BNM issued the Guidelines on the IIMM on 18 December 1993 to facilitate proper implementation of the IIMM.

The IIMM covers the following aspects:

- Inter-bank trading of Islamic financial instruments; and
- M*udaraba* Inter-bank Investments (MII).

Only Islamic banks, commercial banks, merchant banks and eligible finance companies and discount houses are allowed to participate in the IIMM.

### *Inter-bank trading*

Eligible banking institutions are allowed to trade in the designated Islamic financial instruments, such as Islamic accepted bills, Islamic 'green' bankers' acceptances and Islamic debt securities among themselves. GIC are non-tradable but the players may exchange the papers among themselves based on the price issued by BNM.

### *Mudaraba Interbank Investments (MII)*

MII refers to a mechanism whereby a deficit Islamic banking institution ('investee bank') can obtain investment from a surplus Islamic banking institution ('investor bank') based on M*udaraba* (profit-sharing). The period of investment is from overnight to 12 months, while the rate of return is based on the rate of gross profit before distribution for investments of one-year of the investee bank. The profit-sharing ratio is negotiable among both parties. The investor bank at the time of negotiation would not know what the return would be, as the actual return will be crystallized towards the end of the investment period. The principal invested shall be repaid at the end of the period, together with a share of the profit arising from the use of the fund by the investee bank. Beginning 2 February 1996, BNM introduced the minimum benchmark rate for the MII, i.e. the prevailing rate of the Government Investment Issues plus a spread of 0.5 per cent. The purpose of the benchmark rate is to ensure that only banks with reasonable rate returns participate in the MII.

### *Government Investment Issue*

When the first Islamic bank in Malaysia began its operations in 1983, the bank could not, among other things, purchase or trade in Malaysian Government Securities (MGSs), Malaysian Treasury Bills (MTBs) or other interest-bearing instruments. However, there was a serious need for the Islamic bank to hold such liquid papers to meet the statutory liquidity requirements as well as to park its idle funds. To satisfy both requirements, the Malaysian Parliament passed the Government Investment Act in 1983 to enable the government of Malaysia to issue non-interest bearing certificates known as Government Investment Certficates (GICs) (since replaced with Government Investment Issues (GIIs)). GIIs were introduced in July 1983.

The GII represent borrowings by the government for its development expenditure. However, unlike the borrowings by way of the MGS or MTB, the GII do not have a pre-determined rate of interest. It is issued based on the concept of *Qardhul Hasan* (benevolent loan). Under this principle, the purchase of GII by any institution or individuals will be considered as a benevolent loan to the government to enable the government to undertake developmental projects for the benefit of the nation. The providers of the funds (institution or individuals) would not expect any return on their loans but would expect the principal amount to be returned at maturity. The rate of return, if any, would be at the absolute discretion of the borrower, that is, the government. If the government decided to give a return to the GII holders, the Dividend Committee comprising representatives from the Ministry of Finance, BNM, and the Economic Planning Unit and the Religious Affairs Section, both of the Prime Minister's Department, will recommend the rate of return for the GII. Normally, the rate of return is determined by a number of factors such as the economic conditions of the country, existing yield levels for similar instruments, and inflation rate.

The concept of *Qardhul Hasan* does not satisfy the GII as tradable instruments in the secondary market. To address this shortfall, BNM opens a window to facilitate the players to sell and purchase the papers with the Central Bank. The price sold or purchased by the players is determined by BNM which maintain a system to record any movement in the GII. As at the end of 1999, the outstanding amount of the GII issued is RM2 billion.

### *Financial institutions offering Islamic banking services*

The Islamic banks are not the only financial institutions involved in Islamic banking. Other financial institutions also offer Islamic banking services through the 'Islamic Banking Scheme'.

#### *Islamic banks*

1 Bank Islam Malaysia Berhard.
2 Bank Muamalat Malaysia Berhard.

#### *Commercial banks*

1 Affin Bank Berhard.
2 Alliance Bank Malaysia Berhard.
3 AmBank Berhard.
4 Bank Utama (Malaysia) Berhard.
5 Citibank Berhard.

6 EON Bank Berhard.
7 Hong Leong Bank Berhard.
8 HSBC Bank Malaysia Berhard.
9 Malayan Banking Berhard
10 OCBC Bank (Malaysia) Berhard.
11 Public Bank Berhard.
12 RHB Bank Berhard.
13 Southern Bank Berhard.
14 Standard Chartered Bank Malaysia Berhard.

*Finance companies*

1 Affin-ACF Finance Berhard.
2 AmFinance Berhard.
3 EON Finance Berhard.
4 Hong Leong Finance Berhard.
5 Kewangan Bersatu Berhard.
6 Mayban Finance Berhard.
7 Public Finance Berhard.
8 RHB Delta Finance Berhard.
9 Southern Finance Berhard.

*Merchant banks*

1 Affin Merchant Bank Berhard.
2 Alliance Merchant Bank Berhard.
3 AmMerchant Bank Berhard.
4 Aseambankers Malaysia Berhard.
5 Malaysian International Merchant Bankers Berhard.

*Discount houses*

1 Abrar Discounts Berhard.
2 Affin Discount Berhard.
3 Amanah Short Deposits Berhard.
4 CIMB Discount House Berhard.
5 KAF Discounts Berhard.
6 Malaysia Discount Berhard.
7 Mayban Discount Berhard.

## Conclusion

Malaysia has emerged as the first country to implement a dual banking system, that is, an Islamic banking system on a basis parallel with the conventional system in countries with a free market economic system. It has thus emerged as the first country to have a fully fledged Islamic banking system. The Malaysian model has been recognized by many Islamic countries as the model of the future and they have shown keen interest in studying it in order to implement a similar system in their respective countries.

The 'Mudaraba Contract for Investment, Savings and Takaful among Moslems' could be seen as a valuable and Islamically valid investment opportunity but, coupled with life cover, its adequacy in non-life insurance is doubtful. In a non-life insurance policy, one cannot be expected to enter into a *Mudaraba* contract each time one needs to insure some form of property, and if the insurance aspect alone is applied the scheme becomes a variation of with-profit policies and is, therefore, not an Islamic alternative to commercial insurance, as is intended.

*Table 5.1* Number of financial institutions

| | *As at end* | | | | *March* |
|---|---|---|---|---|---|
| | *1998* | *1999* | *2000* | *2001* | *2002* |
| Islamic banks | 1 | 2 | 2 | 2 | 2 |
| Commercial banks | 25 | 23 | 21 | 14 | 14 |
| Finance companies | 18 | 16 | 14 | 10 | 10 |
| Merchant banks | 5 | 5 | 5 | 5 | 5 |
| Discount houses | – | 7 | 7 | 7 | 7 |

*Table 5.2* Number of branches/Islamic banking scheme counters

| | *As at end* | | | | *March* |
|---|---|---|---|---|---|
| | *1998* | *1999* | *2000* | *2001* | *2002* |
| *Islamic banks* | 80 | 120 | 122 | 122 | 122 |
| *Commercial banks* | | | | | |
| Full-fledged branch | 7 | 6 | 7 | 8 | 8 |
| SPI counters | 1,553 | 1,366 | 1,338 | 1,335 | 1,335 |
| *Finance companies* | | | | | |
| Full-fledged branch | 3 | 2 | 2 | 2 | 2 |
| SPI counters | 823 | 735 | 745 | 730 | 730 |
| *Merchant banks* | | | | | |
| SPI counters | 6 | 6 | 4 | – | 0 |

*Table 5.3* Financing deposit ratio (%)

| | *As at end* | | | | *March* |
|---|---|---|---|---|---|
| | *1998* | *1999* | *2000* | *2001* | *2002* |
| Islamic banks | 90.3 | 51.9 | 56.8 | 52.6 | 48.8 |
| Commercial banks | 52.3 | 46.5 | 53.5 | 55.6 | 57.2 |
| Finance companies | 78.7 | 98.8 | 94.4 | 99.3 | 100.2 |
| Merchant banks | 69.4 | 194.0 | 88.7 | 114.6 | 103.1 |

*Table 5.4* Total assets 1994–March 2002 (RM'000)

| *Year* | *IB* | *CB* | *FC* | *MB* | *DH* | *SPI* | *Total* |
|---|---|---|---|---|---|---|---|
| 1994 | 3,046,310 | 1,397,457 | 347,961 | 93,318 | – | 1,838,736 | 4,885,046 |
| 1995 | 3,248,000 | 2,038,916 | 651,277 | 259,230 | – | 2,949,423 | 6,197,423 |
| 1996 | 3,962,000 | 3,652,757 | 1,852,937 | 664,767 | – | 6,170,461 | 10,132,461 |
| 1997 | 5,202,104 | 9,077,980 | 2,924,381 | 676,839 | – | 12,679,200 | 17,881,304 |
| 1998 | 5,698,378 | 11,385,159 | 3,321,390 | 778,134 | – | 15,484,683 | 21,183,061 |
| 1999 | 11,724,223 | 15,589,065 | 4,806,146 | 1,439,347 | 2,577,707 | 24,412,265 | 36,136,488 |
| 2000 | 14,008,934 | 20,058,475 | 7,149,872 | 1,507,952 | 4,288,350 | 33,004,649 | 47,013,583 |
| 2001 | 17,404,759 | 27,026,076 | 9,768,572 | 1,352,925 | 3,748,697 | 41,896,270 | 59,301,029 |
| Mar 02 | 19,095,123 | 27,282,770 | 11,246,057 | 1,358,258 | 3,898,289 | 43,785,374 | 62,880,497 |

*Table 5.5* Total deposits 1994–March 2002 (thousands of RM)

| *Year* | *IB* | *CB* | *FC* | *MB* | *DH* | *SPI* | *Total* |
|---|---|---|---|---|---|---|---|
| 1994 | 2,891,920 | 1,463,139 | 246,710 | 53,944 | – | 1,763,793 | 4,655,713 |
| 1995 | 2,745,335 | 1,744,940 | 378,931 | 56,581 | – | 2,180,452 | 4,925,787 |
| 1996 | 3,283,289 | 2,666,432 | 966,439 | 347,986 | – | 3,980,857 | 7,264,146 |
| 1997 | 3,223,440 | 5,153,239 | 1,170,227 | 348,487 | – | 6,671,953 | 9,895,393 |
| 1998 | 4,039,747 | 8,415,160 | 2,110,717 | 606,456 | – | 11,132,333 | 15,172,080 |
| 1999 | 9,685,166 | 10,576,042 | 3,033,083 | 401,401 | 1,109,163 | 15,119,689 | 24,804,855 |
| 2000 | 11,301,587 | 16,089,422 | 5,392,597 | 867,143 | 2,267,652 | 24,616,814 | 35,918,401 |
| 2001 | 14,375,617 | 22,030,963 | 7,663,718 | 673,451 | 2,362,757 | 32,730,889 | 47,106,506 |
| Mar 02 | 16,103,320 | 22,809,608 | 8,384,778 | 745,437 | 3,019,222 | 34,959,045 | 51,062,365 |

*Table 5.6* Total financing 1994–March 2002 (thousands of RM)

| *Year* | *IB* | *CB* | *FC* | *MB* | *DH* | *SPI* | *Total* |
|---|---|---|---|---|---|---|---|
| 1994 | 1,274,929 | 274,069 | 163,460 | 25,310 | – | 462,839 | 1,737,768 |
| 1995 | 1,966,597 | 842,557 | 452,872 | 229,986 | – | 1,525,415 | 3,492,012 |
| 1996 | 2,259,069 | 2,125,213 | 1,224,931 | 392,518 | – | 3,742,662 | 6,001,731 |
| 1997 | 3,350,689 | 4,705,766 | 2,189,934 | 502,962 | – | 7,398,662 | 10,749,351 |
| 1998 | 3,471,438 | 4,702,815 | 1,878,449 | 408,521 | – | 6,989,785 | 10,461,223 |
| 1999 | 5,029,537 | 4,920,513 | 2,995,546 | 778,202 | 27,773 | 8,722,034 | 13,751,571 |
| 2000 | 6,423,392 | 8,533,577 | 5,089,803 | 769,320 | – | 14,392,700 | 20,816,092 |
| 2001 | 7,671,016 | 12,257,576 | 7,612,937 | 771,608 | – | 20,642,121 | 28,313,137 |
| Mar 02 | 7,852,286 | 13,045,324 | 8,401,775 | 768,719 | – | 22,215,818 | 30,068,104 |

*Table 5.7* Deposit services

| *Products/Services* | *Applicable concepts* |
|---|---|
| Savings deposit | *Wadiah Yad Dhamana/Mudaraba* |
| Current deposit | *Wadiah Yad Dhamana/Mudaraba* |
| General investment deposit | *Mudaraba* |
| Special investment deposit | *Mudaraba* |
| Specific investment deposit | *Mudaraba* |
| Negotiable Islamic Deposit Certificate | *Bai' Bithaman Ajil* (BBA) |
| Islamic Negotiable Instrument of deposit | *Mudaraba* |

*Table 5.8* Retail/Consumer banking

| *Products/Services* | *Applicable concepts* |
|---|---|
| House financing | BBA/*Al-Ijara wa Iqtina* (AIWI) |
| Commercial property financing | BBA |
| Hire purchase | *Al-Ijarah Thumma Al-Bai'* (AITAB) |
| Overdraft | *Murabaha* |
| Share financing/unit trust financing | BBA/*Mudhara/Musharaka* |
| Factoring | *Bai' Al-Dayn* (BAD) |
| Working capital financing | *Murabaha* |
| Credit card | BBA |
| Charge card | *Qardhul Hasan* |
| Umrah financing | BBA |

*Table 5.9* Corporate banking

| *Products/Services* | *Applicable concepts* |
|---|---|
| Project financing | *Mudaraba/Musharaka*/BBA/*Istisna'*/AIWI |
| Bridging finance | *Istisna'*/BBA/*Musharaka* |
| Financing syndication | BBA/*Musharaka/Istisna'/Ijara* |
| Revolving financing | BBA/*Murabaha* |
| Bonds | BBA/*Musharaka/Istisna'/Qardhul Hasan/Ijara* |
| Commercial papers | *Murabaha* |
| Leasing | *Ijara* |
| Industrial hire purchase | AITAB |
| Underwriting, lead arranging/advisory | *Ujr* |

*Table 5.10* Treasury/Money market investment products

| *Products/Services* | *Applicable concepts* |
|---|---|
| Sell & buy-back agreements | *Murabaha* |
| Sanadat (bonds) Mudharabah Cagamas | *Mudaraba/Musharaka*/BBA/*Istisna'/Ijara wa Iqtina* |
| Foreign exchange | *Ujr* |
| Government Investment Issues | *Qardhul Hasan* |
| Forward rate agreements | *Ujr* |

*Table 5.11* Trade financing

| *Products/Services* | *Applicable concepts* |
|---|---|
| Letters of credit | *Wakala/Murabaha/Musharaka* |
| Islamic accepted bills | *Murabaha/Bai' Al-Dayn* |
| Export credit financing | *Murabaha/Bai' Al-Dayn* |
| Bank guarantee | *Ujr* |
| Shipping guarantee | *Ujr* |

*Table 5.12* Other products and services

| *Products/Services* | *Applicable concepts* |
|---|---|
| Stockbroking services | *Ujr* |
| TT/Funds Transfer | *Ujr* |
| Travellers' cheques | *Ujr* |
| Demand draft | *Ujr* |
| Cashiers' order | *Ujr* |
| Standing Instruction | *Ujr* |
| ATM Service | *Ujr* |
| Telebanking | *Ujr* |

# 6

# THE DEVELOPMENT OF ISLAMIC BANKING AND INSURANCE IN SAUDI ARABIA

## A case study

### Introduction

As the stronghold of Islam where the *Shari'a* is the supreme law of the land, Saudi Arabia would have been expected to tackle the problem of insurance by establishing a scheme of 'Islamic' insurance following in the footsteps of countries like Malaysia. In actual fact, commercial insurance companies cannot be set up and registered in Saudi Arabia, and no insurance regulations have been enacted – except certain provisions concerning marine insurance in the Commercial Court Regulations[1] from which the validity of insurance transactions in the Kingdom are inferred.

The case remains that a Saudi Arabian insurance market has not officially been recognized by the State (Faris 1983: 114), although in practice it is largely composed of segments similar to those constituting the insurance market in the States of the Gulf Co-operative Council. However, in Saudi Arabia all insurance business is transacted under the umbrella of commercial firms (ibid.: 113). Being not yet officially legalized, the insurance companies are not practically accepted or licensed to perform in isolation from other commercial activities of the agent, who is usually a merchant or a trader. This wide gap between legal theory and practice is a common feature of many of the States of the Gulf Co-operative Council. In the last two decades very many new insurance companies with a majority of Saudi interests have been established and registered outside Saudi Arabia (ibid.: 114), although almost all of their operations are within the territories of Saudi Arabia. These companies are subsequently referred to as 'national' companies. Foreign insurance companies are still operating side-by-side with the newly formed 'National Insurance Companies'.

Due to the absence of any official statistical data in connection with the Saudi Insurance Market, as well as the absence of any official record for the number of insurance companies in Saudi Arabia, and since various foreign insurance offices are accustomed to entering and leaving the market without any governmental supervision, the real scale of insurance activity within the

Saudi economy would be unknowable. Judged, however, by the whole structure of the economic scope therein, it is estimated to be the largest market not only within the States of the Gulf Co-operative Council, but also in the whole Arab world.

While the *Shari'a* is proclaimed constitutionally to be the supreme and unquestionable source of legislation, the practice diverges in many respects from this governing principle, as various pieces of legislation contain dispositions that are contrary to Islamic law. This contradiction reflects the failure to harmonize a capitalistic economic structure and environment with the *Shari'a* as the majority of the actual religious authorities conventionally interpret it.

Saudi Arabian draft decree regulating insurance, still being modified, and currently in the final stage to be approved by the Shari'a council,[2] widens the gap between theory and practice. It stipulates that no insurance company may be allowed to be constituted in Saudi Arabia, and that all insurance business will have to be transacted through an agent, whose position is regulated in detail by the draft decree. Provisions are made concerning the form and minimum capital of the insurance company to be represented by the agent. The insurance company must be a *joint-stock company* with a paid up capital of a sum equivalent to ten million Saudi Riyals (emphasis added) (Shahab el-Din 1990).

Once adopted, this decree will further substantiate the contradiction that insurance companies may not be constituted in Saudi Arabia because of the controversy concerning the validity of insurance and the opposition of the majority of religious authorities to it. But commercial insurance may freely be undertaken from other countries through Saudi agents. This situation illustrates perfectly the dictum that there is a confrontation between an irresistible force (the economic and social necessity) and an immovable object (the *Shari'a*) (Ballantyne 1990: 121). The acceptance of insurance is imposed by economic reality and restrictions put to it are dictated by considerations pertaining to the *Shari'a*.

### *The National Co-operative Insurance Company*

The pessimists that prevailed with regard to the official recognition of insurance activities in 1960s' and 1970s' Saudi Arabia have lost ground and support. It has been superseded by much optimism due to many reasons. In practice, the country's economy showed a considerable boom during the final 20 years of the twentieth century. Almost all government, and private sector projects are currently insured in compliance with the requirements of the contract conditions between the owner and the contractor, to insure the works, constructional plants and the liabilities. However, it should be noted that the situation in Saudi Arabia regarding insurance is not restricted to the case outlined above. One more tangible and effective turning point in the official attitude towards insurance was the announcement made by the government early in 1985 that resulted in the Royal Decree sanctioning the licensing and the establishment of a State-owned insurance company with an authorized capital of SR500 million (approx. US$143 million) and the 'National Co-operative Insurance Company'[3] commenced operation in 1986.[4] Whatever the future of this newly established company, it was a clear indication of a remarkable change in official concern towards the encouragement of insurance activities in the future of the State economy.

The possibility of allowing other cooperative insurance companies to be established and to operate in the Kingdom was also acknowledged by a decision of the Council of Ministers, but at the time of writing no other insurance company has been formed in pursuance of this decision.

The duty of adherence to the Islamic *Sharï'a* is mentioned in various sections of the articles of association of the National Co-operative Insurance Company. What is particularly interesting is the mechanism adopted by the company in order to confer a cooperative character. First, it must be pointed out that the company is not mutual, because the insured do not become members of it. It is a company, with capital and shareholders. However, what is in the spirit of the articles, beside the duty of adherence to the *Sharï'a*, is that the surplus held by the company, if any, is distributed to the insured if not reinvested or added to the provisional reserves – after making the customary deductions and deduction of a certain percentage (not exceeding 10 per cent of net profit of investments) for the company and its staff. This last deduction operates similarly to *Mudaraba* contracts, whereby the profits are realized on the investment of the capital and the investor. The returns on the investment of shareholders' funds are distributed to them after the deduction of customary expenses.

The main feature of this company is that it embodies certain mutual insurance rules (such as the redistribution of surpluses) and it applies them to a company structure designed to carry out commercial insurance. Such a company would have been a real cooperative but for the following:

- The customers of a cooperative company are usually shareholders in it and even when cooperatives offer services to non-shareholders, they do not lose their cooperative nature as they were initially constituted by a group of people in application of cooperative principles; and
- The National Co-operative Insurance Company (NCIC) was not formed as a genuine cooperative one. Its legal structure is in the form of a joint stock company constituted between three government agencies There is no condition that the insured be a shareholder in the company and no such condition has been imposed even at the inception of the company's activities, so that the fundamental principle of cooperative entities – that the customer be a shareholder – is lacking.

Another basic cooperative principle that is deficient is the rule that each shareholder be entitled to one vote at company meetings, whatever the number of shares held. In the National Co-operative Insurance Company, a shareholder must have 20 shares to obtain one vote and every block of additional 20 shares means an additional vote.

It might be said that the term 'cooperative' used for the NCIC is more an attribute designating the eventual redistribution of surpluses, if any, among the insured (provided such surpluses are not allocated to the provisional reserves). This difference between the NCIC and conventional commercial insurance companies has justified, in the mind of the draftsman, the use of the term 'cooperative', thus rendering the scheme Islamically permissible, since it is considered by many modern Muslim authors that the cooperative or mutual structure validates insurance.

A question that one may ask is: 'what is the likelihood of a surplus being distributed to the insured after the deductions prescribed in the articles of association?' In the absence of the right of the insuring body to make supplementary calls for premiums (to address an eventual deficit) there will be a need for significant annual reserve allocations, thus rendering remote the likelihood of any substantial apportionment of profits among the insured.

As a result of the absence of a genuine and significant cooperative or mutual structure, the only truly relevant feature of this scheme is the general requirement of abidance to the *Shari'a* for investments made by the insurance company. In practice, investment of the collected premiums (in addition to the fairness of the company policy) is the major issue regarding the validity of the scheme. The lawful investment of premiums and the equity of an insurance scheme are not functions chosen for the insuring body and it is in those fields that the NCIC or other companies aiming to abide by the *Shari'a* will have to perform successfully.

On the other hand, it is interesting to note that Saudi Arabian law contains the legal framework required for the establishment of mutual insurance companies. This could be achieved by resorting to the cooperative companies' regulations, embodied in the Saudi Companies Law, which provide for the constitution of cooperative companies with a variable capital in the sense that the increase or writing down of capital is not subject to the strict formalities usually imposed for such operations in conventional joint-stock companies. As a result, this may enable a cooperative company to have shareholders coming into and leaving the company: this would allow the introduction of a membership scheme for all policyholders so that each insured is allocated a certain number of shares, and mutual insurance could be brought in through this medium. However, it seems that there are no practical prospects for such a scheme in the near future and the only insurance company registered in Saudi Arabia is the NCIC, whose policyholders are not integrated into the company as a genuine mutual body would have required.

Table 6.1 overleaf shows the number of foreign and national insurance companies in the States of the Gulf Co-operative Council as at 31 December 1985.

During the last 13 years of its existence in 1980, the NCCI has managed to perform in the range of total gross revenue to SR339.5 million in 1999 (from SR289.2 million in 1998). The company's activities include all sectors of the