The Saudi T`awunī Insurance Model: Concerns about Compatibility with Islamic law in Accomodating “Risk”

by

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Abstract

The Saudi *ta’awuni* insurance model, despite claiming to be compatible with Islamic transactional rules, in fact violates the prohibition of *gharar* (risk) through its commercial structure. The study investigates the ways in which *gharar* (risk) is accommodated in modern insurance models. It argues that the most appropriate solution to comply with the doctrine of *gharar*, is to de-commercialize the *ta’awuni* model by adopting the mutual insurance model, which is capable of satisfying the requirements of sharia relating to the prohibition of trading in *gharar*. 
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I Introduction

Accommodating the systems of international capitalism, in particular banking and other financial services, with Islamic law has been a challenge for Saudi Arabia whose legal system is based on Sharia. In this paper, I will focus on one such service, insurance operations. The insurance industry has become indispensable to the workings of the global economy and over time has become a highly sophisticated business with diverse products covering almost every imaginable risk.

In this paper I will critically examine the tawuni scheme and the overall regulation of the Saudi insurance market. My research is guided by the question whether the “cooperative” insurance model is indeed lawful under the Saudi juridical system based on Islamic law. I argue that the Saudi insurance laws that regulate the current insurance model are in fact incompatible with Islamic law and that the most appropriate solution is to de-commercialize it by adopting the mutual insurance model, which satisfies the requirements of sharia relating to the prohibition of trading in gharar (risk).

Historically, the insurance contract as it is known today did not exist within the nominate contracts regulated by early Islamic jurisprudence. To evaluate the lawfulness of transactions, jurists developed certain prohibitory rules, which imposed limitations on the freedom of contract so that contracts had to meet minimal legal standards in order to be deemed lawful. These restrictions on contracts continue to influence the ways in which Islamic finance operates today. It appears that these legal constraints, were not only based on pure textual mandates in the sources of law, but were to some degree influenced by the socio-economic context in which they operated. From the evaluation methods employed by jurists, it can be
deduced that an influencing factor in the determination of legality, was that contracts had to serve an acceptable economic function.¹

Thus, one of the main restrictions on contracts is the prohibition of gharar in transactions. Islamic jurisprudence contains extensive literature pertaining to the definition of gharar and its applications within the legal system. Its prohibition was based on numerous hadiths and was later expanded by jurists to apply to a variety of contracts.² Another well-known restriction is the prohibition of dealing with riba (unjust increase), which, according to the majority of traditionalist scholars, includes the application of dealing with interest. The insurance contract was deemed unlawful by many Islamic legal scholars on the basis that it violates the prohibition of gharar and riba. This view was held by the Council of Senior Ulama-- an influential institution of religious scholars in Saudi Arabia-- as well as other significant Islamic institutions and individual scholars.

Gharar is said to occur in the insurance contract due to the inherent excessive risk associated with the contract. Riba is said to occur in the two following ways. One is that when a party receives more than what they originally contributed amounting to an increase that is not legally justified. The other means is when companies invest in transactions that involve interest.

Due to the necessity of the insurance contract in modern day transactions, scholars researched whether there could be an alternative system of risk management to substitute the outlawed

¹ El-Gamal, Mahmoud "Mutuality as an Antidote to Rent-Seeking Shari'a Arbitrage in Islamic Finance" (2007) 49(2) Thunderbird International Business Review, [El-Gamal Mutuality]
insurance system they often termed as commercial due to its profit-oriented nature. In the 1980’s, an alternative system termed takaful (mutual solidarity) emerged from Sudan. The system took off and the industry grew to reach many Muslim and non-Muslim countries and became a powerful industry. Takaful proposed a change in the nature of the contract from one that is commutative to one that is donative, since gharar applies less to donative contracts. Thus, the contract would no longer involve transferring risk from one entity to another--instead, takaful proposed that participants pool their assets to collectively manage risks. Again, many scholars, including the Council of Senior Ulama, who had previously objected to commercial insurance, deemed the takaful model to be compatible with Islamic transactional rules.

Saudi Arabia, a country that observes a traditional form of Islamic law, has introduced insurance regulations that it hopes will develop the previously unregulated market. The Saudi insurance laws manage an insurance model termed al-ta’mīn al-tawuni (cooperative insurance) that purports to be compatible with the principles of Islamic law. However, further investigation of the system reveals that the so-called ta’mīn ta’avuni (cooperative insurance) is in fact a stock model with minor cooperative characters. The research shows that al-ta’mīn al-tawuni model maintains most of the elements that the Council of Senior Ulama objected to and considered unlawful. Therefore, insurance practices in Saudi Arabia depict a conflict between Islamic ideals and praxis; between the ulama’s interpretation of law, and the state’s conception of it. They also reveal how form trumps substance in the application of a purportedly Islamic insurance system.

Furthermore, the inconsistencies shown in the ta’avuni model are not merely an isolated instance of misapplication of Islamic law in Saudi Arabia. This thesis examines the Islamic
finance 

finance *takaful* model, from which the Saudi insurance model is derived, and arrives at the conclusion that this model, in most cases, also exhibits similar if not identical inconsistencies with Islamic law. The focus of this study is to examine the concept of *gharar* and how it is accommodated in today’s market economy insurance models. To do this, I study the concept of *gharar* as developed in Islamic jurisprudence, applying an economic analysis to its applications in different insurance models.

If we understand the restrictions on contractual freedom in Islamic law to be informed by considerations for utility, moral objectives and religious ritual components, an economic analysis becomes paramount in understanding the doctrine of *gharar*. This approach is useful since legal analysis that is purely dependent on Islamic jurisprudence would not be capable of analyzing the values of such contracts and whether they are achieving economic efficiency. This is especially important in today’s unprecedented and complex financial systems. In this light, the best way to comprehend the doctrine of *gharar* is to apply the understanding, formulated by scholar Mahmoud el-gamal, that the *gharar* restriction is intended against transactions that greatly hinder or eliminate economic efficiency. Islamic jurists recognized that *gharar* exists with varying degrees in most transactions and decided upon the question of its legality based on that conclusion. Recognizing the value and need for insurance systems in today’s financial systems, it is useful to examine which insurance model possess a lesser degree of *gharar*, or risk.

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Additionally, the modifications of the nature of the contract, as seen in the *takaful* model as well as the *ta‘awuni* model, are only formal in nature. Therefore, it is appropriate to consider the mutual insurance model, which I argue satisfies sharia requirements since the contested *gharar* element would be eliminated in this model where participants serve a dual function as both policyholders and shareholders of the scheme. Premiums would no longer need to be characterized as charity but a pooling of assets in exchange for coverage. Hence, risk is starkly reduced in comparison to the stock model. The model also shows that insurance risk is also thus reduced, since the mandate of the company becomes serving the participants rather than making a profit.

**II Outline and Methodology**

In the first chapter, I lay out some fundamental concepts that relate to the functioning of the Saudi legal system and which would aid in comprehending some of the issues with which my research engages. Following that, I provide an overview of key concepts that relate to the crux of my arguments, such as an explanation of the doctrines of *riba* and *gharar*, through Islamic jurisprudential lenses.

In chapter two, I engage with legal discussions on the legality of the commercial insurance contract. I begin by engaging with Mustafa Al-Zarqa, an influential Islamic scholar known for his controversial proposition that commercial insurance is legal under Islamic law, and responding to some of his arguments. His analysis summarizes the contentions that Islamic law and Islamic scholars may have with the commercial insurance order. I then turn to a fatwa issued in the 1970’s by the Council of Senior Ulama prohibiting commercial insurance. Both Al-Zarqa and the Council of Senior Ulama are scholars who are trained in classical Islamic
legal methodologies and thus employ these methodologies in their findings whilst reaching diametrically opposing conclusions.

In chapter three, I explain the contract of insurance and its characteristics according to common law sources, after which I turn to explaining the three main insurance models that are the subject of my study. First, I briefly address the stock insurance model. Secondly, I address the mutual insurance model expansively, as this model is the one I advocate for in the thesis and which is in principle the most compatible with the doctrine of gharar (risk).

I intend to explain that the mutual insurance model is a type of cooperative as well as explain the ties it has with the cooperative enterprise movement. After providing definitions and applications of this model, I will provide an example of the mutual model in Europe and its various applications. The example serves as a testament that mutual insurance is a major sector that serves an efficient economic function and is capable of translating principles into practice purposefully. After that I compare the stock model with the mutual model to demonstrate the contrasts in values, rights and motives between these two models. The third model I study is the takaful model. Within the takaful model there are two main models: muḍāraba and wakāla, both of which I examine to determine how these structures accommodate gharar. Lastly, I address a fatwa issued by the Council of Senior Ulama regarding the permissibility of a cooperative insurance scheme. In this section I explore how the ulama thought insurance should like in an Islamic legal system.

In chapter four, I intend to account for the history of insurance operations in Saudi Arabia and explain two important pieces of insurance legislation. The first issued in 1999, called the Cooperative Health Insurance Law, which introduces private insurance schemes for certain
segments of the population in Saudi. The second significant law was issued in 2003, called the Law on Supervision of Cooperative Insurance Companies, which regulates and supervises insurance operations and companies. I use the English translations for the title of laws instead of using the Arabic titles, which are provided in the footnotes and the bibliography. Following that I explain the relevant bodies that are given jurisdiction to adjudicate insurance disputes and explore the kind of challenges these bodies face under the regulatory framework.

Afterwards, I critically examine the t´awunī and takaful model and the overall regulation of the Saudi insurance market guided by the question whether the “cooperative” insurance model is indeed cooperative and how it accommodates Islamic legal principles of gharar and riba. The paper then turns to a third model of insurance operations, the mutual model, and examines whether that model could be a better option to reconcile a market economy with Islamic law. This paper will show that the mutual form is not only a viable option for the Saudi Arabian insurance market, but in substance resonates by far the most with Islamic principles of reducing risk in commutative contracts as well as achieving the purposes of sharia in terms of justice and social welfare.
Chapter 1. Fundamentals of Islamic Law and the legal system of Saudi Arabia

In this section, I will lay out some fundamental concepts that inform and shape the Saudi Arabian legal system. I will begin by discussing the four sources of Islamic law in order of their importance: the Qur'an, the Sunnah (the normative practice of the Prophet Muhammad), Ijma' (consensus of the learned) and Qiyas (analogy). I will then provide a summary of the most important interpretive tradition in the Saudi legal context, the Ḥanbali school of thought and the ideals of freedom of ijtihad. Following this overview of sources and methods of interpretation, I will turn to the main actors and institutions involved in interpreting, applying and creating law according to Islamic principles: the King and the Council of Senior Ulama. Briefly, I will lay out the fundamentals of the Basic Law of Government, a sort of constitution, followed by explaining two crucial principles of Islamic law that play a critical role in my analysis of the Saudi insurance scheme, riba and gharar. After that, I will engage in an extensive discussion of the controversies and positions of Islamic scholars regarding the insurance contract.

1.1 Sources of Islamic law: Qur’an, Sunnah, Ijma’, Qiyas

There are four major Sunni schools of law distributed according to region; the shafi’i, malki, ḥanafi and the ḥanbali. Each school of law developed its own methodology for deducting legal rules, which resulted in a relative diversity in Islamic Jurisprudence also
known as *fiqh*\(^4\). All four schools agree on the primacy of the four sources of Islamic law while they differ on their scope and interpretation as well as other standards. \(^5\)

The Ḥanbali, is the latest school to develop from the four major school and is the prominent school of law in Saudi Arabia. Ibn Ḥanbal, was famous for his hadith narration “*Al-Musnad*” which contained about forty thousand hadiths complied according to the names of companions who narrated it from the prophet. Ibn Ḥanbal’s methodology relied heavily on the primary sources of Islamic law: the Quran and sunnah, in its legal deduction accumulating in a highly “textualist approach”. \(^6\) Sources that require human reasoning based on the text were often sidelined or were less significant in his methodology. Since Ibn Ḥanbal’s methodology is prominent in the practice of Saudi courts and thus in shaping the Saudi legal system, my explanation of the sources of law will reference the Ḥanbali position on these sources where relevant.

Under traditional Islamic jurisprudence, there are four sources of Islamic Law. These are the Qur’an, Sunnah, Ijma\(^6\) and Qiyas. The Quran and Sunnah are considered primary sources while Ijma\(^6\) and Qiyas are considered to be secondary. \(^7\) The difference between the primary and secondary sources is that the former have been transmitted from original documents, while the latter are mostly rational judgments determined from the primary

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\(^4\) It is worthwhile to note that Islamic jurisprudence, or *fiqh*, included not only legal pronouncements but subjects that are much wider in scope, such as rules pertaining to worship.


\(^6\) Frank E. Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia*, (Leiden;Brill, 2000) [Vogel]

\(^7\) Imran Ahsan Khan Nyazee, *Outlines of Islamic jurisprudence*, 3rd ed. (Islamabad: Advanced Legal Studies Institute, 2005) at 128
sources.\(^8\) Furthermore, the law discovered through the primary sources may be expanded by means of the secondary rational sources.\(^9\) A law discovered through secondary sources, on the other hand, cannot be extended further.\(^10\)

The Qur’an is the quintessential source of Islamic law and gives validity to all other sources.\(^11\) The Quran is believed to be the speech of God, as revealed to the Prophet Muhammad. The legal rules given in the Qur’an are of three types; they are about the tenets of faith, the disciplining and strengthening of the self, and the rules of conduct arising from the words and actions of the subject.\(^12\) The last category covers the entire domain of fiqh. It has two sub-divisions: rules related to worship and rules related to conduct other than worship.\(^13\) This latter category, known as mu‘amalāt, relates to the relationships of individuals amongst each other, the relationship of individuals with the state and the relationship of the Islamic state with non-Muslim states.\(^14\)

In its technical-legal sense, the word sunnah refers to that which was “transmitted from the Messenger of Allah (p.b.u.h.) of his words, acts and (tacit) approvals.”\(^15\) Sunnah also

\(^8\) Ibid at 129
\(^9\) Ibid at 129
\(^10\) Ibid at 129
\(^11\) Ibid at 129
\(^12\) Ibid at 129
\(^13\) Ibid at 136
\(^14\) Ibid at 136
\(^15\) Ibid at 137
commonly applies to *hadith* and the two terms are often used interchangeably. Although
sunnah may refer specifically to the prophet Muhammad’s code of ethic or way of life.

Two categories of Sunnah can be identified. The first corresponds to the methods through
which legal rules are established.\(^{16}\) This consists of the words, acts and tacit approvals given
by the Prophet Muhammad,\(^ {17}\) all of which are considered sources of law. The other kind of
Sunnah corresponds to the channels of transmission, namely with respect to the degree of
validity in the hadith’s written record.\(^ {18}\) The statements and actions of the Prophet are
recorded in terms of the authoritative strength of the chain of narration.\(^ {19}\) This is validated by
way of the number of individuals narrating in each part of the chain, the individuals’ strength
of character, and whether the chain can be traced back to the Prophet.\(^ {20}\) The elaborate system
that was developed for recording the Sunnah and the significant effort paid to its collection
elevated the importance of hadith in making legal judgments.\(^ {21}\)

The Sunnah is considered to be the second source of Islamic law after the Quran. If a matter is
not found in the Quran, a scholar resorts to the Sunnah for explaining the rule. The Sunnah is
believed to be an elaboration and commentary on the Quran. It extrapolates rules laid down in

\(^{16}\) Ibid at 137

\(^{17}\) *Ibid* at 137

\(^{18}\) Ibid at 137

\(^{19}\) Ibid at 129

\(^{20}\) Ibid at 129

\(^{21}\) Vogel, Supra note 6 at 41
the Quran, explains their meanings and lays down general principles such as “No injury is to be caused or borne.”

Ijma, in legal terms, is “the consensus of mujtahidin [plural of mujtahid meaning independent jurists] from the community of Muhammad (p.b.u.h) after his death, in a determined period upon a rule of Islamic law (hukm shar’i).” For the Ijma to be valid, it must be established by mujtahidin. Some other necessary conditions are that the agreement must be unanimous, all mujtahidin must be Muslim and the Ijma must have taken place after the death of the Prophet, since he is the source of the rule. In addition, the agreement must have taken place among the mujtahidin of a single determined period and that agreement must be based upon a mustanad (meaning sources of Islamic rule). The death of a jurist who participated in the Ijma does not affect its validity. Finally, the Ijma is only valid if it has been transmitted to later jurists by way of tawātur (widespread and independent channels of transmission). That is, its mode of transmission should be definitive.

Ijma can be explicit or tacit. It can be explicit by way of the opinions of the jurists of one period converging on the same issue, or by way of them expressing a unanimous opinion in a

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22 Ibid at 144
23 Ibid at 145
24 Ibid at 145
25 Ibid at 145
26 Ibid at 145
27 ibid at 145
28 Ibid at 146
single session at which they have all gathered. Tacit Ijma means that one mujtahid or more developed a rule on a particular issue and other mujtahidin were silent on the rule.

From the above conditions of Ijma, it can be deduced that it is a source of law that is extremely challenging to achieve. The ḥanbali school, regarded Ijma as a less significant source of law. The Ḥanbali school only accepted Ijma that was achieved at the time of the companions of the prophet and questioned whether ijma could exist as a valid form of legal interpretation.

Qiyas is a form of analogical reasoning that applies an established rule of law and extends it to another situation where there is Allāh. Allāh means that there is a common characteristic in both cases that justifies extending the legal rule.

The Ḥanbali, textualist approach relegates the use of qiyas to cases where there is no other alternative. According to the Ḥanbali methodology, opinions of the prophet’s companions as well as weak hadiths that meet certain conditions take precedence over qiyas.

1.1.1 Ijtihād and Law.

Ijtihād is the exercise of individual reasoning in deducting the relevant legal rules from the sources of sharia. This jurisprudential tool has been a subject of controversy throughout

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29 Ibid at 147
30 Ibid at 147
31 Vogel, supra note 6 at 48
32 Ibid at 48
33 Ibid at 51
34 Ibid
35 Ramadan, supra note 5 at 28
Islamic history. In the 10th century C.E., many ulama advocated for closing the door of ijtihād since every matter that may require ijtihād has been determined and there is no longer a need for the doctrine.37 Furthermore, opponents of ijtihad often claim that ijtihād no longer exists since there are no mujtahidīn. This meant that Islamic scholars had to replicate the rulings already developed by earlier scholars, in some ways, conforming to sort of jurisprudential precedence. In Islamic Jurisprudence, this is called taqlīd, which can be translated to replication. By the time of the Tatar invasion of Islamic countries and the downfall of Baghdad in 1258 CE, the Iraqi ulama officially declared that the door to ijtihad has been closed.38 Of course, the door has not been closed entirely as advocated, since many applications of laws require some degree of ijtihād. Both the Hanbali and the Shafʿi School were less reluctant to minimize the tool of ijtihad and many Hanbali scholars wrote polemics against the concept of taqlīd.39

Ibn Taymiyyah (1263–1328 CE) advocated to the contrary and was an avid defender of the doctrine of ijtihād introducing reforms.40 Ibn Taymiyyah and his pupil Ibn- Al-Qayyem, produced an extensive legal and intellectual literature, that continues to influence the Saudi judicial system and the theological beliefs widely held and taught in Saudi Arabia. Ibn

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36 ibid at 20
37 ibid at 20
38 ibid at 21
39 Vogel, supra note 6 at 62
40 ibid at 22
Taymiyyah advocated ijtihad to a greater extent than many of the scholars at that time. While many ulama required lay men to choose a school of law to follow for the sake of consistency, Ibn Taymiyyah stated that even an unlearned person should be able to exercise ijtihād with no fear of reprisal.\(^\text{41}\) The minimum unlearned individuals are obliged to do, is to exercise a sort of taqlīd, which in his view involves weighing different opinions and choosing what the individual thinks is closer to the truth.\(^\text{42}\) As for the judges and muftis, Ibn Taymiyyah held that they should be full-fledged mujtahīdīn. In his vision of ijtihād, scholars should be able to examine the proofs and not merely follow an opinion due to the popularity of some school or imam.\(^\text{43}\) Additionally, no one should issue a fatwa or decision that is against his or her convictions.\(^\text{44}\) These ideals of Ibn Taymiyyah and his understanding of Ijtihād greatly influences the way the Saudi judicial system functions. Since each judge is entitled to his opinion, cases with similar facts may be judged differently, resulting in perceived inconsistency. This does not mean that judges in the Saudi system fully discount methodology in their reasoning.\(^\text{45}\) Vogel’s study of the Saudi legal system states that judges often follow the methodology of Ibn Hanbal-- not his opinions-- in deducing legal rules in conjunction with their belief in the freedom of ijtihād.\(^\text{46}\)

\(^{41}\) ibid 67
\(^{42}\) Ibid at 68
\(^{43}\) Ibid
\(^{44}\) Ibid
\(^{45}\) Ibid at 74
\(^{46}\) Ibid at 77
The judiciary in Saudi is staunch in defending their “fact-specific rule-making process in adjudicating disputes presented to them.”\textsuperscript{47} Under this model of judiciary, the judge has “no specific binding legal text or controlling precedent, not even his own, and is free to shift between different legal views with equanimity.”\textsuperscript{48} These ideals held by the judiciary have made it challenging for the state to codify the laws in such a way as to include substantive rules. As a result, Saudi Arabia does not have a codified family or civil law. Codifying laws would mean that the judge would have to consult the legislation and is bound by it. This goes against the ideals held and cherished by the judiciary on freedom of ijtihad.

1.2 The Council of Senior Ulama

Since this thesis quotes various fatwas, an explanation is required of what a fatwa is in the context of the Saudi legal system. Linguistically, fatwa can be translated to mean clarification. Fatwa can be described as a religious opinion, which determines the relevant Islamic rule regarding a subject. It is often issued as a response to a query and may apply to a specific situation relating to the inquiry or a hypothetical or general question.

A mufti is someone who is presumably knowledgeable in Islamic law and religion and responds to queries thus making a fatwa. The mufti has a role in shaping the legal system since he participates in determining the law.\textsuperscript{49} An important distinction between a fatwa and a court decision is that the former is non-binding and constitutes an opinion. It is left to the conscience of the muslim whether to accept or reject a fatwa.

\textsuperscript{47} Al-Sudairy, Ziad A MIDDLE EAST LAW AND GOVERNANCE, V. 2 (1), 02/2010, p. 1-16 at 7
\textsuperscript{48} Ibid
\textsuperscript{49} Frank E. Vogel, Islamic Law and Legal System: Studies of Saudi Arabia, (Leiden;Brill, 2000) at 16
In the context of Saudi Arabia, fatwas are made on many levels through formal and non-formal institutions. Here, I would like to discuss the Council of Senior Ulama since their fatwas and methodologies are discussed in this thesis.

The Council of Senior Ulama, who constitute a major part of the religious establishment in Saudi Arabia, play a crucial role in shaping public policy, maintaining Islamic legal and theological doctrines and in deducing pertinent jurisprudential rules and deciding their various applications. Many members of the public also hold members of the Board in high esteem and consider them a spiritual and legal guide and preservers of religion.

The Council of Senior Ulama was founded by the Law on the Council of Senior Ulama, an effort of king Faisal to regulate the ulama’s role and include them in a formal state-run institution. The council was selected first from influential Saudis and can include ulama who are non-Saudi as long as they are salafi. Members of the council are appointed by a Royal Decision. According to the law, the role of the Council is to provide opinions based on Islamic legal sources in matters referred to them by the state. In addition, the council conducts research and issues recommendations pertaining to general rules to the king.

A committee named “Al-lajnah Al-da’emah lil-buḥūth wal-ifta” or The Permanent Committee for Research and Ifta, is comprised of some members of the board of the ulama to conduct

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50 See The law on the Council of Senior Ulama, issued in 1391, by Royal Decree No.A/137, article 2, Online <mohamoon-ksa.com>. There are many variations on the definition of salafism. salafi (adj) refers to someone who identifies with the beliefs, deeds and practices of the salaf (the prophet’s companions’ and those who immediately came after them).

51 Ibid

52 Ibid at s.3 (a)

53 Ibid at s.3 (b)
research for the Council to review and to make fatwas in relation to individuals’ inquiries on religious matters.

1.3 The Basic Law of Governance.
In this section, I will briefly explain some fundamental concepts included in the Saudi semi-constitution document. Saudi Arabia does not have a formal constitution that has a function similar to constitutions in civil or common law countries. The Basic System of Governance resembles a constitution in that it outlines the duties and responsibilities of the state as well as the duties and rights of its citizens. It is significant in the context of the insurance regime because it establishes the role and the responsibility of the state in guaranteeing health services and insuring against old age, disability and natural disasters.

The Basic Law of Governance describes the state’s constitution as consisting of the Quran and the prophetic traditions (Sunnah). This provision reflects the transition of Islamic law from its traditional legal and social settings to its incorporation into a contemporary state structure where it is at the core of the declared political order. There is a diversity of schools, thoughts, and opinions of Islamic law; knowing this, the Basic Law of Governance leaves out important clarifications regarding the precise application of Islamic law in the face of this diversity. It does not inform us which interpretations are to prevail, and it does not specify an Islamic school of law and thought to follow.

As will be seen, this lack of clarity regarding the precise application of Islamic law has influenced the insurance system in Saudi Arabia. It is evident in both the introduction and

54 The Basic Law of Governance, issued in 1412 H., by Royal Decree No.A/90, article 1
regulation of insurance by the state, and can also be seen in the resulting inconsistencies in principles of traditional Islamic law recognized by the Saudi clergy with that of the regulations. This difference reflects an ongoing “competition for jurisdiction”,\(^{55}\) between the state and Islamic scholars.

The Saudi legal system divides jurisdiction for different areas of law between the administrative legal system (Diwan Al-Maṣalim), which is composed of bodies more aligned with state policy, and the general court system, which is more focused on applying sharia and is dominated by the religious establishment. This division reflects the tension between an Islamic law that is based on contemporary political and economic considerations such as utility, effectiveness, and positivism, and an Islamic law that relies on *ijtihād* in its application, driven by a zealous desire to preserve what is considered “traditional” doctrines.

### 1.4 Basic Legal Principles

Within Islamic law there are four main types of contracts which other sub-contracts are derived from: *bayʿ* (sale), *ijāra* (hire or lease), *hiba* (gift), and *kafala* or *ḍaman* (surety contracts). Within traditional Islamic jurisprudence, jurists developed restrictions on the freedom of contracts based on sources of Islamic law.\(^{56}\) One of the most notable limitations on the freedom of contract relates to the prohibition of *riba* and *gharar*. In the following section, I will provide definitions and a brief discussion of these concepts and their controversies, which continue to influence the Islamic financial system.

\(^{55}\) Vogel, supra note 6 at 37

\(^{56}\) Oussama Arabi “Contract Stipulations (Shurut) in Islamic Law: The Ottoman Majalla and Ibn Taymiyya” Vol. 30, No. 1 (Feb., 1998) pp. 29-50 at 29  [Arabi]
1.4.1  **Riba**

*Riba* is one of the main restrictions on the freedom and development of contracts under Islamic law, and one of the main reasons why conventional insurance contracts are prohibited according to most Islamic scholars. Jurists from the four major Sunni schools of law agree that the prohibition of *riba* derives from verses in the Quran and some sayings of the Prophet Mohammad. Islamic legal scholars distinguish between two types of *riba*: *riba al-fadl* and *riba al-nasi’ah*. When specific goods of the same or similar type are exchanged and underpinning this exchange is a notable discrepancy in value, then this transaction is considered *riba al-fadl*.\(^{57}\) When a business transaction involves a delay in paying a debt or performance it is characterized as *riba al-nasi’ah*.\(^{58}\)

*Riba* is a highly contested concept with substantial debate around its definition in Islamic legal literature. All too often *riba* is imprecisely interpreted as interest\(^{59}\) and translated into English as usury, a translation that connotes the exploitative type of consumption loans that emerged in the European context, while unlawful *riba* is not simply about the exploitation of the poor but speaks to larger principles and objectives around fair economic practices and societal wellbeing.\(^{60}\) *Riba* linguistically translates to ‘increase’.\(^{61}\) The word *riba* and its

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\(^{57}\) Board of Senior Ulama, “fatwa Number 5/10” (dated 4/4/1397), Online: <http://www.alifta.net/> [Ulama]

\(^{58}\) Ibid


derivatives are mentioned in the Quran to denote increase. *Riba* is severely prohibited in the Quran and dealers of *riba* are threatened with damnation in this world and the hereafter.\(^{62}\)

While Islamic jurists have always agreed on the unlawfulness of *riba* in principle, the type of objects included in this prohibition and the justifications for this prohibition have been highly contested and the debates are ongoing. A key issue of concern is whether or not interest-bearing loans are prohibited. However, in early periods of Islamic jurisprudence there was an abundant discussion on what types of objects are included in this prohibition and the justifications for this prohibition. The majority of modern scholars prohibit lending money on interest with only a small minority considering this practice to be lawful.\(^{63}\)

The first type of *riba*, *riba al-faḍl*, is concerned about the increased share of value in certain items when traded. According to Al-Bahuti, a *hanbali* scholar, it is unlawful to trade a measurable or weighable item for its like for an increase in value or quantity\(^{64}\). For the sales to be regarded as lawful, items that are measurable or weighable have to be equitably traded with their equivalent and there must be no delay in possession of goods (immediately traded from one hand to another hand)\(^{65}\). This is based on the hadith: “Gold by gold, silver by silver,  


\(^{62}\)See Quran , chapter 2, verses 275,276

\(^{63}\)Fadel supra note 59 at 669

\(^{64}\)Al-Bahūti, supra note 61at 181

\(^{65}\)Ibid at181
wheat by wheat, barly by barly, dates by dates, salt by salt, in equal amounts, and hand by hand."

During the early Islamic period, wheat, barly and other grains were measured by “mikyal” or “sa'” which are volume measurement tools. Meanwhile, precious metals are often quantified by weight. According to such established traditions, it is also prohibited to trade an item measured by volume with another that is measured by weight or vice versa. The rationale behind this ruling is that violating a standard measurement indicates the absence of evenness in the transaction since trading parties will not be able to establish a precise equivalent in the amount exchanged.

The second type of unlawful riba is riba al-nasi’ah. Nasi’ah linguistically means ‘delay’. It is unlawful to delay the delivery or exchange of goods that are included in the prohibition of the first type of riba. Therefore, it seems in the first instance that riba al-nasi’ah is contingent upon the terms of riba al-fadl. For riba alnasi’ah to apply, the exchange must be unequal, thus in breach of the requirements of riba al-fadl.

Al-Bahuti’s interpretation of this prohibits a delay in exchange between types of goods measured by weight for goods measured by volume. Yet, if one of the exchanged items has only serve as mediums of exchange, such as in the case of gold, silver or iron, it is permissible

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66 Ibid at 181
67 Ibid at 181
68 Ibid at 181, hadith narrated by Ibn Majah no. (2199)
69 Ibid at 182
70 Ibid at 183
to delay the possession\textsuperscript{71}. It is also evidently lawful to delay transactions that contain items that are not weighed or measured by volume, such as clothes and animals\textsuperscript{72}.

In Saudi Arabia, the position of the board of senior ulama regarding interest-bearing loans is that it is a type of outlawed \textit{riba}. According to the board, \textit{riba} could exist in currency form since currency would be equivalent to replacing the two major mediums of exchange used in medieval times: silver and gold, in fiqh known as \textit{al-naqdaijn}.\textsuperscript{73} Earlier jurists have disagreed on whether \textit{riba} can be extended to gold and silver. Among the ones that did not extend \textit{riba} to \textit{al-naqdaijn} are the Zahri School of law, and Ibn ‘Uqail from the hanbalis, since prohibition of \textit{riba} to them pertained to a strictly religious practice.\textsuperscript{74} Not surprisingly, scholars who agreed that \textit{riba} can be extended to currency disagreed in terms of their justification for their finding.\textsuperscript{75} One justification for this finding, which is held by Ibn Hanbal, is that \textit{riba} is valid for objects that can be weighed.\textsuperscript{76} Therefore, they found that the major coins are included in the \textit{riba} rules. This group bases its opinion on the prophets’ warning against selling gold for gold except weight by weight (indicating evenness of mass).\textsuperscript{77} The reasoning for Malik and Al-Shafi’i is that the two currencies gold and silver contain a major element of \textit{thamaniyya}, meaning that these items possess a value used for trade. Ibn- Al-Qayyem and Ibn-Taymiyya reasoned that \textit{riba} restrictions can be extended to the two precious metals due to these objects

\begin{itemize}
\item \textsuperscript{71} \textit{Ibid} at 183
\item \textsuperscript{72} \textit{Ibid} at 184
\item \textsuperscript{73} Al-Lajna Al-Da’ma Lil-Buhuth Al-‘ilmiyah Wal-Ifta’, \textit{Hukm Al-‘wraq Al-Naqdiyya,} v.1 (2004) Online < alifta.net > at 83
\item \textsuperscript{74} \textit{Ibid} at 83
\item \textsuperscript{75} \textit{Ibid} at 83
\item \textsuperscript{76} \textit{Ibid} at 83
\item \textsuperscript{77} \textit{Ibid} at 83, hadiths narrated by [Muslim :1584], [Abu-Dawūd : 3353], [Al-Nisa’i: 5470]
\item \textsuperscript{78} \textit{Ibid} at 83
\end{itemize}
being absolutely *thamaniyya*\(^79\). The hanbali jurist Ibn-Muflih disagreed with the opinion that considers *thamaniyya* to be a factor in determining the dominion of *riba* rules. Ibn-Muflih views the logic behind this reasoning as incomplete since monies serve as mediums of exchange (*thamaniyya*) while jewellery does not\(^80\).

The board of Senior Ulama responded by stating that Ibn-Muflih’s argument can be engaged with arguments of those who hold that gold and silver are mostly a *thamaniyya*, that is mostly used as mediums of exchange\(^81\). However, those scholars that argue that gold and silver have use only as mediums of exchange also include money in their interpretation of what items can include *riba*.\(^82\) Moreover, this group does not extend *riba* to jewelry made of gold and silver since an industrial process has changed its nature from mediums of exchange to a type of goods\(^83\).

The Council of Senior Ulama addressed the question of whether *riba* includes interest-bearing loans in a study on the lawfulness of bank customers receiving interest on cash deposits. According to the Board, interest-bearing loans are indeed an act of *riba* and a change of terminology from *riba* to interest does not affect the nature of the act itself.\(^84\) The justification they provide for this finding is based on three key points. First, the contract of *qard* (lending) is charitable in its nature. They base this on numerous hadiths that characterize lending as an

\(^79\) *Ibid* at 83

\(^80\) *Ibid* at 86

\(^81\) *Ibid* at 83

\(^82\) *Ibid* at 83

\(^83\) *Ibid* at 83

\(^84\) ibid at 83
act of charity. Secondly, bank deposits with excepted interest clearly contain the unlawful types of riba. For one the depositor receives an excess of what they originally deposited consequently resulting in the riba of excess. Furthermore, the depositor receives the additional value after a period of time has passed since the initial deposit, resulting in riba of delay. The third point made in the research is that it rejects a historical economic analysis of riba practices in Arabia prior to Islam as a basis for distinguishing between historical practices of riba and the wide contemporary practice of calculating interest. The board rejected the distinction made by some contemporary scholars that argue that deposits invested by banks further production and commerce and are not intended to provide for expanding consumption.

Overall, the Council of Senior Ulama seems to reject a purely economic analysis of the transaction and its purpose. Interestingly, the board examined the economic history of pre-Islamic Arabia and the role of transactions in furthering commerce and as necessary to maintain economic ties and stability. Despite this, the prophet did not distinguish between types of loans in order to legitimize riba in particular cases. The board maintains that if a distinction based on purpose of interest-bearing loans was intended, it would have been

85 Al-Lajna Al-Da’ma Lil-Buḥuth Al-‘ilmīyyah Wal-Ifta’, Bahth Fi-Imu‘amalat al-masrifiyya wal-tahwilat al-masrifiyya, v.5 (1422 H) Online < alifta.net > See hadith: “Lending runs in the course of charity” narrated by Ibn Hanbal in “Al-Musnad” Also: a hadith narrated by Ibn-Majah in “Al-Sunan” : “A muslim who lends twice is recompensed as giving charity twice” Additionally, according to the hadith narrated by Ibn Mas‘ud in Al-Tabarani and Ibn-Hulyah: “every loan is a charity”. at 194
86 ibid at 194
87 ibid at 194
88 Ibid at 194
89 Ibid at 194
90 Ibid at 194
91 El-Gamal Riba, supra note 60 at 2
clarified by the prophet since the Islamic legal system is suitable for all times and all places.\footnote{Ibid at 196}

The board also explains that interest obtained from bank-deposits is marginal in comparison to the revenue made by financial institutions, which subsequently allows for the accumulation and liquidity of social funds to bankers relative to the general public who are disadvantaged by this scheme. \footnote{ibid at 196}

In this regard, it seems that the Council of Senior ulama shares the same idea and criticism that led to the establishment of mutual financial institutions in the west. The difference between the two visions seems to be located at the founding axioms from which conclusions are finally derived. The Council of Senior ulama seem to start with a legal analysis based on traditional Islamic law. This is consistent with the ulama’s role historically and to date. After which the ulama, based on their staunch belief in the system and their role to defend it, seem to rationalize their conclusions and rulings by means of economic and social analysis or by other means. The fact that modern jurists expanded the scope of \textit{riba} to include money indicates their vision that sharia is responsive to modern queries. The interpretation and application of such rules seem to show a genuine concern for the welfare of those who observe Islamic law. Fadel finds that ulama historically cared about how their rules affected public welfare. They considered these rules as consistent with people’s needs and that they could be
rationally justified.\textsuperscript{94} Fadel sees this as evidence that the ulama are not against an economic analysis of the consequences of the rules they establish.\textsuperscript{95}

The ulama’s stance seems uncompromising when it comes to riba. Despite the ulama’s knowledge of the wide practices of loan-bearing interest in Saudi Arabia, which is officially allowed, their stand is firm on the matter. The ulama are often devoted to preach on the ills that riba can spread within society, warning against engaging in transactions involving interest and explaining the doctrine to people via sermons, publications, fatwas, radio and TV programs. By directing their opinions to the public, they avoid confrontation with the state while at the same time preserving their own doctrines. Mutual companies, on the other, have emerged as a response to community needs for alternative types of financial services after people were dissatisfied with prices they deemed exuberant and unfair.

In the insurance context, riba is said to occur when policyholders receive an amount greater than what they originally contributed as a result of a claim.

1.4.2 Gharar

Ibn Taymiyya defines gharar or risk as a transaction with an unknown or uncertain result.\textsuperscript{96} A contract is considered to contain gharar when it does not specify certain important elements such as the outcome of the contract. A prohibition against gharar is in place in order to avoid

\textsuperscript{94} Fadel, supra note 23 at 669
\textsuperscript{95} Fadel, supra note 23 at 670
\textsuperscript{96} Mahmoud A. El-Gamal, An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence, proceedings of the 4\textsuperscript{th} international conference on islamic economics and finance(forthcoming) , first version May 2, 2001 Online <http://report.rice.edu> at 5
unjust transactions that would result from a lack of knowledge regarding the precise outcome or conclusion of a contract.  

The legal basis for the prohibition of gharar is derived from certain Hadiths where the prophet condemns sales that contain uncertainty. In one hadith “The prophet, peace be upon him, has forbidden sales by throwing stones (similar to throwing dice) and sales involving uncertainty”. Another Hadith says, “The Prophet, peace be upon him, prohibited two deals in one.” It can be deduced from the second hadith that not only contract of sales are considered under the prohibition of gharar, but that all types of contracts involving risk are included. Islamic scholars disagree, to a considerable extent, on the degree of gharar that leads a contract to be prohibited. The Maliki School of law upholds the rule that gharar does not disturb the validity of acts of charity. This maliki rule is going to prove significant in the formation of the takaful contract. Contracts in traditional Islamic law can be divided into two main types, onerous and donative. Onerous contracts include: bay’ (sale) and ijāra (hire or lease), while donative contracts include hiba (gift), and kafala or daman (surety contracts). Rules pertaining to riba and gharar do not apply, or they apply with less rigor, to donative contracts as compared to onerous contracts.

At times, when jurists practiced “taqlid,” they extended the doctrin of gharar to many sales in ways that Al-Sanhuri describes as “impractical,” such as outlawing the sale of flour in grains,

97 Ibid at 4
98 Muslim (1513: Hadith 4)
101 Ibid at 39  
102 Mankahady, Samir,“Insurance and Islamic Law: The Islamic Insurance Company” (01/1989) 4:3, ARAB LAW QL , at 199
oil in olives and sesame, ghee in milk, etc. Al-Sanhuri explains that the justification for these opinions is that the subject of the contract did not exist at the time of contracting even though there was no risk associated with such transactions. However, at times, jurists had to engage in a “cost-benefit analysis,” therefore jurists had to strike a balance between the injunctions against gharar and the growing demand for practical solutions.

An example for an exception to the gharar doctrine is baiʿ al-salam, which can be defined as selling an object or thing that does not exist at the time of the contract, with the price being received immediately, and the object being delivered at a later specified time. Jurists justified this exception on the basis that the contract, despite containing gharar, provides for an economic benefit that would be lost otherwise. This indicates that an exception is allowed in cases where there is an actual social and economic benefit from the contract that the benefit would be lost otherwise.

Ibn Taymiya’s definition of gharar is “that whose consequences are unknown”. His student Ibn Al-Qayyem defined it as “that which is undeliverable, whether it exists or not”. The contemporary scholar Al-Zarqa defines “the forbidden gharar” as “a sale of probable items

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104 Ibid at 34
105 el-gamal, gharar at 15
106 Al-Sanhuri, supra note at 34
107 alsanhuri at 34
108 Al-Sanhuri at 34
109 El-Gamal gharar, supra note at 5
110 Ibid
whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling.\textsuperscript{111}

In the insurance context, \textit{gharar} results from the contract being based on the occurrence of a contingent event carrying risk of loss.

\textsuperscript{111} Ibid
2 Islamic Legal Perspectives on Commercial Insurance

Though there is currently only a minority among Islamic scholars who view commercial or conventional insurance as permissible under Islamic law, this perspective can be expected to gain momentum in both the theory and practice of Islamic insurance schemes in Saudi Arabia as well as other countries following or shaped by sharia. This is due to the fact that the permissibility of commercial insurance supports the economic interests of powerful financial and political actors worldwide. It has become widely known that Islamic forms of insurance, known as takaful, provide their customers more accessibility to global markets—mimicking, in that sense, the access of commercial insurance to capital.\(^\text{112}\)

Islamic forms of insurance are supposed to be compliant with Islamic transactional rules, which regulate markets through a code of religious ethics that are responsive to socio-economic conditions and needs. If we proceed, now, to examine Alzarqa’s arguments for allowing commercial insurance under sharia law—one of the earliest and most elaborate proposals of this matter—we will see that he relies upon a very formalistic interpretation of gharar. Al-Zarqa fails to account for the practiced reality of how conventional insurance plays out in the real world, which is in fact the most important aspect of and motivation for any kind of jurisprudence. Looking at the system through an inclusive framework, studying its ethical requirements and turning our attention to the material consequences of modern transactions,

we will find that this kind of insurance is in fact incompatible with Islamic transactional rules and objectives.

2.1 Al-Zarqa’s Position

Mustafa Alzarqa is the most prominent contemporary Islamic scholar working on the conventional insurance contract who deems it permissible under Islamic law. In his book, *Nizām al-taʾmīn : ḥaqīqatuhu-wa-al-raʾyu al-sharʿī fīh*, which can be translated to *The Insurance System: On its nature and legal opinion*, Alzarqa controversially challenges and responds to the currently dominant view that commercial insurance is unlawful. The grand mufti of Egypt also issued a fatwa in 2004 declaring that conventional insurance is lawful while noting that its legality has been heavily debated and is a cause for controversy.

2.1.1 Contractual Freedom In Islamic Law

Al-Zarqa begins his defence of the conventional insurance contract with the argument that Islamic law, specifically *hanafi fiqh*, accommodates new forms of contracts as long as these contracts comply with Islamic legal principles. Al-Zarqa’s premise is consistent with the underlying premise of this research: that Islamic law admits new types of contracts into its corpus as long as they meet certain conditions of legality. While he focuses on meeting


114 El-Gamal, Mahmoud "Mutuality as an Antidote to Rent-Seeking Shari’a Arbitrage in Islamic Finance" (2007) 49(2) Thunderbird International Business Review, at 7 [El-Gamal Mutuality]

115 Al-Zarqa,, supra note at 33
technical and formal details to qualify such admissions, however, I propose adopting a more inclusive approach, thus leading us to arrive at different conclusions.

Al-Zarqa starts his argument by questioning whether the contractual system in Islamic law is limited to contracts that were known in the early period of Islam and whether Islamic law indeed cannot accommodate new forms of contract. He asks whether Islamic law allows Muslims to engage in contracts not explicitly mentioned in the sources of sharia as long as these new contracts satisfy the general Islamic legal framework and its underpinning principles and doctrines, such as consent.

There are a variety of opinions regarding contractual freedom under Islamic law. Historically, Islamic jurists have developed a corpus of particular nominate contracts, some of which existed prior to Islam. The jurists amended these common contracts according to Islamic legal principles.

Contracts in traditional Islamic law can be divided into two main categories, onerous and donative. Onerous contracts include: bayʿ (sale) and ijāra (hire or lease), while donative contracts include hiba (gift), and kafala or daman (surety contracts). Rules pertaining to riba and gharar do not apply, or they apply with less rigor, to donative contracts as compared to onerous contracts. In addition to developing nominate contracts, the jurists have devised

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116 Al-Zarqa, supra note at 33
117 -, Ibid at 33
119 Ibid at 1137
120 Mankahady, Samir, Insurance and Islamic Law: The Islamic Insurance Company. (01/1989) 4:3, ARAB LAW QUARTERLY, p. 199
certain mechanisms for validating agreements in general. In particular, they identified certain prohibitions that relate to Islamic transactional law. These prohibitions mostly relate to the prohibition on transacting with *gharar* and *riba*, which have been explained in the previous section.

Al-Zarqa points to the *baiʿ al-wafa* contract, which is an example of a contract that was newly introduced to Islamic nominate contracts known in Middle Asia in the fifth century of the Islamic calendar. The new contract proved controversial among scholars of that period. Although many scholars viewed the *baiʿ al-wafa* contract as unlawful under Islamic law, the Hanafi School of law opted to view it as an independent contract with distinctive characteristics instead of attaching it to an existing contract. Al-Zarqa’s elaboration on the contractual freedom in *hanafi fiqh*, however, is not a point of conflict when it comes to Islamic law as it is applied in Saudi Arabia.

Despite the fact that insurance contract in its contemporary form is new to Islamic law, the absence of the insurance contract from *fiqh* nominate contracts does not necessarily translate into it being unlawful. The majority of Saudi Arabia’s respected Ulama follow the Islamic legal principle that everything is permissible unless there is evidence in the text that point to the contrary.

Basing their views on the Ḥanbali stance on contractual freedom, Islamic scholars in Saudi Arabia do not seem to object to adopting contracts that do not exist in the sharia nominate contracts. The Ḥanbali School of law, as will be seen, amended many of the principles that

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121 Masud, supra note at 1137

122 Al-Zarqa, supra note at 34

123 Al-Zarqa, supra note at 45
restricted contractual freedom in Islamic law. The reforms introduced by the Ḥanbalis can be summarized in three points. The first is that the Ḥanbalis permitted inserting a stipulation in the contract that results in benefiting one party. Ibn Qudamah, the Ḥanbali jurist from the 13th century, attached this to the condition that the benefit be known and defined. 124

Thus, the Ḥanbalis reversed the opinions of Ḥanafi that prohibited inserting a benefit clause to the contract on the grounds that it may amount to riba as well as basing it on a hadith of the prophet advising against it. 125 The Ḥanbalis contested this rule on the basis that the accuracy of the hadith is questionable and by basing their opinion on another Ḥadith that prohibits against inserting two, and not one, benefit clauses. 126 Another significant Ḥanbali addition to the Islamic theory of contract is the value they place on the intention of the parties, and their consent as adequate requirements for the validity of contracts. 127

In fact, Ibn Taymiyya, whose opinions are influential within the religious establishment, expands on this relative freedom of contract in Ḥanbali fiqh upholding what Vogel describes as an “extraordinary liberal approach to contracts” 128. Ibn Taymiyyah upholds that each contract is presumably valid unless it contravenes with an explicit prohibitory rule found

125 ibid at 40
126 ibid at 40
127 ibid at 41
128 Vogel, supra note at 125
within the text. Similarly, stipulations in the contract are found to be presumably valid unless they are found to contradict a text or negate the purpose of the contract. Ibn Taymiyya, for the purpose of utility and eliminating hardship on Muslims, further removes the restriction on the number of benefit clauses despite the rule being based on a hadith of the prophet.

A significant and relevant reform is that Ibn Taymiyya validated contracts derived from other legal cultures when these contracts are concluded with Muslims. The only condition these contracts should meet is not to contain something unlawful for Muslims.

If we apply Ibn Taymiyya’s liberal approach to the insurance contract, we find that the insurance contract would presumably be lawful, unless a proof found in the text contradicts this and indicates that it is unlawful. As mentioned before, the main objections to the lawfulness of the insurance contract is that it is perceived by many scholars to contain elements of gharar and riba. Since the social and economic benefit of insurance is considered to be abundant, attention needs to be directed at how to lessen the degree of harm produced by these unlawful elements.

2.1.2 **Gharar as the Absence of Economic Efficiency**

A central issue in examining the legality of the conventional insurance contract is the concept of gharar, or risk, which is a defining characteristic of the modern insurance contract.

Alzarqa’s position on gharar is focused to a great extent on the contract itself rather than how

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129 vogel, supra note at 125
130 Arabi, supra note 118 at 42
131 Ibid
132 Ibid at 41
it is accommodated in modern insurance systems. Merely inquiring into *hanafi fiqh* and the ways in which it accepted contracts that contained a certain degree of *gharar* is inadequate for assessing legality. Such an inquiry would need to be accompanied by a focus on how the modern system of insurance has configured itself in order to accommodate risk.

Alzarqa defines unlawful *gharar* as an element that renders the subject of exchange in a contract or a central component of the contract unidentifiable so as to involve elements of wagering or gambling.\(^\text{133}\) The results of such a contract would be far from a determinate, reliable exchange, as one party may reap benefits while the other suffers losses based on mere chance.\(^\text{134}\) In other words, Al-Zarqa describes *gharar* as a contract where the economic utility is significantly reduced or eliminated that it would not be suitable for economic transactions. While this definition may liberate beneficial contracts that have a degree of risk from *gharar* restraints, it is yet extreme since it implies that contracts which contain *gharar* and have a utility are immediately permitted without considering the consequences of such general permission.

Al-Zarqa disregards in his analysis how insurance models influence the rights of participants in the scheme and how models inform critical components such as the degree of risk or *gharar*. Additionally, when there are more then one contracts of *gharar* serving the same utility, focus should be accorded to assessing these models and choosing the one with the minimum risk. This method seems more agreeable with the doctrine of *gharar* but yet is dismissed in his analysis as will be seen when he addresses the mutual insurance system.

\(^{133}\) Al-Zarqa, supra note at 48

\(^{134}\) Al-Zarqa, supra note at 48
Furthermore, jurists permitted exceptions to the gharar rules where there was a clear economic benefit that would be gone otherwise. In the insurance case, there is an alternative represented in the mutual insurance model which can serve the same utility with less risk.

Al-Zarqa formulates his definition of gharar through a study of the common elements in the hadiths that prohibit various contracts on the basis of gharar. Among these hadiths are ones that prohibit the selling of “madamin” and “malaqih.” Madhameen is described as a sales contract whereby one sells what an authentic male camel is predicted to breed in the future. Malaqeeh is the sale of that which an authentic female camel is predicted to breed. The prophet also prohibited selling “dharbat alqanes” and “dharbat alghaes.” Darbat al-`qanis is the sale of prospective fish, birds or other animals that a hunter’s net will catch following the agreement. Darbat al-`gha’is is the sale of prospective pearls that a diver will gather in his next diving session. The prophet also advised against selling the produce of plants and trees early in the farming season, before their quality has been ascertained. Alzarqa concludes, from all these prohibited contracts, a common element, which is “the inability to ascertain the type of the subject of exchange.”

These hadiths refer to the unlawfulness of selling objects that are not yet in the possession of the seller at the time the contract is made, making uncertain the quantity and quality of goods to be delivered. Building upon these hadiths, Islamic jurists have decided that if the subject of

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135 Al-Sanhuri, supra note at 34
136 Al-Zarqa, supra note at 49
137 Al-Zarqa, supra note at 49
138 Al-Zarqa, supra note at 49
139 Al-Zarqa, supra note at 49
a contract of sale cannot immediately be delivered to the buyer, then the contract is unlawful due to the degree of *gharar*.\(^{140}\) For example, a contractual sale is tainted by *gharar* and thus unlawful in the case of a trade for a fish that is not in the seller’s possession because the fish has yet to be caught.\(^{141}\) Alzarqa’s analysis of the above hadiths leads him to distinguish between two types of *gharar*. In his view, the elements of probability and adventure exist in most transactional dealings in which not all things are perfectly certain.\(^{142}\) This is called usual or excepted *gharar*.\(^{143}\) The other type of *gharar* is called excessive *gharar* and is prohibited because it is excessive to the point of not being suitable for economic transactions.\(^{144}\)

Contrasting this understanding of excessive *gharar* and expected or usual *gharar* against the conventional insurance contract, Alzarqa sees that insurance is free from the prohibited excessive *gharar*.\(^{145}\) Insurance, in his view, contains an element of uncertainty that affects only the insurer, while the insured must always receive compensation upon occurrence of a prescribed loss.\(^{146}\) This uncertainty exists vis-a-vis each contract that the insurer concludes with an individual customer.\(^{147}\) Concerning contractual risk between the insurer and the

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\(^{140}\) Al-Zarqa, supra note at 49

\(^{141}\) Al-Zarqa, supra note at 49

\(^{142}\) Al-Zarqa, supra note at 49

\(^{143}\) Al-Zarqa, supra note at 49

\(^{144}\) Al-Zarqa, supra note at 49

\(^{145}\) Al-Zarqa, supra note at 50

\(^{146}\) Al-Zarqa, supra note at 50

\(^{147}\) Al-Zarqa, supra note at 50
grouping of all contracts made, the threat of excessive risk is erased since the insurance system operates on a statistical model, which eliminates (or mitigates) the issue.\footnote{148 Al-Zarqa, supra note at 50}

With regard to the problem of uncertainty for the insured, Alzarqa denies that there is any since he considers the sense of security that the insured obtains from signing the agreement as the legitimate commodity of a contract.\footnote{149 Al-Zarqa, supra note at 50} He argues that whether or not an accident or mishap actually occurs, the insured obtains a sense of security even if the event that is insured against does not occur.\footnote{150 Al-Zarqa, supra note at 50, 51} He believes that such security can be the legitimate subject of exchange since people place the utmost value on security and are inclined to spend a great deal of money, time, and hard work in its pursuit.\footnote{151 Al-Zarqa, supra note at 50, 51} He maintains that there is no evidence in sharia that such a notion of security cannot be exchanged for money.\footnote{152 Al-Zarqa, supra note at 51} This is yet another unsubstantiated claim on part of Al-Zarqa, as another scholar notes: “many jurists [earlier jurists] argued, “security” does not qualify as an object of sale, since it does not constitute a tangible good or service”\footnote{153 Mahmoud A. El-Gamal, Islamic Finance: Law, Economics and Practice, (New York, Cambridge University Press 2006) at 36}.\footnote{154 Al-Zarqa, supra note at 51} Alzarqa seeks to demonstrate the lawfulness of treating safety and security as a commodity to be traded in some of the existing examples of contracts. One example he provides is when a person hires another to guard something.\footnote{154 Al-Zarqa, supra note at 51} He argues that, when someone is hired as a guard,
the job can produce a mere sense of safety and security from different types of hazards.\textsuperscript{155} This is different from hiring a servant to provide a service, a hauler to transport things or people, or hiring someone to produce something.\textsuperscript{156} All these jobs result in performances that have an immediate and measurable physical impact.\textsuperscript{157} However, a guard can be paid for work whose performance is limited to creating a subjective sense of security, which Alzarqa deems comparable to the sense of security provided by an insurance contract.\textsuperscript{158}

Nevertheless, from a legal standpoint, Alzarqa’s characterization of the insurance contract’s subject is erroneous. The subjects of exchange in the insurance contract are the determined premiums and the provided coverage. While it may be true that people achieve a sense of security as a result of concluding the insurance contract, this is not the subject of the contract. The product sold by insurance companies is the promise of coverage (the insurance policy)\textsuperscript{159}, which can be considered as part of a system of risk management whether it results in profit or not. Additionally, contrasting insurance against the work of a security guard is an inappropriate comparison. In the case of insurance, one does not pay for a service that is immediately rendered but rather for compensation for the possibility of a loss. While an insurance policy is conditional (something may go wrong), a guard is materially present and is rendering a service that is not contingent on an event.

\begin{footnotesize}
\begin{enumerate}
\item[155] Al-Zarqa, supra note at 51
\item[156] Al-Zarqa, supra note at 51
\item[157] Al-Zarqa, supra note at 51
\item[158] Al-Zarqa, supra note at 51
\item[159] Boivin, Denis. \textit{Insurance Law}. (Toronto: Irwin Law, 2004) at 16 \cite{Boivin}
\end{enumerate}
\end{footnotesize}
Alzarqa investigates uncertainty in contracts that are considered legitimate in Islamic law. For example, he points to the kafalah contract and how Islamic jurists have found it lawful despite the potential risk to one party to the agreement. kafalah literally translates into guarantee, and it refers to a contractual obligation whereby one party guarantees to pay a debt in case the primary debtor defaults.

Alzarqa suggests that kafalah is permissible even if what is guaranteed is undefined. So if one person were to tell another, “deal with this person. I guarantee the protection of whatever rights you have over him,” this would be considered a permissible kafalah contract in Islamic law. He quotes Ibn Abdeen as saying that, if a person were to tell a creditor, “if your debtor, x, becomes bankrupt, dies, or travels, I shall guarantee him,” this would constitute a correct form of kafalah.160 Extracting from the rules of kafalah regarding chance and risk, Alzarqa proposes that even if insurance contains risk, it must be of the acceptable type that is not prohibited in Islamic law. Nevertheless, there is a clear distinction between insurance and kafalah regarding gharar. Alzarqa’s analogy is missing a critical component. Islamic surety contracts, of which kafalah is one, are donative, not onerous; therefore, gharar does not pose an issue here. The guarantor is not being paid for the guarantee that he or she provides.161

Some scholars claim that life insurance contains an element of jahalah or uncertainty since the premiums paid by the insured until her death are instalments whose completion is undefined. Therefore, uncertainty abrogates the legality of the contract. Alzarqa responds to this by

160Al-Zarqa, supra note at 50

[Vogel, Islamic Finance] at 106
analyzing *hanafi* jurisprudence in a manner similar to his investigation of *gharar*. Hanafi jurists have sufficiently outlined the nature of uncertainty and how it affects the legality of contracts by differentiating between two types of *jahalah*. The first type is uncertainty that greatly affects the legality of the contract. An example of this type of *jahalah* is if a person were to tell another: “I sold or lent you this for this amount,” without specifying the thing which is being sold or specifying the price with the other party’s acceptance. Such a contract is deemed to have an element of uncertainty detrimental to both parties in the case of a conflict. It would be extremely difficult for the judicial system to solve the conflict fairly. A judge would consider both parties’ arguments equally but the ambiguity of the contract would prevent him from identifying key elements in the contract. Furthermore, this uncertainty may lead parties to ask for better deals than that which they had originally intended.

The second type of *jahalah*, or uncertainty, is the type that does not affect the legality of the contract. An example provided for this is if one were to reconcile with another by waiving all her or his rights, without specifying an exact amount. Alzarqa states that this type of reconciliation is valid in *hanafi fiqh* and that the rights of the first party are waived. The reason for its legality--despite the huge undertaking-- is that uncertainty does not preclude the act of surrendering rights. Since all rights have been waived, there is no uncertainty as to what

162 Al-Zarqa, supra note at 50
163 Al-Zarqa, supra note at 50
164 Al-Zarqa, supra note at 51
165 Al-Zarqa, supra note at 51
166 Al-Zarqa, supra note at 52
167 Al-Zarqa, supra note at 52
is being waived: any right one might have had has been waived. However, if the person were to announce that she would surrender some rights, without specification, then the reconciliation would not be valid. This is because it would not be known which particular rights remain untouched. 168 In other words, since only some rights are waived, in order for such a waiver to be effective, it must be known precisely which rights one intends to waive.

Al-Zarqa applies this understanding of jahalah on premiums paid for life insurance. He finds that the uncertainty inherent to such insurance contracts does not abrogate the legality of the contracts since the schedule of premium payments are predetermined. 169 Nevertheless, he acknowledges that the sum of all premiums is what constitutes jahalah, since the total amount paid prior to an individual’s death is unknown. Yet this uncertainty does not invalidate the contract since the insurer has pledged to pay the beneficiaries the agreed upon amount upon the death of the insured, regardless of when he/she dies during the length of the insurance contract. 170 In fact, hanafi scholars, he states, view the sale of a closed box without the knowledge of its content as lawful. This is because the seller and the buyer have both agreed upon this purchase and each can be obliged by their clearly defined will. 171

Al-Zarqa discusses and responds to the rationale put forward by Muslim scholars that render insurance unlawful in Islamic law. He responds to the criticism that insurance is prohibited on the grounds that it is a type of gambling. Al-Zarqa refuses to equate gambling, which he perceives as creating social ills, with insurance, which he perceives as a system of cooperation

168 Al-Zarqa, supra note at 52
169 Al-Zarqa, supra note at 52
170 Al-Zarqa, supra note at 52
171 Al-Zarqa, supra note at 52
and risk management. Al-Zarqa disputes that playing with chance, despite all of the social
defects to which it can lead, cannot be equated with a system that revolves around organizing
a cooperative scheme in a technical manner.\footnote{Al-Zarqa, supra note at 45} Moreover, he argues that insurance provides
the insured security and comfort from potential risks -- without insurance, a person might lose
his abilities and wealth. He further argues that this security cannot be equated with the kind of
security that a gambler could attain from gambling. In fact, he suggests that gambling
constitutes the opposite of security.\footnote{Al-Zarqa, supra note at 46} Al-Zarqa frames insurance as an \textit{exchange} that is
beneficial for both the insurer and the insured. The insurer receives a profit while the insured
is secured before loss is incurred and compensated after loss occurs. Gambling offers no such
exchange.\footnote{Al-Zarqa, supra note at 46}

Indeed, gambling despite it sharing a similarity with insurance, which is the risk, is primarily
different in terms of characteristics and purposes. Risk is created in gambling as a mechanism
for a chance to win while in the insurance contract risk is inherent in the insurance operations.
In both contracts, however, profit is made through trading in risk, which is the point of conflict
I have with Al-Zarqa.

Al-Zarqa also responds to the charge that insurance is a form of unlawful wagering. He asserts
that it is evident that wagering is unlike insurance in that insurance seeks to manage risk and
create a sense of safety and comfort while wagering involves neither risk management nor any
sense of security.\footnote{Al-Zarqa, supra note at 46} The issue of whether insurance contains an element of wagering has been
studied extensively in the common law system. At some point in English legal history, it was

\begin{footnotesize}
\footnote{Al-Zarqa, supra note at 45}
\footnote{Al-Zarqa, supra note at 46}
\footnote{Al-Zarqa, supra note at 46}
\footnote{Al-Zarqa, supra note at 46}
\end{footnotesize}
“difficult to distinguish legitimate insurance activities from gambling.”\footnote{Boivin, supra note 152 at 69} In response, the English parliament passed legislation that prohibits wagers disguised as an insurance contract.\footnote{Ibid}

The legislation distinguished between a legitimate insurance contract and a wager on the basis that the insured must have an interest in the object of insurance. From this, the idea of insurable interest emerged as a requirement for a legitimate insurance contract.\footnote{Ibid} In time, the courts developed different approaches to what defines an insurable interest.\footnote{Boivin, supra note 152 at 70}

There needs to be an understanding of what types of insurance already exist in the west and which are closer to satisfying the prohibition on gharar, jahalah and riba. A contract containing an unlawful condition may not invalidate the contract or disqualify it from being assessed and possibly amended to reduce or eliminate unlawful elements. Al-Zarqa also recognized that not all schemes of insurance or terms to which insurance companies resort may be permitted as lawful insurance under his views.\footnote{Al-Zarqa, supra note at 54} Nor does it result in his approval of anything that is considered conventional in the contract as applied in other legal systems.\footnote{Ibid} Rather, every term is subjected in its legality to sharia. It is possible to rule that an insurance contract that is concluded between two parties as unlawful due to its containing an unlawful

\footnote{Boivin, supra note 152 at 69}
\footnote{Ibid}
\footnote{Ibid}
\footnote{Boivin, supra note 152 at 70}
\footnote{Al-Zarqa, supra note at 54}
\footnote{Ibid}
term. He goes on to provide an example of an unlawful insurance contract: insuring a nominee in an election against loss.182

I argue that analyzing the insurance contract in isolation from the current conventional insurance system poses many risks to the integrity of an Islamic financial system. By isolating the insurance contract from its conventional scheme, we ignore issues that significantly shape the contemporary Islamic insurance order. One factor that is being avoided in this discussion is the hegemonic forces within international economical structures that are constantly reinforced and established in Muslim countries through international institutions and treaties. Another is the reality that Muslim countries often lack formal Islamic institutions that can play a supervisory role in rectifying unlawful terms or contracts. In fact, one of the motivations Alzarqa has noted behind his research on the insurance contract’s legality in Islamic law is the lack of an institutional ruling on this issue despite popular necessity.

Alzarqa’s defense of the conventional insurance system as outlined in civil law is based, to a noticeable extent, on idealizing the system as a system of mutual and practical cooperation despite it being based on a commercial agreement. His investigation on the legality of the conventional insurance contract as it applies to Islamic law has an unbalanced focus in its approach. This imbalance is particularly evident in the lack of investigation of how insurance schemes operate in reality and how the system as a whole fulfills or contradicts the objectives of sharia.

As El-Gamal explains in his article, *Mutuality as an Antidote to Rent-Seeking Shari`a-Arbitrage in Islamic Finance*, gharar is made more prominent by conventional insurance

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182 Ibid
schemes relative to some existing alternatives. The stock insurance model is one that is
commulative and most Islamic scholars agree that unlawful risk occurs in commulative
contracts rather than donative ones. The most effective way to reduce risk, and consequently
seek a sharia compliant insurance scheme, is through establishing a mutual insurance
scheme. The reason for this is that whatever premiums are paid provide benefit to the
members since they are shareholders in this scheme and not merely customers. The premiums
are not donations but they would be invested and used in a way that maximizes the economic
benefit of the shareholders who pay the premiums instead of primarily maximizing profits for
a business’s lead investors.

Alzarqa claims that mutual insurance, which he maintains is the most sharia-compliant form
of insurance, is not being applied for economic reasons, as will be seen in this chapter. In his
analysis of risk, he focuses strictly on the contractual obligation and fails to consider the
element of risk inherent to the functioning of the system as a whole.

Alzarqa's in his study, differentiates between two types of insurance. One he calls mutual
insurance. He identifies the other type as insurance through instalments, which he describes as
the prevailing form of insurance. He states that mutual insurance is structured in a purely
cooperative manner. He states that this type is absolutely lawful without any shubha, or
suspicion, in its lawfulness and against all risks. Its absolute lawfulness is due to the way in
which it is structured. He explains that the mutual insurance is based on a cooperative pool of

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183 El-Gamal *Mutuality*, supra note 108 at?
184 El-Gamal, *Mutuality*, supra note 108 at?
assets that is designed to correct and rectify damages that may occur from incidents. Mutual insurance constitutes an association that does not aim for profit. Rather, its aim is to rebuild what has been damaged. Mutuals are an accurate example of the principle of cooperation, which has been called for by the Quran. In Alzarqa’s view, this system should proliferate and should constitute the conventional system of insurance.

Without elaboration, however, he concludes that this system appears to exhibit difficulties and deficiencies when implemented in practice and therefore has been abandoned in favour of the conventional contemporary system.\textsuperscript{185} The irony of this statement is that his book was released in 1984, at a time when the mutual system of insurance was fully functioning in North America and Europe, as was explained in the section on the subject. _____

The other type of insurance identified by Alzarqa, one which raises suspicions of incompatibility with Islamic law, is the “instalment insurance.”\textsuperscript{186} He concludes that there is no evidence to prove its unlawfulness in Islamic law. This is due to the fact that, in sharia, everything is presumed to be lawful unless there is evidence in sharia that attaches unfavorable judgments to it. In addition, there are no restrictions within sharia that limit people to only certain types of contracts. Rather, it accepts new forms of contracts that are compatible with the doctrines and terms of sharia.

Alzarqa also discusses the significance of the \textit{Aqila} system. All four Sunni schools of law have approved this system.\textsuperscript{187} The idea is that if someone commits the crime of negligent or reckless manslaughter, the relatives of the deceased are entitled to a compensation called \textit{diyah}. In Islamic law, manslaughter requires that compensation be paid to the relatives of the

\begin{flushright}
185 Al-Zarqa, supra note at 55
186 \textit{Ibid}
187 \textit{Ibid} at 60
\end{flushright}
deceased. It is required that certain relatives of the wrongdoer contribute to the *diyah*, and charging close relatives with the responsibility of payment ensures that the *diyah* is paid. Aqila is a community pooling of resources to compensate for damage. Presumably, *diyah* is designed to provide compensation to the affected family as a peaceful alternative to possible retribution by the family of the diseased. In this sense, the Aqila system can be considered to be an early cooperative indemnification and risk management scheme that existed in Arabia.

Alzarqa sees a further similarity in the Aqila system and the insurance system. The Prophet, peace be upon him, has noted that relatives cannot compensate for intentional murder. The reason behind this, Alzarqa notes, is that cooperation in vice is prohibited and could be considered an encouragement for the murderer. The point of similarity is that contemporary laws do not allow insuring against fraud or murder. 188

Alzarqa’s reading of the Aqila system, which is a mandatory system in Islamic law, leads him to ask what prevents Muslims from insuring against fiscal disasters with their own free will. 189 He reads that Islamic law would not have made the system obligatory were it not for a significant purpose, which is cooperation to compensate for loss. 190

An obvious point that distinguishes Aqila from insurance is that Aqila is not a contract while insurance is. The other point is that Aqila is a system of familial and tribal risk management, which had its merits under archaic conditions. It was not designed for profit. Insurance, on the other hand, is a contract with special characteristics and from what Alzarqa describes, it is intended for profit. Taking these two differences and their respective histories into account, we must conclude that, despite some similarities, there are stark differences between the two

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188 ibid at 61
189 ibid
190 ibid
systems. These discrepancies show that conventional insurance is incompatible with the spirit and mandate of Aqila.

The other system that Alzarqa uses in his analysis or comparison to the insurance system is that of state pensions. First, he describes the pension system and asks what the difference is between the pension system and life insurance. He concludes that, in both systems, the person pays a small premium or deductible for which she is uncertain how much she will reap in the end. With pensions, the person receives a periodical amount upon retiring without knowing how much it will be or how long it will last. With life insurance, the person receives an immediate sum of money after maturity and knows exactly how much it is. Alzarqa argues that jahalah (uncertainty) is greater in a pension than in an insurance contract. The Pension system, however, is approved by all Islamic scholars without hesitation\(^\bib{191}\), and it is actually seen as a necessary system that concerns the public's interest, while insurance is not. Alzarqa questions why a pension is readily approved between the state and its workers while insurance is considered unlawful when entered into as a private contract. Here again, Alzarqa fails to see the difference between insurance providers and state-run pensions. A state-run system is concerned with serving the interests of the state and presumably the welfare of citizens. An insurance system that is structured to generate profit for shareholders, on the other hand, may not be as concerned with the welfare of people.

In conclusion, it appears that the analysis in which guides Al-Zarqa through his findings is limited to strictly legal terms. With this type of analysis, he intentionally separates the contract

\(^{191}\) ibid at 62
from its relational context, which explains some of the shortcomings in his arguments.

Nevertheless, Al-Zarqa provided important insights in his jurisprudential-oriented analysis of what constitutes *gharar* since he explained how *gharar* is unpreventable in many contracts and therefore does not effect the validity of all contracts except in severe cases such as *qimār* (gambling) and *maisar* (wager) where the economic utility of the transaction is void.

2.2 The Council of Senior Ulama’s Position

The first Islamic scholar to systematically discuss the meaning and legality of the insurance contract was *ḥanafi* lawyer Ibn Abidin in the early nineteenth century. His thinking has greatly influenced many of today's insurance schemes that seek to operate according to Islamic law.

The dominant perspective among Islamic legal scholars considers the insurance contract in its conventional form to contain *ribā* and *gharar* and hence, to be unlawful.

In the 1970s ACE the highly authoritative Council of Senior *Ulāma* declared conventional insurance unlawful. The Council issued a *fatwa*, decision Number 5/10 dated 4/4/1397 AH, probing the nature of the insurance contract after the question was referred to them by King Faisal Ibn Abdulaziz. The *ulama* used the term commercial insurance to refer to the conventional insurance contract, reflecting its commercial nature, as opposed to the

cooperative type of contracts found in Islamic law. What is problematic in the ulama’a approach is that in deciding matters pertaining to complex contemporary financial systems, they adopt a “textualist” approach that is borrowed from centuries ago and attempt to apply it where it does not properly fit. In these contexts, economic–socio analysis comes as an afterthought and seems to justify the conclusions based on fiqh.

In their fatwa, the ulama asserted that commercial insurance contracts contain elements of jahāla (ambiguity) and gharar fahish (extreme risk), where the insurer cannot determine at the time of the contract how much it will pay in the event of an incident and the insured cannot determine how much it will be required to pay as a premium and whether it will ever receive a payment under the contract. Moreover, commercial insurance contracts were declared unlawful because they were said to contain elements of gambling due to the uncertain outcome of the contract.

The ulama explained that commercial insurance contracts include two types of forbidden riba, riba al-faḍl and riba al-nasi’a. If in the event of loss the company pays the insured, his heirs, or another beneficiary an amount exceeding the sum of money the customer had paid into the insurance scheme, it is considered riba al-faḍl, and hence unlawful. Also, if the company does not pay the customer upon immediate receipt of payment from the insured, but only at a later time as is typical in the insurance context, then this transaction is further

194 ibid
195 ibid
196 ibid
characterized as riba al-nasi’a. The ulama stated that under a commercial insurance contract, if the event covered by the insurance does not take place, money is taken from the beneficiaries who in exchange do not receive anything, and this is prohibited under Islamic law.

The fatwa rejected the idea that commercial insurance contracts constitute muḍāraba, a type of contract permissible under Islamic law. Muḍāraba is a contract of financial partnership in which one partner provides the capital while the other partner provides management. Under this model partners share the profit according to a predetermined percentage, except that the partner providing the capital bears the losses.

According to the ulama, there are two main distinctions between muḍāraba and insurance. Firstly, in muḍāraba, ownership of the investment remains with the investor, while in insurance contracts, investments (capital raised from payment of premiums) are owned by the insurance company. In muḍāraba, the investment money can be inherited by the heirs, while in the insurance contract heirs may be entitled to a benefit despite the deceased having made only one instalment. The second main distinction has to do with the distribution of loss and profit: in mudaraba contracts there is a predetermined percentage agreed upon by the parties to the contract, unlike the conventional insurance contract where loss and profit are borne solely by the company, with the insured only being entitled to pre-defined benefits.

In brief, the ulama rejected the commercial insurance contract all together since they perceive it to contain excessive risk, ambiguity and riba. One of the main objections to the model is that

197 ibid
198 ibid
both insurance parties may receive a value exceeding their initial contribution therefore benefiting from a transaction loaded with risk.

3 Insurance Law and models: A Comparative Study of risk accommodation

The internationally dominant models of insurance have developed along four major identified types. These models precede Saudi Arabia’s ta‘awuni model which was derived from the takaful model, first established in the 1980’s. The four main insurance schemes are: social insurance, mutual insurance, reciprocal exchange, and commercial insurance\textsuperscript{199}. This section will focus on the four main structures, while takaful insurance models will be discussed in

\footnote{\textit{Gamal Mutuality}, supra note at 7}
later sections. Investigating the origins of the contemporary models of insurance, reviewing its definitions, practices, structures and characteristics will aid us in identifying which of these models best comply with Islamic principles and transactional rules. Furthermore, investigating these models will reveal fundamental differences as well as similarities between these models. Yet, before elaborating on these models, I will provide an overview of the insurance contract’s history and its’ characteristics from a common-law perspective.

3.1. Characteristics of the Insurance Contract

The origins of the insurance contract in common law can be traced to Italian traders from Lombardy. Through Italy, it was later introduced into England during the 13th century. From there, other types of insurance policies were developed such as fire and accident insurance. The first fire insurance company structured as a proprietary or joint stock was founded in London in the year of 1667. Meanwhile, the first legal writing on the interpretation of insurance contracts appeared in the 17th century in Europe. Accident insurance was established a little later in Great Britain in the year 1848 by railway companies.

Insurance regulations were born out of three respective legal systems, the French, English and German legal systems. These jurisdictions borrowed from each other in developing their

\[200\] Holt, Chas. M. (Charles Macpherson), *A treatise on the insurance law of Canada, embracing fire, life, accident, guarantee, mutual benefit, etc., with an analysis of the jurisprudence and of the statute law of the Dominion*, (Montreal, C. Theoret, 1898) at 4 [Holt]

\[201\] Ibid

\[202\] Ibid

\[203\] Ibid at 6

\[204\] Ibid at 13
emerging insurance legislations. According to some commentators, mutual insurance played a significant role in the development and growth of modern insurance, which can be construed from some of the early definitions of modern insurance. It is often difficult to trace which system first appeared, mutual or stock, as insurance has roots in most societies and has existed in different forms.

In his treatise, Holt defines the insurance contract as: “a contract whereby one party called the insurer or underwriter, undertakes for a valuable consideration, to indemnify the other, called the insured, or the representatives, against loss or liability from certain risks or perils to which the object of the insurance may be exposed, or from the happening of a certain event.” The definition appears to apply to an insurance contract that is commercial since risk is transferred from one entity to another.

The insurance contract typically involves two parties; the insurer and the insured. Some insurance contracts designate a third party, called the beneficiary. The beneficiary is "someone who is designated by the insured to receive insurance money". Such claimants are third parties who directly receive the insurance benefit. They could be mentioned by name

205 Ibid
206 Gonulal, supra note at pg 22
207 Holt, supra note at 23
208 Boivin, supra note at 16
209 Ibid
or by description in the policy. For example, vehicle insurance in many countries extends to the driver by providing coverage against third party personal liability in cases of car accidents.

Scholars and courts have distinguished the insurance contract from other private contracts by deducting certain characteristics unique to the contract. According to Boivin, insurance is characterized by risk, indemnity, premiums, mutual dependency and finally its’ public nature.

An insurance contract is a conditional contract whereby the insurer covers a claim amount when certain loss occurs according to the rules of the insurance policy. If no loss occurs, the insured is not entitled to the coverage. Hence, the insurance policy is a promise of coverage contingent on the occurrence of certain losses. The insurance contract can be described as aleatory which means dependent on the chance of an uncertain outcome. Some commentators, among them Griswold, explains this aleatory nature as the price of the risk one assumes rather than the actual price of risk paid by the insurer. In the literal meaning of the word, risk means “danger of loss”.

Commutative contracts on the other hand are distinguishable from aleatory on the basis that a “thing given or act done by one party is regarded as the exact equivalent of the money paid or

210 Ibid
211 Ibid at 28
212 Ibid at 14
213 Holt, supra note at 22
214 Ibid
The difference in risk between the insurance contract and wager is that in a wager, risk is created by the agreement itself. However, in an insurance contract, risk exists independently from the contract since it’s a fortuitous event that may or may not occur. In the case of an insurance contract, risk is defined as a "fortuitous event, the occurrence does not depend on the will of the assured". The inherent risk in the insurance contract is central to why Islamic legal scholars deemed it unlawful. Islamic law prohibits transactions that excessively deal with risk.

Another feature of the insurance contract is that it is a contract of indemnity. The objective of entering the contract is indemnity rather than making profit. The premium is the price the insured has to pay in exchange for the promise of indemnification. Holts distinguished in this regard between other types of insurance and life insurance, which he deems to be a different type of contract not based on indemnity. He cites as example how Canadian courts, which are common law courts, deal with the life insurance as a separate class of contract. Other types of insurance, except for life insurance, are based on contingent events, which may or may not occur. However, in life insurance, insurance companies insure “against the consequences of something which is sure to occur - the date only being doubtful”

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216 Holt, supra note at 22
217 Boivin, supra note at 29
218 Boivin supra note at 29
219 Boivin supra note at 28
220 Ibid at 32
221 Ibid at 33
222 Holt, supra note at 24
A third feature of the insurance contract is that it must be consensual and is bilateral.\textsuperscript{223} Contemporarily, however, certain types of insurance may be mandatory in some countries. In most jurisdictions, for example, vehicle insurance is mandatory. This is also true in Saudi Arabia, where insuring against third party liability is a pre-requisite for obtaining a driving license.

Boivin indicates that mutual dependency is a distinguishable feature of the insurance contract. This is because "each party depends on the other to meet a minimal standard of behaviour during the course of their interaction".\textsuperscript{224} Furthermore, the insurance agreement has a strong public nature. Boivin elaborates on this by indicating that insurance contracts do more than the transfer of risk between only two parties, they are rather a device designed to distribute risk among a broad group of people. The insurance industry relies on the principle of mutuality in assigning the prices of premiums.\textsuperscript{225}

### 3.1 The Stock Insurance Model

Much of what has been stated about the history of insurance applies to the stock model insurance, as it is the dominant structure where the company is structured as a joint stock company that aims for profit.\textsuperscript{226} Under this structure, stockholders finance the capital for the stock-based insurance company, they appoint the management of the company, and they take

\begin{itemize}
\item \textsuperscript{223} Holt, supra note at 25
\item \textsuperscript{224} Boivin, supra note at 35
\item \textsuperscript{225} Ibid at 37
\item \textsuperscript{226} Gonulal, supra note at 22
\end{itemize}
on the risk which insurance operations are based on. The capital supplied by stockholders is often used to minimize the risk of loss in insurance operations and to insure that insurance claims are paid. This feature means that stock insurance companies have easy access to capital, which in turn results in engaging in riskier lines and covering many markets.

Since stockholders share in the risk of loss from insurance claims, and management costs are deducted from collected premiums, one way stockholders make profit is when premiums exceed business operation costs. Profits are made through the accumulation of premium payments and the investment of such excess capital after deductions are made for claim payments and management costs.

3.2 The Mutual Insurance Model

In the following section, I will discuss in depth the history of cooperative and mutual insurance and how they developed to become a significant force in shaping community-based economic enterprises. The cooperative enterprise movement, in its various manifestations, had a significant role in the growth of the cooperative and mutual insurance model. Today, the cooperative movement has garnered much support and recognition from various international parties, accumulating in the designation by the United Nations of the year 2012 as the Year of Cooperatives. The purpose of this nomination by the UN was to draw attention to the role of cooperatives in economic and social development and to praise them as an alternative to

227 Gonulal, supra at 22
228 Gonulal, supra note at 22
229 Ibid at 22
230 Ibid at 22
conventional commercial enterprises.\textsuperscript{231} Since this thesis holds that mutual insurance, as it exists in western countries, is mostly compatible with Islamic transactional rules prohibiting trading in risk, a lot of focus will be accorded to explaining the history, structures and principles of mutual insurance companies.

Mutual and cooperative insurance models are distinct from stock based insurance companies in that they are not proprietary businesses, nor is the management of the business restricted to only a small band of directors with the sole responsibility of providing a return on investment to the shareholders.\textsuperscript{232}

3.2.1 Mutual insurance as a form of Cooperative

Cooperative enterprises, as they are known today, began in 1844.\textsuperscript{233} Local community members of a town in northern England decided to form their own cooperative grocery store with the objective of providing them with good quality and affordable food.\textsuperscript{234} It is said that this was a steppingstone moment for the cooperative movement.\textsuperscript{235} In 1895, the International Cooperative Alliance (ICA) was founded in London England with the objective of providing information, defining and defending cooperative principles, as well as promoting trade.\textsuperscript{236} The ICA drew delegates from cooperatives around the world and gained international prominence. Since insurance is a significant business among cooperative ventures, the ICA established an

\begin{flushright}
\textsuperscript{231} See the official website on the International Year of Cooperatives (IYC), http://social.un.org/coopsyear/
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\textsuperscript{232} World Bank, supra note 69 at 33
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\begin{flushright}
\textsuperscript{233} Gonulal supra note at 37
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\begin{flushright}
\textsuperscript{234} Ibid at 37
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\begin{flushright}
\textsuperscript{235} Ibid at 37
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\begin{flushright}
\textsuperscript{236} The International Cooperative Alliance, Online < http://2012.coop/en >
\end{flushright}
International Insurance Committee in 1922\textsuperscript{237}. This International Insurance Committee was later renamed and is now know as the International Cooperative and Mutual Insurance Federation (ICMIF). \textsuperscript{238} Cooperatives businesses are varied and can include various types of businesses other than insurance.

The International Cooperative Alliance (ICA) defines cooperatives in general as “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.”\textsuperscript{239} The ICA states that cooperatives “are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity.”\textsuperscript{240}

Cooperatives are founded upon seven principles, most relevant of which are the principles of “voluntary and open membership” as well as that of “democratic member control”.\textsuperscript{241} The former principle indicates that there is no compulsion in becoming a member. All members have an equal opportunity in joining, given they can meet the responsibilities of the organization, without discrimination whether based on gender, religion, race, and political or social affiliation\textsuperscript{242}. Democratic member control means that each member has a vote and votes are based on membership rather than being based on shares. It also means that all members

\textsuperscript{237} Ibid
\textsuperscript{238} Ibid
\textsuperscript{239} Ibid
\textsuperscript{240} Ibid
\textsuperscript{241} Ibid
\textsuperscript{242} Ibid
have the right to participate democratically in shaping the policy of the cooperative. Another important principle that may differentiate cooperatives from mutual organizations is the principle of “member economic participation”. This principle refers to members’ democratic as well as equitable contribution to the cooperative. Cooperatives set their membership conditions differently according to the type and policy of the enterprise. For example, some cooperatives may mandate members to work in the cooperatives, or may substitute the working requirement by charging an additional fee. Most cooperatives request that their members make payments by way of subscription fees. Members may then benefit from the surplus generated by the cooperative in accordance to the amount of their contribution. The ICA states that cooperatives have to be autonomous and independent even if they deal with other external parties such as businesses or governments. An important value for cooperatives is that they must have objectives other than making profit.

Historically, many countries cooperative movements have alliances and ties with trade unions. Most states have special laws governing cooperative enterprises that are different from laws governing commercial enterprises. The European union for example, issued a statute for a European Cooperative Society in 2003. The statute aims to provide an adequate legal framework for cooperative enterprises in Europe that facilitates “their cross-border and

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243 Ibid
244 Ibid
245 Ibid
246 Gonulal, supra note at 38
247 Ibid
trans-national activities”. Such enterprises have gained international recognition by the International Labour Organization (ILO), which issued a recommendation in 2002 concerning the promotion of cooperatives. The recommendation is aimed at all types and forms of cooperatives.

In its recommendation, the ILO provides a definition similar to that given by the ICA, namely, recognizing them as “an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise”. It also affirms the same principles and core values than those put forward by the International Cooperative Alliance. The recommendation speaks amply of the economic and social benefit that cooperatives promote since they draw participation from all people, and they are also effective in creating jobs, mobilizing resources and promoting investment.

250 Ibid
251 Ibid
252 Ibid
In 2008, Saudi Arabia issued a new law on Cooperative Associations replacing a previous version issued in 1962.\textsuperscript{253} According to the Cooperative Associations Guide, issued by the Ministry of Social Affairs in Saudi Arabia, in 2008 there were a total of 165 cooperative associations in the Kingdom.\textsuperscript{254} These numbers indicate a shortage of cooperative organizing in the social economy of Saudi Arabia. The new law on Cooperative Associations does not define which businesses can be instituted as cooperatives, and there is no mention of insurance enterprises in the association guide issued by the ministry.

3.2.2  Mutual Insurance: History, Definition and Applications

Mutual insurance principles can be traced to several historic periods and groups. According to some accounts, it can be traced back to the Anglo-Saxon guilds that periodically pooled together fixed funds in order to insure members against losses from fire, water, theft and other risks.\textsuperscript{255} In 1683, a mutual was structured in England as “The Friendly Society” for fire insurance followed by other such societies that did not last long due to a series of fires occurring in London between 1784-1786 resulting in the loss of funds.\textsuperscript{256}

Mutual banking and insurance was further developed in eighteenth century Europe and North America as a response to the perceived shortcomings of conventional banking and insurance schemes due to the underpinning profit motive. Ship owners started mutual insurance

\textsuperscript{253} The Law on Cooperative Associations, issued in 1429 H, by Royal Decree No.M/14
\textsuperscript{254} The Cooperative Association Guide, Ministry of Social Affairs website <http://mosa.gov.sa>
\textsuperscript{255} Holt, supra note 206 at 4
\textsuperscript{256} Holt, supra note 206 at 10
companies in the 18th century as they were dissatisfied by the terms offered them by Lloyds. These mutual insurance associations were called “Indemnity & Protection Clubs”.

The idea behind the mutual system then and today is to control risks that members commonly face through a structure that gives them control over decision making regarding different aspects of the insurance company. People decided to group together by profession to collectively mitigate and control the common risks they face in their respective industries. Members or their representatives (professional & trade associations) in this scheme own the company while also acting as its policyholders. Members comprise the general assembly of the company, which is responsible for appointing the board of directors.

There are many forms of mutual insurance organizing. Some mutuals are structured as stocks that are owned by policyholder so they are "capitalized on the lines of stock corporation". The shareholders collect their share of equity in the form of returns on stock capital. A form of hybrid insurance operations also emerged filling a gap vacated by commercial insurers.

257 Khorshid, supra note 57 at 97
258 Ibid at 97
259 Ibid at 97
260 Ibid at 97
261 Ibid at 98
262 Ibid at 99
263 Ibid at 99
264 Ibid at 99
In addition, there are mutual associations that admit members on an assessment basis.\textsuperscript{265} In some of these assessment-based schemes, contributions are collected after a loss has occurred.\textsuperscript{266} This usually is the case with established mutuals that have sufficient funds and reserves.\textsuperscript{267} An example of this type is the "Protection and Indemnity Club".\textsuperscript{268} Mutuals can also manifest in various societies and clubs such as fraternities, which had a significant role in providing welfare services and relief.\textsuperscript{269} Another example is non-profit organizations that help certain communities with private healthcare expenses.\textsuperscript{270} According to Khorshid, reciprocal exchange is a form of mutual\textsuperscript{271} that is prominent with certain professional groups in order to provide liability insurance for its members.

3.2.3 Examples of functional Mutual Insurance Schemes: The European Framework

Europe has the largest mutual insurance sector. The International Cooperative and Mutual Insurance Federation’s (ICMIF) latest report on the global mutual insurance market indicates that the mutual sector wrote 615 billion USD of life insurance business.\textsuperscript{272} This represents an

\begin{footnotesize}
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\item \textsuperscript{265} Ibid at 100
\item \textsuperscript{266} Ibid at 100
\item \textsuperscript{267} Ibid at 98
\item \textsuperscript{268} Ibid at 100
\item \textsuperscript{269} Ibid at 100
\item \textsuperscript{270} Ibid at 100
\item \textsuperscript{271} Ibid at 100
\item \textsuperscript{272} ICMIF, “ICMIF Annual Mutual Market Share for 2009–2010” (2010), Online < icmif.org >
\end{itemize}
\end{footnotesize}
increase of 6.8% since 2007.\textsuperscript{273} Calculating the growth based on region in 2010, the report shows that Europe (38.8%) and the US (36.9%) had the largest market shares of the global mutual insurance market.\textsuperscript{274} By examining the mutual insurance structures that developed in Europe, it is hoped that a precise understanding of the mutual’s role and structures will inform this study and aid in determining the most legally appropriate insurance scheme in Saudi Arabia.

In a research conducted by the institution of Voor Beleid on 'The role of mutual societies in 21st century Europe' authors of the research explain that mutual enterprises are considered 'the main components of the social economy, or third sector in the European Union'.\textsuperscript{275} Following the Second World War the majority of European countries underwent extensive reforms that helped establish a safety net for citizens by setting up 'public social insurance or national health services'.\textsuperscript{276} The research further states that the definition of inequality, poverty or social risk varies greatly depending on the prevailing 'traditions, culture and ideologies in the different countries'. Nevertheless most countries consider the following risks worthy of protection: 'healthcare, sickness cash benefits, maternity benefits, long-term care, invalidity benefits, old age pensions, survivors’ benefits/pensions (i.e. for surviving relatives), benefits

\begin{itemize}
\item \textsuperscript{273} ibid at 5
\item \textsuperscript{274} ibid at 6
\item \textsuperscript{275} Simon Broek et al, The Role of Mutual Societies in the 21st Century (Research Voor Beleid; The Netherlands) at 7 Online: <http://www.europarl.europa.eu/committees/en/studies.html> \textsuperscript{[Broek]}
\item \textsuperscript{276} \textit{Ibid at 15} \end{itemize}
for accidents at work and occupational diseases, unemployment benefits, and family allowances as part of 'social protection systems'.

One of the popular mutual insurance providers in Europe are “Protection and Indemnity Clubs” (P&I clubs). Protection and Indemnity Clubs are mutual associations, which started in the United Kingdom in the 1850’s. Ship owners would pool their third-party liabilities including environmental liabilities to collectively manage the risks of their marine businesses. They proved successful in creating a strong incentive to adopt the highest environmental and safety standards and therefore effectively managing high profile risks. Because of these high levels of risk and unpredictability faced by these clubs, they often reinforce the mutuality structure by creating mutual insurance structures where clubs insure one another.

Mutuals vary widely in their practices and structures according to the various regulatory structures available in Europe, which shape and guide mutual and conventional schemes.

In Europe, mutuals can be distinguished on the basis of the services that are provided. On the one hand, there are insurance mutual companies, which cover many risks such as covering life, and property related risks. These companies compete with commercial insurance providers. On the other hand, there are mutual benefit societies, which provide services in the form of “social welfare” such that they supplement the existing “statutory protection

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277 Ibid at 15
278 ibid at 15
280 Ibid at 57
281 Ibid at 57
282 Broek, supra note at 16
283 Ibid at 7
system”. An example of activities they carry out is the provision of benefits relating to
disability and old age as well as conducting and organizing other social activities. In some
European countries and some cases they “run their own hospitals, nursing homes and
rehabilitation centers”.

The European commission defines mutuals as “voluntary groups of persons (natural or legal)
whose purpose is primarily to meet the needs of their members rather than achieve a return on
investment. These kinds of enterprise operate according to the principles of solidarity between
members, and their participation in the governance of the business.”

Broek’s research on the role of mutual insurance summarizes a few principles, which are
deemed to be central to what is a mutual in the European context. First, as apposed to stock
companies which are a pooling of assets, mutual companies are a “grouping of persons
(physical or legal) called members” which indicates “an absence of shares” in mutual
companies. As a consequence of this mutual structure, the company or society is ruled
through the principle of democratic governance where each member has one vote.

284 Ibid at 7
285 Ibid at 16
286 Ibid at 17
287 Ibid at 19
288 Ibid at 19
289 Ibid at 19
Another principle shared by mutual companies or societies is the freedom to access membership and the freedom to withdraw from membership as explained in the by-laws.\textsuperscript{290} The third principle mentioned is the principle of solidarity among members, which is the very basis of this model. Contemporarily, solidarity can be translated into three essential rules or principles: “joint liability and a cross subsidisation between good risks and bad risks and no discrimination among members”.\textsuperscript{291}

In addition, mutual companies have a “limited profit sharing” component.\textsuperscript{292} Usually mutual companies retain surplus capital in order to invest in strengthening the company’s ability to meet future demands. Members may receive a share in the profit through distribution of surplus or through a discount in premium prices. Broek also states that mutual companies are private and independent organizations that do not rely on government subsidies.\textsuperscript{293}

### 3.3 Ownership Structures and Legal Rights: A Comparison between Stock and Mutual Models

In the following section, I will demonstrate how different structures of ownership lead to different legal implications. A comparison between the stock insurance company model and the mutual/cooperative model will illuminate how differing insurance schemes influence the distribution of rights and values within the model. In particular, this section is necessary for learning the distinction between mutual/ cooperative models and those of stock structures.

\textsuperscript{290} Ibid at 19
\textsuperscript{291} Ibid at 19
\textsuperscript{292} Ibid at 19
\textsuperscript{293} Ibid at 19
A key distinction between commercial or conventional insurance companies and mutual insurance in their various forms is the motif of profit. Conventional insurance companies are often structured as stock companies that are publically traded. The management in such companies is accountable to the shareholders/stockholders who expect the company to make surplus and distribute dividend to shareholders. Therefore, management is often compelled to make investment and administrative choices that are geared towards making profit. Such insurance companies are not founded on the principle of mutual cooperation and mutual pooling of resources.

This distinction was noted in Holt's treatise on insurance. He states that commercial insurance companies should be distinguished from beneficial or mutual aid societies. Insurance is not founded on philanthropic principles and is by nature a commercial enterprise. He states that these societies' objectives are not to indemnify or secure against loss, but rather to provide protection and benefits to their members. He acknowledges that since these societies are often bound by contracts, the result of such arrangements is that members are indemnified in a similar way as to how conventional insurance works. However, he states that their mandate is philanthropic in nature despite the members intentions or self-interest. Despite the philanthropic nature that underlies these societies, these foundations do not diminish the

294 Holt, supra note at 41
295 Ibid
296 Ibid
297 Ibid
298 Ibid at 41
binding obligations ensued by the signing of such contracts.\textsuperscript{299} He adds that “beneficial societies” are governed first by the laws and regulations of the state under which they operate, and they are bound by relevant court decisions.\textsuperscript{300} In addition, “beneficial societies” have their own binding constitution and rules.\textsuperscript{301}

Although some of these societies exist today with similar practices and objectives to those mentioned by Holt, the contemporary mutual company structure discussed in this research often competes with commercial insurance companies and takes up different forms in different jurisdictions. The objective of the members is often to secure against common risks. This objective is foundational to the principles and operations of mutuality.

In the commercial stock insurance model, stockholders or shareholders manage the company and engage in the risk of possible loss. The risk here can be defined as the uncertainty arising from the investment and prospects of the premiums, which are paid in advance.\textsuperscript{302} The insurance company owns the premiums fund, and it consequently owns any losses or profits incurred. The board of directors in such companies aim to making a profit for their shareholders, which explains why these companies are also termed “commercial” insurance companies. In regards to investments. The World Bank report on Mutual and Takaful

\begin{flushleft}
\textsuperscript{299} \textit{Ibid} at 42
\textsuperscript{300} \textit{Ibid}
\textsuperscript{301} \textit{Ibid}
\textsuperscript{302} Golnulal, supra note at 22
\end{flushleft}
Insurance, states that stock based insurance companies usually write riskier lines of insurance due to their ability to tap into capital markets in order to absorb losses.\(^{303}\)

Under the mutual insurance model, policyholders are simultaneously the shareholders of the company. Under such a model, risk is managed by policyholders’ mutual contributions to a common fund, and they mutually bear the risk of loss. There are different existing mutual models operating globally, such as mutual companies where the policyholders are not also shareholders.\(^{304}\) For example, in France, the mutual insurance companies are said to be “controlled” rather than owned by their policyholding membership.\(^{305}\) The managers of the company often tend to make investment decisions that are sustainable in the long-term since their mandate is not profit-driven.\(^{306}\)

What may contribute to the lack of focus on profit in such mutual companies is that policyholders and members are comprised of fragmented equity holders that are less organized and are less likely to demand profits.\(^{307}\) This fragmentation of equity holders may result in difficulties in aligning interests between the equity holders and the managers.\(^{308}\) The dispersion of equity holders means that they are often less organized in monitoring the

\(^{303}\) Ibid at 23  
^{304}\) Ibid at 41  
^{305}\) AISAM, Mutual Insurance: What is it? Why use it? A Guide for Member Policyholders and Staff, Online <www.aisam.org> at 2
^{306}\) Ibid
^{307}\) Golnulal, supra note at 23  
management’s performance.\textsuperscript{309} However, some commentators believe that, theoretically, mutual insurance structures should successfully “eliminate” opportunism on the part of management since the identity of equity holders and policyholders are merged under this model.\textsuperscript{310}

Another possible distinction between mutual and stock based insurance is that mutuals tend to write in insurance lines where the outcome is predictable such as life insurance.\textsuperscript{311} This is explained by their limited access to capital markets, and the fact that mutual companies tend to maintain a surplus of capital. The surplus is usually retained to improve and strengthen the company. Mutual and stock insurance companies may also differ in terms of how they invest premiums.\textsuperscript{312} For example, mutual companies that serve certain religious groups may opt to invest in funds belonging to the same religious group.\textsuperscript{313} Stock companies, since their mandate is to generate maximum profit for their shareholders, may have more freedom in the ways in which they invest provided they are compliant with state laws, their own rules of governance, and any other external rules they are compelled to abide by.

\section*{3.4 Takaful Insurance}

While the majority of contemporary Islamic legal scholars contend that conventional insurance schemes are unlawful, the dominant view among Islamic legal scholars and

\textsuperscript{309} Ibid
\textsuperscript{310} Ibid
\textsuperscript{311} Golnulal, supra note at 23
\textsuperscript{312} Ibid at 23
\textsuperscript{313} Ibid
religious authorities however deems *takaful* insurance, the cooperative Islamic insurance model, permissible. The cooperative model is considered lawful by these scholars because it is said to change the nature of the contract from an onerous transfer of risk from one entity to another in exchange for payment, to a donative contract whereby members of a community facing a common risk contribute each a certain sum of money to a common pool in exchange for coverage against a particular risk. The change in the nature of the contract under the *takaful* model is hence considered not to result in unlawful implications in the same manner as the contested conventional insurance scheme. While many scholars, including the Council of Senior Ulama commended this change of contract to a *takaful* system, there are critical voices of this transition, regarding it as an unnecessary complication.\(^{314}\)

There are various definitions and conceptions of the *takaful* insurance formulated by Islamic legal scholars. Linguistically *takaful* is derived from the noun *kafala*, which means guarantee. The word *takaful* denotes a meaning of mutual or communal solidarity.

Some definitions describe it as a mutual agreement whereby one party (the insured) provides a particular amount of money, called premium, to a pool administered by the insurer who is responsible for providing compensation upon the occurrence of a certain loss within a specified period.\(^{315}\) Under this conception of *takaful*, if the loss does not occur within the specified period, the insured is entitled to a reimbursement of premiums they have paid,


including profits generated from these premiums through the muḍaraba investment scheme.\footnote{316}{Ibid}

This is only a theoretical conception of takaful. In practice, takaful can be defined as a structure where

“Participants (policyholders) make a premium contribution on the Shari’ah juristic basis of tabarru’ (donation) to a common underwriting fund, which will be used mutually to indemnify them in case they suffer specified types of losses. In family takaful (which includes Shari’ah-compliant life insurance), the premium contribution includes a savings or investment element, which is not a donation into a mutual risk pool, but rather a payment into a participant’s investment account.”\footnote{317}{Simon Archer & Rifaat Ahmed Abdel Karim & Volker Nienhaus ed., “Takaful Islamic Insurance: Concepts and Regulatory Issues”, (John Wiley & Sons, 2009) at 169}

There are many distinguishable features of takaful identified by Islamic law scholars such as, that unlike the conventional insurance scheme, takaful is built on the principle of mutual cooperation and solidarity.\footnote{318}{Billah , supra note at 392} The element of riba, which is widely perceived by Islamic scholars as unlawful, is eliminated through investing accumulated premiums in financing techniques that are deemed lawful such as muḍaraba. Muḍarabah is defined in the insurance context as a profit-sharing financing method in which the insured provides premiums, which the insurer invests.\footnote{319}{Ibid} Profits generated by such a transaction are then shared by the insurer and the insured according to the details of an agreement.\footnote{320}{Ibid} An Islamic model of life insurance has a slightly different policy of distribution. This model of life insurance must comply with

\[\text{\textsuperscript{316}Ibid}\]
\[\text{\textsuperscript{318}Billah , supra note at 392}\]
\[\text{\textsuperscript{319}Ibid}\]
\[\text{\textsuperscript{320}Ibid}\]
sharia rules of inheritance and wills\textsuperscript{321}. This means that the nominee in the Islamic life insurance policy is equivalent to a trustee who is obliged to distribute the policy between the heirs in accordance with the Islamic rules of inheritance and wills\textsuperscript{322}. This is different from the conventional life insurance model, which designates a beneficiary or beneficiaries to receive the policy amount in accordance with the contractual agreement.

There are variations on the Islamic life insurance model. One type states that if the assured passes away before the policy’s date of maturity, the beneficiaries are entitled to the total amount of paid premiums, a share in profits, plus dividends generated from the investment of premiums through muḍārabah.\textsuperscript{323} In other policies, the beneficiaries may receive a donation from the insurance company’s charitable fund, if they are deemed to require it\textsuperscript{324}.

In order to eliminate the gharar that is perceived to exist in conventional insurance contracts, Islamic law scholars, as will late be shown in greater detail, have proposed a change in the nature of the insurance contract. This proposed solution alters the contract from a commutative one to a contract of donation, taking advantage of the fact that gharar does not apply to acts of donation. When this was first proposed, there was a lack of elaboration on what are the legal and social implications of the alteration. This lack can be deduced by analysing influential fatwas regarding the \textit{takaful} system. Particularly, it can be seen in the Council of senior ulama’s fatwa, to be discussed further in this chapter.

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\textsuperscript{321} \textit{Ibid} at 393
\textsuperscript{322} \textit{Ibid}
\textsuperscript{323} \textit{Ibid}
\textsuperscript{324} \textit{Ibid}
3.4.1 Different models under takaful.

There are two dominant models in the global Islamic takaful market, with some variations across companies and regions\textsuperscript{325}. These models are the muḍārabah model and the wakālah model.\textsuperscript{326} Sharia scholars have critiqued both models. However, the wakālah model has achieved a considerable degree of acceptance, receiving much less criticism.\textsuperscript{327}

There are certain elements that define the muḍārabah contract in an insurance context. The defining elements of the muḍarabah contract includes the existence of a rab al-amal (a capital provider) who is the participant in the policy and a muḍārib (operator) who is the insurance operator.\textsuperscript{328} The shareholders of the insurance company are responsible for management as well as marketing.\textsuperscript{329} Costumers pay premiums, a portion of which is deposited into the takaful fund. Also, a portion of the takaful fund is taken as a deposit into a sharia-compliant investment fund.\textsuperscript{330} Any claims are paid out from the takaful fund.\textsuperscript{331} Profit made through the investment fund is deposited back into the takaful fund, which then pays operational and

\textsuperscript{326} Ibid at 372
\textsuperscript{327} Ibid
\textsuperscript{328} Ibid at 378
\textsuperscript{329} Ibid at 378
\textsuperscript{330} Ibid at 378, 379
\textsuperscript{331} Ibid at 379
reinsurance costs. After deducting operational costs and reinsurance costs, the surplus is distributed according to the policy between the insurance operator and the participants. If the company incurs a loss rather than makes a profit, it is obliged to provide an interest-free loan to the takaful fund.

Within the wakālah model, the insurance operator makes a profit by deducting a predetermined operation fee from the takaful fund. Following that, deductions are made from the fund to mainly deal with costs such as technical reserves, re-takaful costs and building claim reserves. The remainder of the fund is invested in sharia-compliant investment techniques. After that, total surplus may be distributed between participants in a specific way or a percentage may be held in a contingency reserve. In case of loss, the takaful operator is bound to give an interest-free loan to the fund that could be reimbursed through future surplus. Under this model, the shareholders make profit in two ways. First,

\[^{332}\text{Ibid at 378}\]
\[^{333}\text{Ibid at 381}\]
\[^{334}\text{re-takaful are takaful companies that are specialized in providing reinsurance services to takaful companies. re-takaful companies are considered an alternative to commercial reinsurance companies that often dominate the reinsurance industry.}\]
\[^{335}\text{Ibid at 381, 383}\]
\[^{336}\text{Ibid}\]
\[^{337}\text{Ibid}\]
\[^{338}\text{Ibid}\]
in the case of management and marketing expenses being less than the operation fee\textsuperscript{339}.

Another way shareholders make profit is through their status as muḍārib or investors in the takaful and shareholders fund\textsuperscript{340}.

From the above we observe that the purported difference between takaful and stock insurance relates to the ways financing is conducted. Takaful is supposed to be a “pooling” of assets in a “charitable” manner while in the stock model financing occurs by way of transferring risk from one entity to another in exchange for coverage. However, our investigation of the takaful system reveals that in the case of the muḍārabah model, the separation between the assets of participants and shareholders does not exist since the operator makes profit by acquiring the majority of assets in the policyholders’ funds. In that sense, takaful insurance and commercial insurance both make profit through the act of sharing in excessive risk.

It can also be stated that the wākalah model is more compatible with Islamic transactional rules in terms of risk sharing since the shareholders make profit through an administrative fee rather than by way of transacting with risk. However, some wakālah-structured companies’ acquire an incentive fee from the policyholders’ funds. These companies seem to operate on the same lines of muḍaraba and stock with only procedural differences. It can be concluded that takaful is a form of hybrid that is principally structured as a proprietary while possessing some cooperative elements such as the distribution of surplus. Takaful also contains a variety of mechanisms that are islamically termed, while being modelled in the same fashion as commercial companies.

\textsuperscript{339} Ibid
\textsuperscript{340} Ibid
3.4.2 The Council of Senior Ulama’s Opinion on Takaful Insurance and its Structure.

As discussed above, in a fatwa from 1397 AH 1977, the Council of Senior Ulama declared commercial insurance unlawful. The Council then opened discussion around the permissibility of an emerging Islamic insurance order called ta‘awuni insurance. The Council listened to a proposal made by experts on an alternative insurance model that was said to be consistent with the doctrines, rules and principles of Islamic law. The Council concluded that takaful insurance schemes are lawful and provided four reasons in support of its decision.

Firstly, the nature of the envisioned cooperative insurance contract was to be that of a donation, and as mentioned earlier, donations are not considered to constitute gambling on a risk. Takaful is said to facilitate cooperation in the distribution of risks and establish a collective sharing of financial responsibility in the event of loss or damages. The goal of this collective is not commercial or profit-oriented; the objective is to distribute risk more equitably and to structure a cooperative approach in case of loss or damages.

Secondly, under this scheme shareholders do not invest the premiums collected in usurious transactions and hence the cooperative insurance lacks both types of riba that are said to exist.

\[\text{341 Council of Senior Ulama, On the lawfulness of al-ta\textsuperscript{a}m\textsuperscript{i}n al-t\textsuperscript{a}wun\textsuperscript{i} (Cooperative Insurance), issued in 1397 H., Decision No.51}\]
\[\text{342 Ibid}\]
\[\text{343 Ibid}\]
\[\text{344 Ibid}\]
Thirdly, in *takaful* the lack of knowledge of the exact outcome and benefit in the event of an insured loss poses no harm, because the insured are considered donors. Lastly, the investment of collected premiums is carried out for the purpose of achieving the goals for which the collective was established rather than for pure profit-making. The Council of Senior Ulama used obscure language with regards to the their vision of cooperative insurance. For example, the *ulama* envisioned the proper Islamic scheme as a sharika mukhtalāṭa (mixed company) without elaborating on the meaning. The term mixed company is recognized in the Saudi commercial regulations to be a company that has at least one shareholder liable to the extent of her/his entire wealth for the entirety of the company’s debt. Also, the company must have at least four shareholders whose liability is limited to the extent of their contribution to the company’s capital.

The Ulama might have meant a company that is partly owned by the government and partly owned by private parties. This seems like the appropriate definition for the term when considering the justifications they offered for such model. According to the *fatwa*, the mixed company scheme was chosen for four reasons. Firstly, because of a commitment to Islamic economic thought which leaves the responsibility and accountability for establishing various economic projects to individuals. Under this model, the role of the state is to complement

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345 Ibid
346 Ibid
347 Ibid
348 Saudi Arabian Companies law, enacted in 1385 H., by Royal Decree No. M/6, c 6, ss 149-156 Online ≤ http://www.boe.gov.sa >
349 Council of Senior Ulama, On the lawfulness of al-ta‘mīn al-t‘awunī (Cooperative Insurance), issued in 1397 H., Decision No.51
what individuals are unable to accomplish alone, and to take on a supervisory and regulatory role to ensure the success of these projects and the safety of their operations.\textsuperscript{350} Secondly, a mixed company is preferred because it reflects a commitment to cooperative thinking.\textsuperscript{351} Thirdly, training locals to manage the cooperative insurance scheme creates a space where personal motivations contribute to the success of the cooperative project.\textsuperscript{352} The involvement of locals in the administration is said to involve stakeholders that are more risk averse, as they themselves would have to bear (some of) the consequences of their economic activity, and hence result in fairer and more reasonable premiums.\textsuperscript{353} Fourthly, the company's hybrid nature does not make insurance appear as if it was a gift or grant from the state to the beneficiaries.\textsuperscript{354} The state only cooperates with the people involved in order to protect and support them.\textsuperscript{355} The people involved with the insurance company are the stakeholders, acknowledging the role of the state, while at the same time they are not relieved of responsibility.\textsuperscript{356} The ulama’s model seems to combine a social insurance model with a cooperative insurance model.

The Council of Senior Ulama also carved out some fundamentals to be taken into account when developing an insurance organization or company. For instance the cooperative

\textsuperscript{350} Ibid
\textsuperscript{351} Ibid
\textsuperscript{352} Ibid
\textsuperscript{353} Ibid
\textsuperscript{354} Ibid
\textsuperscript{355} Ibid
\textsuperscript{356} Ibid
insurance provider must have a central headquarters along with branches in all cities of the Kingdom, and the organization’s internal division should be broken down according to the types of risk that are to be covered; for example, separate divisions for health, disability and old age, and by occupation, among others.\textsuperscript{357} A cooperative insurance organization is required also to be flexible to a large degree.\textsuperscript{358}

It is unclear what the ulama intended by specifying the condition of flexibility. Additionally, the organization shall have a Supreme Council that decides on and proposes plans, actions, and regulations.\textsuperscript{359} Those decisions shall take effect only if compatible with the rules of \textit{sharia}.\textsuperscript{360} Moreover, the government should select some members of the council to represent its interests. This is said to help the government fulfill its supervisory role and strengthen the integrity of the insurance process.\textsuperscript{361} Shareholders would get to choose the remaining council representatives. If an identified risk exceeds a fund's resources such that it may be necessary to increase premiums, the state and the participants in the company are to bear this increase.\textsuperscript{362}

The majority of the Council believed that the development of detailed rules on insurance models should be undertaken by a group of experts selected by the state, and that the draft

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{357} \textit{Ibid}
\item \textsuperscript{358} \textit{Ibid}
\item \textsuperscript{359} \textit{Ibid}
\item \textsuperscript{360} \textit{Ibid}
\item \textsuperscript{361} \textit{Ibid}
\item \textsuperscript{362} \textit{Ibid}
\end{itemize}
\end{footnotesize}
should be referred to the Council of Senior Ulama for further study and to assure adherence with the rules of *sharia*. 363

4 Contradictions and Limits of the Saudi *Tawuni* (Cooperative) Model

As mentioned earlier, the insurance contract did not previously exist in the group of contracts known and regulated by traditional Islamic law. Despite this, the insurance industry has become an indispensable part of business in our increasingly globalized world, and it has grown into a highly sophisticated enterprise with diverse products covering almost every imaginable risk. What have become conventional insurance models initially developed in the west dominate the global industry. Recognizing the importance of these internationally recognized models, Saudi Arabia has introduced limited forms of the purportedly “cooperative insurance” in the 1980s.

In 1986, the first government-owned Saudi Arabian insurance company, Al-Tawuniyah, was established with the objective of developing the Saudi insurance industry and setting standards for insurance practice. Until 2004, there was no state regulation of insurance practices in Saudi Arabia. 364 Insurance providers operated within the scope generally provided for commercial firms and many of them operating in the kingdom were registered in other countries. Since

363 *Ibid*

there was no official government supervision, there are no official figures estimating how large the insurance market was prior to the introduction of the legislation.\textsuperscript{365}

One of the key legal sources to consult in order to examine the contemporary insurance regime in Saudi Arabia is the 1992 \textit{Basic System of Governance} which outlines the role and responsibility of the state in providing health services and insuring its citizenry against old age, disability and natural disasters.\textsuperscript{366} Article 27 of the act affirms that it is the responsibility of the state to provide for its citizens when they face emergency, illness, disability and old age, and that the state must maintain social insurance legislation and encourage individuals to participate in charitable organizations and activities.\textsuperscript{367} This article reveals an Islamic social ideal and norm for the government's responsibilities towards its citizens, whereby it is obliged to support and strengthen welfare institutions as a means to provide social and economic rights. Interestingly, Article 27 not only specifies the social rights the citizenry shall enjoy but further commits the government to social welfare institutions and charitable organizations.

The Basic Law of Governance affirms the responsibility of the state to look after public health and provide every citizen with healthcare.\textsuperscript{368} In Saudi Arabia it is widely considered to be the

\textsuperscript{365} Ibid
\textsuperscript{366} The basic law of Governance, issued in 1412, Royal Order No. A/90 , Online < http://www.boe.gov.sa >
\textsuperscript{367} Ibid
\textsuperscript{368} Ibid
state’s duty to provide free public healthcare despite the absence of a taxation system. Saudi Arabia does not heavily rely on taxation, primarily because some interpretations of Islamic law either prohibits taxation or restrict collecting taxes from the citizenry. Sources of state income in Saudi Arabia are narrow and rely heavily on natural resources such as oil revenues whose selling price is highly volatile and the commodity finite.

4.1. The Cooperative Health Insurance Law and its Implementing Regulations

The introduction of the Cooperative Health Insurance Law in 1999 by Royal Decree No: M/10 was a significant steppingstone in the Saudi health insurance industry.\(^{369}\) The law aims to provide healthcare for all non-Saudi residents in the Kingdom through private health insurance. This insurance is intended to cover all non-Saudi residents and their dependents, with the exception of non-Saudis who work for the government.\(^{370}\) Enrolment in a health insurance plan has become a mandatory requirement for obtaining a residency card and the legislation specifies that it is the responsibility of the employer to insure its employees.\(^{371}\) Under this law, foreign residents without an employer are required to privately pay for their insurance. The regulation also states that private insurance schemes may include Saudi citizens in later stages through a decision by the Council of Ministers.

The Cooperative Health Insurance Law also established the Health Insurance Council, which was given responsibility for drafting bylaws with regards to healthcare law as well as

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\(^{370}\) Ibid at s 1

\(^{371}\) Ibid at s 3
making the necessary decisions on policy relevant to them.\textsuperscript{372} The Council is also charged with helping insurance companies fulfil their state mandated responsibilities. Moreover, the Council is to set all relevant fees for their incorporation and daily business. With regards to the regulations and rules that apply to these companies’ operations, the legislation states that the rules set by the Council of Senior Ulama’s \textit{fatwa} Number 51 dating 4/4/1397AH is also to be followed. It is further stated that private insurance groups should operate in a similar manner to the example established by the national cooperative company Al-Tawuniyah. Despite this specification of the law, the ulama’s vision outlined in the fatwa is not consistent with insurance practices in Saudi Arabia. As examined in prior sections, the ulama specified that insurance companies be modelled as cooperatives that do not aim for profit.\textsuperscript{373}

The law also includes some conditions. For example, in cases where employers fail to register their employees in an insurance group plan, the employer becomes responsible for paying insurance fees and other healthcare expenses, and also has to pay a penalty not exceeding the annual premiums for each policyholder.

In accordance with the \textit{Cooperative Health Insurance Law}, a committee has been established comprised of members of government agencies and ministries to look into violations of the law. The committee’s decisions may be appealed to the Board of Grievances (an administrative court) within 60 days of notice of the decision.\textsuperscript{374} It is important to note that the

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\textsuperscript{372} \textit{Ibid} at s 4
\textsuperscript{373} Council of Senior Ulama, On the lawfulness of Cooperative Insurance, Decision No.51
\textsuperscript{374} Nizam al-daman al-sih al-t’awuni (Cooperative Health Insurance Law, issued in 1999, Royal Decree No. M/10, Online <http://www.cchi.gov.sa>, s 14
choice of jurisdiction here is assigned to the administrative judicial branch, which has been the case since the introduction of commercial courts in the Saudi judicial system.

In 2002, a resolution was passed by the Council of Ministers for the application of the *Cooperative Health Insurance Law* to Saudi citizens working in the private and corporate sectors, as well as individuals working as independent contractors. In 2001, car and drivers insurance had already become mandatory for Saudis and expatriates inside Saudi Arabia through a resolution of the Council of Ministers No. 222 dated 13/8/1422.

In 2003, Saudi Arabia introduced extensive legislation in some ways revolutionizing the insurance market. The *Law on Supervision of Cooperative Insurance Companies* supplements the *Cooperative Health Insurance Law* and aims to control insurance and reinsurance activities representing one of the most important pieces of legislation in the Saudi Arabian legal system regulating insurance. It was promulgated by Royal Decree No. (M/32) in 2/6/1424 H, corresponding to 31/7/2003. The law states that insurance companies should be instituted as cooperatives in accordance with the rules of Islamic law. The Saudi Arabian Monetary Agency (SAMA) took on the mission of regulating the insurance market and administering its growth and general practice, and in subsequent years, the SAMA issued many implementing regulations and rules. The law was expected to boost the efficiency and popularity of the insurance market and establish fair competition as well as attract the investment of foreign insurance companies.

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375 Regulations (Modified) for the cooperative health insurance system and approved by Ministerial Resolution No. (6131/30/1 / z) and the date of 8/6/1430 AH

376 The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa >, c 1, s 1
In 2009, the implementing regulations for the *Cooperative Health Insurance Law* underwent substantial amendments. In Chapter 2 of the amendments, there was a reinforcement of the law’s application to Saudi citizens who work in the private sector, as well as any individuals working under labour contracts, regardless of the type of pay they receive.\(^{378}\) The inclusion of Saudi citizens in the cooperative health insurance scheme is glaring evidence of moves towards massive privatization of what was previously a governmental service that citizens had enjoyed for free. In Saudi Arabia, citizens do not pay regular income tax, as that is seen to be inconsistent with traditional Islamic law. The Saudi economy is to a large extent oil-based and the government has a strong hold on most economic activities. In this context, the efforts to privatize health services could be seen as an attempt by the government to diversify sources of income by attracting private investment to the healthcare sector.

The implementing regulations clarifies the types of benefits that must be indicated in the policy, when the right to benefits arises, and when the insurance company can claim indemnification for payments that fall under the insurance policy’s scope. The maximum benefit that an insurance company may provide for a beneficiary is 250,000 riyals. The legislator seems to acknowledge the policy’s limitation, thus the regulations establish a cooperative health insurance fund to cover expenses exceeding the insurance coverage.\(^{379}\) The *Implementing Regulations for the Law on Cooperative Health Insurance* state that insurance companies may make use of a template healthcare service contract created by the health

\(^{377}\) The Saudi Arabian Monetary Agency (SAMA) online, < sama.gov.sa>

\(^{378}\) Regulations (Modified) for the cooperative health insurance system and approved by Ministerial Resolution No. (6131/30/1 / z) and the date of 8/6/1430 AH, c 2, s 2

\(^{379}\) Regulations (Modified) for the cooperative health insurance system and approved by Ministerial Resolution No. (6131/30/1 / z) and the date of 8/6/1430 AH, c 5, s 37
insurance council to guarantee the rights of all the concerned parties. Overall, the template contract is similar to those instituted by insurance companies in addressing rights, obligations and what constitutes a breach of contract. Business owners can expand health insurance coverage to include aspects of diagnostic and treatment that are not included in this law.

4.1 The Law on the Supervision of Cooperative Insurance Companies and its Implementing Regulations.

In 2003, Saudi Arabia introduced extensive legislation in some ways revolutionizing the insurance market. The Law on Supervision of Cooperative Insurance Companies supplements the Cooperative Health Insurance Law and aims to control insurance and reinsurance activities representing one of the most important pieces of legislation in the Saudi Arabian legal system regulating insurance. The law states that insurance companies should be instituted as cooperatives in accordance with the rules of Islamic law.

The Saudi Arabian Monetary Agency (SAMA) took on the mission of regulating the insurance market and administering its growth and application, and in subsequent years,

\[\text{\textsuperscript{380}}\text{Regulations (Modified) for the cooperative health insurance system and approved by Ministerial Resolution No. (6131/30/1 / z) and the date of 8/6/1430 AH, c 8, s 78}\]

\[\text{\textsuperscript{381}}\text{Nizam al-daman al-sihi al-t‘awunî ( Cooperative Health Insurance Law, issued in 1999, Royal Decree No. M/10, Online <http://www.cchi.gov.sa> at s.8}\]

\[\text{\textsuperscript{382}}\text{The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa>, c 1, s 1}\]

\[\text{\textsuperscript{383}}\text{Ibid}\]

\[\text{\textsuperscript{384}}\text{SAMA, the Central Bank of Saudi Arabia, was established by two royal decrees issued in 25/7/1371H corresponding to (20/4/1952) under the reign of King Abdulaziz, the founder of the Saudi state.}\]
SAMA issued many implementing regulations and rules. The law was expected to boost the efficiency and popularity of the insurance market and establish fair competition as well as attract investment from foreign insurance companies.

Under the Law on Supervision of Cooperative Insurance Company, there is no formal requirement for compliance with principles of Islamic law except for the first article, which indirectly refers to it. The first article of the law states that insurance companies should be established as cooperatives in accordance with the article of National Company for Cooperative Insurance that was promulgated by royal decree M/5 dated 1405 H, corresponding to 1986. The author has not been able to find and review the Articles of Association for the National Company for Cooperative Insurance to determine to which extent the articles require specific applications of Islamic law.

Many religious and academic experts expected the Law on Supervision of Cooperative Insurance Companies to regulate insurance companies in Saudi Arabia according to certain standards that are deemed acceptable in sharia. However, whether this law actually regulates insurance practices in Saudi Arabia consistently with the principles of Islamic law as outlined in the Council of Senior ulama’s fatwas regarding the permissibility of the insurance contract, remains a controversial proposition that will be examined further in this chapter.

Furthermore, the law is concerned with regulating “cooperative insurance companies” while leaving out what a cooperative means and how it corresponds with cooperative models in the functions include acting as the Central Bank for Saudi Arabia, it issues the national currency, supervises commercial banks and currency rates, and issues policies and regulations for the management and growth of the Saudi financial system.

385 SAMA’s website
west or cooperative models under *takaful* in the Islamic world.

### 4.1.1 Adjudication of Insurance Disputes

The adjudication of insurance claims is not administered by the general *shariʿa* court system which follows a different conception of Islamic law and which is more aligned with the religious establishment as explained in the section on the ulama and *ijtihat*. Article 20 of the *law on Supervision of Cooperative Insurance Companies* provides that an edict from the Council of Ministers shall form committees with specialized members, and it requires at least one to be a legal consultant. It is assumed that the appointed legal consultant should be familiar with insurance laws as they exist and that they have experience with various legal jurisdictions in addition to being familiar with sharia jurisprudence. This assumption is made based on the novelty of the insurance contract in Islamic law and the need to tap into the experience of multiple relevant jurisdictions.

The committee is assigned with resolving disputes between insurance companies in cases where these companies subrogate the insured persons.\(^{386}\) It is also assigned with settling disputes between insurance companies and their customers in addition to settling violations of regulatory and supervisory instructions issued to insurance and reinsurance companies by SAMA.\(^{387}\) The committee is similarly responsible for adjudicating disputes between self-employed insurance professionals and their customers, and any violations incurred by these

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\(^{386}\) The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa> s 20

\(^{387}\) ibid
professionals in the course of providing services.\textsuperscript{388} 

The law provides ample procedural rules necessary for the establishment, supervision and operation of insurance companies. However, the law and its implementing regulations lack substantive rules, leaving a legislative and judicial gap. Since the insurance contract is considered relatively new in Islamic law, it would be difficult for adjudicating boards to deduce relevant rules due to a lack of precedent. Most likely, the adjudication boards created by the law would not resort to Islamic jurisprudence since they are usually not sharia-trained and are administrators rather than judges. The lack of substantive rules will most likely force adjudication boards to borrow from one or many other legal systems. This may result in inconsistencies of judgments since administrative committees are not required to publish their decisions nor are they bound by precedence. In time, these boards may succeed in developing consistent, substantive rules based on a single or multiple legal practices. Since committees’ decisions are not made public, it will be difficult to ascertain which standards and legal rules are followed or what type of legal challenges they are undergoing. It remains to be seen how the lack of substantive and clear rules in Saudi insurance laws will impact the insurance market and its sustainability.

Decisions made by the insurance committees can be appealed before the Board of Grievances.\textsuperscript{389} The Board of Grievances is an administrative judiciary in Saudi Arabia and is therefore considered to be aligned with state policies. The Board of Grievances acknowledges laws and regulations made by the state in conjunction with islamic jurisprudence. The general courts

\textsuperscript{388} 
ibid

\textsuperscript{389} Ibid at s.22
are often seen as inadequate for administering cases involving insurance claims for the reasons outlined in the first chapter.

The authority to adjudicate claims regarding insurance and its related professions is not restricted to the committee established by the Council of Ministers. Article 22 of the law provides that the Board of Grievances has jurisdiction to settle disputes between insurance and reinsurance companies.\(^\text{390}\) The Board of Grievances has jurisdiction to adjudicate claims regarding violations of the law and its implementing regulations, can enforce the penalties outlined in article 22, and preside over first instance claims that require a prison sentence by SAMA or the committee. The public prosecution is formed by an order issued by the Minister of Finance. Settlement of commercial disputes through Third Party Settlement Specialists is a prominent practice among juridical commercial entities operating in Saudi Arabia since resorting to private arbitration is seen as practical and efficient.

### 4.2 Analysis of the Legality of Tawun Model under Saudi law.

In the past two chapters I explored different perspectives on conventional and *takafül* insurance. Whilst Saudi cooperative insurance was created to comply with Islamic law, my analysis in chapter three leads to the following conclusions. First, that the stock insurance scheme, which the *takafül* insurance is primarily based on, substantively contradicts Islamic transactional rules. Specifically, it contradicts the rule on prohibition of *gharar* in transactions. The second finding is that the so-called cooperative insurance scheme in Saudi Arabia is in

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\(^{390}\) Ibid at s.22
fact a stock insurance scheme with minor cooperative influence. Thirdly, the *takaful* insurance model from which the Saudi cooperative insurance model derives some characteristics, exhibits some contradictions with Islamic transactional rules and objectives. I will show that mutuality is not only formally lawful but that its substance resonates more deeply with Islamic law and its underpinning moral order than the existing *takaful* model.

4.2.1 Contradictions and Limits of the *Tawun*/*Takaful* Model

Overall, the *ulama* provided little guidance on the process and meaning of key concepts underpinning the emerging cooperative insurance scheme. For instance, the implementing regulations or bylaws define insurance simply as a “mechanism of contractually shifting burdens of pure risks by pooling them.”\(^{391}\) In this definition, what constitutes an acceptable pooling of resources is not clearly explained. It is left up to the reader to interpret whether pooling of resources is characterized as an act of donation, in the manner understood by some Islamic legal scholars, or if it is equivalent to a conventional insurance contract. ". Since the conventional insurance contract is widely perceived to contain an element of excessive *gharar*, “risk”, a proposition to change the nature of the contract was regarded as desired, as is evident in the establishment of the *takaful* structures. The change requires that premiums be characterized as donations since uncertainty and *gharar* do not apply to donations.

In the Council of Senior Ulama’s fatwa, a particular form of cooperative insurance was understood as being based on contractual donations. This contract’s fundamental aim is to promote “cooperat[ion] in order to disperse risks through collectively sharing in responsibility

\(^{391}\)Implementing Regulations of the Law on Supervision of Cooperative Insurance Companies, Ministerial Decision no. 1/596 dated (1/3/1425 H) s.1
in cases of crises.” The ulama envisioned that cooperative insurance would be created for different professions such as teachers, street vendors, doctors, lawyers, etc. In their view, cooperative insurance groups “fundamentally aim towards cooperating to manage risks” and “have no intentions for trade and making profit out of participants’ funds.” In Islamic law, an unconditional donation does not yield any legal expectation of return or profit. The nature of donations is that they are “non-contingent” as well as “non-binding”. Viewing premiums as tabarruʿ, which means donation in Arabic, is an unnecessary complication according to some distinguished commentators. Agha sees the alteration of the insurance contract from a commercial or onerous one to a donative one as a change that raises questions on “enforceability”, while it also harbours “transactional” issues and complications.

Under his hypothesis, the structure and practice of takaful actually contradicts the objectives behind implementing the system. The majority of established Islamic scholars and institutions, including the Council of senior ulama, do not adequately examine the difference between a participant making a non-binding donation rather than a premium payment that prompts a series of legal implications. Therefore, Agha’s contribution to this topic is significant in clarifying the Islamic legal implications of popular takaful models.

392 Council of Senior Ulama, On the lawfulness of al-taʿmīn al-tawunī (Cooperative Insurance), issued in 1397 H., Decision No.51
393 Oliver Agha, Tabarruʿ in Takaful: Helpful Innovation or Unnecessary Complication, UCLA Journal of Islamic and Near Eastern Law. Vol 9, 2009-2010 Number 1. PP 102
394 Ibid at 103
395 Ibid
396 Ibid
One of the complications with considering premium payments as donations is that donations, from a legal point of view, are unilateral obligations that do not yield returns to the person making them. So in the context of insurance, making a donation to the takaful fund does not legally bind the insurance operator to compensate the person who made the donation, even upon the occurrence of an insurable loss. Noticeably, this puts the participant in the takaful or t’awun scheme at a disadvantage. The mutual or stock insurance scheme does not face the same difficulty.

Even though those participating in the takaful insurance contract expect compensation upon the occurrence of certain losses, legally speaking, the insurance operator is not bound to comply when the contract is characterized as a donative one. The expectation is, therefore, that the takaful model is practiced somewhat like a conventional insurance contract, even though the lack of legal responsibilities derived from a donative approach leave both insured and insurer without many of the rights they might otherwise have.

These complications go against the objective of the takaful contract, which is to indemnify participants for certain losses as a form of risk-management. It can be concluded that the principle of tabarru’, or donation in Islamic law, is inconsistent with contemporary takaful transactions and operations.

\[^{397}\text{Ibid}\] at103

\[^{398}\text{Ibid}\]

\[^{399}\text{Ibid}\]

\[^{400}\text{Oliver Agha, Tabarru’ in Takaful: Helpful Innovation or Unnecessary Complication, UCLA Journal of Islamic and Near Eastern Law. Vol 9, 2009-2010 Number 1. PP 115}\]
Characterizing premiums as donations poses other, secondary, issues as well. Since it is unlawful for the donor to seek benefit from their payment or to retrieve their donation, legally they become un-entitled to retrieve a share from the takaful fund or a share in surplus. Here again, the principle of tabarru' goes against what is actually practiced in takaful schemes. In most contemporary takaful structures, there is an expectation that participants will receive a portion of the surplus or the remainder of the takaful fund after making certain deductions. Under the Saudi insurance regulations, takaful companies are obliged to distribute 10% of the net surplus to participants in the scheme or alternatively grant that percentage in the form of reduced premiums.\(^{401}\)

Theoretically, this contradiction between the principle of tabarru' and takaful operations gives rise to a potential enforceability issue. This contradiction is significant even if it does not actually manifests itself in the existing practice of the system. In the Saudi context, this contradiction portrays the widening gap between two visions or interpretations of Islamic law.

In Saudi Arabia, insurance disputes are adjudicated through administrative boards that are under the jurisdiction of Diwan al-Mazalem (the Board of Grievances). This jurisdictional choice means that enforceability would not pose a serious issue since boards adjudicating these matters would most likely primarily resort to the available laws and regulations issued by the government as well as refer to the content of the contract. The implementing regulations, uses the term subscription/ installment and does not define premiums as a contribution.\(^{402}\) Issues of enforceability may arise if the general courts, which have general

\(^{401}\) Implementing Regulations of the Law on Supervision of Cooperative Insurance Companies, Ministerial Decision no. 1/596 dated (1/3/1425 H), s 70

\(^{402}\) ibid, s 1 (6)
jurisdiction, pass a verdict on an insurance case. The general courts in Saudi Arabia primarily focus on the Quran, sunnah, and Islamic jurisprudence as their sources in adjudication. The choice of judicial jurisdiction made by the government limits the issue to the confines of theory rather than posing an active issue of enforceability.

Legal Islamic scholars in Saudi have issued fatwas permitting cooperative insurance as an acceptable alternative to the commercial insurance scheme, which they consider unlawful. Since Islamic scholars are influential in Saudi Arabia, the fatwas permitting cooperative insurance can be seen as encouraging the growth of the insurance sector and result in an increased demand for them from the public. The ulama observed that their fatwa led the Saudi cooperative scheme to receive an increase in public turnout. The ulama have also noted that the Saudi cooperative scheme does not represent their vision or meet the requirements they stated. They also observed that insurance companies often use the term ʿawun (cooperative), takaful or Islamic in their products and commercial names while not reflecting this in their operations. As a result of this, the ulama have tried, when possible, to clarify that their fatwas are not faithfully represented by the Saudi insurance market.

During an interview on a Saudi radio program (nour ʿla al-darb) that regularly hosts prominent ulama in order to discuss fatwas for the general public, Sheikh Abdulaziz Bin Baz was asked about a commercial appearing in the newspaper stating that the Board of Senior Ulama including him, permit cooperative insurance. According to the fatwa published on Abdulaziz Bin baz's website, the commercial cited the Council of Senior Ulama’s decision no.51 and listed the influential ulama who made it. The commercial used mention of the fatwa

403 Nour ʿla al-darb, fatwa on Commercial insurance and Cooperative insurance, “online” binbaz.org.sa
to promote the sale of car, property and liability insurance products. The interviewer asked the sheikh if he endorses the commercial.

The sheikh responded by expounding on the fatwa and detailing what lawful cooperatives should look like. He stated that cooperative insurance is a solution for people to collectively mitigate damage to one's property or self. What differentiates it from commercial insurance is that it is structured as a non-profit and is intended for cooperation and charity. He stated that in a cooperative it is permissible to seek an agent to manage the funds for the purposes of collective action and charity as opposed to seeking a profit. The sheikh promised to inquire further on the advertisement and act accordingly. It is evident from this radio broadcast and from the board of senior ulama’s fatwa that the ulama do not agree on the obligation of returning surplus to the participants since they are making donations and therefore should not expect profitable returns.

The fact that cooperative insurance in Saudi Arabia does not live up to the substance of the term, may have implications on the way people perceive and trust the insurance system in Saudi Arabia. This confusion and mistrust may be exacerbated by the fact that the current insurance system and its practice runs contrary to the ulama’s vision of lawful insurance conventions. This is an example of conflict between theory and actual practice in the Saudi legal system. There is discord between Islamic legal interpretation as represented by the senior ulama and the states’ laws.

4.2.2 Is the Saudi T‘awun (Cooperative) Model in practice a Cooperative?

As already mentioned, the first article of the Law on Supervision of Cooperative Insurance Companies states that insurance companies should operate in a cooperative manner as
provided by “the article of establishment of the National Company for Cooperative Insurance promulgated by Royal Decree M/5 […] and in accordance with the principles of Islamic sharia.”

Despite the initial requirement of compatibility with sharia, the remainder of the law regulates insurance and reinsurance companies in ways that could be interpreted as contravening sharia’s transactional rules. The author has explained that the stock company structure is not compatible with the concept of mutuality and further contradicts the rule on prohibition of gharar. The concept of gharar in Islamic law relates to whether the transaction involves excessive risk. Upon examining the different opinions on gharar, this author has come to the conclusion that the stock based insurance company’s structure contains this excessive risk (gharar) outlawed in sharia.

The law is made ambiguous by the fact that terms with different meanings are used interchangeably in it, and this interchangeability touches on the implementing regulations and the use of various companies’ names. Although the major legislation on insurance is entitled “The Law on Supervision of Cooperative Insurance Companies,” and despite the fact that it regulates “joint stock companies” as per s.3(1), the actual structure of the proposed company is neither purely cooperative nor purely stock based. In terms of how risk is accommodated under the current law, it mimics the structure of the stock insurance model, which is the conventional model of insurance worldwide. As regards distribution of surplus, there are certain cooperative elements incorporated into the model.

404 The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa > at s. 1
Let us first address the dominating commercial character of the model and then discuss the cooperative character. Under the Saudi insurance laws, in order for a company to be licensed, “the applicant must be a joint-stock company.”\(^\text{405}\) The laws and regulations in Saudi Arabia concerning insurance focus exclusively on the stock insurance model.

The question arises as to whether other models could be permitted under Saudi laws, such as benevolent societies that are less common than commercial or mutual insurance companies. The existing regulations are not clear on this point since the extensive legislation has paid scant attention to alternative insurance models. Furthermore, the requirement that an insurance group must be structured as a stock company coupled with the extensive legislation in support of stock companies may preclude the emergence of any alternative model. Article 81 of the implementing regulations, however, leaves it to the Saudi Arabian Monetary Agency to determine whether an alternative insurance scheme may be accepted and given license. Article 81 of the implementing regulations states that “no person shall introduce a pension plan, or a reciprocal exchange, or a self-insurance scheme without the prior written approval of the Agency.”\(^\text{406}\) The focus on the stock insurance scheme and the disregard for alternatives from regulation could be a strong factor for SAMA to discourage the growth of an alternative system. The existence of supporting regulations is important for the growth of an alternative insurance model since it would provide a predictable and organized framework for companies to follow while decreasing the chance of disputes arising as a consequence of ambiguity. For the purpose of the insurance laws and regulations in Saudi Arabia, an insurance company is

\(^{405}\) The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa > s 3 (1)

\(^{406}\) Implementing Regulations of the Law on Supervision of Cooperative Insurance Companies, Ministerial Decision no. 1/596 dated ( 1/3/1425 H) at s. 81
defined as “a public joint stock company conducting insurance and/or reinsurance activities”.

The implementing regulations define risk as a “situation involving the chance of loss or no loss, but no chance of gain”. While this definition may correctly apply to the insured, who, in essence must not profit from the contract since the purpose of their participation is indemnification rather than making profit, risk per the regulations has the potential of producing gain for the company. Therefore, when considering how stock insurance companies make profit, the supplied definition of risk may apply to the insured but not to the operator who has a chance of gain.

Saudi law specifies that companies must establish three separate accounts: accounts for shareholders, accounts for policyholders, and accounts for the insurance operations. The rationale behind this distribution may have to do with the semi-cooperative nature of insurance companies under Saudi law. According to Islamic rules pertaining to risk, companies must differentiate between the shareholders’ accounts (loss and profit) and the policyholders’ accounts. The policyholders’ account contains the total of premiums. The merit of such rule is that risk is shared by the participants and should be calculated separately. Islamic law forbids transactions that involve excessive risk. The separation of accounts indicates that the participants are mutually sharing the risks and mutually managing potential losses. If the company’s function was to receive risk as a transfer from the policyholder in exchange for the

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407 Ibid at s.1
408 Ibid
409 The Law on Supervision of Cooperative Insurance Companies, issued in 1424 H., by Royal Decree No. M/32, Online <sama.gov.sa> at s.2(2)
premium payments, the transaction would be forbidden since the parties are exchanging in unlawful risk. In this case, the company would have the potential of profiting or losing from this transfer of risk.

Further readings of the law indicate that this separation of accounts is superficial and does not in reality preclude insurance parties from transacting in risk. Technically, there are separate accounts among shareholders and policyholders. However shareholders can receive income from surplus generated by an excess of premiums after all necessary deductions are made from the fund, as is evident in article 70 of the implementing regulations.

For the purpose of calculating surplus, Article 70 (implementing regulations) provides that companies should themselves determine the extent of earned premiums (remainder of premiums after claims), income from re-insurance commissions and/or other insurance operations revenues (from investments of funds and assets).\(^4\)

The surplus represents all of the above-mentioned provisions, minus incurred costs, marketing, operational and administrative expenses. The company must then apply necessary technical provisions and reserves to that surplus. In a subsequent section of the regulations, the company is given the choice of separating policyholders’ investment accounts, or adding them to the company’s net surplus. The regulations define the company’s net surplus as:

\(^4\) Implementing Regulations of the *Law on Supervision of Cooperative Insurance Companies*, Ministerial Decision no. 1/596 dated (1/3/1425 H) at s.81
“adding or subtracting the investment return of the policyholder’s invested funds, and subtracting the general expenses related to the policyholder’s portion of the investment activities.”

The regulations set a formula for distributing the net surplus, which entails distributing 10% of the net surplus directly to the policyholders. Alternatively, the company may award policyholders in the form of a reduction in premiums. This is basically the cooperative feature in the Saudi insurance scheme. The remainder, which constitutes 90% of net surplus, is to be distributed to the stockholders’ income statements according to regulation. From that 90%, the shareholders must allocate 20% as a statutory reserve until the company’s reserve amounts to 100% of paid capital.

*Takaful* can be seen as a hybrid that contains elements of both cooperatives and stock companies. If one were to imagine a spectrum of values to represent insurance companies, ranging from pure stock on one end and pure cooperative/mutual on the opposite end, insurance companies in Saudi Arabia would be seen occupying a space closer to the stock end. In essence, the insurance scheme in Saudi Arabia is designed for a stock company and evidence shows that it predominantly possesses the principles and values of a commercial enterprise. However, since the regulation allocates 10% of net surplus to policyholders, there is a slight cooperative character.

The focus is on regulating insurance groups as stock companies while overlooking other schemes from regulations. On the other hand, the regulations do not allow companies to be

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411 *Ibid* at s.1

412 *Ibid* at s.70 (2)
purely commercial -- hence the distribution of surplus to policyholders. This places the Saudi insurance scheme closer to a stock company than to a mutual; the cooperative element can be read as secondary or incidental. Consequently, since the contract effectively transacts in risk exchange between the policyholder and the shareholder, it could be interpreted as violating sharia rules and thus invalidating the legality of said transactions.

The choices that takaful companies provide to their customers vary according to regions and jurisdictions. Since Takaful is founded on the premises of complying with sharia, there is a need to assess whether the actual implementation of takaful models are consistent with sharia.

In a recent market report on takaful insurance, it was noted that instructions by the Saudi Monetary Agency (SAMA) required cooperative insurance companies to eliminate wakālah structures and make internal adjustments.\(^{413}\) It seems that some insurance companies, have previously structured themselves according to the wakālah model, thus attracting customers who are doubtful of the legality of other insurance schemes in the Saudi market. The report found SAMA’s mandates to have an impact on the competitive advantage these companies possessed by appealing to the Saudi “religious sensitive” market. It also concluded, however, that the outcomes cannot be known since some Saudi insurance companies appeal to the market through establishing shari‘a committees within the company.\(^{414}\)

In the previous section on the Saudi insurance structure, the author illustrated how insurance companies make profit and manage risk in ways that contravene sharia. The Saudi insurance


\(^{414}\) *Ibid*
model is not based on participants mutually bearing risk as per the requirements of sharia outlined by scholars. As a consequence of the stock based structure, the investment risk is also borne by the shareholders. In addition, regulations on insurance companies’ investments lack any sharia directives and actually contradict Islamic mainstream views with regards to dealing with *riba*.

The risk of investment in a mutual is borne by the policyholders, or owners. In a *takaful*, there are separate investment funds for shareholders and policyholders borne by each respective category. Theoretically, in the Saudi insurance context, there is supposed to be a separation between accounts of shareholders and policyholders in terms of risk management and investment of funds. However, the previous discussion of how this theoretical separation does not exist in reality also applies to a lesser degree with regards to investment accounts. Article 70 of the regulations gives the company the choice between “adding or subtracting the investment return of the policyholder’s invested funds, and subtracting the general expenses related to the policyholder’s portion of the investment activities.”

As laid out in the previous chapter, the ulama declared takaful to be lawful because, in cooperative insurance, the funds are not invested in transactions generating interest. The law on Supervision of Cooperative Insurance Companies and its implementing regulations do not contain any provisions that explicitly stipulate that insurance operations be free of interest or that they need to comply with basic sharia principles. While they do demand that insurance companies follow the laws and regulations of the country in general, many banks and financial institutions in Saudi Arabia use financial instruments that are based on or deal with interest. Moreover, some aspects of the implementing regulations are silent with regards to the requirement that investment to be interest free and therefore compliant with sharia principles.
For example, table 1 of the implementing regulations allows some levels of capital investment in certain types of interest bearing ventures. Some of the permitted categories of investment include local government bonds, foreign government bonds, foreign corporate bonds and local corporate bonds. Bonds are defined as a debt investment in which an investor loans money to an entity (corporate or governmental) for a defined period of time, at a fixed or variable interest rate.\footnote{Definition of bonds. Investopedia, Online < investopedia.com >} Bonds are used by businesses, municipalities, and local and national governments to finance a variety of projects and activities.\footnote{Ibid} Although bonds can technically be interest free, they are usually fixed with a certain interest rate and there is no requirement in the relevant Saudi regulations that the bonds must be compatible with sharia. Furthermore, in table 2 of the implementing regulations, there exists an express acknowledgment of transactions involving interest. Table 2 identifies how companies should distribute their in the absence of SAMA’s approval for the company’s investment policy. Table 2 specifies assets that are admissible for insurance companies to invest in, such as accrued interest and rent at a 2.5% rate.

The implementing regulations preclude insurance companies from investing in certain financial instruments such as derivatives and off-balance-sheet items except for the purposes of diversification in accordance with efficient portfolio management after receiving SAMA’s written permission.\footnote{Implementing Regulations of the \textit{Law on Supervision of Cooperative Insurance Companies}, Ministerial Decision no. 1/596 dated (1/3/1425 H) at s. 62} The regulations provide some details on when it is permitted to invest in such instruments. Conditions include that derivatives must be listed on a financial exchange, are capable of being closed off, are founded on permissible assets, and have an evaluated
pricing basis. The company has to set aside assets that can be used to settle any obligations or adverse changes on the derivatives and their coverage. The party with which the company is transacting on derivatives has to be in a reputable and acceptable financial position.

These specific restrictions illustrate the technical and market-oriented aspects of insurance regulation requirements, though there is ambiguity when it comes to the Islamic and cooperative elements such as those requiring that insurance investments be interest-free. Despite that these terms may violate traditionalist interpretations concerning the prohibition of riba, the regulations appear to follow a protective regulatory framework. Thus the terms set above may not necessarily contradict more modern interpretations of interest in Islamic law.

4.3 Mutual Insurance: A more viable Model under Islamic law

Because of legality issues in the tawuni or takaful structure, I suggest that we shift our focus to the mutual insurance model, which I argue is capable of satisfying shari'a requirements relating to the prohibition of trading in risk. As we have seen, the change in the nature of the insurance contract as to consider it donative is only formal since the contract operates similar to a commercial insurance contract. Reconstructing insurance to fit contracts that are traditionally recognized in Islamic law by the four Sunni schools is an “unnecessary complication”418 since Islamic law admits and acknowledges new forms of contracts as long as they do not contradict the rules of sharia.

One of the main problems that proposals such as this one faces is that the islamic financial industry, as El-Gamal states, is often centered around conventional commercial schemes while

using Islamic terms to give the system legitimacy in pursuing its purely profit oriented goals. \(^{419}\) El-Gamal explains that in Islamic systems of insurance and banking, there is a tendency to “synthesize” or convert unlawful practices of risk and credit into an “Islamic rent-seeking scheme” in order to make it profitable for whoever the managers of the company are accountable to. \(^{420}\)

Muslim scholars and policy makers need to recognize two things in this regard. One is that the insurance contract is inherently one that possesses a high degree of risk which is deemed to contravene with the prohibition of gharar. The second point is that Islamic law permits contracts containing gharar if maṣlaḥa (benefit) outweighs the mafasid (harms). \(^{421}\) Insurance clearly forms an integral part of the financial system worldwide and is an indispensable system for a functional economy. Muslims often require insurance and in some cases are obliged to subscribe to some insurance policies such as vehicle and health insurance. Hence, they should have access to insurance options that are compliant with shariʿa restrictions on contracts. Correspondingly, attention needs to be focused on which insurance model is most suitable and is amenable to Islamic transactional rules. In particular which model satisfies the prohibition on transacting with gharar (risk).

The mutual model seems to represent an alternative that accommodates risk in ways that are acceptable to Islamic transactional rules. Many scholars prohibit the insurance contract on the basis that transacting with risk is unlawful. The mutual model provides an acceptable solution to that legal restriction. Under the mutual model, policyholders have a dual status of being

\(^{419}\) El-Gamal Mutuality, supra note at 11

\(^{420}\) Ibid

\(^{421}\) IEI-Gamal Gharar, supra note
policyholders as well as shareholders in the company. Mutuality reconstructs the relationship and dynamics found in stock insurance companies by uniting the identities of shareholders and customers. This consequently aligns the interests of shareholders and policyholders. Alligning interests may have an immediate impact on how risk is accommodated under the model.

In the stock insurance or banking model, there is a tendency to respond to shareholders. El-Gamal shows that this inclination to respond to shareholders instead of account holders or policyholders, increases the business risk. El-Gamal shows that the stock business model provides a strong incentive for the managers to respond to the shareholders profit motives.

The increase of risk in the stock model, El-Gamal contends, positively correlates with higher immediate returns for the company as well as results in better cost efficiency.

On the contrary, in the mutual scheme where account holders or policyholders are also the shareholders, the managers respond to the needs of those who wish to mitigate risk. As a consequence, the managers tend to make business decisions that are low in risk, low in profit, and provide better service for the shareholders who are at the same time the participants or customers in the scheme. El-gamal argues that the elimination of “sharia rent-seeking schemes “is a step toward realizing the principles behind sharia bans on high risk and credit transactions.

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422El-Gamal Mutuality, supra note at 7,8
423Ibid at 7
424Ibid at 8
425Ibid
426Ibid at 7,11
El-Gamal claims that the best way to avoid prohibited riba and gharar is through mutual insurance schemes. He argues that trading in “unbundled credit and risk” are the reasons behind which riba and gharar or risk are prohibited. In that sense, an interest-bearing loan is an extreme example of dealing in unbundled credit while gambling is an example of trading in excessive risk. He states that the means by which Islamic finance can be “unbundled” is through applying mutual banking and mutual insurance systems that were established and developed in the west.

El-Gamal contends that the purpose behind the prohibition of riba can be understood as an attempt “to prevent unfairness in transactions,” as stated by the Islamic jurist, Ibn Rushd. Contemporary takaful companies have elected to follow conventional schemes of insurance rather than those of mutuals.

What is lacking in the structures and regulations of today’s insurance markets is consideration of the moral reasons behind deeming certain financial systems unlawful. El-gamal shows us that the current sharia based arbitrage schemes in the financial sector in Islamic countries deploy sharia only to make lucrative gains. These schemes tend to focus on changing the forms of contract without regard to the substance of the transaction, and the substance remains the sale of risk or credit. Therefore, there exists a need for substantive changes made through mutualization, which will eliminate the profit-motive behind these economic and legal transactions and structures. In his opinion, there is a need to redefine the Islamic brand name as a “community-ethic,” so that indigenous and ethical providers can be distinguished.

427 Ibid at 4
428 Ibid at 4
429 Ibid at 11
430 Ibid at 4
431 Ibid
from conventional and international conglomerates.\textsuperscript{432} This will prevent rent-seeking sharia arbitrage from using the same brand name.\textsuperscript{433} This proposition is much needed in the Saudi insurance market where providers liberally utilize the “takaful” or “t‘awunī” brand without reflecting that in their business transactions.

In conclusion, the mutual insurance structure de-commercializes the profit oriented stock model by distributing risk to a pool of funds that is mutually provided by the participants. In doing so, the structure significantly reduces the risk associated with the transaction and transforms it from a commercial one to an act of mutual solidarity. The mutual model ought to be the prototype model that inspires the current state of insurance that I have demonstrated to be incompatible with the shari‘a rule against gharar.

\textsuperscript{432} Ibid at 11
\textsuperscript{433} Ibid
Conclusion

Even though the Saudi insurance laws appear to regulate a cooperative model that is deemed to comply with sharia, inquiry into the law reveals that the structure is in fact one that is based on a stock model. Furthermore, insurance companies often use takāfūl in their brand names despite the use of a primarily commercial model with some secondary characteristics that may be attributed to a cooperative. These findings lead us to question the consideration for adopting this tawunī model which not only contradicts with the majority of ulama’s opinions, including the Council of senior Ulama, but also uses the takafūl attribute quite liberally devoicing it from its content. This question would require further research on the public policy considerations for such laws.

In my analysis of Islamic legal discourses on the legality of commercial insurance, I find that Al-Zarqa by utilizing islamic jurisprudential methodologies, came to the conclusion that the commercial insurance contract is acceptable in islamic law. The Council of Senior Ulama also use a textualist approach in their interpretation, but arrive at a different conclusion, that
commercial insurance is unlawful. What is missing in both views is employing a proper understanding of the transaction. The ulama have characterized for example the insurance contract to be similar to wagering and gambling while this is not exactly the proper characterization of how risk plays out in the insurance contract. This lead us to question the methodology and whether it is appropriate in this context of modern financial systems.

The thesis advocates for the mutual insurance scheme, which I have shown to significantly reduce the risk in the transaction by uniting the interests of policyholders and shareholders.

This issue deserves addressing since the system of insurance in Saudi Arabia fails to provide a real alternative to Muslims when it replicates the stock commercial model. This failure comes to a huge cost for the average Muslim who wishes to conduct their life according to religious principles.
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