TAKAFUL: AN INNOVATIVE APPROACH TO INSURANCE AND ISLAMIC FINANCE

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1. INTRODUCTION

In many of its applications, Islamic finance presents a novel approach to modern financial transactions. Because it developed outside the current financial industry, the underpinnings of Islamic finance sharply contrast with traditional financial instruments. Yet, the application of Islamic principles to finance brings Islamic finance wholly into the modern era. In fact, modern Islamic financial practice is largely a product of the traditional financial transactions that have developed over time. This does not mean that Islamic finance is indistinguishable from the current financial trends. It is still a unique approach that fulfills a dual purpose: granting Muslims an alternative to traditional financial instruments, while making these instruments an attractive option in modern economies. However, adopting Islamic finance in modern economies poses unique challenges. The United States' corporate and legal structures, in particular, provide interesting examples of some issues confronting corporations that offer Islamic products. Islamic finance covers the full gamut of modern financial areas, from loans to insurance. This paper focuses on insurance, or *takaful*—the name given to the practice of insurance under principles of Islamic finance.

Takaful insurance is not only an innovative approach to Islamic finance, but also a viable alternative to conventional insurance. This paper will begin with an exploration of the underpinnings of the modern Islamic financial system with regards to its impact on *takaful*. Next, the paper will lay the foundations and forms of

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takaful. Finally, the paper will compare *takaful* as applied in Malaysia with the potential for a *takaful* market in the United States. Specifically, the paper will examine the viability of *takaful* in light of potential *Entanglement Clause*[1] issues.

2. ISLAMIC LAW AND FINANCE: AN INTRODUCTION

2.1. Islamic Law in General

In understanding Islamic finance, it is important to start with a brief overview of Islamic law because Islamic finance is the application of Islamic law to financial and commercial transactions.[2] Islamic law (Shariah) is derived from the *Quran* (Islam's holy book) and the *Sunnah* (actions and sayings of Prophet Muhammad).[3] The interpretation and application of Islamic law is known as *fiqh*. There are four mainstream schools of Islamic jurisprudence within the Sunni tradition: Hanafi, Maliki, Hanbali, and Sha'afi.[4] Each of these schools has certain nuanced differences in their respective approaches to interpreting Islamic law. Since Islamic law has developed over 1,400 years, there is not always uniformity in application or interpretation of the governing principles.[5] A third element in Islamic law is *ijmaa*, or scholarly consensus, in interpreting the Quran and Sunnah. The lack of uniform consensus among scholars voids *ijmaa* in a particular area of law, thereby allowing for the existence of diverse but equally valid legal holdings. As is the case with many areas of Islamic law,

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[1] *See* U.S. CONST. amend. I (setting forth the constitutional constraint that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof"). This point will be discussed further in section 1.2.

[2] *See* KILIAN BALZ, SHARIA RISK?: HOW ISLAMIC FINANCE HAS TRANSFORMED ISLAMIC CONTRACT LAW 1 (Islamic Legal Studies Program Harvard Law School 2008) (defining Islamic finance as "financial transactions conforming to Islamic legal principles").

[3] *See id.* (defining Islamic law as "the body of legal rules" developed by scholars studying these two texts).

[4] There are also a number of Shi'a schools of thought, however, the analysis in this paper is limited to the Sunni tradition, to which 90% of the Muslim population adheres.

[5] *See generally* FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 24 (Kluwer Law International 1998) (detailing the development of Islamic law and its interplay with banking and finance).

Islamic financial transactions can take many forms depending on the school of thought employed.

This paper will not delve into the different applications of Islamic law to financial transactions under each school of thought. Instead, it will focus on the most common financial structures currently in use. Islamic finance, as a viable alternative to traditional finance, grows out of two major shifts.[6] First, Islamic finance has developed in response to the globalization of financial markets and the adoption of Western financial institutions throughout the world's economies.[7] Institutional and contractual practices originating in the Western world have embedded themselves in the economies of the Muslim world. Second, Islamic finance is part of a larger trend that began in the 1970s.[8] That trend is the shift towards reintroducing Islamic law in many parts of the Muslim world. Despite this trend, laws and legal institutions derived from Western legal systems remain the dominant modal system.

One of the challenges in developing and applying Islamic law in a wholly Western financial system is that many of the common financial instruments have no counterpart in Islamic law. So, while classical Islamic law may offer a complete body of commercial and contract law, it is important to note that the current Western system of commercial and contract law does not neatly fit into the preexisting scheme. Thus, Islamic scholars are required to evaluate and determine which Western modes of financial transactions are acceptable, and how Islamic law can be interpreted and applied to modern financial instruments to bring them within the purview of Islamic law. As the demand for certain types of financial products grows, Muslim scholars will be pressed to develop Islamically acceptable alternatives. Islamic finance has become the most innovative element of contemporary Islamic law.[9]

According to Frank Vogel, a former Professor at Harvard Law School and a leading expert on Islamic Law generally, Islamic

[6] *See* BALZ, *supra* note 2, at 11 (illustrating how globalization shifts have shaped Islamic finance).

[7] *See id.* (attributing the need for Islamic finance to globalization of Western financial institutions).

[8] *See* VOGEL & HAYES, *supra* note 5, at 20–21 (describing the shift toward greater concern with compliance with Islamic law courts starting in the 1970s).

[9] *See generally id.* at 21–29 (explaining the evolution of Islamic finance and its innovative application in Islamic Law).

financial analysis can be broken down into two approaches. First is the Islamic law aspect, which aims to characterize modern financial behavior in terms of Islamic legal rules.[10] This approach accounts for Islamic law's concern with individual action and the welfare of the individual as a task delegated to the state. The second approach is steeped in Islamic economics.[11] Here, the aim is to develop Islamic economies as a viable alternative to the Western economies that predominate. In order to be viable, the Islamic economies must produce more beneficial outcomes than do their Western counterparts. In shaping this new economic theory, economists would, for example, look to Islamic moral principles and legal institutions (e.g., requirements on giving charity).[12] However, since this approach is still in developmental form, Islamic rules ground Islamic finance without much regard for economics.[13] Furthermore, many Muslims are willing to pay a premium to ensure that their business transactions are in line with Islamic principles without having as much concern for profit-maximizing outcomes.[14]

2.2. *Islamic Contract Law*

In order to understand modern Islamic law, a brief primer on Islamic contract law is necessary. Islamic contract law centers around rigid nominate contracts that do not have counterparts in conventional finance. Unlike the ideal of freedom of contract, a basic underpinning of the objective theory of contracts adhered to in common law jurisdictions such as the United States, there is no generalized theory of contracts in Islamic law.[15] In particular, the freedom to contract will always be limited by Islamic legal rules

[10] *See id.* at 23 (outlining how Islamic religious law defines Islamic banking and financial analysis).

[11] *See id.* at 29–30 (explaining the economic approach to Islamic law).

[12] *See id.* at 31 (describing how classical Islamic law influences Islamic banking and finance).

[13] *See id.* (establishing Islamic principles as the foundation of Islamic finance rather than economic principles).

[14] *See* Nurul Islam, *Islamic Banking Means Western Opportunity*, GALLUP MANAGEMENT JOURNAL, Aug. 14, 2008, http://gmj.gallup.com/content/109360/islamic-banking-means-western-opportunity.aspx#2 (explaining why some Muslims are willing to pay higher premiums for Islamic financial products).

[15] *See generally* Wayne Barnes, *The French Subjective Theory of Contract: Separating Rhetoric from Reality*, 83 TUL. L. REV. 359 (2008) (describing the objective theory of contracts).

that prohibit all transactions involving interest, or *riba*. Thus, even when the Ottomans introduced a civil code in the 17th century, a general theory of contract was not developed. Instead, jurists developed a number of nominate agreements with their own set of rules. This structure of nominate contracts grew out of pre-Islamic contracts that were common in the time prior to the 6th century. These nominate contracts were studied and amended to comply with Islamic principles. A number of mechanisms to validate contracts falling outside of the nominate scheme were also developed by jurists. However, an absolute right to contract still remains undeveloped since contracts that violate prohibitions on *riba* or *gharar* (uncertainty) cannot be valid.[16]

Contracts under Islamic Law were necessary for a limited type of contractual transactional forms under which business was conducted. These contracts led to the development of a set of rigid, trade-based contracts that lay the foundations for contemporary Islamic contracts to be used and developed in the Islamic finance industry.[17]

The prototypical contract was the contract of sale, or *bay'*.[18] The basic form of the sale contract transferred ownership of some lawful, fixed property immediately deliverable for a determined price.[19] All other contracts derived their form by analogy to the sale contract because Islamic jurisprudence dealt with that method in great detail.[20]

Some typical contracts in Islamic finance included those for loans, gifts, sales, sales at a mark-up (*murabaha*), leases (*ijara*), joint ventures and partnerships (*musharaka*, *mudharabah*), manufacture and construction contracts (*istisna'a*), and agency contracts (*wakalah*).[21] These contracts are instruments currently in use by Islamic banks and conventional banks offering Islamic products.

[16] *See generally* Hussein Hassan, *Contracts in Islamic Law: The Principles of Commutative Justice and Liberality*, 13 J. ISLAMIC STUD. 257, 259 (2002) (detailing the historical development of contracts in Islamic law).

[17] *See id.* at 259–62 (summarizing trade-based contracts).

[18] *See* VOGEL & HAYES, *supra* note 5, at 102 (describing the elements of Islamic contracts).

[19] Lawful in this context refers to validity under Islamic law, meaning the sale does not involve an Islamically prohibited item.

[20] *See* Hassan, *supra* note 16, at 285 (explaining the elements of the sale contract through Islamic jurisprudence).

[21] *See* VOGEL & HAYES, *supra* note 5, at 103 (listing the different types of contacts in Islamic finance).

The primary focus in this paper will be on *mudharabah* and *wakalah* contractual forms. Islamic insurance companies typically use *wakalah* (agency) and *mudharabah* (joint-venture partnerships) contracts or a mixed model of a *wakalah* and *mudharabah* scheme.[22]

A *wakalah* contract allows for full representation in most contractual arrangements.[23] The contract can be gratuitous, where the agent provides management without compensation, or fee-based. However, the contract is revocable at will by either party. There are certain rules that militate against the possibility of revocation, but the authority of the agent depends on continued consent from the principal.[24] In the insurance context, this allows an agent to act as manager under a fee-based arrangement.

Another commonly used contract is a *murabaha* contract. A *murabaha* contract is essentially the sale of a good with a certain mark-up built into the price.[25] This mark-up can reflect any cost the seller may encounter in the deal. An *istisna* contract is very similar to a construction loan. It is a payment arrangement between a buyer and seller for a particular good spread out over a period of time, such as the payment for the manufacturing of a house over the period it is being built.[26] *Ijara* contracts parallel traditional leases. This is kind of contract can either be a lease with a purchase option or a lease of an item that will revert back to the owner upon termination.[27] One key difference between a traditional and Islamic lease is who has responsibility over upkeep of the item. In a traditional lease, the responsibility lies with the lessee; however, in an Islamic lease the responsibility falls to the lessor.[28]

A second key contract form in Islamic insurance is a *mudharabah* arrangement. A *mudharabah* contract is an equity investment that is a profit sharing agreement between two

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[22] *See* MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 153–154 (Cambridge University Press 2006) (discussing elements of a *wakalah* contract in Islamic cooperative insurance).

[23] *Id. Wakalah* shares similarity with common law agency in that it allows a third party to serve as a representative to effectuate a transaction or deal.

[24] *See* VOGEL & HAYES, *supra* note 5, at 107 (explaining the legal rules of *wakalah* contracts).

[25] *See id.* at 140 (explaining a *murabaha* contract).

[26] *See id.* at 146–47 (explaining *istisna* contracts).

[27] *See id.* at 143–44 (describing the *ijara* lease).

[28] There are exceptions to this allocation of responsibility, for example, in the case of willful destruction of property. *Id.* at 144–45.

parties.[29] In this type of arrangement, one party supplies the capital, while the other supplies management oversight and entrepreneurial skills. Profit is shared amongst the parties according to an agreed-upon, predetermined formula, and risk is carried by each party. The risk carried is in line with the type of investment, money, or time each party provides. Finally, an equity arrangement between two or more parties is known as a *musharakah* contract.[30] Here, each party contributes both managerial expertise and money according to an agreed-upon formula.[31]

While there is no general theory of contract law, there are certain conditions that agreements must fulfill. In general, there is the requirement of good faith that is derived from the Quran: "[*F*]*ulfill the covenant of God when you have entered into it, and break not your oaths after you have confirmed them* . . . ."[32] Islamic finance scholars have interpreted this verse and many others to read an element of good faith into contractual relationships.[33] Good faith, honesty, disclosure, truthfulness, and sincerity make up the moral attributes of a contract. Beyond these requirements, there are three key prohibitions that should not be part of any contract.[34]

The first is a prohibition on interest. While some scholars debate the permissibility of interest in financial transactions, the vast majority of traditional scholars agree on its total prohibition.[35] The prohibition against interest can be found in both the Quran and Sunnah. A Quranic verse on point states, "*Allah has permitted trade and has forbidden* [interest]."[36] This prohibition's importance is evinced by the verses directly addressing the impermissibility of

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[29] *See id.* at 138 (detailing the *mudaraba* arrangement).

[30] *See* FINANCIAL ENGINEERING AND ISLAMIC CONTRACTS xix (Munawar Iqbal & Tariqullah Khan eds., 2005) (defining *musharakah* contracts).

[31] *See* VOGEL & HAYES, *supra* note 5, at 195 (describing the elements of a *musharaka* contract).

[32] *Qu'ran* 16:91.

[33] The element of good faith is also a part of common law contracts. In particular, see section 17 of the Marine Insurance Act of 1906 of the United Kingdom, which codified the concept of "utmost good faith" for marine insurance contracts.

[34] *See* MOHD. MA'SUM BILLAH, APPLIED TAKAFUL AND MODERN INSURANCE: LAW AND PRACTICE 47 (3d ed. 2007) (stating that contracts that contravene Shariah prohibitions will be invalid).

[35] *See* VOGEL & HAYES, *supra* note 5, at 150–51 (noting that interest-bearing investments are forbidden).

[36] *Qu'ran* 2:275.

interest. This concept sets Islamic financial transactions apart from conventional business practices. In conventional finance, interest is part and parcel to the structure of most transactions.

The second obligatory prohibition is that against uncertainty, or *gharar*.[37] A well-known saying of the Prophet elucidates this point, stating: "*whoever buys food, let him not sell them until he has possession of them*."[38] This rule of *fiqh* voids the sale of nonexistent or uncertain objects, even if the relative risk is very low.[39] This relates in a sense to the final prohibition that forbids gambling, or *maysir,* in Islamically compliant contracts. The Quran states, "*intoxicants* [] *and gambling . . . are an abomination . . . eschew these such that ye may prosper*."[40] The reasoning for this prohibition stems in part from the idea that gambling may create enmity amongst people.[41]

These prohibitions have broad implications and are equally applicable to insurance contracts. Because insurance typically involves risk, uncertainty, *and* interest, it poses a unique challenge to Islamic law. Under traditional Islamic law, the game-oriented risk profiles of insurance would not meet the requirements of a legally-valid contract between parties.[42] In order to work around this inherent obstacle, Islamic scholars have taken a somewhat unique and innovative approach to insurance, which will be explored in the next section.[43]

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[37] *See* VOGEL & HAYES, *supra* note 5, at 63–64 (describing the prohibition on uncertainty as resulting from an urge to ensure moral security in transactions).

[38] This is recorded in a Hadith found in Al-Bukhaari, 2132; Muslim, 1525.

[39] Such as a contract for uncaught fish, or an unborn calf.

[40] *Qu'ran* 5:90.

[41] *See generally* VOGEL & HAYES, *supra* note 5, 46–92 (explaining the reasoning behind the prohibition on gambling and that prohibition's effect on financial transactions).

[42] *See* EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 36 (Tom Baker & Jonathan Simon eds., University of Chicago Press 2002) (describing how a Western perspective of insurance could appear in conflict with Islamic law).

[43] *See id.*, at 37 (explaining that Islamic scholars reinterpreted the nature of insurance as being large, aggregate transactions with a charitable purpose in order to gain religious approval).

3. ISLAMIC INSURANCE, OR *TAKAFUL*

3.1. Overview of Takaful

Islamic insurance, and, more broadly, Islamic finance, place special emphasis on social welfare as a criterion of business practice.[44] In addition to the importance placed on welfare, there is also a strong focus on discouraging wealth maximization.[45] Islamic insurance tends to incorporate both of these ideals in its approach to affording security to individuals in the form of insurance. Thus, Islamic insurance is a cooperative model of insurance.

There are no counterparts to conventional insurance in classical Islamic law. Islamic insurance is an innovative modern approach to dealing with demand for an instrument that can reduce one's exposure to certain types of risk. Under its conventional form, insurance is similar to a gamble and would be a violation of the rules of *gharar*. In a conventional agreement, an insured person pays a cash premium in exchange for a promise made by the insurer that it will pay a certain amount in case of a given future contingency. There is no guarantee that the future contingency will ever come to pass, and disputes about whether the contingency has occurred or pre-existed the contract have bred enormous litigation. Thus, the insured is taking a gamble, and the insurer is benefiting from this gamble. Under conventional insurance practice, the operation of insurance is also heavily reliant on principles of interest. Insurance companies often invest their premiums in interest-bearing investments, which also invokes the prohibition against *riba*.[46]

An influential Islamic scholar, Mustafa al-Zarqa, made an argument for the acceptability of conventional insurance practices as insurance contracts in the aggregate pose very little uncertainty, since the risk for which the parties are contracting can be valued.[47]

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[44] *See* VOGEL & HAYES, *supra* note 5, at 26 (discussing the role of social welfare in Islamic finance).

[45] *See id.* (noting that Islamic finance encourages a fair distribution of wealth).

[46] *See id.*, *supra* note 5, at 150 (describing why insurance systems were traditionally viewed as violating *riba* and *gharar*).

[47] *See* EL-GAMAL, *supra* note 22, at 147–149 (suggesting that some Islamic scholars believe that conventional insurance inherently runs afoul of religious doctrine).

This argument was not enough to quell the general unease pious Muslims have with the idea of conventional insurance. Thus, a new approach emerged which shifted the conceptual focus of insurance away from individual contractual agreements and towards the institution of insurance's benefit to society as a whole.[48]

Islamic insurance shifts the focus to a broader lens—insurance as a collective endeavor, which is an alternative to the bilateral relationship that exists in the conventional model. It is this institutional approach that forms the basis for *takaful*. This collective model grew out of the social insurance practices that were practiced at the beginning of Islam, such as *al-diyah* (blood money), a practice in which the relatives of a killer paid money to the heirs of the deceased in order to allow the killer to escape his legal burden.[49] These amounts were to be paid by way of mutual collaborations in which money was set-aside in case the need arose for its use.[50]

Takaful, which literally means "solidarity," is a system in which members decide to protect each other from loss. In line with Islamic ideals of welfare and charitable giving, the system is a collective enterprise that allows a community to pool together resources in order to assist members of the community in times of need resulting from casualty or loss. Professor Tom Baker characterized the differences in the theoretical underpinnings between conventional and Islamic insurance: conventional insurance seeks to eliminate risk for the individual, whereas Islamic insurance aims for risk elimination within a given social group.[51]

While the scope of insurance policies within the *takaful* model may vary, they are governed by the principles of either a *wakalah* or *mudharabah* contract, or a mixed model borrowing from both.[52] The basic structure of a *takaful* arrangement is as follows: (1) a *takaful*

[48] *See* VOGEL & HAYES, *supra* note 5, at 151 (describing the conceptual shift in Islamic law that allowed for the development of insurance).

[49] *See* BILLAH, *supra* note 34, at 6–7 (listing the historical underpinnings of traditional Islamic insurance).

[50] *Id.* (describing the aspects of *al-dinya*).

[51] *See* EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY, *supra* note 42, at 37–38 (differentiating between Islamic insurance and conventional insurance).

[52] *See* BILLAH, *supra* note 34, at 18–19 (illustrating the various types of insurance contracts available under Islamic law).

company is organized; (2) members make periodic payments that the company maintains in individual accounts for each member; (3) these amounts are invested in Islamically sound financial products. As part of the contract, the members agree that if any of them suffer a covered loss, then each will make a proportionate gift from their accounts to cover that loss.[53] The legality of this contract is derived from the idea that gratuitous acts allow for a higher degree of uncertainty, and from the *Maliki* (one of the four schools of thought in Sunni Islam) opinion that gift promises can be binding.[54] Under this framework, the insurance pool is more akin to a charitable institution as opposed to a profit-earning institution, because the insurance company does not act like an insurer in the conventional sense; instead, it manages the business aspect of the cooperative on behalf of the members.[55] Finally, under a *takaful* model, there is generally a governing body, known as a Shariah board, that regulates the *takaful* company to ensure that products being offered by the company are within the confines of Islamic law (*Shariah*). The salient characteristic of *takaful* companies is that profits are shared by the policy holders rather than given to third-party shareholders as is the norm in conventional insurance companies (Figure 1).

3.2. Elements and Models of Takaful

There are five key considerations for a *takaful* company. First is the concept of mutual guarantee—is the idea that the basis of the insurance contract grows out of a cooperative spirit. So, the Islamic ideals of brotherhood, solidarity, mutual help, and shared responsibility play a central role.[56] The second consideration is ownership of the fund. Since the fund is based on a cooperative model, the fund is simply managed by a corporation, while the actual ownership lies with the participants of the fund who must

[53] *Id.* (describing the conceptual framework of *takaful*).

[54] *See* VOGEL & HAYES, *supra* note 5, at 142 (explaining how, under the *Maliki* School, a promise can be considered binding if the promise has a motive and there is reliance on the promise by the promisee).

[55] *See* Ali Adnan Ibrahim, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 AM. U. INT'L L. REV. 661, 715–16 (2008) (describing how *takaful* functions).

[56] *See generally* Mohd. Ma'sum Billah, *Sources of Law Affecting 'Takaful' (Islamic Insurance)*, 2 INT'L J. ISLAMIC FIN. SERV. 1 (2001) (describing how *takaful* can be justified through divine principles).

pay out claims.[57] However, a *takaful* operator may be required to ensure the fund is solvent by providing an interest-free loan in case of insolvency, which is paid back by participants' future contributions. A share of the profits, if there are any, is predetermined. The third is eliminating uncertainty. Fourth, the company must determine how the fund will be managed, whether to employ a *wakalah* arrangement, a *mudharabah* contract or a mixed model. Unlike conventional insurance models where underwriting surplus is the primary source of profit, *takaful* operators receive either an income through a *wakalah* arrangement, profit sharing through a *mudharabah* contract, or some other compensation depending on the model employed.[58] These models will be further described below. Finally, the investment conditions of a given economy also play a role in determining how best to structure the *takaful*.

The three major *takaful* models in the context of general and life insurance are as follows: *mudharabah*, *wakalah*, and the mixed model. Because life insurance is often treated as a separate subject under Islamic law, it will only be discussed briefly. Life insurance is treated as an independent subject because many scholars have objected to its permissibility on a number of grounds. The argument against life insurance is two-fold. Firstly, it is viewed as a way to insure against death, which would be unlawful under Islamic law, because life and death are in the hands of God.[59] The second objection arises out of the conventional life insurance policy structure that allows an individual to appoint a nominee as a beneficiary of the policy upon death.[60] This would violate the traditional inheritance laws found in the Quran, which outline how funds are to be distributed in case of death. Despite these general objections, life insurance, like other general insurance structures, has been re-conceptualized so it can fit Islamic law principles and be a viable option for practicing Muslims.[61] For example, under

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[57] *See generally* TAKAFUL ISLAMIC INSURANCE: CONCEPTS AND REGULATORY ISSUES 9–13 (Simon Archer et. al. eds., Jon Wiley & Sons (Asia) Ltd. 2009) [hereinafter TAKAFUL ISLAMIC INSURANCE] (detailing the structure of the insurance corporation).

[58] *See* VOGEL & HAYES, *supra* note 5, at 138–43 (differentiating *takaful* from conventional insurance).

[59] *See generally* BILLAH, *supra* note 34, at 71–84 (describing some of the objections to life insurance posed by Islamic scholars).

[60] *Id.* at 33.

[61] *See id.* at 32–33 (explaining the reconceptualization of Islamic insurance).

Islamically valid life insurance policies, the designated beneficiary is simply responsible for paying out the policy to the deceased's heirs in accordance with Islamic inheritance laws. Life insurance models are very similar to the general insurance models discussed below.

The three most common management options for *takaful* operators are derived from the contractual arrangements described in previous sections of this paper. These models govern the relationship between the participants in a *takaful* fund and the operator who manages the funds paid by participants.

The first option is based on the *wakalah* (agency) contract. Under the *wakalah* contract in an insurance arrangement, the participants in the *takaful* arrangement will appoint the *takaful* operator as their agent or manager to handle all the activities of the *takaful* fund in accordance with established guidelines. A predetermined fee compensates the agent or manager, and the participants, as principals, share all profits and risks.[62]

The second model is derived from the *mudharabah* contract. Under this model, the *takaful* operator will share in the returns from the investments of the *takaful* fund according to a predetermined profit-sharing arrangement. If there is no profit, the operator will receive no compensation for management services (Figure 2).[63] The third widely used model is known as a mixed model. Under this structure, the *takaful* operator will be assured compensation under the *wakalah* contract and will receive a share of profits, if any, under a *mudharabah* contract.[64]

3.3. General Considerations

The application of conventional regulations to *takaful* operations can be problematic. One such regulation is the capital adequacy requirement found in many countries including the United States. This poses a problem for *takaful* companies because there is a separation between policyholder and shareholder funds. Depending on how assets and liabilities are valued, *takaful* operations may fail to meet their regulatory obligations.[65] This will

[62] *Id.*, at 18–19.

[63] *Id.*; *see also* TAKAFUL ISLAMIC INSURANCE, *supra* note 57, at 43–44 (discussing *takaful* management methods).

[64] BILLAH, *supra* note 34, at 18–19; *see also* TAKAFUL ISLAMIC INSURANCE, *supra* note 57, at 43–44 (explaining *wakalah* and *mudharabah* contracts).

[65] *See generally* ERNST & YOUNG WORLD TAKAFUL REPORT 2009 (2009)

be discussed further in the context of United States' insurance regulations below.

Another consideration for operating *takaful* companies is related to the deregulated nature of markets. A Shariah board generally governs Islamic insurance companies and Islamic banks.[66] These boards advise companies on how to structure instruments and often place their stamp of approval on those they deem Islamic. While these boards are commonplace in Muslim countries with strong Islamic finance practices, they are not found everywhere. This may lead Muslims in emerging markets to be wary of products being offered as Islamic products because there are no regulations in place to ensure that those products are truly compliant.[67]

Finally, Islamic insurance companies may face stiff competition from conventional insurance companies. While there will always be a group of people willing to pay a premium to guarantee they are fulfilling their religious obligations, competitive pricing is necessary to create a true market for *takaful*. Some countries have proposed and passed legislation that would offer incentives to *takaful* operators in the form of tax breaks.[68] This is one method to overcome the pricing barrier that may exist between conventional and Islamic insurance.

4. ISLAMIC INSURANCE APPLIED: A COMPARATIVE ANALYSIS OF MALAYSIA AND THE UNITED STATES[69]

4.1. Malaysia

In contrast to the United States, Malaysia has a sizeable Muslim population.[70] However, like the United States, Malaysia has a

(discussing valuation issues that may arise for *takaful* insurers).

66 *See* BILLAH, *supra* note 34, at 57 (explaining the function of Shariah boards in the financial context).

67 *See generally* Rod Monger & Mufeed Rawashdeh, *Islamic Finance Enters the Mainstream*, MGMT. ACCT. Q., Spring 2008, at 1 (noting the progress and challenges that Islamic finance faces during its rapid expansion into new markets).

68 See *infra* sec. 4 for a discussion of Malaysia's efforts to create a competitive *takaful* market.

69 Malaysia is often a leading innovator in Islamic financial products, while the United States has just recently emerged as a player in the field.

70 Malaysia is sixty percent Muslim. US DEP'T. OF STATE, BACKGROUND NOTE MALAYSIA (Jan. 28, 2010), http://www.state.gov/r/pa/ei /bgn/2777.htm.

secular common law system,[71] and a secular Western-based economy.[72] Yet, the Malaysian insurance market is able to accommodate both conventional and *takaful* insurance within the regulatory framework of the country. Additionally, Malaysia was the first country to adopt legislation specifically geared towards *takaful* operations.[73] As a leading innovator in Islamic financial products, Malaysia has the largest *takaful* market, totaling just under one billion dollars.[74]

While there is a rigid separation between church and state in the United Sates, Malaysia actively legislates on religious matters. In fact, Islamic insurance was introduced in Malaysia after a federal body declared conventional insurance to be contrary to Islamic law.[75] *Takaful* insurance practice grew out of a piece of legislation known as the Takaful Act of 1984.[76] The Act covers a wide range of topics including, requirements for carrying out a *takaful* operation, registration, establishing advisory boards, insolvency, and capital requirements. The Act directly addresses the Islamic nature of *takaful* and imposes a requirement of Shariah compliance. Section 8(5)(a) states: "The Director General shall also refuse to register an applicant unless . . . the aims and operations of the *takaful* business . . . will not involve any element which is not approved by the S[h]ariah."[77] In order to ensure compliance, there are provisions within the act that govern the establishment of a Shariah advisory board for *takaful* operators. Furthermore, section 53 provides that *takaful* operators "may seek the advice of the

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[71] *See* Haemala Thanasegaran, *Growth of Islamic Insurance* (Takaful) *in Malaysia: A Model for the Region?*, 2008 SING. J. LEGAL STUD. 143, 143 (2008) (defining Malaysia as a "secular common law system"). *But see Malaysian Opposition MP Wants Constitution Amended to Enhance Islam's Position,* BBC WORLDWIDE MONITORING, Oct. 22, 2009 ("Islam is the religion for the Federation including in terms of the law and [S][h]ariah."). Whether Malaysia is secular or not is debatable.

[72] *See* Nik Ramlah Mahmood, *Takaful: The Islamic System of Mutual Insurance—The Malaysian Experience*, 6 ARAB L.Q. 280, 281 (1991) (describing Malaysia's secular economic rules).

[73] *See generally* BILLAH, *supra* note 34, at 303 (discussing the state of *takaful* in Malaysia).

[74] *See* ERNST & YOUNG, *supra* note 65, at 15 (indicating that Malaysia has the largest *takaful* market in Southeast Asia with $0.8 billion in contributions).

[75] *See* BILLAH, *supra* note 34, at 286 (describing the manner in which *takaful* was adopted under Malaysian law).

[76] *See id.* (describing the origins of the Takaful Act).

[77] Malaysia Takaful Act 1984, s.8(5)(a).

S[h]ariah advisory council," which was established under the Central Bank of Malaysia Act in 1958.[78] While established by law in Malaysia, such federal bodies would likely be unconstitutional in the United States.[79] In addition to seeking advice from the advisory council, the approval of new *takaful* operators also comes from the Central Bank.[80] Although the Central Bank is responsible for administering both *takaful* and conventional insurance, the operation of both industries is mutually exclusive. Section 67(2) of the Takaful Act also states that the Insurance Act of 1963, which governs the conventional insurance operations in Malaysia, is not applicable to *takaful* companies.[81] However, *takaful* remains within the purview of civil law jurisdiction. Disputes over *takaful* are handled by the Malaysian civil courts and legislation falls under the responsibility of the Federal government, even though Shariah courts and, to some extent Shariah law, exists within the country.[82] One shortcoming with the Takaful Act is that it does not explain what it means to be compliant with Shariah. There is also no definition or explanation for what Shariah is, or how it should be enforced. It simply advises *takaful* operators to "seek advice" but does not make this advice binding.[83] Thus, Shariah boards operate with discretion to interpret and apply law.[84]

While every element of *takaful*, as practiced, is not apparent from the text of the legislation, the Takaful Act largely governs

[78] *Id.* at s.53(a).

[79] *See* Commack Self-Service Kosher Meats, Inc. v. Weiss, 294 F.3d 415, 431 (2d Cir. 2002) (holding that the Kosher Fraud laws established by the state were in violation of the Establishment Clause). Under the New York State Kosher Fraud Laws, an advisory board determined whether certain foods were indeed kosher. *Id.* at 418. These laws were challenged as being a violation of the First Amendment. *Id.* This point is discussed further in section 1.2. below.

[80] *See* Thanasegaran, *supra* note 71, at 146 (detailing the role of the Central Bank in setting *takaful* practices).

[81] *See* Malaysia Takaful Act 1984, s.67(2) (excluding *takaful* companies from the provisions of the Insurance Act of 1963).

[82] *See* Thanasegaran, *supra* note 71, at 147–48 (describing the Malaysian regulatory system with regards to Islamic insurance adjudication).

[83] *See* Malaysia Takaful Act 1984, s.53(a) (providing operators with the discretion to seek advice on achieving Shariah compliance).

[84] *See* Wafik Grais & Matteo Pellegrini, *Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services* 2 (World Bank Policy Research, Working Paper No. 4054, Nov. 2006) (discussing emerging corporate governance arrangements that comply with Sharia). Standards and regulations regarding Shariah implementation and application are emerging in Malaysia and elsewhere.

contractual obligations arising under *takaful* arrangements. Furthermore, life insurance, or family *takaful* as it is called under the Act, and general *takaful* are treated separately. While some of the following points are applicable to both family and general insurance, the particulars of the *takaful* contract refer only to general *takaful*, which is offered for motor vehicle, fire, theft, and accident protection. The following are requirements *takaful* arrangements must meet under the Act.

First, the Act codifies the requirement of utmost good faith through a strict duty to disclose, imposed on both participants and operators.[85] While this element is detailed in the Act, the origins of the requirement can be found in the common law rules that govern in Malaysia.[86] Failure to disclose, as defined under the Act, can lead to a fine and/or imprisonment. Second, Malaysian *takaful* is based on the model of the *mudharabah* contract scheme.[87] Both parties in the insurance contract share in the profit and risk involved in the contract. Under the *mudharabah* scheme, the participants in the *takaful* operation are entitled to a return on the premium or contribution as determined by the contract. While the contribution paid by the participant is considered charity to fulfill the Islamic law rules, *takaful* operators often provide bonuses if no claim has been filed under the policy. This bonus is either paid upon renewal of the policy for five years, or as a bonus upon the maturity period of each policy.[88] Third, in practice, regulations for capital adequacy are relaxed.[89]

Furthermore, Islamically speaking, the *takaful* operators do not bear underwriting risk in the conventional sense of the term. This is because the operators' fund is obligated to provide a loan in case of insolvency. Under current regulations, there is a minimum capital requirement; however, this will change as Malaysia recently passed a comprehensive plan to phase in a risk-based capital

[85] *See* Malaysia Takaful Act 1984, §11(1)(l)(K) (authorizing cancellation of registration of an operator who furnished misleading information or omitted material facts in its registration application).

[86] *See id.* §28 (discussing the requirement of Good Faith); Thanasegaran, *supra* note 71, at 151–52 (noting the common law origins of certain duties in Malaysian law).

[87] *See* BILLAH, *supra* note 34, at 287 (explaining the type of *takaful* practiced in Malaysia).

[88] *See id.* at 289 (discussing the benefits provided by the *takaful* operator).

[89] *See* TAKAFUL ISLAMIC INSURANCE, *supra* note 57, at 221 (discussing regulation of shareholder funds investment in *takaful* companies).

("RBC") framework.[90] While conventional insurers have been required to comply with this regulation since early 2009, *takaful* insurers have been given additional time to adopt this system. This framework may pose a challenge to *takaful* insurers. As mentioned previously, under *takaful* arrangements, there is a division between policyholder and shareholder funds. Furthermore, in case of a deficit, the shareholder fund is to provide a loan to the policyholder fund to meet its claims obligations. The RBC framework may undervalue the hedging of the risk, as currently practiced.[91]

The Takaful Act, through various measures, incentivizes the development of *takaful*. The specific incentives provided to *takaful* operators in the Takaful Act make Islamic insurance an economically attractive financial product for insurance companies to offer. However, creating similar legislation in the United States would contravene the Establishment Clause.[92] On a macro level, Malaysia has introduced a few key regulations in order to encourage the growth of the *takaful* industry. Incentives are necessary to enable *takaful* operators to competitively price their products when compared to conventional insurers that operate side-by-side. The first incentive offered for *takaful* operators is tax incentives and neutrality.[93] Section 2(8) of the Income Tax Act of 1967 allows Shariah compliant institutions, including *takaful* operators, to apply for tax neutrality or incentives. Any financing scheme necessary to ensure Shariah compliance would be eligible under this section to apply for tax neutrality. In essence, this offers *takaful* companies a level playing field with their conventional counterparts. The second incentive Malaysia offers is aimed at

[90] *See generally* Yahya Adnan Ahmad, *Actuarial Society of Malaysia Presentation: Applying Risk Based Capital Framework to Takaful Products*, ACTUARIAL SOC'Y OF MALAYSIA (Feb. 12, 2009), http://www.actuaries.org.my/backup/includes/attachment.asp?attachment=1&id=399 (outlining the risk-based capital framework in Malaysia).

[91] *See id.* at 25 (discussing how reserving strains operate).

[92] *See* Lemon v. Kurtzman, 403 U.S. 602, 614 (1971) (noting that the objective of the Establishment Clause "is to prevent, as far as possible, the intrusion of either [church or state] into the precincts of the other"). Under U.S. Constitutional jurisprudence there is a separation of church and state, which prohibits the state from giving preference (or penalizing) any one religion over another.

[93] *See* Jennifer Chang, *Positioning Malaysia as an Islamic Financial Center*, MALAYSIAN ISLAMIC FINANCE (2006) http://www.malaysianislamicfinance.com/monthly/mifsupplement/article5.html (last visited Apr. 14, 2011) (discussing tax incentives offered to foreign businesses in Malaysia).

encouraging foreign corporations to offer Islamic products. The country has opened up *takaful* licenses for businesses transacting in foreign currency and also established a ten-year tax exemption for any company registered under the Takaful Act of 1984 on income derived from transactions carried out in foreign currencies.[94] These provisions would likely run afoul of the First Amendment in the United States.[95]

Malaysia has been a forerunner on the Islamic finance front and it continues to offer innovative products and solutions to encourage expansion and investment in the field. By introducing the Takaful Act of 1984, Malaysia codified the acceptability of *takaful* as an alternative to conventional insurance. While ensuring that *takaful* operations would be Shariah compliant, it also created a regulatory scheme that would work in its secular economic context.[96] Furthermore, Malaysia complemented this innovative Islamic financial product with regulations that make *takaful* an attractive option for foreign and local investment. Malaysia paved the way for introducing *takaful* into the mainstream. The United States, on the other hand, has just begun its exploration of the viability of *takaful,* as detailed below. However, the Malaysian experience may provide U.S. *takaful* operators with a useful example.

4.2. United States

The United States provides an interesting case study because of the potential for First Amendment conflicts with regards to Islamic financial regulations. While conventional Islamic finance has found a niche within the United States regulatory framework, it is unclear where *takaful* stands.[97]

Takaful insurance is just emerging as a viable alternative to traditional insurance in the United States.[98] It is offered as a service

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[94] *See id.* (explaining the provisions made for foreign companies in Malaysia aimed at growing the *takaful* insurance market via foreign corporations).

[95] *See generally* Lemon, 403 U.S. at 614–15 (outlining legislation and Entanglement Clause issues under the First Amendment). This point will be discussed further in the section below.

[96] *See* Thanasegaran, *supra* note 71, at 154–55 (explaining the Takaful Act of 1984 and its history).

[97] *See generally* Mahmoud Amin El-Gamal, *Overview of Islamic Finance*, OFF. OF INT'L AFF., OCCASIONAL PAPER NO. 4, 10–12 (2006) (discussing and assessing the state of Islamic finance in the United States).

[98] *See* Chelsea Schilling, *Bailed-out AIG Offers Islamic Insurance to U.S.*,

for Muslims who wish to abide by Shariah principles in their financial dealings. While *takaful* insurance is an innovative Islamic financial product, it is not wholly unfamiliar to the United States. Mutual insurance, as well as insurance pools, can serve as useful comparisons to the *takaful* model because both models provide for a degree of risk pooling by the policyholder. In fact, the structure for *takaful* may have been inspired by the Protection and Indemnity ("P&I") Clubs founded in England, which were used for protecting the shipping industry from loss.[99] These clubs were a form of mutual insurance where the members agreed to pool their money and provide funds in case of loss to any one member.[100] Such P&I clubs still exist in the United States in order to provide a source of mutual marine insurance.[101]

Since *takaful* products are a new entry on the U.S. insurance scene, it is unclear how readily they will fit into the regulatory framework. It is also unknown whether there will be enough demand to support their growth. Furthermore, the First Amendment concerns mentioned above complicate the prospects for the viability and growth of Islamic insurance. However, the United States can still look to Malaysia as an example of a Westernized economy that has embraced Islamic insurance.

In contrast to the federal system in Malaysia, the United States has a state-regulated insurance system, though there is some support for an optional federal insurance regulatory framework.[102] Indeed, there is a National Association of Insurance Commissioners that seeks to achieve uniform regulations by voluntary cooperation amongst the states. But this paper will speak on a generalized level about insurance regulations in the

WORLDNETDAILY, (Dec. 5, 2008, 1:00 AM) http://www.wnd.com/index.php?fa=PAGE.view&pageId=82726 (describing AIG's initial *takaful* offering in the United States). AIG began offering *takaful* insurance in the United States in 2008.

99 *See* Mahmood, *supra* note 72, at 287 (describing P&I Clubs in England and describing how they differ from *takaful* insurance).

100 *See id.* (explaining the difference between the Protection and Indemnity Clubs and *takaful* as a difference in investment of the collected funds).

101 *See P&I and FD&D Services*, THE AMERICAN CLUB, http://www.american-club.com/go.cfm/p_i_and_fd_d_services (last visited Apr. 14, 2011) (offering P&I service in the United States).

102 *See* TOM BAKER, INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS 651 (2d ed. 2008) (describing the insurance regulatory framework in the United States).

United States in order to explore regulatory alternatives that would support the growth of *takaful* insurance.[103]

Essentially, each state determines its own licensing requirements for insurance companies. In order to obtain a license, a company must demonstrate that it has the experience and management capability to run the company and show that it is financially sound.[104] In addition, companies must fulfill the solvency regulations set by the state.[105] Solvency requirements ensure that companies are able to retain adequate reserves to meet the promises they have made. Capital requirements, financial reporting, and accounting requirements determine solvency.[106] There may also be limits on the types and concentration of investments made with held reserves. Finally, insurance companies are required to justify their premium rates.[107] Some states may set insurance rates at a premium that values insurance as a social tool—a goal also underlying *takaful* models of insurance. In these states, premiums are determined by calculating the underlying costs of providing the insurance and the rate of return on capital needed by investors.[108]

There are also a number of substantive insurance regulations, including insurance guaranty funds, residual market mechanisms, and insurance risk classifications. Insurance guaranty funds became widespread in the 1960's as a tool to assure solvency of an insurance company.[109] It is an emergency measure that requires any surviving insurers to provide funds to cover an insolvent insurer's claims in case of failure. States adopted these measures to boost consumer confidence. A second regulation that states have enacted is a residual market mechanism, which ensures high-risk customers will have access to insurance.[110] This is accomplished by setting a ceiling on the rates these customers can be charged. A final common substantive insurance regulation is insurance risk

[103] *See id.* at 638 (discussing licensing requirements and regulation of solvency in the United States).

[104] *See id.* at 638–39 (stating U.S. licensing requirements).

[105] *See id.* (describing the need for solvency regulation by the state).

[106] *See id.* at 639 (listing the factors that determine solvency in the U.S.).

[107] *See id.* (discussing rate regulations in the U.S.).

[108] *Id.*

[109] *See id.* at 683 (chronicling the history of insurance guaranty funds in the U.S.).

[110] *See id.* at 693–703 (discussing how residual market mechanisms operate in the U.S.).

classification.[111] This is a process by which insurance companies apply judgments about the future claiming behavior of a group to the individuals who are classed within the group. The potential for this tool to lead to a race to exclude higher risk individuals from the pool is high; a company will lower its pricing to the remaining members, which simultaneously increases the potential for greater profit. As higher risk individuals turn to other companies for insurance, those companies raise their risk profile and become less competitive on the market.[112]

While many of the above-stated regulations will not negatively impact *takaful* providers, there are a few regulations that may pose a problem for *takaful* insurers trying to establish business in the United States. In terms of licensing, *takaful* companies may have problems demonstrating their financial soundness as compared to conventional insurance companies.[113] Since the members in a *takaful* arrangement agree to insure one another and share in risk and profits, there may be some obstacles in establishing the company as a financially sound insurance provider; the financial soundness would depend on the number of participants, as well as the risk and profit sharing structure agreed upon by participants and management. The United States would likely be constitutionally precluded from passing regulations that would relax financial soundness standards only for *takaful* companies.[114] Second, in terms of solvency, capital requirements in the United States may not take account of the separation between policyholder and shareholder funds. Under *takaful*, in case of potential insolvency, the shareholders fund must provide an emergency loan to meet the existing claim obligations. Yet, it is unclear whether solvency requirements will take into account the back-up sources

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111 *See id.* at 705–08 (defining how insurance risk classification operates in the U.S.).

112 *See generally id.* at 637–708 (discussing insurance regulation in the United States).

113 *See* ERNST & YOUNG, *supra* note 65, at 36 (describing the increase in competition as a result of licenses being awarded to locally-backed entities and *takaful* windows of large conventional incumbents).

114 *See* Lemon, 403 U.S. at 612–13 (explaining the separation between church and state under the First Amendment). Services, such as providing kosher food for servicemen, are generally constitutional; but legislation carving out an exception for companies offering Shariah compliant financing will probably run afoul of the Establishment Clause, since it would not be religiously neutral. *See also* Sch. Dist. of Abington Twp. v. Schempp, 374 U.S. 203, 226 (1963) (stating that the state is neutral when it comes to "the relationship between man and religion").

of funding, which resemble insurance guaranty funds, in that they ensure claims will be paid. It is also uncertain how competitive a *takaful* insurer will be in comparison to a conventional insurance company.

While the theoretical underpinnings for *takaful* insurance take the form of communal responsibility, the United States insurance industry is underpinned by opportunism.[115] The conventional insurance contract gives the insurance company two profit-making advantages. First, the insurance company has all the power at the point of claim and can take advantage of the insured. Second, it has the information at the point of sale, which allows it to price its products at the highest value point. *Takaful* as an Islamic product would be unable to utilize either of these advantages to remain Shariah compliant, as the main goal is not to turn a profit but to offer a community service. However, if *takaful* is envisioned as a tool needed by a few who are willing to pay extra, then competitive pricing is less important. The higher premium may also be tempered by the fact that policyholders have the opportunity to make a profit on their investment. From a more general perspective, *takaful* insurance can be compared to mutual insurance or insurance pools organized by certain industries. Therefore, the technical aspects may find analogues in conventional insurance that would assist in developing guidelines that govern *takaful* options. However, this also poses a challenge for Islamic insurers—namely a potential constitutional conflict.

An advisory board often handles oversight of companies that offer *takaful* insurance in Muslim countries, including Malaysia.[116] While these boards are statutorily authorized in Malaysia, setting up a state or federal regulatory board would contravene the separation of church and state.[117] The purpose of having such boards in the United States would be the same as it is in Malaysia. They would be able to provide consumers reassurance that the

[115] *See* BAKER, *supra* note 102, at 642 (discussing the phenomenon of opportunism in the insurance industry).

[116] *See* Thanasegaran, *supra* note 71, at 148 (discussing regulation of *takaful* in the Muslim world).

[117] As mentioned above, regulatory boards judging whether or not something fits the parameters of a religious requirement will not likely pass muster under the Establishment Clause. *See* Commack Self-Service Kosher Meats, Inc. v. Weiss, 294 F.3d 415, 431 (holding that a state board charged with overseeing kosher standards under New York Kosher Fraud laws was in violation of the Establishment Clause).

product being offered is truly Shariah compliant. Another justification for a Shariah board would be that it would be able to work with regulators to explain the function and structure of the *takaful* contracts so solvency or capital adequacy requirements can be tailored to meet the needs of *takaful* companies. However, as mentioned previously, setting up a separate regulatory structure for *takaful* would be problematic under the First Amendment.[118]

Under First Amendment jurisprudence, the government cannot draft legislation that gives preferential treatment to any one religion.[119] Granting *takaful* companies certain allowances to put them on equal footing with traditional insurance companies may be subject to constitutional challenges; *takaful* would be classified as a religious service because it is considered Shariah compliant.[120] One way to work around this obstacle would be to draft neutral legislation that would redefine solvency requirements, taking into account that certain insurance companies may choose to structure the division between shareholder and policyholder funds differently.

Islamic insurance has already entered the United States insurance market without any substantive changes to insurance regulations. In late 2008, AIG introduced the Takaful Homeowners Policy as a first step in bringing *takaful* to the United States.[121] AIG plans to expand their offerings to include car and life insurance. However, legal challenges to AIG's *takaful* product may prevent further expansion. A fundamental misunderstanding of what Shariah is and how it is applied further complicates the expansion

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[118] *See supra* note 114 and accompanying text (explaining that carving out regulations only for *takaful* may violate the first amendment Establishment Cause); *see also* U.S. CONST. amend. I (declaring "[c]ongress shall make no law respecting an establishment of religion").

[119] *See* Sch. Dist. of Abington Twp. v. Schempp, 374 U.S. 203, 226 ("We have come to recognize through bitter experience that it is not within the power of government to invade that citadel, whether its purpose or effect be to aid or oppose, to advance or retard.").

[120] This is the argument made by petitioners in Murray v. Geithner. *See* Complaint at ¶ 2, Murray v. Geithner, No. 08-15147 (E.D. Mich. Dec. 15, 2008) ("This governmental policy and practice conveys a message of endorsement and promotion of Shariah-based Islam and its religious beliefs and an accompanying message of disfavor of and hostility toward Christianity and Judaism . . . in violation of the Establishment Clause.").

[121] *See AIG Offers First Takaful Homeowners Insurance Product for U.S.*, INSURANCE JOURNAL, December 2, 2008, http://www.insurancejournal.com/news/national/2008/12/02/95930.htm (noting AIG's entrance into the *takaful* market in the United States).

of *takaful*. As an example, Congressman Tancredo (R-CO) had put forth legislation that would make it illegal to advocate Shariah law.[122] While, the legislation fails to define Shariah law and was improperly titled as the "Jihad Prevention Act," if it had passed into law, it could have had significant implications for any company determined to establish Islamic financial institutions in the United States. Such legislation demonstrates the general mistrust surrounding Shariah compliant instruments and demonstrates the undercurrent of tension that exists in the United States with respect to Shariah generally. As previously mentioned, under the current framework, a Shariah board operating on a state or federal level would receive intense criticism even if it were not, legally barred.

In any case, *takaful* companies should be aware of the challenge raised against AIG under the Establishment clause. While this should not normally have any effect on a company that is privately owned, the current economic crisis has led the government to be more heavily involved in financial institutions like AIG. There has been a legal challenge to AIG's *takaful* product under the Establishment Clause because *takaful* is explicitly described as a Shariah compliant product. While AIG is a unique situation that may make such a claim ripe, there is always the possibility that companies considering *takaful* or any other Islamic financial products would be wary of offering such products in the United States because of fear over litigation.

The First Amendment's Establishment Clause provides that "Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof. . . ."[123] This provision has been construed as a bar against statutes that may "advanc[e] or inhibit[] religion."[124] Establishment Clause challenges are analyzed under a three-part test: "first, the [] statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion; finally, the statute must not foster 'an excessive government entanglement with religion.'"[125]

The challenge to AIG's *takaful* offering was not directed at AIG, but instead it was a suit against the federal government. *Murray v.*

122 Jihad Prevention Act, H.R. 6975, 110th Cong. (2008).

123 U.S. CONST. amend. I.

124 Zelman v. Simmons-Harris, 536 U.S. 639, 648–49.

125 Lemon, 403 U.S. at 612–13 (citation omitted).

Geithner, in effect, challenged AIG's *takaful*-based products as a violation of the Establishment Clause.[126] AIG was given bailout money by the government under the Emergency Economic Stabilization Act of 2008 (EESA).[127] While on its face, the act does not violate the Establishment Clause since it gives the Treasury the ability to purchase troubled assets from any institution, EESA was used to purchase $40 billion worth of AIG shares.[128] AIG is considered the market leader in Shariah compliant financing; therefore, tax dollars would indirectly be going towards the financing of Shariah-based products. The suit specifically mentioned AIG's *takaful* operations, including AIG-Takaful-Enaya in Bahrain and the Takaful Homeowners Policy.[129] If, on appeal, the court finds that the funds appropriated under EESA are being used to fund, and thereby advance, Shariah-based religious activities, then the funds advanced to AIG may contravene the Establishment Clause.[130] At the motion to dismiss stage of the case, the United States' majority interest in AIG was an important part of the analysis. The fact that Shariah products, including *takaful*, were only a minor part of AIG's business was dispositive, on summary judgment, in determining whether the funds granted to AIG would be in violation of the First Amendment.[131] Hence,

[126] *See* Murray v. Geithner, 624 F. Supp. 2d 667 (denying a motion to dismiss allegations that the federal government's control over a company which utilized Sharia-compliant financing violated the Establishment Clause). While summary judgment in this case was recently granted in favor of defendants, the case will likely be appealed. *See* Murray v. Geithner, 2011 U.S. Dist. LEXIS 3788 (E.D. Mich. Jan. 14, 2011) (granting defendant's motion for summary judgment).

[127] *See generally* Murray v. Paulson, Complaint ¶¶ 20–22 Murray v. Geithner, No. 08-15147 (E.D. Mich. Dec. 15, 2008) (claiming that congress authorized $40 Billion taxpayer dollars to AIG under EESA).

[128] *See* Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5211 (2008) (allowing for the use of tax dollars to purchase troubled assets).

[129] *See* Murray, 624 F. Supp. 2d at 670 (detailing AIG's *takaful* operations); *see* Murray, 2011 U.S. Dist. LEXIS 3788, at *3 (explaining in its summary judgment opinion that government funds were not provided to AIG to promote Shariah, but rather to prevent the company from failing).

[130] *See* Murray, 2011 U.S. Dist. LEXIS 3788, at *32–33 ("Courts have found excessive entanglement where government-aid programs require the government to make inspections or evaluations of the religious content of a religious organization, delegate government power to a religious body, or closely monitor contact between secular and religious bodies."). However, it is unlikely that an appeals court will find in favor of Murray on this point, because the simple provision of funds without more is generally not enough to create excessive entanglement in contravention of the First Amendment.

[131] *See id.* at 25 ("Plaintiff has not even presented evidence showing that a

while *Murray v. Geithner* survived the motion to dismiss, it did not survive as a matter of law at summary judgment.[132] It remains to be seen how the appeals court will rule; although, it is unlikely that any court will find in favor of the plaintiffs in this case because they were unable to meet the burden of showing excessive entanglement between the government and AIG's Islamic products. An adverse outcome in this case may impact the ability and willingness of financial institutions to serve the Islamic market in several ways. First, it would serve as an obstacle to meeting the needs of the Islamic market, since it is necessary for financial institutions to be able to access federal funds to survive a financial crisis. Second, it may pose compliance issues that warrant more relaxed regulatory standards to facilitate Shariah compliant insurance and other financial instruments. Finally, risk-averse corporations may seek to avoid similar litigation and decline to offer *takaful* and other Islamic financial products.

However, there are a number of ways that companies can frame *takaful* in order to avoid the pitfalls of litigation and challenge the assertions made in *Murray v. Geithner*. One potential method would be to frame Islamic insurance as a service that is needed for practicing Muslims. A useful comparison would be the provision of kosher or halal (food that fits the Jewish or Muslim dietary requirements respectively) meals in the armed forces or in public school cafeterias.[133] These provisions are largely seen as services to religious groups that do not violate the First Amendment. However, setting up or evaluating standards that govern such food would be problematic under the decision in *Commack*.[134] Thus, while it is likely that a U.S. government-

substantial portion of AIG's activities are subsumed with SCF [Shariah Compliant Financing]. Instead, the evidence reflects that SCF is a *de minimus* aspect of AIG's business, accounting for approximately 0.022% of AIG's consolidated revenue in 2009.").

132 *See id.* (granting summary judgment in favor of the defendants).

133 *See* Amiram Barakat, *The U.S. Army: Kosher for Pesach* , HAARETZ.COM, March 24, 2003, http://www.haaretz.com/hasen/pages/ShArtWar.jhtml?itemNo=276037&contrassID=33&subContrassID=4&sbSubContrassID=0 (lauding the provision of kosher and halal food by the army); *see also Broward County School Board is "Keeping Things Kosher" at Ben Gamla Charter School*, ACLU (Sept. 12, 2007), http://www.aclu.org/religion-belief/broward-county-school-board-keeping-things-kosher-ben-gamla-charter-school (noting that a public charter school serving kosher food would not pose a First Amendment issue, but teaching Judaism would implicate the First Amendment).

134 *See* Commack Self-Service Kosher Meats, Inc., 294 F.3d at 431 (2d Cir.

sponsored Shariah board or direct government consultation of such a board in Bahrain would likely constitute a First Amendment violation, it is unlikely that AIG's *takaful* product itself would violate the First Amendment. AIG and other such corporations, as profit driven companies, should be allowed to create and promote financial products that further their bottom line. Because public institutions are able to offer halal and kosher food as a service to individuals who have a preference for religiously sound meals, Shariah compliant financial products should also be available for purchase by individuals with a preference for such instruments, regardless of whether the corporation receives public funds.

Secondly, whether or not a financial product is Shariah-compliant should not affect the analysis of whether it is a religious product. Unlike the specific appeal of halal or kosher food, *takaful* insurance may be an attractive option for anyone who is interested in socially-sound insurance products. A useful comparison would be of a governmental incentive that indiscriminately applies to both religious and non-religious institutions, such as those with 501(c)(3) status. Section 501(c)(3) of the Internal Revenue Code provides that a charity can benefit from the non-profit status under the law regardless of religious status.[135] Thus, *takaful* can be construed simply as an innovative financial product that is acceptable to anyone, but also fits the parameters of Islamic finance. The fact that it is Shariah compliant does not make it contrary to the religious tenants of any other religion. In fact, the coverage, terms, commissions, and sales of *takaful* homeowners' insurance by AIG are identical to the coverage, terms, commissions, and sales of its traditional homeowners' policy.[136] The differences between the policies lie in how AIG has structured the separation and investment of the funds.[137]

2002) (holding that a state board charged with overseeing Kosher standards under New York Kosher Fraud Law was unconstitutional where it exclusively adopted orthodox Judaism's kosher standard).

[135] *See generally* I.R.C. § 501(c)(3) (2010) (granting organizations that meet particular requirements tax-exempt status).

[136] *See AIG Offers First Takaful Homeowner Insurance Product for U.S., supra* note 121 (describing the coverage of the *takaful* product).

[137] *See id.* (discussing the segregation and investment of funds).

5. CONCLUSION

Malaysia and the United States both have secular governmental structures in place. However, Malaysia affirmatively acknowledges the acceptability of Shariah through its regulatory framework. The Establishment Clause prohibits the Federal Government from advancing any religion. Therefore, any statute that would allow for affirmatively setting up a separate regulatory framework for *takaful* would be invalid on its face. However, a statutorily authorized regulatory framework, while beneficial, is not necessary for establishing a *takaful* product in the United States. AIG was able to begin offering *takaful* products without any changes to the existing regulatory framework. Thus, while the United States will likely be unable to provide tax incentives and Shariah advisory councils to *takaful* operators, *takaful* operators can still work with preexisting regulation to create a viable option for those interested in *takaful* as an alternative to conventional insurance. Additionally, regulations that are neutral on their face but also beneficial to *takaful* operators may not pose a constitutional issue.[138] Instead, such regulation may redefine the boundaries of insurance to include insurance companies that separate policyholder and shareholder funds since this is a financially sound practice.

Finally, the Establishment Clause could be used to challenge any regulations that would inhibit Shariah compliant *takaful* products from being successfully introduced to consumers who believe it is a religious obligation to only use such products. Regulations such as the Jihad Prevention Act single out a religious group as a target of prosecution.[139] This type of regulation would prevent companies like AIG or other private institutions from offering *takaful* insurance or any Islamic financial product simply because it is Shariah compliant.

[138] In the UK, the Financial Services Authority has taken a "level playing field" approach for Islamic financial products. *See* Mushfique Shams Billah, Comment, *Arab Money: Why Isn't the United States Getting Any?*, 32 U. PA. J. INT'L L. 1055 (2011) (pointing out the alternative of using facially neutral language to frame Shariah legislation and thereby avoid the constitutional issue).

[139] *See* Jihad Prevention Act, H.R. 6975, 110th Cong. §§ 2–4 (setting forth the provisions that, "[a]ny alien who fails to attest, in accordance with procedures specified by the Secretary of Homeland Security, that the alien will not advocate installing a Sharia law system in the United States is inadmissible" to the United States and any alien advocating for Sharia law in the United States will have their visas or naturalization status revoked).

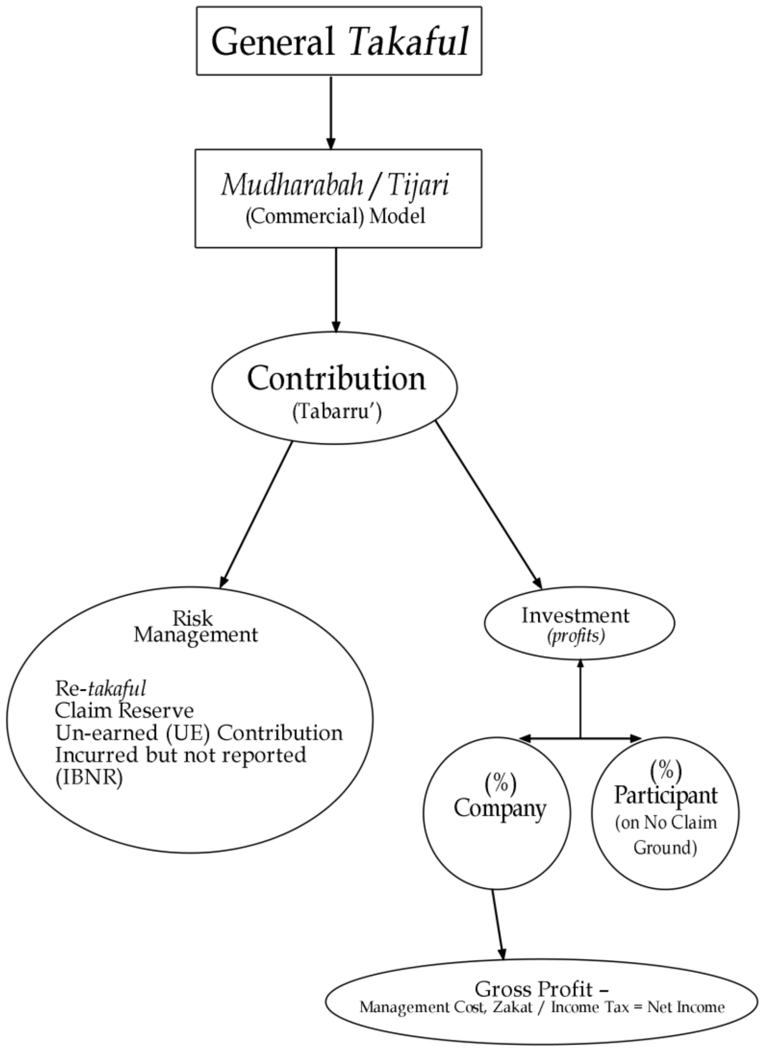
Takaful is a financially sound alternative to conventional insurance. This is evidenced by the fact it is currently offered across the Middle East, Malaysia, the United Kingdom, and even in the United States. *Takaful* serves as a socially responsible model of risk management and, thus, should appeal to anyone who prefers this approach to the conventional opportunistic model that currently dominates the global insurance market. Islamic insurance is not only an innovative approach to conventional insurance but it is also an innovative approach to Islamic finance. Its success can guarantee an exploration of new models of financing that borrow their ideals and principles from ethical and religious paradigms. As a result of the sound investment principles of *takaful*—not partaking in interest, for example—it is expected to grow to a $10 billion industry, despite the economic downturn.[140]

As the market for Islamic finance evolves, the insurance industry will benefit from developing clearer rules and tighter regulations for Shariah compliant products. It will be interesting to see the development of *takaful* in the United States because it will provide insight into which *takaful* models are the most profitable and which ones are seamlessly compatible within the preexisting insurance structure. These lessons will ultimately lead to increased profits for financial services companies, because, currently, only 5% of the world's Muslim population utilizes insurance. As *takaful* models are developed and proven in the market, the firms offering those products will be best positioned to service the Muslim population—which amounts to one quarter of the world's population—making *takaful* not only a much-needed service but also one with great potential for growth.[141]

140 *See AIG Offers First Takaful Homeowners Insurance Product for U.S.*, *supra* note 121 (reporting estimates from Ernst & Young's *2008 World Takaful Report*, estimating the global *takaful* market to be at $5.7 billion in 2006 with projections estimated to be in excess of $10 billion by 2010).

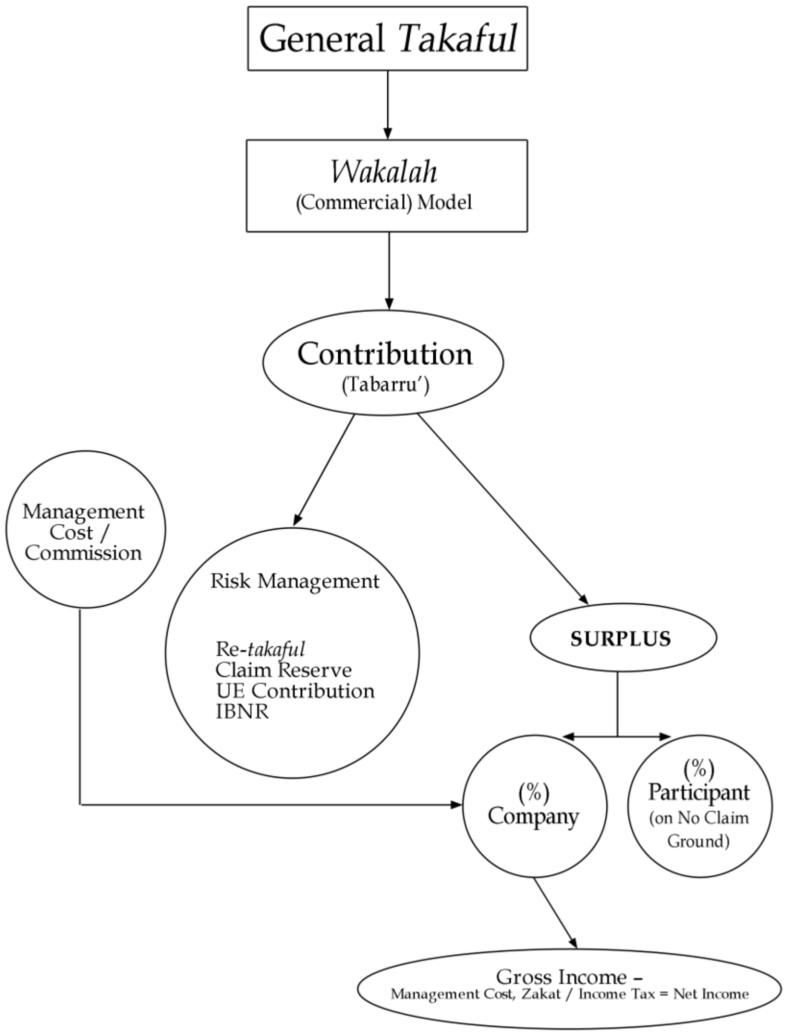
141 *See id.* (stating that Muslim countries account for twenty-five percent of the world population).

FIGURE 1: MUDHARABAH ARRANGEMENT[142]



142 Billah, *supra* note 34, at 20.

FIGURE 2: WAKALAH ARRANGEMENT[143]



143 *See id.* at 22.