# Proposals Of Insurance Model To Interest Free Banking

Melahat Karadağ[a], Hamide Selçuk[a]

[a] Faculty of Economics and Administrative Sciences
Business Administration Department
KTO Karatay University, Konya, Türkiye
melahat.karadag@karatay.edu.tr

**Abstract**

Since the ancient times, humankind has always been faced with hazardous situations, struggled to survive and experienced loss of lives, property and valuables at the end of these combats. Societies have been applied several measures to minimize these losses and damages that they experience along with their lives. Indeed, because it is usually not possible to compensate the economic losses by the people incurred these damages, the insurance mechanism has arisen, which constitutes a precaution mechanism against adverse circumstances that could be faced in the future and this material burden has been shared among individuals by distributing it to extensive masses of people in the expense of a small premium to compensate their losses. In our contemporary era, the insurance sector has economic benefit more than its social dimension; and one of the reasons which prevent its expansion in a country with Muslim majority such as Turkey is the religious preferences and social life style of the people. From this point of view, the present study aims to investigate how insurance process in the interest-free banking can be applied in terms of practical and theoretical ways.

Keywords: banking; interest free banking; insurance; takaful

## 1. Introduction

Societies have faced risks constantly along their lives since the old ages and used various methods that could simply be called insurance in order to protect themselves from those risks. Risk is the possibility of happening of an undesired occurrence in the future. Insurance, on the other hand, is a social institution organized with the purpose of minimizing the risks that individuals and entrepreneurships face and which they would have hardship in covering on their own and eliminating damages by spreading and sharing them when they occur.

From a financial point of view insurance brings unexpected damages together in a pool and exchanges the expected cost of damages into insurance cost. In this way, the cost of damages and the risk that occurs are shared among all members of the pool.

The importance of insurance business in developed countries has increased because of its functions such as preventing socioeconomic losses, providing capital accumulation and loan opportunities, increasing social welfare and tax incomes, and contributing into employment. Funds created in insurance sector are used in state bonds and real estate fields. The reasons for investments in state bonds can be mentioned as safety, high liquidity opportunities, tax advantages and availability to be used as assurance. The reasons for them to be used in real estates despite the low productivity can be outlined as value increase that might occur in real estate prices and those increases can be added to the capital and they can be used as assurance easily.

When it is examined in relation with beliefs, insurance business that holds great economic benefits as well as social ones has not shown the necessary development in Muslim countries such as Turkey. The ban on interest, undeserved gain and gamble because they are seen as unfair earnings, and because the insurance was not explained well enough by religious authorities and the failing in construction of the institutional structure affected people negatively and caused them to look at insurance processes negatively. Intensive work in developing non-interest insurance philosophy and applications are in progress in Islamic countries in recent years (Khorsid, 2005, p. 30).

This study aims to theoretically examine the insurance transactions in non-interest banks that run non-interest finance transactions and to bring in 3 model suggestions for non-interest banks. The study has three parts. The first part will deal with insurance business while the second part will be about non-interest banking. The third part will cover non-interest insurance, non-interest insurance types, insurance work by non-interest banks and how this service is provided.

In the conclusion and evaluation section, information obtained in this study will be evaluated and results reached and suggestions will be put forth.

## 1. Concept of Insurance

Insurance, a word of Latin origin, and it means a mechanism of taking precautions at present time against negations that might occur in the future and covering the damages of victims from a joint pool. Insurance business consists of the philosophy of protection from a risk. As a single person or institution does not have the power of eliminating the risks that might occur and covering the cost without sharing the risk with others will bring a heavy burden. The philosophy of helping each other can be accepted as the main reason of the birth of insurance business.

Insurance establishment is the best defense vehicle against the incidents that are possible to occur. Insurance business, which was born out of the need of assistance, solidarity and assurance against unexpected events that individuals or institutions might face, has become a part of industrial, commercial and social lives. Insurance business is an indication of economic and social development in developed countries (Tayfun, 1997, p. 14). Insurance, which is described as an arrangement that redistributing the unexpected losses financially collects possible losses in a pool that holds great risks and converts possible losses into insurance cost (compensation) (Dorfman, 1994, p. 2). In this way, the cost of having a risk for individuals and institutions reduces with the shared risk, thanks to the financial system provided with payments of insurance premiums. In addition, collected premiums form big economic funds (Obaidullah, 2005, p. 120).

The economic functions that insurance provides in terms of risk management can be sorted as follows:

- The insured can leave the conservative production policies that reserve a fund with insurance for risks and use modern risk management applications and use the capital tied in those funds.
- It provides a suitable loan opportunity to the entrepreneur who has his possessions insured and transfers the benefits to the insurance company as mortgage.
- It makes possible to take braver steps for the entrepreneur by sharing the partial risks they take (Ergenekon, 1995, pp. 2-3).
- Insurance, by lifting the limitations on investments by taking risks under insurance and makes the capital tied to funds and opens the way for broader investments.
- Insurance companies pay their share of taxes while handling the insurance works and carrying out economic actions. With this aspect, insurance is a great source of tax for the state budget (Güvel, 2004, p. 29).
- By lifting the blocks in front of international trade with types of insurances such as exports loan insurance and transportation insurance, it makes foreign trade volume expand (Atalay, 2004, p. 23).

Insurance, which is the second biggest source of funds, makes institutional savings while forming great funds in economy. In general, insurance;

- Transfers the risks, ,
- Eliminates the effect of damages and losses,
- Forms funds (Sayılgan, 2004, p. 143),
- Compensates damages,
- Eliminates fears and worries regarding the future,
- Provides loans (Rejda, 2002, p. 27),
- Contributes into the balance of payments (Ünal, 1994, p. 40).

## 2. Non-interest banking system

When the history of non-interest banking is examined that is based on sharing profits and losses, it is seen that the need for non-interest banking emerged with industrialization movements in Islamic countries in the 20th century and the sudden increase of oil prices in 1970s. Individuals' savings were evaluated on a base of profit-loss partnership but with the industrialization, a non-interest bank was needed to bring together those individuals' savings to fund great investment projects.

Since Islam does not permit earning without working, it has a clear attitude against the interest. According to Islam, interest, which makes wealth to be owned by certain circles, eliminates the principle of justice and living in a society with brotherly feelings, as well as the principle of having equal risks.

Interest literally means increase, excess, plus value, multiply, addition and growing. Islam divides interest into two: Interest of debt (nesia) and interest of excess (fadl). Debt interest means that the amount payable at the end of the term is more than the debt. Excess interest is the interest occurs during the buying and selling of property or money.

Islam brought in the mechanism of "profit partnership" instead of interest, which is a gain that is not worked for and based on capital and made the profit, related to production of capital owners` halal. That's why profit and loss partnership emerged as an alternative to interest in Islam.

Non-interest banking model has two goals: Final goal and short-term goal. The final goal is eliminating the exploitation, unfairness, cruelty and imbalance caused by interest by singling it out and presenting an alternative that the interest does not rule, that operates all banking transactions and funds the economy. Its short-term goal is assisting the country development, making it powerful economically, eliminating a series of problems caused by economic backwardness, helping economic units needing funds, attracting the savings of Muslims who are in fear of Allah into economy in a halal way, using them in investments and bringing the country economy to a level that can compete with non-Muslim economies (1993, p. 50).

Goals of non-interest banking can be summarized as follows (Akın, 1986, p. 116):

a- Expanding the frames of relations with banking sector by spreading non-interest banking services,

b- Arranging tools in a way to attract savings and funds and making them join halal profit of investments that are suitable to Islamic principles,

c- Providing funds for the needs of various sectors and making those who need them use the funds in certain methods,

d- Making arrangements so that economic and social development and income distribution are made fairly to the whole society and providing other banking services.

When functions such as main expenditures, organization structures and collecting and offering financial resources to finance those who need funds for investments, it will be clear that non-interest banks are organized in a very similar way to the banking model that operates with classic interest. However, there are fundamental differences between non-interest banks and classic banks. The difference between their goals and methods they follow is reflected on the names of accounts open in those banks. For example, "saving collection" methods of interest banks are named as time deposit and current accounts, but non-interest banks' "saving collection" accounts are named as current account and participation account. Private current accounts are accounts where the money is withdrawn partially or fully, the account holder is not paid anything in return and capital payment is guaranteed. Participation accounts are special partnership accounts that produce a result of profit or loss that would occur through the operation of funds and that does not pay any previously decided income to the holder or guarantee the full payment of the capital. On the other hand, fund provision transactions are made with financial supports, profit/loss partnership, financing the holder against goods, etc. Institutional Finance Support is a process in which the cost of all commodities, real estates and services required by the institution (loan client) are paid by the non-interest bank to sellers/providers and in return the institution owes the total amount. In a way, institution's capital is provided. Individual Finance Support is a process in which the cost of individual needs such as cars and buildings bought by the individuals directly from sellers are paid by the non-interest bank to sellers/providers and in return the buyer owes the total amount. Financial Renting is provision of movable or immovable goods within the financial renting laws and marketing for rent by the non-interest bank. Financing the Document Provided in return of Goods is a process of providing finances in return of the document of delivery within the Foreign Trade and Foreign Exchange regulations. Investment of Profit/Loss Partnership is the process of providing finances to natural or incorporated persons who need financing to join their profit or losses in all their activities or a certain activity or profit or loss that would occur in buying and selling of a good. A Contract of Profit and Loss Partnership between the customer and non-interest bank is signed. Joining shares in profit and loss and assurances, if there is any, are clearly shown in the contract.

The non-interest bank idea which first emerged in around 1955 and applied in 1960s found a large field of application in the Middle East, Africa and Far East and then spread to Europe and America. Many banks in Europe and America (Citibank, Union Bank of Switzerland, Kleinwort Benson, ANZ Grindlays, Goldman Sachs, United Bank of Kuwait and Arab Banking Corporation) established units that operate in non-interest banking principles. Significant increases are seen in banks' departments that run on non-interest banking rules in Europe and America.

Ideological structure of non-interest banking and insurance are summarized so far. Since the banking system in many countries forms the base of economy and insurance and because they are almost the only source for using the funds collected for insurance, non-interest banking is examined and methods for using the funds are tried to be summarized. In the following section, insurance business in non-interest banking will be taken up and their relation with Islamic banking will be shown when necessary.

## 3. Insurance Business in Non-Interest banking System and Model Suggestion

In Muslim societies since the early years of Islam, the services provided by modern commercial insurance services were provided by compulsory and/or voluntary institutions such as *blood money, zakat, foundations, pension funds, Akhism guild, and guilds*, which could be described as religious social security systems, by often waiting for a return from Allah and therefore, insurance in modern sense was not needed. Historically, it is known that there were regulations in those areas. However, gaps occurred in operating classic institutions as results of developments and changes occurred over the time made those institutions lose their importance. Therefore, individuals and societies looked for different alternatives to protect themselves from risks they might face in life and insurance came out as an institution as an answer to their needs.

Insurance concept has been a matter of argument among the Islamic lawmen in Muslim societies for long years; some scholars argued that insurance was lawful but some others rejected it saying that insurance consists interest, gamble and strangeness.

Today, in non-interest banking system, modern commercial insurance is operated as a transaction of takaful. Takaful means *mutual protection* in Arabic and it consists a financial support to policyholders and their inheritors in case the losses and damages written in the agreement occur.

Takaful; is the definition of modern insurance processes in Islamic economic system. Takaful system covers the needs of individual and joint sectors with the investments it makes. Takaful enterprises that offers individuals a program which plans long term saving and investment goals is divided into two as family takaful enterprise and general takaful enterprise. Family takaful enterprise holds long-term agreements like 10, 15, 20, 40 years and they can be resembled to life insurance processes in modern insurance. General takaful processes on the other hand covers modern insurance's non-life insurance branches like fire, accident, engine and engineering (Billah, 2006, p. 3). .

There is three models in takaful based on concession, partnership and representation. Since the concession model comes across as a model in which the participants do donations or concessions in order to widen their takaful funds, it finds an application space in social or public enterprises or programs with no profit targets. This model is used for aids accumulated from donations participants make voluntarily for people with fewer opportunities in society. In partnership model used by profit organizations, there is a distinction between policyholders and shareholders, and takaful or insurance enterprise. Takaful funds taken under control with a partnership agreement signed with shareholders are directed to investments and a profit from those investments is expected. Policyholders take the role of fund provider or rab'el maal. In partnership, takaful enterprise takes a share from the profit obtained through investments. In representation model, policyholders voluntarily give takaful enterprise the authority to use their funds, together with the fees for representation. In this model too, profits obtained are shared between the takaful shareholders and policyholders with a ratio defined previously (Obaidullah, 2005, pp. 128-134).

Takaful processes need a serious knowledge and experience. But non-interest banks are thought to reach the same success as basically non-interest banks have similar takaful operations like investment and concession. From non-interest banking point of view, three different models have been prepared and points to be pay attention to in those models and responsibilities can be summarized as follows:

1. Providing and increasing participation with a good advertisement. The important point here is that takaful shall not be sold. Invitation to takaful should have participation goal.
2. Takaful should be explained to masses,
3. To develop a suitable management system to operate takaful program fully,
4. Holding registers of participating members correctly,
5. Making investments in line with Islamic rules,
6. Developing new takaful products,
7. Determining members' participation shares fairly with a sense of equality,
8. Paying the takaful gains when the participant asks for it,
9. Determining the amount of concession by participants.

The first model is prepared on the basis of representation. In representation-based processes, what is basic is a person's transfer to another person or group of authority to act on behalf of himself. Non-interest banks can make investments and do takaful processes with the representation they receive from participants.

**Hata! Başvuru kaynağı bulunamadı.**

**Fig. 1.** Model 1

In the first suggested model, non-interest bank provides participation with promotion and ads of takaful. Participant gives representation to manage his savings in investments to non-interest bank voluntarily. Non-interest bank takes 30 % of savings as representation fee. It manages the 70 % by investing it in Islamic rules. Costs regarding the investment and takaful operation costs belong to non-interest bank. The non-interest bank takes 20 % of profit obtained, while the 80 % is transferred to the risk fund. After a deduction of compensation and retakaful costs, the left portion is transferred into the participant's account.

In addition, foundation, donation and other incomes of participants in non-interest bank can create a pool that would benefit the group with fewer opportunities. Participants make donations to this pool from the value left for them. People who have limited financial opportunities and participants whose opportunities became limited can benefit from this pool.

By changing this model slightly, another model as shown below can be created. In this new model, non- interest bank can take a share from the money left over. In this case, the non-interest bank does not take any share from the profit made with investments.

The share non-interest bank will take from the left over from risk fund is 15%. In this model too, operating and investment costs will belong to non-interest bank.

**Hata! Başvuru kaynağı bulunamadı.**

**Fig. 2.** Model 2

Another model can be formed on the basis of partnership. As known, partnership is a kind of risk capital based on labor-capital partnership.

**Hata! Başvuru kaynağı bulunamadı.**

**Fig. 3.** Model 3

In this model, savings are used in investments on behalf of participant and profits are shared between participant and non-interest bank. The only difference of this model from the other model is that the participant does not give representation to the bank but receives shares from non-interest bank's investment profit and from the value left in risk fund.

## Conclusion

As long as the risks exist, it is the religion's responsibility to form institutions to protect those who are exposed to risks. While bringing a solution to this, it is necessary to do valid processes from belief's angle and to protect those who are exposed to risks proportionately with the participation share they pay. The important thing is how this system will be established and how the insurance enterprise will be run. The existence of non-interest banks that will form the basics of the system will also be the base for operating the system. The second important point is regulating the relations between the participants and the institution, among the members of the institution and with the state on religious rules. Then, institutions that will operate with those rules will carry out the functions of fund raising in economy and protection according to individual risks.

It has been thought that three models of takaful processes can be applied in non-interest banks. In the first model studied, participant gives representation to non-interest bank voluntarily for it to run his saving in investments. Non-profit bank takes a pre-decided portion of saving as representation fee and it uses the left portion to make investments suitably. Non-interest bank takes a share of profits from the investments and the rest is transferred to a pool where risk funds are formed. After the deduction of paid compensations and retakaful fees, the rest is transferred to participant's account. Participants make donations to a pool of foundations, donations and other incomes from the value left for them and people who have limited financial opportunities and participants whose opportunities became limited can benefit from this pool.

The second model can be formed by changing the first one slightly. The only difference of this model from the first model is that the non-interest bank can take a share from the funds left in the risk fund and in return it will not take any shares from the profits obtained from investments. In the final model, savings of participants are used in a base of partnership and again profits are shared between the participant and non-interest bank. The only difference of this model from the other two models is that participant does not give representation to the non-interest bank and non-interest bank takes a share both from investment profit and risk fund.

In all three models, savings of participants are used in investments, profits are added to their accounts and to an aid fund so a social security forms on its own for the group with limited opportunities. When looked from this angle, results of these model applications will be as follows:

1. Gives society confidence,
2. Damages of unexpected losses will reduce,
3. Because of new investments, it will give energy to the economy,
4. Increases employment rate,
5. Increases national income,
6. It will attract the savings of those who do not use insurance because of interest applications into the economy,
7. Increases economic welfare,
8. Opens a door of assurance for the group with limited opportunity automatically with aid and donation funds.

## References


Akın, C. (1986). *Faizsiz Bankacılık ve Kalkınma.* Ankara: Kayıhan Yayınları .

Atalay, A. U. (2004). *Avrupa Birliği Perspektifiyle Hizmetlerin Serbest Dolaşımı Kapsamında Türk Sigortacılık Sektörünün Değerlendirilmesi.* Ankara: Avrupa Birliği Genel Sekreterliği Ekonomik ve Mali konular Dairesi.

Billah, M. M. (2006). *Principles of Contract Affectivity Takaful and Insurance – Compared 26.05.2006, s. 3.* Retrieved May 26, 2006, from www.İslâmic-finance.net,.

Dorfman, M. S. (1994). *Introduction to Risk Management and Insurance.* Newyork: Prentice-Hall.

Ergenekon, Ç. (1995). *Sigorta Sektörü.* İstanbul: İstanbul Menkul Kıymetler Borsası.

Güvel, E. A. (2004). *Sigortacılık.* Ankara: Seçkin Yayınev.

İslâm Bankacılığının Hedefleri. (1993). *Yeni Dünya Dergisi* , 50.

Khorsid, A. (2005). *İslâmıc Insurance.* Newyork: Routledge Curzan.

Obaidullah, M. (2005). *İslâmic Financial Services* . Saudi Arabia.

Rejda, G. E. (2002). *Principles of Risk Management and Insurance.* Addison Wesley.

Sayılgan, G. (2004). *Finansal Piyasalar ve Finansman Teknikleri.* Ankara: Turhan Yayınevi.

Tayfun, A. (1997). *Sigortacılık.* Ankara: Tutibay.

Ünal, T. (1994). *Sigorta Sektörünün Ekonomik İşlevi ve Fon Yaratma Kapasitesi.* İstanbul: İstanbul Ticaret Odası.