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Motor *Takāful* in Banks' *Ijārah* based Financing: The Issue of Undercoverage

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Abstract. This narrative study shows how and why a vehicle leased under *ijārah* should be covered at its market value with a *takāful* company, otherwise compensation would only be on partial or proportionate basis if a defined loss occurs. An Islamic bank when gives a vehicle on *ijārah* basis, it takes comprehensive *takāful* coverage for mitigation of the physical aspects of risk like accidental damage, third party loss, theft and snatching. While renewing the coverage on yearly basis, bank covers the vehicle on book value which is always less than their market value. Therefore, when a loss occurs, the *takāful* company provides proportionate compensation which is always far less than actual loss.

KAUJIE Classification: I44
JEL Classification: G22

INTRODUCTION

Background

ABC *Takāful* Company established its branch office in Peshawar in 2008. In those days, there was comparatively less business in the market due to economic recession and prevalence of terrorism related activities in the region. Most of the general insurance and *takāful* companies were competing for survival. ABC *takāful* company hired its team for Peshawar and were tasked to introduce the concept of *takāful* as well as to generate business. The marketing team of the company started approaching individuals as well as corporates having insurable assets and offering them *takāful* services. In financial services, clients are normally reluctant to take services from new companies. Same is the case with *takāful* where clients prefer to pay and get coverage from the big names like State Life insurance, EFU, Adam jee and Jubilee insurance etc. *Takāful* was a new concept and a newly established company was competing for business; therefore, most of the clients were found reluctant to take their coverage.

However, with good contacts in the local business community, Mr. Gul the newly appointed Manager and his team managed to convince some of the clients and they took

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takāful coverage for their factory machinery and vehicles. Moreover, the Manager finalized a corporate deal with a XYZ Islamic bank which agreed to take *takāful* services for all the vehicles they might give on *ijārah* to their clients. It was indeed a big success for a newly established company as the business started pouring and every month, the company, started getting increasing business from the XYZ bank.

Objectives of the Narrative Study

The narrative is aimed to achieve the following objectives:

- Understanding the application of the concepts of depreciation and under coverage in general *takāful* claims
- Understanding the role of surveyor in general *takāful* claims
- Understanding the process flow of claim in motor *takāful* when a partial loss occurs.
- To enable the readers to calculate a claim and explore the consequences of undercoverage in general *takāful*.

Car *Ijārah* Scheme of the Bank

In 2005, XYZ bank gave a vehicle on *ijārah* to one of its corporate clients Mr. Qadir. He was running a Pharmaceutical manufacturing unit and was availing several services of the bank including an annual LC limit of Rs. 100 million for import of machinery and chemical. Moreover, he was also availing *murābaḥah* limit for local purchases and multiple machinery, and vehicles *ijārah*.

Due to absence of *takāful* companies in Pakistan up to 2006, Islamic banks insured the vehicles with any insurance companies. Since 2006, when the *takāful* companies started operations in Pakistan, Islamic banks started taking coverage of their vehicles and other assets from *takāful* companies. After signing an agreement with ABC *takāful* company, XYZ bank started taking coverages from the former for its new as well as old cars. In 2009, when coverage of Mr. Qadir's car expired, as per agreement, the bank sent the case of its renewal to ABC *takāful* company. The bank provided following information to the company:

- Value at which the car is to be covered (Sum Covered) = Rs. 473,850/-
- Make and model = Toyota Corolla Gli, 01.01.2006
- Chassis & engine number: ABC
- Use of car (private)
- Name, CNIC and address of the client i.e. user of the vehicle

After receiving the preliminary information as above, the *takāful* Company performs the inspection function . If the car is an old one, the inspection is mandatory, while in most of the cases when the vehicle is a new one, it issues coverage without inspection. After inspection, the company issues *takāful* coverage and sends it to the bank. The Islamic bank being owner of the car, has to pay annual contribution to *takāful* company.

Depreciation in *Takāful* and Insurance and the Principle of Indemnity

Takāful is based on some fundamental principles which provide a foundation to the whole system. Those principles of insurance which don't violate Sharī'ah are also observed in *takāful*. One of such principle is the "Indemnity" principle which says that *takāful* company pays the claim for bringing the client in the same financial condition as he or she was before the loss to its asset. This principle also tries to prevent a client not to make profit out of an incident, but to make compensation up to the extent of loss. For observing this principle, depreciation is charged in claims of partial loss, and then the remaining actual loss of the client is paid. In rare cases, *takāful* and insurance companies agree with the client for not charging any deprecation. This practice is a bit more common while covering vehicles of the corporate clients. This practice is a violation of one of the basic principles of *takāful* and insurance.

Undercoverage of a Car

In Pakistan, it is the market practice of nearly all the banks that they consider useful life of a vehicle equal to 10 years. Therefore, they depreciate the value of a vehicle by 10% every year in their books. They also take *takāful* coverage of the vehicle on book value which is generally less than the market value, except some special vehicles like sports or some luxury cars. Toyota and Suzuki brands are very popular in Pakistan and with the passage of time, the market value of Toyota and Suzuki vehicles increases, or at least, does not decrease as the book value decreases annually, while the bank takes *takāful* coverage on their book values which is always far less than the market value. When sum covered is less than market value, the vehicle is said to be undercovered with *takāful* company.

In this case, as per market practice, the bank depreciated (reduced) the value of the car by 10% every year. In 2006, the bank covered the car with sum covered Rs. 650, 000/- being the invoice price of the vehicle. Since, it was a new car, so the insurance company didn't inspect it and coverage was issued. Being a Toyota brand, in onward years, the market value of the car increased and exceeded the initial value. In 2007, 2008 & 2009, the bank reduced the sum covered of the car to Rs. 585000/- , 526500/- and 473850/- respectively. Meanwhile, market value of the car increased year by year and reached to Rs. 950, 000/- in year 2009 while the bank covered it only for Rs. 473850.

It is responsibility of the *takāful* company to disclose to the client the repercussions of covering an asset at a lower value than its market value. As proper disclosure is an essential ingredient of exchange transactions as per Islamic law, it's better to bring the undercoverage issue in client's knowledge in written form. But neither the Company nor the bank performed the needful.

On 10th September, 2009, the client while driving on a highway, lost control of his car, went down, toppled and fell in a ditch. He was almost unconscious due to shock and few injuries. The car was also badly damaged. Very soon, rescue workers reached to him and he was shifted to hospital. Later on, office staff of the client informed the bank about the car accident. The bank informed *takāful* company. The company asked its staff to take the car to a workshop for preparing a loss estimate. The office staff towed the car and shifted it to the workshop.

The motor workshop checked the car and prepared a loss estimate showing following detail:

- New Parts to be replaced and their values
- Service charges of items to be repaired
- Denting and painting charges
- Others

The workshop sent the loss estimate to *takāful* company.

Engagement of Surveyor

Normally, in comparison with family (life) *takāful* claims, general *takāful* claims are always more tricky to settle. In family *takāful* claims, there is no need to ascertain the amount of loss as the sum covered along with profit on investment part of the contributions is paid to the nominee when the covered person dies. While in general *takāful* claims, one has to check whether the claim is covered or otherwise; if it is covered then what should be the amount to be paid as fair compensation. There is always a chance that a dispute may arise between the company and the client about the payable amount. Therefore, in general claims, it is the worldwide practice that insurance and *takāful* regulators authorise technical people to conduct surveys and advise *takāful* and insurance companies about the settlement of the claim. The regulator decides a threshold amount of loss estimates; all claims above that amount have to be processed by the surveyor only, instead of company. In Pakistan, general insurance and *takāful* companies can only process claims with loss estimate equal or below Rs. 25000/- without a surveyor.

In Mr. Qadir's car claim, loss estimate was Rs. 500,000/- (subject to dismantling of the car and it may go up further or reduce). Therefore, *takāful* company had to engage a licensed surveyor to investigate and advise the company about the claim settlement. Therefore, company engaged ABC survey firm to look into the claim. It sent the coverage detail and loss estimate to the surveyor. The surveyor studied the documents, inquired the market value of a similar items from different vendors and found that car was under covered by almost 50%. As the car was more than three years old, hence 40% depreciation on new parts was also applied which was apparently irrational. Surveyor reached there and started negotiating the repair cost with the workshop. There is a market norm that in case a person takes a vehicle to the workshop, the mechanics ask whether the vehicle is covered or not. If the client says it's covered with *takāful* or insurance company, the mechanics exaggerate the repairing charges as they know that surveyor would negotiate the rates. Surveyor knows the values of different parts and service charges for repair, dent and paint charges. Therefore, in this case, the surveyor also negotiated with the workshop, the values and charges mentioned by it in the loss estimate. After negotiation, surveyor managed to bring the loss estimate down to Rs. 430,000/-.

The details of the claim were as under:

Total claim: Rs. 430,000

Labor charges: PKR 80,000

Value of new parts: PKR 350,000

Year of manufacture = 01.06.2006

Age of vehicle = Difference of Date of Accident and date of manufacturing

= 10.09.2009 - 01.06.2006 = Three years, three months & nine days = 39 months (Less than 15 days are ignorable)

TABLE 1
Scale of depreciation

Sr. No	Age of the Vehicle	Scale of Depreciation
1	0 - 6 months	05%
2	More than 6 months and up to 12 Months	10%
3	More than 12 months and up to 24 Months	20%
4	More than 24 months and up to 36 Months	30%
5	More than 36 months and up to 48 Months	40%
6	More than 48 months and up to 60 Months	50%
7	More than 60 months and up to 72 Months	60%

In this case, car is 39 months old, therefore Depreciation @ 40% will apply for new parts Depreciation on new parts: (40% x 350,000) = Rs. 140,000/-

Payable Claim

Labor charges, plus value of new parts (less depreciation), less under coverage: (80,000 + 210,000) = 290, 000.

Rs. 290,000/- was to be the payable amount if the client had covered the vehicle on its complete market value. Now, the vehicle is covered 50% less than the market value, therefore 50% under coverage will apply as under: 290,000 X 50% = Rs. 145,000/- is the payable amount to Mr. Qadir with respect to the claim subject to dismantling of car and actual work.

Surveyor also informed the client and the company that as per his opinion Rs. 145,000/- would be the fair compensation to the client according to the coverage. Therefore, the client was required to pay Rs.285, 000/-(430,000 - 145000) to the workshop while the company would pay Rs. 145,000/- to the workshop. Since Mr. Qadir was hospitalized, therefore, Manager Finance of Mr. Qadir's company was dealing the *takāful* coverage related matters. The undercoverage disappointed the manager as he believed that car was comprehensively covered with *takāful* company and only depreciation on new parts was to be borne by the client. He couldn't understand the undercoverage practice and informed the bank about the extra burden of Rs. 145,000/- to be borne by him. He also requested the bank to look into the matter and try to reduce the financial burden on their firm. Between the lines, he also conveyed to the bank that his employer is a big client for the bank and if the bank didn't manage to work out a proper solution, it might switch over their business to another bank.

The bank therefore, contacted *takāful* company and requested to increase the payable amount to their client. ABC *takāful* company informed the bank that they had earlier informed the bank, verbally as also in written form, that all of their vehicles were under covered due to the practice of *takāful* coverage on book value of the vehicles. Moreover, staff of the claim section of *takāful* company excused to help the client further. Feeling the gravity of the situation, the bank staff raised the matter with their senior management which invited senior officials of *takāful* company for a meeting.

The manager of the *takāful* company was asked to suggest a solution for the problem, otherwise, the bank had the option to reconsider their contract with the company which might result in loss of business. The *takāful* manager was feeling the gravity of the situation. At one side, the rules allowed to pay Rs. 145,000 only, while in that case, there was a likelihood that the bank would stand with their valuable client, thus ending the agreement with ABC *takāful* company, and its Manager would not be able to reach its business target. The Manager asked the bank executives to give him some time for sorting out a suitable solution. While leaving, he again reiterated its earlier stance that they kept informing the bank since long about the consequences of undercoverage but the bank didn't take any action on that. The bank agreed to renew *takāful* coverage of all vehicles on market value in future but requested him to work out a suitable solution of the problem in this case.

The *takāful* manager discussed the matter in a meeting with his colleagues. He asked them to give suggestions, but at the same time, he made it clear that he wouldn't go against the rules, so, the solution should be workable within the laws. After discussion, the manager suggested to buy new parts of same quality from a local vendor as their prices were normally far less than the prices of new parts with authorised dealers of an automobile company which would reduce the claim size and depreciation as well bringing the whole claim to relatively small size. The impact of under coverage would also reduce. All agreed upon the solution as it was not violating any rule and would still benefit the client. The manager also asked the surveyor to reduce the under coverage to 30%, but the later only agreed to reduce it to 40%.

The *takāful* Manager called the bank and suggested the same solution. The bank noted the advice with thanks and asked the client to take prices of required new parts from the open market. Manager Finance of Mr. Qadir's company went to the market and took prices from different shops. Surprisingly, all the shops quoted considerably low for those parts without compromising the quality. The lowest quotation was Rs. 260,000/- He also informed the workshop that they would bring new parts from open market and the workshop would only fix and paint it. The workshop agreed. With the approval of *takāful* company, surveyor asked the workshop to start the repair of the damaged car.

Since the loss estimate was Rs. 430,000/- but when the actual repair work began, it was found that several parts could be repaired instead of replaced. Therefore, the bill of new parts purchased further reduced to Rs. 230,000/- and the repair bill increased by Rs. 10,000. After two days of work, the car gets repaired and workshop informed the client and the surveyor.

The *takāful* manager informed the bank they would be paying Rs. 136,800/- to the client while he had to bear the amount of Rs. 183200. Prior to that the client had to bear Rs. 285000. The bank conveyed the information to Mr. Qadir's company and they later on confirmed to accept the amount. The bank conveyed their acceptance to *takāful* manager and thanked him for his efforts in this regard.

Same criteria of under coverage apply in theft and total loss of the vehicles. If Mr. Qadir's car was stolen in 2015 or destroyed totally in an accident, *takāful* company will have paid 50% of the sum covered of Rs. 984,150 i.e. Rs. 492, 075. This amount will not be sufficient to buy another of same brand and model. Therefore, *takāful* companies always advice their clients to get coverage of their assets at the market price.

Suitability of the Study

The study is suitable for:

- Undergraduate and graduate students taking courses of *takāful*
- Research students with particular focus on practice of Islamic finance
- People working in general *takāful* companies in areas of marketing and claims
- Trainers giving trainings to people working in general *takāful* companies

Further Research and Analysis Areas

Identify parties which are involved in this study.
Following are the parties involved in the study:

- Mr. Qadir and his firm
- *Takāful* company
- Workshop
- Surveyor
- Firm providing car towing services
- Market - shop from which new parts were purchased

1. How *takāful* companies prevent clients from getting a claim amount more than their actual loss using the concept of depreciation?

Answer: Companies use depreciation concept which applies on new parts in a partial loss only. It is applied @10% each year and is charged according to the vehicle's useful life consumed by the client.

2. How under coverage results in a lower compensation than the actual loss?

Answer: Claims in under covered assets are proportionately paid by the company. The assets should be covered on market rates and if it is covered with the company lowere than its market value, then the remaining portion is considered to be self-covered i.e. with the client himself. If loss occurs, the *takāful* company will pay only its portion of the claim while the rest has to be borne by the client.

3. Calculate the net payable amount while applying 40% depreciation on new parts and 60% under coverage on total payable amount.

Answer: The final bill of car repair was as under:

- The workshop bill (only service charges) = Rs. 90,000/-
- Total bill of new parts replaced = Rs. 230,000
- Total bill = Service charges + value of new parts = 90,000 + 230,000 = Rs. 320,000
- Since client has already consumed 40% useful life of the car including all its parts, therefore, loss for the client due to accident pertains to the remaining 60% useful life of the car and it needs to be paid by the company.
- Labour charges were payable in full
- Under coverage by 60% was also applied
- Payable amount in terms of new parts = 60% value of new parts
- = 60% of 230,000 = 138000/- (To be borne by the company)
- 230000 x 40%= 92000 (To be borne by the client)
- Service charges are to be paid in full
- Service charges = 90,000.
- Payable amount = 60% value of new parts + Service charges
- = 138000 + 90000 = 228,000.
- Since the car is 40% under-covered (i.e. 40% value of the car is considered to be covered by the client himself, and remaining 60% value of the car is covered with the company, the company will pay only 60% of each and every claim; therefore, 60% of Rs. 228,000 (Rs. 136800/-) is payable to the client
- Therefore, Depreciation on new parts @ 40% = 230000 x 40% = 92000 (to be borne by the client) while the rest of amount Rs. 183,200 (Depreciation of Rs. 92,000 + under coverage 91,200) to be borne by the client.

4. Why there is a role of surveyor in general claims, while in life claims, there is no role of surveyor ?

Answer: Usually, in general *takāful* claims, only a third party claim surveyor or loss adjuster licensed by the regulatory authority is allowed to investigate and process the claims. Claims made under general *takāful* are more difficult to settle than claims made under family *takāful* for the following reasons.

- In life claims, there is no need to ascertain the extent of loss, because the sum assured (along with any profit from investing contributions) has to be paid to the beneficiary when the participant dies. However, in general *takāful* (for example, claims relating to a car accident, a fire or goods damaged in transit), the extent of the loss does need to be determined.
- Finding out the exact cause of loss is also more complex in general *takāful* than it is for life claims.
- To avoid disputes between *takāful* operators and participants about general *takāful* claims, an independent claim surveyor or loss adjuster is engaged in the process. This ensures that a more impartial approach is taken to settling claims. Understanding the role of the surveyor is important, so we will discuss this in detail later in this article.

Analysis of Undercoverage Policy

Claim process is a litmus test for every insurance or *takāful* company. Companies take due care in processing claims. Their growth depends on the way they handle the claims. Companies always keep several options while processing a claim. It depends on the companies priorities that which option to take. Such companies also exist in market which resist claims and do not pay claims smoothly. While most of the companies try to pay claims in the best manner in order to get more business from the market. In this case, Mr. Gul also had several options to deal the claim.

Option 1:

Total loss

The sum covered of the policy taken was Rs. 473,850 and it was the maximum liability of the company in case of any single loss. The initial loss estimate was Rs. 430,000 and it was near to the sum covered. The company could declare the partial loss as total loss and could have paid Rs. 473,850 to the bank. The salvage would also become property of the company due to presence of subrogation clause in the contract. As the market value of the car was already around Rs. 950,000/- and the car was repairable, therefore, *takāful* company could easily sell the salvage for around Rs. 400,000/- But there would be a loss for the client as the bank would recover the profit from the amount of Rs. 473,850 and would be leaving very less for the client. While in the solution suggested by the *takāful* company manager, the client received Rs. 138,080; moreover, the client would also get the car upon completion of the *ijārah* period.

Option 2:

Lumpsum Amount

Sometimes, in case of complicated claims, *takāful* company offers a lumpsum amount to the client. Company normally doesn't ask the client to present loss estimates, etc. It only asks for the receipt of the payment made to workshop and pays a portion (lumpsum) amount to the client. In this claim, this way out didn't seem workable to *takāful* manager as very less amount could be offered due to presence of 40% deprecation and 50% undercoverage of the car.

The Selected Option:

The option suggested bt the *takāful* Manager was the most suitable option as on the one hand it was in conformity to the claim rules and, on the other hand, the client got maximum compensation in the given circumstances. Moreover, *takāful* company also managed to convince the bank to cover their vehicles on market value instead of book values. It would enhance the contribution (premium) collection of the company resulting in more business and would also help in resolving the future problems that could arise due to undercoverage.

SUGGESTED READINGS

For developing discussion and answering questions, the readers are expected to have knowledge of the *takāful*. Some suggested reading:

1) Malik, A., & Ullah, K. (2016). *Introduction to takāful: Theory and practice.* Peshawar, Pakistan: CEIF IMSciences:
History and concept of *takāful* pp. 31-32
Principle of indemnity. pp. 16
Motor *Takāful* pp. 57
Under coverage and depreciation, pp. 58
Motor vehicle proposal form pp. 175
Motor claim form pp. 229
2) Claims Management: 2000 edition. Chartered Insurance Institute, UK.
3) Htay, S. N. N., & Arif, M. (2015). *Accounting, auditing and governance for takāful operations.* Singapore: John Wiley & Sons Pvt. Ltd.

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