Rationalizing the *Takaful* Organizational Form with Institutional Theory

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ABSTRACT

This article examines the organizational structure of *Takaful* ('Islamic' insurance) as it constitutes an interesting case study of a relatively inefficient system that has grown in popularity. This challenges the neoclassical economics view that the most efficient organizational form succeeds. We employ institutional theory to shed light on this puzzle. We realize the resolve of Muslim religious scholars and their political Islamic compatriots to regain legitimacy is the primary reason why this inefficient institution exists. Our results in this form of insurance lead us to question the ideology of blending religious values in the broad financial services sector. We conclude that it will ultimately lead to financial regression, perpetuate the further decline of the emerging Muslim economies and reinforce the spatial disparities between them and the developed world.

JEL Codes: D02, G20, G22, O16, P47, Z12.

Keywords: Agency issues (i.e., political struggle); cultural political economy; economic and spatial development; institutional theory; *Takaful* ('Islamic' insurance)

1. Introduction

> '…the study of institutions, power struggles and norm setting, have not yet been paid significant attention in discussing the recent arrival of Shariah-based practices in international markets.' (Eddy S. Fang, 2014, p.1172)

Financial development involves the meticulous interaction of financial instruments, institutions, and markets to mitigate the costs of information, transactions, and contract enforcement in the financial system. It invigorates the efficiency of the financial sector to reinforce economic growth through resource allocation and technological advancement. Rajan and Zingales (1998) illustrate that sustainable financial development aids in (i) abating poverty and inequality by allowing the access of financial services to the poor and underprivileged; (ii) advancing risk management by mitigating the susceptibility to shocks; (iii) augmenting investment and productivity; and (iv) invigorating robust financial policies and regulatory infrastructure to contain shock to the economic system.[1]

The predominantly Muslim majority countries are in dire need of financial development (Ray and Kamal, 2019).[2] Apart from Albania and Turkey, which are part of the global North, the rest of the Muslim world accounts for 28.86 per cent of the global South population. In light of this backdrop, 'Islamic' finance (IF) is extolled as a way forward to bring those economies about parity with the global North (Abedifar et al., 2015; Lai, 2015). This movement towards Islamization of financial services advocated by cadres of political Islam and religious scholars under the pretext of a more equitable economic order is marching ahead quite resolutely with an average annual growth rate of 8.3 per cent. It is estimated to have surpassed $2 trillion in 2017. A part of it is the $26.1 billion of the global *Takaful* ('Islamic' insurance) market (at the end of 2016), growing at a rate higher than the conventional insurance market - *Takaful*: 12.5 per cent per year; insurance: 2.3 per cent (non-life) and 2 per cent (life) (Bassens et al., 2013; Lai et al., 2017; IFSB, 2018).

The emergence of *Takaful* offers a rare ground for examining the institutional theory. Unlike other IF institutions, such as Islamic banks, *Sukuk* (Islamic bonds), or Islamic mutual funds that operate employing similar organizational structures with their conventional counterparts, *Takaful*'s institutional form differs significantly from the mainstream insurance. The prohibition of *gharar* (ambiguity) in the commutative transaction motivates the mutual structure of *Takaful*. Williamson (1983, p. 351) contends that 'specialized governance structures arise in response to the efficiency needs of each type of organization.' The neoclassical economics literature, therefore, suggests that a nascent organization structure should converge to that offering the lowest possible price to survive the competitive environment (Fama and Jensen, 1983a, b). The current institution of *Takaful*, however, seems to depart from this survival of the fittest logic. As discussed further in this manuscript, the obscure *Takaful* organizational form exists at a lower economic efficiency level than that of the conventional one (see Ismail et al., 2011; Abdul Kader et al., 2014; Karbhari et al., 2018).

The purpose of this essay is to study the Takaful organizational form by querying the following: (i) Can we rationalize the *Takaful* organizational form from economic as well as religious principles? (ii) If not, why does *Takaful* still exist (given its lack of efficiency) compared to conventional insurance? (iii) What broad ramifications can our study draw upon this movement towards 'Islamic' financialization and its impact on the underlying Muslim economies?

We shed light on the inefficient Takaful structure puzzle by employing the Cultural Political Economic framework (CPE). This approach allows incorporating the 'cultural turn' into our analysis without losing emphasis on economic aspects (Jessop and Oosterlynck, 2008). The institutional form's context offers a broader outlook covering the societal, historical, and political dimensions through structural and semiotic techniques (Belfrage and Hauf, 2017). On the one hand, we employ Fama and Jensen's (1983b) framework to discuss how internal agency issues (i.e., political/ power struggle between subgroups of an institution) lead to distinct organizational forms in both conventional and its 'Islamic' counterpart. On the other hand, we engage with the institutional isomorphism of DiMaggio and Powell (1983), where they contend that 'organizations compete not just for resources and customers, but for political power and institutional legitimacy' (p.150). Here, we argue that the 'distinct' organization structure of *Takaful* is a proxy used by political Islam and religious scholars to regain their political power as 'legitimators of global IF circuits' after centuries of the dominance of autocrats and that of colonial powers (Robinson, 2009).

While our article conducts a novel case study of the nascent *Takaful* institution from a CPE perspective, its repercussion goes beyond the organizational form theory.[3] Our concern is whether this populist movement stemming from political Islam and religious scholars will perpetuate the Muslim world's underdevelopment, as depicted in Kuran (2018). The clergy, in alliance with political Islamists, can subvert the industry architecture based on ideas that are in variance with not only economic principles but also religious ones. This impacts the financial development of the emerging Muslim economies as postulated in the well-known Weber's Protestant Ethic thesis (1904-5/1958)[4] and leads to the spatial inequalities as reinforced in Ezcurra and Rodríguez-Pose (2014).

Our study contributes to at least three strands of literature. First, we revitalize the sparse academic research on *Takaful,* expounding the religious establishment's diatribe against conventional insurance without contemplating the rich literature supporting the same (Khan, 2015). We advance the *Takaful* literature by critically integrating the rich conventional insurance literature with the cultural (i.e., religious) value system. That is, we critique the interpretation of both the religious scholars and the cadres of political Islam. We accomplish this by analyzing the original religious sources in light of the objectives of Islamic law (*Maqāsid al-Sharī'ah*).[5]

Second, we add to the CPE of organizational form literature by examining Takaful institutions' case as encouraged by Fang (2014). Here, our findings go beyond economic analysis. While the survival of the fittest perspective fails to explain the inefficient *Takaful* organizational form (Fama and Jensen, 1983a, b), the neo-institutionalism approach proves useful in illuminating the issue (DiMaggio and Powell, 1983). In a way, we also extend the: (i) organization mimicry analysis of Bassens et al. (2013); and (ii) grafting ideas of Lai et al. (2017) in a broader context of Islamic financial institutions emanating as a result of the political will of the religious scholars with their political Islamic allies.

Finally, we also contribute to the literature on the culture-led economic development of the global South, particularly the CPE of majority-Muslim countries. Extending El-Gamal (2006), Khan (2010) and Kuran (2018), we illustrate that it is not Islamic law per se that has let down the Muslim world but religious scholarship and political Islam. Our study finds the bulk of institutional details and theoretical analysis of contemporary religious scholars to be flawed. We feel that these scholars have opened a pandora's box to further the underdevelopment of these economies. We anticipate our results to lead to a rethink of the populist 'Islamic' financial services movement, open the eyes of the ordinary individual (akin to a representative economic agent) and the less rigid clergy and the followers of political Islam. We hope that our efforts will stem the tide of the underdevelopment of these economies.

We initiate our study in Section 2 by elaborating on insurance's crucial role in economic and spatial development. We follow this by deliberating on the political economy and the institutional underdevelopment of the Muslim world in Section3. We then discuss alleviating the various internal agency issues (stemming from political/ power struggle) that culminates in different organizational forms in Section 4. Section 5 illustrates the errors endemic in the nascent literature conceptualizing *Takaful* devoid of the internal politics. We then rationalize the existence of inefficient *Takaful* institutions as an outcome of the political will of the religious establishment and their political Islamic associates through the lens of DiMaggio and Powell's (1983) neo-institutionalism in Section 6. This allows us to shed light on religious scholars' frivolous constraints in other areas of 'Islamic' financial services. Finally, we conclude our study with prescriptions for the emerging Muslim economies in Section 7.

2. The Crucial Role of Insurance in Economic Development

The insurance mechanism is based on the principle of distributing the risk of a specific event from a vulnerable (or a poorly capitalized) entity (namely, the insured) to a well-capitalized entity (called an insurer) employing the portfolio theory to mitigate its losses. Insurance indemnifies the financial loss of the insured (or the beneficiaries of the same). This compensation of loss is vital for the financial survival of the insured. That is, the insurance contract makes a difference between financial security and poverty. Insurance, thus, contributes to social preservation by improving the financial stability of the underlying economic entities. It offers peace of mind, improves consumption, favours entrepreneurial activity, and raises creativity and innovation–all influencing economic growth positively (Grant, 2012). The insurance industry's significance lies in the fact that much economic activity would not occur without a reliable mechanism for pooling and transferring risk. It thus enables innovation within an economy by offering to underwrite new risks (Keucheyan, 2018). In other words, insurance inevitably supports the rest of the economy. It provides a vital underpinning for stability and confidence in their economic and social interaction (Musthaq, 2020).

The insurance industry contributes positively to economic development through complementarities with the banking sector and the stock market. By reducing information and transaction costs, pooling risk, enhancing financial intermediation through the channelling of savings to domestic investment, and fostering a more efficient capital allocation through the gathering of substantial firm information, insurance activity may contribute to reinforcing the process of resource allocation done by banks and capital markets (Musthaq, 2020). For instance, the insurance company can be an alternative accumulator of a significant amount of funds to finance long-term investments such as infrastructure (Knight and Sharma, 2016; Pan et al., 2017). This leads to an improvement in the financial sector's performance and efficiency.[6]

The insurance company also has a stabilizing role because of the positive correlation between its long-term liability and long-term investment, resulting in a favourable asset-liability duration match. This contrasts with banks, which convert their short-term liability (i.e., deposits) into longer-term assets (i.e., loans). Banks generally increase their return with duration (under a normal yield curve). In other words, they stretch the duration gap outwards. Insurance companies, however, adopt a liability-driven investment approach. They match their asset profile with their liability profile. Asset-liability management (ALM) is a key function within insurance companies and an essential strand of insurance economics (Thimann, 2014).

Liquidity risk is pervasive in banking (Allen and Gale, 2000), but not in insurance. Banks risk being liquidity-short, while insurers are liquidity-rich. Deposits are the largest item on banks' balance sheets. For the euro area, they amount to €16 trillion (in October 2020) or 120 per cent of the region's GDP (European Central Bank, 2020). Hence, bank liabilities are predominantly short-term and withdrawable at will. Insurance liabilities are less susceptible to withdrawal risk. The liabilities for general protection insurance, e.g., car, property, and health, are not callable at will. They relate to exogenous events that policyholders do not influence. The liabilities that are theoretically callable are those involving life insurance businesses that are not related to annuities. But there are often penalties for early withdrawal on these. Thus, the insurance company contributes less to the economy's systemic risk (Thimann, 2014).

Finally, as institutional investors, insurance companies enhance the efficiency of capital markets through their active participation in corporate governance. Chung and Zhang (2011) show that the fraction of a company's shares held by institutional investors increases with the quality of its governance structure. Grace and Rebello (1993) postulate that insurance helps company managers signal the quality of their business in states of firm-specific risk uncertainty. This reduces borrowing costs, enhances debt capacity, and enables firms to make positive net present value investments (Zou and Adams, 2008).

In contrast to the above, the literature also documents the dark side of insurance. First, Alami (2017) asserts that health insurance might reinforce inequities by widening the gap between needs and provisions thereby emphasizing the ability to pay as a basis for accessing quality care. Second, the provision of insurance also reinforces the risk-taking behaviour of the insured, thus increasing the loss of accumulated capital (Ward and Zurbruegg, 2000). Finally, insurance also disincentivizes savings (Ward and Zurbruegg, 2000). The developments in financial intermediation may lead to improvements in the capital accumulation process. However, the benefits may be outweighed by the potential decrease in the domestic savings rate. Financial intermediaries help investors mitigate their risk by diversifying their portfolios. This decrease in risk diminishes the need of investors to save. This problem is further exacerbated by the increased accessibility of credit, leading to a decrease in the precautionary saving motive.

Thus, it is not easy to affirm the relationship between insurance companies, financial intermediation, and economic growth. The economic benefits derived from insurance are likely to be conditional on the cultural context of a given economy (Fukuyama, 1995).

3. The Institutional Underdevelopment of the Muslim World

There is a long-standing debate in the literature on the underdevelopment of the Muslim world. One set of studies termed as the Impediment Theory contends that the underdevelopment stems from Islamic beliefs that became formalized in the region's teachings, practices, laws, and institutions. Max Weber (1904-5/1958) and Timur Kuran (2018) are among the advocates of this theory.

In contrast, the second set of studies termed as the Facilitator Theory defends Islamic beliefs contending that political illegitimacy since the early Islamic history (ensuing from the Mu'awiyah dynasty), absence of genuine democracy, and a lack of transparency impacted the Muslim socio-political economy. This stimulated restrictions on freedom of speech, abuse of public funds, corruption, poor governance, and injustice. Muhammad Umer Chapra (2008) is one major disseminator of this theory. He believes that the above issues stemming from political illegitimacy affected the development of Islamic jurisprudence (*fiqh*). This had an extensive negative impact on Muslim society as the friction between the jurists and the autocratic rulers in the medieval era led to their persecution. The jurists were compelled to confine themselves to purely religious matters losing touch with the changing economic environment. Subsequently, the dynamism imbibed in jurisprudence in the earlier centuries withered away.

Historically, however, the religious elites have been co-opted by the political establishment and have legitimized their autocracy, as postulated in Ebrahim and Sheikh (2018). They take an intermediate position between the Impediment and the Facilitator theories. They contend the stagnation of emerging Muslim economies primarily to the retrograde outlook of the jurists. The jurists' monopoly over interpretations of the scripture and Prophet Muhammad's traditions led to the jurisprudential rulings in the realms of economy and finance. This is the key reason behind the underdevelopment of financial instruments, markets, and institutions, as Robinson (2009) posited. Zaman (2002) corroborates this by asserting that the new field of IF, including the *Takaful* industry, offers religious scholars an alternative to regaining their power after more than a century. Here, the contemporary jurists acting as the 'gatekeepers of Islamic financial circuits' are involved in 'organizational mimicry' (Bassens et al., 2013) by grafting ideas from Western institutions (Lai et al., 2017).

3.1 *The Unintelligible Institutional Framework of Takaful*

The contemporary jurists strive to distinguish 'Islamic' insurance from its conventional counterpart. This perspective is expounded in Khan (2015, p. 135) as follows:

> … conventional insurance is primarily a contract of risk transfer as it transfers the risk of loss insured from the policyholder to an insurance company against an agreed amount of premium. The insurance company owns the premium written and any surplus or deficit generated by the insurance operation. Policyholders only have the right to claim under conditions identified in the insurance policy. Islamic insurance on the other hand is a contract of risk sharing among policyholders. The insurance company, referred to as the takaful operator (TO), merely manages affairs of the business against a variety of financial incentives. Premiums collected by the TOs are, therefore, in principle, owned by the policyholders as a group and so is any surplus or deficit from the insurance operation. Participants in this case insure one another on a non-profit basis and make contributions to the takaful on the basis of tabarru' (conditional and irrevocable donation) which is a noncommutative contract.

We find the above distinction to be incoherent. First, insurance, conventional or 'Islamic,' offers protection of assets (or human capital, i.e., life/health) against disasters/ unforeseen events. Is it then not a Put option in the real (as opposed to financial) sector of the economy? It can be a complete risk transfer if the contract has no deductible, co-payment, and co-insurance. It can involve risk sharing under deductibles, co-payments, and co-insurance.

Nonetheless, religious scholars perceive detached options as involving gambling (*maysir*), while options embedded in financial contracts as ones that are not (Tariq and Dar, 2007). This way of thinking has led them to classify conventional insurance premiums as encompassing Islamic injunctions of *ribā* and *gharar*, narrowly construed as usury and ambiguity. This perspective was endorsed for political reasons in the medieval ages when the jurists were co-opted by absolute monarchs (Ebrahim and Sheikh, 2018). In their view, those who run afoul of the above two injunctions are implicated in gambling (*maysir*) (Khan, 2015). Ebrahim et al. (2016) have critiqued the religious scholars' above outlook by rationalizing *ribā* and *gharar* in financial contracts to protect property rights and prevent the deterioration of a complete market equilibrium into an incomplete one. The second issue (i.e., gharar) is expunged by mitigating asymmetric information and excessive risk transfer.[7]

Second, the organizational form undertaken by *Takaful* companies is also in variance with that proposed in the literature. A number of studies state that it should involve a cooperative (or a mutual form) entailing solidarity (Abdul Kader et al., 2014; Khan, 2015; and Karbhari et al., 2018). This view emanates from the Sudanese scholar Al-Seddiq M. Al-Darir, who was awarded the 1990 King Faisal Prize (along with M. Umer Chapra) for his contribution to the development of *Takaful*.[8] However, policyholders do not have any say in its administration as *Takaful* operators (TOs) decide on all the key issues such as the pricing of the premiums, the risk undertaken, asset (i.e., portfolio) management, and the selection of the managers. This is because a large number of TOs are publicly owned stock companies (El-Gamal, 2006).[9] To us, this resonates with what Khan (2010) terms as 'duping' or Bassens et al. (2013) term as 'organizational mimicry.' That is, in reality, the practice is different from what is being asserted. This variance could be because mutual companies face capital constraints. They cannot sell equity as they are 'owned' by policyholders. They are also restricted from selling debt due to religious restrictions. The above leads us to the question: what organizational form does *Takaful* entail? Is it a: (i) mutual (cooperative) as alluded in the above literature; or (ii) a hybrid as discussed in Vishwanathan and Cummins (2003) and Erhemjamts and Leverty (2010);[10] or even (iii) a stock (i.e., publicly-owned) insurance company as decried by El-Gamal (2006)?

4. The Agency Issues Inducing Disparate Conventional Insurance Organizational Forms

The efficiency of an organization is contingent on its institutional design. This involves a complex process in which subgroups seek to achieve divergent objectives that include their private gain. Here, an organizational structure is analyzed as a result of political struggles or a series of intertemporal political agreements.

Neoclassical economists contend that organizations undertake the optimal form that allows them to survive by delivering their products (and/ or services) at the lowest price while covering agency and production costs (Jensen and Meckling, 1976; Fama and Jensen, 1983a, b). The literature defines agency issues as emanating from a conflict of interest (or political/ power struggle) between a principal and an agent, where one part has an informational advantage over the other (Wezel and Ruef, 2017).

Vishwanathan and Cummins (2003) discuss two major agency issues to hypothesize the coexistence between stock and mutual organizational forms in the insurance industry. The first conflict of interest is between the insurance company owners and their policyholders. The owners' goals are to maximize the company's equity market value, while the policyholders' objectives are to minimize their premiums and reduce the risk of unpaid claims. The mutual organizational form merges the two adversarial claims to mitigate this friction. The second conflict of interest is between the owners of the insurance company and its managers. This is because the managers' goals are to maximize their welfare stemming from their compensation and perquisite consumption.

A stock insurance company owner can effectively control managerial behaviour by employing a number of market mechanisms not feasible in a mutual insurance company. These include stock options, proxy fights, and the takeover market. Vishwanathan and Cummins (2003) state that an insurance company's type of organizational form is contingent on whether the owner-policyholder or the owner-manager conflict is more dominant. They refer to various coexistence theories to describe the insurance company's ultimate organizational structure as follows.

First, the *managerial discretion hypothesis* espouses that the stock-based form suits a firm better in business lines requiring exceptional management decision making (Mayers and Smith, 1981; Wells et al., 1995).[11] This view is supported by the *expense preference hypothesis* contending that stock-based firms' managers are more successful in minimizing costs (in contrast to a mutual firm) because of effective monitoring and controlling mechanism (Zou et al., 2009).[12] This is also in harmony with the *efficiency hypothesis,* which asserts that firms align themselves in line with the most efficient organizational form (Cummins et al., 1999b; Cummins et al., 2004; Biener and Eling, 2012).[13] On the other hand, the *maturity hypothesis* argues that the mutual organizational form matches firms with prolonged duration activities (either in contract or settlement period) (Mayers and Smith, 1981). Finally, the *informational hypothesis* suggests that firms in low-risk business lines will opt for a mutual form, while those in high-risk businesses will select the stock form (Smith and Stutzer, 1990, 1995). Table 1 elaborates on the coexistence of the stock versus mutual ownership form.

Insert Table 1 about here.

The empirical evidence shows that the stock-based insurance firms collected more premiums across the U.S., but mutual wrote more contracts per-line per-state (Born et al., 1998). The stock-based insurance firms show more losses (i.e., bear more risk) than mutual (Lee et al., 1997). This result is supported by Ho et al. (2013), who find mutual-based firms taking on less underwriting and investment risk. The stock-based firms depict higher returns on equity, illustrating cost efficiency. In contrast, mutual-based firms offer cheaper insurance (Gardner and Grace, 1993 – in life insurance; Cummins et al., 1999b – in property-liability insurance; and Swiss Reinsurance Co., 1999 – mutual depict lower returns on equity but higher solvency ratios).

5. The *Takaful* Structure and its Inefficiency

5.1 *Conceptualizing the Takaful Organizational Form Devoid of Internal Politics*

The *Takaful* literature fails to discuss the two agency (i.e., political) issues discussed above, which yield disparate mainstream organizational forms co-existing in different business lines (Khan, 2015). It toes the lines of religious scholars without considering the broader socio-economic rationale stemming from the *Maqāsid al-Sharī'ah*.

First, conventional insurance is incorrectly identified as usurious and ambiguous, synonymous with gambling, as mentioned in the earlier section (Kayali, 2015). Next, the scripture is incorrectly alluded to enjoin cooperation, thus encouraging risk sharing in the form of mutual insurance. Further impetus is provided from the *Sunnah*, urging the relieving of a fellow human being's hardship. Reasoning by analogy is drawn from the schemes of cooperative risk sharing historically by Muslims in Islam's medieval era (Khan, 2015). This rationale may constrain or compel the Muslim world to adopt inefficient business practices under the pretext of 'custom.'

Economists are aware of the loss in welfare stemming from superfluous constraints. This is one reason why the contemporary Muslim world has failed to advance (Ebrahim and

Sheikh, 2018). Apparently, the well-known religious maxim of permissibility is ignored.[14] The injunctions enjoining easiness (*Taysīr*) and removal of hardship (*Rafʿal-Haraj*) are not heeded (see Kamali, 2002, p. 70-73). In short, religious scholars have imposed unnecessary restraints. Other studies also support our assertions, including (i) El-Gamal (2007), who describes IF as a 'prohibition-driven industry,' and (ii) Kayali (2016), who states, 'since when does Islam frown upon profits in the first place?' However, El-Gamal (2007) and Kayali (2016) do not examine the rationale behind the constraints, i.e., the incorrect terminology, which has boxed the jurists as described below.[15]

Second, fallacious statements are made in accordance with an incorrect nomenclature of the Arabic word *ribā* as delineated in Ebrahim and Sheikh (2018). This involves incorrectly terming the *Takaful* premiums as charitable donations (Khan, 2015).

Third, the literature (Abdul Kader et al., 2014; Khan, 2015) discusses an esoteric model involving the historic profit-sharing (*Mudharabah*) or surplus-sharing (modified *Mudharabah*) in conjunction with the agency (*Wakalah*) contract to mitigate the agency issues between the policyholders and the TO, which is mostly a corporate entity (El-Gamal, 2006). We find the following problems with the modelling of the same. First, this model precludes the agency (i.e., political) issue between the TO and its manager, as mentioned in the previous section. This flawed approach impacts its efficiency, as discussed in Table 1 (Karbhari et al., 2018). Second, the *Wakalah* contract analysis ignores the distribution system emphasized in Baranoff and Sager (2003). Third, the emphasis on these forms of contracting reinforces the retrograde outlook of the Islamic jurists and the political Islamists (Schacht, 1995; Ebrahim and Sheikh, 2015, 2018).[16] This is because both are enamoured by medieval facilities and feel nostalgic about them as they were prevalent in the 'golden era' of the Muslim world (between the 7th and 14th centuries). These are implemented in *Takaful* as they are not practical in 'Islamic' banking. The *Mudharabah* facility mandates 100 per cent capital contribution by policyholders. This constriction itself creates an incentive issue as the TO has none of its capital at stake. Another form of inefficiency endowed by Islamic jurisprudence is denying any control rights to the policyholders (Ebrahim and Sheikh, 2015). This profit-sharing model's employment conveys operational issues for *Takaful* insurers (Abdul Kader et al., 2014). Finally, the literature is silent on the portfolio of assets invested in the technical reserve (i.e., allocated funds for paying future liabilities). The structure of this is problematic due to the incoherence in the interpretation of Islamic rulings. This has led the industry to adopt ad hoc ways to securitize assets (Ebrahim et al., 2016). For example, Wijnbergen and Zaheer (2013) find that 'asset-based' Islamic bonds endorsed by Islamic jurists aggravate legal risk. Abdul Kader et al. (2014) and Ismail et al. (2011) depict poor performance of *Takaful* assets compared to conventional insurance companies.

It should be noted that conventional insurance companies also offer participation policies where the policyholder chooses portfolios to invest his/her assets. This flexibility includes investing in socially responsible equity funds and securitized real estate equity (i.e., Equity REITs). To us, this makes conventional insurance appealing for the following reasons: (i) there is no significant difference between the performance of socially responsible mutual funds and their mainstream counterparts (Renneboog et al., 2008); (ii) Equity REITs help in portfolio diversification better than debt securities (Case et al. 2012).

5.2 *The Inefficiency of the Takaful Organizational Form.*

The worth of every organizational form is measured by contrasting its effectiveness (i.e., the ability to deliver its promises) and efficiency (i.e., the capability of accomplishing its goals without wasting resources) vis-à-vis its competitor (Maskell, 2001). Since *Takaful* claims to have different objectives from insurance, comparing the efficiency of both organizational forms is more appropriate than their effectiveness. The literature reveals *Takaful* inefficiency from various perspectives, as described in Table 2 below.

Insert Table 2 about here.

First, Ismail et al. (2011) depict that *Takaful* has low technical and scale efficiencies than conventional insurance. This is evaluated for a sample of 19 Malaysian *Takaful* companies in the period 2004-2009. Second, Abdul Kader et al. (2014) illustrate operational and cost inefficiencies of non-life *Takaful* companies in contrast to their conventional counterpart. This is conducted using panel data for 2004-2007 from 17 Muslim countries. Third, Karbhari et al. (2018) find operational, technical and scale inefficiencies for 137 *Takaful* companies operating in 21 countries from 2002-2013.

The rationale for the above inefficiencies of the *Takaful* industry is attributed by Ismail et al. (2011) and Abdul Kader et al. (2014) to organizational constraints. Karbhari et al. (2018), on the other hand, hold managerial lethargy and operational apathy (stemming from low economies of scale and scope) for the poor performance of the same. The *Takaful* industry is not effective in controlling the endemic agency (i.e., political) issues and the higher costs emanating from them (compared to the conventional insurance industry). TOs incur higher management expenses and staff costs. Furthermore, the investment performance is lower than its conventional counterpart due to the poor portfolio structure.

The above results necessitate a critical examination of other 'Islamic' financial services to evaluate the soundness of judgment of contemporary religious scholarship.

6. Legitimizing the Inefficient *Takaful* Organizational Form Under Institutional Theory

Given the Takaful organization's inefficiency, the next plausible question is why this configuration still perpetuates. This kind of inefficiency should have no chance of surviving in the realm of neoclassical economics (Fama and Jensen, 1983a, b). The new institutionalism approach offers a promising answer to the question of how does *Takaful* assume institutional legitimacy. We argue that, apart from surviving through efficiency, an organization also pursues political legitimacy. The new field of IF has been conceived predominately by two key players: religious scholars and political Islam in sponsorship of oil-surplus nations (Lai, 2015).

The IF movement offers religious scholars and political Islam an alternative to regaining their power as the 'legitimators of the global Islamic financial institutions.' One way to do that is by endorsing the current *Takaful* structures to serve as a signalling device displaying conservative Muslims' piety (Berg and Kim, 2014). This allows the *Takaful* organization to remain in existence despite operating at lower efficiency than its conventional counterpart. Wilde et al. (2010, p. 586) state that they 'prioritize concerns about their institutions' legitimacy over the concerns about efficiency and growth.' This is in harmony with DiMaggio and Powel (1983, p. 153), who state that 'the institutional isomorphic processes can be expected to proceed in the absence of evidence that they increase internal organizational efficiency.'

Political Islam is a 'force' behind Islamic economics and finance. Its agenda is to forcefully inculcate the Islamic value system in all realms of life. Ahmed (2015) illustrates how Syed Abul A'la Mawdudi instigated the populist movement towards 'Islamic' financialization. He furthers this discussion on how the cadres of this political group permeated many institutions in the emerging Muslim world and the developed world.[17] Ahmed (2015, p. 57) describes this as follows:

> The Islamic economic proponents, in their zeal to reform the existing financial system, seem to have populated the institutions (and academic journals) in

> Islamic economics (and finance) with like-minded scholars to bolster their case. The resources of these institutions have been diverted to sponsor conferences where the key disciples of Mawdūdī and party cadres are invited to respectively present keynote addresses and papers with little academic rigor. Likewise, the journals edited by Islamists are focused on promoting their ideologies even at the expense of research for the economic betterment of the Muslim world. Nonetheless, all this mental jostling has been in vain as it has failed to lay the theoretical foundation or the intellectual base of the field. …The failure to do so has been a stumbling block for the financial services industry in the Muslim world and has been heavily criticized by many.

Ahmed (2015) also highlights its founder's economic vision and its followers' intellectual contribution. He laments the inability of the *Jamaat-e-Islami* members to develop state-of-the-art instruments, institutions and markets. This is due to lack of academic rigour attributed to: (i) being fixated in antiquity as they romanticize the early history of the Muslim world; (ii) overemphasizing the normative while ignoring the positive; (iii) overemphasizing altruistic behaviour; (iv) overemphasizing the literal meaning of the scripture thereby ignoring its spirit; and (v) disregarding the role of institutions and the upgrading of an outdated legal system.

Their endeavours, however, are ineffectual without legitimacy from the religious establishment. They thus support a juristic interpretation of the scripture and the authentic traditions of Prophet Muhammad.

The religious nomenclature/ rulings related to business transactions, which were developed twelve hundred years ago, have remained static as its formulators did not adapt to the changing intellectual and socio-economic environment. This is in contrast to the rapid pace of development of financial economics in the past sixty years. The static religious scholarship has stifled the Muslim world's creativity and has held back the development of financial instruments, institutions, and markets (Ebrahim and Sheikh, 2018). This failure to keep pace has retarded the development of the Muslim economies.

7. Conclusion

This essay examines the movement towards the Islamization of financial services, legitimized as financial development. We adopt an institutional perspective to extend the studies of Bassens et al. (2013), Fang (2014), Lai et al. (2017), and Kuran (2018).[18] This allows us to incorporate the 'cultural turn' into our analysis without ignoring crucial economic aspects (Jessop and Oosterlynck, 2008). We focus on a narrow subsector, namely, that of the *Takaful* industry, as it comprises an intriguing case of a relatively less efficient system that has nonetheless grown in popularity. This challenges the idea that the most efficient organizational form succeed. We therefore examine the reasons behind the success of *Takaful* and the consequences of the same. We find several issues from both economic and religious perspectives. We find variance in the literature and practice about its structure. The premise behind the industry is based on a bizarre understanding of economic principles by religious scholars. The research on the same is incoherent and does not identify whether *Takaful* entails a mutual (as identified by Abdul Kader et al., 2014; and Karbhari et al., 2018) or a hybrid (as highlighted in the conventional insurance literature such as Erhemjamts and Leverty, 2010) or even a stock-based company (as deplored in El-Gamal, 2006).

We also identify the inefficiencies of *Takaful* over its conventional counterpart. They are attributed to: (i) the organizational constraints imposed by the religious scholars who are not trained in the intricacies of financial economics; (ii) operational apathy stemming from low economies of scale and scope and (iii) managerial lethargy (Ismail et al., 2011; Abdul Kader et al., 2014; and Karbhari et al. 2018). The above result makes us realize that *Takaful* is financial regression instead of advancement. The current version of it is not a new paradigm in insurance.

As the existence of the inefficient organizational form of *Takaful* is not feasible in the neoclassical framework of Fama and Jansen (1983a, b), we emulate the neo-institutionalism perspective of DiMaggio and Powel (1983) to evaluate the puzzle. We contend that political Islamic personnel employ the equivocal organization structure of Takaful in alliance with religious scholars as a proxy to regain their political power and institutional legitimacy (Robinson, 2009). The 'certificate' given by religious scholars, who act as the legitimators of the global IF industry, works as a 'stamp of piety' for its customers, agnostic to the economic inefficiency of the product (Wilde et al., 2010; Bassens et al., 2013; Berg and Kim, 2014).

The ramifications of our findings bestow new insights to the Weberian thesis postulating the relative underdevelopment of the Muslim world vis-à-vis the developed world. We attribute the same to: (a) the religious scholarship, which tends not to maximize economic efficiency as it puts other goals first; and (b) the obstinacy of the cadres of political Islam (Weber, 1904-5/1958; Ahmed, 2015). Our results agree with:

(i) Manova (2013, p.711), who states that '…weak financial institutions hinder growth and general economic activity;*'* and

(ii) Alfaro et al. (2004, p.91) described as follows: 'Schumpeter recognized the importance of well-developed financial intermediaries in enhancing technological innovation, capital accumulation, and economic growth almost a century ago. In a nutshell, the argument goes that well-functioning financial markets, by lowering costs of conducting transactions, ensure capital is allocated to the projects that yield highest returns and therefore enhance growth rates.'

Our study also affirms the findings of Ebrahim and Sheikh (2018), who advocate an intermediate position between the Impediment Theory of Weber (1904-5/1958) and Kuran (2018) and the Facilitator Theory of Chapra (2008). We argue that the underdevelopment of the contemporary Muslim world is primarily due to the view of the jurists, who hold a monopoly in certifying products in the financial marketplace as *Sharī'ah* compliant. The jurisprudential rulings deduced in the medieval era are among the key reasons behind the lack of cutting-edge financial instruments, markets, and institutions.

We feel that the recent alliance of religious scholars and political Islamists will not improve the lot of the emerging Muslim economies in contrast to the earlier links of the scholars with the autocrats highlighted in Ebrahim and Sheikh (2018). On the contrary, this will only exaggerate the disparities in development and, thus, spatial inequalities between the predominantly Muslim regions and the rest of the world (Ezcurra and Rodríguez-Pose, 2014). The Muslim world is doomed from one crisis after another. The only way out of this morass is for policymakers and economists etc. within the Muslim world to (i) comprehend the gravity of the situation; (ii) reform the educational institutions from rote learning to that of critical thinking;[19] (iii) revise (or purge) the religious edicts conducted in the medieval era;[20] (iv) create institutions (that check the power of the ruling elite as well as the clergy and that of political Islamists) to promote property rights; and (v) ensure that all financial development is conducted under the oversight of financial economists instead of leaving them in the sideline.

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Notes

1 A growing literature on the finance-growth nexus is also concerned about the adverse impacts of 'financialization' (Storm, 2018). The disproportionate growth of the financial system aggregates financial fragility and uneven geographies of development (Pan et al., 2017). However, we argue that the positive articulation between finance and economic progression is more appropriate in the spatial context of our study, i.e., the underdeveloped financial system of the Muslim regions.

2 The 57 Muslim-majority countries in the world are quite underdeveloped, contributing roughly 13.75 per cent of the world economy in 2019 despite comprising around 24.41 per cent of the global population. In contrast, the 27 countries in the European Union plus the United Kingdom, which comprise around 6.70 per cent of the world population, contribute roughly 18.10 per cent to the global economy. The ramification of this impoverishment is the political instability of its constituent nation-states and the negative impact (in the form of illegal immigration, terrorism, etc.) on the rest of the world (Gould and Klor, 2014).

3 Our results confirm the assertions of Fang (2014, p.1172), who states that: 'The religious and normative nature of Islamic economic precepts, however, does not fit well with classical economics' assumption of purely profit-maximizing agents.'

4 The Weberian thesis attributes the underdevelopment of the Muslim world to its cultural doctrines and the lack of dynamic review of the same (Weber, 1904-5/1958).

5 The objectives of Islamic law are to ensure the preservation of faith, intellect, life, lineage, and wealth of human beings (Kamali, 2000). We feel that without a deep knowledge of economic theory, one may not be able to comprehend and thus make a judgment on the *Maqāsid al-Sharī'ah* of financial institutions. This is because economic theory endows the understanding of the preservation of wealth, which impacts on the other four objectives.

6 In contrast to the above, Cummins et al. (1999a) provide evidence that suggests productive inefficiency of life insurers.

7 We do agree with the *Takaful* literature that investment of conventional insurance companies in toxic debt, which is not effaced of the ill-effects of: (i) asymmetric information (adverse selection and moral hazard); and (ii) agency costs of debt (risk-shifting and underinvestment) can lead to the meltdown of not only these securities but also their underlying institutions and markets (Abdul Kader et al., 2014; Khan, 2015 and Karbhari et al., 2018). This subsequently impacts the real sector of the economy, as observed in the banking crisis across the globe (Fritz and Mühlich, 2019).

8 https://kingfaisalprize.org/professor-al-seddiq-m-al-darir/

9 El-Gamal (2006, p. 170) laments that 'even companies that use the term *takaful ta˘awuni* (cooperative mutual guaranty or insurance) are structured as stockholder instead of policyholder ownership.'

10 Historically, there have been insurance companies such as Manhattan Life in the 1850s, which have adopted a 'mixed' or hybrid organizational form, as reported in Smith and Stutzer (1995).

11 Wells et al. (1995) find that managers of mutual-based insurance firms have higher free cash flows at their disposal in contrast to stock-based firms. This leads managers of mutual to invest these cash flows on unprofitable investments.

12 Zou et al. (2009) support this by illustrating that mutual-based insurance firms tend to pay significantly lower dividends than stock-based firms.

13 Cummins et al. (1999b) conclude that mutual-based firms are less cost-efficient. However, Cummins et al. (2004) recognize differences in efficiency only for small mutual insurance companies. Finally, Biener and Eling (2012) find no evidence that stock-based firms are more cost-efficient than mutual-based firms.

14 Commercial transactions and contracts are permissible unless there is a clear injunction to the contrary (see Kamali, 2002, p. 66-70).

15 The constraints imposed by the religious establishment runs afoul of the Qur'ānic injunctions (5:87) and (16:116) that prohibit making things unlawful, which in itself are lawful.

16 The economic decay of the Muslim world is described by Schacht (1995, pp. 76-77) as follows:

> Islamic law, which until the early 'Abbāsid period had been adaptable and growing, from then onwards became increasingly rigid and set in its final mould…. the changes which did take place were concerned more with legal theory and the systemic superstructure than with positive law…. Islamic law… has become more and more out of touch with later developments of state and society.

17 Mawdudi was the first person awarded the King Faisal Prize in 1979 (https://kingfaisalprize.org/sayyid-abul-alaa-al-mowdoodi/).

18 We conduct a thorough study of the *Takaful* industry. This goes beyond the general statement made by scholars such as Kuran (2018, p. 1308), who states that 'many of the financial procedures touted as Islamic are ruses that medieval jurists developed expressly to circumvent inconvenient legal barriers. Certain ruses such as the double sale used to bury interest payment in a fictitious transaction, have Christian equivalents dating from the Middle Ages, when the Church prohibited interest.'

19 To bolster the intellectual development of the emerging Muslim economies, controls need to be placed to constrain the hegemonic abuse of power of both the clergy as well as cadres of political Islam. Safeguards need to be installed in the: (i) recruitment of open-minded intellectuals in educational institutions, as well as the (ii) selection of unbiased referees in the evaluation of articles in academic journals.

20 This includes those construed by the folks of Political Islam.

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APPENDIX

Table 1. Contrasting Stock versus Mutual Insurance Companies

Stock Ownership	Policyholder Ownership
- This reduces owner-manager agency costs.	- This eliminates policyholder-manager agency costs.
- This provides access to capital markets.	- This reduces the moral hazard.
- This should dominate in the following areas: i. Commercial Coverage and areas requiring managerial discretion, ii. Lines with significant economies of scale.	- This should dominate in the following areas: i. Personal lines (less discretion required), ii. Liability insurance (lags may provide opportunities for managerial abuse). iii. Environments with aggregate uncertainty.

Source: El-Gamal (2000)

Table 2. Survey of Literature illustrating the Inefficiency of the Takaful form

Study	Data Set Description	Results compared with conventional insurance
Ismail et al. (2011)	Here, the sample comprises 19 *Takaful* companies in Malaysia during the period 2004-2009.	*Takaful* companies have low technical and scale efficiencies.
Abdul Kader et al. (2014)	Here, the sample comprises panel data of Non-life *Takaful* companies for 2004-2007 from 17 Muslim countries.	Non-life *Takaful* companies illustrate low operational and cost efficiencies.
Karbhari et al. (2018)	Here, the sample encompasses 134 *Takaful* companies operating in 21 countries during the period 2002-2013.	*Takaful* companies depict low operational, technical and scale efficiencies.

Source: Authors of this article