

SHARIAH RFP MODULE 2: RISK AND TAKAFUL PLANNING

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SHARIAH RFP PROGRAMME

Module 2: Risk and Takaful Planning

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Chapter 1

Risk Management

Chapter Outline:

- 1.1 Concept of Risk Management
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Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the concept of risk management and the basic concepts of risk
- Define risk management and understand the importance of managing risks
- Identify the process and techniques involved in risk management.

1.1 Concept of Risk Management

Risks are managed through a process called risk management. Risk management, at first, may appear to be an overwhelming task. Risk management is a structured approach to managing uncertainty related to a threat that could affect assets and earnings of a business or an individual through a sequence of human activities such as risk identification, risk assessment, risk mitigation, etc.

Normally, when risks exist, they are either managed or left as they are. To leave risks as they are without trying to manage them is considered a risky action; therefore, the need for risk management is crucial.

1.2 Importance of Risk Management

To understand how to manage risks effectively, one must understand the nature of risks and the concepts related to them. Most importantly, one needs to know the definition of 'risk' and what are the elements of 'risk'.

1.2.1 What Is Risk and How It Differs from Chance?

'Risk' is a factor, thing, element, or course involving uncertain danger. It is a chance of something happening that will have an impact on an event. Or simply put, it is an uncertainty of an outcome of a future event. For the purpose of this module, 'risk' can be defined as *"uncertainty about financial loss from an exposure"*. In everyday life, we are exposed to risks as well as the unexpected losses due to risk exposure, such as, financial losses and death. The causes of these losses are called 'perils'.

Since a risk is an uncertainty of an outcome of a future event, it is important to differentiate 'risk' from 'chance'. 'Chance' implies some doubt about the outcome in a given situation. 'Chance' differs from 'risk' in the sense that its outcome is normally favourable, whereas for risk, the focus is more on the possibility of loss. For example, in a gymnastic tournament, normally the athletes worry about the risk of making mistakes but there is a chance of winning the tournament.

1.2.2 Basic Concepts of Risk

Peril and hazard are among the basic concepts of risk. Examples of common peril are old age, sickness, inability to work, premature death, theft, fire, flood, etc. Risk, peril and hazard are interrelated. The relationship between these three can be clearly seen in the following example. When one drives a car, one might be involved in an accident due to negligence or the car might suddenly breakdown on the highway. These events (the accident and the breakdown), are classified as hazards. A hazard will contribute to a risk as a result from peril caused by the accident. The concepts of risk, peril and hazard will be discussed further in Chapter 3.

1.2.3 What Is Risk Management?

Engaging in risk management activities allows a business or an individual to have better control over its overall performance. Risk management involves managing various types of risks. The type of risk that we are mainly concerned with is financial in nature. It is a fact that all individuals face the risk of financial loss of some kind and practically at all times. There is a need for individuals and businesses to properly manage the multiple risks they face but they seldom have the right expertise. Nevertheless, experts such as professional risk managers and financial planners can be called upon to assist.

Risk management can be described as all activities performed within a business or by an individual to identify, assess and control the uncertainties which may impact on its/his ability to achieve its/his aims, objectives and opportunities.

Risk management should be viewed as a positive and enabling process, which if embraced well, can help a firm to achieve positive outcomes from the decisions it makes. It can also be said to be a process of identifying the negatives of why a decision, action or opportunity should not be taken, leading to opportunities not being pursued.

Risk management is not a process to completely avoid taking risks, but more a process which if used effectively can help a business or an individual pursue innovative opportunities with higher levels of risks, because the exposure to risks is then properly understood and managed down to acceptable levels.

Another avenue to understanding risk management is that risks can be effectively managed when we hold on to this question as our guide: *Why are we managing the risks in the first place?* The answer to this question should focus on two scenarios: pre and post-loss. The **pre-loss** scenario is about proper and adequate measures or actions to be taken to cover certain losses should they happen. On the other hand, the post-loss scenario is to make sure an individual can still meet his daily survival requirements after a loss-event has taken place.

Factors that contribute to a pre-loss scenario are:

i. Economy

A business or an individual could plan and prepare for unexpected or potential losses in the most cost-effective way. It involves analysing the cost of safety programs or the amount of contribution that have to be paid if the business or individual decides to participate in an insurance/takaful program. Accordingly, this cost may vary from one country to another depending on the state of the economy. The high level of competition in a developed economy would lead to a decrease in such costs and increase in quality, which may not be the case in developing economies.

ii. Anxiety Reduction

Management of anxiety due to loss exposures or risks is also important. Exposure to losses could cause great discomfort and fear to business firms. Fear of being sued by customers due to defective products or fear of a factory burning down in a fire can cause anxiety to the firm. Considering costs, the occurrence of such event a single time would wipe out all cost savings from not purchasing the needed insurance policy. In the case of an individual, the difficulty of finding a new home in case of fire can be traumatic, especially if one's financial resources are limited. Therefore, risk management is crucial in order to minimize the unexpected losses.

iii. Meeting Legal Obligations

Government regulations may require a firm to install safety devices to protect workers or label consumer products appropriately. Individuals are required to have motor insurance/takaful cover before road tax discs can be issued for their cars. Note that failure to meet such requirements may be very costly and problematic to businesses.

Factors that contribute to a **post-loss scenario** are:

i. Continuity and survival of a business or a family

Survival of the company is the most important factor. When risks are properly managed, firms can resume their operations and move on with their business activities and survive; otherwise, business might be lost to competitors. In the case of a family, its members will face tremendous financial difficulty at the sudden demise of its sole breadwinner. An insurance/takaful benefit can compensate for the loss of the breadwinner's earnings. Similarly, an unexpected accident such as fire or theft may severely damage the business. However, a suitable insurance scheme shall minimize the effect of such unfavourable events in order to enable firms to survive and overcome turbulent circumstances.

ii. Earnings stability

The business survival would provide firms with the opportunity to achieve their financial goals and overcome their unexpected losses through the continuity of production. Eventually, this shall reflect on the earnings and income stability in the long run. When the business activities of a firm can continue in the face of a loss situation, its earnings or income can also be sustained.

iii. Continued development and well-being

It is crucial for a firm to continue growing its business through development of new products and innovation in order to survive in the market. Losses could hinder this type of development if not properly managed. In a family, shortage of funds for children's further education can be demoralizing.

iv. Social Responsibility

The impact of losses to a firm could be so severe that its employees, suppliers, creditors and the community are also affected. Good risk management is needed for the firm to mitigate the impact of those losses.

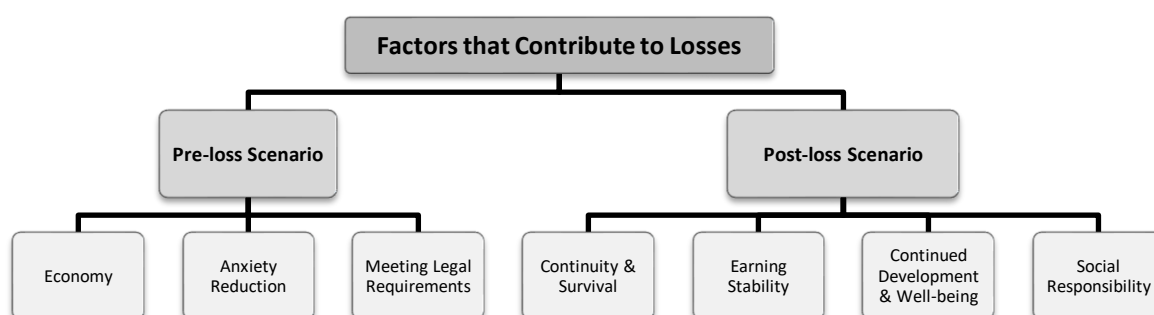


Figure 1: FACTORS THAT CONTRIBUTE TO A LOSS

1.3 Processes in Risk Management

There are five-steps involved in the Risk Management process:

- 1) Identification of Risk
- 2) Evaluation of Risk
- 3) Development of Risk Management Plan
- 4) Implementation of Risk Management Plan
- 5) Review and monitoring of Risk Management Plan



Figure 2: RISK MANAGEMENT PROCESS

1.3.1 Identification of Risk

Risk identification is the most important step in the risk management process. Identification of risks is to make out the risks that could damage the finances of an individual or a firm. The identification process normally comes before the solution process. Once the risks are identified, they must be measured and evaluated individually to determine the probability or chance the loss will occur and the financial impact it can have on an individual or a firm.

There are three classes of risk or loss exposures: property, liability and personal risk exposures.

- **Property risk exposures**

Property risk exposures of an individual or a firm can be a direct or an indirect exposure. *Direct exposure* is when one is involved in a car accident where one's car is completely damaged. *Indirect exposure* refers to the situation where the individual suffers a loss of income due to damage caused to the property or other casualties. As per earlier example of the car accident, the individual could be so badly injured that he needs medical attention which incurs expenses involving a certain amount of money.

Examples of property risk exposures: physical damage to buildings, factories, furniture, vehicles, etc.

- **Liability risk exposures**

Liability risk exposures are a condition that creates the possibility that an individual's financial resources may be diminished as a result of a liability risk (claim for damages due to injury to another, or damage to another's property).

There are two elements in a liability risk exposure:

- 1) Chance of a claim for damages--that you might be sued.
- 2) Financial consequences--investigation, defense, and judgment.

Examples of liability risk exposures: defective products, sexual harassment of employees, discrimination against employees etc.

- **Personal risk exposures**

These arise from the possibilities of death, illness or injury of an individual. In the case of death, there is no adverse financial impact if the deceased has no dependants. However, the same cannot be said of a retired individual if he is ill or injured, and is without an adequate source of income and insurance to cover medical expenses. Hence, personal risk exposure is associated with financial losses and other expenses resulting from a premature death or disability. Whilst a financial loss represented by an income may incur due to death or disability of an income earner, other expenses may be incurred too such as special treatment, child care and equipment.

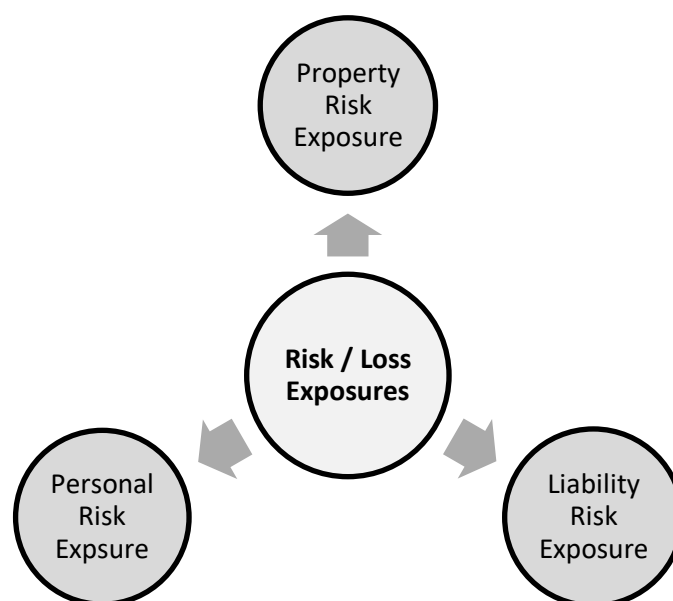


Figure 3: RISK/LOSS EXPOSURES

1.3.2 Evaluation of Risks

Risk evaluation is the process of determining the risk significance for action to be taken after considering the resources available to support that action. Risk evaluation involves the estimation of frequency and severity of risk exposures and ranking them to their relative importance. Risks with high potential losses will be given priority in the risk management plan.

- **Risk Frequency** refers to the number of times a loss-producing event will occur during a given time period.
- **Risk Severity** refers to the cost or amount of loss, in monetary terms, arising from a loss-producing event.

Not all risks are significant and need to be handled or insured. Size does not matter in determining whether a risk should deserve attention. Smaller risks can be ignored even if there is a great chance that they may occur. On the other hand, risks which carry potentially severe financial impact on an individual's life or the firm's well-being should be handled first even if they have a slight chance of occurring. The chance of occurrence or frequency does not matter in determining whether a risk deserves attention.

Risk		Risk Frequency			
		Unlikely	Not likely	Possible	Probable
Risk Severity	Extremely severe	Dangerous	Dangerous	Extremely dangerous	Extremely dangerous
	Severe	Moderately dangerous	Dangerous	Dangerous	Extremely dangerous
	Mild	Moderately dangerous	Dangerous	Dangerous	Dangerous
	Insignificant	Not dangerous	Not dangerous	Moderately dangerous	Dangerous

Table 1: EVALUATION OF RISKS BASED ON FREQUENCY AND SEVERITY

Example:

A loss exposure with the potential of bankrupting a firm is much more important in a risk management plan than frequent risk exposures that cost a small amount.

1.3.3 Development of Risk Management Plan

Once the risks have been evaluated completely, it is time for selection and application of the different techniques used in risk management. The selection of techniques takes place in the plan development stage. The techniques are selected and deemed suitable for use in risk management based on their costs and effectiveness. There are four techniques involved in a risk management plan.

1. Risk avoidance

It is an effort by an individual to avoid dealing with the risk at all. The risk is left as it is or activities that are risky are avoided. For instance, an individual in retirement may refrain from drinking alcohol to prevent degenerative diseases from setting in at a later stage of his life. Another example is a business refraining from operating in a flood-prone area to avoid losses resulting from floods.

2. Risk (loss) control

It is a process where an individual or a firm takes steps to reduce the severity of a possible loss or to reduce the possibility of the loss occurring. This can be done by using loss prevention and loss reduction techniques. **Loss prevention** refers to a measure that reduces the frequency of a particular loss while **loss reduction** is a measure that reduces the severity of a loss after it occurs. For instance, on the one hand, a firm may hire patrolling security guards, install video cameras and/or use secured storage facilities as a loss prevention technique. On the other hand, if a firm needed to store flammable items in its warehouse, it may install water sprinklers to minimize damages in case of a fire occurrence as a loss reduction technique.

3. Risk retention

It is a process of handling the risk personally or internally. It refers to the firm's willingness to retain part or all of the losses that can result from a given risk. Retention can be divided into two:

- **Active retention** - Aware of the loss exposure and plans to retain part or all of it.
- **Passive retention** - Failure to identify a loss exposure and failure to act.

Examples of risk retention:

Active retention: The owner of a bookshop may deliberately retain the risk of petty theft by employees or shoplifters.

Passive retention: A firm fails to identify its assets damaged in a flood.

4. Risk Transfer

It is the process of shifting (to others) a risk that is neither avoided nor retained through either insurance or non-insurance based contract.

Insurance transfer

Refers to an arrangement where a contracted compensation will be paid to the insured if the insured suffers financial loss caused by fortuitous events. Insurance is appropriate for loss exposures that have allowed probability of loss and high severity of loss.

Non-insurance transfer

Refers to methods other than insurance by which a pure risk and its potential financial consequences are transferred to another party. Examples of these methods include contracts, leases and hold-harmless agreements.

Examples of non-insurance transfers:

- A firm's photocopying lease can specify that maintenance, repairs and any physical damage to the photocopy machines are the responsibility of the photocopy firm.
- A publishing company may insert a hold-harmless clause in its contract with all authors. Thus, the authors and not the publisher are held legally liable if the publisher is sued for plagiarism.



Figure 4: RISK MANAGEMENT PLAN DEVELOPMENT

1.4 Techniques of Risk Financing

Risk retention and **risk transfer** are techniques used in financing risk. These techniques will provide funding for losses that may occur.

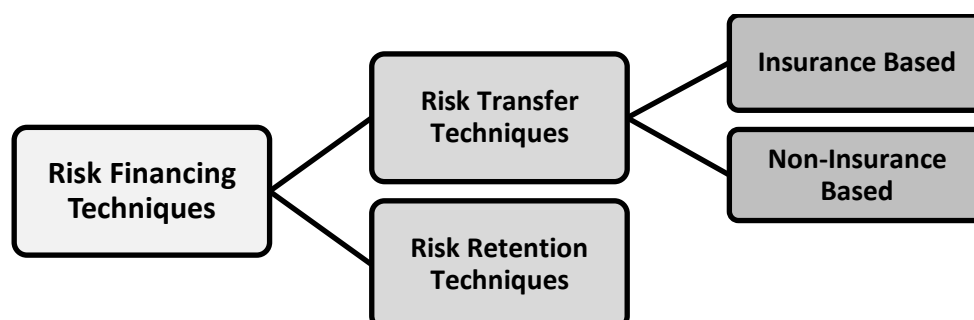


Figure 5: RISK FINANCING TECHNIQUES

1.4.1 Implementation of Risk Management Plan

After the selection and application of suitable techniques have been applied to the area of risk exposures, the plan is ready for implementation. In performing this step, risks should be prioritized in order of their importance and then matched to actions to be taken in dealing with them. One of the actions that can be taken is to insure the risks.

To effectively implement the risk management plan, a proper and relevant action plan should be in place for each technique.

i. Risk avoidance

A mixture of actions can be used, namely: elimination, substitution, separation and rational planning.

- **Elimination** refers to removing the source of the risk in the plan. For instance, avoid taking part in dangerous sports activities such as car racing; a bank decides to avoid dealing in derivatives due to the associated high risks; a construction company closes the sites during storms in order to avoid the risk that a worker may get injured; a retail company decides to discontinue collecting personal details in order to avoid any information security breach; an investor rejects an offer to invest in stocks in which he/she cannot understand their complex business and risk factors.
- **Substitution** concerns the replacement of one activity or substance with another, which is less dangerous. For example, replace taking part in a dangerous sport like car racing with a less dangerous sport like badminton; a manufacturing company may replace its older machinery with inherently safe machinery and change how tasks are performed to ensure safety.
- **Separation** means a placement or division of items so that hazardous or dangerous mixing cannot occur. For instance, two chemicals that can react when put together should be stored in two separate rooms in order to prevent an explosion; a manufacturing company may store its products in few warehouses located in various areas in order to avoid the risk that a single hazardous event such as a fire or a tornado destroys all finished products at once.
- **Rational planning (diversification)** is to avoid some risks through careful organization by creating alternatives or contingency sources for critical items. For example, a business should get more suppliers of a critical raw material so that it will not get caught in an out-of-stock position on that item; a manufacturing company may allocate its resources to create multiple lines of production to ensure variety of products in order to avoid the risk that a severe loss to one line of business does not paralyze the company's production.
- Duplication is meant to ensure the existence of a backup plan so that a system failure does not cause an irreparable harm to the business. For instance, a tech company may create an information system backup server to be readily available in case the primary server fails.

ii. Risk (loss) control

Risk (loss) control technique is meant for risks that cannot be avoided and when the individual concerned does not wish to transfer the risk. Managing these types of risks can be done in three ways:

- **Loss prevention** means reducing the chance of loss for any risk that cannot be avoided. For example, when one is working in a hospital dealing with AIDS patients, one should wear proper attire and adhere strictly to guidelines.
- **Loss reduction** refers to controlling the severity of each loss when an unexpected event takes place. For example, installing a high-level security system in the house in case of break-ins.
- **Loss sharing** is one way that could reduce the impact of risks where an individual or an organisation may share risky activities with others. An example would be forming a joint venture with others in a business so that in the event of bankruptcy, losses and liabilities can be shared with more people.

iii. Risk retention

This is the most pervasive move where an individual or an organization willing to retain part of their risks rather than passing them on to others. Most of the risks faced by an individual or organization daily cannot be prevented. Therefore, those who choose not to reduce, transfer or avoid the risks will retain the possibility of loss. It is, hence, important for them to ensure the level of loss severity for each risk in order to retain a bearable loss.

Risk retention can be divided into two:

- Active retention - Aware of the loss exposure & plans to retain part or all of it.
- Passive retention - Failure to identify a risk exposure and failure to act.

Example of retention:

Active retention: The owner of a grocery store may deliberately retain the risk of petty theft by employees or shoplifting; a company may decide to set aside reserves rather than buying an insurance policy to cover unexpected losses resulting from the exposure to a specific risk.

Passive retention: An individual who fails to identify his assets damaged in a fire; a company may decide to neither accumulate reserves nor buy insurance to protect itself against a specific risk. Passive retention usually occurs due to ignorance, indifference and procrastination.

iv. Risk transfer

There are two forms of risk transfer, i.e. insurance and non-insurance transfer. The idea of risk transfer is to plan how to finance those losses when they arise.

- **Insurance transfer:** potential risk at hand is in a pure risk situation. For example, an individual may sign up for an insurance contract for the risk of loss of earnings due to death for a certain amount of money.
- **Non-insurance transfer:** potential risks are contractually transferred to another party, forcing that party to either retain or insure the risk.
Examples: property contracts and leases agreements.

1.4.2 Reviewing and monitoring a Risk Management Plan

Reviewing and monitoring are the final activities in the risk management plan. These activities involve periodic reviews and monitoring the implementation process, as well as progressive revision on the plan in order to be up-to-date with the situational changes in life.

Reviewing and monitoring are crucial in a risk management plan as an individual or organization's well-being might change due to current economic conditions, or an individual's current state of health might not be the same as when he first signed up for the insurance contract, or his needs for insurance is no longer present. Reviewing and monitoring need to be done in order to identify any deficiencies or necessary adjustments and also to ensure the objectives of the plan are being attained.

Risk Rating	Low	Moderate	High	Extreme
Monitoring	Routine practices are sufficient	Management responsibility to monitor	Management attention is required	Urgent and active management is a must

Table 2: MONITORING VARIOUS LEVELS OF RISK

1.5 Conclusion

This chapter covered the Risk Management. Among the aspects discussed are: Concept of Risk Management, Importance of Risk Management, Processes in Risk Management, and Techniques of Risk Financing. These aspects are very important in the area of financial planning as they represent one of the driving components in the advice and recommendation.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Which of the following would be the best definition of risk management?
 - A. Systematic development of methods in handling risks faced in daily routine.
 - B. Management of risks by using insurance.
 - C. Wealth accumulation process by way of reducing risk exposures.
 - D. The process of risk elimination.

2. In risk management,_____.
 - A. loss is the unlikable outcome of risk
 - B. risk is the unpleasant outcome of loss
 - C. exposure is the undesirable outcome of loss
 - D. loss is the unlikable result of business ventures

3. Which of the following explains the difference between risk and chance?
 - A. Outcome of risk is more favourable compared to chance.
 - B. Risk is tolerable but chance is not tolerable.
 - C. Outcome of chance is favourable compared to risk.
 - D. Risk is uncertainty of future whereas chance is a definite event.

4. What are the two forms of risk transfer?
 - A. Re-insurance and non-insurance
 - B. Insurance and non-insurance
 - C. Personal loss and liability loss
 - D. Pre-loss and post-loss scenarios

5. Which of the following statement is part of risk retention?
 - A. An individual or a firm is aware of the loss exposure and plans to retain part of the loss.
 - B. Successfully identify the risk exposure but failure to act.
 - C. Safest way in dealing with risk.
 - D. Associated with unbearable risk.

6. _____is to control the severity of each loss when an unexpected event takes place.
 - A. Loss prevention
 - B. Loss sharing
 - C. Loss transfer
 - D. Loss reduction

7. Which of the following are among the mixture for risk avoidance?
- A. Exploitation, substitution, rational planning and separation
 - B. Substitution, elimination, rational planning and separation
 - C. Implementation, elimination, rational planning and separation
 - D. Separation, exploitation, grouping and rational planning
8. _____ is an effort by an individual to avoid dealing with the risk altogether.
- A. Risk retention
 - B. Risk transfer
 - C. Risk planning
 - D. Risk avoidance
9. _____, _____ and _____ are factors contributing to a pre-loss scenario.
- A. Economy; meeting legal obligation; anxiety reduction
 - B. Economy; anxiety reduction; meeting personal obligation
 - C. Anxiety reduction; meeting personal obligation; financial
 - D. Economy; anxiety reduction; financial
10. Which of the following is accurate about risk?
- A. Most risks can be eliminated
 - B. Leaving risks alone is not a risky action
 - C. Risks cannot be eliminated but can be mitigated
 - D. Mitigation of risk is impossible
11. A rice company decides to set aside reserves rather than buying an insurance policy to cover unexpected losses resulting from storms. This arrangement refers to _____.
- A. Risk avoidance
 - B. Risk control
 - C. Active retention
 - D. Passive retention
12. A commercial mall decides to neither accumulate reserves nor buy insurance to protect itself against fire. This arrangement refers to _____.
- A. Risk avoidance
 - B. Risk control
 - C. Active retention
 - D. Passive retention

Answer: 1-a, 2-a, 3-c, 4-b, 5-a, 6-d, 7-b, 8-d, 9-a, 10-c, 11-c, 12-d.

Chapter 2

Risk Management in the Islamic Point of View

Chapter Outline:

- 2.1 Concept of Risk in Islam
- 2.2 Importance of Risk Management in Islam
- 2.3 Approaches in Risk Sharing
 - 2.3.1 Belief (*I'tiqadiyyah*)
 - 2.3.2 Dealings (*'Amaliyyah*)
 - 2.3.3 Morality (*Akhlaqiyyah*)
- 2.3. Risk Management in Islamic finance and its principles
 - 2.3.1. General Requirement
 - 2.3.2. Credit Risk
 - 2.3.3. Equity Investment Risk
 - 2.3.4. Market Risk
 - 2.3.5. Liquidity Risk
 - 2.3.6. Rate of Return Risk
 - 2.3.7. Operational Risk
- 2.4. Risk Transferring Versus Risk Sharing
- 2.5. Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the Concept of Risk in Islam
- Explain the Importance of Risk Management in Islam
- Identify the Types of Risks and Approaches Used in Risk Sharing in Islam
- Understand the difference between risk sharing and risk transferring

2.1 Concept of Risk in Islam

Before we move on to the next chapter about insurance, we need to know the basic concept of risk from the Islamic perspective. 'Risk' in Islamic terms is *Ghorm*. *Ghorm* comes from the legal saying, *al-ghorm bil-ghonm* meaning 'no pain no gain' (Saiful Azhar Rosly, 2005). When it comes to business activities, risk (*ghorm*) implies two types of risks: market risk and financial risk.

As explained in the previous chapter, risk is an uncertainty of an outcome of a future event. All risks can result in losses to an individual or an organization. Losses in the context of Islamic Insurance are depreciation or lost in economic value of an asset. In this context, our Prophet (s.a.w.) once said, *"Take advantage of five opportunities before five other things: Your youth before your senescence, your health before your illness, your wealth before your poverty, your leisure before your haste, and your life before your death."* (narrated by Al-Hakim)

In the history of Islam, there are many incidents closely related to risks which can be used as benchmarks. In facing and managing risks, several steps can be implemented:

- Risk avoiding
- Risk reduction
- Risk sharing
- Risk controlling

The management of risks was practiced by Prophet Muhammad (s.a.w.) when he decided to perform *hijrah* to the Madinah from Makkah. In Makkah he was threatened by the Quraisy who did not want him to practice Islam. The Prophet (s.a.w.) made a detailed plan to managed contingencies. For instance, he assigned Sayyidina Ali (one of the Companions) to replace him in his bed to mislead the Quraisy into thinking that he was still in the house. In actual fact, the Prophet (s.a.w.) had left the place far enough to avoid capture by the Quraisy. Another managed contingency was the use of a less traveled route from Makkah to Madinah. The *Hijrah* was planned in stages with the companions leaving Makkah for Madinah in batches in order to minimize the risk of them being captured. These plans show that the practices of risk avoidance and risk reduction are among the essences of risk management that need to be taken in order to ensure success of a plan.

Other than the story of *Hijrah*, there is another example of the risk management element during the era of Prophet Muhammad (s.a.w.) where risk control was practiced in the Battle of *Badr*. In the Battle, one of the Prophet's companions, Al-Hubab, suggested that the Muslims encamp further south of the nearest water well, keep a basin of water for themselves, and destroy the other wells thereby restricting the Quraisy's access to water. The Prophet (s.a.w.) approved of his plan and it was carried out. This plan enabled the authorities that guard the supply of water, the most important resource in a war in the desert, to have better control of the battle. In the Battle of *Khandaq*, *Salman Al-Farisi* suggested that the Muslims dug out a channel surrounding Madinah as a fortress. By digging out the channel, it enabled the Muslims to guard the city of Madinah more effectively.

Before one is able to manage risks effectively, one should perform thorough planning. By proper planning, one can change each difficulty into an opportunity. As a Muslim, one should be wise in planning ahead, preparing for any uncertainties that may come one's way in achieving goals or objectives. This can be seen in the example of Prophet Yusuf when the King of Egypt had a

vision in his dream of seven undernourished cows eating seven large cows, seven stalks of wheat and seven dry stalks. The King asked Prophet Yusuf the meaning of this dream. Prophet Yusuf, with the wisdom that had been granted to him by Allah (SWT), gave his counsel on the matter, as described in Yusuf verses 47-49:

“For seven years shall ye diligently sow as is your wont: and the harvests that ye reap, ye shall leave them in the ear, - except a little, of which ye shall eat. “Then will come after that (period) seven dreadful (years), which will devour what ye shall have laid by in advance for them, - (all) except a little which ye shall have (specially) guarded. “Then will come after that (period) a year in which the people will have abundant water, and in which they will press (wine and oil).”

From these sacrifices of wealth and emotions, positive values which are important in the shaping of our religious identity and strong resilience can be instilled. Again, from the Yusuf, it shows that proper planning and managing risks are among the important tasks in our life on our journey to be a successful *Khalifah*. We should be able to educate our family to be grateful for all that have been granted. Bring them to be aware of other peoples' sufferings and hardships, and help them understand that there are many who live in worse conditions. Those are key values to be nurtured in our family.

Indeed, behind each sacrifice of time, money, emotions and efforts, there are abundant benefits which can be gained, such as spiritual upliftment, stronger family ties, and greater awareness of the challenges faced by others in the community.

Besides avoiding, reducing and controlling risks, Islamic history also instructed about sharing risks. The principle of risk sharing was stated in the statute of Madinah. It was the responsibility of all citizens of Madinah, as stated in the statute of Madinah to share out among the society, the payout to release those captured in wars.

2.2 Importance of Risk Management in Islam

As risks are ever present, risk management is an important element in life. Islamic risk management also deals with risks and uncertainties of business outcomes and individual hardships. Managing risks, the Islamic way, centers on a religious base which promotes social responsibilities, equalities and fairness. In fact, Islam promotes good risk management as one of the objectives of Shariah is to protect life, lineage and wealth. An individual, business or society will never progress if opportunities at hand where certain risks are inherent are avoided totally. Therefore, when one practices good risk management, it shows that one has fulfilled one's obligations as a good Muslim.

An example of a Shariah-based system that has been used to mitigate risks is takaful. Takaful adopts principles that are similar to insurance for risk mitigation. Without risks, there would be no need for insurance or Takaful.

Takaful system is a protection plan based on Shariah principles where a group of people agrees to share their risks and provides mutual protection of assets and property in the event of loss incurred by one of its members. A sum of money is contributed by all members to a common takaful fund in the form of participative contribution (*tabarru'*), where he or she undertakes a contract (*aqad*) to become one of the participants by agreeing to mutually help each other, should any of the participants suffer a defined loss.

The takaful system currently practiced in Islam promotes many noble values. For instance, death of the sole breadwinner in a family could cause a financial crisis. However, if a takaful system is in place, it would ease the family's burden. From a larger economic perspective, the takaful plan also helps to transfer funds to useful investments where it could help the economy grow

2.3 Approaches in Risk Sharing

The activities of risk sharing will help to protect individuals from tragic consequences of losses as a result of risks. Risk sharing could be accomplished by spreading risks and perils across the group whereby any resulting losses to individual assets and property are shared among a large number of community participants, as practiced in takaful.

In the previous chapter, we have discussed on traditional risk management processes which involve five steps of activities: Identification of Risk, Evaluation of Risk, Development of Risk Management Plan, Implementation of Risk Management Plan and Review and monitoring of Risk Management Plan.

Similarly, in Islamic approach to risk management, the processes must comply with Shariah principles whereby the additional values of Islamic rules have been added to the traditional risk management processes. In managing risks for organizations, the risk sharing approach is done in such a way where suppliers of funds become investors instead of creditors while the provider of financial capital and the entrepreneur will share the business risks in return for a share of the profits. Whereas for individuals, risk management processes and decision-making in the eyes of Shariah, should be based on three elements: Belief (*I'tiqadiyyah*), Dealings (*'Amaliyyah*) and Morality (*Akhlaqiyyah*).

In Shariah, the primary objectives behind a Muslim's conduct of activities are to bring benefit to the people. He is concerned with his affairs in this world and also the hereafter. Therefore, he aims to secure benefit for the people and protect them against corruption and evil. The purpose and the wisdom behind the enactment of all or most of the Shariah rulings is called *maqasidal*- Shariah.

2.2.1 Belief (*I'tiqadiyyah*)

Belief is one's personal convictions about what one should strive for in life and how one should behave; in other words it is one's 'values'. A Muslim's belief (*I'tiqadiyyah*) is strongly based on the pillars of Islam and *iman*. These two pillars play an integral part in a Muslim's life. They help to mold each individual into a good *khalifah* or good Muslim. The five pillars of Islam are unity of God (*tauheed*), fasting (*saum*), prayers (*solat*), pilgrimage (*hajj*) and Alms (*zakat*) and the six pillars of *iman* are belief in Allah, belief in the angels, belief in prophets (peace be upon them), belief in the holy books, belief in the resurrection and the events of *qiyamah* and belief in the predestination by Allah of all things, both the good and the bad.

Belief (*I'tiqadiyyah*), in relation to risk management, means a deep consciousness of the unity of direction of what we want in life, clarity of purpose of survival, avoidance of wrongdoing, and equality among people. In propelling one's journey in life, one should have a sense of self-control and a community that is united in sharing pleasure, suffering, and risks. It also implies that humbleness and some hardship can sustain and enrich civic and individual responsibility.

As a Muslim, one must focus on undivided commitment to principles and to time to reflect on spirituality. In managing risks, one must comply and adhere to the Shariah principles and *non-permissible activities* must be avoided. Furthermore, risk sharing is one avenue that allows one to discharge his obligation towards those who are in need and are facing hardship. It also enables those who are capable and in a position of responsibility to execute their moral and social duty to narrow the gaps between the have and the have-nots. The Prophet Muhammad (s.a.w.) declared, “*No Muslim plants a plant, or sows a field and birds, men and beasts eat there from but it is his alms-giving*”. (Muslim)

2.2.2 Dealings (*‘Amaliyyah*)

Dealings constitute the relationship between human and his creator (*ibadah*), and human & human (*mu’amalah*). As a Muslim, it is very important to reflect on the fact that, no matter what one does or what one plans to do, it always falls back to one’s relationship with one’s creator: Allah (SWT), and with the rest of humankind. Those reflections will help one to remain conscious of one’s deeds in life and always abide by the Shariah principles. In that, risk management is not excluded.

Decision-making in risk management is considered the most critical stage in its processes. Any activities pertaining to managing risks must always adhere to the Shariah principles and all decisions made must consider the element of social responsibility, equity and fairness to the rest of the humankind. The impact of such decisions would be indirectly reflected in the community’s prevailing economic state. For example, one would participate in a *takaful* plan to mutually contribute a sum of money that can be used to help the poor and needy of the community.

2.2.3 Morality (*Akhlaqiyyah*)

Finally, morality comprised of relationships between human & his Creator (*ibadah*) and human with Allah’s creation. Human and Allah’s creation relationship means the relationships between human beings and non-human beings.

In order for us human to seek a higher end and ultimate happiness (*Sa’adah Haqiqiyyah*) in life, we should remember that Allah (SWT) did not just create humans but the rest of the universe. This means all living things on earth are the creations of Allah (SWT). For instance, in conducting business today, do people really think about the morality behind all their activities and decisions? In order for a business to reduce costs, instead of investing in a high end waste management system, they rather pollute the environment by discarding and discharging all their production waste into the river nearby. This scenario is what actually happened everywhere. As a result, it will give threat to other living things and the rest of the environment. So, it is crucial for each and every one of us to practice respects with each other, not just between human but also between non-human (i.e. animals, plant, etc.) in order to achieve ultimate happiness in life and the hereafter.

2.3 Risk Management in Islamic finance and its principles

According to the IFSB risk management guidelines there are six types of risk management from an Islamic perspective, credit risk, equity investment risk, market risk, liquidity risk, rate of return risk and operational risk. They are briefly explained below:

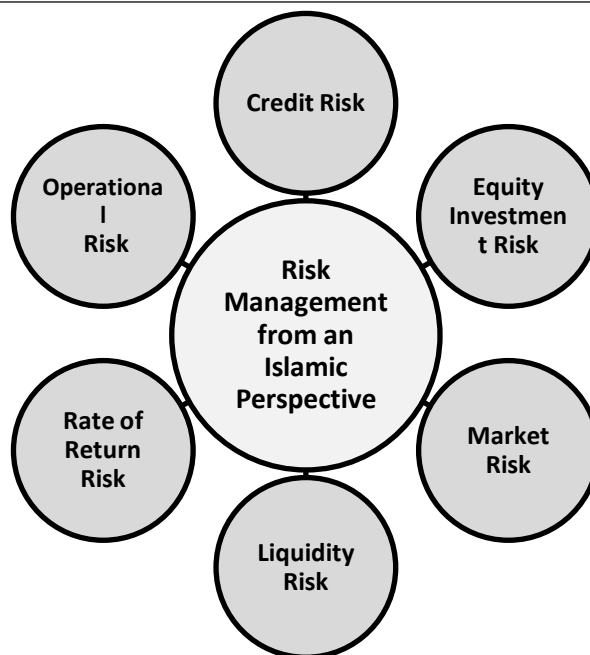


Figure 6: RISK MANAGEMENT FROM AN ISLAMIC PERSPECTIVE

2.3.1 General Requirement

There is one principle under the general requirement, it is as follows: Principle 1.0: The Islamic Institutions Financial Services (IIFS) shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority

2.3.2 Credit Risk

There are four principles under credit risk, they are as follows:

Principle 2.1: IIFS shall have in place a strategy for financing, using various instruments in compliance with Shariah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

Principle 2.2: IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

Principle 2.3: IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

Principle 2.4: IIFS shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

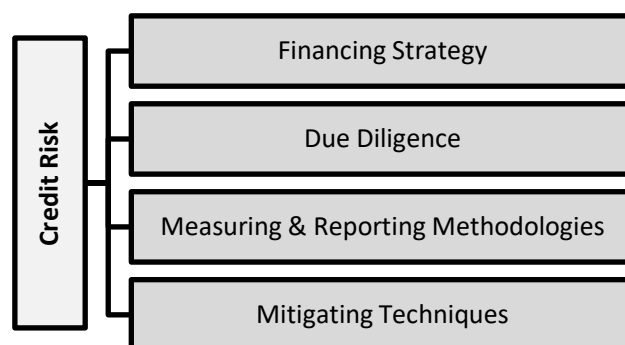


Figure 7: CREDIT RISK PRINCIPLES

2.3.3 Equity Investment Risk

There are three principles equity investment risk, they are as follows:

Principle 3.1: IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including *Mudārabah* and *Mushārah* investments.

Principle 3.2: IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the *Mudārib* and/or *Mushārah* partners.

Principle 3.3: IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for *Mudārabah* and *Mushārah* investments, subject to the approval of the institution's Shariah Board.



Figure 8: EQUITY INVESTMENT RISK PRINCIPLES

2.3.4 Market Risk

There is one principle under market risk, it is as follows:

Principle 4.1: IIFS shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

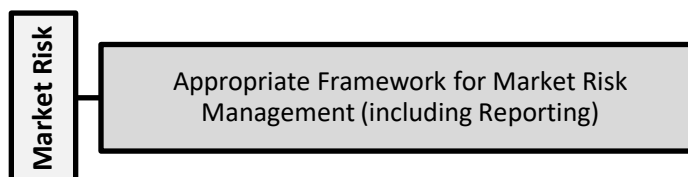


Figure 9: MARKET RISK PRINCIPLE

2.3.5 Liquidity Risk

There are two principles under liquidity risk, they are as follows:

Principle 5.1: IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

Principle 5.2: IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.

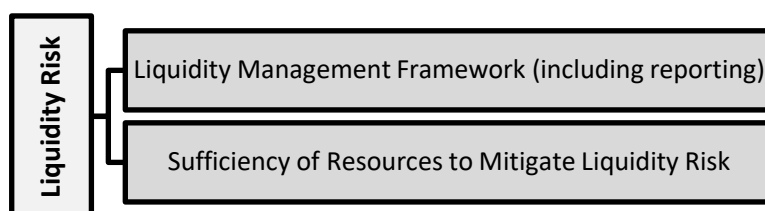


Figure 10: LIQUIDITY RISK PRINCIPLES

2.3.6 Rate of Return Risk

There are two principles under rate of return risk, they are as follows:

Principle 6.1: IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

Principle 6.2: IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.

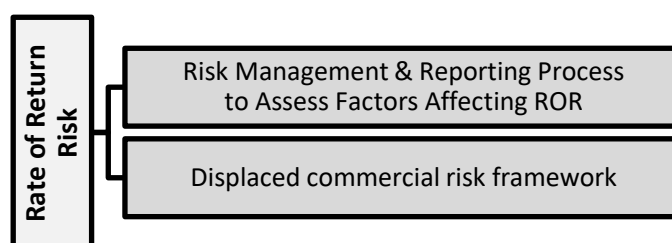


Figure 11: RATE OF RETURN RISK PRINCIPLES

2.3.7 Operational Risk

There are two principles under operational risk, they are as follows:

Principle 7.1: IIFS shall have in place adequate systems and controls, including Shariah Board/ Advisor, to ensure compliance with Shariah rules and principles.

Principle 7.2: IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with the IIFS's own funds, the IIFS shall ensure that the bases for asset, revenue, expense, and profit allocations are established, applied and reported in a manner consistent with the IIFS's fiduciary responsibilities.

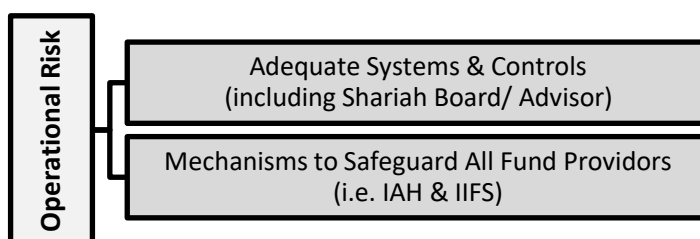


Figure 12: OPERATIONAL RISK PRINCIPLES

2.4 Risk Transferring Versus Risk Sharing

Risk sharing refers to the case where the financier agrees to share in both the profits as well as the losses of the investment. Accordingly, if the entrepreneur generates profits then the financier is to share in the profits. However, if the former fails to do so then the latter only gets his/her capital back; if the investment suffered losses then they are solely borne by the financier. On the contrary, interest-based economy stipulates that funds are provided to the entrepreneur on the condition of

being repaid with a pre-agreed fixed reward added to the principal irrespective of the results of the investment. Hence, unlike the case of risk sharing, risks are solely borne by the entrepreneur in the interest-based system.

The following example illustrates the mechanism of risk sharing and risk transferring (shifting). Assume E is an entrepreneur whilst F is a financier. F provides capital to E on the basis that F is to share in the profits as well as losses of the investment. Assume R offers to buy the risks of F in exchange for a fixed price. Hence, R must compensate F in case of losses. The preceding arrangement illustrates risk transferring to a third party, which is prohibited in Islam since it contradicts the principle of “profit comes with risk”. Such an arrangement is purely speculative rather than productive. However, if R offers to manage the risk of F in exchange for a price then it becomes permissible.

On the macro perspective, risk sharing and risk transferring have different impact on the economy as well as society members. Whilst risk transferring is inefficient and unjust, risk sharing emphasizes an efficient and equitable system in the economy and brings the brotherhood values among society members. The efficiency of risk sharing values can be seen through allocating funds based on expected investment profitability and productivity rather than the creditworthiness of the sponsors as the case in interest-based system. Moreover, risk sharing is seen as an effective tool to encourage innovation and entrepreneurship in which brilliant ideas can push the wheels of the economy forward. On the contrary, allowing the transferring of risks to entrepreneurs while guaranteeing the capital of financiers will create an extra pressure on the former while protecting the latter, which shall prevail inequitable values in the society and inefficiency eventually.

In a nutshell, risk sharing emphasizes a more equitable income distribution whereas risk transferring results in a continuous transfer of wealth from entrepreneurs to financiers through guaranteeing their capital and reward (i.e. interest payment). In the long run, such practices will adversely affect income distribution and damage social values among society members.

2.5 Conclusion

This chapter covered the Risk Management in the Islamic point of view. Among the aspects discussed are: Concept of Risk in Islam, Importance of Risk Management in Islam, Approaches in Risk Sharing and Risk Management in Islamic finance and its principles which includes General Requirement, Credit Risk, Equity Investment Risk, Market Risk, Liquidity Risk, Rate of Return Risk and Operational Risk. These aspects are very important in the area of financial planning as they represent one of the driving components in the advice and recommendation.

Additional Reading Material:

Article

Bouslama, G., & Lahrichi, Y. (2017). Uncertainty and risk management from Islamic perspective. *Research in International Business and Finance*, 39, 718-726.

Hassan, M. K., & Kayed, R. N. (2009). The global financial crisis, risk management and social justice in Islamic finance. *ISRA International Journal of Islamic Finance*, 1(1), 33-58.

Book

Hassan, K., & Lewis, M. (Eds.). (2009). Handbook of Islamic banking. *Edward Elgar Publishing*.

Self-Assessment

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Which one of the following is the **correct** group of steps that can be taken in managing risk?
 - A. Risk planning, risk reduction, risk mitigation, risk identification
 - B. Risk measuring, risk mitigation, risk grouping, risk identification
 - C. Risk avoiding, risk reduction, risk sharing, risk controlling
 - D. Risk avoiding, risk measuring, risk sharing, risk controlling

2. What are the two risks that normally relate to a business activity?
 - A. Financial risk and credit risk
 - B. Market risk and financial risk
 - C. Market risk and credit risk
 - D. Credit risk and investment risk

3. In Islamic insurance, losses are associated with
 - A. Risks-sharing
 - B. Depreciation
 - C. Loss-sharing
 - D. Profit-sharing

4. _____, _____ and _____ are among the noble values that are used as the main elements in managing risks the Islamic way.
 - A. Social responsibility, believe in the hereafter and equity
 - B. Fairness, responsibility and consideration
 - C. Honesty, social responsibility and equity
 - D. Equality, social responsibility and fairness

5. An Islamic system that has been used to deal with risks is
 - A. *Takaful*
 - B. *Musharakah*
 - C. *Mudarib*
 - D. *Tabarru'*

6. Which one of the following best describes the risk-sharing approach in a business?
- A. Suppliers of funds will become the creditors instead of investors and they will share the risks together.
 - B. The risks will be borne by the suppliers of funds alone.
 - C. The business risks will be shared between the financial capital provider and the entrepreneur whereas the suppliers of funds will become the investors instead of creditors.
 - D. The business risks will be borne by the creditors alone.
7. _____, _____ and _____ Shariah-based _____ are three important elements risk management.
- A. *Ibadah*, *mu'amalah* and *'amaliyyah*
 - B. *I'tiqadiyyah*, *'amaliyyah* and *akhlaqiyyah*
 - C. *Musharakah*, *mu'amalah* and *ibadah*
 - D. *Istisna'*, *i'tiqadiyyah* and *akhlaqiyyah*
8. Deep consciousness of the unity of direction of what we want in life and clarity of purpose of survival best suit the concept of _____.
- A. *I'tiqadiyyah*
 - B. *Mu'amalah*
 - C. *Akhlaqiyyah*
 - D. *'Amaliyyah*
9. Which of the following statements best describes the *akhlaqiyyah* concept?
- A. Practicing respect between human and non-human beings.
 - B. Practicing respect between human and human.
 - C. Practicing respect not just between human and human but also between human and non-human.
 - D. Practicing respect between human and creator.
10. Dealings constitute the relationship between human & _____; and human & _____.
- A. Creator, human
 - B. Creature, human
 - C. Non-human, creator
 - D. Creator, creature
 - E. Creator, non-human

Answer questions 11 and 12 based on the following:

A financier provides capital to an entrepreneur to be invested in a specified project on the basis that the former is to share in the profits as well as losses of the investment. A third party offers to buy the risks of the financier in exchange for a fixed price in which he must compensate the financier in case of losses. The preceding arrangement illustrates risk transferring to a third party, which is prohibited in Islam.

11. Such an arrangement is prohibited because:
- A. The arrangement involves *riba*
 - B. The arrangement is not covered under standardized Islamic contracts
 - C. The arrangement is purely speculative
 - D. None of the above
12. What is the solution for this arrangement to become permissible?
- A. The subject matter of the transferred risk must be permissible
 - B. The transferred risk must be identified
 - C. The third party must become a partner then he can bear the whole investment risk
 - D. The third party may manage the risk of the financier in exchange for a price

Answer: 1-c, 2-b, 3-b, 4-d, 5-a, 6-c, 7-b, 8-a, 9-c, 10-a, 11-c, 12-d.

Chapter 3

RISK AND INSURANCE

Chapter Outline:

- 3.1 Introduction
- 3.2 Related Concepts of Risk
 - 3.2.1 Peril
 - 3.2.2 Hazard
- 3.3 Categories of Risk
 - 3.3.1 Pure and Speculative Risk
 - 3.3.2 Fundamental and Particular Risk
 - 3.3.3 Enterprise Risk
- 3.4 Types of Pure Risk
 - 3.4.1 Liability Risk
 - 3.4.2 Property Risk
 - 3.4.3 Personal Risk
- 3.5 Insurance
- 3.6 Functions of Insurance
 - 3.6.1 Primary function
 - 3.6.2 Secondary function
- 3.7 Basic Principles of Insurance
- 3.8 Classes of Insurance
- 3.9 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Define risk, peril, hazard and loss
- Understand the concepts and principles of insurance
- Identify the different categories of risk
- Understand the importance of insurance
- Describe the two classes of insurance

3.1 Introduction

Every individual is invariably exposed to the possibility of misfortune or ill luck, such as accident, burglary, fire and even death. One needs to be adequately prepared when dealing with catastrophes and disasters, particularly in terms of financial resources. One may use one's personal savings or borrowings to cope with such situations, although these measures may not be sufficient. Hence, additional financial resource is important.

One such measure available to the public is the cover or protection provided under the various types of insurance policies. Very few people go through their daily activities without being involved in some form of insurance transaction, be it motor insurance or mortgage insurance attached to housing loans. By having insurance protection, one could at least reduce the financial burden that results from an unfortunate event.

3.2 Related Concepts of Risk

In addition to what has been discussed in Chapter One, other terms which are relevant to the concept of risk are peril and hazard.

3.2.1 Peril

Peril refers to the cause of a loss. Common perils include fire, flood, collision, earthquake, sickness and premature death. When a peril occurs, property may be destroyed or lost and persons could be injured or killed. Any loss of property or lives will invariably lead to financial losses.

Examples of peril:

1. *If your car is damaged in an accident, the accident is the peril or the cause of loss.*
2. *If a restaurant is destroyed in a fire, the fire is the peril.*

3.2.2 Hazard

Hazard refers to the condition that increases the chance of loss. There are four (4) types of hazards:

a) Physical Hazard

This refers to a physical condition that increases the chance of loss.

An example of physical hazard:

Defective wiring in a building that increases the chance of fire

b) Moral Hazard

This refers to character defect (dishonesty) in an individual that increases the chance of loss. Moral hazard is present in all forms of insurance and it is difficult to control.

An example of moral hazard:

Intentionally burning unsold merchandise that is insured to collect from an insurer

c) Morale Hazard

It refers to carelessness or indifference to a loss because of the existence of insurance. Careless acts will likely increase the chance of loss.

An example of morale hazard:

Leaving a door unlocked that allows a burglar to enter the house because all major household items are well-covered with insurance

d) Legal Hazard

This refers to a characteristic of the legal system or regulatory environment that increases the frequency or severity of losses.

An example of legal hazard:

Large damage awards in liability lawsuits

3.3 Categories of Risk

Risks can be classified into several distinct categories. The most important categories are the following:

1. Pure and Speculative Risks
2. Fundamental and Particular Risks
3. Enterprise Risks

3.3.1 Pure and Speculative Risk

a) Pure risk

This refers to risks that can result in only loss or no loss. The only possible outcomes are adverse (loss) or neutral (no loss). Nothing beneficial can come from an exposure to pure risks. Pure risks are more predictable and easier to apply the law of large numbers. Pure risks can be handled by insurance techniques.

Examples of pure risks:

- i) *Risk of damage to property resulting from fire, lightning, flood or other natural disasters*
- ii) *Premature death*
- iii) *Expensive medical expenses*

b) Speculative risk

This refers to the possibilities that can result in loss, no loss or profit (gain). It is an uncertainty about an event that could produce either a profit, neutral (no loss) or a loss. Speculative risks are rarely insured because it is difficult to apply the law of large numbers.

Examples of speculative risks:

- i) *Investments in the stock market*
- ii) *Price movements of foreign currencies, agricultural and other commodities*
- iii) *Venturing into a business*

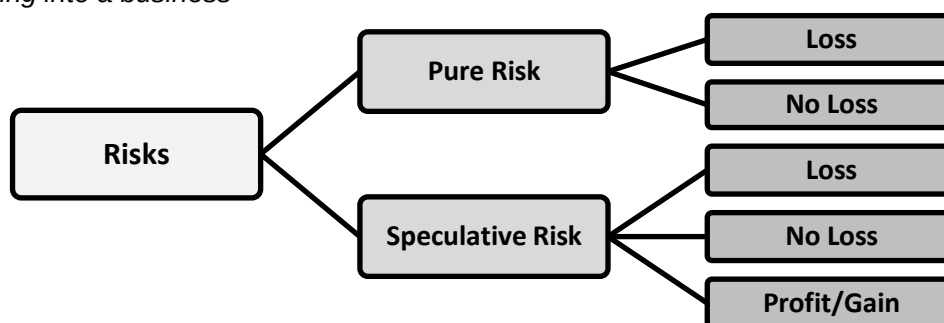


Figure 13: MAIN CHARACTERISTICS OF PURE AND SPECULATIVE RISKS

There are three (3) reasons to distinguish pure risks and speculative risks:

1. Insurance companies typically only insure pure risks. With certain exceptions, insurance companies do not insure speculative risks. Thus, other techniques for dealing with speculative risk must be used.
2. The law of large numbers can be applied more easily to pure risks than to speculative risks. It is important because it enables insurance companies to predict future loss experience.
3. Society as a whole may benefit from a speculative risk even though a loss occurs. However, it is harmful if a pure risk is present and a loss occurs.
For example, when new technology was developed to produce CDs and DVDs, video rental outlets and companies that sold tape cassettes went out of business. Despite this, society benefited because the new technology was more efficient and cost-effective.
However, when a pure risk occurs, such as a tsunami or flood, society normally does not benefit from it.

3.3.2 Fundamental and Particular Risk

a) Fundamental Risk

A risk which when it occurs, the whole society or a large number of people within the economy is affected.

Examples of fundamental risks:

- i) *Risk of property damage from earthquake, flood (other natural disasters)*
- ii) *Loss of lives arising from war*
- iii) *Risk of a terrorist attack*

b) Particular Risk

A risk which when it occurs, only individuals and not the entire community are affected.

Examples of particular risks:

- i) *Risk of damage to property from accident, theft, robbery*
- ii) *Injury resulting from auto accident*

3.3.3 Enterprise Risk

This refers to all major risks faced by a firm. It includes pure risk, speculative risk, strategic risk, operational risk and financial risk. Since the meanings of pure and speculative risks have been discussed above, the next section will only describe strategic, operational and financial risks.

a) Strategic Risk

It refers to the uncertainty of loss with regard to the firm's financial goals and objectives.

An example of strategic risk:

A bank ventures into a new line of business (real estate investment). The new business line may not be profitable to the bank.

b) Operational Risk

It refers to the uncertainty of loss regarding the firm's business operations.

An example of operational risk:

A trading company that offers online services to its customers may suffer losses if 'hackers' break into the company's computer system.

c) Financial Risk

This refers to the uncertainty of loss with regard to adverse changes in commodity prices, interest rates and foreign exchange rates.

An example of financial risk:

'Sweet Tooth' Corporation that agrees to deliver various confectionaries at a fixed price to a supermarket chain in three months, may lose money if cocoa price rises.

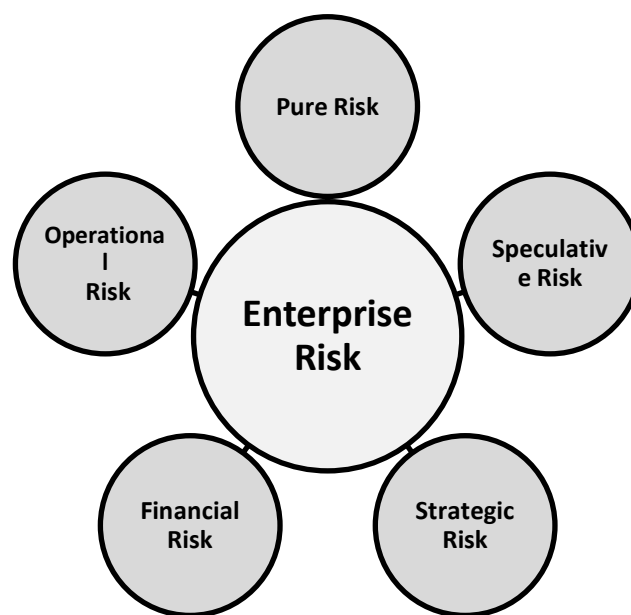


Figure 14: ENTERPRISE RISK

3.4 Types of Pure Risk

Since pure risks are insurable, this topic will emphasize primarily on pure risks. There are three (3) types of pure risk that create financial insecurity, namely:

1. Personal Risks
2. Property Risks
3. Liability Risks

3.4.1 Personal Risk

This refers to risks that directly affect individuals. They lead to the possibilities of loss or reduction of income, extra expenses incurred and depletion of assets. Personal risk is further divided into four (4) types:

a) Risk of Premature Death is the possibility of death of a breadwinner with financial obligations. This risk may cause financial problems if the deceased has dependants to support or dies with unfulfilled financial obligations.

b) Risk of Insufficient Income during Retirement is the possibility of retirees losing their earned income if they do not have sufficient financial assets or other sources of retirement income. The risk may cause a reduced standard of living.

c) Risk of Poor Health is the possibility of having to pay catastrophic medical bills and loss of earned income.

d) Risk of Unemployment is the major threat to financial security. It results from business cycle down swings, technological and economy changes, etc.

3.4.2 Property Risk

This refers to the possibility of loss due to damage to property from various causes, such as fire, flood, earthquake, and other natural disasters.

There are two (2) types of property risks:

a) **Direct Loss** is the financial loss that results from physical damage, destruction or theft of property.

An example of direct loss:

The physical damage to a factory that was on fire is a direct loss.

b) **Indirect Loss or Consequential Loss** is the financial loss that results indirectly from the occurrence of a direct physical damage or theft loss of the property.

An example of indirect loss:

In addition to the physical damage to a factory in the case of a fire, the owner loses his income or sales while a new factory is being built. Thus, the loss of income/sales is a consequential loss.

3.4.3 Liability Risk

This refers to the risk of inflicting bodily injury or property damage to someone else. In such a case, the court may order one to pay substantial damages to the person one has injured. In liability loss cases, there is no maximum upper limit with respect to the amount of the loss.

An example of liability risk:

Business firms can be held legally liable for defective products that harm customers.

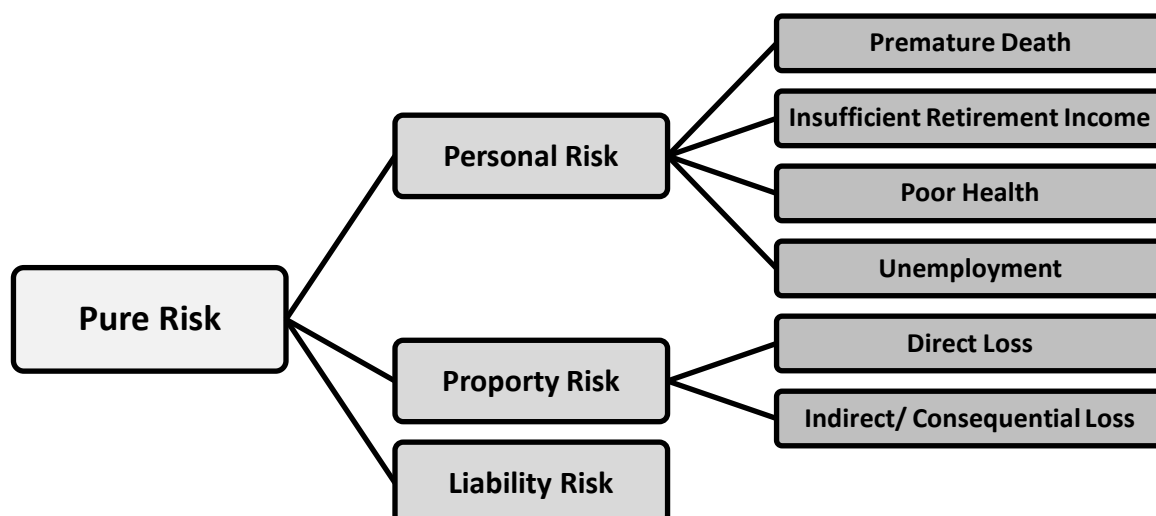


Figure 15: TYPES OF PURE RISK

3.5 Insurance

Definition:

Insurance can be defined as an economic institution based on the principle of cooperation and formed for the purpose of establishing a common fund. The need for this fund arises from chance occurrences of nature whose probability can be fairly estimated.

Insurance, as a company, seeks to provide protection against financial loss caused by fortuitous events. The services provided involve payment of contracted compensation to the insured against unforeseen losses.

3.6 Functions of Insurance

Functions of insurance can be divided into two:

3.6.1 Primary function

The primary function of insurance is the equitable distribution of the financial losses of the few who are insured among the many insured. Accordingly, insurance companies collect premium payments from policyholders in exchange for compensations paid upon the occurrence of specified undesirable events.

3.6.2 Secondary Function

a) Cost Stabilization

Through insurance, firms can avoid the necessity of having to put aside capital to provide for financial protection against losses. This provides a means of stabilizing the costs involved in managing risks.

b) Stimulates Business Enterprise

The risk transfer mechanism provided by insurance makes it possible for business firms to get started and flourish.

c) Removes Fear and Worries

By transferring risks, insurance removes fears and worries of losses of business firms. It helps to establish confidence and enables forward planning of economic activities.

d) Reduction of Losses

Insurers help to reduce losses through their actions and recommendations; for example, rating and survey inspection services.

e) Means of Saving

Insurance provides a saving avenue, especially through endowment insurance. Endowment is a combination of decreasing term insurance (protection) and increasing element of savings and investment. By combining the two features in a single plan, the endowment insurance provides both protection and savings to the insured.

f) Sources of Capital for Investment

Insurance companies accumulate large funds from the premiums charged, out of which claims are met. These funds are usually invested in the public and private sectors, thus, helping the overall development of the economy.

3.7 Basic Principles of Insurance

Insurance contracts are not only subject to the general principles of the law of contract, but also certain special legal principles that are embodied in insurance contracts. The principles are:

1. Insurable Interest
2. Utmost Good Faith
3. Indemnity
4. Subrogation
5. Contribution
6. Proximate Cause

3.7.1 Insurable Interest

Insurable interest is the legal right to insure arising from the legitimate financial interest which an insured has in a subject matter of insurance. An individual with insurable interest on a subject must stand to lose financially if the subject of insurance is damaged, destroyed or lost.

Legitimate financial interest refers to a financial interest, which is recognized by law. If a person's financial interest in a subject matter of insurance is not legally recognized, he/she lacks the required insurable interest to affect a valid insurance.

Example:

We have an insurable interest in our car because we stand to lose financially if it is damaged in a road accident.

Examples where insurable interest exists are:

- i) An individual on his/her own life.
- ii) An individual on his/her spouse's life.
- iii) A parent on the life of a child below the age of majority.
- iv) A creditor on the life of a debtor, to the extent of the debt.
- v) Employer on the life of key personnel.
- vi) A partner in business on his/her other partners.

3.7.2 Utmost Good Faith

According to this principle, the proposer (potential policyholder) has the duty to disclose fully and accurately all material facts relating to the proposed risk, that a proposer knows or is reasonably expected to know, whether asked or not. Material fact is a fact which will influence the underwriter in deciding whether to accept or decline the risk or the amount of premium to be charged. The material fact depends on the nature of the proposed risk.

Example:

A person's health history is a material fact for a life insurance policy. However, the information is not a material fact for a fire policy.

3.7.3 Indemnity

This principle requires the insurer to restore the insured to the same financial position as he/she had enjoyed immediately before the loss. The objective of the principle of indemnity is to ensure the insured, after being indemnified, shall not be better off than before the loss, although he/she may receive less than the loss as a result of policy limitations. For example, a commercial property was insured against fire for one year in exchange for a premium paid. If a fire occurs and the building significant structural damages, the insurance company must indemnify the owner either through reimbursing him for the costs of repair or by reconstructing the damages using the insurance company's own contractor.

3.7.4 Subrogation

This principle provides that an insurer who has indemnified an insured for a loss may exercise the insured's rights to claim from the third party in respect of the loss. The objective of this principle is to prevent the insured from getting more indemnity when he/she has two or more insurance to cover the losses. For example, assume you had a car accident caused by another driver who ran a red light. Your insurance company will pay for all the accident expenses and then pursues legal action against the driver at fault. Subsequently, your company will seek reimbursement from at fault party's insurance company. Thus, your company will recover any amount paid.

3.7.5 Contribution

This principle provides that an insurer who has indemnified an insured for a loss may call upon other insurers liable for the same loss to contribute proportionately to the cost of the indemnity payment. For example, a homeowner insured his new home against fire at two different insurance companies for a total amount of RM100,000. If a fire occurred and the homeowner files a claim to one of the two companies, the company will pay the RM100,000 and then collect half of the amount from the other company according to the contribution principle.

3.7.6 Proximate Cause

In an insurance claim, the insurer is only liable for a loss caused by an insured peril. The insurer is not liable for a loss caused by either an uninsured peril or an excluded peril. Losses may arise due to two or more causes which involve both insured and excluded perils. This principle provides that when a loss is the result of many causes, the proximate cause (the dominant or effective cause) must be identified and attributed as the cause of the loss. For example, a construction worker falls from a ladder during work and only breaks his leg. The company staff immediately calls 911. On the way to the hospital the ambulance car has an accident and all people on board die. In this case, the proximate cause of the worker's death is the collision of the ambulance car and certainly not the broken leg.

3.8 Classes of Insurance

The insurance business can be classified into two classes, namely life insurance and general insurance.

3.8.1 Life Insurance

Life insurance is a contract between the policyholder (insured) and the life insurance company (insurer), where the policyholder agrees to pay the insurer premiums in return for insurance coverage. The insurer will pay the policyholder or the policyholder's beneficiary a sum of money in the event of the policyholder's death, permanent and total disability, critical illness, the maturity date (in the case of endowment policy) and any other specified events. Life insurance is an effective financial tool to protect dependants from financial loss, because by paying a relatively small amount of money, the risk of possibly large financial losses is transferred to the insurance company.

Generally, the compensation or the life insurance policy benefit can be used to:

1. Pay off the policyholder's outstanding loans (mortgage, car loans and other bills).
2. Replace lost income after the insured dies.
3. Provide for the cost of children's education.
4. Pay for medical bills in cases of critical illness.
5. Fund retirement expenses.

3.8.1.1 Characteristics of Life Insurance

a) Life Insurance Contracts are Long-term Contracts

Period of coverage under life insurance contracts are long. Under whole life insurance, the coverage depends on the insured's whole life or up till the insured is 100 years old. For endowment insurance, the coverage period ranges from 10, 20 or 30 years or until the insured is 65 years old. Term insurance, on the other hand, is a temporary insurance and can be renewed at the end of the period of coverage. The period of insurance may be anything from one year, five years, ten years, or in some cases as long as 20 or 25 years or till age 55 or 60 of the insured.

b) Premium Rate is fixed

Whole life and endowment insurance policies use the level-premium method in determining the premiums charged. Under this method, the premiums are fixed throughout the insurance period and do not increase with the age of the insured. As for term insurance, the premium is fixed during the insurance period, but the premium will be increased once the policy is renewed. Thus, the insured will be charged with a higher premium as he ages.

c) Payment of a Claim Terminates a Life Insurance Contract

In life insurance, with the exception of permanent health insurance policies, the settlement of a claim ceases or terminates the contract. However, in the case of a general insurance, the contract is not terminated by the payment of claim, and in fact, further claims can be made within the period of the contract. However, once the total sum insured has been paid, the contract would be terminated.

d) Insurable Interest

Existence of insurable interest is a prerequisite for a life insurance contract. To have an insurable interest, the purchaser of a life insurance policy must stand to suffer a financial loss due to the death of the person on whose life the life insurance policy has been bought.

e) The Risk to be Insured Increases with Time

In life insurance contracts, the mortality risk increases with age and with the duration of the contract. Thus, a younger policyholder may be charged with a lower premium rate, compared to an older policyholder. In terms of duration, shorter insurance period will be charged with lower premium rate than longer insurance period.

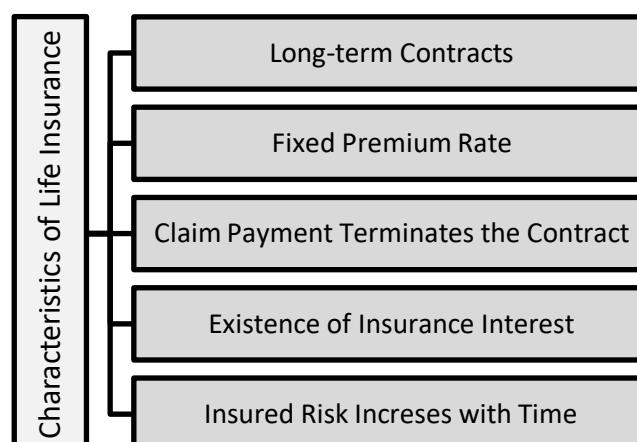


Figure 16: CHARACTERISTICS OF LIFE INSURANCE

3.8.1.2 Life Insurance Products

Life insurance is concerned with the events occurring during the span of human life. These include early death, disability or prolonged old age. Each of these situations creates a need, and it is the aim of life insurance to meet these needs. For this purpose, life insurance companies have designed many types of policies. The traditional life insurance policies are term, whole life and endowment policies.

a) Term Insurance

Term insurance is the earliest and simplest form of life insurance contracts and is also known as a temporary insurance. It is designed to provide financial protection if the insured dies, or suffers permanent or total disability (PTD) during a specified period of time. If the insured survives the term, nothing is paid. Term insurance is cheap because it focuses on protection with no savings or investment features. The period of insurance may be anything from one year, five years, ten years, or in some cases as long as 20 or 25 years or till age 55 or 60 of the insured.

Term insurance policies consist of two (2) key features, namely, convertibility and renewability. The convertibility feature allows the insured to convert the policy into more permanent forms of insurance, such as whole life or endowment insurance, before the term expires. Policies can be renewed without the evidence of insurability (no proof of health needed). The renewability feature, on the other hand, allows the policy to be renewed for additional periods, without the evidence of insurability. However, the premium is increased at each renewal and is based on the insured's attained age.

b) Whole life Insurance

Whole life insurance is a form of permanent contract. It provides lifetime protection with cash value benefits. Traditionally, there are two (2) types of whole life insurance:

- **Ordinary Life Insurance**

It is also known as straight life or continuous premium whole life. The policy provides lifetime protection or up to the age of 100, and the death claim is certain. If the insured is still alive at the age of 100, the face amount of the insurance is paid to the policyholder. Under ordinary life insurance, the premium does not increase with age over the period of protection. Due to this, the premium will be overcharged during the early years and undercharged during later years, when premiums are inadequate to pay death claims. The policy also has savings and investment features that provide cash surrender value benefits. The cash value is accumulated through the overpayment of insurance premium during the early years. The cash value can be redeemed by surrendering the policy or be borrowed under a loan provision.

- **Limited-Payment Life Insurance**

The policy provides lifetime protection with the premiums remaining level throughout the protection period. The premiums, however, are paid only for a certain period, such as 10, 20, 25, 30 years, or until the insured reaches the age 65. After that certain period, the policy will be completely paid up and no additional premiums are required even though the coverage remains in force.

c) Endowment Insurance

Endowment insurance is a policy that combines insurance protection and savings elements. The emphasis is on the saving elements with smaller coverage elements than whole life policies. It has a fixed maturity, commonly it is 10, 15, 20, and 25 years or up to a certain age limit. Endowment covers the insured against death, permanent or total

disability (PTD) and critical illness. Benefits under endowment policies include sums assured and accumulated bonuses. The benefits are paid either when the policy matures or when the insured dies within the period of protection. Generally, endowment insurance is used as a means to save in a systematic manner, where a fixed amount of money will be set aside until the maturity date to meet future commitments. Endowment insurance is useful in a number of ways depending on the term chosen by the policyholder. Long term endowment plans are used as a convenient means of providing for old age or augmenting pensions. Short-term endowments are used either for personal usage or to cover for children's education expenses.

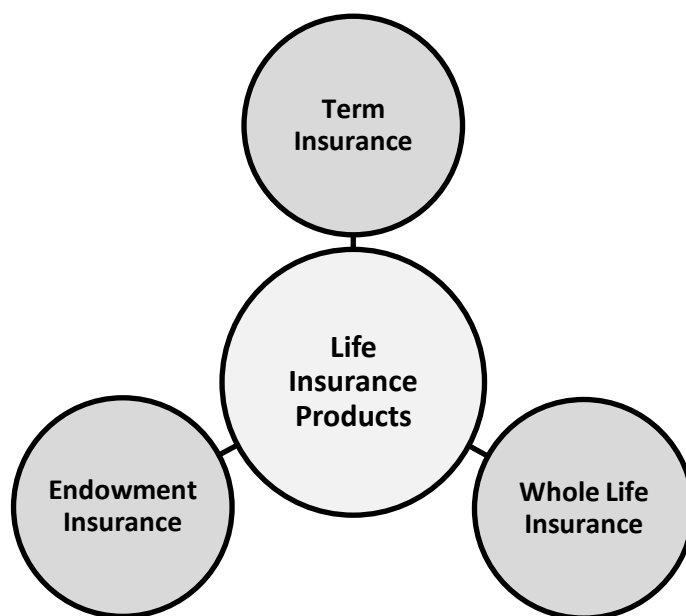


Figure 17: LIFE INSURANCE PRODUCTS

3.8.2 General Insurance

General insurance provides coverage against risks that are usually not covered by life insurance. It is a short term contract that secures the payment of compensation in relation to material loss or damage inflicted upon properties as a consequence of catastrophes or disasters.

The difference between life insurance and general insurance contract is, for life insurance, compensation is paid dependent on harms inflicted on a human life; whereas for general insurance, compensation is paid dependent on damages to properties although sometimes the distinction is unclear. For example, a death or disability could be the outcome of an injury caused by a car accident. In this case, the car is the subject matter of a general insurance. Therefore, the claim can be under the general insurance contract. Another difference is, in life insurance, (except for term insurance because a risk is covered for a limited period), every policy will eventually become a claim. For general insurance, an accident under a motor policy or the fire under fire policy, may or may not happen.

3.8.2.1 Characteristics of General Insurance

a) General Insurance Contracts are Short-Term Contracts

General insurance contracts are usually made for a period of one year. At the end of the period, the contract can be renewed by mutual consent of both the insured and the insurance company.

b) Premiums Charged May Vary

To renew a general insurance contract, the insurance company will reassess the risk. Based on the reassessment, there is a possibility that a different rate of premium will be charged. The difference in the rate could be due to:

- change in the nature of the individual risk to be insured
- overall change in the premium rates for that particular class of business

c) General Insurance Contracts are Contracts of Indemnity

The aim of general insurance claim is to place the insured in the same financial position as he/she had enjoyed immediately before the loss occurred. The objective of the principle of indemnity is to ensure the insured, after being indemnified, shall not be better off than before the loss.

d) Payment of a Claim Does Not Terminate a Contract

In general insurance, the contract is not terminated by the payment of a claim, provided that there is no total loss claim paid. Thus, the insured can claim more than once within the period of the contract for the balance of the sum insured. For example, several car accidents in one year.

e) The Risk to be Insured Does Not Necessarily Increase Over Time

For general insurance contracts, the insured risk may not increase with duration. The risk could possibly be reduced due to better safety measures taken by the insured; for example, the installation of fire extinguishers or better wiring system in a factory.

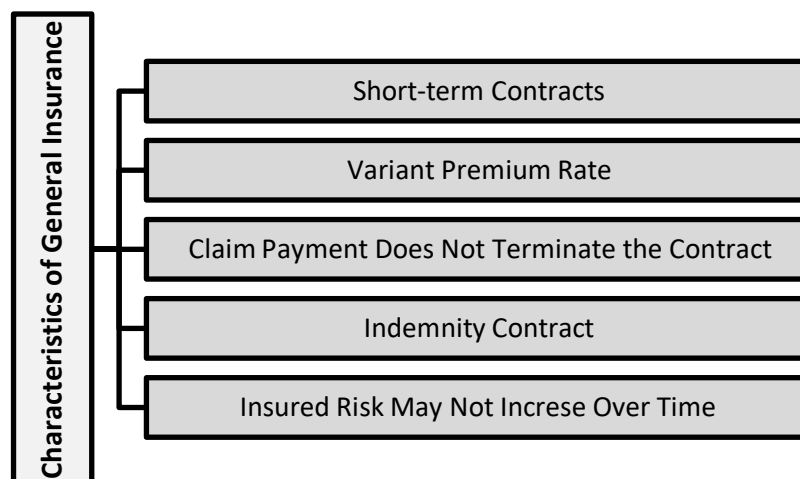


Figure 18: CHARACTERISTICS OF GENERAL INSURANCE

3.8.2.2 General Insurance Products

As mentioned earlier, general insurance contracts are designed to meet the needs for protection in relation to material loss or damage upon properties, assets or other belongings of their policyholders. For this purpose, general insurance companies have designed many types of policies. The main classes of general insurance are as follows:

a) Fire Insurance

Fire insurance provides cover against loss or damage to property caused by fire and other specified perils. The main types of insurance cover under this class of insurance are namely:

- **Fire Policy**

A fire policy is compulsory for those who have taken a housing loan because the bank requires the property it is holding as security to be insured. A standard fire policy will cover loss or damage to buildings, such as factories, offices, shops and private dwellings and its contents caused by fire, lightning and explosion of gas used for illuminating and domestic purposes only.

Payment of additional premium under this policy may extend the coverage to include special perils (e.g. riot, strike and malicious damage, flood, earthquake, storm, etc.). Like any other policy, a fire policy also excludes some specified perils.

- **Houseowners' Insurance Policy**

A houseowners' policy provides wider coverage than a basic fire policy. It is specially designed for those who wish to insure their private dwellings (e.g. a house or apartment). Coverage under the houseowners' policy normally includes the following risks:

- (i) Loss or damage to the building, including garages, fixtures, walls and gates.
- (ii) Loss of rent, not exceeding 10 percent of total sum insured.
- (iii) Insured's public liability as the owner of the premise.

Payment of additional premium may extend the coverage of this policy to include riot, strike and malicious damage, subsidence and landslip and plate glass exceeding RM500 per piece. Exclusions under this policy include suspension of theft coverage if there is no forcible entry or if the private dwelling was unoccupied for more than 90 days.

- **Householders' Insurance policy**

A householders' policy covers the insured's home contents against loss or damage. The insured will be indemnified against losses caused by the same perils which are normally covered by houseowners' insurance policy. Under this policy, the insured could insure personal belongings, such as jewelry, furniture and household appliances.

- **Consequential Loss Insurance**

Consequence loss insurance covers loss suffered as a result of an interruption to the insured's business following damage at the insured premises by fire, lightning or explosion of gas used for domestic purpose. This policy is normally issued in conjunction with the fire insurance on business premises. This is to ensure that funds are available for the repair of material damage and that the business will be reverted to normal.

Table 3.2: Summary of Fire Insurance Policies and Coverage

Coverage Against	Loss or damage to property caused by fire and other specified perils
Type Of Policy	Subject Matter of Insurance
Fire Policy	Buildings and Contents
Houseowners' Insurance	Private Dwellings (house & apartments)
Householders' Insurance	Household contents
Consequential Loss Insurance	Insured's Profits

b) Motor Insurance

Every car or motorcyclist owner knows that he/she needs to buy motor insurance because the law requires it. Motor insurance in Malaysia is regulated by the Road Transport Act 1987. The Act requires that every motorist must insure, with an authorized insurer, any liability which may occur in respect of the death of or bodily injury to a third party caused by the use of the motor vehicle on the road.

There are three (3) types of motor insurance policies, namely:

- **Third Party**

It provides coverage for both bodily injury and property damage of the third party. However, the policy does not cover damages or loss to the insured's own car. It also does not protect the insured if his/her car is stolen.

- **Third Party and Theft**

It provides third party cover plus loss and damage to the insured's vehicle against fire or theft. However, the policy still does not cover damages to the insured's car if it is involved in an accident.

- **Comprehensive Cover**

Provides cover for damage to the insured's vehicles caused by accidental collision, lightning, malicious act, fire or theft. Payment of additional premium may extend the coverage of this policy to the car owner as the following:

- i) damage caused by strike, riot and civil commotion
- ii) damage caused by flood, typhoon and earthquake
- iii) breakage of windscreen
- iv) personal accident to other passengers
- v) theft or accident damage of audio players

Table 3.3: Summary of Motor Insurance Policies and Coverage

Type of Policy	Coverage
1. Third Party 2. Third Party Fire & Theft 3. Comprehensive	1. Act Only Cover + third party's property 2. Third Party cover + loss/damage to insured's vehicle by fire and theft 3. Third Party Fire & Theft cover + accidental damages + medical expenses + personal accident cover

c) Miscellaneous Accident Insurance

Miscellaneous accident insurance comprises all the types of insurance protection that do not fall within fire and motor insurance classes. This policy can be categorized into four (4) types of covers, namely:

- i) Theft Insurance
- ii) Liability Insurance
- iii) Personal Accident Insurance
- iv) Fidelity Guarantee Insurance

d) Key person insurance

It is also commonly called Keyman insurance and key man insurance, which is an important form of business insurance. There is no legal definition for "key person insurance". In general, it can be described as an insurance policy taken out by a business to compensate that business for financial losses that would arise from the death or extended incapacity of an important member of the business.

To put it simply, Keyman Insurance is a standard life insurance, TPD insurance or trauma insurance policy that is used for business succession or business protection purposes. The policy's term does not extend beyond the period of the key person's usefulness to the business.

Keyman Insurance policies are usually owned by the business and the aim is to compensate the business for losses incurred with the loss of a key income generator and facilitate business continuity. Key person insurance does not indemnify the actual losses incurred but compensates with a fixed monetary sum as specified on the insurance policy. For example, a doctor discovers a cure for cancer but he has not finalized the drug in order to be commercialized. However, the pharmaceutical company's board of directors decides to buy a key person insurance policy on him. Accordingly, if the doctor dies, the pharmaceutical company will receive a compensation which will be used to employ a successor to the deceased doctor.

Many businesses have a key person who is responsible for the majority of profits, or has a unique and hard to replace skill set such as Intellectual Property that is vital to the organization. An employer may take out a key person insurance policy on the life or health of any employee whose knowledge, work, or overall contribution is considered uniquely valuable to the company. The employer does this to offset the costs (such as hiring temporary help or recruiting a successor) and losses (such as a decreased ability to transact business until successors are trained) which the employer is likely to suffer in the event of the loss of a key person. Keyman insurance also helps to protect a company's valuation. For example, the market price of a listed company would drop sharply upon the death of a key person. However, if the investors were informed about the existence of a key person policy that will cover financial losses arising from the death of a key person then they would retain the company's shares.

As keyperson insurance is more of a type of insurance policy than an actual policy, the term is used somewhat loosely and may include other insurance used for other business specific purposes, including:

1. Buy/Sell Insurance (Shareholder Insurance)
2. Debt Protection
3. Revenue Protection

e) Professional liability insurance (PLI)

It is also called professional indemnity insurance (PII) but more commonly known as errors & omissions (E&O) in the US, is a form of liability insurance that helps protect professional advice- and service-providing individuals and companies from bearing the full cost of defending against a negligence claim made by a client, and damages awarded in such a civil lawsuit. The coverage focuses on alleged failure to perform on the part of, financial loss caused by, and error or omission in the service or product sold by the policyholder. These are potential causes for legal action that would not be covered by a more general liability insurance policy which addresses more direct forms of harm. Professional liability coverage sometimes also provides for the defense costs, including when legal action turns out to be groundless. Coverage does not include criminal prosecution, nor a wide range of potential liabilities under civil law that are not enumerated in the policy, but which may be subject to other forms of insurance.

Professional liability insurance is required by law in some areas for certain kinds of professional practice (especially medical and legal), and is also sometimes required under contract by other businesses that are the beneficiaries of the advice or service.

Professional liability insurance may take on different forms and names depending on the profession. For example, in reference to medical professions it is called malpractice insurance in which doctors and nurses may cover themselves against the risk of being accused of misdiagnosing an illness or providing the proper treatment, while errors and omissions (E&O) insurance is used by consultants, brokers and lawyers in which they may cover themselves against the risk of giving wrong advice that may cost the customer a significant amount of money. Other professions that commonly purchase professional liability insurance include accounting, and financial services, construction and maintenance (general contractors, plumbers, etc., many of whom are also surely bonded), and transport. Some charities and other non-profit NGOs are also professional-liability insured



Figure 19: GERALD INSURANCE PRODUCTS

3.9 Conclusion

The chapter begins with defining what is risk and provide as explanation on other concepts of risk, which include peril and hazard. It explains that since every individual is invariably exposed to the possibility of misfortune, one need to be financially prepared when dealing with such misfortune. One such measure available to the public is the cover or protection provided under the various types of insurance policies. By having insurance protection, one could at least reduce the financial burden that results from an unfortunate event. The chapter also provides explanation on categories of risks, namely pure and speculative. Insurance companies often insure pure risks as it can be easily applied to the law of large number The next section covers the discussion insurance, detailing its function (primary and secondary), and the six basic principles that embodied insurance contracts. The last section explains the classes of insurance, namely the life insurance and general insurance. For each class, the characteristics and example of products are provided.

Self-Assessment

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Indifference to loss because of the existence of insurance is an example of a
 - A. physical hazard
 - B. objective probability
 - C. moral hazard
 - D. morale hazard

2. Which of the following statements about speculative risk is **TRUE**?
 - A. They are almost always insurable by private insurers.
 - B. They are more easily predictable than pure risks.
 - C. Their occurrence may benefit the society.
 - D. They involve only a chance of loss.

3. Batu Pahat Tobacco Company is concerned that the company may be held liable in a court of law and forced to pay a large award. The characteristics of the judicial system that increase the frequency and severity of losses is known as
 - A. moral hazard
 - B. particular risk
 - C. speculative risk
 - D. legal hazard

4. All of the following are programs to insure fundamental risks **EXCEPT**:
 - A. Federally subsidized flood insurance
 - B. Automobile physical damage insurance
 - C. Employees Provident Fund (EPF)
 - D. Unemployment compensation

Answer questions 5 and 6 based on the following:

After investing all of her savings in a restaurant, Amy has little cash left. She is advised to insure the restaurant well so that in the case of an unfortunate event, she will be indemnified.

5. The shifting of risk to the insurance company by Amy is based on the principle of
 - A. Indemnity
 - B. Pooling of losses
 - C. Risk transfer
 - D. Subrogation

6. If the insured peril occurs, Amy will not make a profit from the compensation received from the insurance company. She will only be placed in the same financial position as before the loss occurs. This is based on the principle of
- A. Indemnity
 - B. Pooling of losses
 - C. Risk transfer
 - D. Subrogation

Answer questions 7 and 8 based on the following:

Raja has been smoking for 15 years. After he went for a medical examination, the doctor diagnosed him with lung cancer. Raja needed to go for intensive treatment for three months. During that time, his medical bill cost about RM20,000 and he lost about RM10,000 in income, as he was not able to work.

7. Based on Raja's situation, which of the following is the peril?
- A. Medical bill of RM20,000
 - B. Raja's smoking habit
 - C. Lung cancer disease
 - D. Income lost of RM10,000
8. Which of the following is the hazard?
- A. Medical bill of RM20,000
 - B. Raja's smoking habit
 - C. Lung cancer disease
 - D. Income lost of RM10,000
9. Julia owns a successful restaurant. One night, after the restaurant had closed, a fire started when the electrical system malfunctioned. In addition to the physical damage to the restaurant, Julia also lost profits that could have been earned while the restaurant was closed to repair the damage. The loss of profits is an example of
- A. Direct loss
 - B. Speculative risk
 - C. Fundamental risk
 - D. Indirect loss

10. Sany recently purchased a life insurance policy that provides lifetime protection. Although the policy protects him throughout his lifetime, Sany only has to pay the premium for 10 years. No additional premium is required, although the coverage remains in force. What type of policy is Sany's?
- A. Limited-payment life insurance
 - B. Ordinary life insurance
 - C. Endowment insurance
 - D. Convertible term insurance
11. What kind of insurance coverage a doctor needs to protect himself against misdiagnosing his patients?
- A. Miscellaneous accident insurance
 - B. Key person insurance
 - C. Endowment insurance
 - D. Professional liability insurance
12. A company's board of directors is anxious that the sudden death of their creative employee may result in major financial losses and a sharp decrease in its share price. What type of insurance policy is needed to protect the company?
- A. Miscellaneous accident insurance
 - B. Key person insurance
 - C. Term insurance
 - D. Professional liability insurance

Answer: 1-d, 2-c, 3-d, 4-b, 5-c, 6-a, 7-c, 8-b,9-d,10-a, 11-d, 12-b.

Chapter 4

Takaful: The Shariah Compliance Issues

Chapter Outline:

- 4.1 Introduction
- 4.2 Takaful: A Terminological Discussion
- 4.3 Ruling Sources of Takaful
 - 4.3.1 Primary Sources
 - 4.3.2 Secondary Sources
- 4.4 Prohibited Elements in Takaful Contract and Practices
 - 4.4.1 *Riba*
 - 4.4.2 *Gharar*
 - 4.4.3 Some Other Prohibited Elements
- 4.5 Shariah Adviser: Roles and Functions
- 4.6 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the Shariah concept of Takaful as applied to a contract of Takaful
- Know the various ruling sources and authority of Takaful
- Identify the prohibited elements involving Insurance practices
- Understand the roles and functions of Shariah advisors in the Takaful business

4.1 Introduction

It is true to state that Shariah is the foundation of Islamic banking and finance. In Islamic history, the reference to an Islamic code of belief begun with Prophet Adam (AS) and a belief in the Oneness of Allah; the revealed religion remains the same tenet until the final prophet sent to human beings. However, Shariah facet of the revealed religion differs accordingly. Since the situations and the needs of the populace were different, the teachings too followed the types and nature of nations during the time of revelation.

Islam therefore, as the final and comprehensive religion, contains the whole aspect of human life and endurance. One important part of life is Financial Planning. Therefore, Islamic financial planning which is Shariah-based Financial Planning is not complete if elements of Shariah compliancy are not understood and well-explored by the planner. As an Islamic financial planner, one needs to understand the basic and essential concepts related to Shariah matters. Even though the upcoming ruling principles and teachings are basic to the understanding of a Muslim, the conceptual understanding of areas pertaining to Takaful matters still need further explanation and exploration. Matters on *riba*, *gharar*, *al-Quran*, *al-Sunnah* and others might be familiar to all Muslims and readers. The depth of the discussion is on their concept and its approach towards the takaful contract.

4.2 Takaful: A Terminology Discussion

The concept of takaful was first introduced in Malaysia in 1984 when the first takaful operator was established to fulfill the need of the general public to be protected based on Islamic principles. From the emergence of takaful now on, the term '*takaful*' has become well-known and understood by all. Takaful has also become another good alternative for Muslims when dealing with financial planning.

'Takaful' was derived from the Arabic root word '*kafala*' which means:

- to bail
- to guarantee
- to warrant
- to indemnify
- to secure one's needs

The term has been used in al-Quran, i.e. the word of Allah, the major ruling of Muslims by His saying:

"Help (ta'awun) one another in furthering virtue (birr) and God consciousness (taqwa) and do not help one another in furthering evil and enmity"

Al-Maidah (5:2)

It was also found in al-Hadith, i.e. the word of Prophet Muhammad (s.a.w.), another ruling source of Muslims:

"Tie the camel, then submit (tawakkal) to the will of God"

(Narrated by *Al-Tirmidhi*)

The word '*takafala*' refers to mutual indemnity and the concept of takaful refers to mutual contribution of participants to the same fund with the purpose of having mutual indemnity in the case of peril or harm. Humans mitigate the encountered risks in several ways such as taking shelter, settling in low-risk environment, saving for the time of need and cooperating with those exposed to similar risks in order to withstand the severe circumstances and shocks. Hence, the concept of insurance in Islam is not meant to completely avoid risks or prevent their occurrence.

Instead, the concept of takaful is meant to mitigate the material losses and lessen the burden in the aftermath of crisis.

In some situations, Allah used the word *al-Ta'min* as in surah (Quraish 106:4) by saying:

“(He) who have fed them against hunger, and has made them safe from fear”

(Quraish 106:4)

The word '*al-Ta'min*' was derived from the word '*amana*' which means to secure, to calm, to feel free or a feeling of being free of harmful and frightening elements.

The term is related to takaful since it also provides a person security and a peaceful life with the protection given in a takaful contract. Since the beginning of time human beings have worked hard to achieve security and safety. These primary basic needs are followed by the need for food and drink. Maqasid al shariah classify humans' needs into three levels, namely necessities (*daruriyyat*), needs (*hajiyyat*) and luxuries (*tahsiniyyat*). Necessities are essential to preserve one's faith, life, wealth/ property, mind and offspring. Humans seek to achieve their needs until they reach the desired level of satisfaction.

Another term related to takaful is '*al-Tadhamun*' which was derived from the word '*dhamana*' meaning 'to guarantee'. Thus, *al-Tadhamun* refers to mutual guarantee given by various parties to assist and provide for any calamities and tragedies experienced by any member of that takaful.

As a conclusion, takaful in the Islamic point of view is an alternative to insurance based on the principle of *ta'awun* or mutual assistance. It provides mutual protection of assets and property and offers joint risk-sharing in the event of loss incurred by one of its members. Takaful is similar to mutual insurance by which the members are the insurers as well as the insured. In other words, Takaful is a protection plan based on Shariah principles. Once a person contributes a sum of money to a common takaful fund in the form of participative contribution (*tabarru*) he/she undertakes a contract (*aqad*) to become one of the participants by agreeing to mutually help each other, should any of the participants suffer a defined loss. Takaful is meant to bring people of the society together to overcome undesired and/or unexpected circumstances through a means of risk sharing and cooperation. Hence, the prosperity of takaful may not only reflect on the takaful companies and participants but on the economy as a whole. It complements the Islamic financial system by providing desired protection schemes that are compatible with shariah for both individuals and companies.

In Malaysian context, takaful is regulated under IFSA 2013 based on the following provision:

National Fatwa Committee in Malaysia resolved that the present-day life insurance business provided by the conventional insurance companies was not in line with the principles of Shariah as it contains elements which are against Islam such as *riba* (usury), *gharar* (uncertainty) and *maisir* (gambling).

4.3 Ruling Sources of Takaful

Takaful is a Shariah-based insurance and its ruling source should be mainly upheld by divine sources. In addition to the comprehensive coverage of divine sources, secondary authorities are referred for technical and detailed understanding of takaful concepts applicable in the Islamic context.

4.3.1 Primary Sources

In Islam, the main sources of reference for Muslims are Al-Quran and Al-Sunnah, thus they are the primary sources of Shariah. As a way of life, the practical elements of Islam cover every aspect of human life. This is based on the commandment from Allah (SWT) to the Muslims to refer to these sources in order to solve any issues arising in their daily lives. Allah (SWT) says:

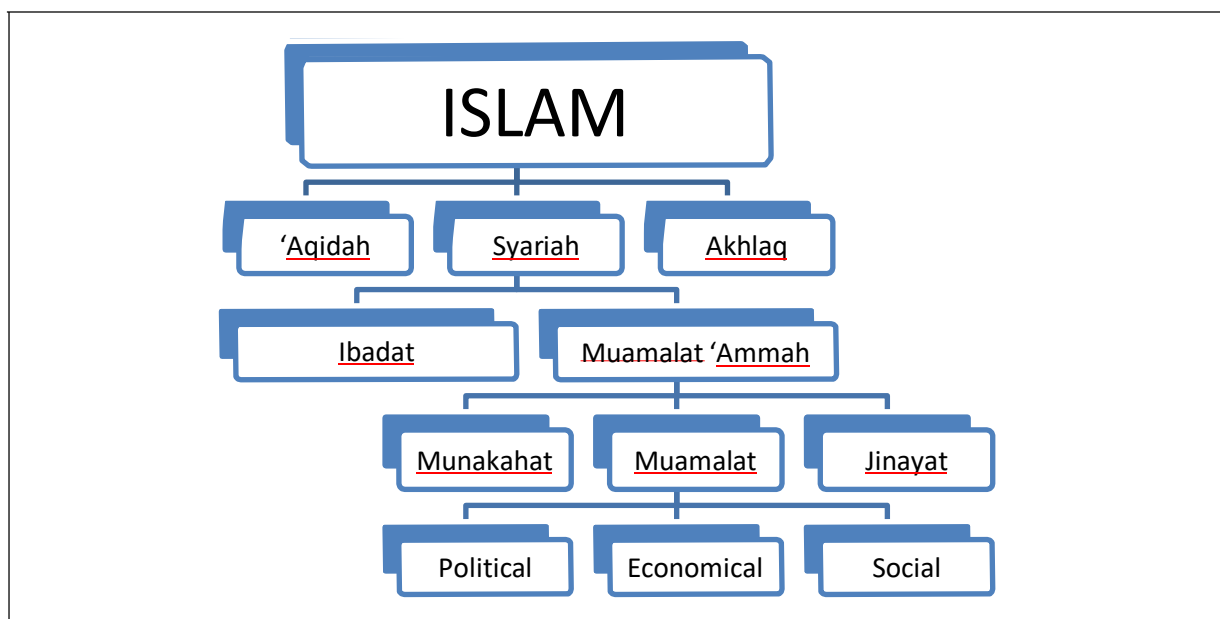
“O you who believe! Obey Allah (SWT) and obey the Prophet (Muhammad), and those charged with authority among you. And if you differ over anything among yourselves, refer it to Allah (SWT) i.e. al-Quran and the Prophet i.e. al-Sunnah”
(Al-Nisa’ 4: 59)

Allah (SWT) also says:

“And whatever the Prophet has given you – take it; and what He has forbidden you (from doing) – refrain from it”
(Al-Hashr 59:7)

Therefore, as a complete religion, Islamic teachings embrace all the facets of activities in this world and the hereafter. In essence, all the commandments of Allah the Almighty encompass all aspects of human life including the essence of economy, society and state. There are three foundations that underline the guidance contained in the Islamic faith. They are *‘Aqidah*, *Akhlaq* and Shariah as illustrated in the following Chart1.

CHART 1: ISLAM AS A WAY OF LIFE



The main discussion in this chapter relies on *muamalat* matters that involve the economic activities of humans. Since economics is a study of human behaviour, in this point of view, economics is a triangle relationship between human & human, also human & the creator of the sources – Allah. Therefore, in Islamic economics, the element of *al-Falah* is very important as it is the final rewarding state of Muslims involved in any economic activities in the worldly affairs.

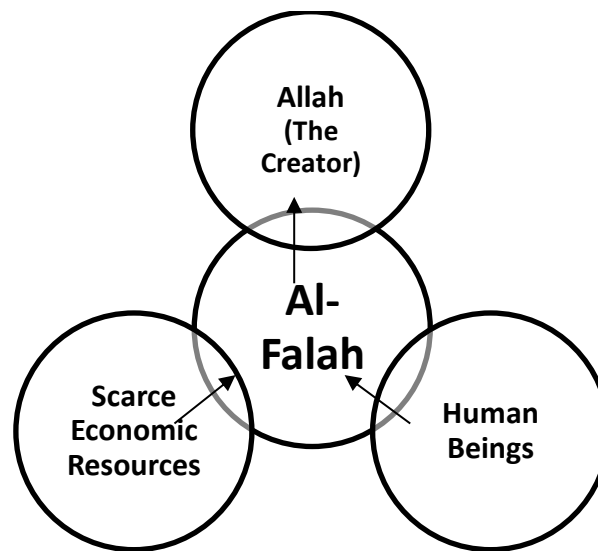


Figure 20: RELATIONSHIP BETWEEN HUMAN AND ALLAH IN ECONOMIC ACTIVITIES

Al-Falah in this context refers to an infinite reward which will be achieved in the hereafter provided a Muslim follows all injunctions and the normal process of life as a Muslim. With regards to temporary rewards in this life, *al-Falah* can be taken and understood as the motivational factor of a human in dealing with his economic activities. Whatever routes and activities a person is involved in, he/she should remember and relate to the main function in life as a vicegerent of Allah (*khalifatullah*) on earth who upholds a trust (*amanah*) from the creator.

4.3.2 Secondary Sources

Apart from the two primary sources which are al-Quran and al-Sunnah, *ijtihad* or the interpretations of Islamic jurists over issues pertaining to people's life which are founded on the general principles as stated in both primary sources, become the basis and sources of rulings in Shariah. The *ijtihad* or interpretations are classified as secondary sources of Shariah. In order to perform *ijtihad*, other secondary sources are direly required including *ijmaa'*, *qiyas*, *maslahah*, *istihsan*, *istishab*, *sadd zari'ah*, *urf*, *maqasid al-shariah* and many more which have been accepted in Islamic jurisprudence. Thus, *Ijtihad* could be performed in the absence of authority stated in the primary sources – al-Quran and al-Sunnah. However, the *ijtihad* done by *mujtahid* should fulfil the basic requirements and refer to the other sources of rulings in Islam that will be discussed in the following sections.

The *ijtihad* widens the perspectives and practical indication of all Shariah matters and Islam itself. In addition, the performance of the *ijtihad* proves that Islam recognizes the concept of '*murunah*' or flexibility in dealing with human lives and matters. In many new issues and advance technologies, a lot of new resolutions need to be made and many outdated regulations need to be relooked. Thus, *ijtihad* is the scope for discussion and debate by the reliable one known as *mujtahid*. *Mujtahidun* or qualified legal scholars are the essential element in the performance of *ijtihad*. A scholar should fulfil certain requirements to be a *mujtahid* and should be a person who is responsible for whatever resolutions made for the sake of the *ummah*. Some of the requirements and criteria of a *mujtahid* are those who fulfil the following:

- One who is able to converse and understand Arabic language entirely since it is the tongue of the al-Quran.
- One who understands the contents of the whole al-Quran especially the legal verses (*ayat al-ahkam*).
- One who understands *al-hadith* related to Shariah rulings.
- One who understands and is able to apply *usul al-fiqh*.
- One who is aware and updated with the unanimously agreed rulings of previous scholars.
- One who knows and understands *maqasid al-Shariah*.
- One who is spiritual and has a natural ability to perform *ijtihad*, such as a deep understanding of the whole concept of Islam.
- Fair, just (*'adil*) and *taqwa* (has higher consciousness)

How does Islam recognize the other secondary sources of Shariah? The basis for these secondary sources is derived from a *hadith* of Prophet (s.a.w.) when he appointed Muaz as a judge in Yemen:

The Prophet (s.a.w.) asked Muaz on several essential principles that the latter would use for judgement while in Yemen. The Prophet (s.a.w.) said: “O Muaz, *what basis would you use when you make a judgement?*”

Muaz replied that he would make a judgement based on the text of Al-Quran.

The Prophet (s.a.w.) then asked him, “*What if you do not find the matter in question in the al-Quran?*” Muaz replied that he would judge based on the decisions made by the Prophet (s.a.w.).

The Prophet (s.a.w.) asked him again, “*What if I had never decided on such matter?*” Muaz then replied that he would resort to *ijtihad* using his individual wisdom and understanding without transgressing the boundary (set by al-Quran and al-Sunnah). Muaz’s response on how he would decide the cases which require his rulings was endorsed by the Prophet (s.a.w.) by saying, “*Praise to Allah (SWT) who has given guidance to the Prophet (s.a.w.) and to the Prophet’s representative (Muaz)*”.

(Narrated by Abu Daud and Tirmizi)

Therefore, the performance of *ijtihad* is consistent with the al-Quran and al-Sunnah and the other ruling sources of Muslims as long as the resolution seeks for *maslahah* of the people and Islam in general.

Ijmak (Consensus)

Ijmak means a unanimous agreement among the *mujtahidun* of a Muslim community on any Shariah ruling in a particular period following the demise of the Prophet (s.a.w.). With the emergence of advance technologies today, such as video conferencing and wireless communication, *Ijma'* can be carried out more easily since discussions among *mujtahidun* would include a wider group of scholars worldwide.

Qiyas (Analogy)

Qiyas refers to likening a new case in question without textual evidence to an original ruling which is supported by explicit legal text which shares the same cause (*'illah*). Thus, Imam Shafii regards *qiyas* as a basis for exercising *ijtihad*. It has been regarded as a legal source, which contributes significantly in deciding new unresolved issues. In practical application, al-Qiyas is a situation where the scholars compare similar available issues to the current issue in order to apply a similar legal opinion.

Maslahah (Public Interest)

Maslahah means deciding a ruling based on the principle of general public interest in issues which do not have a clear and specific ruling from a legal text of either al-Quran or al-Sunnah. Generally, Islamic jurisprudence emphasises the principle of *maslahah* in enforcing any rulings. Therefore, any matter that will bring about public benefit and fulfil their needs would usually be accompanied by legal text in the form of an order to do something. However, if the matter would cause harm to the general public, then the legal text would come in the form of a prohibition. The performance of *maslahah* is closely related to the 5 objectives of Shariah (*Maqasid al-Shariah*); i.e. protection of life, religion, intellect, lineage and property.

Istihsan

Istihsan refers to setting aside an established ruling backed by *dalil* (evidence) on matters in favour of an alternative ruling which is stronger and more convincing than the first ruling. In its technical approach, *istihsan* exercises personal opinion (*al-Ra'y*) in order to avoid any rigidity and unfairness that might result from the application of Shariah. For example, the original ruling regarding endowment is that it must be in the form of something permanent such as real estate. However, based on *Istihsan*, it was allowed an endowment to be in the form of movable assets (*mal manqul*) such as books, vehicles, etc.

Istishab

Istishab refers to the presumption of continuity of an original ruling as long as there is no other *dalil* to establish to the contrary. Hence, such continuity is not proved by positive evidence but rather by the absence of new evidence. For example, a man was lost and it is doubted whether he is still alive. Based on *Istishab*, the man is presumed to be alive unless there exists evidence proving the certainty of his death.

Sadd Dhara'i' (Harm and Evil Prevention)

Sadd Dhara'i' signifies an approach used to prevent any means to evil in order to prevent forbidden acts. It is regarded as an early preventive measure to keep a Muslim away from committing actions prohibited by Allah (SWT). For example, the selling of grapes to winemakers or selling weapons in a warzone. Though such acts are permissible in Shariah (i.e. selling grapes or weapons), they are prohibited to avoid the associated evil considering the circumstances (i.e. the sale to winemakers or the sale in the warzone).

`Urf (Customary Practice)

`Urf is defined as established norms that are common to the majority of people in a community either in the form of sayings or doings. It is a common customary practice which is collectively accepted and applicable as a legal basis of ruling as long as it does not contradict the Shariah ruling. In the context of Islamic banking and finance, *`urf iqtisady* (a common business practice) is considered as a basis of Shariah rulings. Ibn Nojaim received a question regarding the case when someone rents a kitchen to cook sugar and there was pottery in the kitchen in which the owner gave the permission to use it. According to *`urf*, the lessee guarantees the pottery. The answer came that *al-ma'rouf kal mashrut*, meaning that what is known as *`urf* is the same as if it is concluded as a condition.

Maqasid al-Shariah (Objectives of Shariah)

Maqasid al-Shariah refers to the objectives which are being sought to be realised by the Shariah when deciding on a ruling aimed at protecting human interests. These objectives are the primary aspects that are very important to human lives, and are also known as *dharuriyyah al-khams* (the five necessities). They cover religion, life, intellect, lineage and wealth. *Maqasid al-Shariah* deals closely with the other sources of Shariah as listed above.

4.4 Prohibited Elements in Takaful Contract and Practices

4.4.1 Riba

'*Riba*' is derived from the Arabic root word '*rabawa*' which means 'increase and grow'. According to some, this refers to excessive or exploitative charging of interest; it also refers to interest itself whether in excess or moderation. In Islamic terminology, 'interest' means effortless profit, profit which comes free from compensation, or extra earning obtained that is free of exchange. In one opinion, *riba* is considered a loan with the condition that the borrower will return to the lender more than and 'better' than the quantity borrowed.

In short, *riba* can be:

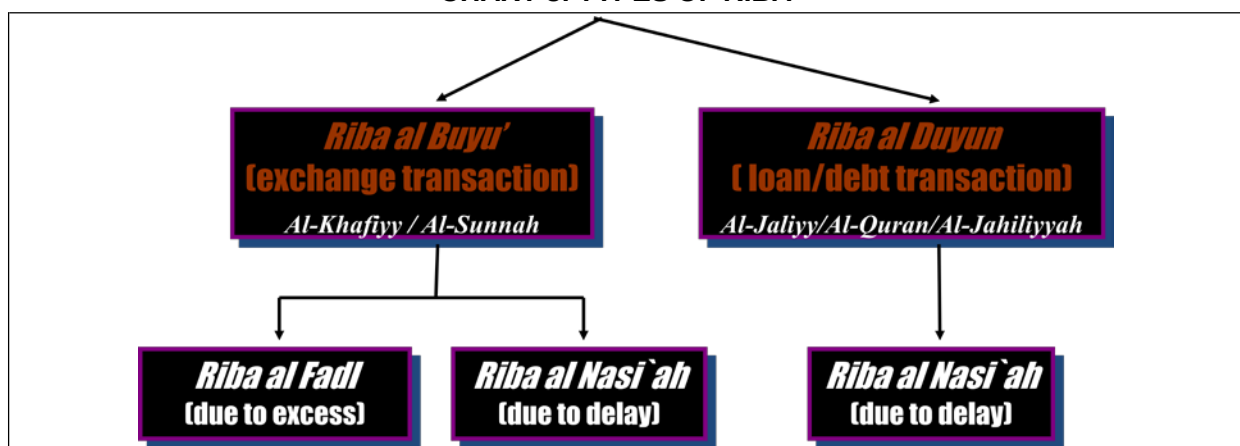
- an unlawful gain derived from the quantitative inequality of counter values in any transaction purporting to effect the exchange of two or more items, which belong to the same class and are governed by the same '*illah*' (effective cause).
- every excess in return of which no reward or equivalent counter value is paid.
- a predetermined excess or surplus over and above the loan received by the creditor, conditionally, in relation to a specified period.

Therefore, whatever definitions given to the term '*riba*', it gives a negative inclination towards the borrower and provides effortless profit to the lender. The situation might invite unfairness and injustice in some situations. For example, when a person is in dire need of cash, the lender could take advantage on his/her unfortunate situation. The following discussions will elaborate on this issue in a practical and professional way.

Technical implications of *riba* can occur in two ways:

- Deferment in the time of exchange; also known as *riba al-nasi'ah*
- Quantity of one of the counter values; also known as *riba al-fadhl*

CHART 3: TYPES OF RIBA



Based on these two, the types of *riba* are also divided into two types:

- *Riba al-Buyu'*
- *Riba al-Duyun*

Riba al-Buyu'

Riba al-Buyu' is also known as *riba al-khafiyy* or *riba al-sunnah* and exists due to an exchange transaction of two products. In barter system, changing two *ribawi* items may involve *riba* if it does not follow the Shariah elements regulated. The types of *ribawi* items were listed by the Prophet Muhammad (s.a.w.) in the following hadith:

“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt - like for like, equal for equal, and hand-to-hand (spot); if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand or spot transaction.”

(Narrated by Muslim)

In this type of *riba*, both time of delivery and quantity of the counter values should be taken into account seriously. *Riba al-fadl* occurs if the exchanged counter values of similar types of products are not equal in amount or quantity when prompt delivery is exercised. *Riba al-nasi'ah* applies when the time of exchange of the *ribawi* items is deferred or not on the spot or not via cash transaction.

The following chart simplifies the existence of *riba al-nasi'ah* in barter trade and *al-sarf* (currency exchange):

CHART 4: RIBA AL-BUYU' IN BARTER TRADE AND AL-SARF (CURRENCY EXCHANGE)

Food				Commodity Money		ʿIllah (Ratio decidendi)	
Salt	Dates	Barley	Wheat	Silver	Gold	Type	
*	*	*	*	1	2	Gold	Commodity Money
*	*	*	*	2	1	Silver	
1	1	1	2	*	*	Wheat	Food
1	1	2	1	*	*	Barley	
1	2	1	1	*	*	Dates	
2	1	1	1	*	*	Salt	

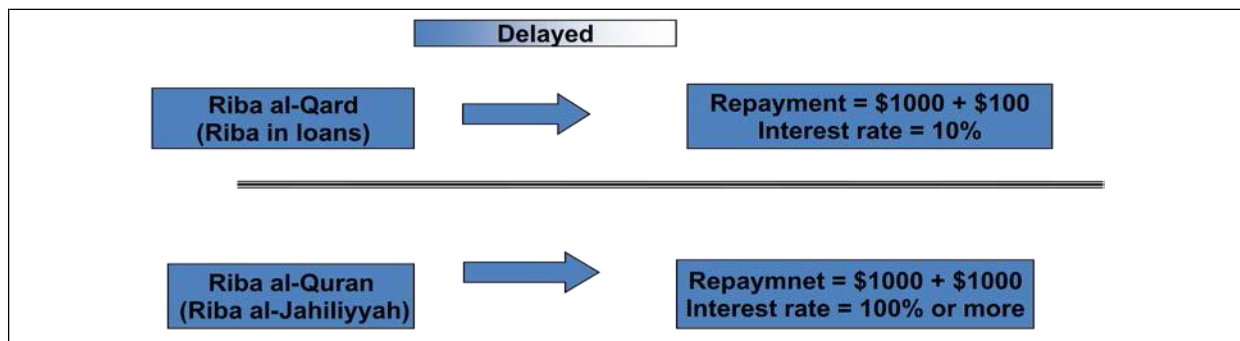
1 (1) Prompt delivery(time) only

2 (1) Prompt delivery (time) & (2) with the equivalent quantity

Riba al-Duyun

Riba al-duyun, on the other hand, occurs in a delay in repayment of a loan transaction. In this contract, *Riba al-nasi'ah* will exist when the loan repayment is postponed and delayed thus incurring extra payment for the loan. The illustration below shows the application of *riba al-duyun* in products financing:

CHART 5: RIBA AL-DUYUN IN LOAN



In addition, the excessive amount of interest is also known as *riba al-Quran* since the source of ruling for excessive amounts of interest is the al-Qur'an as in the following ayah:

“O ye who believe, devour not usury doubled and multiplied but fear Allah that ye may prosper” *Al-Imran (3:130-132)*

In a nutshell, the core of Islamic insurance business is compliance with Shariah. Accordingly, *takaful* companies do not have the option to link any of their investments to interest as the case of their conventional counterparts. This is due to the fact that Shariah strictly prohibits riba. Thus, *takaful* companies have no other option but to invest in Shariah-compliant investments. Presently, there exist Shariah alternatives to *riba*-based instruments. For instance, *sukuk* is the alternative for bonds.

4.4.2 Gharar

In insurance, the element of *gharar* may exist from doubts that take place in four ways:

- In contracts and compensation
- In a contract's outcome
- In the length of a contract period
- In the amount of compensation and premium

Further understanding of *gharar* is important in insurance so that compliancy of Shariah is maintained. The Arabic word '*gharar*' means 'risk, uncertainty, danger, peril, jeopardy and hazard'. Unlike *riba*, *gharar* is not precisely defined. In its root word '*gharara*', signifies revealing oneself and one's property to destruction without being aware of it. While the prohibition of *riba* is absolute, some degree of *gharar* or uncertainty is acceptable in the Islamic framework. Only conditions of excessive *gharar* need to be avoided. Another explanation of '*gharar*' is the sale of probable items whose existence or characteristics are not certain due to their risky nature which makes the trade similar to gambling.

The two main types of *gharar* are *gharar fahish* and *gharar yasir*. *Gharar fahish* refers to excessive risks that can bring a major effect on the contract and nullify the contract. *Gharar yasir* is more moderate in terms of effect, and is considered small and trivial. This is why the presence of *gharar* is tolerated.

Gharar fahish can then be implied theoretically and practically in two ways.

- First, *gharar* implies uncertainty, doubt and ambiguity which are dominant in nature such as sale of fish in the water.
- Second, it implies deceit, fraud and cheating such as Sale of *najsh* – a sale with fraud elements where one offers a high price for a product without any intention to buy but merely to induce someone who really wants to buy it to pay a higher price.

The Quran has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. It may be in the form of hazard or peril leading to uncertainty in any business, deceit, fraud or undue advantage. Apart from the above simplistic definition of *gharar*, some definitions of *gharar* seem to have a parallel in the concept of uncertainty in conventional finance.

As an example, the *gharar* element is applicable in the sale of fish in the sea, birds in the sky, an unborn calf in its mother's womb, a runaway animal, the semen and unfertilized eggs of camels, unripe fruits on the trees, etc. All such cases involve the sale of an item which may or may not exist. For instance, the fish in the sea may never be caught, the calf may be stillborn, and the fruits may never ripen. In all such cases, it is in the best interest of the trading parties to be very specific about what is being sold and for what price. For instance, Ahmad and Ibn Majah narrated on the authority of Abu Said al Khudriy:

The Prophet (s.a.w.) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.

(Narrated by Ahmad and Ibn Majah)

4.4.3 Some other prohibited elements

Ghubn (Fraud)

In takaful, the element of fraud is unanimously considered to be not Shariah-compliant. In an insurance contract fraud occurs due to the object of the contract being unclear.

Qimar and Maysir (Gambling)

In all matters pertaining to Islamic financial planning, *qimar* is the most avoidable element. In the practice of conventional insurance, gambling exists with the exposure of the person's property and premium to unknown events, or gambling per se. The insured also pays a small amount of money in anticipation of collecting a large sum, which is also another form of gambling.

Jahalah (Ignorance)

In conventional insurance, the insured person pays for returns that are unknown to both parties. For example, in the case of life insurance, both parties act according to the contract without knowing the profits or losses that might be accrued to them.

4.5 Shariah Adviser: Roles and Functions

The Shariah Advisory Council of Bank Negara Malaysia (SAC) was established on 1 May 1997 as the authority for the ascertainment of Islamic law for the purposes of Islamic banking business, Takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on Shariah principles and is supervised and regulated by Bank Negara Malaysia. The SAC members are appointed by the Minister of Finance pursuant to Section 16B of the Central Bank of Malaysia Act 1958.

Therefore, *Shariah* compliance is the essence and fundamental foundation of an Islamic-based insurance or Takaful. Thus, it is mandatory for every takaful company to have a Shariah Advisory Council (SAC) or Shariah Supervisory Board (SAB) that plays a crucial role and is vested with the responsibility to ensure that all takaful products are in strict compliance with the principles of Shariah in its operations.

Hence, all matters pertaining to takaful operations including the underlying concepts of the products, structures, term sheets, documentation, accounting and operational procedures must comply with Shariah principles. The existence of a complete *Shariah* framework for takaful operation is very important especially in ensuring the existence of one set of opinion in matters relating to the *Shariah* so that it would increase public confidence and enhance market development. For example, the takaful operator's operational model (e.g. *wakalah* model, *mudharabah* model or a combination of *shariah* contracts) must be approved by the SAC.

In legal practices, every Islamic financial institution is required to establish a *Shariah* Committee. In the case of a BAFIA IBS bank, it may establish one *Shariah* Committee for the banking group. However, if a takaful operator is part of that group, the takaful operator must establish its own separate *Shariah* Committee, due to the legal requirement under IFSA 2013.

The Board of Directors of an Islamic financial institution upon recommendation of its Nomination Committee shall appoint the members of the *Shariah* Committee. For the appointment and reappointment of a *Shariah* Committee member, prior written approval must be obtained from Bank Negara Malaysia. The appointment shall be valid for a renewable term of two years. In approving the appointment and reappointment, Bank Negara Malaysia may impose necessary conditions it deems fit in addition to the requirements in these Guidelines.

A member of a *Shariah* Committee shall be an individual. A company, institution or body shall not constitute a *Shariah* Committee for the purpose of these guidelines. The proposed member of the *Shariah* Committee shall at least either have qualification or possess necessary knowledge, expertise or experience in the areas of Islamic jurisprudence (*Usul al-Fiqh*) or Islamic transaction/commercial law (*Fiqh al-Mu'amalat*).

It should however be noted that paper qualification on the above subjects will not be mandatory as long as the candidate has the necessary expertise or experience in the above areas.

The members of the *Shariah* Committee shall be persons of acceptable reputation, character and integrity. Bank Negara Malaysia reserves the right to disqualify any member who fails to meet the requirements. In particular, any member may be disqualified due to any of the following breach of corporate governance:

- He has acted in a manner which may cast doubt on his fitness to hold the position of a *Shariah* Committee member;
- He has failed to attend 75 per cent of meetings scheduled for *Shariah* Committee in a year without reasonable excuse;
- He has been declared a bankrupt, or a petition under bankruptcy laws is filed against him;
- He was found guilty for any serious criminal offence, or any other offence punishable with imprisonment of one year or more; or
- He is subject to any order of detention, supervision, restricted residence or banishment.

Upon the discovery that any member of a *Shariah* Committee becomes subject to any ground of disqualification or otherwise becomes unfit to hold such appointment as provided in these Guidelines and/or in the letter of approval from Bank Negara Malaysia, the Islamic financial institution shall terminate the appointment of the *Shariah* member.

The members of the *Shariah* Committee are subject to the following restrictions:

- In line with section 16B(6) of the Central Bank of Malaysia Act 1958, an Islamic financial institution is not allowed to appoint any member of the SAC to serve in its *Shariah* Committee; and

- To avoid conflict of interest and for reasons of confidentiality within the industry, an Islamic financial institution shall not appoint any member of a *Shariah* Committee in another Islamic financial institution of the same industry.

For this purpose, Islamic financial institutions which are regulated under the IFSA 2013, FSA 2013 are classified as of the "Islamic banking industry", whilst Islamic financial institutions that are regulated under IFSA 2013 are classified as of the "takaful industry".

All *Shariah* Committee members are expected to participate and engage themselves actively in deliberating *Shariah* issues put before them. The main duties and responsibilities of the *Shariah* Committee are as follows:

(a) To advise the Board on *Shariah* matters in its business operation

The *Shariah* Committee shall advise the Board on *Shariah* matters in order to ensure that the business operations of the Islamic financial institution comply with *Shariah* principles at all times.

(b) To endorse *Shariah* Compliance Manuals

The Islamic financial institution shall have a *Shariah* Compliance Manual. The Manual must specify the manner in which a submission or request for advice be made to the *Shariah* Committee, the conduct of the *Shariah* Committee's meeting and the manner of compliance with any *Shariah* decision. The Manual shall be endorsed by the *Shariah* Committee.

(c) To endorse and validate relevant documentation

To ensure that the products of the Islamic financial institutions comply with *Shariah* principles in all aspects, the *Shariah* Committee must endorse the following:

- a. the terms and conditions contained in the proposal form, contract, agreement or other legal documentation used in executing the transactions; and
- b. the product manual, marketing advertisements, sales illustrations and brochures used to describe the product.

(d) To assist related parties on *Shariah* matters for advice upon request

The related parties of the Islamic financial institution such as its legal counsel, auditor or consultant may seek advice on *Shariah* matters from the *Shariah* Committee. The *Shariah* Committee is expected to provide assistance to them so that compliance with *Shariah* principles can be assured completely.

(e) To advise on matters to be referred to the SAC

The *Shariah* Committee must advise the Islamic financial institution to consult the SAC on any *Shariah* matters which have not been resolved or endorsed by the SAC.

(f) To provide written *Shariah* opinion

The *Shariah* Committee is required to record any opinion given. In particular, the Committee shall prepare written *Shariah* opinions in the following circumstances:

- a. where the Islamic financial institution make reference to the SAC for advice; or
- b. where the Islamic financial institution submits applications to Bank Negara Malaysia for new product approval in accordance with guidelines on product approval issued by Bank Negara Malaysia.

(g) To assist the SAC on reference for advice

The *Shariah* Committee must explain the *Shariah* issues involved and the recommendations for a decision. It must be supported by relevant *Shariah* jurisprudential literature from the established sources. The *Shariah* Committee is also expected to assist the SAC on any matters referred by the Islamic financial institution.

Upon obtaining any advice of the SAC, the Shariah Committee shall ensure that all SAC's decisions are properly implemented by the Islamic financial institution.

Responsibilities of Islamic financial institution towards the *Shariah* Committee

To ensure the smooth running of the *Shariah* Committee, an Islamic financial institution is responsible: -

(a) For referring all *Shariah* issues to the *Shariah* Committee

The Islamic financial institution must refer all *Shariah* issues in its business operations to the *Shariah* Committee for advice. The submission for an advice or a decision must be made in a comprehensive manner for an effective deliberation by the *Shariah* Committee. This will include explaining the process involved, documents to be used and other necessary information.

(b) For adopting the *Shariah* Committee's advice

The Islamic financial institution is required to adopt and take the necessary measures for implementation of the *Shariah* Committee's advice.

(c) For ensuring that product documents be validated

The Islamic financial institution shall obtain validation of the *Shariah* Committee relating to *Shariah* issues in all product documentation.

(d) For the *Shariah* Compliance Manual

The Islamic financial institution shall ensure that the *Shariah* Compliance Manual referred to in Paragraph 20(b) is endorsed by the *Shariah* Committee.

(e) For providing access to relevant documents

The Islamic financial institution must provide necessary assistance to the *Shariah* Committee. The *Shariah* Committee must be given access to relevant records, transactions, manuals or other relevant information, as required by them to perform their duties. For this purpose, the *Shariah* Committee members are granted exemptions from the secrecy provisions under the respective legislations.

(f) For providing sufficient resources

The Islamic financial institution must provide the *Shariah* Committee with sufficient resources, such as budget allocation, independent expert consultation, reference materials and training. It is also the duty of the Islamic financial institution to familiarise the *Shariah* Committee with its operation and business.

(g) For remunerating the members of the *Shariah* Committee accordingly

The Board shall determine the remuneration of the *Shariah* Committee members (through its Remuneration Committee). The remuneration shall commensurate and reflect the roles and functions of the *Shariah* Committee.

4.6 Conclusion

This chapter covered the Takaful: The *Shariah* Compliance Issues. Among the aspects discussed are: Takaful: A Terminological Discussion, Ruling Sources of Takaful which include Primary Sources and Secondary Sources, Prohibited Elements in Takaful Contract and Practices which includes *Riba*, *Gharar* and Some Other Prohibited Elements, the chapter ends with *Shariah* Adviser: Roles and Functions as important aspect in the takaful operation. These aspects are very important in the area of financial planning as they represent one of the driving components in the advice and recommendation.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Which of the following terms connotes Takaful in its terminological essence?
 - A. *Al-Iman*
 - B. *Al-Taw'in*
 - C. *Al-Tawkil*
 - D. *Al-Tadhamun*
2. The following are the main elements in the basic tenets of Islam **EXCEPT**
 - A. *'Aqidah*
 - B. Shariah
 - C. *Akhlaq*
 - D. *Muamalah*
3. Which of the following applications is **INCORRECT** for the types of *riba*?
 - A. *Riba al-Buyu'* - selling wheat for barley with similar price on the spot
 - B. *Riba al-Fadl* - selling wheat for wheat with different weight on the spot
 - C. *Riba al-Yad* – selling wheat for barley in undetermined time and occasion of receipt
 - D. *Riba al-Nasi'ah* – selling wheat for wheat with similar weight and different price in the future
4. Which of the following illustrates the application of *riba* in conventional banking?
 - A. Transparent loan payment amount for every month
 - B. Pre-determined penalty for late payment of loan
 - C. Permanent return profit in saving account
 - D. Pre-determined profit charges on loans
5. Which of the following is **false**?
 - A. *Riba al-sunnah* is also known as 'hidden *riba*'
 - B. *Riba al-Quran* is also known as *riba 'al-nasi'ah*
 - C. Any fixed percentage charge (of the initial loan) over and above the initial
 - D. If the extra charge on a business loan is small, fair and not burdensome, it can be accepted in the name of business cost
6. *Riba* contains the following elements, **EXCEPT**
 - A. The loan capital must be cash
 - B. Determination of surplus is in relation to time
 - C. Excess or surplus is over and above the loan capital
 - D. Bargain is conditional on the payment of a pre-determined surplus.

7. A person is authorized to perform *ijtihad* with the following criteria **EXCEPT**
 - A. Has the ability to converse and understand Arabic Language entirely
 - B. Able to memorize a *hadith* related to Shariah rulings
 - C. Understands the contents of Al-Qur'an
 - D. Has an ability to apply *Usul Fiqh*
8. The following examples refer to the existence of *Gharar* in a contract **EXCEPT**
 - A. Selling birds in the sky
 - B. Purchasing a runaway animal in a zoo
 - C. Buying unripe fruits on a rambutan tree
 - D. Trading unborn calf in the mother's womb
9. Which of the following is **NOT** a duty of the Shariah Committee?
 - A. To advise the Board on Shariah matters in its business operation
 - B. To prepare and search for relevant documentation
 - C. To advise on matters to be referred to the SAC
 - D. To assist the SAC on reference for advice
10. Which of the following is **NOT** a duty of an Islamic Financial Institution in matters pertaining to the Shariah Committee?
 - A. To have a Shariah Compliance Manual from the Shariah Committee
 - B. To provide the Shariah Committee access to relevant documents
 - C. To remunerate the members of the Shariah Committee accordingly
 - D. To validate that product documents are according to the related discussion
11. Which of the following does NOT disqualify a Shariah committee member?
 - A. He has acted in a manner which may cast doubt on his fitness to hold the position of a Shariah Committee member
 - B. He has failed to attend 25 per cent of meetings scheduled for Shariah Committee in a year without reasonable excuse
 - C. He has been declared a bankrupt, or a petition under bankruptcy laws is filed against him
 - D. He was found guilty for any serious criminal offence, or any other offence punishable with imprisonment of one year or more
12. Which of the following is not a prohibited element in Takaful contract?
 - A. Riba
 - B. Gharar
 - C. Maysir
 - D. Short sale

Answer: 1-d, 2-d, 3-c, 4-c, 5-d, 6-a, 7-b, 8-b, 9-b, 10-d, 11-b, 12-d.

Chapter 5

Takaful: A Comparison with Conventional Insurance

Chapter Outline

- 5.1 Introduction
- 5.2 General Comparison on Takaful and Insurance
- 5.3 Legal Comparison of FSA 2013 and IFSA 2013
- 5.4 The Various Approaches of Takaful Models
- 5.5 Takaful and Re-Takaful
- 5.6 Re-Takaful and Re-Insurance
- 5.7 Types of Retakaful Arrangements
- 5.8 Conclusion

Chapter Objectives

Upon completion of this chapter, you should have knowledge of:

- To compare and contrast between the Takaful and insurance
- To highlight the various approaches in Takaful models
- To explain the differences between Takaful & Re-Takaful
- To distinguishes between the Re-Takaful and Re-insurance

5.1 Introduction

Takaful industry has achieved its milestone and success within insurance industries. In these recent years, the emergence and rapid growth of takaful products and responses have attracted many parties especially in the same business areas to venture into this business. However, there are still lack of information and understanding in matter pertaining to the differences between takaful and insurance in many fields such as on their conceptual understandings, their legal frameworks and the various models of takaful products. For example, takaful is structured on the basis of *tabarru'* (donation) and *ta'awun* (mutual assistance); a takaful contract is a risk sharing contract, whilst insurance is structured on the basis of risk transfer; a conventional insurance contract is a contract of exchange. For another example, the investment preference differs between takaful and conventional insurance companies. Their investment portfolios' composition changes accordingly. Based on the SAC resolutions in different jurisdictions, interest income must not surpass a certain level. Hence, a high proportion of interest-based investments in the investment portfolio of takaful companies triggers shariah risk which may result in severe losses. The preceding scenario is nonexistent in the case of conventional insurance. Thus, this module will clarify those matters and provide simplicity in the process to understand both concepts of insurance and takaful.

5.2 General Comparison of Takaful and Insurance

In general, the followings are the issues to be examined and understood – especially to fully appreciate the differences between conventional insurance and takaful:

1. Sources of capital and returns to capital
2. Organizing principle, i.e. relationship among participants themselves and between participants and the takaful operator
3. Treatment of expenses and liability for claims
4. Zakat and charitable features – how to cleanse profits
5. Funds management – pooled or unitized
6. Investment of premiums in accordance to shariah
7. Dissolution – who ends up with any surplus capital
8. Regulations, taxation and auditing

In the general perspective, the difference between takaful and insurance is rooted on the source of laws for these two. The former is derived mainly from divine revelations i.e. Holy Quran and *Al-Sunnah* and these are the main reference of takaful in Malaysia and in the world. All opinion opined by jurists, Shariah scholars, Shariah advisors and committees must have direct reference to these sources. An advance discussion on these sources has been highlighted in Chapter 4. For the latter, the sources of laws and regulations are set by state and man-made law. Thus, the law is subject to amendment and improvement since man-made laws are always changing and improving.

In matters related to the treatment in investment by the insurance operators, the investments of premiums are conducted by insurer with no involvement by policyholders. However, a different approach was done by takaful operators in which a different treatment of investment will be done according to different takaful contracts. A takaful contract that specified under principles of *Mudharabah* will pre-determine the percentage of contributions that will be invested and how profits are shared whilst under *Wakalah* contract, similar practice is used and the participant can direct his investments into a range of united funds.

Another issue is where to invest. In the insurance industries, the insurer invests the premiums consistent with the profit-motive with no ethical guidelines; hence, *riba* and *maysir* are existent. The investment can be made in any liquor, tobacco, gambling companies and other unethical businesses. Whereas in takaful practices, takaful operators can only invest contributions made by participants in accordance with Islamic values and Shariah guidelines as supervised by the Shariah advisors of every operator.

The following table summarizes the important aspects of the differences between conventional insurance and takaful:

General Rulings	
Takaful	Conventional Insurance
Sources of laws: Based upon divine revelations (Holy Quran and <i>Hadith</i>)	Sources of laws & regulations: State (Government policy) and man-made laws
The contracts involved are a combination of <i>tabarru'</i> contract (donation) and agency and/or profit-sharing contract between the individual insured and the pool of insured as represented by the takaful.	The contract is in the form of a policy of an exchange contract (sale and purchase) between the insured (policyholder) and the insurance company.
Different contract has different approach. Principle of <i>Mudharabah</i> : Sharing concepts of premiums to be invested and the results. Principle of <i>Wakalah</i> : Similar practice as <i>Mudharabah</i> plus participant can direct his investments into a range of united funds.	Investment of premiums conducted by insurer: No involvement by policyholders.
Investment must be guided by Islamic values and Shariah guidelines.	Investment are profit motive: No moral guidelines, existence of <i>riba</i> and <i>maysir</i>

Another major issue to be differentiated is the business orientation of both areas. In the insurance industry, the contract of sale affects the operator through a profit maximization motive. The motive is for making profit and maximizing returns to shareholders such as investing in bonds and preferred stocks where there exists a possibility of capital appreciation as well as regular income. However, both investments are not applicable in the case of takaful due to Shariah prohibitions. Thus, the element of protection and insurance comes as a secondary aim; whereas in takaful, community well-being, optimizing operations for affordable risk protection, and fair profits for the operator are the motives. Therefore, the operators' and contributors' main business is the protection and mutual responsibility, followed by the profit-motive by the operators.

However, if we observe the current practice of takaful industries today, it is similar to that of the conventional business agenda. The elements of takaful and mutual responsibility are set aside and profit maximization comes first. Operators of takaful should be vigilant of this phenomenon in order to prevent the takaful industry from deviating from its actual motive.

With regards to capital contribution, the initial capital in the insurance industry is supplied by the shareholders. In the takaful industry, the initial capital is supplied by *rabb al mal* or paid via contributions (premiums) from the participants. Another issue is in the case of losses. In insurance practice, losses are transferred among insurance pools and from policyholders to

shareholders. Whereas in takaful, since the contract is clearly pre-defined, the losses are retained within the classes of business and the sole obligation of the participants. In dealing with agents and broker status, in insurance, the agents and brokers are typically independent of the insurer and are paid a fee from the premium charged to policyholders that is not disclosed. However, transparency is available in takaful in which the agents are employees of the takaful companies and any sales commission is disclosed.

A summary of the above differences is given in the following table:

Business Operation	
Takaful	Conventional Insurance
Community well-being optimizing operations for affordable risk protection as well as fair profits for the operator.	Profit-motive, maximizing returns to shareholders.
Initial capital supplied by <i>rabb al mal</i> or paid in via contributions (premium) from participants.	Initial capital supplied by shareholders.
Losses retained within classes of business written and sole obligation of participants.	Transfer of losses among insurance pools and from policyholders to shareholders.
Agents are employees of the takaful and any sales commission should be disclosed.	Agents and brokers are typically independent from insurer and paid a fee from the premium charged to policyholders that is not disclosed

The major part in insurance and takaful is on their treatment of returns. This part regulates the procedures and processes postulated by the operators. In insurance, profits and/or bonus units are to be returned to policyholders as determined by managers and the Board of the insurer. In takaful, the pre-determined takaful contract specifies in advance how and when profit/surplus and/or bonus units will be distributed. Thus, the process is pre-determined based on the contracts agreed while the amount will be determined in the future. In matters pertaining to distribution of insurable interest, the right of insurable interest in life insurance is vested in the nominee absolutely. In takaful, the right of insurable interest is determined by Islamic principles of *fara'id* (inheritance) and the nominee acts as a trustee.

In the treatment of dissolution, in insurance, all the reserves and excess/surplus belong to the shareholders. In takaful, however, all the reserves and excess/surplus could be returned to the participants, although there is consensus opinion that prefer the dissolution to be a donation for charity. In terms of benefits, they are paid from the general insurance account owned by the insurer but in takaful, benefits are paid from contributions (*tabarru'*) made by participants and is considered as mutual indemnification. Finally, in the process of claim, the insured in insurance policy may elect cost or replacement cost valuation and claim accordingly whether or not he chooses to rebuild the property. However, in takaful, the insured may not gain 'profit' from takaful but he is entitled to compensation only for the repairing, rebuilding or replacement of the property. It should be noted that takaful is not aimed to prosper a person but to relief and assist.

The table below shows the differences in simplified version:

Treatment of Return	
Takaful	Conventional Insurance
A takaful contract specifies in advance how and when the returns - profit/surplus and/or bonus units will be distributed.	Profits and/or bonus units to be returned to policyholders as determined by managers and Board of insurer.

Right of insurable interest is determined by Islamic principles of <i>faraid</i> (inheritance).	Right of insurable interest is vested in the Nominee insurance.
Dissolution - reserves and excess/surplus could be returned to participants, although consensus opinion prefers donation to charity.	Dissolution – reserves and excess/surplus belong to the shareholders.
Benefits paid from contributions (<i>tabarru'</i>) made by participants as mutual indemnification	Benefits paid from general insurance account owned by insurer
Insured may not 'profit' from takaful and entitled to compensation only for repair, rebuild or replacement	Insured may elect cost or replacement cost valuation and claim accordingly whether or not they choose to rebuild property

There are a few other matters that show differences between conventional insurance and takaful. Firstly, the tax issue. For insurance, the taxes are subject to local, state and federal taxes only. However, for takaful, the taxes are subject to local, state and federal taxes (if any) in addition to an obligation to provide annual tithe (*zakat*) donations for charity.

In terms of accounting for insurance, the accounting is consistent with GAAP and prevailing statutory rules. Auditing is done for uniform application of accounting standards. As for takaful, the accounting standards are also consistent with national rules (which may be GAAP) in addition to prevailing statutory rules. For auditing, the same standards are applied plus conformance with Islamic rules; typically with *Shariah* Advisory oversight. The summary is as below:

Other related Issues	
Takaful	Conventional Insurance
Taxes - subject to local, state and federal taxes (if any) plus obligated to arrange annual tithe (<i>zakat</i>) donations to charity	Taxes - subject to local, state and federal taxes.
Accounting standards consistent with national rules (with may be GAAP) plus prevailing statutory rules. Auditing: same standards plus conformance with Islamic rules; typically with <i>Shariah</i> Advisory oversight.	Accounting consistent with GAAP and prevailing statutory rules Auditing for uniform application of accounting standards.

Another view in differentiating the takaful and conventional insurance contracts (propriety and mutual) with regards to general insurance can also be developed in the following table. Based on the table, a similar comparison may be made between conventional insurance and takaful in the case of life insurance. In the latter case, in both conventional mutual and takaful, investment profits belong to the policyholders, except that in takaful the operator may share in these profits as a *mudarib* fee for fund management. However, there are also some products (such as 'Whole Life' cover and 'Defined Benefit' pensions) which takaful does not offer as they are not *Shariah* compliant. In the following table, there are five items to be differentiated namely:

1. Contract
2. Responsibility of policyholders/ participants

3. Liability of the insurer/operator
4. Access to capital
5. Investment of Fund

ITEM	Conventional Insurance (Propriety)	Conventional Insurance (Mutual)	Takaful
Contract	A policy in the form of an exchange contract (sale and purchaser) between the insured (policyholder) and the insurance company.	A policy in the form of a risk sharing contract between the individual insured and the pool of insured as represented by the cooperative insurance company	The contracts involved are a combination of <i>tabarru'</i> contract (donation) and agency and/or profit sharing-contract between the individual insured and the pool of insured as represented by the takaful.
Responsibility of policyholders/ participants	Policyholders pay premium to the insurer.	Policyholders pay contributions to the pool in the form of premiums paid to the cooperative insurance company. Any underwriting surplus belongs to the policyholders, who are also liable for any deficit. Annual surpluses are normally retained in underwriting reserves out of which any annual deficits are normally met.	Participants make contributions to the scheme. Any underwriting surplus belongs to the policyholders, who are also liable for any deficit. Practices regarding disposition of annual underwriting surpluses or deficits vary In some takaful, operator manages underwriting under a <i>mudarabah</i> contract and shares in underwriting surplus as a <i>mudarib</i> fee
Liability of the insurer/operator	Insurer is liable to pay claims according to the policy using the underwriting fund and, if necessary, shareholders' funds.	Pool is liable to pay claims according to the policy using the underwriting fund.	Takaful operator acts as the administrator of the scheme and pays the takaful benefits from the takaful (underwriting) fund. In the event of deficiency in the takaful fund, the takaful operator is expected to provide an interest-free loan to the takaful fund to cover the deficiency.

Access to capital	Access to share capital and debt with possible use of subordinated debt.	No access to share capital, but access to debt with possible use of subordinated debt	Access to share capital by takaful operator but not to debt, except for interest-free loan from operator to underwriting fund.
Investment of Fund	There are no restrictions apart from those imposed for prudential reasons.	There are no restrictions apart from those imposed for prudential reasons.	Assets of the takaful funds are invested in Shariah-compliant instruments.

5.3 Legal Comparison of Takaful and Insurance in the Act context

Currently in Malaysia there are two acts that govern the takaful and insurance practices namely:

1. FSA 2013
2. IFSA 2013

As for the legal and Shariah issues, there are list of differences between takaful and insurance. The following differences zoom into 27 issues relating to legal and Shariah matters on takaful and insurance as put forward by Prof. Dr. Ma'sum Billah:

1. Sources of regulatory framework
2. Regulatory authorities
3. Supervisory bodies
4. Legal requirements for the formation & operation of company
5. Legal capacity
6. [As to age factor]
7. Subject matter
8. Justified risk
9. Essence of intention
10. Formalities
11. Disclosure
12. Insurable interest
13. Payment of premium
14. Lapse of premium
15. Surrender value
16. Policy loan / withdrawal
17. Forfeiture
18. Claim
19. Ex-gratia
20. Effects of commission of suicide
21. Damages
22. Effects of nomination
23. Legality on distribution of benefits
24. Agency commission
25. Legitimacy of funds
26. Accounts & accounting regulations
27. Investment of funds

ISSUES	TAKAFUL	INSURANCE
Sources of Regulatory Frameworks	Divine-justified Principles: • Chief Sources; • Secondary Sources; • Specific Sources; • Shariah Based Precedents; • Legislation; • Juristic Opinions (<i>Fatwa</i>); • Decisions of the Shariah Supervisory Board.	Man-made Laws: • Statutes; • Case Laws; • Miscellaneous; • Specific Sources.
Regulatory Authorities	• IFSA 2013; • Ministry Of Finance • Central Bank; Subject to the Shariah Principles	• FSA 2013; • Ministry Of Finance • Central Bank; Subject to the Common Law Principles
Supervisory Bodies	• National Shariah Advisory Council; • Supervision Department of IBTD of Central Bank; • Shariah Supervisory Board (s). To ensure a Shariah-justified transparent dealing.	• Supervision Department of Insurance of the Central Bank.
Legal Requirements for the Formation & Operation of Company	• MOA & AOA; • Registration (License); • Required Assets; • Deposit; (S. 4 (2) TA – 1994) • Sustainable Solvency Margin; • Shariah Compliance [S. 8(5) (a)]; • Establishment of the Shariah Supervisory Council [S. 8 (5) (b)]; • Annual Registration Fees [S. 9 (1)].	• MOA & AOA • License [S. 9 (1)]; • Required Assets or Paid up Share Capital • [S. 18 (1)]; • Required Fees [S. 21]; • Solvency Margin; • Compliance of the Insurance Act and Other Regulations.
Legal Capacity [As to age factor]	The Minimum Age for a Person to Hold a Takaful Certificate is: • 18 years (Existing Phenomena) S. 64 TA 1984; • 15 years (As justified by the majority <i>Ulama's</i> views). Suggested Model: • 15 Years with maturity (absolute); • 15 Years with no maturity (conditional); • Below 15 Years with maturity (conditional); • Below 15 years with no maturity (conditional); • Foetus (conditional) who may also have the right to be insured (with a short-term policy) by the name of the respective mother for the foetus'	• The minimum age for a person to buy a policy is 16 years, but an infant between the age of 10 and 16 may also have the right to have it subject to the written consent obtained from the respective guardian. [S.153 (1) (2) IA 1996] • So far there is no provision providing insurance coverage for the foetus.

	health protection.	
Subject Matter	Shariah justified (<i>mal al-mutaqawwim</i>)	Common Law justified
Justified Risk	Defined Risk	Pure Risk
Essence of Intention	Intention to create both spiritual & legal relations.	Intention to create legal relations only.
Formalities	With bilateral contract.	With unilateral contract
Disclosure	Disclosure of material facts or matters need not necessarily include the past moral hazard of the subject matter affecting the policy.	Disclosure of material facts or matters includes both past & present moral and physical hazards of the subject matter affecting the policy. [S.150 IA 1996]
Insurable Interest	- The right of one's insurable interest is unlimited; - It can be exercised on any person or property, but the benefits over the policy shall be distributed on the basis of principles of <i>faraid</i>, <i>waqf</i>, <i>hibah</i>, <i>wasiyyah</i>, <i>qard</i> and <i>amanah</i>.	- The right of insurable interest in life policy is limited. - Vested only on certain designated persons (i.e. spouse, children, under aged wards, employees etc.). [S.152 (2) IA 1996].
Payment of Premium	Paid premium (contribution) is treated as both donation (<i>tabarru'</i>) and savings (<i>mudarabah</i>)	Paid premium creates an obligation against the insurer on a sale and purchase relation.
Lapse of Premium	The paid premium (contribution) shall not be forfeited on the ground of Lapse of Premium.	The paid premium shall be forfeited (after the expiry of grace period) on the ground of lapse of premium.
Surrender Value	All premiums credited into the PA shall be refunded to the policyholder together with the investment return made through PA on the basis of <i>mudarabah</i>.	- Any policyholder, who surrenders his policy before maturity, is entitled to get some compensation known as surrender value. This usually amounts to a sum lesser than the total premiums that he has paid to the company. - Example: Under an Endowment policy, the surrender value would be approximately equal to the fund buildup from the premiums paid, less expenses and past benefits rendered.
Policy Loan / Withdrawal	- Up To 70% from PA. - No interest or service charge is levied. - Need not be paid back.	- Up To 70-90% from cash value. - Required to be paid with interest.
Forfeiture	The paid premiums of the participant into PA can for no reason be forfeited, even for a breach of utmost good faith or any other offence or wrong committed by the participant.	The paid premiums of the policyholder may sometimes be forfeited, especially for breach of utmost good faith, lapse of premium, etc.
Claim	In a Life/Family Takaful, the claim	In a Life insurance policy, the claim

	shall include the benefits from both PA and PSA accordingly. Claim shall be reasonably justified.	shall include the amount agreed in the policy regardless of when the risk occurs.
Ex-gratia	- The doctrine of ex-gratia is outside the contractual obligation. - The operator shall not be bound by anything which is not within the contractual terms. - Hence, in Life Takaful practices, the doctrine of ex-gratia may not be justified. - However, alternatively the doctrine of <i>al-ihsan</i> is adopted. (Benevolence) may be adopted on appreciation basis.	The doctrine of ex-gratia is adopted in insurance practices on obligatory basis.
Effects of Commission of Suicide	- Under a Takaful policy, the cause of death of the participant shall be immaterial. - Hence, the beneficiary/beneficiaries shall have the right to claim legitimate benefits from the operator regardless of whether the death of the participant is caused by natural, suicide or killed while committing a crime; - Benefit over the policy is the legitimate right of the beneficiary/beneficiaries. - Therefore, the beneficiary/beneficiaries shall not be deprived due to the act of suicide committed by the participant.	Under a Life insurance policy, if it is proven that the policyholder has committed suicide within the first two (2) years of the policy with an intention of leaving benefits to his beneficiaries, no right of claim shall be entertained.
Damages	- There is no justification to award unlimited or unreasonable damages, but only justified one; - And that is reliant on the principles of <i>diyat</i>, <i>daman</i>, <i>ta'awun</i>, and shared-responsibilities.	- The courts of justice are in some cases empowered to award unlimited damages - Against the insurer. (Suraizam Bin Akodori V Mohd. Ismail Bin Isa & Anor [1996] 2 CLJ lxxxix.) (Ss. 7-8, 12 Of The Civil Law Act 1956)
Effects of Nomination	The nominee in a Life Takaful policy shall not be treated as an absolute beneficiary, but a mere trustee or an executor who is under a responsibility to receive the benefits over the policy and distribute them among the right beneficiaries according to the principles of <i>faraid</i>. (S. 167 of the FSA 2013).	- The nominee in a life policy (if the policyholder is a non-Muslim) shall be treated as an absolute beneficiary over the policy. - No other person shall have the right to claim all or part of the benefits disbursed to that nominee. (S. 166 of the FSA 2013).

Legality on Distribution of Benefits	- In the case of a Muslim participant, the distribution shall take place in line with <i>faraid</i>. - But if the participant is a non-Muslim the distribution shall be subject to the Distribution Act 1958.	- If the policyholder is a Muslim, the distribution shall take place in line with <i>faraid</i> (S. 167 of the FSA 2013). - In the case of a policyholder other than a Muslim, the distribution shall be in line with nomination clause. (S. 166 of the FSA 2013).
Agency Commission	- The agents shall be regarded part and parcel of the operator who shall be paid for their services only by the operator out of the shareholders' fund. - They shall in no situation, have the right of commission out of the collected premium, unless a full written consent at the material time of formalities is obtained from the contributor in accordance with Al-Nisa 4:29.	- The agents are to be paid with commission out of the collected premiums. - Obtaining consent from the policyholder is irrelevant.
Legitimacy of Funds	Funds belong to the participants and are managed by the operator for a legitimate consideration for the services rendered.	Funds belong to the company, though separation of assets is maintained between the shareholders and the policyholders.
Accounts & Accounting Regulations	- For General Takaful, the account is known as <i>tabarru'</i>, which means donation. - For Life Takaful, there are two accounts namely, PA, which is treated in line with the principles of <i>mudarabah</i>; while the other account is PSA, which is treated on the basis of <i>tabarru'</i>. - Cash Accounting is preferred generally as far as income is concerned. (To avoid <i>gharar</i>) - Accrual Accounting is preferred as far as expenses are concerned. (To avoid unexpected risks)	- For General Insurance, the paid-premium is credited into the account which is generally known as General Insurance Account. - In Life Insurance policies, similarly, the collected premiums are credited into the account known as Life Insurance account or fund. - Several methods used, i.e. cash, accrual, deferred, embedded values, etc.
Investment of Funds	- The funds shall be invested in any interest-free Shariah-justified scheme. - The entire procedure shall comply with the guidelines of the Shariah. - Investment returns must not be driven by any unethical commercial activities.	- The funds may also be invested in an interest-based scheme. - They can also be invested in any scheme or project, which may not necessarily be supported by the Shariah discipline.

5.4 The Various Approaches of Takaful Models

As discussed earlier in this chapter, there are three models currently used in Malaysia and endorsed by IFSB namely:

1. Pure *Mudarabah* Model
2. Pure *Wakalah* Model
3. Modified Model – Combination of *Mudharabah* and *Wakalah*

The following discussion will further elaborate and focus on the differences among these models with a special reference to the Shariah elements and technical application as practiced by takaful operators mainly in Malaysia.

These models have their own advantages and limitations. It should be noted that AAOIFI has issued accounting regulations in the year 2000 as guidance for takaful operators stating that *mudarabah* practices were preferred for investment aspects of takaful while *wakalah* practices were preferred for risk sharing/underwriting aspects of the takaful operation. Thus, these two elements are complementary and the implementation of both contracts will promote success in the takaful industry.

According to MTA, the takaful operators listed with different models namely are:

1. ACR Re-takaful
2. AIA AFG Takaful
3. AIA Public Takaful
4. AM Takaful Family
5. Sun Life Malaysia Takaful
6. Etiqa Takaful
7. Great Eastern Takaful
8. Hong Leong MSIG Takaful
9. HSBC Amanah Takaful
10. MAA Takaful
11. MNRB Re-takaful
12. Munich Re-takaful
13. Prudential BSNTakaful
14. Swiss Re
15. Takaful Malaysia Berhad
16. Takaful Ikhlas
17. Asean Re-takaful

The first model to be discussed is the generic *Mudarabah* Model. Theoretically, in a *mudarabah* model, the takaful operator acts as a *mudarib* (entrepreneur) and the participants as *rabb al-mal* (capital provider). The contract specifies how the investment profit and/or surplus from the takaful operation are to be shared between the takaful operator and participants. Based on the Shariah aspects of *mudarabah* contract, losses are borne solely by the participants as the providers of capital on the condition that the operator is free from any misconduct and negligence, and in that case the *mudarib* is not entitled to receive any compensation for his efforts.

Secondly, Pure *Wakalah* Model where the principal-agent relationship is used for both underwriting and investment activities. In underwriting, the takaful operator acts as an agent on behalf of the participants to manage the takaful fund. All risks are borne by the fund and any operating surplus if allowable by the SAC belongs exclusively to the participants. The takaful operator does not share directly in either the risk borne by the fund or any surplus/deficit of the fund. Instead, the operator receives a fixed fee called a

wakalah fee for managing the operation on the participants' behalf, which is usually a percentage of contributions paid. However, some operators in Malaysia have modified this model to include a performance fee, charged against any surplus, as an incentive to manage the takaful fund effectively. The investment of the takaful fund is also based on a *wakalah* contract in which the operator charges the participants a fee in exchange for services rendered.

The third model is a combination of *wakalah* and *mudarabah* contracts. In this model, the *wakalah* contract is adopted for underwriting activities, while the *mudarabah* contract is employed for the investment activities of the takaful fund. Hybrid models attempt to overcome the issues that exist in individual models such as *mudarabah* or *wakalah*, where the takaful operator either takes the role of a *mudarib* or *wakil*, respectively. A hybrid model aims to strike a balance between the *maslahah* of both participants and shareholders since it offers a fair *wakalah* rate to participants as well as a performance fee to takaful operators/ shareholders in the form of a predetermined share in the surplus as an incentive for outstanding results. This approach appears to be favored by some international organizations and is widely adopted by takaful undertakings in practice.

5.5 Takaful and Retakaful

Retakaful is the reinsurance of takaful business based on Islamic principles. Reinsurance is a form of insurance where an insurance company can transfer to another insurer (the reinsurer) all or part of its liabilities in respect of claims arising under the contracts of insurance that it writes. This enables an insurance company (reinsured or direct insurer) to protect itself against the risk that its total claims costs in any one year may be so large that its profits are wiped out, or may even cause the company to be insolvent. This is the essence of the concept of social solidarity, cooperation and mutual indemnification of losses of members where there is joint indemnification of the loss or damage that may occur, out of a fund that is collectively contributed to. Theoretically, it is expected that both reinsurance and *retakaful* would improve operational and financial stability of insurance and *takaful* companies, respectively. Accordingly, *takaful* and insurance companies that undergo low levels of profitability need to use more insurance. Cole and McCullough (2006) opine that insurers with high levels of profitability should use less reinsurance since their profits can absorb unexpected losses.

Takaful as its direct explanation is the protection based on the concept of *tabarru'* or mutual protection, responsibility and cooperation. Thus, *retakaful* is a process of putting the takaful company as being insured by another main company. Currently, Asean Re-Takaful is a Shariah based *retakaful* company available in Malaysia. Among the main challenges in the Islamic financial industry worldwide is the lack of *retakaful* companies that are capitalised to the levels required by insurers. The level that is required of a company to be classified as a *retakaful* company is an 'A' rated *retakaful* company. This has resulted in takaful companies having to reinsure on a conventional basis due to the scarcity of *retakaful* providers, contrary to the preferred option of seeking cover based on Islamic principles.

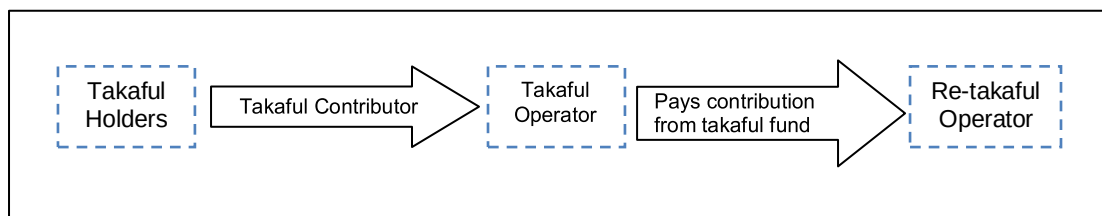
The situation however, has made the Shariah scholars allow dispensation to takaful companies to reinsure on a conventional basis as long as there are no *retakaful* alternatives available on the basis of *Darurah* (emergency). Takaful companies, therefore, actively promote co-insurance. A number of large conventional reinsurance companies from Muslim countries take on retrocession. A large proportion of risk is placed with international reinsurance companies that operate on a conventional basis. The retrocession from takaful companies ranges from some 10% in the Far East where Takaful companies have relatively smaller commercial risks (so far), to the Middle East where up to 80% of risk is reinsured on a conventional basis.

In other words, retakaful is actually a ‘takaful for takaful operators’. Retakaful is defined by the IFSA 2013, as an arrangement consistent with sound takaful principles for retakaful of liabilities in respect of risks incurred or to be incurred by the takaful operator in the course of carrying on takaful business. The Shariah principles applying to takaful apply to retakaful operations as well. The difference, if any, is that in retakaful operations, the participants are takaful operators instead of individual participants.

Retakaful has a close relationship with takaful operations where retakaful is a form of takaful and the competitiveness of retakaful market depends on the competitiveness of the direct takaful market. Actually retakaful is a form of insurance where the takaful operator pays an agreed upon premium from the takaful fund to the reinsurance company or retakaful operator, and in return, the reinsurance company or the retakaful operator will provide security for the risk reinsured. Reinsurance is best thought of as ‘insurances for insurance companies’ or we also can say that retakaful is a ‘takaful for takaful operators’. It is a way for a primary insurer to protect itself against unforeseen or extraordinary loss.

With regards to the retakaful contract, even though a typical reinsurance transaction is generally based on the principles of *al-‘aqd* (contract), the nature of this transaction is quite different from other forms of commercial contracts in conventional reinsurance. Whilst the contract must ensure that the policy is for the purpose of sharing responsibility to provide some material security against unpredicted loss or damage resulting from unexpected risks on both life and property, it must also comply with Shariah principles. Therefore, the reinsurance contracts must be financial transactions that bind both the reinsurance company and the insurance company on the general principles of *al-‘aqad*.

To simplify the explanation on the relationship between takaful and retakaful, the following diagram can be useful:



From the above diagram, takaful holders are individuals or companies that participate in the takaful schemes, either general takaful or family takaful, and pay an agreed upon contribution to the takaful operator to protect them from unforeseen risks and also extraordinary losses. Then, the takaful operator takes a portion of this money from the takaful fund and pays a contribution to the retakaful operator to get retakaful protection to spread its risks. Retakaful contracts may cover a specific risk or a broad class of business.

Retakaful or Islamic reinsurance is about handling risks. It is a risk aversion method in which the takaful ceding company resorts to either a conventional reinsurer or a retakaful operator to reinsure original insured risks against an undesirable future situation if the risks insured were above the normal underwriting or claim. Thus, a takaful ceding company may, based on limited financial resources, hedge against possible incapability to meet all takaful commitments from a financially capable retakaful operator or reinsurer, which will take over the coverage of the large proportion of the risks.

A member of the Shariah Supervisory Board of the Dubai Islamic Bank, Fathi Lashin stated that retakaful does not, in principle, differ from takaful operations. The Shariah principles applying to

takaful apply to retakaful operations as well. The difference, if any, is that in the retakaful operations, the participants are takaful operators instead of individual participants. It is argued that a takaful ceding company cannot do without retakaful facility as the current practice of insurance business has shown the need for reinsurance. Therefore, there is a need for takaful operators to split risks by way of establishing retakaful operators. By doing so, they share their risks with retakaful companies. The retakaful operator, on the other hand, assumes the responsibility of managing and investing the contributions of Takaful operators on the basis of a fixed fee or profit-loss sharing.

Whilst there exist some benefits of retakaful, namely enhancing the overall financial performance and improving the underwriting performance by spreading risks and reducing the risk of catastrophe exposure, a great dependence on reinsurance is associated with a negative effect of potential low profitability. This is due to the fact that takaful companies with low retention limits act as brokers since a high proportion of their collected contributions is handed over to retakaful/reinsurance companies. Accordingly, their performance would be highly dependent on that of the retakaful companies. Thus, high level of reinsurance dependence increases costs and results in low premium retention levels, which may have a negative influence on profitability of companies. Moreover, the takaful companies' managerial expenses, which are not covered under the retakaful scheme, will worsen the scenario since brokers and free agents do not usually have this sort of expenses as they operate on different grounds from takaful operators.

5.6 Retakaful and Reinsurance

As in above, retakaful is one of the risk management tools used by takaful operators to transfer part of the risk under the takaful fund to another takaful operator or retakaful operator. In practice, under retakaful, the takaful (Islamic Insurance) operator pays an agreed premium from the takaful fund to the retakaful operator, and in return, the retakaful operator provides security for the risk insured.

Retakaful and reinsurance might seem similar but they have essential elements that differentiate these two. The first item should be the Shariah compliancy of both, in which retakaful is fully compliance and guided by Shariah principles whereas reinsurance is still subject to non-compliance of the product like the availability of the elements of *riba* and *gharar*. The following table shows the differences between retakaful and reinsurance.

ITEMS	RETAKAFUL	REINSURANCE
<i>Riba and Gharar</i>	Retakaful operation does not earn commission as a profit or interest, because this commission is subject to <i>riba</i> and dilutes the purpose of setting up a takaful operation. The retakaful operation is dependent on actual expenses spent by the Takaful operator in the process of retakaful.	The conventional reinsurance operation is subject to <i>riba</i> and <i>gharar</i> , which are not in line with Shariah principle. For instance, the reinsurance commission which the direct insurance company earns from the reinsurance treaty. It is because this commission is framed in a way that renders the commission <i>ribawi</i> , it implicates a high degree of <i>gharar</i> .

Principle of Insurable Interest	According to Islamic laws with regards to insurable interest, which is holding specific financial interest in the subject matter of the insurance, as a cardinal principle of the legality of the retakaful contract. Under Islamic Laws, the reinsured party does not get insurable interest or cannot reinsure the property of the original insured party without permission from the policyholder. However, because the retakaful operation is based on the <i>mudarabah</i> principle, it vested a right to reinsure on the insurer because the permission from the policyholder is automatically inherent in the contract of <i>mudarabah</i>.	Insurable interest is vested in the reinsured party. The fact that the reinsured party has issued a policy and assumed liability to it, the original insured party has been held to have given it (the reinsured party) insurable interest sufficient to enable it (the reinsured party) to reinsure. The point is that although the reinsured party (direct insurance company) has no actual legal interest in the property (the subject matter of the original insurance policy), it has assumed responsibility in regard to it, and has therefore put itself into a position, recognized by law, in which it would be prejudiced by its loss.
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5.7 Types of Retakaful Arrangements

The latest guidelines on retakaful were issued by the Islamic Financial Services Board (IFSB) in 2016 (Guiding Principles for Retakaful). The guidelines elaborated on the various types of retakaful offered in global takaful markets such as treaty, facultative, proportional, non-proportional, captives and finite risk (financial) arrangements. Note that the latter was neither considered as a prominent feature of the retakaful market nor was allowed by the Shariah board of the Islamic Development Bank (IDB).

5.7.1 Treaty

This type of retakaful arrangements is the most comprehensive among other types as it covers all risks written by takaful companies subject to the terms of the retakaful contract. Treaty contracts are usually long-term in nature and are often renewed on annual basis.

5.7.2 Facultative

Facultative arrangements usually cover all or part of a single certificate of the takaful company. These contracts are commonly used for large or unusual risks that cannot be fully retained by the takaful company as they exceed its capacity. However, facultative retakaful arrangements are usually negotiable in which the takaful company is not obliged to offer the risk to the retakaful company after it has been evaluated by the retakaful company. The latter may also opt to accept or decline a specific risk.

5.7.3 Proportional

As suggested by the name, this retakaful arrangement only reimburses a predetermined proportion of claims incurred by the takaful company based on the treaty. The most common types of proportional arrangements are quota share and surplus.

Under a quota share arrangement, the takaful company pays a fixed proportion of total

contributions to the retakaful company, e.g. 20%. In return, the retakaful company is obliged to cover the same contractual fixed proportion of claims incurred by the takaful company, e.g. 20%.

A surplus arrangement is often used by takaful companies to cede the large risks and retain small ones. For example, a surplus treaty may state to have a retention of RM50 million and a limit of RM100 million. Accordingly, a risk with sum insured of less than RM50 million will not be ceded but rather retained by the takaful company; a risk with sum insured between RM50 and RM150 million will be ceded and the proportion ceded is determined based on the formula: $(\text{sum insured} - \text{RM50 million}) / \text{sum insured}$; a risk with sum insured in excess of RM150 million would also be ceded and the proportion ceded is based on the formula: $(\text{RM100 million} / \text{sum insured})$. Subsequently, the retakaful company reimburses all claims according to the calculated proportion.

5.7.4 Non-proportional

In this arrangement, the retakaful company reimburses the takaful company when the claims exceed an amount specified in the contract but capped to a maximum limit. For example, a non-proportional arrangement states to cover RM100 million in excess of RM50 million. Accordingly, the takaful company bears the initial RM50 million; the retakaful company reimburses the takaful company for incurred claims between RM50 million and RM150 million; the takaful company only recovers up to RM100 million should the claims exceed RM150 million.

The most common non-proportional retakaful arrangements are, namely 'excess of loss' and 'stop loss'. The former usually covers an individual risk or losses caused by a single event while the latter covers the whole account of the takaful company.

5.7.5 Captive

A captive is an entity created and wholly owned by a group of companies for the purpose of providing coverage for its members. It helps to avoid volatile reinsurance/retakaful pricing, insure difficult risks, increase cash flow, provide access to reinsurance/retakaful markets that are beyond their capacity and design products tailored to meet their needs. Though captives resemble mutual insurance companies, the members directly control their retakaful business and place their own capital at risk in anticipation of a financial reward associated with better control over their retakaful business.

5.7.6 Finite Risk

Under this retakaful arrangement, the relationship between the retakaful company and takaful company takes the form of a lender-borrower. A cedant risk is not pooled with other cedants risks. Subsequently, accumulated surplus/deficit reverts to the single cedant account. The retakaful company receives a fee for managing transactions of the cedants. The absence of pooling risks/risk sharing has rendered this arrangement impermissible by Shariah scholars.

5.8 Conclusion

This chapter covered the a comparison between takaful and conventional insurance. Among the aspects discussed are general comparison on takaful and insurance which includes legal comparison of FSA 2013 and IFSA 2013, the various approaches of takaful models, takaful and retakaful and retakaful and reinsurance. These aspects are very important in the area of financial planning as they represent one of the driving components in the advice and recommendation process.

Self-Assessment

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. In Takaful, the major source of reference is the divine laws whereas insurance refers to
 - A. god-inspired law
 - B. man-made law
 - C. old books
 - D. experience

2. In the principles of *Al-Mudharabah*, the following concept is applied **EXCEPT**
 - A. Sharing the premium
 - B. Sharing the results
 - C. Sharing the investment
 - D. Sharing the beneficiary

3. The initial capital in the insurance industry is supplied by the
 - A. *rabb al-mal*
 - B. *mudarib*
 - C. shareholders
 - D. contributor

4. The following are the supervisory bodies for takaful **EXCEPT**
 - A. Supervision Department of Islamic Banking and Takaful Department of Central Bank
 - B. National Shariah Advisory Council
 - C. Shariah Supervisory Board
 - D. National Fatwa Council

5. In Takaful, the funds belong to_____ and in insurance they belong to_____.
 - A. participants, company
 - B. company, participants
 - C. agent, operator
 - D. operator, agent

6. Just as the nominee in Takaful is treated as_____, the nominee in insurance is treated as _____.
 - A. executor, trustee
 - B. trustee, executor
 - C. trustee, absolute beneficiary
 - D. absolute beneficiary, trustee

7. In General Takaful, the account is known as_____, meaning_____.
- A. *al-mudarabah*, partnership
 - B. *al-wakalah*, agent
 - C. *al-takaful*, mutual cooperation
 - D. *al-tabarru'*, donation
8. The following statements are correct on retakaful **EXCEPT**
- A. Retakaful is a form of takaful
 - B. Retakaful is a “takaful for takaful operators”
 - C. Retakaful operator provides security for the risk reinsured
 - D. Retakaful concept implies that a takaful company protects the retakaful company
9. The following are the major differences between retakaful and re-insurance **EXCEPT**
- A. Shariah compliancy
 - B. the availability of the elements of *riba* and *gharar*
 - C. the availability of agent
 - D. the investment variety
10. Retakaful is defined as
- A. a renaming process of takaful companies
 - B. a process of restructuring one's takaful policy
 - C. a process of changing takaful operator to another operator
 - D. a process of putting the takaful company as being insured by another main company.
11. Facultative retakaful arrangement covers
- A. all risks written by takaful companies subject to the terms of the retakaful contract
 - B. all or part of a single certificate of the takaful company
 - C. a predetermined proportion of claims incurred by the takaful company
 - D. takaful company when the claims exceed an amount specified in the contract but capped to a maximum limit
12. Non-proportional retakaful arrangement covers
- A. all risks written by takaful companies subject to the terms of the retakaful contract
 - B. all or part of a single certificate of the takaful company
 - C. a predetermined proportion of claims incurred by the takaful company
 - D. takaful company when the claims exceed an amount specified in the contract but capped to a maximum limit

Answer: 1-b, 2-d, 3-c, 4-d, 5-a, 6-c, 7-d, 8-d, 9-c, 10-d, 11-b, 12-d.

Chapter 6

Family Takaful

Chapter Outline:

- 6.1 Introduction
- 6.2 Overview of Global Family Takaful Market
- 6.3 Concept of Family Takaful
- 6.4 Family Takaful Benefits
- 6.5 Operational Workflow of Family Takaful
- 6.6 Types of Family Takaful Schemes
 - i. Ordinary Family
 - ii. Annuity
 - iii. Investment-Linked
- 6.7 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the concept and operation of family takaful
- Explain the two operational work flows of family takaful
- Identify the various types of coverage provided by family takaful

6.1 Introduction

A family takaful plan, equivalent to the Islamic life insurance, provides protection with a long-term saving and investment program. It provides mutual financial assistance among its participants through a financial program that pools efforts to help the needy due to untimely death and other mishaps resulting in personal injury or disablement. Family takaful would enable participants to participate in the scheme with the following aims:

- To save regularly for a fixed period of time to create a kind of retirement or long-term contingency fund.
- To invest with a view of earning profits which are Shariah compliant.
- To avail of cover in the form of payment of takaful benefits to heir(s) should the participant (insured) dies or becomes disabled before the expiry date of his/her participation in the takaful plan. (Takaful is a contract to participate not buy and sell, hence, the word 'expiry' is more appropriate.)
- To obtain the blessing of Allah for helping others.

A family takaful scheme provides participants with a protection and savings plan. The participant or his/her beneficiary will be provided with financial benefits if the participants (insured) suffer a mishap. At the same time, the participant will also enjoy savings because a major portion of the contribution will be deposited in an account for the purpose of investments.

6.2 Overview of Global Family Takaful Market

Family takaful market possesses a great growth potential as it currently represents only 17% of the global takaful market. According to Milliman Global Takaful Report 2017, the global gross written contribution of family takaful is estimated at USD2.6 billion in 2015. In USD terms, the industry experienced a negative growth rate of 1%, which is due to the sharp fall in the Malaysian ringgit and Indonesian rupiah; two of the largest family takaful markets. However, in local currency terms, the majority of family takaful markets experienced a positive growth, as shown in the figure below.

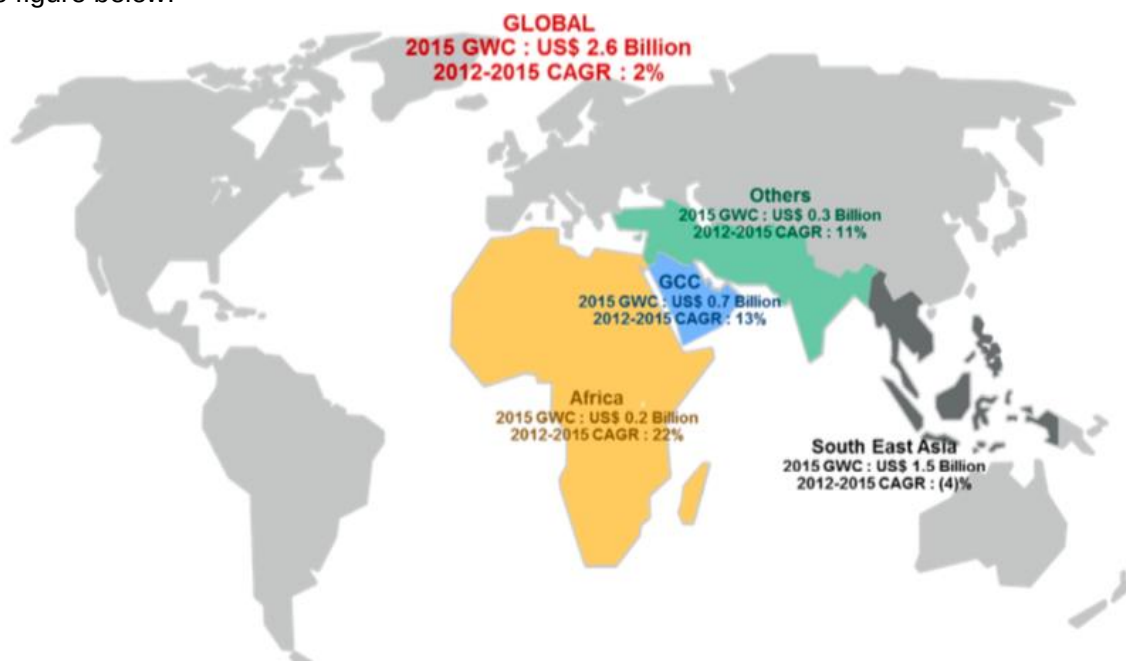


Figure 21: GLOBAL FAMILY TAKAFUL MARKET (USD)
(Reproduced from Milliman Global Takaful Report 2017)

South East Asia dominates the global family takaful market with 57% market share in 2015, as shown in the figure below. In terms of Gross Written Contributions of family takaful business, South East Asia region recorded USD1.5 billion compared to USD0.7 billion in the GCC region; the former recorded more than double the latter in terms of collected contributions.

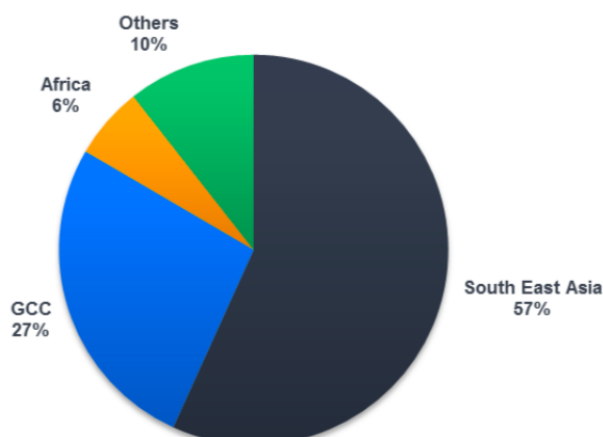


Figure 22: GLOBAL MARKET SHARE OF FAMILY TAKAFUL BY REGION (USD)
(Reproduced from Milliman Global Takaful Report 2017)

Although the commercial activity of the takaful business is reflected in two basic types, namely, family takaful and general takaful, family takaful is more dominant in terms of performance. Family takaful remains as the main income generator for the takaful industry in Malaysia, and has contributed more than 70 percent of the industry's income since 2000. According to Milliman Global Takaful Report 2017, Malaysia had the highest global market share of family takaful with 33% in 2015. In South East Asia, Malaysia captured the lion's share of 57%, as shown in the figure below. Its Gross Written Contributions amounting at USD0.8 billion and a growth rate of 4% in local currency terms. In terms of annual contributions equivalent, which is commonly used as a global measure to analyze growth in the family takaful business, Malaysia experienced a 12% growth in local currency terms.

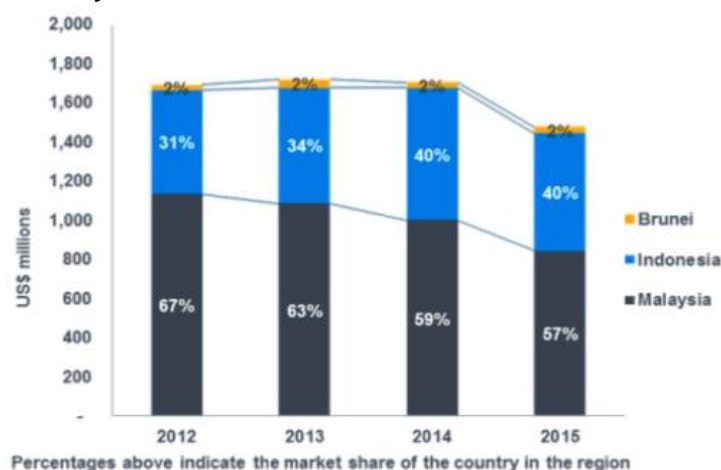


Figure 23: GROSS TAKAFUL CONTRIBUTIONS OF FAMILY TAKAFUL IN SOUTH EAST ASIA (USD)
(Reproduced from Milliman Global Takaful Report 2017)

6.3 Concept of Family Takaful

Participants of family takaful are required to pay installments or contribution (premium) regularly to the operator. Installments can be either paid monthly, quarterly, semi-annually or annually. Participants undertake a contract (*'aqd*) for part of the contribution to be in the form of participative contribution (*tabarru'*) and the other part of savings and investment.

The contribution will be credited in the family takaful fund. The fund is then split into two accounts, Participant's Investment Account (PIA) and Participant's Special Account (PSA). The Participant's Special Account is also referred to as the Participant's Risk Account (PRA). The terms may be used interchangeably in this module but would refer to the same account. A major portion of the contribution will be credited into the Participant's Investment Account (PIA), solely for the purpose of savings and investment. The takaful operator will invest the savings and investment contribution and the profit will usually be shared between the operator and the participant according to a pre-agreed ratio; the balance of the contribution is credited into the Participant's Special Account (PSA) as *tabarru'* (donation). It will be used to fulfill the obligation of mutual help, should any of the participants face a misfortune arising from death or permanent disability. It is from this account that takaful benefits are paid to the heir(s) of any participant who may die before the maturity period. If the participant survives until the date of maturity of the plan, he/she will be entitled to share the net surplus from the fund, if any. However, it is important to note that not all takaful operators have a sharing of surpluses provision.

It is vital that the installments paid by the takaful participants be invested in a manner deemed fit by Shariah principles. All investments must be free of *riba* and approved by the Shariah Advisory Council (SAC). Any returns (profits) from the investment will be shared in accordance with the principle of *Mudarabah* in a certain ratio as mutually agreed between the operator and the participants.

Some of the salient features of Family Takaful are:

- The plan is open to all individuals aged 18 to 55 years (some plan provides protection up to 65 years old).
- The plan provides a choice of maturity periods (5, 10, 15, 20, 25 years).
- The plan provides a combination of protection and long-term savings.
- The plan provides no forfeiture in the event of cancellation.
- The plan provides facility for partial-withdrawal.
- The plan provides financial benefits as well as investment profits if participants are inflicted with a tragedy.
- The plan provides periodic contribution payments (monthly, quarterly, semi-annually or annually).
- The plan provides surplus sharing with takaful operator.

The above features, however, are only applicable to the traditional endowment plans only.

A Family Takaful plan however, usually excludes the following claims:

- Attempted suicide or self-inflicted injury whether one is sane or insane
- If the participant breached the law
- If the participant provoked an assault
- If the participant were under the influence of drugs or alcohol
- If the participant were to suffer from AIDS or is HIV positive
- Other causes prohibited by Shariah law

6.4 Family Takaful Benefits

A family takaful plan provides benefits in the event of the participant's death, upon the expiry date of the plan, and if the participant decides to surrender the plan before the plan expires.

6.4.1 Death Benefit

In the event that a participant should die or suffer permanent disability before the maturity of his/her takaful plan, the beneficiary is entitled to the following benefits:

From Participant's Investment Account (PIA)	Participant's Special or Risk Account (PSA or PRA)
1. Total accumulated amount of the contribution paid by the deceased from the effective date of his/her takaful plan to the due date of payment prior to his/her death.	The outstanding takaful contributions which would have been paid by the deceased should he/she survives the period of the plan (calculated from the date of death to the date of maturity of the takaful plan).
2. His/her share of profits from the investment return.	

6.4.2 Maturity Benefit

If a participant lives until the date of maturity of his/her takaful plan, the benefits paid upon maturity shall be as follows:

From Participant's Investment Account (PIA)	Participant's Special or Risk Account (PSA or PRA)
1. Total accumulated amount of the contribution paid by the participant during his/her participation in the takaful plan.	The net surplus allocated to the participants based on the last actuarial valuation of the PSA or the PRA. The amount of surplus to be distributed varies according to the terms of participation and the age of the participants.
2. His/her share of profits from the investment return.	

6.4.3 Withdrawal Benefits

If a participant decides to withdraw from his/her takaful plan before the expiry date of his takaful plan, he/she is entitled to receive the following benefits:

From Participant's Investment Account (PIA)	Participant's Special or Risk Account (PSA or PRA)
1. Total accumulated amount of the contribution credited into his PIA from the date of entry to the date of surrender. The amount shall depend on the amount of installments paid by the participant and the length of term the participants has contributed to the plan.	Participant will not receive any benefit from PSA or PRA as the fund is considered a form of donation.
2. Profits from investment accumulated during the same period.	

6.5 Operational Workflow of Family Takaful

In Malaysia, the models used in takaful contracts as practiced in the industry are mainly hybrids of *wakalah* and *mudarabah* models. There is also a *ju'alah* (reward for performance) element used in the contract. *Ju'alah* concept in a takaful contract is where the participants make an offer to the operator that they will pay a sum amount of contributions to the takaful fund, in view of making the operator obliged for rendering the service to the insured through providing a

financial security against the defined risk. Basically, *ju'alah* is similar to the *wakalah* contract, except that the payment to the agent (operator) is measured on his output and performance.

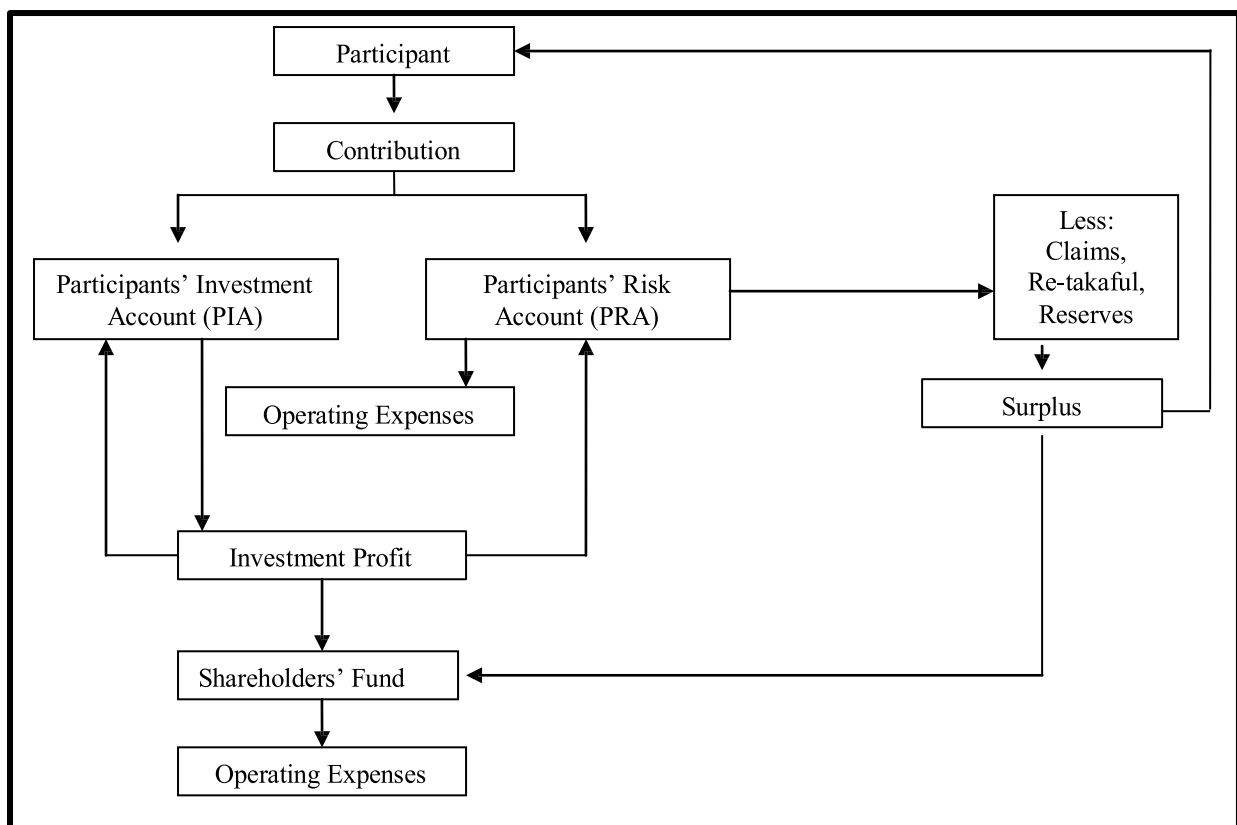
Only one takaful operator, Syarikat Takaful Malaysia Bhd (the first takaful operator in the country) adopted the *mudharabah* model.

6.5.1 Mudharabah

The *Mudharabah* model is only the basic model in takaful operation. According to this principle, there are two parties involved in a contract, the takaful operator (*mudharib*) acting as the fund manager and participants (*sahib-ul-mal*), the fund provider. The operator will accept takaful installments or contributions (premium) from the participants and manage the fund on behalf of the participants. The contract specifies how the profit or surplus from the operations of takaful managed by the operator is to be shared, in accordance with the principle of *Mudharabah*. The sharing of such profit may be in a ratio of 50:50, 60:40 or 70:30 as mutually agreed by both the contracting parties. However, if the investment suffers a loss, the losses will be borne by the participants.

Diagram 6.1 shows the operational flow of the *Mudharabah* model for family takaful. The contribution (premium) paid by the participants will be divided and credited into two separate accounts, as mentioned in the previous section, namely, Participant's Investment Account (PIA) and Participant's Risk Account (PRA). In practice, the percentage allocated to the PIA and PRA is determined by the operator according to the participant's age and maturity term and will be made known to the participants. Normally, most of the contribution will go to the PIA. Surplus in PRA, after deducting claims, retakaful and reserves at the end of the year, will be distributed to the takaful operator and the participants based on the agreement of the contract.

Diagram 6.1: Al-Mudharabah Model for Family Takaful



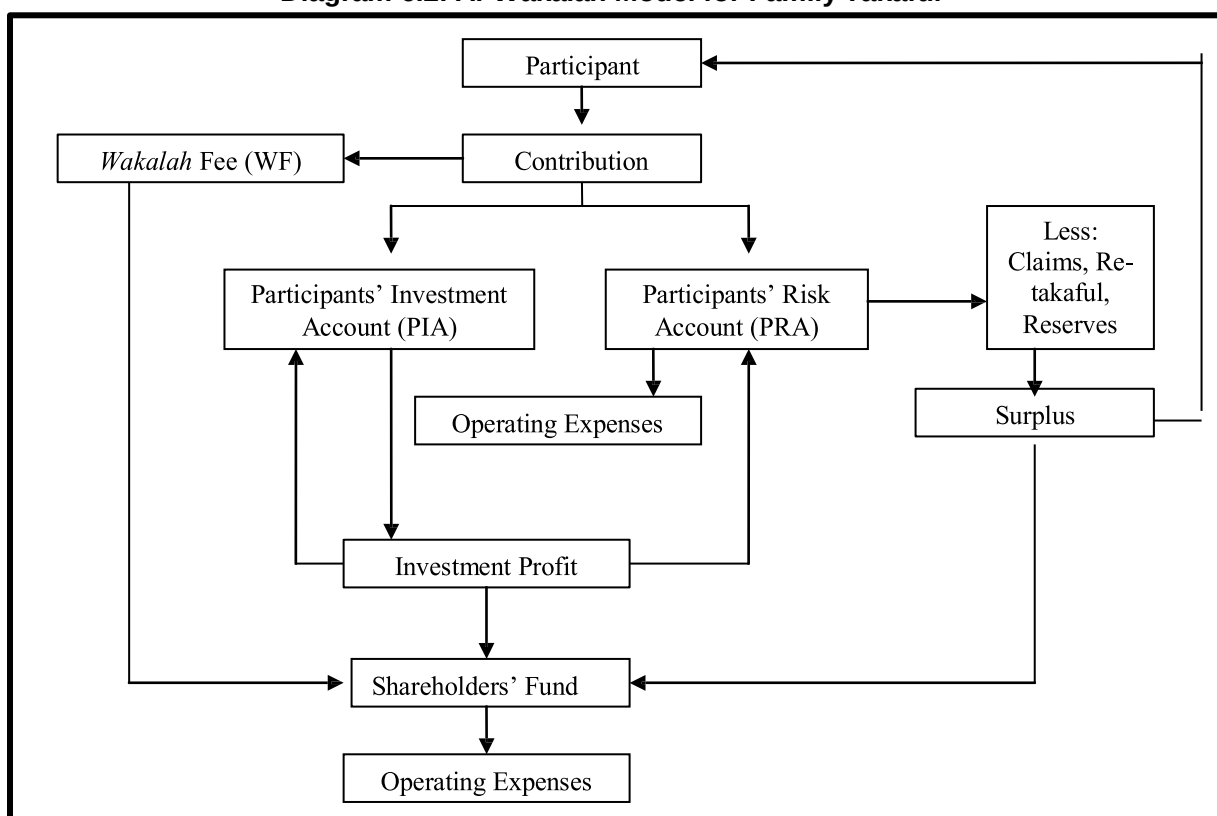
Source: Takaful Annual Report, 2005

6.5.2 Wakalah

The *Wakalah* concept is essentially an agent-principal relationship, where the takaful operator acts as an agent on behalf of the participants and earns a fee (*wakalah* fee) for the services rendered. The fee can be a fixed amount or based on an agreed ratio of investment profit or surplus of the takaful funds.

Diagram 6.2 shows the operational flow of the *wakalah* model for family takaful. The participant pays contribution under the family takaful products. The contribution will be divided into three types of accounts, namely *Wakalah* Fee (WF), Participant's Investment Account (PIA) and Participant's Risk Account (PRA). The allocation between WF, PIA and PRA is based on the pre-agreed ratio as specified in the contract. *Wakalah* fees which consist of commission and management expenses will be paid to shareholders. The PIA fund and excess in PRA after deducting operating expenses will be invested according to the principles of *Shariah*. If there is an investment profit, it will be distributed between the takaful operator and the participant in the form of performance fee (for takaful operator) as stated in the contract. The amount in PIA will be accumulated and paid to participant upon death, surrender or maturity. The amount in PRA will be used to pay claims, re-takaful and reserves. Surplus in PRA, after deducting claims, re-takaful and reserves at the end of the year, will be distributed to the takaful operator and the participants based on the agreement of the contract. Shareholders will use the WF to pay all operating expenses. However, there are some operators who do not share the surplus in PRA with the participants.

Diagram 6.2: Al-Wakalah Model for Family Takaful



Source: Takaful Annual Report, 2005

Advantages, Disadvantages between *Wakalah* and *Mudarabah*

Both models *Wakalah* and *Mudarabah* are *Shariah* compliant; hence the advantage or disadvantage is in the area of some features related to business decision and market incentive. The market has the freedom to choose either model as far as the *Shariah* compliance status is concerned. Both are governed by IFSA Act 2013, and are under the

preview of Bank Negara Malaysia supervised by the Shariah committee. The *Wakalah* is more flexible pertaining to Shariah regarding Shariah rules and principles compared to *Mudharabah* which is under strict Shariah requirement. However *wakalah* puts the Takaful operator to act as agent for both parties, the shareholders and the participant which puts the agency status under some constrain, where the issue of conflict of interest may rise. *Mudharabah* is very strict with regards the requirement of the capital, profit, management and liability in the business operation. However, it should be noted that both models may have different implications on the creation of fund, fee, surplus, losses and others aspects which make the regulators and the market players make their selection on the convenient models. However, from a Shariah perspective both are acceptable, it is more towards a business decision when it comes to the selection of the model. Whilst the *Wakalah* model is subject to a less strict Shariah requirements and is easier to be applied, the *Mudharabah* model could encourage the takaful operator to improve the investment performance aiming at a higher level of profitability due to the fact that *mudharib* share stimulates and creates incentive for takaful operators to invest wisely in order to increase the *mudharib* share. Thus, an optimal model may be a combination of both (hybrid model).

6.6 Types of Family Takaful Schemes

Generally, family takaful plans can be grouped as follows:

1. Ordinary Family
2. Annuity Plan
3. Investment-Linked Plan

6.6.1 Ordinary Family

There are two categories under this type of cover, namely, Individual Family Takaful and Group Family Takaful.

i. Individual Family Takaful

The plan provides financial benefits arising from death or permanent disability, as well as long-term savings and investment profits that are distributed upon claim, maturity or early surrender. Example: Education Plan, Mortgage Plan and an Individual Medical Plan.

ii. Group Family Takaful

Under this plan, a minimum number of participants are required to qualify. The plan usually covers employees of companies, members of clubs, associations and societies. The participants will receive protection in the form of financial benefits arising from death or permanent disability. Example: Group Term Takaful Plan, and Group Medical and Health Takaful

6.6.2 Annuity Plan

The plan provides regular income upon the participant's retirement where he is not actively employed. Commonly, in Malaysia the Normal Retirement age is 60 years old, according to The Minimum Retirement Age Act 2012 (MRA Act). An Annuity Plan is a plan that actually protects the annuitant (person receiving the payment) against the risk of outliving his/her financial resources by providing guaranteed income for life. Even though a retiree is not actively working, he/she will still incur personal and household expenses during the retirement years. Furthermore, invariably, cost of medical expenses would increase during old age for which no other cover is affordable. Hence, uncertainties exist as to how long individuals will need the income after they have retired to provide for old age. If personal savings and investment are not sufficient, individuals living to advance age may outlive their income sources. Some annuities

are payable throughout the life of the annuitant, whereas others are payable for a certain period of time that does not depend on anyone's life or death. However, annuity plans are still not common in Malaysia. Annuity payments are composed of both earnings and a partial liquidation of principal. Example of annuity plans that were available in the market at one point of time was the EPF Annuity Scheme (SAKK) and EPF Annuity Takaful Scheme (SATK).

6.6.3 Investment-Linked Plan

An investment-linked plan is a takaful plan that provides flexibility to the participant in terms of managing his/her protection and investment needs in one account. The plan gives the participant a mix of takaful protection and an investment account with the flexibility to change this mix at any time. The takaful protection covers death and permanent disability. Some plans may allow a person to vary the amount of contribution according to the individual changing financial circumstances. A portion of the participant's contribution is used to buy investment units, such as units in equities, fixed income securities or other form of assets, as long as they are Shariah compliant. An investment linked plan usually allows the participant to 'switch' their current investment fund to other types of investment fund. You can claim part of your investment-linked units at any point in time based on the prevailing unit price. There are many investment-linked plans available in the market and the operators are required to publish their unit prices in the news dailies.

The plan contributions can be made as single contribution i.e. one lump sum or on a regular basis, either monthly, quarterly, half-yearly or yearly. Structured plans which include protection of the participants initial capital also falls into this category of takaful plans.

6.7 Conclusion

The chapter begins with a description of family takaful plan, which is equivalent to the Islamic life insurance that provides protection with a long-term saving and investment program. Family takaful enables participants to aim for regular saving for a fixed period of time to create a retirement or long-term contingency fund, investing with a view of earning profits which are Shariah compliant, getting takaful coverage in the form of payment of benefit to heir(s) should the participant (insured) dies or become disabled before the expiry date of his/her participation in the takaful plan and most importantly obtaining the blessing of Allah for helping others. Although the commercial activity of the takaful business is reflected in two basic types, namely family takaful and general takaful, family takaful is more dominant in terms of performance in Malaysia, as it has contributed more than 70 percent of the industry's income since year 2000.

This chapter also explains the benefits provided by family takaful plan that comes in three forms: death benefit (in the event that a participant should die or suffer permanent disability before the maturity of his/her takaful plan), maturity benefits (if a participants live until the date of maturity of his/her takaful plan) and withdrawal benefits (if a participant decides to withdraw from his/her takaful plan before the expiry date of his takaful plan). The chapter also describes the available operational workflow of different models in Malaysia, mainly the hybrid of *wakalah* and *mudarabah* models. The chapter ends with the section on the types of family takaful plan which are normally grouped into three, such as ordinary plan, annuity plan and investment-linked plan.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. In a family takaful contract, if the loss does not occur against the participant within the specified period, the participant is entitled to
 - A. the whole amount of paid premiums.
 - B. the paid premiums, share of profits made out of the cumulated paid premiums and net surplus from the *tabarru'* contribution.
 - C. nothing, because if no claims were made within the specific period, the premium is forfeited.
 - D. the share of profits made from the cumulated paid premiums .

2. In a family takaful contract, if the participant dies within the protection period, his/her beneficiary is entitled to
 - A. the whole amount of paid premiums
 - B. the paid premiums and share of profits made out of the cumulated paid premiums
 - C. the paid premiums, share of profits made out of the cumulated paid premiums and outstanding *tabarru'* contribution which he/she would have paid should he/she survive the plan
 - D. the share of profits made from the cumulated paid premiums

3. In the *Mudharabah* concept, if there are losses from the investment, the losses shall be borne by the
 - A. participants
 - B. operator
 - C. shared by the participants and the operator
 - D. beneficiary

4. In the *Al-Wakalah* model, the takaful operator acts as an agent on behalf of the
 - A. participant
 - B. takaful company
 - C. beneficiary
 - D. shareholder

5. Hakim contributes RM100 per month for his family takaful plan. How would the contribution most likely be treated in practice?
 - A. RM100 will be credited into PA
 - B. RM100 will be credited into PSA
 - C. RM70 will be credited into PA and RM 30 into PSA
 - D. RM10 will be credited into PA and RM 90 into PSA

6. Which of the following claims would **NOT** be excluded from the family takaful plan?
- A. An attempted suicide by an insane participant.
 - B. A participant who suffers from AIDS.
 - C. A participant who is injured in an accident while driving under the influence of drugs.
 - D. A participant who undergoes an emergency operation.
7. Which of the following is **NOT** a feature of family takaful?
- A. Facility for part-withdrawal
 - B. Forfeiture in the event of cancellation
 - C. No forfeiture in the event of cancellation
 - D. Surplus-sharing with takaful operator
8. If a participant surrenders his/her takaful certificate before the maturity date of his takaful plan, he/she is **NOT** entitled to receive
- A. the whole amount of paid premiums.
 - B. the paid premiums and share of profits made out of the cumulated paid premiums.
 - C. anything, because if he surrenders the certificate, the premium is forfeited.
 - D. the net surplus from the *tabarru'* contribution.
9. Which of the following is coverage provided by a family takaful plan?
- A. Any losses inflicted on properties
 - B. Any losses inflicted on life or limb
 - C. Accidental death or injury to a third party
 - D. Liability arising from damage caused by participant to a third party
10. Which of the following is **NOT** a type of family takaful product?
- A. Houseowner plan
 - B. Annuity plan
 - C. Mortgage plan
 - D. Education plan
11. Which of the following takaful models raise the issue of agency-problem?
- A. *Mudarabah* model
 - B. *Waqf* model
 - C. *Wakalah* model
 - D. Hybrid model
12. Which of the following takaful models is expected to improve the performance (especially the investment performance) of takaful operator?
- A. *Mudarabah* model
 - B. *Waqf* model
 - C. *Wakalah* model
 - D. Hybrid model

Answer: 1-b, 2-c, 3-a, 4-a, 5-c, 6-d, 7-b, 8-d, 9-b, 10-a, 11-c, 12-a.

Chapter 7

General Takaful

Chapter Outline:

- 7.1 Overview of Global General Takaful Market
- 7.2 Concept of General Takaful
- 7.3 Operational Workflow of General Takaful
 - 7.3.1 *Al-Mudharabah* Model
 - 7.3.2 *Al-Wakalah* Model
- 7.4 General Takaful: Motor
 - 7.4.1 Types of Vehicles
- 7.5 General Takaful: Property
 - 7.5.1 Home
 - 7.5.2 Fire
 - 7.5.3 Consequential Loss
- 7.6 General Takaful: Personal Accident
 - 7.6.1 Types of Coverage
- 7.7 General Takaful: Miscellaneous
- 7.8 Conclusion

Chapter Objectives

Upon completion of this chapter, you should have knowledge of:

- Understand the concept of general takaful
- Describe the operational workflow of general takaful
- Identify the types of general takaful and schemes its application

7.1 Overview of Global General Takaful Market

The general takaful industry constitutes the major portion of the global takaful market. According to Milliman Global Takaful Report 2017, the global gross written contribution of general takaful is estimated at USD12.3 billion in 2015; almost 5 times the global family takaful market. The industry continues its two digit growth of 17% in 2015 compared to 16% in 2014, as shown in the figure below.

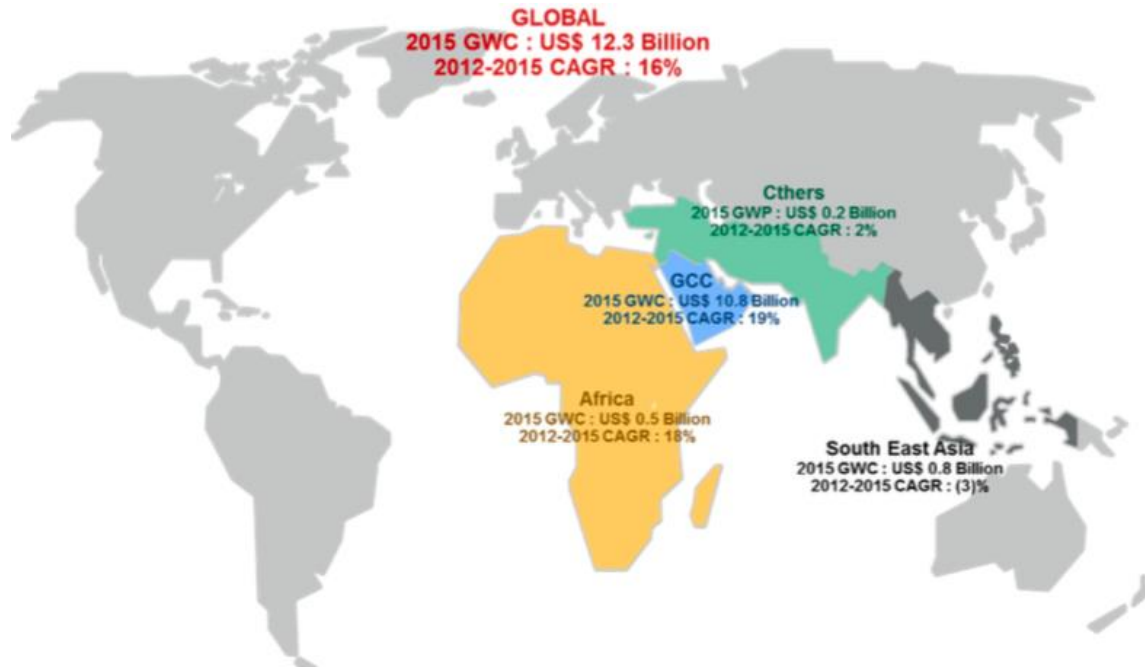


Figure 24: GLOBAL GENERAL TAKAFUL MARKET (USD)
(Reproduced from Milliman Global Takaful Report 2017)

According to Milliman Global Takaful Report 2017, South East Asia region recorded USD0.8 billion compared to USD10.8 billion recorded in the GCC region in terms of Gross Written Contributions of general takaful business, as shown in the figure below. Unlike the case of family takaful business, South East Asia lags behind the GCC with only 6% global market share compared to the lion's share of 88% market share in the GCC.

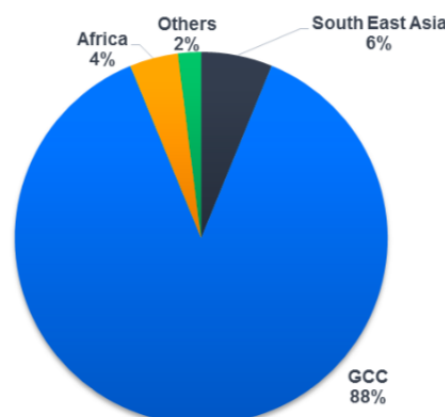


Figure 25: GLOBAL MARKET SHARE OF GENERAL TAKAFUL BY REGION (USD)
(Reproduced from Milliman Global Takaful Report 2017)

Malaysia in 2015 had the highest market share of general takaful business with 70% in South East Asia, as shown in the figure below. Its Gross Written Contributions amounting at USD534 million compared to USD142 million recorded in Indonesia which comes second in the region. In terms of growth, Malaysia exhibited positive growth of 6% in local currency terms, though in USD terms the growth is negative due to the sharp fall of the Malaysian ringgit.

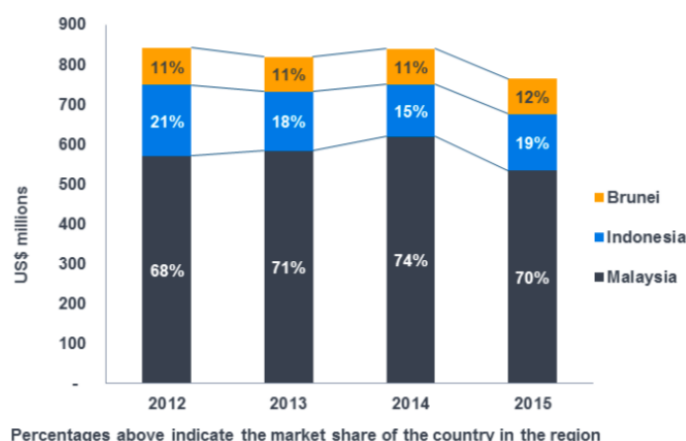


Figure 26: GROSS TAKAFUL CONTRIBUTIONS OF GENERAL TAKAFUL IN SOUTH EAST ASIA (USD)
(Reproduced from Milliman Global Takaful Report 2017)

7.2 Concept of General Takaful

Like the family takaful, the general takaful concept is similar where a sum of money is contributed to a takaful fund in the form of participative contribution (*tabarru'*). The fund's contributor will undertake a contract (*'aqd*) to become one of the participants by agreeing to mutually help each other, should any of the participants suffer any form of misfortune, either arising from death, permanent disability and any loss or damage of property, or any other such misfortunes as covered under the takaful scheme. In this regard, the risks covered under general takaful are wider in scope.

Generally, general takaful plans or schemes provide the benefits of protection only during the period of coverage. The investment element is minimal or virtually non-existent. If during the period of coverage, the participants do not make any claims, they may be entitled to a share of the surplus in the fund which will be shared between the participants and the takaful company. This is usually the case under the *Mudarabah* model but sharing of surplus funds does not apply in the pure *Wakalah* model.

7.3 Operational Workflow of General Takaful

General takaful schemes are basically on a short-term basis (normally one year), between a group of participants to provide mutual compensation in the event of a defined loss.

The schemes are designed to meet the needs for protection of individuals and corporate bodies in relation to material loss or damage resulting from a catastrophe or disaster inflicted upon properties, assets or belongings of participants.

In the event of a catastrophe or disaster resulting in a loss or damage to a property or bodily injuries or other physical disability to a person, the owner of the property or the person concerned may suffer substantial financial losses.

For instance, if a house is destroyed or damaged by fire, the owner would certainly require a sufficient sum of money to repair or rebuild the house, as well as enough money to replace the damaged furniture, fixtures and fittings. Similarly, a person who is injured in an accident would require an adequate sum of money to pay for medical treatment. With the various general takaful schemes offered in the market, that person will be assured of takaful benefits in case of misfortune resulting from such losses or damage.

There are two types of general takaful models practiced in Malaysia, which are the *Mudarabah* (profit-sharing basis) and *Wakalah* (agency basis).

7.3.1 *Mudharabah* Model

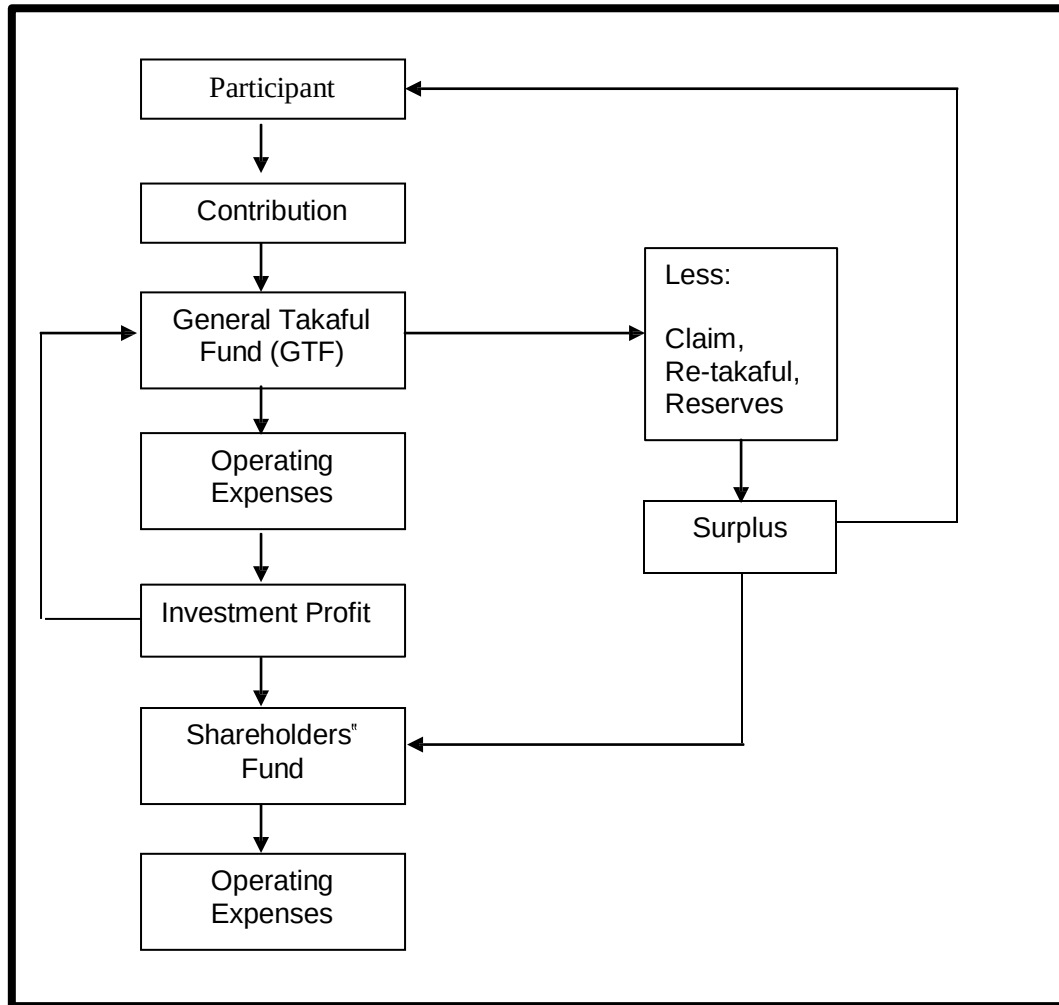
In this model, the contract stipulates the rights and obligations of the participants as well as the company. To participate in the various schemes, the participants agree to pay the takaful contributions as *tabarru'*. The company manages the general takaful business including the investment of the general takaful fund.

As *mudarib* (takaful operator), the takaful company will invest the general takaful fund in line with Shariah principles and all returns on the investment will be pooled back to the fund.

In line with the virtues of cooperation, shared responsibilities and mutual help as embodied in the concepts of takaful, the participants agree that the company shall pay from the general takaful fund, compensation or indemnity to fellow participants who have suffered a defined loss upon the occurrence of a catastrophe or disaster.

The fund shall also pay for other operational costs of the general takaful business such as for the retakaful arrangements and the setting up of technical reserves. General takaful companies resort to retakaful in order to protect themselves against unexpected risks and severe financial losses. Hence, the relationship between a takaful and retakaful company is similar to that of a participant and a takaful company. Retakaful and setting up reserves aim at improving the operational and financial stability of takaful companies. Studies such as Ismail (2013) discovered a positive relationship between retakaful dependence and investment yield (a proxy for investment performance) of general takaful companies in Malaysia; a proper retakaful improves underwriting performance through spreading the risks.

This contract specifies how the profit from the operations of takaful is managed by the *mudarib* to be shared, in line with the Shariah principles of *mudarabah*, between the participants as the providers of capital and the *mudarib* as the entrepreneur. The sharing of such profit must be in the form of ratios such as 60:40, 70:30, etc. as mutually agreed between the contracting parties.

Figure 7.1: Al-Mudharabah Model for General Takaful

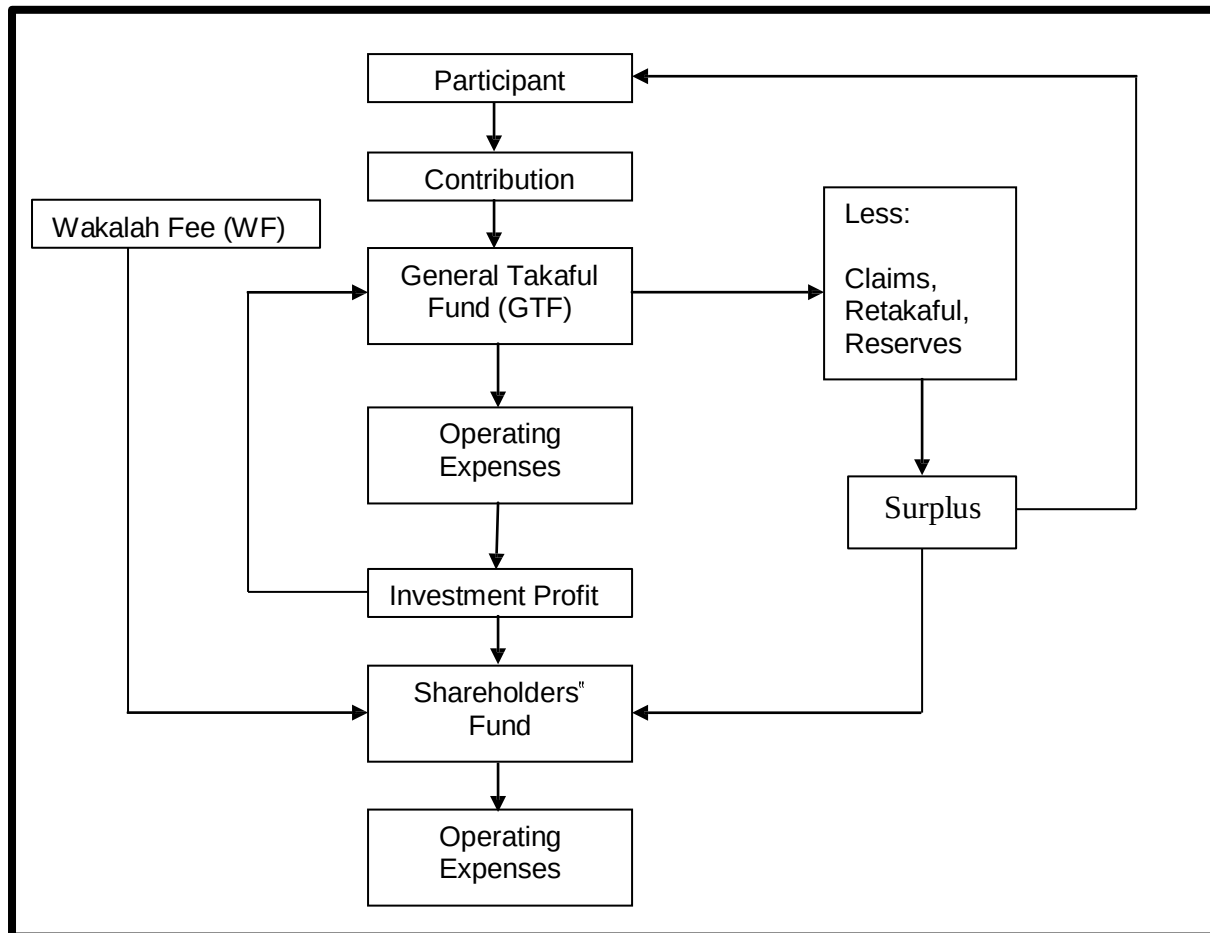
Source: Bank Negara Malaysia, Annual Report 2005

Diagram 7.1 shows the process flow of the *Mudharabah* model for general takaful. In this model, participants of any general takaful protection scheme, such as motor protection, fire protection and etc., will pay the takaful operator a contribution as a donation (*tabarru'*) to help each other.

The funds will be pooled into a General Takaful Fund (GTF) and will be invested by the takaful operator in Shariah compliant investments. All profits generated from the investments will be deposited back in the General Takaful Fund (GTF). Surplus at the end of the year after deducting claims, re-takaful and reserves will be distributed to the takaful operator and participants based on the pre-agreed ratio as stipulated in the contract.

7.3.2 *Wakalah* Model

The concept of *Wakalah* is essentially an agent-principal relationship, where the takaful operator acts as an agent on behalf of the participants and earns a fee (*wakalah* fee) for the services rendered. The fee can be a fixed amount or based on an agreed ratio of investment to profit or surplus of the takaful funds.

Figure 7.2: Al-Wakalah Model for General Takaful

Source: Bank Negara Malaysia, Annual Report 2005

The diagram in Figure 7.2 shows the *wakalah* contract process flow for general takaful. In this contract, participants will pay contribution as a donation (*tabarru'*) to help each other and the contribution will be divided into two types of accounts i.e. *Wakalah Fee (WF)* and General Takaful Fund (GTF). The allocation between *Wakalah Fee* and General Takaful Fund is based on the pre-agreed ratio between the participants and the takaful operator as specified in the contract. The *Wakalah Fee* consists of commission and management expenses which will be paid to shareholders' fund. For pure *Wakalah* model, as mentioned earlier, there will be no sharing and distribution of the surpluses but for the modified *Wakalah* model, which is the most widely used in Malaysia today, a portion of the annual surplus can be allocated for a technical or capital reserve on behalf of participants or distributed as a payout to the participants based on the pre-agreed ratio as stipulated in the contract.

7.4 General Takaful: Motor

The Road Transport Act 1987 requires all motor vehicles to be insured at least for liabilities for injuries to third parties before they can be used on public roads. But, are all insurance and takaful covers the same? No, not necessarily. Although Motor is a tariffed class, insurance and takaful companies are allowed to impose different levels of loadings and deductibles. Furthermore, different companies offer different levels of service and adopt different technology and approaches to claims-handling.

Motor takaful covers participants against loss or damage to their vehicles due to accidental fire, theft or accidents. It also covers bodily injury or death of a third party, as well as loss or damage to a third party's property.

In motor takaful plans, the participants will contribute sums of money to a general takaful fund in the form of participative contribution (*tabarru'*). Based on the contract (*'aqd*) undertaken, the participants may be entitled to a share of the surplus in the fund if they did not make any claims during the period of takaful. Nonetheless, a No Claims Discount (NCD) would be provided for future contributions when no claims results.

7.4.1 Types of Vehicles

- **Private Car**

These will include three-wheeled cars and station wagons used for social, domestic and pleasure purposes, and for the business or professional purposes of the plan holder.

Whether or not the car is one's dream car, it takes one to one's destination; but it being on the road everyday, rain or shine, makes it susceptible to many unpredictable events. Motor Takaful is the shield that protects vehicle against these unforeseen events, so that it eases one's mind.

- **Commercial Vehicle**

These include all vehicles (including three-wheeled carriers) not provided for under the private cars or motorcycles classification. The following is the subdivision of the commercial vehicles under the Tariff:

- Motor trade (road risks)
- Goods carrying vehicles
- Cars for hire (public taxis)
- Hired cars – hirer driving or chauffeur-driven
- Special Types (including agricultural and forestry vehicles, those for site-clearing and leveling plants, cranes, mobile plants, delivery trucks, fire brigade vehicles, etc.

Commercial Vehicle Takaful provides coverage for a number of vehicles under one plan. If one uses motor vehicles of any sort in connection with one's business, one needs to get coverage against injury or damage just as that for private car coverage. Failure to take up this plan for commercial vehicles can result in unnecessary penalty.

7.5 General Takaful: Property

With Property takaful, one is assured of comprehensive protection for one's house (including the contents). The most important thing is that one will have peace of mind as one's assets are securely covered.

Common perils that are covered under property takaful are:

- Fires
- Lighting
- Explosions
- Aircraft damage
- Impact damage
- Bursting and overflowing of water tanks
- Thefts (by forcible entry only)
- Hurricanes, cyclones, typhoons, windstorms
- Earthquakes, volcanic eruptions
- Floods
- Loss of rent (not exceeding 10% of the total sum covered)
- Personal Public Liability

7.5.1 Home

There are two types of home takaful, the Houseowners Takaful and Householders Takaful. Houseowners Takaful covers homes against loss or damage caused by floods, fires and other such perils. Not only does it protect the house, but also the garage, outbuildings, walls, gates and fences around the property, as well as permanent fixtures and fittings. Householders Takaful covers the loss or damage to the contents of residential property. One may participate in a Houseowners Takaful or a Householders Takaful, or both for complete coverage.

How much coverage is needed?

The participant must ensure that the amount covered in their houseowners takaful plan reflects the rebuilding cost of his house (and other damages on his property). If the amount covered is less than the rebuilding cost, an average condition will be calculated, meaning that if he underinsures his property to only 80% of its rebuilding worth, he will only be entitled to claim 80% of the value of damage sustained. If he is not sure of the extent of coverage needed, he must consult his takaful agent for a better understanding of the best coverage option.

7.5.2 Fire

When one has a property to call one's own, one hopes that it will last through time and be able to pass it on to one's children in the future. However, the future is unpredictable and anything can happen including a fire that may destroy that very property. That is why one needs Fire Takaful. It helps ensure that the property is well-protected against the unexpected; so that one's loved ones will also have a place to call their own in the future.

7.5.3 Consequential loss

Consequential loss is normally taken up to supplement the fire plan on business premises to ensure that funds are available for the repair of material damage and that the insured's business can resume without delay should there be damages caused by a fire.

How would a claim be made?

If a participant has suffered a loss or damage to his home, he will need to get in contact with his takaful operator as soon as possible and ensure that the operator provides the relevant information to process his claim. The participant needs to be aware of the basis of his coverage as this will affect the settlement of claims should he need compensation.

7.6 General Takaful: Personal Accident

A quote says "To protect loved ones is to protect ourselves". For our loved ones, a minimum cover of protection must be provided at all times. In a nutshell, our personal well-being is of utmost importance to our children. They depend on it, to lead a worry-less life. Takaful Personal Accident is a solution to be financially-able in the toughest of times at the most affordable cost.

Personal accident (PA) takaful is an annual plan that provides the participant and his beneficiaries with compensation in the event of death, disablement or injuries arising from an accident. He can either participate in a PA takaful for himself or a group plan for his family. PA takaful is also available for short durations, like when one is travelling, to cover any accident occurring during the travel period.

While the basic PA takaful cover provides 24-hour worldwide coverage, there are exclusions to basic PA takaful. However, through paying additional contributions, certificate holders can extend their cover to include the certificate exclusions. The participant needs to check with his takaful operator on the additional coverage he can purchase for his PA takaful.

7.6.1 Types of coverage

Death

In the event of death the coverage will be based on the accident; and solely and independently of any other cause, except illness resulting directly from, or medical or surgical treatment rendered necessary by such bodily injury, resulting in the death or disablement of the participant within (12) months from the date of the accident.

Permanent Disablement

In the event of disablement which entirely prevents the participant from attending to his business or occupation of any kind. The disablement must continue uninterruptedly for a period of at least (12) months from the date of accident. The chances of recovery are beyond hope of improvement.

Temporary Total Disablement

In the case of disablement for temporary basis which entirely prevents the participant from attending to his business will also be covered.

Temporary Partial Disablement

This is a disablement which prevents the participant from attending to a substantial part of his business or occupation but does not constitute temporary total disablement.

Medical Expenses

Reimburses the actual medical expenses incurred for treatment of bodily injury due to the accident up to the specified amount.

Funeral Expenses

Up to the amount of the Plan applied for, as a result of accidental death.

General Exclusion

The exclusion includes wars, invasion acts of foreign enemies, hostilities or war-like operations as per list below:

- Acts of terrorism
- Nuclear weapon material
- Entering or descending from aircrafts
- Professional sports
- Wood-working machinery driven by mechanical power
- Drugs or alcohol
- Sickness or diseases of any kind, pregnancies or childbirths or pre-existing physical defects or infirmity, insanity, suicide or intentional self-inflicted injuries.
- Provoked murders or assaults
- The participant whilst committing or attempting to commit any unlawful act
- AIDS or AIDS-related complications

How to choose the plan?

When choosing a Personal Accident Takaful, one must always:

- Check the scope of cover offered by the takaful operator. Different takaful operators, offer different covers, exclusions and benefits.
- Disclose all material facts on the risks to be covered.
- Consider one's requirements, and pick the plan that meets them best.

When participating in Personal Accident takaful, there are several important points that need to be considered:

- **Scale of benefits**
The scale of benefits refers to the amount of compensation payable by the takaful operator in the event of death, disablement or injury. One should note the scale of benefits in the plan as it varies among takaful operators.
- **Multiple coverage**
If one has more than one Personal Accident (PA) takaful or insurance, in the event of death or disablement, one or one's beneficiary will be entitled to compensation under each plan. However, for certain losses such as medical expenses where compensation are on reimbursement basis, one will only be compensated once, based on the actual loss suffered.
- **Beneficiary**
One is advised to nominate a beneficiary and ensure that the beneficiary is aware of the PA takaful that one has participated in.

7.7 General Takaful: Miscellaneous

7.7.1 All Risks

This plan is designed to cover loss, damage or destruction to the participant's property by any accident or misfortune. However, the coverage excludes wear and tear depreciation; mechanical or electrical defect breakdown; damage to traveling trunks, bags etc.; scratching or denting of any article or cracking and/or breakage of glass and the like; deeds, bonds, bills of exchange etc.; war, invasion, an act of foreign enemy etc.; consequential loss; legal liability; radioactive contamination and nuclear weapons material.

7.7.2 Burglary

This plan is designed to cover loss or damage to the covered property by theft consequent upon actual forcible and violent breaking into or out of a premise or by armed robbery or robbery with violence. Damage to premises as a result of theft can be covered upon request subject to an additional contribution.

7.7.3 Plate Glass

The plan is designed to cover all types of plate glass in a building. The protection afforded by this plan is very wide and generally it covers any accidents, especially impact damage by any means or misfortunes.

7.7.4 Machinery & Equipment

This plan is mainly to cover immobile industrial or commercial equipment. It indemnifies the covered against loss or damage to the covered property arising from fire and lightning; theft or housebreaking; accidental external damage; and windstorm, flood and water damage.

7.7.5 Equipment

This plan is restricted mainly to cover mechanically propelled vehicles (or equipment) which is not licensed for use on public roads. Such vehicles (or equipment) are tractors, forklifts, excavators and loaders. The plan will indemnify the participant against direct physical loss of or damage to the property covered arising from accidental collision or overturning consequent upon mechanical breakdown or consequent upon wear and tear; fire external explosion self-ignition or lightning; and burglary housebreaking or theft.

7.7.6 Money

This plan is intended to protect Industrial or Business establishment against loss of money which may be carried by a messenger and/or employees of the participant and which may be in transit from one place to another. It covers money in transit and money in the premises against loss or destruction by any robbery, hold-up or theft. The plan provides coverage for money in transit; money in the premises; and damage to the safe.

7.8 Conclusion

This chapter covered the general takaful. Among the aspects discussed are: concept of general takaful, operational workflow of general takaful, general takaful: motor, types of vehicles, general takaful: property, general takaful: personal accident and general takaful: miscellaneous. These aspects are very important in the area of financial planning as they represent one of the driving components in the advice and recommendation.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Which of the following accurately describes the **general takaful** concept?
 - A. A portion of money contributed on contractual basis to the General Takaful Fund to help each other.
 - B. Participative contribution performed by participants who mutually agree to help each other.
 - C. Participants pay a donation to help others when needed.
 - D. The Takaful operator accepts payment on a contractual basis from participants to help others.

2. Which of the following is **FALSE** about general takaful?
 - A. Participants will undertake a contract by agreeing to mutually help each other.
 - B. Two types of contract in general takaful are profit-sharing and agency contract.
 - C. The contribution funds will be invested by the takaful operator into Shariah-compliant investments.
 - D. General Takaful is designed to meet the needs for protection of corporate bodies in relation to material loss or damage.

3. In the *Wakalah* model, the commission and management expenses will be parked into the
 - A. *Wakalah* Investment account
 - B. *Wakalah* Fee account
 - C. *Wakalah* Profit account
 - D. *Wakalah* Takaful account

4. **Motor Takaful** covers participants against
 - A. loss or damage to the vehicle due to accidental fire, theft or accident only.
 - B. loss or damage to the vehicle due to accidental fire and theft only.
 - C. loss or damage to the vehicle due to accidental fire, theft or accident plus bodily injury or death and property of a third party.
 - D. loss or damage to the vehicle due to theft or accident plus damage of a third party's property.

5. **Fire Takaful** is a plan to protect a participant's
 - A. property from an expected event of fire.
 - B. Property from an unpredictable event of fire.
 - C. vehicle from an unpredictable event of fire.
 - D. money from an unpredictable event of fire.

6. Which of the following is **TRUE** about Personal Accident plan?
 - A. The plan provides compensation to the holder and beneficiaries in the event of death, disablement or injuries arising from an accident.
 - B. The plan will provide compensation to the participant in the event of death and disablement arising from an accident.
 - C. The plan provides compensation to the holder and third party in the event death and injuries arising from accident.
 - D. The plan will provide compensation to the participant in the event of death arising from an accident.

7. Coverage against loss, damage or destruction to the participant's property by any accident or misfortune is a description of
 - A. Money plan
 - B. Burglary plan
 - C. All Risk plan
 - D. Fidelity Guarantee plan

8. Which of the following falls under **Miscellaneous Takaful**?
 - A. Burglary
 - B. Money
 - C. Equipment
 - D. All of the above

9. As a plan holder of a Motor takaful, the participants will be able to make claims for the following circumstances:
 - A. When there is damage to the vehicle.
 - B. When involved in a motor accident.
 - C. When a third party vehicle is involved.
 - D. A and B

10. Houseowners takaful is a plan that covers
 - A. a home against loss or damage caused by floods, fires and other such perils.
 - B. the loss or damage to the contents of home property.
 - C. a home against damage caused by fires and other perils.
 - D. the loss or damage to the contents of business property.

11. A proper retakaful scheme helps the general takaful company to:

- A. Improve operational stability
- B. Improve claim management
- C. Overcome the agency-problem that exists in *wakalah* model
- D. Decrease overhead expenses

12. In *mudarabah* model, the profit sharing must be:

- A. Pre-agreed up front
- B. In the form of a ratio
- C. 50:50
- D. A and B
- E. A, B and C

Answer: 1-b, 2-d, 3-b, 4-c, 5-b, 6-a, 7-c, 8-d, 9-d, 10-a, 11-a, 12-d.

Chapter 8

Investment Linked Takaful

Chapter Outline:

- 8.1 Introduction
- 8.2 The Fundamentals of Investment Linked Takaful Plan
- 8.3 Types of Investment Linked Fund Takaful
- 8.4 Types of Investment Linked Cover
- 8.5 Considerations when Choosing ILTP
- 8.6 Unique Features of ILTP
- 8.7 Benefits and Risks of Investing Investment-Linked Funds
- 8.8 Conclusion

Chapter Objectives:

Upon complete this chapter, you should have knowledge of:

- Elaborate on the Fundamentals of Investment Linked Takaful Plan
- Discuss the types of Investment Linked Fund Takaful
- Explain the different types of Investment Linked Cover
- Highlights the unique Features of ILTP
- Highlights the benefits and Risks of Investing Investment-Linked Funds

8.1 Introduction

Takaful products were traditionally used by individuals to manage their risks. Ranges of family and general takaful products were used in Malaysia since the inception of a takaful company in 1984. Over the time, takaful operators innovate to create products that contain investment exposure rather than only limited to risk management. In a certain extent, this development helps takaful products to be more accepted by the Malaysian public. Although the majority of population in Malaysia is Muslim, the penetration rate of takaful products is still lower than that of conventional insurance, as shown in the figure below. In terms of takaful, the penetration rate of family takaful is 50% higher than that of general takaful. Thus, the Malaysian takaful market has high potential to increase penetration rates through designing products that meet the needs of the predominantly Muslim population.

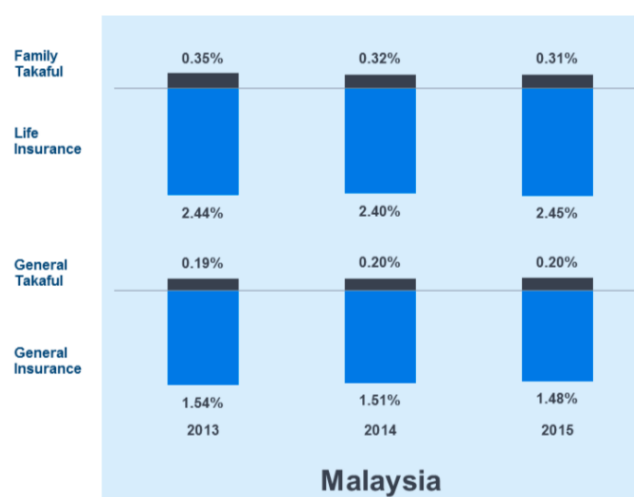


Figure 27: PENETRATION RATES IN MALAYSIA
(Reproduced from Milliman Global Takaful Report 2017)

Though the takaful growth in Malaysia is negative when measured in USD terms, the market has experienced positive growth between 2011 and 2015 in local currency terms; note that the Malaysian ringgit has depreciated against the USD by 7%, 6% and 19% in 2013, 2014 and 2015, respectively. As discussed in the previous chapters, the market share of family takaful is higher than that of general takaful. Considering gross written contributions of takaful and insurance in 2015, family takaful constituted 7% compared to 55% for life insurance whereas general takaful constituted 5% compared to 33% for general insurance, as shown in the figure below. These statistics emphasize the great potential for innovative takaful products such as ILTP.

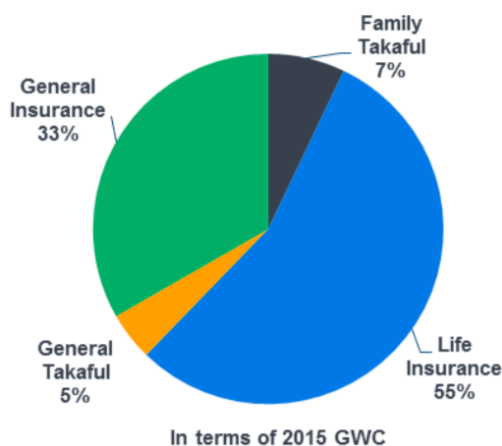


Figure 28: GWC OF TAKAFUL AND GENERAL INSURANCE IN MALAYSIA
(Reproduced from Milliman Global Takaful Report 2017)

In a nutshell, investment linked takaful has been rapidly growing over the years and presently dominates the Malaysian takaful market. The market share of unit-linked business went from 42% in 2012 to 47% in 2015. This fast growth is thought to be mainly due to low capital requirements under the Risk-Based Capital Framework for Takaful Operators.

8.2 The Fundamentals of Investment Linked Takaful Plan

An investment-linked takaful is a variable of family takaful plan that combines takaful cover and investment. This means that the contribution to an investment-linked takaful plan will cover disability benefits as well as the investment in Shariah-compliant investment funds of the individuals' choice, depending on takaful operators' policy.

The investment-linked takaful will allocate your contribution in two parts. A portion of the participant's contribution will be channeled to *tabarru'* fund, for the purpose risk management or protection. This ensures that the risk management need of the participant is catered for, which suits the main reason of participant to engage in a takaful plan in the first place. For protection, the participant in a family takaful plan is looking for the protection in the case of death or disability. The contract between the takaful operator and that of the participant in the management of *tabarru'* fund could be either *mudarabah* or *wakalah*, depending on the choice of contracts practiced in the takaful company.

The rest of the contribution will go into buying investment-linked units. The participant can choose which Shariah-approved investment funds to invest in. The investment-linked units are then managed by the takaful operator, who in return receives a fee (*'ujrah*) for its services. The rapid development of Islamic capital market ensures that takaful funds are having plenty of Islamic financial papers to choose from. This is witnessed by nearly 90% of shares listed on Bursa Malaysia are Shariah-compliant, increased issuance of *sukuk* and increased numbers of unit trust funds, exchange traded funds (ETFs) and real estate investment trusts (REITs).

Similar to other family takaful funds, participants will receive a share of the surplus in the takaful fund, based on the pre-agreed ratio between the participants and the takaful operator in the case if the participant does not make a claim during the takaful period.

Before an individual decides to take on the takaful products which include the investment coverage, there are many aspects that the individuals/investors must decide. The issues that are pertinent includes:

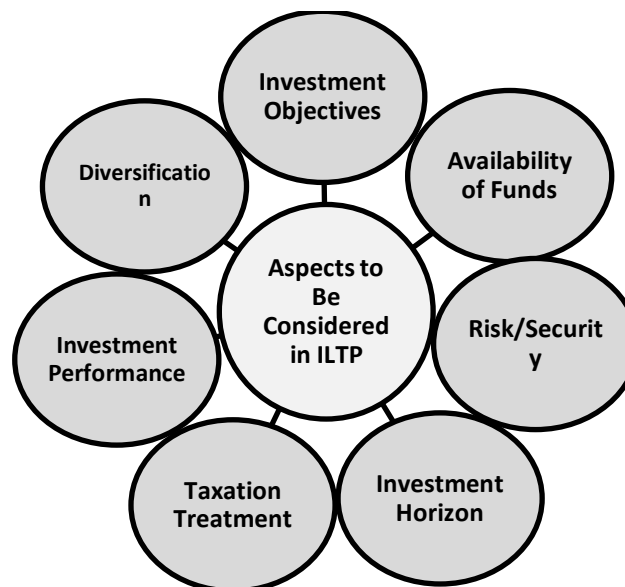


Figure 29: ASPECTS TO BE CONSIDERED BY PARTICIPANTS BUYING ILTP

a) Investment Objectives

Participants have to decide to various ranges of risk exposures; low, intermediate or high. Life cycle hypothesis states that younger participants/investors are capable of taking higher risks as compared to older investors. Thus, for younger investors, the portion of contributions ideally is to be channeled to growth funds rather than in fixed income funds.

b) Availability of Funds

After determining the investment objectives, the participants/investors are to match the desired investment objectives to the funds that are suitability based on the availability of the funds.

c) Risk or Security

This factor depends on risk profile of the participants. Risk profile depends on the level of tolerance as well as risk appetite of the participants. Risk tolerance measurements are more objective, taking into account the level of wealth as well as the age of the participants. Participants with higher amount of wealth have higher risk tolerance as compared to the one with lower amount of wealth. The same goes to the age of participants too.

d) Investment Horizon

Investment horizon relates very much to the age of the participants/investors. The longer the investment horizon of the participants/investors, the greater the risk the participants are able to take on the investment. Another consideration is the investment objective of the participant. Young participants with a short term investment objective will have shorter investment horizon.

e) Taxation Treatment

Takaful contribution is treated differently to investment placement from the taxation point of view. Investors have to, from time to time, monitor the tax provision when investing in investment-linked takaful.

f) Performance of the Investment

Performance of the investment from the selected funds; growth, fixed income, mixed funds should be monitored to achieve the maximum returns. Most of takaful providers allow for a certain numbers of fund-switching in a year. This is to provide room for participants to manage the funds to achieve maximum performance. Similar to the unit trust investment performance, participants are not to rely on past performance of the funds under the investment-linked takaful to decide on which funds to invest in.

g) Diversification

By definition, a degree of diversification is achieved the moment participants allocate a portion of contributions to investment-linked units. This is because the contribution is invested in funds which in turn invest in variety of Islamic financial papers.

8.3 Types of Investment Linked Fund Takaful

An investment linked takaful is a fund where a portion of participants' contribution is used to buy investment units, such as units in equity or fixed income securities. The takaful protection covers death and permanent disability. A family takaful rider is an extension of the basic family takaful. The rider provides coverage against personal accident and disability, medical and health. Table 1 illustrates the coverage available under general and family takaful.

What is being protected	Class of Takaful products	Peril = Cause or source of loss	Hazard = Conditions that increase the chance of loss
Assets for its capacity to generate income Assets for its value	General	Fire, burglary, collision, flood, etc.	Storing of flammable items, unlocked front door, reckless driving, house built by the river
The person for his capacity to generate income	Family	Illness, premature death, disablement	Family history, smoking, obesity, drinking, sexual promiscuity, etc.

Source: BNM (2013). Available on: <http://www.islamicfinanceinfo.com.my/discover-takaful/know-your-takaful-products/investment-linked-takaful>

For family takaful, which partly provides for income protection, the amount of cover should at least cover outstanding liabilities, such as, home mortgages, credit cards and other financings. Additional cover should depend on the client's attitude towards the necessity of surviving spouse having to work for income, maintenance of lifestyle, number of dependents and the stage of life. Selection of type and amount of cover should be appropriate to client's needs to cushion a crisis.

To boost the return of a family takaful fund, many participants take more risks by exposing themselves to market risk by having a portion of their contributions to investment. There are two ways to invest in an investment-linked takaful, namely single contribution plan and regular contribution plan.

8.4 Types of Investment Linked Cover

Participants have the option to choose from the single contribution plan or regular contribution plan. Regular contribution plan brings about the benefit of dollar-cost averaging. If participants invest regularly, they will reap the benefit of buying units at lower price when the price of units is low, instead of selling at the low price situation.

i. Single Contribution Plan

- With this plan, participants invest one single lump-sum payment.
- The sum assured is usually a percentage of the single contribution, while the benefit payments are the sum assured and the value of the investment-linked units.
- This plan is more suited to you if you have a substantial sum ready for investment.

For example, participants can start to participate in the investment linked fund with a minimum of RM5,000. Further investments can be made with a minimum of RM500.

ii. Regular Contribution Plan

- This plan lets participants make the contributions either monthly, quarterly, half-yearly or yearly.
- The sum assured is usually a multiple of the annual contribution.
- The benefit payment is the sum assured and the value of participants investment-linked units.

For example, participants can start to participate in the investment linked fund with a minimum of RM1,000. Further monthly investments can be made with a minimum of RM100.

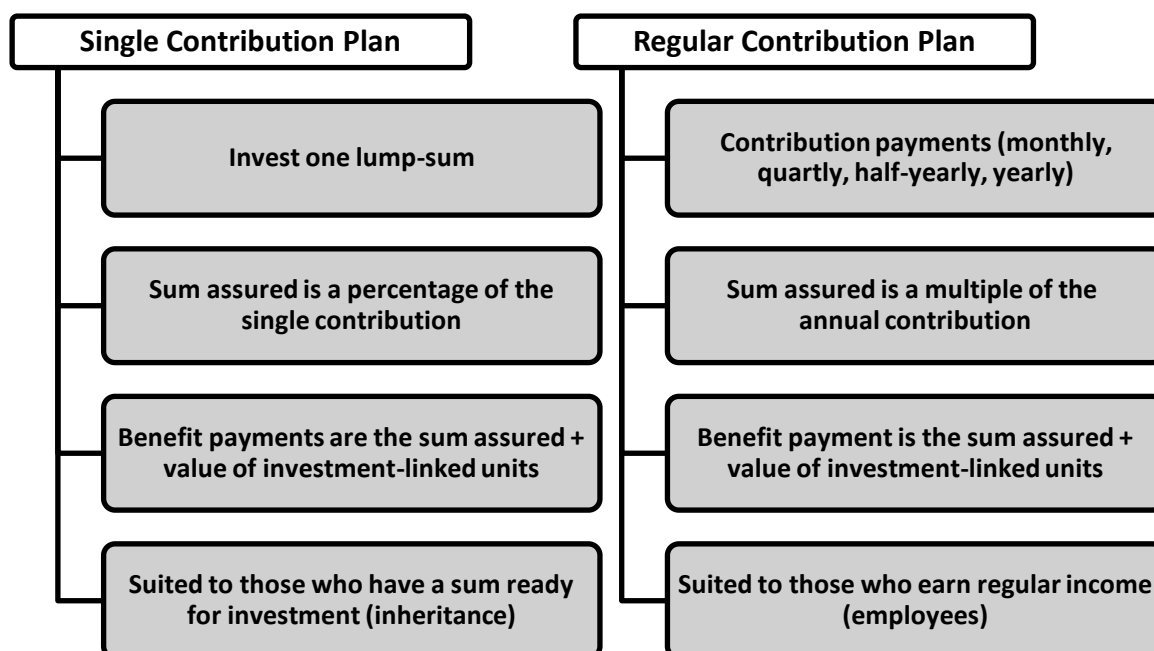


Figure 30: SINGLE CONTRIBUTION PLAN VERSUS REGULAR CONTRIBUTION PLAN

8.5 Considerations when Choosing ILTP

When participants are choosing the plan, there are several considerations that have to be taken into account. Among the considerations are:

- Decide on the allocation of participants contribution towards protection and investment.
- Consider the amount participants wish to invest in either single contribution or regular contribution plans.
- Consider the types of funds and the level of risk that participants are comfortable with.
- Evaluate the options carefully to find a plan that suits participants needs.
- Find out the types and amount of fees and charges that may be applicable, i.e. management fees and other fees that may be imposed for different services performed.
- Know the flexibility for fund switching.
- Know when you can claim part of investment-linked units at a certain point in time.

8.6 Unique Features of ILTP

Investment-linked takaful offers the participants these unique features:

- Participants have the flexibility to choose own level of protection and investment.
- Participants can vary the amount of contribution according to changing financial circumstances.
- Participants can switch the investment fund to other types of investment funds.
- Participants can claim part of the investment-linked units at any point of time.
- Participants can choose from a variety of investment-linked funds (equities, bonds or other financial instruments) to invest in.

8.7 Benefits and Risks of Investing Investment-Linked Funds

Like unit trust, an investment linked fund is a professionally managed investment fund, normally by an insurance company, which pools participants' money with that of many other investors with similar investment objectives. The aggregate sum is then used by the fund to build a diversified investment portfolio which comprises stocks, bonds and other assets in accordance with the investment objective of the fund.

Investment linked funds helps in participants' investment planning by giving them a choice of placing their money in a diversified investment options. The investment-linked fund provides investors with an opportunity to attain medium to long term capital growth by investing primarily in equities.

By investing in the investment-linked fund, participants have an opportunity to participate in the growth of our dynamic economy through a professional investment team. The investment fund will endeavor to meet the expectation of participant in the long term.

Other benefits include:

- Diversification of investment portfolio
- Different Investment Funds Options
- Professional expertise
- Liquidity
- Ease of transactions
- Flexibility

Participants also must be aware of the risk of investment that investors are taking when contributing to the investment linked funds. The performance of investment linked unit will depends on the performance of the market as well as the underlying instruments that are affected by the systematic and unsystematic risk.

8.7.1 Risk of Investing in Investment linked Unit

Investors tend to think of "risk" in predominantly negative terms, as something to be avoided or a threat that we hope would not materialize. However, in the world of investment, risk is inseparable from performance and, rather than being desirable or undesirable, is simply necessary. Hence, understanding risk is one of the most important parts of a financial education.

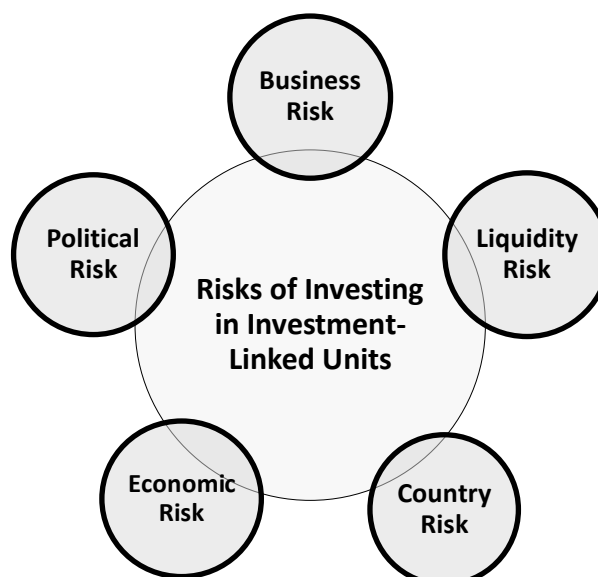


Figure 31: RISKS OF INVESTING IN INVESTMENT-LINKED UNITS

i. Business Risk

Business risk is a form of risk that a company or firm undertakes when it attempts to operate within a specific field or industry. Business risks include everything related to business activities, e.g. financial, operational, people and product. It can also be defined as a threat of an event/action that may affect company's ability to achieve its business objectives. The most common business risks are, namely strategic risk, compliance risk and operational risk. Strategic risk is the risk that a company's strategy may become less effective over time. For instance, Tesco which is a low-cost provider faces strategy risk when another company such as Aeon decides to undercut Tesco's prices. Compliance risk usually arises in highly regulated industries such as banking. For instance, a bank operating in a country where laws change rapidly faces the risk of failing to comply with law and regulations which may wipe out all profits. Operational risk relates to a failure in business day-to-day performance. For instance, when HSBC international anti-money laundering team failed to stop money laundering activities in Mexico, the company ended up paying USD1.9 billion fine.

ii. Liquidity Risks

Liquidity risk is a risk resulting from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. Hence, companies face liquidity risk when a valuable asset cannot be sold or traded at its market value due to lack of buyers or market inefficiency in which there is no platform to connect and match sellers' offers with buyers' demands. For example, a company owns a building with RM10 million market value may sell it for less than its actual price due to the lack of buyers in difficult economic conditions. Although the building can be sold for more than RM10 million in better economic times, the company needs cash to meet its financial demands and has no option but to sell it in an illiquid market and suffer losses.

iii. Country Risk

Country risk is a collection of risks related with investing in a foreign country. These risks include political risk, economic risk, exchange rate risk, sovereign risk and transfer risk, which is the risk of capital being frozen or locked up by government action. Country risk varies from one country to another. Some countries have high enough risk to discourage much foreign investment. For instance, setting up a company in the Middle East may not be as costly as it is in developed countries and, additionally, profitability may be high considering the low level of taxes

in the region. However, the high potential of war in the company's country or one of its neighbouring countries would severely harm the company and even burn it to the ground.

iv. Economic Risk

Economic risks is a form of risk results from economic factors, e.g. interest, inflation and foreign exchange rates. These risks are categorized as systematic risks as they affect almost all the companies regardless of business and industry involved. The increase in interest rates, for instance, inflates the cost of operation, which subsequently reduces the profit margin of companies. Inflation also has the same impact to businesses - the higher the inflation rate, the smaller the earnings of companies. Foreign exchange rates have two possible impacts to export businesses. When the Ringgit deflates in value against US Dollar, the exporters suffer lower income from their business. The good thing is they possibly enjoy higher demand as our products become relatively cheaper to our trading partners. For importers, the cost of their imported goods will be higher, thus squeezing their profit margin thinner.

v. Political Risk

Similar to economic risks, political risks also give impact on all businesses. Political stability is an important consideration in these times when it comes to making investment decisions. Political risk can be measured in terms of internal strife to conflict between neighbouring countries, and other unseen dangers due to terrorism. Thus, these is another type of systematic risk. For instance, the result of 8 March 2008 General Election sparked a shock among investors and business community, tumbling down the stock market the very next trading day. Luckily, confidence was quickly restored, thanks to the matured Malaysians who witnessed the stock market expanding on its recovery rally till March 31, 2008. This is one example of political impact on businesses.

8.7.2 Risk tolerance

Risk tolerance is the degree of uncertainty that an investor can handle in regards to a negative change in the value of their portfolio. Risk tolerance is determined by several factors, which include age, income stability and investment objective.

The main reason for the need to classify someone into a specific category is because most investment advisors use asset allocation models that correspond directly with each category. Once an investor is put into a category, his money can easily be invested appropriately by using a model portfolio.

In general, there are five categories for investors:

i. Conservative

Most conservative investors want their portfolio to provide them with an inflation-adjusted income stream to pay their living expenses. These people are either retired or reaching retirement. Some are on tight budgets and are barely making a living as it is, so they are very afraid of losing the money they have left. They do not have sufficient time to recoup any losses.

The majority of their money should be held in cash and high quality short- and intermediate-maturity bonds. Risky asset classes are typically avoided altogether.

ii. Moderately Conservative

Investors in this category are either retired and getting their pay check from portfolio income, soon to be retired, or have been burned by poor investment and lost a lot of money in the past. This group of investors wants to be protected from large downside market fluctuations and is not willing to fully participate when the market's rally move upwards.

Their portfolio should include fixed income securities, real estate, and commodities that track inflation. Core equity asset classes are used, but risky asset classes should be held at a minimum.

iii. Moderate

Majority of investors are in this middle of the road category. They are middle-aged, have stable job and have at least little awareness about financial planning. These folks want good returns, and know they are taking some risk to get them. Their portfolio should have a balanced mix of most all major viable asset classes, which includes conservatively managed bond funds as well as high-risk stock funds.

This category typically uses the largest number of asset classes to both reduce risk and increase profits. Both safe and risky asset classes are utilized intelligently. Balance between profits and loss reduction is the goal.

iv. Moderately Aggressive

This group of investors is willing to take on more downside risk than the markets, but expect to be substantially ahead of the game when the markets go up. For their portfolio, fixed income positions should be minimized and risky asset classes are fully utilized. These include bond and international stock mutual funds.

These investors want to take the risks of winning the game by playing hard offense, but still don't want to lose too much in a short period of time. Most investors of this type want to accumulate a significant amount of wealth in the future, and are willing to wait a significant amount of time for the rewards (and to recoup short-term losses).

v. Aggressive

These investors want to substantially outperform the markets and know they are exposed to much more risk than the markets. They could accept a loss of up to 40% of their portfolio value in a few months, which may take years to recoup these losses. These investors typically hold mostly growth, small-cap, and sector mutual funds. Any fixed-income products in the portfolio are a small percentage and also are of the riskier types that are aggressively managed. The purpose of any cash held is to absorb loss cutting strategy, and to take advantage of perceived buying opportunities.

Most aggressive investors want to accumulate significant wealth in the future, are in a hurry to have enough income from other sources to fund their living expenses, and/or have not yet personally experienced significant losses in the markets.

8.8 Conclusion

The combination of the risk management and investment exposure in investment-linked takaful serves both the purpose of managing risk as well as for the purpose of wealth creation through investment exposure via capital gain and stream of income. Participants, however need to be aware of investing in investment-linked takaful in order to take into account their financial objectives, either slanted towards risk management or wealth generation. This is for the participants to correctly match their risk tolerance and risk appetite with the investment-linked products available in the market.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Investment linked takaful has the following features, **EXCEPT**:
 - A. Participants have the flexibility to choose own level of protection and investment.
 - B. Participants can switch the investment fund to other types of investment funds.
 - C. Participants can claim part of the investment-linked units at any point of time.
 - D. Participants can choose from a variety of investment products to be included in the funds

2. Investment link takaful cater for two areas of wealth management:
 - A. Portfolio monitoring, protection
 - B. Portfolio construction, risk management
 - C. Risk management, investment
 - D. Protection, portfolio rebalancing

3. Which of the following is **NOT** a general responsibility of a Takaful agent being a promoter of Islamic finance?
 - A. The Takaful agent's character and conduct must be in conformity with Shariah
 - B. The Takaful agent must serve Muslim clients only
 - C. The Takaful agent must not conduct any business during Friday prayers
 - D. The Takaful agent must have basic knowledge of *fiqh muamalat*

4. Which of the following are the types of Family Takaful Plan?
 - A. Personal Accident
 - B. Term
 - C. Investment-linked takaful
 - D. Motor

5. The following are the characteristics aggressive types of investors, **EXCEPT**
 - A. These investors typically hold mostly growth, small-cap, and sector mutual funds.
 - B. They could accept a loss of up to 10% of their portfolio value in a few months, which may take years to recoup these losses.
 - C. Any fixed-income products in the portfolio are a small percentage and also are of the riskier types that are aggressively managed.
 - D. Have enough income from other sources to fund their living expenses

6. The following are the factors that increases the investment amount in the participants' investment account **EXCEPT**:
- A. Cash withdrawal
 - B. Claims filed
 - C. *Ujrah* payment due to takaful operator
 - D. Cash withdrawal from *Tabarru'* fund to Investment fund
7. Which from the statement is **TRUE** on Investment-linked takaful
- I. Rider for Investment-linked takaful provides coverage against personal accident, disability, medical and health.
 - II. Participants may choose from aggressive, moderate and low investment risk to invest
 - III. A portion of participants *tabarru'* fund is used to buy investment units
 - IV. investment-linked takaful covers the losses of investment value
- A. I only
 - B. I and I only
 - C. I, II and III only
 - D. I, II, III and IV
8. Risk tolerance degree of uncertainty that an investor can handle in regards to a negative change in the value of their portfolio. Risk tolerance depends on the following factor, **EXCEPT**:
- A. Age
 - B. Risk taking behavior
 - C. Income
 - D. Investment objective
9. The following are types of income possible to be received by the takaful operator that manages the investment funds of the participants
- I. Profit sharing from *mudarabah*
 - II. Profit sharing from *musharakah*
 - III. *Ujrah* for management fees
 - IV. *Ijarah* fees
- A. I only
 - B. I and I only
 - C. I, II and III only
 - D. I, II, III and IV
10. Investment-linked takaful will invest in these investment vehicles **EXCEPT**
- A. Warrants
 - B. Shares Options
 - C. Government bonds
 - D. REITs

11. Strategic risk is considered a:
 - A. Liquidity risk
 - B. Compliance risk
 - C. Business risk
 - D. Operational risk

12. The risk that of an employee failure to accomplish his assigned task is considered a:
 - A. Economic risk
 - B. Compliance risk
 - C. Systematic risk
 - D. Operational risk

13. Carbon is a mobile phone company that produces the lightest mobile and thinnest mobiles in the world. The risk that another mobile phone company may succeed to produce the same weight of mobile and sell it in a lower price is considered a:
 - A. Strategic risk
 - B. Economic risk
 - C. Systematic risk
 - D. Operational risk

14. Single contribution plan is a type of investment-linked cover which has the following features **EXCEPT**
 - A. Participants invest one single lump-sum payment
 - B. The plan allows the participant to make contributions monthly
 - C. The plan is suitable for an individual who has a substantial sum ready for investment
 - D. The benefit payments are the sum assured and the value of the investment-linked units

15. Regular contribution plan is a type of investment-linked cover which has the following features **EXCEPT**
 - A. Participants can make the contributions either monthly, quarterly, half-yearly or yearly
 - B. The sum assured is usually a multiple of the annual contribution
 - C. The plan is suitable for an unemployed individual who inherited money and don't know how to invest it
 - D. The benefit payment is the sum assured and the value of participants investment-linked units

Answer: 1-d, 2-c, 3-b, 4-c, 5-b, 6-d, 7-b, 8-b,9-c,10-c, 11-c, 12-d, 13-a, 14-b, 15-c.

Chapter 9

Takaful Agent: Ethics and Codes of Conduct

Chapter Outline:

- 9.1 Introduction
- 9.2 Takaful Agent: A Terminological Discussion
- 9.3 Ethics of Takaful Agent as *Dai'*
 - 9.3.1 The Power of Intention
 - 9.3.2 *Al-Siddiq* (The Truthfulness)
 - 9.3.3 *Al-Amanah* (The Trustworthiness)
 - 9.3.4 *Al-Tabligh* (The Preaching)
 - 9.3.5 *Al-Fatanah* (The Wisdom)
- 9.4 Agent: Codes of Conduct
- 9.5 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the position of Takaful agent in regard to the concept of *Wakalah*
- Understand the basic *akhlaq* of a Takaful agent
- Exemplify in their lives the agent's code of conduct
- Act as *da'i* in representing Islam by sharing information on Takaful matters

9.1 Introduction

Agents and their clients have relationship with each other. This statement is consistent with the elements that ground the concepts or principles applied in takaful, such as mutual responsibility, mutual cooperation and mutual protection. Those principles which are informed and discussed in the Quran could be considered the heart of the takaful practice. As a takaful agent, those concepts should be understood meaningfully and wholeheartedly since the main duty of a takaful agent is to inculcate feelings of mutual responsibility, mutual cooperation and mutual protection among the policyholders or contributors.

To elaborate the concept in details, mutual responsibility is a feeling of responsibility towards one another and it is the foundation of solidarity of an Islamic community. The poor feels safe being sheltered by the rich and the sick do not feel abandoned because they know the healthy will provide help. This principle was stated by the Prophet (s.a.w.) in the following *hadith*:

"The attitude of the believer and feeling of brotherhood to one another is like that of the single body. When one member of the body is hurt, it will have an effect on the whole body"

(Narrated by Bukhari and Muslim)

"The relationship between one believer and another (in a community) is like that of a building where one part of the building strengthens the other parts"

(Narrated by Bukhari and Muslim)

"Each one of you has a responsibility and each one of you is responsible towards those under your responsibility"

(Narrated by Bukhari and Muslim)

Based on above *hadiths*, Muslims in principle are brothers. They need to support and complement each and every weakness in each other. This complementary state makes Muslims very much like a huge building in which every part of the building has its own function and role. The similar analogy is given to human beings since their life is limited and their strength is also limited. Therefore, in the Takaful concept, the agent act as the complementary state of a person and try to support the weaknesses possessed by a client by acting as his agent.

The second principle is mutual cooperation in which this principle is elaborated in many places in the *Quran* and the *Sunnah* as in the following:

"Help one another in furthering virtue and God-consciousness (taqwa), and do not help one another in furthering evil and enmity"

(Al-Maidah 5:2)

"A Muslim is the brother of a fellow Muslim. He should neither commit oppression upon him nor ruin him; and he who meets the needs of a brother. God will meet his needs and he who relieves his brother from hardship Allah will relieve him from the hardness to which he could be put on the day of judgement"

(Narrated by Muslim)

"God always help those who help their brother."

(Narrated by Abi Daud)

Help your brother either those oppressed or those who oppress. The companions ask "Oh Messenger of God, we understand about helping the oppressed how do we help those who oppress?" The Messenger (s.a.w.) replied "relieve them of their power"

(Narrated by Bukhari and Muslim)

As Muslims run the world altogether, they are in dire need of mutual help and cooperation since humans, as created by Allah (SWT) with a lot of weaknesses. Allah (SWT) reminds humans to always help each other in regard to good deeds, providing good information and help. Therefore, in the concept of takaful, helping other Muslims is not just considered a part of the marketing process, but is also a part of 'ibadah that is guided in the *Quran*. The agent who calls on the other Muslims for beneficial information and awareness on the concept of helping others (takaful) is rewarded and regarded as *da'i* (Islamic preacher) in the way of God. In addition, the word 'takaful' indicates an institution of mutual cooperation that supports the system as a whole.

The next related principle is mutual protection as a continuous implication of mutual responsibility and mutual cooperation. The *Quran* mentions specifically in several places in regard to the need for protection from hunger and fear as in the following verses:

"(He) who has fed them against hunger, and has made them safe from fear"

(Quraish 106:4)

"And remember when Abraham said "My Lord, make this city (Mecca) a place of security"

(Al-Baqarah 2:126)

The Prophet (s.a.w.) also highlighted the situation in the following *hadith*s:

"Indeed a believer is one who can give security and protection to the life and property of mankind"

(Narrated by Ibn Majah)

"By God in Whose power I am under, one will not enter paradise unless he provides protection to a neighbor in difficulty"

(Narrated by Ahmad)

"A person is not a believer if he sleeps comfortably on a full stomach while his neighbor suffers from hunger"

(Narrated by Al-Bazza)

The above-listed verses and *hadiths* indicate that security and protection are among the essential needs of a human being. The concept of protection could be widened and varied into the many types of protection. The concept of security signified many modes and means of security. Takaful concept is a part of protection and security. Hence, the agent should understand that a policyholder is protected against the listed risks and secured from them. It should be understood that 'protection' and 'security' in general, refer to hindering or obstructing a person from facing any difficulties or harm. However, 'protection' and 'security' in the takaful concept mean coverage and treatment are provided by the takaful operator to minimize harm and to provide tranquility and serenity to the life and the family members of the policyholders. Thus, in the present situation, takaful is the best solution and choice a person can opt for against any unforeseen incidents and harmful situation that might be faced. By shifting the risks to protection, a person can feel more comfortable and at peace throughout his/her life.

9.2 Agent: A Terminological Discussion

The practice of an agent in *muamalat* began in the period of the Prophet Muhammad (s.a.w.). He has shown very good examples on the appointment of agents. For instance, he appointed agents to collect *zakat*, to marry a woman, to buy animals and others. In advance, there are many Quranic indications of the permissibility of appointment of agents in society especially in matters pertaining to social and *muamalat* matters. Allah (SWT) says:

“(Yusuf) said: “Set me over the store-houses of the land: I will indeed guard them, as one that knows (their importance)”

(Yusuf 12:55)

“Alms are for the poor and the needy, and those employed to administer the (funds); for those whose hearts have been (recently) reconciled (to Truth); for those in bondage and in debt; in the cause of Allah. and for the wayfarer: (thus is it) ordained by Allah, and Allah is full of knowledge and wisdom”

(Al-Tawba 9:60)

The two verses above indicate the position of *Wakeel* in which Allah (SWT) used the phrase “*I will guard them*” and “*those employed to administer*”.

As a basis, the term ‘agent’ in Arabic is known as *wakeel* which is derived from an Arabic root word ‘*Wakala*’ which means to delegate, to handover, to entrust, to represent, to replace or to assign.

According to the *Shafi’i* school of thought, ‘agency’ (*wakalah*) is a contract to delegate one’s rights to act on behalf of another party in matters that can be delegated within the period of his life. The person who runs that act of *al-wakalah* is known as a *wakeel*.

In more practical explanation, an agency is a state of transferring a job to a trusted one in dealing with pre-agreed affairs. The act of taking the place of a person due to his inability or absence with mutual consent by both parties is permissible in Islam. Among the dealings and affairs permitted in Shariah for such situations include financial dealings such as trading, financial planning, takaful agents and others.

Once a person is given the mandate to deal with the property, it is an *amanah* for the agent to run and manage the property according to what is pre-agreed in the contract. In the takaful practice, an agent or *wakeel* acts as “agent with fees”, which is derived from the premium paid by the participant. More specifically, the shareholders (company) charge a *wakalah* fee from contributions paid by the contributors to cover most of the business expenses. The fee rate is fixed annually in advance in consultation with the Shariah committee of the company. In order to give incentive for good governance, the management fee is related to the level of performance of the agent.

The agent who receives the agency fee (*ujr*) as an appreciation for services provided in managing the fund, is given a certain pre-agreed amount as agreed contractually by the shareholders, policyholders and agents. Therefore, this relationship is more transparent and the fees collected by the agent are pre-determined and clearly explained to the client. Unlike the case of conventional insurance contract, there is no *gharar* element and uncertainty in this contract.

In addition, according to the *Encyclopedia* of Islamic Banking and Insurance, *wakalah*, in practical terms, refers to a concept of a businessman entrusting another to act in his stead or as his representative. The *Encyclopedia* further elaborates the conditions which must be met under *wakalah*. Some of these conditions are:

- i. The essence of the appointment of an agent is the proposal and acceptance of the position.
- ii. It is a condition that the person who appoints an agent be legally competent to do the work for which the agent is appointed. Thus, an insane person or an infant cannot appoint an agent.
- iii. A person can appoint an agent to conduct all business transactions that he would be able to do personally. Thus, it is lawful to appoint an agent for selling or buying, letting or hiring, giving or taking a pledge, for depositing or receiving a thing for safekeeping, making or receiving a gift, making a compromise, bringing an action, paying or receiving a debt and for receiving anything.
- iv. An agent appointed to sell and buy or to pay or receive a debt, is a custodian of his principal's property and in the position of a trustee.
- v. An agent is entitled to receive remuneration only when stated in the contract.

In the Takaful industry, the *wakalah* concept is very much linked to the following rationales:

- i. It is difficult for takaful members to voluntarily carry out the administrative work as the scheme gets bigger.
- ii. To set up a takaful operation system during the initial phase of the program requires heavy expenditure on the part of members. The question arises is whether all members agree or can afford to contribute towards meeting this high start-up cost.
- iii. During the early phase of implementation, it is possible that claims, re-takaful cost and expenses could exceed collected contributions and investment income. This would mean a loan to the participants is to be provided to avoid insolvency of the takaful program (i.e. inability to pay claims). From an Islamic perspective this is undesirable for it may reflect poor management of the takaful program.
- iv. Members may not have all the technical expertise associated with managing the takaful funds. The skills required are underwriting, marketing, claims management, legal, accounting, actuarial, IT and so on.
- v. The takaful program may not be managed in an organized or structured manner unless a dedicated, professional, highly skilled and financially reputable party is involved.

In the Malaysian context, a similar concept of Takaful is applied in the collection of *Khairat Kematian* that is collected and managed by the mosques' committees. The principle of takaful adopted by the usage of an agent (the collector of fund), the availability of religious assistance in regards to the funeral process (the concept of cooperation is practiced) and the funds collected are donated (not much but can assist the heirs) to the heirs based on the concept of *tabarru'*.

Dr. Wahbah al-Zuhayli in his book stipulated a number of conditions for the agent (*wakeel*) so that the agent will be functioning according to the need of the customer. The additional conditions are as follows:

- i. An agent must be capable of understanding the nature of the business that he conducts. In the case of takaful agent, he/she must be able to explain based on a deep understanding of the products offered by the operator.
- ii. The *Shafi'i* scholars added that an agent of any financial dealings must be known to be of good characters or 'adl including the takaful agent. This is to ensure that the reputation of any takaful operator is secured and preserved.

9.3 Ethics of Takaful Agent as Da'i

“Actions are (judged) by motives (niyyah), so each man will have what he intended. Thus, he whose migration (hijrah) was to Allah and His Messenger, his migration is to Allah and His Messenger; but he whose migration was for some worldly thing he might gain, or As exhibited by the Holy Prophet Muhammad (s.a.w.), the most reliable source and reference on akhlaq, the ethics of an agent can be related to his attributes. The most important akhlaq an agent should possess is convincing himself with niyyah (intention) in every activity done, followed by the akhlaq exemplified by the Prophet (s.a.w.). As stated in many sources of reference, his attributes comprised of sidq (truthfulness), amanah (trustworthiness), tabligh (preaching/advocacy) and fatanah (wisdom/intelligent). Therefore, an agent or wakeel of a client for continuing and representing the participant in doing takaful should possess those attributes as his/her major reference. In addition, some other ethics or akhlaq are added to be more practical and relevant to the practice of agency in takaful industry.

9.3.1 The Power of Intention (Niyyah)

Muslim agents in particular, should always understand that between an act of worship and a common act there is a separation, and the border that separates these two is intention or *niyyah*. The Prophet (s.a.w.) stated in the very first *hadith* in the Forty Hadith of Imam Nawawi which means:

for a wife he might marry, his migration is to that for which he migrated”

(Narrated by Bukhari and Muslim)

Hence, with intention, all activities involved in promoting takaful products, i.e. the activities of an agent in approaching a client, marketing the product through explaining the product details and providing information, processing the client's needs and demands, and contacting the heirs when any calamities occur are considered as *'ibadah* or act of worship. It is important to note and verify here that an act of *'ibadah* will entitle an agent for rewards by Allah the Almighty and the intention should be referring to the Provider of all human needs, that is Allah (SWT). This is the most important distinguishing factor between activities of Muslim agents and non-Muslim agents. Both will get fees from their clients, but additional rewards are given by Allah (SWT) to the Muslims due to the presence of *niyyah* in the business.

9.3.2 Sidq (Truthfulness)

As a takaful agent, it is his main function to work in deliberating only the truth and facts to his customers. The truthfulness of a person shows that the agent has credibility, can be relied on as an agent (*wakeel*) in its true sense. It is important for an agent to speak and explain only the truth and distant himself from any act of lying and dishonesty. Besides, a truthful agent will also fulfill his promises, especially when promising the client with any service like appointments, gifts and others. The absence of this (promise fulfillment) will lead the agent to be attributed as *munafiq* which is placement in hellfire as stated by the Prophet (s.a.w.) in the following *hadith*:

“There are four characteristics which if found in one would make him a sheer hypocrite and one who possesses one of them possesses a characteristic of hypocrisy, till he abandons it. When he is trusted, he betrays the trust, when he speaks, he lies, when he makes a covenant, he acts treacherously and when he falls out, he deviated from the path of truth.”

(Narrated by Bukhari and Muslim)

There are several other attributes related to the concept of *Sidq*, such as honesty, steadfastness, humility, loyalty, patience, uprightness and purity. A customer who needs assistance and explanation requires a good and reliable agent to convey all the information pertaining to policies, benefits, limitations, and other matters in regard to the takaful contracts. Therefore, *Sidq* or truthfulness is an essential character that an agent should possess. The Prophet (s.a.w.) also stated the following:

“A trustfulness and trustworthiness businessman will be placed with the groups of the prophets and the messengers, the truthful persons and the Shuhada”

(Narrated by Al-Tirmizi)

9.3.3 *Amanah* (trustworthiness)

Amanah or trustworthiness is also an important element that a takaful agent should be attributed with. Its opposite, dishonesty brings on negative implications that lead to dissatisfaction in the client. A trustworthy person is one who demonstrates responsibility for what he speaks and understands the weight of the contents and context of his words. For instance, contribution paid by the client should be treated according to the wishes of the client. An agent should not treat the contribution as his own and on his own accord, postpone the payment or make decisions on how the contribution should be treated. The needs and wishes of the client should be fulfilled and carried out by the agent. The agent is to act as an advisor and not as a decision maker. Therefore, the decision of his client is the final say and not the agent's suggestions.

As trusted by his client, the agent should act accordingly to put his client in a comfortable state since it is the purpose of having a takaful policy. With regard to his action, a trustworthy person should portray a good example and follow the good *akhlaq* extolled by the Prophet (s.a.w.) and seek to emulate the Prophet (s.a.w.) in carrying out his duties as a trustworthy agent. There are several acts related to trustworthiness such as being principled, accurate, transparent, dependable, analytical, punctual and factual.

9.3.4 *Tabligh* (Preaching/Advocacy)

Being an agent, message and information delivery, and knowledge transfer would be the first stages in approaching customers. Regardless of the prospects' awareness, understanding and interests, they should be given correct information and understanding on the importance of takaful protection for themselves and their family members. Prospects should also be exposed to the need for takaful in facing risks and the need for Islamic financial planning for future undertakings. Providing such information is part of the duty of a *da'i* that needs knowledge and information so those clients have clear and correct information on the topic of discussion. This practice in fact is related to another attribute of the Prophet (s.a.w.) that is *tabligh*.

A takaful agent must comprehend the Shariah matters related to takaful as well as Shariah issues that exist in conventional insurance considering the low level of awareness and lack of information among the Malaysian Muslims. Hence, basic Shariah concepts such as *gharar*, *tabarru'*, *riba*, *maysir* and *wakalah* are critical to equip takaful agents with the required knowledge and information to illustrate the differences between takaful and conventional insurance to clients. Therefore, besides putting monetary compensation in the form of fees contributed by a client as a major aim, focus should be set on sharing information with the client. An agent should develop conversation or discussion with their prospects. The monetary compensation will

then follow based on the will of Allah (SWT). This attribute will put an agent in a state of comfort because he leaves the part of compensation to Allah (SWT) (“..as he wishes he will receive Allah’s bounties.”); and if the agent faces disappointment from rejection by the client, he should rest in the satisfaction that information and knowledge has been shared with the prospect. Similar to a *dai’*, the agent should convey information correctly and precisely, rather than make uncertain promises and flatter his client. Lies and uncertainty should be avoided by the agent so that the information and facts given are reliable.

9.3.5 *Fatanah* (Wisdom/Intelligence)

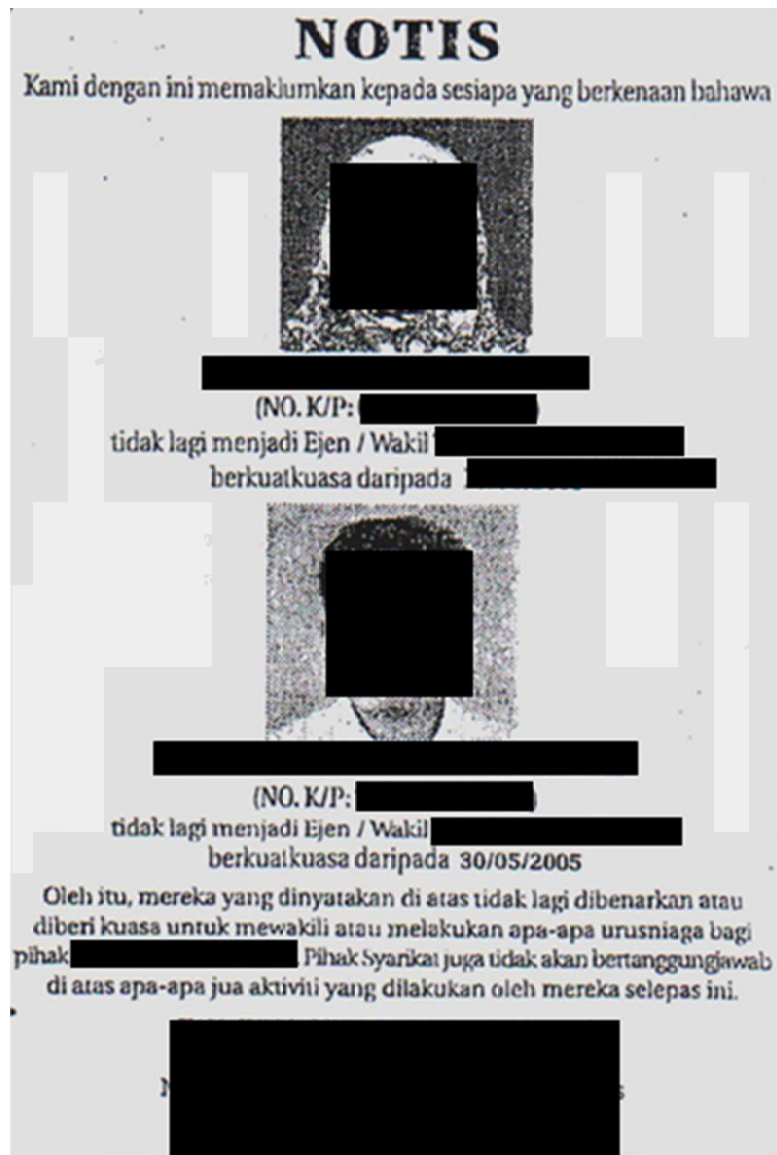
Fatanah or wisdom/intelligence is value-added characteristics that a takaful agent should possess. Instead of understanding the ideas through relying solely on takaful concepts, intelligence/wisdom in giving ideas, information and facts will give positive impacts on an agent. Wise men always think equitably, decide accordingly and under control of every action and decision made by them. This attribute normally comes together with an open-minded way of thinking, rationale and realistic with every conduct and judgment made. As for takaful agents, the way they handle and manage the clients, their beneficiaries, their nominees and other related parties require them to be wise and prudent so that they can control and maintain good relationship with all parties.

In facing any conflicts such as disagreement with client or other negotiation processes, wisdom and intelligence might help a lot to ease the situation. Among other concepts that can be related to wisdom are spirituality, equitability, open-mindedness, intelligence, ethics and judicious.

9.4 Agent: Code of Conduct

Takaful agent acts as a representative of takaful operator. Thus, his credibility is highly dependent on the operator and the code of conduct underlined by the operator. Generally, the agent is ruled with a certain code of conduct. Failure to observe the code will penalize the agent in a few stages of penalty.

An agent who fails to observe the code will be blacklisted by Bank Negara Malaysia (BNM), Malaysian Takaful Association (MTA), and The Life Insurance Association of Malaysia (LIAM). Therefore, his contract as an agent to an operator will be terminated and his termination will be reported to BNM and Polis Di Raja Malaysia (PDRM). A notice will then be published for announcement and proclamation by the operator as in the following example:



9.5 Conclusion

It is apparently to be understood that being an agent for takaful operators is a noble job. An agent is not only serving the customer for the policy offered by the operators, most importantly, the agent act as *da'i* to accomplish a better understanding among Muslims on the need to mitigate risks according to *Shariah* compliant methods. Perseverance of those listed ethics or *akhlaq* will bring the industry to a success worldly i.e. economically and in the hereafter.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. Which of the following terms connotes the term *Wakalah* in its terminological essence?
 - A. Delegation
 - B. Representation
 - C. Assignment
 - D. Guidance

2. The following are the main terms related to the concept of 'Takaful Agent' **EXCEPT**
 - A. *Al-Wakeel*
 - B. *Al-Ujr*
 - C. *Al-'Aqad*
 - D. *Al-Bay'*

3. What are the basic conditions of being a *Wakeel*?
 - A. Educationally graduated
 - B. Legally competent
 - C. Physically neat
 - D. Spiritually religious

4. The practice of *Wakalah* is essential in the Takaful industry due to the following rationales **EXCEPT**
 - A. The administrative work of takaful activities is too difficult to be managed by only one person as the scheme gets bigger.
 - B. The initial stage of setting-up the takaful operation requires heavy expenditure on the part of members.
 - C. The community in general cannot support the operation and this will bring difficulties in controlling the crowd.
 - D. The fund management needs technical expertise such as underwriting, marketing, claims management, legal, accounting, actuarial, IT and so on.

5. How will *niyyah* or intention in its devotional dimension affect an agent's action?
 - A. *Niyyah* will change an agent's perception towards a customer.
 - B. *Niyyah* will provide solution and remedies for any failure of rejection.
 - C. *Niyyah* will differentiate between act of worship and other common activities.
 - D. *Niyyah* will supervise an agent's action and control his manners.

6. The following are the main attributes of a Takaful agent that are related to the attributes of the prophets **EXCEPT**
- A. *Amanah*
 - B. *Fatanah*
 - C. *Dhamanah*
 - D. *Tabligh*
7. A truthful agent will act in the following manner **EXCEPT**
- A. Fulfilling his promise
 - B. Provoking his customer
 - C. Giving reliable information
 - D. Advising accordingly
8. As a preacher, a Takaful agent should respond accordingly to the following situations **EXCEPT**
- A. Providing talk on Takaful
 - B. Arranging special session with prospects
 - C. Controlling the demands on prospects
 - D. Explaining to the prospects all related Shariah concepts
9. A situation where a Takaful agent tells his relatives about the contribution paid by his client contradicts the concept of:
- A. *Amanah*
 - B. *Fatanah*
 - C. *Dhamanah*
 - D. *Tabligh*
10. The following are the agencies involved when an agent fails to observe the agent's code of conduct **EXCEPT**
- A. Bank Negara Malaysia (BNM)
 - B. Malaysian Takaful Association (MTA)
 - C. Polis DiRaja Malaysia (PDRM)
 - D. Amanah Raya Berhad (ARB)
11. The concept of ***Amanah*** relates to the act of:
- A. Deliberating only the truth and facts to the customer
 - B. Fulfilling the needs and carrying out the wishes of the customer through acting as an advisor rather than a decision maker.
 - C. Transferring the knowledge and delivering correct information to the customer rather than making uncertain promises
 - D. Handling and managing the customer's matters in an intelligent, wise and prudent manner
12. The concept of ***Fatanah*** relates to the act of:
- A. Deliberating only the truth and facts to the customer
 - B. Fulfilling the needs and carrying out the wishes of the customer through acting as an advisor rather than a decision maker
 - C. Transferring the knowledge and delivering correct information to the customer rather than making uncertain promises
 - D. Handling and managing the customer's matters in an intelligent, wise and prudent manner

The Prophet (s.a.w.) said:

"The attitude of the believer and feeling of brotherhood to one another is like that of the single body. When one member of the body is hurt, it will have an effect on the whole body"

(Narrated by Bukhari and Muslim)

13. The above *hadith* emphasizes the concept of:

- A. Mutual responsibility
- B. Mutual cooperation
- C. Mutual protection
- D. All of the above

14. The concept of **Tabligh** relates to the act of:

- A. Deliberating only the truth and facts to the customer
- B. Fulfilling the needs and carrying out the wishes of the customer through acting as an advisor rather than a decision maker.
- C. Transferring the knowledge and delivering correct information to the customer rather than making uncertain promises
- D. Handling and managing the customer's matters in an intelligent, wise and prudent manner

15. The concept of **Sidq** relates to the act of:

- A. Deliberating only the truth and facts to the customer
- B. Fulfilling the needs and carrying out the wishes of the customer through acting as an advisor rather than a decision maker.
- C. Transferring the knowledge and delivering correct information to the customer rather than making uncertain promises
- D. Handling and managing the customer's matters in an intelligent, wise and prudent manner

Allah (SWT) says:

"Help one another in furthering virtue and God-consciousness (taqwa), and do not help one another in furthering evil and enmity"

(Al-Maidah 5:2)

16. The above verse emphasizes the concept of:

- A. Mutual responsibility
- B. Mutual cooperation
- C. Mutual protection
- D. All of the above

Answer: 1-d, 2-d, 3-b, 4-c, 5-c, 6-c, 7-b, 8-c, 9-a, 10-d, 11-b, 12-d, 13-a, 14-c, 15-a, 16-b.

Chapter 10

Claim: Family & General Takaful

Chapter Outline:

- 10.1 Introduction
- 10.2 Family Takaful Claims
 - 10.2.1 Death Claims
 - 10.2.2 Maturity Claims
 - 10.2.3 Personal Accident, Sickness or Disability Benefit Claims
- 10.3 General Takaful Claims
 - 10.3.1 Claim Procedures
 - 10.3.2 General Procedure for Motor Takaful Claim
- 10.4 Claims Management Versus Claims Handling
- 10.5 Claim Disputes
- 10.6 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Understand the types of claims under Family Takaful
- Understand the types of claims under General Takaful
- Explain the channels to solve disputes

10.1 Introduction

A claim is an application made by a participant to seek indemnity for his/her losses provided for under the contract of takaful. As a claim is a process under which the participant would be able to exercise his/her rights under the contract, all efforts must be given to ensure that such rights are duly honored. It can be said that a claim is the ultimate test of responsibility of the takaful operator to compensate the economic loss of the participant as promptly and fairly as possible.

However, the handling of the claim process is one of the most complicated procedures of the takaful operation. Furthermore, takaful operators have the right to safeguard its role as the trustee of the takaful fund by ensuring that all claims are genuine. Any negligence on the part of the operator that may lead to an unjustified and false outflow of the fund would mean a failure of the operator in carrying out its duties.

In the event of a claim, a participant or beneficiary should take note of the general procedure for making a claim applicable to all classes of family takaful and general takaful:

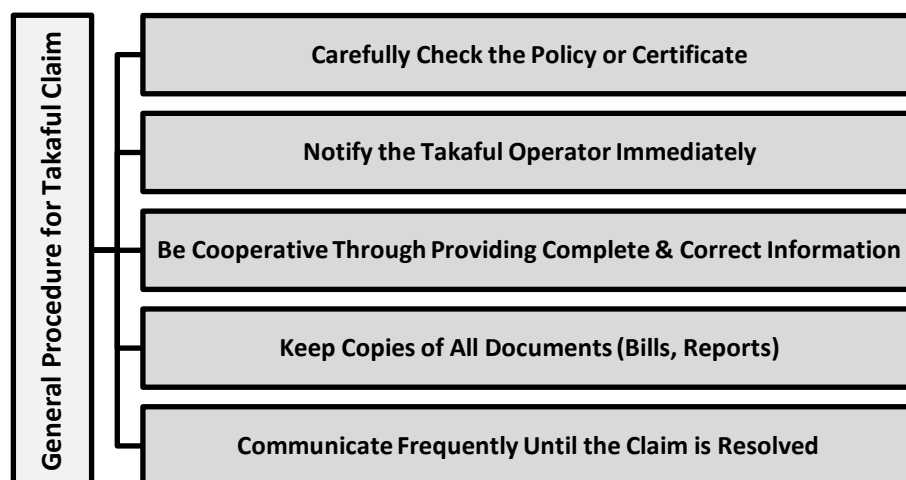


Figure 32: GENERAL PROCEDURE FOR A TAKAFUL CLAIM

i. Check the policy or certificate

- Check whether the loss or damage is covered.
- Check on items excluded or any portion of loss that you will have to bear.
- If you are in doubt about the proper procedures, seek advice from the takaful operator or the agent.

ii. Notify the takaful operator

- Notify the takaful operator about the accident as soon as possible.
- Request for a claim form and seek advice on the documents required to support the claim.
- In some cases, a police report may be required, e.g. in a motor accident, a police report must be made within 24 hours.

iii. Provide complete and correct information

- Be cooperative and give all the information requested by the takaful operator.
- Incorrect or incomplete information will cause delay in processing the claim.

iv. Keep copies of all documents

- Keep copies and records of all documents, i.e. bills, reports and correspondence.

v. Communicate frequently

- The takaful operator should acknowledge receipt of the claim within seven days.
- Keep in regular contact with the operator until the claim is resolved.
- If the offer made does not meet your expectation, you may negotiate.

The next section will discuss the claim procedures for both family and general takaful in detail.

10.2 Family Takaful Claims

The termination of a family takaful contract is usually marked by the settlement of a claim. It is expected of the takaful operator and its agents to service the claim promptly. The reputation of an operator often lies in the promptness with which claims are settled. The takaful operator will pay the participants or the beneficiary, subject to the terms and conditions of the certificate. In the event of a claim, the participant or the beneficiary should:

- Notify the takaful operator as soon as possible.
- For maturity claim, provide a copy of the family takaful certificate.
- For a death claim, the beneficiary or nominee needs to provide certain documents, e.g. certificate of death, deceased's ID, the takaful certificate and other documents.

For family takaful, a claim can arise under one of the following situations:

- i. Upon death of the participant (insured)
- ii. On maturity of the takaful contract
- iii. Personal accident, sickness or disability benefits claims

10.2.1 Death Claims

Upon death of the participant, the beneficiary or the claimant should notify the takaful operator. The operator, on its part, will advise the beneficiary on the procedures to be followed and the necessary documentation needed to provide proof of death. Among the important documentation are participant's name and identity card number, policy number, address, and date and cause of death.

For every death claim, the beneficiary or the claimant must provide three proofs to the operator, namely (i) proof of death, (ii) proof of age, and (iii) proof of title and ownership

i. Proof of Death

The deceased's beneficiary or claimant must provide the operator with documentary evidence which establishes the death of the participant beyond any doubt.

Generally, the operator would accept any of the following documents as the proof of death:

- a) Death Certificate
- b) Coroner's Report
- c) An order of pronouncing a statutory presumption of death (for someone who has gone missing for more than seven years)
- d) Certificate evidencing the death of service personnel and war death
- e) Certificate showing that death has occurred at sea
- f) Medical certificate by last medical attendant

ii. Proof of Age

The operator would also request for proof of age of the deceased participant. If there is any misrepresentation of age during the initial contract, an adjustment to the claim amount would be made. Generally, the operator would accept any of the following documents as the proof of age:

- a) Official certificate of birth
- b) School leaving certificate from a government or government-aided school
- c) Identity card issued by the Malaysian Government
- d) Statutory declaration by the deceased or by an elderly relative where the birth certificate has been lost or destroyed or the duplicate copy is not obtainable
- e) Extract from service record of government, semi-government and reputed commercial firms
- f) International passport

iii. Proof of Title and Ownership

Besides proof of death and proof of age, the takaful operator has to ensure that the claim proceeds on death are paid to the person entitled to receive it. The following documents are acceptable to the operator as proof of title and ownership:

- a) A deed of assignment
- b) A probate of the will obtained from a court of law
- c) A letter of administration issued by a court of law

As practiced in the distribution of benefits in insurance, the right of insurable interest in life policy is limited to certain designated persons such as spouse, children, underage wards, employees, etc., as written in the policy.

However, for a takaful claim, the benefits over the policy shall be distributed on the basis of the principles of *Faraid*, *Waqf*, *Hibah*, *Wasiyyah*, *Qard* and *Amanah* (as prescribed by the policyholder). If it is not prescribed, the basic practice will be followed via the *Faraid* distribution. The designated person in the policy acts as trustee but not the sole owner of all the benefits.

10.2.2 Maturity Claims

In the case of takaful endowment policies, the maturity amount is payable in the event that the participant survives to the end of the protection period. For maturity claims, the operator would usually notify the participants of the policy impending maturity date and would request the participant to comply with the particular procedures. The operator would forward an identity form, survival form and a discharge form for completion to be returned with the original policy.

To settle a maturity claim, a participant is usually required to provide the following proof of claims:

- a) If the participant is the insured
 - proof of age
 - proof of survival
 - completed discharge voucher
 - the original policy certificate
- b) If the participant is not the insured (e.g. in an education policy)
 - a deed of assignment or any other title document
 - a statement by the insured proving that he/she is alive and is unable or unavailable to sign the survival certificate

For endowment policies, the operator would normally incorporate settlement options which can be exercised on maturity. The common options are:

- To cash maturity proceeds
- To convert the maturity proceeds into an annuity
- To leave the maturity proceeds as a deposit with the operator on agreed terms

10.2.3 Personal Accident, Sickness or Disability Benefit Claims

For personal accident, sickness or disability claims, the participant (insured) must prove to the satisfaction of the operator and comply with all other conditions of the contract. For Personal Accident policies, the doctrine of proximate cause is important, as more than one condition may exist in leading to a claim. It is important to note that if the operator considers that the claim is brought about by an excluded peril, the onus (responsibility) is on the operator to establish this.

Under these types of claims, it is customary for insurers to issue printed forms that supply all the immediately needed information. The forms and other details of the accident or illness also contain questions which aim to establish whether or not the original basis of protection has changed. If the operator is satisfied as to the validity of all the documents and it is proven that there is no breach of the policy conditions, the operator will pay the claim amount. However, if there is a reason for the operator to doubt the claim, the claim process is delayed, as an investigation will take place.

Among the documents required under Personal Accident, sickness or disability claims are medical leave chit, medical report, salary slip and photographs depicting injury sustained.

10.3 General Takaful Claims

Unlike family takaful, the termination of a general takaful contract is not marked by the settlement of a claim. The participant may produce a claim more than once, provided the amount is still within the sum assured. For general takaful, the takaful operator will indemnify the participants based on the sum assured. However, all general takaful claims will be based on the principle of indemnification, where the full sum assured is usually not payable, unlike family takaful claims. The principle of indemnification specifies that the insurer is required to restore the insured to the same financial position as he/she had enjoyed immediately before the loss incurred. Thus, the insured, after being indemnified shall not be better off than before the loss, although he/she may receive less than the loss as a result of policy limitations.

10.3.1 Claim Procedures

The general procedure for claim applicable to all classes of general takaful plan is as follows:

a) Notice of Claim

It is a common condition of takaful certificates that participants must notify the takaful operator as soon as possible of the occurrence of any event that may give rise to a claim. This condition is applicable to enable the operator to take appropriate necessary action pertaining to the claim made. The participant may submit the claim personally or through an authorized representative.

b) Make A Police Report

In some cases, a police report may be required. For motor accidents, police reports must be made within 24 hours.

c) Proof of Loss

The participant is required to provide full particulars and proof of loss. For this purpose, it is necessary for the participant to submit the claim in writing by completing a standard claim form designed by the operator for the respective classes of a takaful plan. It is also important for the participant to support the claim with the relevant documents and reports.

d) Investigation

When a claim form and the relevant particulars are submitted, the claim officer is required to examine and scrutinize the particulars thoroughly. Wherever appropriate, a careful and thorough investigation on various aspects of the loss should be conducted. It is crucial to determine that the claim is genuine and made in accordance with the terms and conditions of the takaful contract as stipulated in the contract. The operator must be fully satisfied that there is no intention by the claimant to defraud or cheat the operator by submitting a false claim application.

A claim application must be processed and settled promptly. Nevertheless the speed in the payment and settlement should not be made at the cost of a comprehensive investigation. The claims officer may decide to conduct an investigation or appoint a professional investigator, such as a loss adjuster or a surveyor.

e) Settlement of A Claim

If it is proven that the claim is valid in accordance with the terms of the contract, the settlement of claim will be made immediately.



Figure 33: CLAIM PROCEDURE OF GENERAL TAKAFUL PLANS

10.3.2 General Procedure for Motor Takaful Claim

Claim under motor takaful may arise under the following situations:

Own Damage Claims

- Partial Loss
- Total Loss
- Theft
- Windscreen

Liability to Third Party

- Damage to property belonging to third party
- Death and/or bodily injury to third party

a) Processing of Claims for Partial Loss**i) Documents to be submitted by the participants under Partial Loss are:**

- Claim Form
- Police report
- Estimate of repairs
- Copies of the identification card and driving license of the participant and driver
- Copies of the registration card and road tax of the vehicle

ii) Appointment of Adjuster

An adjuster is to be appointed if the repair cost is substantial and where in-house survey cannot be carried out. Judgment on probable repair cost may be made by evaluating the repair estimate and circumstances of accident, as well as the extent and severity of damage.

iii) Approval

If the claim is valid and justified, an approval letter will be issued to the repairer, directing him to undertake the repair work of the damaged vehicle.

iv) Re-Inspection

The claim officer may require the newly repaired vehicle to be re-inspected to ensure that the standard of repair work undertaken is satisfactory.

v) Discharge

If the repair work is satisfactory, the participant or claimant is required to complete the discharge voucher before he/she is allowed to take possession of the vehicle. If the vehicle is subject to a leasing/finance endorsement, an official signatory from the leasing/finance company must be obtained on the discharge voucher.

vi) Payment

On receipt of the Discharge Voucher and the bill of repairs from the workshop, payment can then be prepared and remitted to the workshop in accordance with the guidelines issued by the Central Bank.

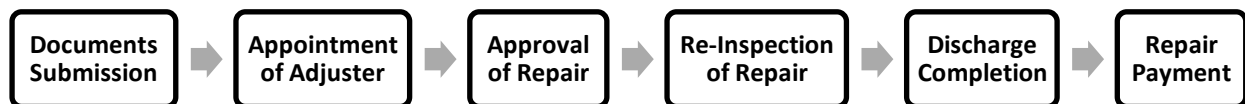


Figure 34: MOTOR TAKAFUL CLAIM PROCESS FOR PARTIAL LOSS

b) Processing of Claims for Total Loss

It refers to a loss of a vehicle beyond repair or if the repair work is to be carried out, its total cost would be uneconomical. The procedures for total loss claims are similar to that for partial loss claims plus the following:

- i) An offer shall be made to the participant and the discharge voucher, once completed must be returned to the operator. The original registration card of the vehicle, original certificate of the policy and a set of keys to the vehicle must also be returned to the operator.
- ii) If the vehicle is subject to a leasing/finance endorsement, full payment must be made to the leasing/finance company.

c) Processing of Claims for Theft

Under a claim for a stolen vehicle, an investigator must be appointed immediately to investigate the theft. The claim officer must inform the JPJ and the police, of the operator's interest in the vehicle.

d) Processing of Claims for Windscreen

The documents required for a windscreen claims are:

- Claim form
- Copy of the participant's identification card
- Photographs of the damaged windscreen
- The bill for the replacement of the damaged windscreen

The above documents will be scrutinized by the officer and if they are in order, payment will be made to the participant.

e) Third Party

Claims from a third party can be either property damage or death/bodily injury. Special considerations under third party claims are:

- i) The operator will only be liable to indemnify the participants against liability to third parties in respect of property damage or death/bodily injury caused by the usage of the vehicle if all the terms and conditions in the contract have been observed.
- ii) Liability to third party should be viewed strictly from the provision of the law.
- iii) Offer for settlement must be made directly to the claimant.
- iv) A proper discharge must be obtained from the claimant before payment is made.
- v) Liability of the participant can only be determined by the courts.
- vi) Panel lawyers can be appointed to handle third party claims if deemed necessary, but as far as possible, third party claims should be handled by claim officers themselves.

10.4 Claims Management Versus Claims Handling

Theoretically, an increase in claims or expenses leads to a decrease in profitability of takaful companies i.e. higher value of claims paid directly reduces takaful companies' profits. Hence, takaful companies that can reduce their claims are likely to achieve substantial savings. Generally, claims cost comprises payouts and expenses. According to a report (Driving Operational Excellence in Claims Management) published by Deloitte in 2011, claims cost often accounts for up to 80% of collected premiums. Thus, emphases should be directed towards claims management rather than claims handling.

The difference between claims handling and claims management is that the former is process oriented whereas the latter is wider in scope. Claims handling involves four stages. First, to report a claim, the takaful company confirms whether the policy associated with the claim is valid, admissible or the peril is covered under the policy. Second, an inspector is appointed to visit the spot and do the assessment and submit the report thereafter. Third, the takaful company examines the report and calls for relevant supporting documents if needed. Finally, based on the assessment, the claim is processed and shall be settled accordingly.

Claims management involves not only claim processing but also include strategic planning, cost monitoring and the role of employees handling the claim. The Productivity Commission (2002) emphasized that good claims management is "proactive in recognizing and paying legitimate claims, assessing accurately the reserve associated with each claim, reporting regularly, minimizing unnecessary costs, avoiding protracted legal dispute, dealing with claimants courteously and, wherever possible, handling claims expeditiously".

In addition, fraudulent claims may constitute a large share of claims. In 2012, Statistical Analysis System (SAS) reported that 10% of the overall conventional insurance claims are fraudulent. In this regard, a study of Abdou, Ali and Lister in 2014 found that, compared to conventional insurance companies, takaful companies in Malaysia have more prudent underwriting practices in place to overcome information asymmetry. However, the sophisticated fraudulent methods require takaful companies to be updated on the evolving tools to combat fraud. In the past, fraud detection highly relied on historical record of fraud. Nowadays, it is very difficult to detect an organized complicated fraud scheme. Note that organized fraud cases involve multiple companies and therefore it requires comprehensive data networks to be dealt with. In Turkey, SAS Fraud Framework for Insurance, which is an advanced analytics solution, had led to the discovery of USD 86 million in potential fraud cases in less than a year.

Compared to family takaful companies, general takaful companies are more exposed to fraud due to the different nature of business. According to the survey of The Economic Landscape and Operational Performance Metrics Bulletin in 2010, 62% of claim officers reported exaggerated or potentially fraudulent automobile claims.

10.5 Claim Disputes

From the many claims settled by takaful operators or insurers, there are cases that end up in disputes. Disputes between claimants and takaful operators and insurers generally involve one of the following two issues:

- The question of whether the operator/insurer is liable ; or
- The quantum of loss, if the operator/insurer is liable

When a dispute arises, it may be resolved through the following channels:

i. Negotiation

When there is a dispute, the participant or claimant is usually seen by a claim official who will try to settle the dispute through discussion. If the dispute relates to a claim that has been rejected by the operator, the claim official will try to explain why the claim was rejected. On the other hand, if the dispute is on quantum of loss, the official may try to negotiate for an amicable compromise.

ii. Litigation

When a claimant is unhappy with the outcome of the negotiation, he/she may take court action against the operator. Litigation is considered as the last resort by the operator, thus, the operator would try to bring about an out of court settlement, unless the dispute involves a huge claim or an important principle.

iii. Arbitration

In practice most general takaful and insurance policies have an arbitration clause which may provide for all disputes or disputes relating to quantum of loss. This clause suggests that disputes will have to be referred for arbitration before court action can be taken. Arbitration is preferred to litigation because it is speedier and less costly than court action. Furthermore, the hearing is in private rather than in an open court.

iv. Mediation

The Financial Mediation Bureau (FMB) is an independent body set up to help in the settlement of disputes between customers and their financial service providers who are its members. The FMB provides a free, fast, convenient and efficient avenue to refer customers' disputes for resolution as an alternative to courts. These disputes may be banking/financial related as well as insurance and takaful related.

The following are members of FMB.

- Commercial Banks
- Investment Banks
- Islamic Banks
- Insurance Companies (Life, General, Composite and Reinsurance)
- Takaful Operators
- Development Financial Institutions
- Payment System Operators and Payment Instrument Issuers

With respect to insurance and takaful related disputes, FMB can mediate all disputes between policyholders/certificate holders/claimants and their own or third party insurers/takaful operators. Award or decision of the FMB is binding on the institutions but not the complainant.

For complaints, disputes or claims involving a financial loss, the amount claimed should not exceed the following:

Banking/financial related :	RM 100,000 (except for fraud cases involving payment instruments, credit cards, charge cards, ATM cards and cheques for which the limit is not more than RM 25,000)
Insurance/takaful related :	RM 200,000 (Motor and fire insurance/takaful) RM 100,000 (Others) RM 5,000 (3rd party property damage)

10.6 Conclusion

A claim is the ultimate test of responsibility of the takaful operator to compensate the economic loss of the participant. It can be said that a promptly and fair claim is a process under which the participant would be able to exercise his/her rights under the contract, and all efforts must be given by the operator to ensure that such rights are duly honored. However, the handling of the claim process is one of the most complicated procedures of the takaful operation. This chapter discusses the claim process in both family and general takaful. Under family takaful, a claim may arise under one of the three circumstances, namely upon death of the participant (insured), on maturity of the takaful contract and personal accident, sickness or disability benefits claims. The chapter also explained the proof needed for each of the above circumstances. Unlike family takaful, the termination of a general takaful is not marked by the settlement of a claim. The participant may produce a claim more than once, provided the amount is still within the sum assured. For general takaful, the takaful operator will indemnify the participants based on the sum assured. Since the highest claim in Malaysia is recorded under motor takaful/insurance, the chapter specifically discusses the claim procedures under motor policy. For instance, claims of motor takaful exceeded 100% for the period from 2005 to 2007 in Malaysia. In this regard, the chapter discusses the available remedies through differentiating between claims handling and claims management.

In the last section, the chapter explained that of the many claims settled by takaful operators or insurers, there are cases that may end up in disputes. Disputes between claimants and takaful operators and insurers generally involve one of the two issues; the question of whether the operator/insurer is liable or the quantum of loss, if the operator/insurer is liable. When a dispute arises, it may be resolved through negotiation, litigation, arbitration or mediation.

Self-Assessment Test

Multiple Choice

Circle the letter of the correct choice for each of the following.

1. What are the issues that cause disputes between a participant/claimant and the takaful operator?
 - A. Whether the operator/insurer is liable OR the quantum of loss, if the operator/insurer is liable.
 - B. The amount of paid premiums and the share of profits made out of the cumulated paid premiums.
 - C. Whether the dispute can be taken to court OR the quantum of loss, if the operator/insurer is liable.
 - D. The share of profits made from the cumulated paid premiums.

2. What are the methods of settling a claim?
 - A. Negotiation, arbitration and mediation
 - B. Negotiation, litigation, arbitration and mediation
 - C. Negotiation, arbitration, out of court action and mediation
 - D. Negotiation, litigation, consultation and mediation

3. For family takaful, a claim can arise under of the following situations, **EXCEPT**
 - A. Upon death of the participant (insured)
 - B. On maturity of the takaful contract
 - C. On third party complaints
 - D. Personal Accident, Sickness or Disability benefits claims

4. The followings are documents required for death claims **EXCEPT**
 - A. Death certificate
 - B. Coroner's report
 - C. Certificate of death service personnel and war death
 - D. Medical leave chit

5. Which of the following are the types of cases handled by FMB?
 - A. Disputes/claims involving terms and conditions of policy or certificate
 - B. Disputes involving amounts above RM 200,000
 - C. Complaints involving third party injury claims
 - D. Complaints involving underwriting issues

6. Which of the following are the types of cases **NOT** handled by FMB
 - A. Disputes/claims involving terms and conditions of policy or certificate
 - B. Complaints involving underwriting issues
 - C. Disputes/claims involving terms and conditions of policy or certificate
 - D. Disputes involving amounts up to RM100,000

7. The proof of maturity claims involve these documents **EXCEPT**
 - A. Proof of age
 - B. Death certificate
 - C. Proof of survival
 - D. The original policy certificate

8. Which of the following are the documents required under personal accident, sickness or disability claims?
 - A. Medical leave chit, medical report and salary slip
 - B. Original policy certificate, medical report and salary slip
 - C. Medical leave chit, death certificate and salary slip
 - D. Medical leave chit, medical report and coroner's report

9. Which of the following is **NOT** a claim under motor takaful?
 - A. Partial loss
 - B. Total loss
 - C. Theft
 - D. Property belonging to a third party

10. Which of the following is **NOT** a claim under liability to third party?
 - A. Damage to property belonging to third party
 - B. Death of third party
 - C. Bodily injury to third party
 - D. Disputes involving amounts above RM100,000

11. Claims handling involves the following stages, **EXCEPT**
 - A. Reporting a claim
 - B. Appointment of inspector
 - C. Cost monitoring
 - D. Providing proof of loss

12. Claims management involves the following, **EXCEPT**
- A. Strategic planning
 - B. Cost monitoring in order to minimize unnecessary costs
 - C. Role of employees handling the claim
 - D. Discharge completion
13. In comparison with claims handling, it can be concluded that claims management is:
- A. Wider in scope
 - B. Process oriented
 - C. Focused on providing relevant and supporting documents
 - D. Less efficient to detect fraud
14. In case a dispute arises between the takaful operator and claimant, which of the following methods of settling a claim can be the most harmful to the takaful company?
- A. Negotiation
 - B. Litigation
 - C. Arbitration
 - D. Mediation

Answer: 1-a, 2-b, 3-c, 4-d, 5-a, 6-b, 7-b, 8-a, 9-d, 10-d, 11-c, 12-d, 13-a, 14-b.

Chapter 11

The Importance of Takaful in Shariah Financial Planning

Chapter Outline:

- 11.1 Introduction
- 11.2 Types of Takaful Plans
- 11.3 Steps in Calculating Adequate Takaful Coverage
- 11.4 Basic Applications of Risk Management: A Case Study
- 11.5 Pitfalls in Risk Management
- 11.6 Conclusion

Chapter Objectives:

Upon completion of this chapter, you should have knowledge of:

- Recognize the Types of Takaful Plans
- Understand the Basic Applications of Risk Management in a Case Study
- Know the Pitfalls in Risk Management

11.1 Introduction

Individuals participating in takaful will enjoy benefits beyond risk management. In relation to financial planning our focus will be on Family Takaful plans. In addition to the protection for the possibility of income loss due to death and disability of the breadwinner of the family, participation in takaful schemes will benefit individuals because it will serve as a means of wealth target accumulation via the use of instruments, such as, education takaful and investment-linked takaful. Takaful is one of the quickest ways to build wealth for the purpose of bequest to the family. General Takaful plans primarily concern the risk mitigation of an economic loss an individual property or asset. In this chapter, a hypothetical case on the evaluation on the needs for takaful will be discussed.

11.2 Types of Takaful Plans

The broad category of family takaful plans is:

i. Term

A Term Plan provides protection for a specific period of time. The beneficiaries can only utilize the benefits when the participants pass away or suffer from total or permanent disability during the policy's term. Despite the low amount of contribution, this plan offers the highest coverage compared to other takaful plans. However, it does not offer savings and any investment element. On top of that, the return in the *tabarru'* account is very minimum as the main purpose of this plan is for protection.

ii. Whole life

This is a life time protection with a fixed death benefit. The contribution is fixed and paid throughout the participant's life. This plan combines both protection and savings. The investment portion will accumulate savings (cash value) from which the participants can withdraw for their own personal use. Comparatively, this plan is expensive as it has both protection and savings.

iii. Endowment

This plan combines the need for protection and also savings. The main advantage of this plan is that it provides a stream of income at the end of a specific period. If the participants were to die, then the money will be paid to the beneficiaries. However, it is costly.

iv. Investment-linked

In an investment-linked takaful plan, part of the contribution will be invested in a variety of Shariah-approved investment funds and the other part is used to provide the participants with coverage against death and permanent disability. Participants have the right to decide on the allocation of the contribution between investment and protection, and also in terms of the choice of funds for investment.

Another classification that can be made on the types of family takaful is:

- a) Ordinary family takaful
- b) Investment-linked takaful
- c) Child education takaful
- d) Medical and health takaful

Family Takaful Versus General Takaful

Generally, takaful schemes under General Takaful consist of home takaful, motor takaful and personal accident takaful. Table 11.1 below illustrates further the coverage available under general and family takaful.

Table 11.1: A Comparison of General Takaful and Family Takaful

What is being protected	Class of Takaful products	Peril= Cause or source of loss	Hazard=conditions that increase the chance of loss
Assets for its capacity to generate income	General	Fire, burglary, collision, flood, etc.	Storing of flammable items, unlocked front door, reckless driving, house built by the river.
Assets for its value			
The person for his capacity to generate income	Family	Illness, premature death, disablement	Family history, smoking, obesity, drinking, sexual promiscuity, etc.

11.3 Steps in Calculating Adequate Takaful Coverage

11.3.1 The Need Analysis Method

a) Determine the Objective of Buying Insurance

You can only know how much protection is required after you have decided on the purpose of purchasing the takaful plan. Some people may buy takaful plans because they want to prepare themselves in case they die before they can settle their housing loans. Takaful may be needed to provide for children's education in case the breadwinner is no longer able to work due to permanent disability. In summary, the following are reasons why people opt for takaful plans:

- To provide for children's education
- To pay any outstanding debts e.g. housing loans, car loans, etc.
- To provide a stream of income flow in case of permanent disability
- To supplement family income in case of any misfortune
- To provide for retirement planning

If you know the reasons, then you can decide how much is sufficient for your family. For example, you may need to purchase a takaful plan with coverage of RM500,000 if you expect your children will need this approximate amount for their future education fund. If you have other objectives, such as to pay for your outstanding debts, you may have to buy another takaful plan which is designed to provide fund to settle outstanding loans in case of death or permanent disability. Today, takaful providers have diversified their products by designing specific plans for specific purposes or objectives.

b) Estimate Amount of Funds Needed

The next step is for you to decide how much you need the funds to cover. You have the options to cover all (100 percent) or partially. For those who cannot afford to cover all, at least partial coverage would help to lighten the burden of having to deplete all sources of funds or savings when the time comes.

c) Compute Amount of Financial Resources Available

Besides takaful plans there are other financial resources that one can fall back on should the breadwinner dies. Examples of these resources are EPF contribution, pension, insurance or takaful provided by employers, savings, properties, unit trust funds and other types of investment funds. You need to consider these resources to avoid participating in too many plans that you do not really need.

d) Estimate Amount of Takaful Cover Needed

After considering all of the above only you can decide how much coverage is adequate for your family. However this is not a one-off planning. You need to review your family needs every three to five years as your family needs may change. You may have additional family members or new obligations or commitments.

e) Design Your Takaful Plans.

There are options for you to add to your takaful plan. This is called riders. There are many types of riders such as for temporary disability, etc.

11.3.2 The Human Life Value Method/Multiple Earnings Method

This is the simplest method. Using this method one only needs to multiply an arbitrary number to the annual income. In general people will use 3-10 times to estimate the amount needed in the future, i.e. after retirement.

11.4 Basic Applications of Risk Management

The main reason for participating in a takaful plan is for protection. The protection is in terms of life or family takaful, or the protection of assets, as well as liability protection. For example, the mortgage-reducing term takaful will ensure that the house remain with the family if the participant dies.

Besides giving protection, a takaful plan also provides a lump sum that may serve as the fund that can be used as a legacy. Investment-linked takaful schemes also serve the purpose of investment, albeit at a lower return than from the investment in shares and unit trusts. Family takaful can serve as savings too considering that the cash maturity benefit is payable to the takaful participant at the end of the protection period.

An illustration of a couple's financial planning needs will be discussed to understand how takaful can be used to manage liabilities, protect income and serve as a method of building wealth. Participation in takaful may also act as a means of investment via investment-linked takaful.

THE CASE STUDY SALWA AND FARID

Introduction

Salwa and Farid have read about Islamic financial planning in a local financial magazine. Firstly, they know from their reading that the process starts from the in-depth review of the clients' current financial situation; and secondly, from an establishment of a personal financial plan that shows how the clients' goals and objectives can be achieved. In Islamic financial planning, the objectives are to plan for success in this world and the Hereafter; a dual dimension of planning instead of the one period for conventional financial planning.

They visited your office and personally met you. They would like to know more about Islamic financial planning from you and how it can help them create strategies in managing their financial affairs to meet life goals, especially on the risk management aspect of financial planning.

You had a dialogue session with them explaining the role of an Islamic financial planner and the Code of Ethics and Professional Responsibility that financial planners have to comply with. After having raised several questions and feeling satisfied with your explanation, they decided to be your clients.

During the second client-planner meeting session on 14th February 2008, they were ready to be interviewed and to share their goals that relate to risk management. Based on their reading, they know that risk management ranks before investment and other types of planning in order to manage risks arising from possible loss of income, and financial losses due from the possible damage to their assets.

They would like to know what are the areas that takaful can relate to the activities of financial planning, i.e. risk management, savings, investment, wealth target and possibly more. They also wonder about the amount of coverage that is suitable for them. You are to provide all the required information based on the data acquired during the interview.

Personal Information

Farid and Salwa are 38 and 36 years old respectively and they reside in Gombak. They have been married for 8 years and have a daughter and a son; Juliana is 6 years old while Johan is 4 years old.

Plans for Children's Education

The couple wants to set up an education fund for each of their children. Farid and Salwa anticipate that the children will begin attending college at the age of 18. They hope that their children can secure places in the local public universities but are willing to consider sending them to reputable private colleges with overseas twinning programs.

According to Farid's survey, the cost of studying at local private colleges is about RM15,000 per year, currently. Farid would like to have the money for tuition and living expenses ready before the children begin their Bachelor programs.

Employment and Income Information

Farid is the Head of Legal Department of a public-listed company. He earns RM120,000 a year and is provided with a car costing RM100,000. He is covered under the group term life policy with benefit equivalent to 3 times his annual salary. The company also covers outpatient medical expenses for the staff and their families.

Farid contributes 11% of his salary to EPF, while his employer contributes 14%. Farid expects his salary to increase by 7% per annum. Presently, Farid has RM250,000 in his EPF account.

Salwa is a tutor in a public university earning a salary of RM 2,500 per month. At the moment, she has RM30,000 in her EPF account. Another source of income is the bonus paid by the government, equivalent to 1 month's salary.

Other Financial Information

Their family house is a double-storey link, purchased 8 years ago for RM150,000 in joint names. Farid and Salwa took a conventional housing loan of RM120,000 with interest at 8% p.a. for a period of 25 years. The value of houses in Gombak has appreciated tremendously and the house is now worth at least RM350,000 based on the valuation of their neighbor's house recently sold in the market. They had spent about RM80,000 on the renovation of the house 2 years back.

The family has a car which Farid had purchased two years ago, mainly for Salwa's use. The purchase price of the car was RM70,000 and Farid had paid a 20% down payment while the balance was financed by an Islamic hire–purchase scheme. According to Farid, he is paying about RM1,000 monthly via bank standing instruction and has another 4 years of installments to settle.

Other assets owned by the couple are as follow:

Asset	In the name of:	Quantity	Account balance or Market value (in RM)
Wadiah Current account	Farid and Salwa		70,000
Gold jewellery	Salwa	600 grams	6,000
Tabung Haji account	Farid		300
Tabung Haji account	Salwa		5,000
Maybank stock	Farid	2,000 shares	16,800
KPJ Healthcare stock	Farid	1,000 shares	3,100
Tradewinds stock	Farid	2,000 shares	6,600
Guocoland stock	Farid	2,000 shares	3,000
PHEIM Asia Ex-Japan Unit Trust Fund	Farid	5,000 shares	5,000
Phillip Master First Ethical Unit Trust Fund	Farid	5,000 shares	2,000

Current expenses of the family include:

Items	RM	Occurrence
Groceries	1,000	Monthly
Utilities	250	Monthly
Vacation	2,000	Yearly
Eating Out	500	Monthly
Car insurance	1,500	Yearly
Car maintenance	2,000	Yearly
Petrol	250	Monthly
Golf fees, etc	200	Monthly
Books	800	Yearly
Clothing	4,000	Yearly
Charitable donations	500	Yearly
Juliana's preschool	400	Monthly

Both Farid and Salwa carry credit cards. Their total outstanding balance currently is RM10,000. According to Farid, 80% of the expenses charged to his credit card are company-related and fully reimbursable. Upon being reimbursed by his company, Farid would remit all to settle the related charges. Farid does not give a fixed allowance to Salwa for her personal expenses, but provides her with a supplementary credit card. Salwa's credit limit is RM1,000. According to Salwa, her expenses are about RM700 monthly.

Retirement and Other Plans

Farid expects to continue working at least until 55. The couple plans to perform their pilgrimage (*Hajj*) after Johan starts his secondary schooling.

The couple's idea of retirement is quite simple. They would be happy if they were to continue living in their current house, have enough income to sustain them and are healthy. But, most of all, Farid and Salwa hope to see their children do well in their lives and continue to spend time with the parents.

The scope of financial planning involves several components including:

- (i) Cashflow and Liability Management
- (ii) Risk Management and Takaful
- (iii) *Zakat* and Tax
- (iv) Islamic Investment
- (v) Retirement
- (vi) Islamic estate and *Waqf*

However, as stated above, the main concern of the couple relates to which takaful plans can contribute to an efficient financial plan.

The following plan which is an illustration only is constructed based on the writer's personal viewpoint and experience. It would necessarily encompass the six-step financial planning (prioritizing of objectives, data gathering, data analysis, plan structuring, plan implementation and plan monitoring and review) processes that were discussed in earlier chapters.

THE PLAN - FARID AND SALWA

Although the couple is very much interested in risk management, it does not mean that takaful does not relate to other areas other than the risk management area. The following are the issues identified during the interview with the couple.

I. Issues Identification

FINANCIAL PLANNING COMPONENT	Importance towards client's objective from first interview
(i) Cash flow and Liability Management To know whether the couple has the cash flow to be spent on managing their risks. This is after the calculation of the amount of cover needed by the couple.	High
(ii) Risk Management and Takaful Through his employer, Farid is covered for RM360,000 on his life, and the family is covered for basic medical expenses – Need to assume basic risk management objectives, review takaful need analysis to identify specific area to protect and suggest appropriate takaful coverage including sum assured amount and type of takaful plan.	High
(iii) Islamic Investment Couple wants to have a college education fund for their children – Need to compute how much is needed for Juliana and Johan, and how to achieve the target amount. Farid's portfolio consists of mixed assets – Need to identify which are Shariah and Non-Shariah compliant. Need to advise Farid on how to re-structure his portfolio to be Shariah-compliant.	High High
(iv) Retirement Even though the couple's retirement plan is simple – still need to estimate how much is needed during their retirement period and how to achieve the target amount.	Medium
(v) Islamic Estate and Waqf To determine whether the amount of cover is adequate for his family if he were to die while the children are still in school (or university). The possibility of Farid creating a <i>waqf</i> fund from the proceeds receivable from the cash maturity values from the takaful plan.	High Medium

Based on the activities identified and the priority set to the case, a financial plan is constructed for the couple to adopt.

II. Analysis and Plan Construction

Data gathered was analyzed in the appendices and the findings are:

FINANCIAL PLANNING COMPONENT	ISSUES
(i) Cash flow and Liability Management A. Net Worth Statement (Appendix 1) As at 14th February 2008, the net worth of Farid and Salwa are RM 469,408 and RM174,446 respectively. B. Cashflow Statement (Appendix 2) For 2008, the cashflow for Farid and Salwa are RM3,324 and RM28,925 respectively. This works out to a monthly surplus of RM277 for Farid and RM2,410 for Salwa. Conclusion: Presently, Farid has the assets and Salwa has the cashflow.	
(ii) Risk Management and Takaful Farid has two major liabilities at present, namely, home (RM103,109) and car financing (RM48,000), totaling RM151,109. While the house is jointly owned with Salwa, takaful coverage for Farid being the breadwinner should be for the whole balance outstanding. In case Farid dies or becomes disabled, the family needs roughly RM3,800 or RM4,600 per month respectively. Or, RM45,900 or RM55,500 yearly. The Takaful coverage needed on the life of Farid are: 1) RM103,109 for home financing using Mortgage-reducing Term Takaful for the next 17 years. 2) RM48,000 for car financing using Fixed Term Takaful for the next 4 years. 3) RM850,000 for household expenses in case of death or disability of breadwinner using affordable Family takaful package. The total coverage needed above is roughly RM1,000,000. Assuming RM360,00 is by Farid's employer, he still needs RM640,000 of takaful coverage.	Through his company, Farid is covered for RM360,000 on his life, and the family is covered for basic medical expenses – Need to assume basic risk management objectives, review takaful need analysis to identify specific area to protect and suggest appropriate takaful coverage including sum assured amount and type of takaful plan.

This coverage can be met through the various combinations of takaful plans. Basically, the RM640,000 is arrived at after considering the outstanding balance for the house in Gombak, family car, capital needed to sustain family expenses and the insurance coverage provided by Farid's employer (Refer to Appendix 2 for the detailed calculation).

Investment-linked Takaful

The couple may also participate in investment-linked takaful, so that they can balance the need for risk protection and their investment towards college funds, as well as for *hajj* expenses.

Investment-linked takaful provides flexibility to the percentage of participants' contribution going to protection and investment. The contribution is also flexible to reflect the financial situation of the participants up to a tolerable level. The participants also have the options to pick and choose the funds available to reflect their risk appetite. As some portion of the contribution is channeled to equity investment, returns can fluctuate; high during bullish times, low during bearish times. As such, participants may enjoy higher returns as compared to investing in the usual family takaful.

On the downside, unfavorable returns will wipe out participants' contribution intended for protection. During the times when equity is not a good choice, the demand for this type of takaful will be lower. This is a major drawback for participating in investment-linked takaful as takaful is meant for protection. However, if the couple has a medium tolerance to risk, they will be able to generate wealth whilst protecting their assets with this type of takaful plan.

Individuals may have medium to high risk acceptance depending on the following reasons:

- a) age: older individuals tend to shy away from risks
- b) gender: women are more risk adverse
- c) income and wealth: the higher the amount of income and wealth, the higher the risk toleration level
- d) other factors such as type of employment (self-employed are risk-takers) and the influence of culture in risk-taking.

In terms of risk characterization, there are 5 risk elements:

- a) risk propensity (tendencies in financial situations)
- b) risk attitude (willingness to incur monetary risk)
- c) capacity (financial ability to incur risk)
- d) knowledge (understanding of risk and risk-return trade-off)
- e) objectives (investment goals)

The couple has to decide their level of risk by examining their financial situation using the risk characterization as above.

(iii) Islamic Investment The total fund needed is RM368,566. This figure has considered the 5% and 4% inflation rate for tuition and living expenses. The list of Farid's investment portfolio that are Shariah compliant: <table><tr><th>Shariah-compliant</th><th>Asset</th></tr><tr><td>No</td><td>Maybank stock</td></tr><tr><td>Yes</td><td>KPJ Healthcare stock</td></tr><tr><td>Yes</td><td>Tradewinds stock</td></tr><tr><td>No</td><td>Guocoland stock</td></tr><tr><td>No</td><td>PHEIM Asia Ex-Japan unit trust fund</td></tr><tr><td>No</td><td>Phillip Master First Ethical unit trust fund</td></tr></table> At present, the breakdown of Farid's investment portfolio is: <table><tr><th></th><th>Equity</th><th>Unit trust</th></tr><tr><td>Maybank stock</td><td>16,800</td><td></td></tr><tr><td>KPJ Healthcare stock</td><td>3,100</td><td></td></tr><tr><td>Tradewinds stock</td><td>6,600</td><td></td></tr><tr><td>Guocoland stock</td><td>3,000</td><td></td></tr><tr><td>PHEIM Asia Ex-Japan UnitTtrust Fund</td><td></td><td>5,000</td></tr><tr><td>Phillip Master First Ethical UnitTtrust Fund</td><td></td><td>2,000</td></tr><tr><td>Total value</td><td>29,500</td><td>7,000</td></tr></table> The couple may join the Education Takaful for both of the children. However, the amount is quite large, which results in a high amount of contribution needed. In their case, investing in shares and using other sources of income in addition to EPF savings is also feasible.		Shariah-compliant	Asset	No	Maybank stock	Yes	KPJ Healthcare stock	Yes	Tradewinds stock	No	Guocoland stock	No	PHEIM Asia Ex-Japan unit trust fund	No	Phillip Master First Ethical unit trust fund		Equity	Unit trust	Maybank stock	16,800		KPJ Healthcare stock	3,100		Tradewinds stock	6,600		Guocoland stock	3,000		PHEIM Asia Ex-Japan UnitTtrust Fund		5,000	Phillip Master First Ethical UnitTtrust Fund		2,000	Total value	29,500	7,000	Couple wants to have children college education fund – Need to compute how much is needed for Juliana and Johan, and how to achieve the target amount. The fund can be built through education takaful. Indirectly, the analysis of the couple' investment is relevant since their investment will provide some amount of returns that will reduce the amount of coverage for takaful. Farid's portfolio consists of mixed assets – Need to identify which are Shariah and Non-Shariah compliant; Need to advise Farid how to re-structure his portfolio to be Shariah-compliant.
Shariah-compliant	Asset																																							
No	Maybank stock																																							
Yes	KPJ Healthcare stock																																							
Yes	Tradewinds stock																																							
No	Guocoland stock																																							
No	PHEIM Asia Ex-Japan unit trust fund																																							
No	Phillip Master First Ethical unit trust fund																																							
	Equity	Unit trust																																						
Maybank stock	16,800																																							
KPJ Healthcare stock	3,100																																							
Tradewinds stock	6,600																																							
Guocoland stock	3,000																																							
PHEIM Asia Ex-Japan UnitTtrust Fund		5,000																																						
Phillip Master First Ethical UnitTtrust Fund		2,000																																						
Total value	29,500	7,000																																						
(iv) Retirement Farid expects to continue working until he is 55 years old i.e. 17 more years to go. No estimation of how much is needed has been done for the couple due to the simplicity of their financial goals for retirement. But it is estimated that in 2025, Farid will have the following:		Even though the couple's retirement plan is simple – still need to estimate how much is needed during their retirement period and how to achieve the target amount.																																						

<u>Cash available upon 55</u>			
EPF balance	573,005		
EPF additions	1,300,200		
less: EPF withdrawals	436,199		
Net EPF balance	1,437,006		
Investment- equity	109,151		
Investment- unit trust	22,112		
Investment- surplus savings	158,170		
Total cash available	1,726,438		
Put cash in REIT to generate income	103,586		
Rental from cottage @ 6% yield	32,313		
Annual	135,900		
Monthly	11,325		
Farid's cash of RM1.73 million and his investment in the holiday cottage can generate current income of RM11,325 per month. Another source of retirement income is the cash maturity benefit to be received from the takaful plan they are planning to participate in. Usually, the cash maturity benefit is about 1/3 of the amount of accidental death payout. Basically, the participants will get back the amount of money contributed in the takaful fund (without much appreciation to the value contributed). If a person contributed around RM 3,119.20 per year for 24 years (amounting to 74,860.80), the cash maturity benefit will be RM 80,441.03 in 24 years' time. From this we can see that takaful coverage is not an excellent method to accumulate wealth but more of the protection of wealth.			
(v) Islamic Estate and <i>Waqf</i>			
The amount receivable from the cash maturity benefit from the takaful plan can be used to set up the <i>waqf</i> fund when Farid is 55 year old.			

Note.

1. The above would assume that the required takaful solutions are available for the Plan to be implemented.
2. No plan would remain static throughout. Constant monitoring and review would be required as client circumstances change from time to time. A financial plan needs to be reviewed at least once a year.

APPENDICES TO THE PLAN-FARID AND SALWA

APPENDIX 1 NET WORTH STATEMENT as at 30/4/2008

Shariah compliant	ASSETS	Farid	Salwa	Total		Assets subject to Zakat		
						Farid	Salwa	Total
Yes	Wadiah (joint) Gold jewellery	65,000	5,000	70,000	Wadiah (joint)	65,000	5,000	70,000
Yes	Tabung Haji		6,000	6,000			0	0
Yes	Due from company	300	5,000	5,300				
Yes	Due from husband	7,200						
Yes	Maybank stock		5,000	5,000				
No		16,800		16,800	Maybank stock	16,800		16,800
Yes	KPJ Healthcare stock				KPJ Healthcare stock			
Yes	Tradewinds stock	3,100		3,100	Tradewinds stock	3,100		3,100
Yes	Guocoland stock				Guocoland stock			
Yes	PHEIM Asia Ex-Japan Unit Trust Fund	6,600		6,600	PHEIM Asia Ex-Japan Unit Trust Fund	6,600		6,600
No		3,000		3,000		3,000		3,000
No	Phillip Master First Ethical Unit Trust Fund				Phillip Master First Ethical Unit Trust Fund			
No	SJ house	5,000		5,000	SJ house	5,000		5,000
No	Family car				Family car			
		2,000		2,000		2,000		2,000
		250,000	30,000	280,000				0
		175,000	175,000	350,000				0
		52,500		52,500				0
	Total assets	586,500	226,000	812,500		101,500	5,000	106,500
	LIABILITIES							
	Credit card Gombak house - Conventional	10,000		10,000	Rate	2.5%	2.5%	
	Family car - Islamic HP	51,555	51,555	103,109	Vs. Nisab	8,500	8,500	
	Owing to wife	48,000		48,000	Zakat due	2,538	0	2,538
	Zakat due	5,000		5,000				
		2,538	0	2,538				
	Total liabilities	117,092	51,555	168,647				
	NET WORTH	469,408	174,446	643,854				
					Loan balance using FC100V			
					Amrt			
					PM1=1			
					PM2=96			
					n=300			
					I%=8/12=0.66667			
					PV=120000			
					PMT=-926.18			
					BAL: solve =103108.53			

	<u>Equity</u>	<u>Unit trust</u>
Maybank stock	16,800	
KPJ Healthcare stock	3,100	
Tradewinds stock	6,600	
Guocoland stock	3,000	
PHEIM Asia Ex-Japan		
Unit Trust Fund		5,000
Phillip Master First		
Ethical Unit Trust Fund		2,000
Total value	29,500	7,000

APPENDIX 2

CASH FLOW ANALYSIS

Notes:	Monthly	Farid Yearly	Salwa Yearly	Total
		120,000		120,000
			32,500	32,500
estimated tax payable		13,963		13,963
11% by Employee		13,200	3,575	16,775
total inflow		92,838	28,925	121,763
Household	1,000	12,000		12,000
Household	350	4,200		4,200
Household	500	6,000		6,000
Household		2,000		2,000
Household	500	6,000		6,000
Household		1,500		1,500
Household		2,000		2,000
Household	250	3,000		3,000
Household	734	8,802		8,802
Household	200	2,400		2,400
Household	800	800		800
Household		4,000		4,000
Household		500		500
Household	400	4,800		4,800
Household	700	8,400		8,400
Repayment	1,000	12,000		12,000
Repayment	926	11,112		11,112
Total Outflow		89,514	0	89,514
Inflow less Outflow		3,324	28,925	32,249
Monthly surplus		277	2,410	2,687

Scenario	
Farid dies	Disabled
12,000	12,000
4,200	4,200
6,000	6,000
1,500	1,500
2,000	2,000
3,000	3,000
	8,802
	800
4,000	4,000
4,800	4,800
8,400	8,400
Total	45,900
Monthly	3,825
	55,502
	4,625

Capital needed to sustain family

Average amount needed per year
= 50,701
Principal Intact Amount
= Amount needed/div.
yield of 6%

= **845,017**

11.5 Pitfalls in Risk Management

Too Little Coverage

The most common mistake that people make is having too little coverage. They go for the cheapest contribution or premium without considering the goals of buying the plan and underestimate the amount that is adequate for their family. They only realize the mistake when a claim is made. For instance, lenders generally require the home buyer to purchase an all-risks homeowner's policy which covers the mortgage amount. However, the mortgage amount is often lower than the house value since it doesn't consider the initial down payment which may constitute up to 20% of the house price. In such a scenario, the participant would not receive enough coverage from the takaful company if the house was totally destroyed in the event of fire or flood. As for businesses, some business owners automatically choose the cheapest takaful policy rather than buying adequate limits. Unfortunately, such policies will not provide enough coverage if the repair cost exceeds the limit of the takaful policy. Moreover, a company cannot be certain that it will not cause harm to third parties. Accordingly, lawsuits can be very unpredictable. Note that one large claim can put a company out of business. Hence, a company may opt for public liability takaful to protect its business from legal liabilities.

Overprotection (Too Much Coverage)

Some people are too obsessed with takaful plans. They buy whatever plan that is promoted to them. This is another mistake that people tend to make. Takaful is not the only source of fund that one needs to have for protection. There are many other financial resources you can use to supplement temporary cut of income or protection. Among them are EPF contribution, SOCSO, investments and savings. Buying too many takaful plans can be very expensive. Some plans only permit you to claim once. For example, you are not allowed to claim from more than one takaful company for an accident. In this case, it is useless to have the same plan from different takaful providers.

Absence of “Essential” Covers (Not Enough Coverage: Riders)

Having not enough coverage is very detrimental to financial planning. Many takaful providers offer a variety of riders for takaful participants to choose from. For example, you may need personal accident coverage, critical illness, temporary disability etc. One needs to evaluate thoroughly the family needs and whether the riders offered are worth taking up for the small amount of contribution.

Participating in an Inappropriate Takaful Plan (Plan should Match Needs)

Since there are many takaful plans in the market, one needs to choose the one which is most appropriate to one's family needs. For example, children education plans may not be appropriate for single takaful participants. Another example is one who cannot afford to pay higher contribution but needs a high amount of protection should not participate in a whole life plan but should go for a term plan instead. Thus, the participant needs to assess what he/she really wants from the takaful policy. Subsequently, he/she can weigh those goals against the cost of each policy. If the participant only needs to cover a mortgage, a term plan is suitable; if the participant is looking for some returns on top of the mortgage cover and he/she does not mind paying a little more, a whole life policy is more suitable.

Too Late to Participate in a Takaful Plan

Delay in purchasing a takaful plan might result in a higher amount of contribution. In general, the older the person, the higher would the contribution be for the same amount of coverage. This is because of the concept of time value of money. The worst is procrastinating participation only to find that it is too late for you to do so as you have been diagnosed with a critical illness.

11.6 Conclusion

This chapter covered the Importance of takaful in *Shariah* financial planning. The important themes of this chapter are namely, types of takaful plans, steps in calculating adequate takaful coverage, basic applications of risk management, a case study and pitfalls in risk management. This is to demonstrate the relevancy and importance of takaful in the advice of the financial planner.

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