

***Takāful*: Concept, Underwriting Scope and Risk Management**

Azman Mohd Noor¹

Abstract

Akin to the growth of Islamic banks, *takāful* has been introduced in the market to replace conventional insurance. This is in response to the market demand of the large Muslim communities around the globe to comply to their religious teaching and to live a life adhering to the divine law (Sharī'ah). *Takāful*, which in principle is based on *tabarru'* (gratuitous contribution and donation) used *muḍārabah* model in the beginning. The new trend has been towards adopting *wakālah* model instead of *muḍārabah*. Waqf, another model which combines both *wakālah* and *muḍārabah* has also been introduced. *Takāful* operators are offering investment products apart from their core business in providing protection. *Takāful* seems to be similar to conventional insurance in the sense of providing protection, indemnity and coverage for the insured risks, but is different in many perspectives. This paper aims at describing *takāful* models and related few selected Sharī'ah issue in underwriting scope and managing risks from Sharī'ah perspective².

Keywords: *Takāful* models, *Tabarru'*, *Waqf*, *Muḍārabah*, *Wakālah*, Underwriting, Surrender value.

1. Introduction

Takāful is derived from an Arabic word which means solidarity and mutual assistance, whereby a group of participants agree among themselves to support one another, jointly against any defined losses. In a *takāful* agreement, the participants contribute (consideration) a sum of money as wholly or partially *tabarru'* (donation) into a common fund

¹ The author belongs to Department of Fiqh and Usul al-Fiqh, IIU, Malaysia. The paper was prepared for Takaful Seminar organized by Aloi Nissei Dowa Insurance Endowment Course, Waseda University, Tokyo, May 17, 2012.

² Editorial Note: This paper is based on Malaysian concepts and practices of *takāful*; different from that of the Middle East / the mainstream view. It, however, contains valuable information on *takāful*. JIBM will welcome to publish any critical appraisal prepared with intention to make the system nearer to Sharī'ah as far as possible.

(pool), which could be used mutually to assist (compensate) any member who suffers a defined loss or damage (peril).³

Takāful business can be divided into General *takāful* and Family *takāful*. Basically, General *takāful* reflects absolute *tabarru'* where the participants do not expect any return from their contribution except payment of claims, if any. However, in Family *takāful* the *tabarru'* is partial, the remaining considered as investment and, therefore, besides claims (if any) participants also expect return from their investment. This is because the participants' contribution is divided into two separate accounts; the individual personal account and the *tabarru'* (risk/solidarity) account. The individual account, to which the major portion of the payment is allocated, is purely for savings and investment. The *tabarru'* account, where the balance of the payment goes, is to build up a reserve for death benefits to the heir(s) of the participant who dies prematurely or for the participant's own benefit in case of total permanent disability. The *takāful* operators invest the funds in the personal and *tabarru'* accounts in the Shari'ah compliant investment instruments. They normally give the participants the right to know how the fund is managed, how surrender values are computed and how profits are shared.⁴

Globally, the *takāful* industry has been growing rapidly, appealing to both Muslims and non-Muslims. The industry is expected to grow by 15-20% annually, with contributions expected to reach USD7.4 billion by 2015. Currently, there are more than 110 *takāful* operators worldwide.⁵

Malaysia has achieved significant milestones in the development of its *takāful* industry. With the enactment of the *takāful* Act 1984, the first *takāful* company was established in 1985. Since then, Malaysia's *takāful* industry has been gaining momentum and increasingly recognised as a significant contributor to Malaysia's overall Islamic financial system. Its

³ See Issues in Regulation and Supervision of *takāful*, IFSB; and International Association of Insurance Supervisors (IAIS), August 2006.

⁴ Bank Negara Malaysia, Concept Paper "Guidelines on *Takāful* Operational Framework" 2009. clause 10.10, "Sound investment management in *takāful* operations is important to achieve not only appropriate returns to meet different objectives of the *takāful* funds but also to ensure that the funds can meet the obligations when *takāful* benefits fall due, including on surrender and maturity of *takāful* certificates. It is the *takāful* operators' fiduciary duty to manage the investments in a sound and prudent manner, in line with Shari'ah requirements and participants' expectations."

http://www.bnm.gov.my/guidelines/06_others/Concept%20Paper%20%20Guidelines%20on%20Takāful%20Operational%20Framework.pdf. Accessed on 10th April 2010.

⁵ Central Bank of Malaysia (Bank Negara of Malaysia website), http://www.bnm.gov.my/microsites/financial/0204_ib_takāful.htm#tkf. Accessed on 18th Sep. 2010.

takāful assets and net contributions experienced strong growth with an average annual growth rate of 27% and 19% respectively from 2003 to 2007.⁶

2. *Takāful* Models

Before we look at Sharī'ah issues on Investment-Linked products, it is important to look at the existing *takāful* models which are the backbones for the *takāful* business operation. There are a number of contracts that govern the relationship between the participants (policy holders) and the *takāful* operator. The most widely used contracts are: *tabarru'*, *wakālah* (agency) and *muḍārabah* (profit-sharing).

The Sharī'ah Advisory Council of 'Bank Negara Malaysia' has made the resolution that a *takāful* contract is generally established on the Sharī'ah principles of *tabarru'* and *ta'āwun ta'awun*, apart from the agreement among the contracting parties⁷. In the formulation of a *takāful* product, the principle of *tabarru'* has been the main underlying Sharī'ah principle, although the application of other principles such as *wakālah* and *muḍārabah* also complement the *takāful* operational structure.

2.1 *Wakālah* Model

Wakālah is a process of assigning or entrusting to another person a certain task. Under this model, the principal agent relationship is used for both underwriting and investment activities. In underwriting, the *takāful* operator acts as an agent on behalf of the participants to run the *takāful* fund. All risks are borne by the fund and any operating surplus belongs exclusively to the participants. The *takāful* 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 set fee called a *wakālah* fee for managing the operation on behalf of the participants, which is usually based on a percentage of contributions paid. However, the operator's remuneration may include a performance fee (part of the underwritind surplus) as an incentive to manage the *takāful* fund effectively. Some contemporary scholars who allow the sharing of surplus between the policy holders and the *takāful* operator regard it as a *ju'alāh* for the management's good

⁶Central Bank of Malaysia (Bank Negara of Malaysia website), http://www.bnm.gov.my/microsites/financial/0204_ib_takāful.htm#tkf. Accessed on 18th Sep. 2010.

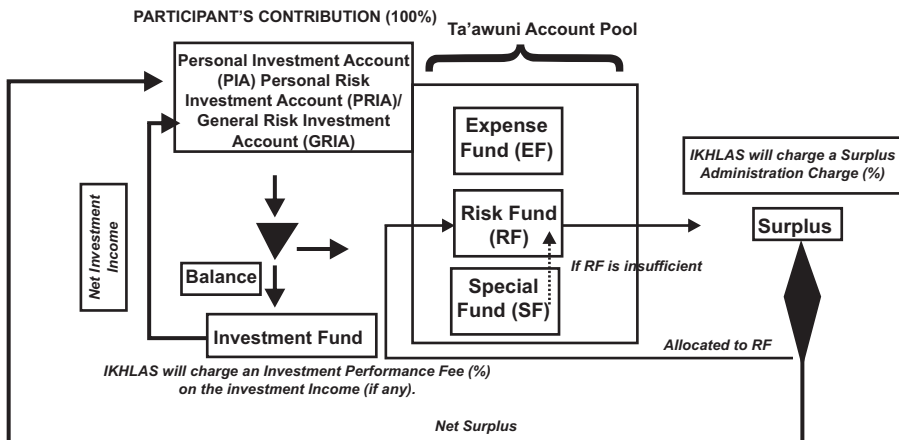
⁷ See <http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1511&print=1>. Accessed on 125th April 2010.

performance in handling underwriting.⁸ However, this is against the general view of the scholars and the AAOIFI standards on *takāful* where shareholders of *takāful* operators are not allowed to share the surplus with the participants (See: Ayub, 2007: 423-426).

2.1.1 *Takāful Ikhlās Wakālah Model (Example)*

In line with international and local developments in the practice of Islamic financial protection services, *Takāful Ikhlās* has adopted the *wakālah* contract for managing the *takāful* business. *Takāful Ikhlās* employs the following contracts to administer the operations:

- *Tabarru'*: a contract where the participant agrees to donate a pre-determined percentage of contribution to the Risk Fund to provide assistance to fellow participants.
- *Wakālah*: a contract where the participant authorises *takāful Ikhlās* to conduct the affairs of *takāful* business i.e providing protection, investment etc. on his/her behalf.
- *Takāful Ikhlās* Model allows the use of intermediaries as a medium to better serve the customers' needs, payment of surpluses and profits, where applicable to participants and calculation of shared benefits on a monthly basis.



⁸ Reasearcher's interview with Syeikh Abd al-Sattar Abu Ghuddah, at International Islamic University Malaysia, 6 March 2008.

Note:

For General *takāful*, all contributions, net of Expense Fund (EF), in the GRIA is dripped for *tabarru'* at the onset into the Risk Fund (RF) and Special Fund (SF). Any investment income in the Risk Fund (RF) and Special Fund (SF) is allocated back into the Risk Fund (RF) and Special Fund (SF), respectively. In this instance, *Ikhlās* does not charge an investment Performance Fee. Net surplus distribution is allocated and administered on an annual basis.

2.2 Muḍārabah Model

In a *muḍārabah* model, the *takāful* operator acts as a *muḍārib* (entrepreneur) and the participants are *rab al-māl* (capital providers). The contract specifies how the investment profit and/or surplus from the *takāful* operations are to be shared between the *takāful* operator and the participants. Losses are borne solely by the participants as the providers of capital except in the case of any misconduct and negligence by the operator, in which case the *muḍārib* is not entitled to receive any compensation for his efforts.⁹ This model was the earliest model introduced by some *takāful* operators in Malaysia after the introduction of the *takāful* Act 1984.

By this principle, the entrepreneur (*takāful* operator) accepts payment of the *takāful* installments or contributions - the capital of *muḍārabah*. The contract specifies how the underwriting surplus is supposed to be shared between the participants as the providers of capital and the *takāful* operator as the entrepreneur. The operation of *takāful* may thus be envisaged as a profit-sharing business venture between the *takāful* operator and the individual members of a group of participants. This structure was also known in Malaysia as 'modified *muḍārabah*'.¹⁰

There has been a lot of criticism against this model. Among others, it becomes much more in favour of the operators who are always in a winning situation where they can share the surplus with the participants according to the *muḍārabah* profit sharing ratio, but do not share the loss, if any. This model is definitely against AAOIFI standards on *takāful*. An irregularity lies in the distribution of the underwriting surplus from the *tabarru'* fund since surplus is actually the remaining capital, not the accrued profit.

⁹ See Issues in Regulation and Supervision of *takāful*, Islamic Financial Services Board (IFSB) and International Association of Insurance Supervisors (IAIS), August 2006, clause 9.

¹⁰ <http://www.takāful-malaysia.com>

/V5/index.php?option=com_content&task=view&id=24&Itemid=161.

2.3 Waqf Model

This model is applied in Pakistan and South Africa. The operator or participants establish a *waqf* entity with their preliminary contribution. This is to create a legal entity for the *waqf* fund responsible to collect donations (*tabarru'*) and to provide protection and indemnity to the participating members. Any contributions which are in the form of premiums shall belong to the *waqf* fund. The same is true with the yields of the investment. The proceeds are used to pay claims and compensations to the members facing any unfortunate events.¹¹

The *takāful* operator acts as the *waqf* manager who is entitled to receive payment for the services rendered.

3. Sharī'ah Principles for Managing Investment Portfolios

As far as investment of funds is concerned, there are two recognized methods, and both are allowed in Sharī'ah:

- a) Management on *muḍārabah* basis, according to which the management fee of the *muḍārib* is specified as a share (i.e. percentage) of the profit made by the fund.
- b) Management on agency (*wakālah*) basis, in which the management fee is specified for the agent as a fixed amount (lump sum), or as a percentage of the underwritten amount, which eventually becomes a lump sum or a percentage of the net asset value. This form is considered permissible by some jurists, on the basis that it is analogous to an agency fee which is based on a percentage of the price.

Another form that combines the two methods is when the manager receives a basic fee plus a specified performance fee based on a certain hurdle rate of return being achieved.¹²

4. Structuring Takāful Based on Sharī'ah Principles

It is observed that most of the contemporary scholars discussed the structure of *takāful* with the absence of the investment linked products.

¹¹ Syeikh Muhammad Taqi al Uthmani, "*Ta'sil al-ta'min al-takāfuli 'ala asas al-waqf*," pg. 11-20 presented at 26th Nadwah al Barakah Economic Conference, 10-11 October 2005. See also Sheikh Abu Ghuddah, *Buhuth fi al-mu'amalat wa al-asalib al-masrafiyyah al-Islamiyyah*, vol 9, Dallah al-Barakah Group, 2008.pg. 287. Also "*Nizam al-ta'amin al-takāful takāfuli min khilal al-waqf*", Int'l Conference on Co-operative Insurance in the Framework of Waqf", 4th-6th March 2008, IIUM, Kuala Lumpur.

¹² See AAOIFI Standards, 1424-5H/2003-4, Standards for Investment Fund, p. 422.

They suggest it as *iltizam bi al-tabarru'*, *waqf*, or a contract of *ta'awun* (mutual cooperation)¹³, wherein the participants are bound to make contribution and the *takāful* fund, is also duty bound to provide protection with the sum assured. If there is any surplus, the policyholders are also entitled to get it back. All the structures are to serve the original concept of *takāful*, not on securing profit from investments. It should be born in mind that investment linked *takāful* and most of the latest *takāful* models provide a means of investment where installments or lump sum contributions are divided into investment and *tabarru'*. As such, it is not sufficient to have only a *tabarru'* or mutual cooperation contract of *takāful*. The investment contracts such as either *muḍārabah* or *wakālah bi al-ajr* should also be concluded separately.

4.1 Contractual Relationship

It is important to know who is who in the contract. Who is the owner of the fund? The *takāful* operators should also know that they are managing the funds of participants on trust as a *wakīl* (agent) only, because the fund does not belong to them. Since the contract is based on *amānah* (trust), they are responsible for compensating any loss or damage resulting from their willful negligence.

This is because the contractual relationship between the participants and the *takāful* operator is a *mu'āwadah* contract. The nature of a *wakālah bil 'ajr* (agency with fee) contract in Islamic fiqh according to the majority of jurists is a contract of *mu'āwadah* which should be concluded with (mutual consent),¹⁴ as any uncertainties in fees and job descriptions cannot be tolerated. Since it is a bilateral contract, mutual consent and agreement are needed in concluding the contract as well as in case of termination. Meanwhile, the contract among the participants themselves is *tabarru'* (benevolent donation) and *ta'awun* (mutual cooperation). In this case, uncertainties of claims, and how much each participant's contribution to be channeled to the members in need and how much he gets can be tolerated.

¹³ Dr.Yusuf al-Shubayli opines that *takāful*'s underlying contract is neither *tabarru'* nor *mu'āwadah* but a new contract of *ta'awun* (mutual assistance and solidarity). See Dr. Yusuf al-Shubayli, "*Muqaranah bayn nizam al-waqf wa al-ta'min al-takāfuli*," International Conference on Co-operative Insurance in the Framework of *waqf*", 4th-6th March 2008, IIUM, Kuala Lumpur, pg.7-8.

¹⁴ Sheikh Ali Muhyiddin Qarah Daghi, Review of Fatwas Issued During Al-Baraka Banking Group Symposium, Dallah al-Baraka 29th symposium on Islamic Economics, 6-7 September 2008, pg. 223-224.

The contractual relation between the customers, the *takāful* operator and the fund manager in the case of outsource, should be clearly defined. How much is the fee charged upfront; how much goes to the *takāful* agent; how much goes to the *takāful* operator and how much is charged by the investment link fund manager, must also be clear. Most of the participants cum investors do not know about contracts which bind them with the *takāful* operator or third party fund manager.

5. How *Takāful* Operator Makes Money

Different from conventional insurance where all the premium paid to the insurance operator is regarded as its money, and the surplus becomes its profit, *takāful* operator makes money from the management fee, being an agent and hired by the participants for doing underwriting works, investment of the fund and also payment of the claims. Based on the rules of *wakālah bi 'ajr* (agency with fee), the contract becomes binding as it becomes a contract of *ijārah* (hire). This rule is applicable for charging the managerial fee on both investment and *tabarru'* funds. It is a condition of a valid agency contract that the quantity of the task be made known (no uncertainty).¹⁵ This also applies to the commissions paid to the agent who markets the *takāful* investment product. The operator may also get a share of the surplus on the basis of *muḍārabah*. But, as discussed above, it is subject to criticism by the Sharī'ah scholars.

6. Differences Between *Takāful* and Conventional Insurance

The following are some differences between *takāful* and the conventional insurance:

1. *Takāful* operator is not selling a policy certificate or a protection as it is in the conventional insurance but instead, taking a fee for the services rendered. The risk fund itself has a legal and financial entity and liability which is independent from the *takāful* operator. As such there should be two different accounts, one for the risks fund and the other for the shareholder.
2. *Takāful* operator can only underwrite a business which is acceptable from Sharī'ah perspective. The conventional insurance does not differentiate between what is allowable and what is not. As such *takāful* operator should have a Sharī'ah department or secretariat, Sharī'ah committee and Sharī'ah compliance auditor.

¹⁵ Sheikh Ali Muhyiddin Qarah Daghi, *ibid.* pg. 223-224.

3. Profit commission paid by reinsurance operator cannot be recognized as an income to the *takāful* operator, but can be returned to the risk fund to strengthen its financial adequacy at the *takāful* operator level.
4. Any contribution or premium from the participants shall remain intact as their money until payment of claim is made to the beneficiary nominated by the participant at the event of peril. As such, the surplus in contrary to conventional insurance shall not be treated as a recognized profit to the *takāful* operator.
5. Any return from the investment portfolio shall be treated as owned by the participants. The operator is only entitled to the profit if the contractual relationship is clearly stated onset such as profit sharing or a fee for the services rendered.
6. Any reserves in the risks funds or investment funds do not belong to the *takāful* operator. As such, in case of wind up, it should be channeled to charity.

7. Sharī'ah Compliance Manual for *Takāful* Operations

Sharī'ah compliance manual is the backbone of any Islamic bank or *takāful* institution. It spells out the establishment of Sharī'ah committee, its membership and qualification, the procedures of appointment, privileges, roles and responsibilities, and term of references. The Sharī'ah compliance manual also provides the establishment of Sharī'ah secretariats, i.e the full time officers, who will do research, and supervisory as well as auditing works to maintain Sharī'ah compliance status and its reporting structure.

As to business operation, among others, the manual should also prescribe the manner of selling the product whether non Muslim agent can sell the product and whether an agent can sell both conventional insurance product along with *takāful* products.

The Sharī'ah Compliance manual should also prescribe the accepted risk and the rejected ones, manner of payments of claims, accepted claims and their procedure, rejected claims, its relation with agents, *retakāful* and reinsurance operators, the modes of ceding, being it facultative or treaty and the Sharī'ah parameters for each modes, the status of benefits marketing policy and the company's activities.

7.1 Managing Risks

The very purpose of *takāful* is to provide protection and mutual guarantee against risks among the participants in the scheme. Risk management is almost similar to conventional insurance which includes but not limited to the following¹⁶:

- Due Diligence in Underwriting
- Transferring Risk/Sharing the Risks with Reinsurance/*Retakāful* Operator and Retrocession
- Exclusions of the Risks in the *takāful* Coverage

7.1.1 Due Diligence in Underwriting

Apart from using competent actuarial and related mechanism in assessing risk, it should be borne in mind that not all risks can be accepted in *takāful* business. As to types of risks, the following is an extract of *takāful Ikhlās* Sdn Bhd Sharī'ah Compliance manual for *takāful* underwriting:

7.1.2 Accepted Risks

- a) Matter which is not forbidden by Sharī'ah or not harmful.
- b) For customers, who change their genders, the risk may be accepted depending on underwriting guidelines.

7.1.3 Rejected Risks

- a) Matters prohibited by Sharī'ah:
 - Risk involved with gambling
 - Risk involved with *riba*.
 - Risk involving *shirk* (associating partners with Allah).
 - Risk on producing impermissible thing or bringing harmful effects to the community.
 - Risk on impermissible activity like entertainment activities which contradict with Sharī'ah, liquor factory worker, entertainment centre worker, disco worker and etc.
 - Risk on producing tobacco goods.
- b) Risk for mixed activities between permissible and impermissible activities, these criteria should be observed:

¹⁶ Key Disciplines in Risk Management by *takāful* Operators are given in Appendix-I.

- The *ḥalāl* and *ḥarām* ratio should be 70:30.
- Social expectation about coverage for the risk.
- Fundamental activities done by the risk owner related to the public interest of Islamic community and country, whereas there is only a slight element which is not in line with Sharī'ah and involving *'umum balwa* (impermissible things which is difficult to be avoided), *'urf* (habitual practice) and rights of non Muslim which endorsed by Islam.

8. Transferring Risk / Sharing Risks with Reinsurance / *Retakāful* Operator and Retrocession¹⁷

Reinsurance is a means by which an insurance company can protect itself with other insurance companies against the risk of losses. Individuals and corporations obtain insurance policies to provide protection for various risks (hurricanes, earthquakes, lawsuits, collision, sickness and death, etc.). Reinsurers, in turn, provide insurance to insurance companies. The company requesting the cover is called the cedant although the latter term is not in common use.¹⁸

Reinsurance is always referred to as “insuring the insurer”. Essentially, therefore, it is the insurance of liabilities assumed by an insurer under contracts of insurance, the reinsurer agreeing to assume a liability to pay all or part of the claims that may arise under the contract of insurance the reinsurance has written.¹⁹

Retakāful is normally known as an Islamic way of reinsurance. To make thing short, whilst reinsurance transfers the risk from insurer to reinsurer (depending on the structure), *retakāful* adhere to the risk sharing principle, like its *takāful* practices.

8.1 The Functions of Reinsurance (and *Retakāful*)

The main drivers for an insurance / *takāful* company to buy *retakāful* can be summarised in these points:

¹⁷ The part of paper on reinsurance and *retakāful* issues is mainly take from Dr. Aznan Hasan's paper on “*Sharī'ah Issues in the Operation of Retakāful and Reinsurance: A Preliminary Exploration from Sharī'ah Perspective*”, presented at Sharī'ah Scholar's Dialogue, 4th Muzakarah Penasihat Syariah Kewangan Islam 2009, organized by CERT, on 2nd November 2009, at Nikko Hotel, Kuala Lumpur.

¹⁸ <http://en.wikipedia.org/wiki/Reinsurance>

¹⁹ Carter, Robert L., Lucas, Leslie D, *Reinsurance Essentials*, Reactions Publication, London, n.d, p9.

8.1.1 Risk Sharing

The nature and purpose of reinsurance is to reduce the financial cost to insurance companies arising from the potential occurrence of specified insurance claims, thus further enhancing innovation, competition and efficiency in the marketplace. The cession of shares of liability spreads risk further throughout the insurance system.

8.1.2 Income Smoothing

Like other companies, an insurance company needs to earn a profit to remain solvent and to be able to raise fresh capital to finance the expansion of its business. Every move of underwriting shall be calculated wisely to ensure that all risks have been evaluated carefully when pricing. To mitigate further the risk, reinsurance ceding will be employed to avoid any miscalculated risk and to make the company's results more predictable by absorbing larger losses and reducing the amount of capital needed to provide coverage.

8.1.3 To Protect Solvency Margin and to Allow for a Better Underwriting Flexibility and Capacity

The ability of insurance company to underwrite business depends largely on its balance sheet. This test is known as solvency margin. When the limit is reached, an insurance company cannot underwrite further business unless it enlarges its capital by injecting new capital and this is not easy. This requirement to have sufficient capital is to strengthen the capability of the insurer to meet the claims, especially when large risks and catastrophic losses occur. Another way to allow for more underwriting capacity is by buying "surplus relief" reinsurance, where some of the risks are passed to another party. By doing so, it will be able to underwrite more, because some of its capital has been "freed" by transferring its risks to the insurers. Hence, by having reinsurance coverage, a cedant can write higher policy limits while maintaining a manageable risk level. That is why reinsurance (or *retakāful* underwriting) is very important for *takāful* companies to be able to compete with conventional insurance which have a bigger balance sheet to absorb the net retained loss exposure.

8.1.4 Stabilization of Insurance Portfolio

Reinsurance can help stabilize the cedant's underwriting and financial results over time and help protect the cedant's surplus against shocks from large, unpredictable losses. Reinsurance is usually written so that the cedant retains the smaller, predictable claims, but shares the larger, infrequent claims. It can also be written to provide protection against a

larger than predicted accumulation of claims, either from one catastrophic event or from many. Thus the underwriting and financial effects of large claims or large accumulations of claims can be spread out over many years. This decreases the cedant's probability of financial ruin.

8.1.5 Underwriting Assistance

Reinsurers deal with a wide variety of insurers in many different circumstances. Consequently, they accumulate a great deal of information regarding experience of various insurers with a particular coverage and the method of rating, underwriting and handling various types of coverage. This experience can be quite useful particularly to small or medium size insurer or *takāful* operator can underwrite risk, usually reserved for the big operators, by reinsuring a sizable portion of it to a *retakāful* operator.

8.2 The Forms of Reinsurance

The types of *retakāful* contracts are largely modeled after the conventional framework. Briefly, the reinsurance contract can be arranged as:

8.2.1 Facultative

Facultative *retakāful* is issued on an individual analysis of the situation and facts of the underlying policy. It may cover all or a part of the underlying policy. By deciding coverage case by case, the reinsurer can determine if it wants the risk associated with that particular policy. Facultative reinsurance is used by the reinsured to reduce the chance of loss or risk associated with a certain policy. It is also known as Single Risk Reinsurance.

8.2.2 Treaty Retakāful

Treaty *Retakāful*, on the other hand, is written to cover a particular class of policies issued by the *takāful*. Exemplified of classes covered by treaty *retakāful* are all property *takāful* policies or all casualty *takāful* policies offered by the *takāful* operators. Treaty *retakāful* automatically passes the risk to the *retakāful* for all policies that are covered by the treaty, not just one particular policy. Treaty policies are more general than facultative policies because the *retakāful* decision is based on general potential liability rather than on a specific enumerated risk.

To differentiate the two, we can simply say that treaty *retakāful* / reinsurance covers a set of subject policies, for a specified period of time. An example of this would be "all homeowner policies". This is more obligatory because all the terms of the contract between the primary insurer and the reinsurer must be met. The primary insurer must cede the

business and the reinsurer is obliged to assume the business (under the contract stipulations). This is more popular when a large number of homogeneous risks are being insured.

On the other hand, facultative insurance covers only one underlying insured, and is written one account at a time. The reinsurer retains the “faculty” or the ability to accept or reject a risk that is offered. Facultative is more commonly used on larger or unusual risk, for example an oil tanker. Also differently than treaty, facultative reinsurance is non obligatory, meaning that the primary insurer doesn't have to cede the business and the reinsurer is not obliged to accept the risk.

8.2.3 Facultative Obligatory

Facultative obligatory contracts are proportional (surplus) reinsurance arrangements limited to the type (s) of business specified in the agreement (e.g. specified industry in the case of property business). They fall between the wholly voluntary facultative and the obligatory treaty contracts by leaving the ceding company free to decide whether it will offer a risk for reinsurance, but the reinsurer is obliged to accept any risk that may fall within the scope of their argument. Because the business ceded tends to be less balanced than with a surplus treaty plus the fact that the ceding company is not bound to cede but the reinsurer is obligated to accept, facultative obligatory covers are not popular with reinsurer.

In addition to the three types of reinsurance, there are two ways that coverage can be allotted between the parties: either proportionally or non-proportionally:

- A. Proportional reinsurance is where the insurer obtains coverage for only a portion or percentage of the loss or risk from the reinsurer. The proportion of coverage is typically based on the percentage of premiums paid to the reinsurer. For example, if the reinsured pays 40 percent of the premiums to the reinsurer, then the insurer recovers 40 percent of its losses when it pays the original policyholder according to the original policy terms. The insurer can only recover a portion of its total loss, not the entire amount. The amount actually paid by the insurer is not figured into the reinsurance contract, only the percentage of loss the policy will cover. In addition, the reinsurer will allow a “ceding commission to the insurer to compensate the insurer for the cost of writing and administering the business (agents’ commission, modeling, paperwork, etc.).

The proportional reinsurance can be subdivided into two:

- a) Quota share: a form of reinsurance in which premiums and losses are shared proportionately between the ceding company and the reinsured. Under quota share, the same percentage applies to all reinsured policies in a given class of business. For example, an insurance company might purchase a 50% quota share treaty; in this case they would share half of all premium and losses with the reinsurer. In a 75% quota share, they would share (cede) $\frac{3}{4}$ of all premiums and losses.
 - b) Surplus share: it is also known as variable quota shares. A form of pro rata reinsurance indemnifying the ceding company against loss to the extent of the surplus insurance liability ceded, on a share basis similar to quota share. Essentially, this can be viewed as a variable quota share contract wherein the reinsurer's pro rata share of insurance on individual risks will increase as the amount of insurance increases, given the same reinsurer's retained line, in order that the primary company can limit its net exposure to one line, regardless of the amount of insurance written.
- B. Non proportional reinsurance only responds if the loss suffered by the insurer exceeds a certain amount, which is called the "retention" or "priority". An example of this form of reinsurance is where the insurer is prepared to accept a loss of \$1 million for any loss which may occur and they purchase a layer of reinsurance of \$4 millions in excess of \$1 million. If a loss of \$3 millions occurs, then insurer will retain \$1 million and will recover \$2 millions from its reinsurer(s). In this example, the reinsured will retain any loss exceeding \$5 million unless they have purchased a further excess layer (second layer) of say \$10 million excess of \$5 million.

The main forms of non-proportional reinsurance are 'excess of loss' and 'stop loss'. In excess of loss, the reinsurer is liable for the balance of losses exceeding the reinsured's deductible, subject to upper limit. Under the Excess of Loss Treaty arrangement, for example, a *takāful* operator will only call upon the *retakāful* when an accident or series of accidents arising out of one event, results in aggregate losses that exceed the retention capability of the scheme. It can have three forms – "Per Risk XL" (Working XL), "Per Occurance or Per Event XL" (Catastrophe or Cat XL), and "Aggregate XL". In per risk, the cedant's insurance company might insure commercial property risks with policy limits up to \$10 million, and then buy per risk reinsurance of \$5 million in excess of \$5million. In this case a loss

of \$6 million on that policy will result in the recovery of \$1 million from the reinsurer.

In catastrophe excess of loss, the cedant's per risk retention is usually less than the cat reinsurance retention (this is not important as these contracts usually contain a 2 risk warranty i.e. they are designed to protect the reinsured against catastrophic events that involve more than 1 policy).

Generally, stop loss/excess of loss ratio schemes intend to ensure stability of claim costs that need to be absorbed internally within the scheme. Whilst excess of loss protects the scheme from one loss (or series of losses) and any one event that goes beyond their net retention, the stop loss protects the scheme from the overall loss ratio that may go beyond their net retention, the stop loss protects the scheme from the overall loss ratio that may go beyond certain level of acceptability.

8.3 Sharī'ah Issues in Reinsurance

Sharī'ah ruling on the need of reinsurance vis-a-vis *retakāful*:

Reinsurance contract suffers from similar problem like the conventional insurance. Majority of modern scholars, fiqh academies, Sharī'ah bodies etc., have ruled that conventional reinsurance is not Sharī'ah compliant in principle. However, after considering the necessity for the *takāful* companies for *retakāful* arrangement and the insufficient *retakāful* coverage (for many reason, among others: small capacity, higher contribution rate, relatively poor rating as compared to conventional reinsurance), various opinions and resolutions have been passed in allowing *takāful* companies to have reinsurance arrangement with conventional reinsurance on dire needs (*ḥājjah*) or necessity (*ḍarrūrah*) basis. This allowance, however, is subject to some conditions, the most important of which are:

- a) The ceding to conventional reinsurance should be as small as possible.
- b) The *takāful* company shall not take any commission/ fees from the conventional insurance.
- c) The *takāful* company shall not hold any reserves on behalf of the reinsurance company, if it has interest for that holding.
- d) There shall be no arrangement for the *takāful* to involve in the investment of Reinsurance Company and there is no sharing of profit from that investment (in whatsoever way) to the *takāful*.
- e) The period of ceding should be as short as possible.

9. Exclusions of Risks in the *Takāful* Coverage

Risks in *takāful* industry can also be mitigated by having exclusion clauses. The following are a few examples of general exclusions of coverage in most of the products.

a) Natural Disaster

There are a number of natural disasters which are beyond human control such as flood, typhoon, hurricane, earthquake, landslide and tsunami, perhaps earthquake and tsunami are the most horrifying of them all and represent the most risk to humans in this modern world. These are known as “major force” or “the act of God”. It is suggested to always use the term “natural disaster” instead of “the act of God”.

We may recall the biggest earthquake and tsunami to have occurred in the last forty years. It was an earthquake with a magnitude of about 9.0 on the Richter scale that centered at about 100 miles west of Indonesia’s island of Sumatra, and at depth of 6.2 miles under Indian Ocean. It was estimated that more than 300 thousand people lost their life or are still reported missing, with millions becoming homeless and with no immediate livelihood. Property damage to infrastructure and residences and commercial buildings was extensive and losses are estimated as being a few billion dollars. It is important to note that although losses of lives were estimated to be the highest in the modern history, losses to life insurance were considered to be modest. This is because the most hit areas represented a very low insurance density. Had the earthquake and tsunami occurred to any higher insurance density cities such as Medan or Jakarta of Indonesia, then the loss to the insurance industry would have been astronomical.

b) Asbestos Liability²⁰

The first *asbestos* related lawsuit became a reality in Texas, USA about four decades ago. Until the end of 1970’s close to 1,000 asbestos cases were filed in federal courts across the USA. Claim filings began to increase dramatically in the first half of decade of the 1980’s alone. The last half decade of 1980’s saw yet another sharp increase in the number of

²⁰ Asbestos is a set of six naturally occurring silicate minerals used commercially for their desirable physical properties. The prolonged inhalation of asbestos fibers can cause serious illnesses including malignant lung cancer, mesothelioma, and asbestosis (a type of pneumoconiosis) <http://takāful-insurance.net/conventional-insurance-pblem/asbestos-liability> accessed 18092010

claims filed. It is roughly estimated that about 45,000 cases were filed during 1980s. Up to recent years, it is estimated that asbestos related claims in the USA alone might be as high as US\$ 65 billion, with about one third of those losses have become the largest single cause of loss to the insurance industry.

There are a numbers of factors and issues that have made asbestos losses uncontrollable to the insurance industry. First, in hindsight it was the insurance industry's mistake to provide such wide cover for a complex class that was beyond their proper knowledge at that time. The potential exposure in fairness was unknown, because at the time of writing the business, the exposure to asbestos related illnesses had not surfaced.

Secondly, it was because of the insurance products itself that became vulnerable to interpretation beyond the original intention of the coverage. An example of this was the fact that earlier asbestos related claims were mostly filed under the products section of commercial policies, which normally set a limit on such coverage.

c) Exclusions of Coverage by Products

There are many products offered by *takāful*, e.g. the personal accident products. We take an example from *takāful Ikhlās* Malaysia: *Takāful Ikhlās* Personal Accident provides comprehensive protection plan for participants in the event of death or bodily injury or permanent disablement due to an accident. It also offers both Individual Personal Coverage Accident and Group Personal Accident Coverage.²¹

Other related products pertain to i) death due to accident; and solely and independently of any other cause, except illness directly resulting 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; ii) permanent disability which entirely prevents the participant from attending to his business or occupation of any kind and the chances of recovery are beyond hope of improvement; iii) temporary total disablement which entirely prevents the participant from attending to his business of any kind on a temporary basis; iv) temporary partial disablement which prevents the participant from attending to a substantial part of his business or occupation but does not render him temporary total disabled; v) Medical expenses reimbursement with regard to treatment of bodily injury due to the

²¹ <http://www.takāful-ikhlas.com.my/generalTakāful/personalAccident.asp>. Accessed on 18th Sep. 2010.

accident up to the specified amount; vi) funeral expenses, up to the amount of the Plan applied for as a result of accidental death; and vii) general exclusion relating to:

- War, invasion act of foreign enemy, hostilities or war-like operations;
- Act of terrorism;
- Nuclear weapon materials;
- Entering or descending from aircraft;
- Professional sports;
- Wood-working machinery driven by mechanical power
- Drugs or alcohol;
- Sickness or disease of any kind, pregnancy or child birth or pre existing physical defects or infirmity, insanity, suicide or intentional self inflicted injury;
- Provoked murder or assault;
- The participant whilst committing or attempting to commit any unlawful act;
- AIDS or AIDS related complexity.

Generally, *takāful* operators will not cover accidents caused by the following events:

- War risks;
- Suicide and insanity;
- Self-inflicted injury;
- Influenced by liquor, drugs or narcotics;
- AIDS/HIV or any other venereal diseases;
- Provoked murder or assault;
- Childbirth, pregnancy or miscarriage;
- Involvement in unlawful activities;
- Hazardous sports.

It is also quite common for *takāful* to exclude people in the 'high-risk' professions, such as:

- Police/military and law enforcement officers;
- Divers;
- Pilots or crew members;
- Aircraft testers;
- Racing drivers;
- Seamen or sea fishermen;
- Professional sports persons;

Some *takāful* operators might extend coverage to some of the above exclusions if the participant pays additional contributions. It is best to check with the *takāful* provider to learn more about the exclusions in the *takāful* package and how to extend the coverage.²² Exclusions in case of Marine Cargo *Takāful* are given in Appendix-II.

Example: *Ikhlas* Contractors' All Risks (CAR) *Takāful*.²³

The cover provided by CAR *takāful* is only subject to a few obvious exclusions which the international insurance market usually applies. These exclusions named in the certificate essentially comprise: Loss or damage due to war or warlike operations, strike, riot, civil commotion, cessation of work, requisition by order of any public authority,

- Loss or damage due to willful act or willful negligence of the participant or of his representatives,
- Loss or damage due to nuclear reaction, nuclear radiation or radioactive contamination,
- Consequential loss of any kind of description whatsoever, such as claims from penalties, losses due to delay, loss of contract,
- Loss or damage due to mechanical and/or electrical breakdown or derangement of construction machinery, plant and equipment,
- The cost of replacement, repair or rectification of any deficiencies in the contract works.
- Loss or damage due to faulty design,

²²http://www.insuranceinfo.com.my/choose_your_cover/cover_personal_needs/overview.php?intPrefLangID=1 Accessed on 18th Sep. 2010

²³ http://www.takāful-ikhlas.com.my/generalTakāful/contractors_all_risks.asp. Accessed on 18th Sep. 2010.

- However, loss of or damage to correctly executed items resulting from the inadequacy of other items of the contract works is generally covered under CAR *takāful*.

10. Non Sharī'ah Compliance Risks

A. Underwriting non Sharī'ah Compliant Business.

This happens when *takāful* operator underwrites non Sharī'ah compliant business and subject matters such as liquor, pork related product, pornography, conventional interest based financial institutions. If the *takāful* operator has mistakenly underwritten such business, the fee charged cannot be recognized as income and shall be channeled to charity.

B. Investment Avenue and Revenue

The pool of funds is invested in: Sharī'ah approved shares, term and call deposits, and sovereign *ṣukuk*. Among the investment avenues is to invest in Islamic debt securities as this is allowable according to the Malaysian Securities Commission standard. Without a doubt the majority of the Middle Eastern scholars do not allow it. There are different standards to screen the shares such as FTSE Sharī'ah index, Dow Jones Sharī'ah index, AAOIFI and Malaysian Securities Commission. The Sharī'ah advisory council of each *takāful* operator should decide on the standards used for the screening.

C. Purification of Non *Ḥalāl* Income

It is undeniable that the yields of the investment may come from mixed up investment activities and avenues. Cleansing or purification of returns is basically the act of deducting the non-*ḥalāl* "tainted income" which is not acceptable from the Sharī'ah point of view, from the total returns on investments. The main sources of returns on investment which must be cleansed are dividends and capital gains.²⁴ For the Muslim investors, it is their obligation to make sure that their income comes from *ḥalāl* sources. If there is some non-*ḥalāl* element, then that non-*ḥalāl* should be removed by making donation to charities.

For the time being, there has been no international Sharī'ah standard over the requirement of cleansing the tainted income or the mechanisms to cleanse the non-*ḥalāl* returns. Some jurisdictions or particular Islamic

²⁴ Engku Rabiah Adawiah Engku Ali and P.Odierno, Hassan Scott. "Essential Guide to *takāful*" Kuala Lumpur: Centre for Research and Training, 2008, pg.157.

financial institutions require the purification/cleansing of the non-*ḥalāl* income. The Securities Commission of Malaysia in its investment guidelines is silent about this. This is perhaps by taking into consideration the fact that not all investors are Muslim. But, it may not be acceptable because Islamic financial institutions are supposed to offer only Shari'ah compliant instruments. Nevertheless, the act or initiative to cleanse can be done either by the fund manager or individual investor. Generally, the returns are cleansed by causing a portion of the dividends/ capital gains equivalent to the percentage of "tainted" income to be donated to charities.

There is a legal maxim mentioned by Ibn Taimiyyah,

"من اختلط بماله الحلال والحرام أخرج قدر الحرام، والباقي حلال له"

"If *ḥalāl* mixes up with *ḥarām*, provided that the *ḥarām* portion is cleansed, the rest is *ḥalāl*."²⁵

There is another legal maxim, "When the *ḥalāl* items are mixed up with the *ḥarām* items they are considered as *ḥarām*". This is applied to the mixed items of *ḥalāl* and *ḥarām* which are inseparable constructively or physically, for example in the case of the mixture of slaughtered animal and non- slaughtered. As for separable items such as money, the *ḥalāl* and *ḥarām* portions can be separated by taking out the *ḥarām* portion. The reason for this is because what makes it *ḥarām* here is not the very item itself but rather the external factors. In other words, it becomes *ḥarām* because of prohibited acts or violation of the Shari'ah rules in generating the income either by *riba* or stealing.

According to Imam Ibn Taimiyyah, *ḥarām* mixture can be divided into two major classifications:

- a) What is *ḥarām*/ prohibited in itself such as the meat of a dead animal which is not slaughtered. If it is not specific, such as one knows that someone is selling the meat of a carcass in the market and he does not know which one is *ḥalāl* and which is *ḥarām*; in this case it is not *ḥarām* to purchase the meat. In the case that he is uncertain between a specific mixture between the slaughtered and non-slaughtered (carcass), then he is not allowed to buy any of the two.

²⁵ Cf. Al-Nadawi, Ali Ahmad, *Jamharat al-qawaid al-fiqhiah fi al-mu'āmalāt al-māliyyah*, vol. 1, p.398.

- b) What is prohibited because of external factors such as stealing or what is possessed via invalid contract such as *riba* or gambling. In this case, if they are mixed up with *ḥalāl* and *ḥarām* the mixture is not *ḥarām*, but the *ḥarām* portion should be removed.

The repentance for those who have a mixture of *ḥalāl* and *ḥarām* assets is to channel the *ḥarām* portion or its value to charity.²⁶ In addition, such assets should be purified to avoid future occurrence of such *ḥarām* business or assets. If the manager does not purify the non *ḥalāl* income, then he should announce to the Muslim investors about the percentage of non *ḥalāl*.

11. Conclusion

Takāful, like the conventional insurance industry is no longer limited to providing protection, but is now an avenue for investment opportunities. Customers are participating in *takāful* schemes, especially the investment linked products because of the attractive features (i.e. combination of protection and investment). Apart from the purpose of solidarity (*takāful*), and giving rewards from the donation (*tabarru'āt*) to the members in need, the participants can also generate profit from their investments. But these two contracts are of different natures and should be concluded separately.

A *takāful* operator can charge fair fees for the *tabarru'* portion²⁷ which can be treated as a non commercial venture, and as for the investment portions, the operator can either charge a fee as a broker or a manager of investment funds, or share profit with the member investors.

In managing the risks, *takāful* operators are using almost the same approaches as of the conventional insurance apart from the restrictions and guidelines to comply with the Sharī'ah principles. In mitigating risks, the process, modes and procedures of reinsurance and *retakāful* should be approved by the Sharī'ah advisory boards.

If the manager of the investment fund does not purify the portion of the non-*halāl* income of the investment, then the Muslim investors should be informed about the percentage of non-*halāl* income so they could purify it by themselves. Alternatively, for the purpose of purification, the *takāful* operator may set up a special charity fund to be channeled for the charity avenues, not for the interest of the participation members. This cannot be treated as part of the operator's corporate social responsibility.

²⁶ Sheikh al-Islam Ibn Taymiyyah, *Majmu' al-Fatawa*, vol 22, pg.142.

²⁷ See: Syekh Dr. Ali Muhyiddin al-Qurrah Daghi, *al-Ta'min al-Islami*, pg. 330-331.

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