

SHARI'AH NON-COMPLIANCE RISK MANAGEMENT IN TAKAFUL INDUSTRY

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ABSTRACT

Business and risk are not separable. Rather they come as a package. Takaful is not exceptional. Both Takaful and insurance industries face operational risks, legal risks, business risk etc. These are common to both industries. However, the Takaful industry has an additional risk, i.e. *Shari'ah* compliant risk since it is required to abide with the *Shari'ah* in all aspects of its business activities. *Shari'ah* compliance is essential since it is the principal element that distinguished Takaful from conventional insurance. A lot of research has been conducted on risk management. However, there is limited study in *Shari'ah* risk management of the Takaful industry. Thus, the aim of this paper is to highlight on the importance of non-*Shari'ah* risk management in Takaful. This paper is written based on a thorough review of the relevant literature. It underscores the importance of Takaful operators to manage non-*Shari'ah* compliant risk. This paper will be an eye opener for the Takaful operators, investors, Takaful participants and regulators.

Keywords: *Takaful, Shari'ah compliance, Risk management*

INTRODUCTION

Risk is defined as any adverse effect that has the possibility of occurring and has the capacity to prevent an organisation from achieving its organisational objectives. Risk management covers all the activities and actions starting from the risk identification until risk communication to the top management as well as the risk managers. To effectively manage risk, crucial laws of minimising loss, lengthen the duration of the window of opportunity and preparing for unpredictable circumstances should be considered carefully (Commonwealth of Australia, 2008). The global financial crisis of 2007/2008 highlighted the role of risk and the inability of financial institutions to protect themselves from such exposure (Bank for International Settlements, 2009).

The continuity and sustainability of any organisation are dependent on how much attention is paid to this important element of risk management. The financial institutions score above the rest as they are the core components of the global financial system. This makes risk management particularly crucial for them. Numerous research has been carried out to enhance the risk management approach followed in these financial institutions. However, research related to Islamic financial institution remains limited with the focus on *Shari'ah* risk management of the *Takaful* industry (Islamic insurance industry).

Muslim scholars have recommended Islamic finance because of the non-*Shari'ah* compliant attributes of the traditional finance industry. The later finance system is established on the rules of interest which in itself is not allowed from the Islamic perspective.

Shari'ah compliance lies at the core and remains the most predominant factor in Islamic finance business operations. *Shari'ah* non-compliance risk in Islamic finance is failure to comply with *Shari'ah* in carrying out the finance business activities and operations. *Shari'ah* compliance is exclusive and treated as the central element of Islamic finance. Any deficiency to comply with the *Shari'ah* will negatively affect the trustworthiness of Islamic finance and the faith of the market participants among the depositors and investors. Therefore, Islamic finance needs to ensure that this unique risk, i.e., non-*Shari'ah* compliant risk, is audited and cared for properly; otherwise, it will blur the difference between Islamic and conventional finance.

Nonetheless, the attention towards *Shari'ah* risk management is slowly growing. Many do not discuss *Shari'ah* risk management in its length and breadth but are satisfied with including it in operational risk management. The newly established guidelines by the regulator (Bank Negara Malaysia) such as *Shari'ah* Governance Framework (SGF) in 2011 and Islamic Financial Services Act (IFSA) in 2013 came as a breath of fresh air for the scope of *Shari'ah* compliance risk

management, particularly in Malaysia. It has invited more research to lay the groundwork for and facilitate the robustness of *Shari'ah* risk management.

This study intends to draw attention to the important role of *Shari'ah* non-compliance risk management in *Takaful*. The paper is authored after consulting secondary sources through the library and online research materials such as books, journals, articles, magazines, Acts and regulations guidelines and other materials.

This paper is organised into six sections. Section two points out the definition and classical view of risk. Section three focuses on risk in Islam and its management from the Islamic perspective while section four forwards the concept of *Takaful* and its development. Section five touches on *Shari'ah* non-compliance risk management in *Takaful*. Section six concludes the research paper.

LITERATURE REVIEW

Definition and Classification of Risk

Risk is associated with every phase of human development and starts from birth. Once we leave the safe sanctuary of our mother's womb, we are exposed to the worldly environment with which we as a new-born baby are unfamiliar. The exposure to the environment exposes the baby to various risks, whether he is healthy or not. From birth to burial, this risk follows him like his own shadow. Since risk has a part to play in the unfolding of our daily lives, many researchers partake in defining risk in many different ways. For instance, risk is the adverse result or negative consequences that may occur due to the divergence from the anticipated desirable outcome (Lowrance, 1976; Graham & Weiner, 1995; Vaughan, 1997; Campbell, 2005). Some consider risk as an undesirable outcome that may occur due to the level of uncertainty (Rosa, 2003; Hillson & Webster, 2007; Renn, 2005 & 2008).

Risk can be classified into pure risks and speculative risks (Kassar, 2008; Diacon & Carter, 1992). Pure risk is the one in which there is no prospect of gain, whether a risk materialises or not. The speculative risk, on the other hand, refers to a situation where the probability of gain or loss are equal such as in gambling or a business undertaking (Crockford, 1987).

According to Salman (2015), risk can be defined as “a positive or negative event whose probability of

occurrence and impact (both financial and non-financial) can be measured reasonably”. Risk can be classified into two types, i.e. the speculative risk (which is identical to gambling where their likelihood of a gain or loss) and the pure risk (which is an expectation of loss or no loss) (Kassar, 2008; Diacon & Carter, 1992). The risks in business may be categorised into five general types: strategic risk, financial risk, operational risk, compliance (regulatory) risk and other risks. Strategic risk is defined as “a possible source of loss that might occur due to the quest of an unsuccessful business plan”. For example, a strategic business risk may come about due to a flawed decision taken at a managerial level or from its erroneous implementation. It may occur from inadequate resource allocation, or from a collapse occurring because the business was unable to respond in an appropriate manner to the dynamic business environment. Financial risk is defined as “the likelihood of loss inherent in the financing methods which might have a negative effect on the ability to provide adequate returns”. Operational risk is described as “possibility of loss occurring from the internal deficiencies of a firm or a malfunction in its controls, operations, or procedures”. Compliance (regulatory) risk is defined as “exposure to financial loss arising from the chance of regulatory agencies making changes in the current rules or them imposing new rules that will have a negative impact”. Other risks that should not be ignored include risks emerging from accidents and other circumstances beyond one's control like natural disasters, war, and major shuffles in market conditions, etc.

Risk in Islam

Alhabshi, Kamaruddin, Hamzah & Ezamshah (2012) state that the word “risk” is derived from the Arabic word “risq” or the Latin word “risqum”. In the 12th century the word “risq” was used to represent the possibility of a particular event, but it does not necessarily have a favourable or opposing consequence. As a rule, “Risqum” was meant to represent a negative outcome, but occasionally, a positive outcome is also referred to by the same word. In common English, these words have been known from the 18th century, but now they are widely in use.

Risk is vital for *Takaful* to exist and that makes it indispensable to look at the concept of risk in Islam. In Islam, it is believed that the difficulties are an inseparable part of human life which occurs by the Will

of Allah. That makes this world a temporary abode and a place of test and the Hereafter as the eternal life where we will be compensated for the difficulties we face.

The Qur'ān and Sunnah state:

"We will certainly put you through trial of fright, lack of food, and poverty, death and crop loss. Present the steadfast with good news." (Surah Al-Baqarah, 104)

"Do you anticipate going into Paradise without being put to the test like those who came prior to you?" (Surah Al-Baqarah, 214)

"You should be aware that your wealth and your offspring are a trial and that God owns extraordinary reward." (Surah Al-Anfal, 28)

Abu Huraira describes an event where the Messenger of Allah details Allah's words. The Exalted, says: "I possess no recompense but Jannah for a believing worshiper of Mine who exhibits forbearance and expects My recompense when I remove his most-liked from the dwellers of the earth." (Sahih Bukhāri)

Our success or failure in the Hereafter is dependent on how well we fare in the tests that are given to us in the world according to the above-stated authorities. We should strive to live a life governed by Shari'ah in all aspects, which include should we carry on our business activities. The profit that a business earns will only be considered legitimate if the risk, effort and liability are part of the process of earning a profit. These three terms are known as *iwad*. We thus are forced to conclude that we cannot rule out risk as a regular phenomenon in our daily life.

Islamic Dimension of Risk Management

We have already touched upon how risk cannot be ruled out from our daily lives. If we look to Islamic history, we see an apparent example of how the Prophet (PBUH) managed risk during Islam regards risk management as an important part of life that can ensure the social well-being of a person (Abdullah, 2012). This notion is supported by the following verses:

"O Yusuf! O person of truthfulness! Provide us explanation with respect to seven large cows which are being consumed by seven lean ones and seven green ears and further seven withered; maybe, I may go back to the citizens, perhaps they may know. "You will grow food for seven running years, and then leave whatever you harvest in its ear, except some which you may consume as food. Then at the close end of it shall come

seven arduous years, that shall feed on what you had kept in reserve earlier, apart from a bit of it which you may preserve. Then after that there arrive a year wherein the subjects will be blessed with rainfall and in which they will press juice" He pronounced. (Surah Yusuf, 49 & 49).

The Prophet Yusuf interpreted the dream of the King of Egypt. He predicted seven years of prosperity wherein the soil would be fertile and plenty of water available followed by seven lean years. During the fruitful period, the people of Egypt were advised to toil hard for more plantation and harvest. However, Prophet Yusuf also suggested not going overboard with the harvest such that it would result in waste. He suggested to harvest to fulfil the needs and save the rest of the harvest for the lean years. These verses reveal the importance that Islam has given to planning ahead and managing the undesirable risks to avoid hardships in the future.

"O my sons, do not set foot in the city by only one gateway: rather access by distinct entrances. Not that my advice can benefit you against the Will of God: None has the final decision but God: On Him do I have relied: and let those who trust rely on Him" (Surah Yusuf, 67).

In Surah Yusuf, we see Prophet Ya'qūb (a.s) who was the father of Prophet Yusuf, advising his sons to avoid entering from the same gate so as to mitigate the risk while entering the City of Egypt. He cautioned his children to be careful while on the journey and entering from different gates was a measure to achieve it. He might have suggested the same because Egypt was not a small city. It could have numerous dangers that they would not have thought about. If all of them entered from the same gate and something was to befall them, all of them would land in the same problem without the chance of one rescuing the other. However, by entering different gates, such a risk could be avoided. This action prescribed by Prophet Ya'qūb (a.s) could mitigate a potential danger and is considered a major strategy to manage risk. Later, Prophet Ya'qūb (a.s) also asked his children to put their trust in Allah. This verse reveals to us the significance of risk management and a rule of managing risk to minimise the potential undesirable outcomes; that is to follow a plan while trusting Allah that he alone suffices to protect us from all harm.

The following Qur'ānic verses calls for people to improve their condition while seeking Allah's (SWT)

aid and counsel.

"Verily Allah will not alter the state of a people until they change what is in themselves (within their own selves)." (Surah Ar-Ra'd, 11).

"But on Allah lay down your belief if ye have trust." (Surah Al Ma'ida, 23)

The following ḥadīth supports the verses of Qur'ān where the Prophet (PBUH) emphasises the fact that efforts from the human side are as important as trusting Allah, and that both go hand in hand as far as managing risk is concerned.

A Bedouin Arab entered the mosque and left his camel outside untied. The Holy Prophet (PBUH) asked him if his camel would run astray and he replied with "Inshaallah". To which the Prophet (PBUH) answered "Tie your camel first, then, say Inshaallah." (Sahih al Bukhāri narrated by Anas bin Malik)

Moreover, a look into the journey to Madīnah will exhibit the Prophet's (PBUH) genius in managing risk. The Prophet (PBUH) asked 'Alī to sleep in his bed when he (PBUH) found out that he was in the danger of getting murdered by the assassins that Quraysh had posted around his (PBUH) house. Throughout the night of migration, they kept vigil, sneaking a look every now and then through an opening in the door to make certain that he was still in the bed. As the night advanced, they became confident of their plan anticipating that they would kill him (PBUH) early in the morning the moment he leaves his house. In the morning, they came to know that they had been looking at Alī while the Prophet (PBUH) managed to travel safely thus managing risk. Based on the above incident it is seen that the Shari'ah encourages managing risk to ensure protection and personal well-being.

The Concept of Takaful

During the time of the Prophet (PBUH) the practice of "Aqilah" was widespread and practised by the Arab tribes, the Prophet (PBUH) himself and his Companions (Salman and Htay, 2014; Arifin *et al.*, 2013; Alhabshi *et al.*, 2012; Archer, Karim, & Nienhaus, 2011; Jaffer *et al.*, 2010; Othman & Abdul Hamid, 2009). It can be roughly described as the payment to the heir of the victim by the kin of the murderer. The practice of Aqilah gave birth to the concept of Takaful.

The Arabic term "Takaful" can thus be traced back to the time of the Prophet (PBUH) where it meant joint

guarantee among the participants. The term itself was derived from another Arabic word "Kafalah" which meant taking care of one another (Kassar, 2008; Yazid *et al.*, 2012; Alnemer, 2013; Htay and Salman, 2013).

Kafalah can also be described as a means of a guarantee, taking responsibility or ensuring that one's needs are secured (Alnemer, 2013; Salman, 2014; Kasim *et al.*, 2016). The principles of *Ta'āwun* and *Tabarru* come together to give birth to the term 'Takaful'. While *Ta'āwun* is described as cooperation, *Tabarru* is the practice of collective sharing of risk by participating members of a policy (Billah, 2002; Maysami & Williams, 2006; Usmani, 2007; Saaty & Ansari, 2008; Kassar, 2008; Noor, 2009; Zuriah & Hendon, 2009; Fadzli *et al.*, 2011; Alhabshi *et al.*, 2012; Yazid *et al.*, 2012; Arifin *et al.*, 2013; Salman & Htay, 2014; Noordin, 2014; Faruk & Rahaman, 2015; Salman *et al.*, 2017).

In the contemporary world, there are various definitions of *Takaful*, some of which are as follows:

'Takaful' means an arrangement based on mutual assistance under which Takaful participants agree to contribute to a common fund providing for mutual financial benefits payable to the Takaful participants or their beneficiaries on the occurrence of pre-agreed events; (Islamic Financial Service Act, 2010).

Islamic Insurance is an agreement of some persons facing certain types of risk, to remedy the losses raised from those risks, by paying subscriptions on the basis of commitment for donation, with this amount will be established an insurance fund, that will have its own juristic personality, and with separate financial liability, from this fund the compensation will be done for the losses that affect any subscriber due to insured risks took place, and it will be done according to the laws and documents. This fund will be managed by a committee selected among the documents holders, or by a stock company with certain charges, that will carry out the management of insurance related works and the investment of stocks of the fund. (Accounting, Auditing and Governance Standards for Islamic Financial Institutions, 2014).

According to Salman *et al.*, (2015), the contemporary concept of Takaful can be explained as the concept of providing financial assistance to the participants on the basis of mutual help, brotherhood and solidarity if the participants face misfortune. Therefore, Takaful moves a step ahead of the conventional insurance in terms of

ensuring the protection of the participants ethically as well as morally without the consideration of maximising profit.

The Growth and Development of *Takaful*

The practice of *Aqilah* was widespread in the time of the Prophet (PBUH) and was continued by his companions. It was practised even in the time of *Sayyidana 'Umar* (Rz). We know this by an incident in which he directed a Diwan of Mujahidin to help each other mutually if anyone of them commits a murder (Billah, 2003; Billah, 2007; Salman *et al.*, 2015). The concept of *Aqilah* leads to the concept of *Takaful* which has continued place since the Prophet's (PBUH) time until now (Matsawali *et al.*, 2012).

Thus, the following paragraphs will raise the subject and touch on its practices as exercised in different centuries. In the 19th century, a break through was achieved when a Hanafi lawyer by the name Ibn Abidin (1784–1836) became the first person to discuss the lawful premise of insurance. Before his work to uncover the importance of insurance practices, from the 14th to 17th century, insurance was concentrated on marine trade only. Ibn Abidin (1784–1836) was the earliest Islamic thinker who brought to light the general idea and a legal premise of an insurance agreement (Klingmuller, 1969).

Since his work, insurance practices have advanced to be based on legal institutions rather than customary practices. Muslim jurists also did their work and issued *fatāwa* against the illegitimate nature of conventional insurance. In the 20th century, *Takaful* was introduced by many institutions as an alternative (Billah, 2003; Kassar, 2008; Ezamshah, 2011; Alhabshi *et al.*, 2012; Htay & Salman, 2013). Such institutions include (Fisher & Taylor, 2000):

- φ Higher Council of Saudi Arabia in 1397 AH (1976)
- φ Fiqh Council of Muslim World League in 1398 AH (1977)
- φ Fiqh Council of the Organisation of the Islamic Conference in 1405 AH (1984)
- φ Grand Council of Islamic Scholars in Mecca, Majma Al-Fiqh in 1985

Ernst and Young (2013), highlights the number of *Takaful* operators in key *Takaful* market centres. According to this report, the total number of *Takaful*

operators in the key market is 174. Out of these 34 are in Saudi Arabia, 11 in Malaysia, 43 in GCC countries (excluding Saudi Arabia), 29 in ASEAN (excluding Malaysia), 12 in South Asia, 36 in Africa and 9 in the Levant.

Takaful operators in the key market cover Medical and Family *Takaful* which form the majority of business lines in the markets (Arifin, Yazid, & Hussin, 2014). 80% in South Asia, 50% in ASEAN and 47% in MENA belong to Family and Medical *Takaful*. According to The Global *Takaful* Insurance Market: Charting the Road to Mass Markets by Deloitte (2014), more than 62% of the gross *Takaful* contribution comes from the GCC countries globally. It is expected to reach USD20 billion by 2017 by contributions after growing at a significant pace.

Shari'ah Non-Compliance Risk Management in *Takaful*

Risk in Islamic finance is classified into generic risks or unique risks. The unique risks are inclusive of the *Shari'ah* non-compliance risk which is the most important and crucial for the Islamic finance industry including the *Takaful* industry.

Shari'ah non-compliance risk is the unique risk in the *Takaful* industry compared to the conventional insurance. *Takaful* operators have no other choice but to adhere to the *Shari'ah* principles. A breach of *Shari'ah* guidelines and principles may render the contracts invalid from the Islamic perspective. The consequences will be far-reaching from hurting the expectations of the participants, to damaging the reputation of the *Takaful* industry and causing financial loss, to exposing it to regulatory or legal action. It is also bound to have repercussions regarding the incidence and management of other risks (IFSB, 2013).

Shari'ah non-compliance risk relevant to the *Takaful* industry starts from the product development stage. In addition to being competitive with their conventional counterpart, the *Takaful* products are outlined along the lines of *Shari'ah* requirements. Without the approval of the *Shari'ah* committee, *Takaful* products cannot be introduced. This approval should come both at the institution as well as central government level.

Takaful products not only need more documentation and approval but must also meet a list of requirements before the launch of any insurance products. Product

development in *Takaful* is thus inherently more complex (IFSB, 2013).

Moreover, unlike the insurance industry, the *Takaful* industry is exposed to the non-*Shari'ah* compliant risk in the investment decision making. Insurance operators are sensible decision makers. They exercise caution in choosing the best investment which goes well with its portfolio thus providing minimal risk while ensuring maximum returns, without any religious restriction in place. Income generated in the form of profits is used to pay interest to policy holders, pay dividends to shareholders and pay claims. It is the choice of investment narrowed down to *Shari'ah* compliant investments only which become a major issue for the *Takaful* industry.

A fund manager invests in *Shari'ah* compliant investments. The fund manager is appointed by the *Takaful* operator and supervised by the *Shari'ah* advisory committee of the *Takaful* Company to manage the investment. Thus, the *Takaful* operator's task is to need to meet the additional criteria, i.e. *Shari'ah* compliance, in addition to the criteria laid down by the insurance operators.

Shari'ah non-compliance risk is the biggest risk *Takaful* operators seem to be exposed to in the operating stage. Even the advertising of the *Takaful* products needs to be done in such a way so as not to mislead the potential customers. Upon getting the contribution for the *Takaful* products and distribution of the profits, the *Takaful* operators should be adhered the respective adopted *Takaful* models. To avoid rendering the whole operation as non-*Shari'ah* compliant.

In addition to that, *Shari'ah* compliance risk also creeps in due to other factors. The major factors include the lack of standardisation and the difference of opinions and perceptions among Muslim scholars. Lack of standardisation is a major cause of the variation in the practices among the *Takaful* operators, as in the case of the practice of *Hibah* and surplus distribution.

Some countries allow the distributable amount to be given out as per the deceased person's will. In other countries, the amount is distributed according to *faraidh*. In a similar way, places like Malaysia allow surplus distribution while in the Middle East, the AAOIFI does not allow this practice.

Islamic investors and *Takaful* participants might become confused by such variance in the *Shari'ah*

rulings. The standardising of *Shari'ah* interpretation will benefit all by saving time and cost, providing financial soundness, ensuring clarity of conduct and uniformity in financial analysis, as well as boost public confidence (Kamal Rahayu Musa, 2008).

AAOIFI's standards have been made obligatory for Islamic financial institutions in Bahrain, Dubai, Jordan, Sudan, Syria and Qatar. In Malaysia, all the Islamic banks and *Takaful* operators must abide by the rules of the *Shari'ah* Advisory Council for solving any *Shari'ah* issue. This is one of the best methods to curtail the *Shari'ah* issues and to standardise the *Shari'ah* rulings. All leading Islamic regulatory and standard-setting bodies and every Muslim hosting country of Islamic finance will have to coordinate to succeed in this mission.

DISCUSSION

The unique and essential feature of Islamic finance and *Takaful* is that the business activities and transactions must be in accordance to *Shariah* rulings and regulations i.e. subject to *Shariah* Law. The most important element to be avoided is *riba*/interest of which in conventional insurance *riba*/interest is the fundamental element. Other fundamental prohibition are elements of *gharar* (uncertainty), *maysir* (gambling) which are not allowed in the investment and business portfolio of Islamic finance.

With the above highlighted differences in the feature of *Takaful* in comparison to the conventional insurance, has naturally leads to a different environment of unique risks to be managed by *Takaful* companies. The unique risks are identified, described and determined along with the issues and challenges faced by *Takaful* companies during the development and implementation of products, procedures, processes and system platform to address those unique risks.

Shariah principles and *Shariah* compliance are the backbone and paramount to *Takaful* business operation. *Shariah* non-compliance risk in insurance system is a failure to comply with *Shariah* law in performing the insurance business activities and operations. *Shariah* compliance is unique and considered as the fundamental element of Islamic Finance (IF) where *Shariah* non-compliance will affect the market, the confidence of the stakeholders and damaging of the IFs reputation.

Shariah non-compliance risk is an emerging key risk and a challenging issue which require high management

prioritized and mitigation tools by IFIs. Understanding of the *Shariah* non-compliance transactions would be another important element to be installed.

IFIs business operations are largely driven by values, principles, objectives and ruling of *Shariah*. It is a great task and challenge to strengthen the effective values of *Shariah* compliance throughout the business operation of IFIs. Comprehensive compliance with *Shariah* principles would bring confidence of public and financial market on the strength and credibility of the Islamic banking and financial business operations.

CONCLUSION

This paper highlights the importance of non-*Shari'ah* risk management in the *Takaful* industry. It was started by discussing the definition of risk in general. The meaning of risk is explained from an Islamic perspective. Islam does not undermine the essential role of risk management. It recognises that the concept of insurance is good; however, it prohibits the practices of insurance due to the involvement of prohibited elements such as interest, uncertainty and gambling. As an alternative tool of risk management, *Takaful* has been introduced by Muslim scholars. When the origin of the concept of *Takaful* is reviewed, it can be traced back to the time of Prophet (PBUH). The practice of *Aqilah* is evidence of the practice of *Takaful* in ancient times. Finally, *Shari'ah* non-compliance risk management in *Takaful* is also emphasised since it is the main cause of the existence of *Takaful* industry.

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