



CRITICAL ANALYSIS ON THE PRACTICES OF  
FAMILY TAKAFUL AND LIFE INSURANCE  
PRODUCTS IN MALAYSIA

BY

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requirements for the degree of Masters of Science in  
Islamic Banking and Finance

Institute of Islamic Banking and Finance  
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## ABSTRACT

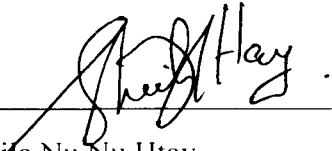
This paper discusses about the differences and similarities in the Malaysian practice of individual family *takaful* product and conventional individual life insurance product between the *takaful* operators and insurance companies. The motivation of this research is to help the consumers and the industry to better understand the similarities and differences of the development processes and the operations of the *takaful* and insurance products. Since some claimed that the conventional insurance practice is not entirely unlawful, the researcher believed that there is a need to critically review *takaful* products and make a comparison with insurance products from the product development process until the maturity and seek the opinions of *shari'ah* scholars on the differences of the practices between *takaful* and insurance company. This paper is also expected to make the public fully understand the reason behind the *shari'ah* compliancy and non-compliancy of a certain contract and operating process of the products so that the contemporary Muslim *Ummah* can gain benefits from it. The statistical methods that the researcher uses in this research are descriptive analysis and content analysis due to the fact that the research is more inclined towards qualitative rather than quantitative. The outcome of this research shows that there are some significance differences in the operations of the products which will potentially enlighten the public. Nonetheless, more in-depth research could be undertaken by analyzing and contrasting other intriguing products that are more complex to be undisputable regarding the differences between *takaful* and insurance products.

## ملخص البحث

هذه الورقة تناقش أوجه التشابه والإختلاف في التجربة الماليزية للمنتج الخاص بالتكافل العائلي الفردي و للمنتج التقليدي الخاص بالتأمين على الحياة بين شركات التكافل وشركات التأمين. الدافع لهذا البحث هو أن يساعد المستهلكين والصناعة لفهم أفضل لأوجه التشابه والإختلاف للإجراءات التطويرية والجوانب العملية لمنتجات التكافل والتأمين. بما أن البعض ادعى أن ممارسة التأمين التقليدي ليست غير مشروعة كليا، فإن الباحثة تعتقد أن هناك حاجة لمراجعة نقدية لمنتجات التكافل ومقارنتها بمنتجات التأمين التقليدي فيما يتعلق بإجراء تطوير المنتج حتى إتمام تطويره والتعرف على آراء علماء الشريعة في أوجه الإختلاف في الممارسات بين شركة التكافل والتأمين. ومن المتوقع أيضا أن هذه الورقة ستجعل عامة الناس يفهمون تماما السبب وراء مطابقة بعض العقود والإجراءات العملية للمنتجات للشريعة وعدم مطابقتها، وبهذا تستطيع الأمة المسلمة المعاصرة أن تحقق الفوائد منها. التحليل الوصفي كطريقة إحصائية هي التي تستخدمها الباحثة في هذا البحث وذلك يرجع إلى حقيقة أن هذا البحث متجه أكثر إلى النوعية أكثر من الكمية في البحث. النتيجة النهائية لهذا البحث تثبت أن هناك بعض الإختلافات المهمة في الجوانب العملية للمنتجات التي بالإمكان أن تزيد من فهم الجمهور. مع ذلك، ممكن القيام ببحث أكثر عمقا من خلال دراسة ومقارنة منتجات أخرى غامضة والتي هي أكثر تعقيدا لقطع أوجه الإختلاف.

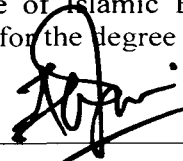
## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.



Sheifa Nu Nu Htay  
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfillment of the requirement for the degree of Master of Science in Islamic Banking and Finance.



Abdul Rahim bin Abdul Rahman  
Dean of IIUM Institute of Islamic  
Banking and Finance

## DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for my other degrees at IIUM or other institutions.

Wan Reena Zahirah

Signature ..... Wan Reena .....

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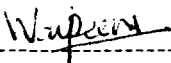
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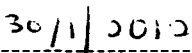
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AND LIFE INSURANCE PRODUCTS IN MALAYSIA**

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## LIST OF ABBREVIATIONS

MRTA	Mortgage Reducing Term Assurance
PA	Participant's Account
PSA	Participant's Special Account
TPD	Total or Permanent Disability
MRTT	Mortgage Reducing Term <i>Takaful</i>
GCT	Group Credit Term

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

Humans are prone to perils and misfortune. Accident does happen whether it is anticipated or not. Therefore, precautionary steps should be taken to protect individuals from any unforeseen perils and misfortune. This concept of protection is in line with the *shari'ah* and is supported by the following *hadiths*.

#### ***Hadith 1:***

*In the Hadith narrated by Tirmizi and on the authority of Anas bin Malik; it is told that a man asked the Prophet SAW, "Oh the Messenger of Allah! Should I leave my camel (untie) and put trust on Allah SWT or I should tie it (camel) then depend on Allah SWT". The Prophet SAW said, "Rather tie it and then depend on Allah SWT".* (Sunan At-Tirmidhi, n.d.)

#### ***Hadith 2:***

*Umar r.a said "I heard the Prophet SAW said; "If you depend on Allah SWT truly, He will provide you sustenance the way He provides to a bird, which flies out hungry in the morning, and comes back to the nest in the evening with the stomach full".* (Sunan At-Tirmidhi, n.d.)

The *hadiths* above emphasize the importance of efforts being put in by an individual in mitigating possible risks arising from any particular activities or transactions before placing our trust in Allah s.w.t. Trust in Allah does not mean that one should not give any importance to material resources or endeavor. What it really

means is that along with their due importance, one should have full trust in Allah. Without His Will, any attempts are of no avail. Nevertheless, it is necessary to have efforts or attempts because their procurement is also ordained by Him. Birds do not keep sitting in their nests for food but fly out in search for it. Hence, this is where the concept of insurance comes into the picture. Insurance is an attempt by the human to avoid misfortunes that might fall upon them.

Abu Zahra, a *Hanafi* scholar, believed that cooperative insurance (which is quite different from mutual insurance) is legal whether it is compulsory or voluntary. Similarly, a *Hanafi* scholar, Ibn Abidin (1784-1836) also believed that with regards to other types of insurance (such as mutual insurance), he could not place the insurance under groups of contracts known in Islamic law which are *bay'* (sale), *tabarru'* (donation) and *ijarah* (hire) (Mankabady, 1989). Although he admitted that one of the fundamental principles in Islamic law is that contracts are legal, unless they are expressly prohibited, he believed that the contract of insurance is illegal on the following ground:

- a) *Riba* (usury) arising from earning interest<sup>1</sup> on the accumulated funds received from the assureds.
- b) *Gharar* (uncertainty) resulting from a promise to pay a sum of money upon the occurrence of specified events. The lack of equality between what the assured gives and what he takes, brings the contract under *gharar* which is forbidden in *shari'ah*.<sup>2</sup>

Under non-mutual conventional insurance, the company accepts premiums from the insured at a level which it anticipates will cover claims and result in a profit.

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<sup>1</sup> In some Arab countries, interest is couched under different terms as fee, commission, brokerage, etc.

<sup>2</sup> Samir Mankabady, Insurance and Islamic Law: The Islamic Insurance Company, *Arab Law Quarterly*, Vol, 4, No. 3 (August 1989): 199-205.

This process of anticipation is akin to *maysir* (gambling). The insured also pays premiums to the company in exchange for indemnity against risks that may not occur. This process of ambiguity is akin to *gharar*. Lastly, the company engages in investments that derive their income from interest and/or prohibited industries (Pricewaterhouse Coopers, 2008).

On the other hand, *takaful* can be considered a *shari'ah* compliant form of conventional cooperative insurance. *Takaful* is based on principles of *ta'awun* (mutual assistance) and the *tabarru'* provided. *Takaful* is also similar to conventional cooperative insurance whereby participants pool their funds together to insure one another (Mankabady, 1989). However, there is no profit distribution in conventional cooperative insurance.

There are five key elements in the construction of a *takaful* company. The first key element is the concept of mutual guarantee. The basic objective of *takaful* is to pay for a defined loss from a defined fund. The loss is covered by a fund created by the donations of the participants.<sup>3</sup> Liability is spread amongst the participants and all losses are divided between them. Practically, the participants are both the insurer and the insured. This key element is supported by a verse from *Surah Maidah* from the *Qur'an* stated below.

“...*Help you one another in righteousness and piety, but help you not one another in sin and rancor...*” (*Al-Qur'an*, 5:2)

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<sup>3</sup> In *takaful*, a person that takes up the *takaful* coverage is known as the participant while a person that takes up the insurance coverage is known as the policyholder. The policyholder is known as the participants in the *takaful* as the customer is invited to participate in a policy as a participant. However, both terms refer to the same person who is the person being protected by the insurance/takaful coverage.

The second key element is the ownership of the fund whereby the participants are the owners of the fund and are entitled to its surpluses and profits. The third key element is the minimization of the uncertainty which is done through the concept of *tabarru'*. *Tabarru'* is a voluntary act to mutually help one another in the case of a participant's loss without any pre-determined monetary benefit. The *tabarru'* results in the transfer of ownership of the fund which then minimize the uncertainty. The fourth key element is the management of the *takaful* fund whereby the management is done by the *takaful* operator. The *takaful* operator will utilize either (or a combination) of two *shari'ah* compliant contracts namely *mudharabah* or *wakalah* depending on the adopted model. Finally, all investment must be *shari'ah* compliant, which prohibits any investment in *haram* industries and requires the use of the instruments that are free from *riba* (Kroll, 2008).

Even though it is not particularly clear when the *takaful* practices began in Islam, it may be concluded based on the nature of the *takaful* contract today, that insurance transactions by their very nature had been practiced before the time of the Holy Prophet Muhammad s.a.w., and have since been gradually developed until the beginning of the nineteenth century when the *Hanafi* scholar Ibn Abidin became the first Islamic scholar who came up with the meaning, concept and legal entity of the insurance contract.<sup>4</sup> As a result, we can see in the world today a number of insurance companies which are operating based on the divine principles of Islamic law (Mankabady, 1989).

Furthermore, based on The World *Takaful* Report 2011, the global *takaful* contributions grew by 31% in 2009 to US\$7 billion as of 2011. The opportunities in core markets also suggest a US\$12 billion industry by 2011. It is also seen that the

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<sup>4</sup> Kling Muller, Earnest, "The Concept and Development of Insurance in Islamic Countries" in *Islamic Culture*, Vol. 43, (January 1969): 30.

global gross *takaful* contributions reached US\$7 billion in 2009, and continue to boast healthy growth. Despite having this significant growth achieved by the *takaful* industry, the researcher feels that some important aspects that might jeopardize the image of the *takaful* companies should be addressed. These issues will be analyzed and discussed in this research paper.

## 1.2 PROBLEM STATEMENT

Based on the studies of the prior researchers, *takaful* has been introduced due to the *shari'ah* non-compliant nature of insurance business. As being mentioned in the background of study above, even though some of the practices are lawful in the eyes of *shari'ah*; the main factors that make insurance business *shari'ah* non-compliant are uncertainty (*gharar*), gambling (*maysir*) and interest (*riba*).

However, when *takaful* industry started, some of the *takaful* contracts, operating processes and structure were adopted from the conventional insurance (Frenz & Soualhi, 2010). Therefore, the researcher feels that *takaful* might be seen as a replica of the conventional insurance. Thus, it is believed that there is a need to critically review *takaful* products and make a comparison with insurance products from the product development process until the maturity and seek the opinions of *shari'ah* scholars on the differences of the practices between *takaful* and insurance company.

At present, there is no research that has been done in comparing and contrasting between *takaful* and insurance products from the beginning (i.e. product development stage) until the end (maturity) and other issues like underwriting, claim process, information and technology system and etc. Hence, this research aims to



understand the detailed phases of the product development processes and operations of the selected *takaful* and insurance products. This is to make sure that the public fully understand the reason behind the *shari'ah* compliancy and non-compliancy of a certain contract and operating process of the products. This research also aims to discard the negative claim that *takaful* product is an exact replica of the conventional insurance product.

### **1.3 RESEARCH OBJECTIVES**

This research intends to discuss some of the pertinent issues related to the practices of the *takaful* and insurance companies. In the light of the study, the researcher is trying to achieve two objectives. The first objective is to compare and contrast the family *takaful* and life insurance products in terms of the product development stage and its operations such as the term of contract, pricing, *tabarru'* portion, nomination, claims disbursement in the case of suicide, termination of the policy, marketing strategies, lapse ratio and in event of deficit of the risk fund. The second objective is to seek the opinions of *shari'ah* scholars on the differences between the *takaful* and insurance products.

### **1.4 RESEARCH QUESTIONS**

In order to reiterate and simplify the objectives mentioned above, the researcher has formed two research questions. Below is the first question:

- a) What are the main similarities and differences between *takaful* and insurance practices?

Furthermore, the second aim of this research is to find out the opinion of the *shari'ah* scholars on the detailed stages of the product development process and its operations as to which stage renders the products *shari'ah* non-compliant and the reason behind it. Hence, the second question is developed as follows:

- b) What are the reasons (i.e. interest, gambling, uncertainty or etc) to reject insurance as *shari'ah* non-compliant by analyzing the insurance product development process and its operations in detail?

## 1.5 MOTIVATION OF THE RESEARCH

All transactions in an Islamic system must be governed by the norms of Islamic laws or *shari'ah*. Hence, the prohibition of *gharar*, *maysir*, *riba* and etc must be emphasized and cannot be underestimated. Since there is a possibility that these elements will surface in the operations of the *takaful* company if not being taken care properly, the *takaful* company and *takaful* industry's image as a whole might be jeopardized.

Thus, the motivation of this research is to help the consumers and the industry to better understand the similarities and differences of the development processes and the operations of the *takaful* and insurance products. This researcher also hopes that this research will resolve the misunderstanding that the *takaful* company and its product are an exact replica of the conventional insurance.

## 1.6 SCOPE OF THE RESEARCH

Family *takaful* products and life insurance products are known to be the products which have the largest controversies, demand and potentials. In addition to that, the negative claim being made that the *takaful* product is an exact replica of the insurance product is mostly attributed to the family *takaful* products. Hence, the researcher will undertake to examine one family/ life insurance product from both the *takaful* operator and insurance company with regards to its product developmental stage and its operations. The products chosen will be the family product and life insurance product that have the highest demand from the participants/policyholders.

In addition to the above, the research is mainly based on the library research, product research and interviews with related personnel from the *takaful* and insurance companies. This researcher will also send out questionnaires to the *takaful* operators, insurance companies and *shari'ah* advisors with regards to the general operations, the product developmental processes of the family *takaful* and life insurance products and *shari'ah* matters. The results from the interviews and questionnaires will be the main findings of this research.

## 1.7 LIMITATION OF THE RESEARCH

Like every other research, this research is also subjected to limitations. The researcher has identified three main limitations attributed to this research. Firstly, the researcher will not examine all family *takaful* and life insurance products. This researcher will only examine the product that has the highest demand from the clients. This is because if the researcher was to examine all the family and life insurance products, this research will be too complex, time consuming and costly.

Secondly, the researcher will not interview all the available *takaful* and insurance companies in the market as there is an issue of the time limitation and some of the companies do not entertain the researcher's request for an interview.

The third limitation is the issue of the private and confidentiality of the company. Most companies hesitate to share their product development processes in detail because of this issue. They are afraid that certain confidential information will be exposed to their competitors.

## **1.8 SIGNIFICANCE AND CONTRIBUTION OF THE RESEARCH**

The researcher hopes that this research will be beneficial and useful to the consumers, regulators, *takaful* operators and the *shari'ah* advisors.

The significance of this research involves the capability of being able to raise the awareness of the consumers about the characteristics of the *takaful* and insurance products in terms of the similarities and differences. Furthermore, this research is also conducted to better understand the product development process and its operation and as to why it makes the *takaful* products to be deemed *shari'ah* compliant and the insurance products as otherwise.

Next, it is hoped that the regulators will have a better understanding of the real practices of the *takaful* and insurance companies and hence, will promulgate significant guidelines related to the practices.

Also, *takaful* operators can compare and contrast their practices with insurance companies and the *takaful* operators can have a better way of explaining the *takaful* processes to their *shari'ah* advisors through this paper.

Finally, this research is deemed to be beneficial to the *shari'ah* advisors in attaining the knowledge of the product development process and its operation. By this way, the *shari'ah* advisors will have a better understanding in the practice of the products. Hence, it is hoped that the *shari'ah* advisors can disseminate better resolutions in each *shari'ah* board meetings.

## **1.9 ORGANIZATION OF THE RESEARCH PAPER**

The rest of this research paper is organized as follows: Chapter two will discuss the literature review. Chapter three is mainly about the research methodology adopted in this research. This includes the description of the sample, data collection procedures and questionnaires used in this research. Chapter four will consists of the findings from this research. This chapter will also include the results of the questionnaires to the *shari'ah* advisors. The researcher will conclude this research paper in chapter five.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

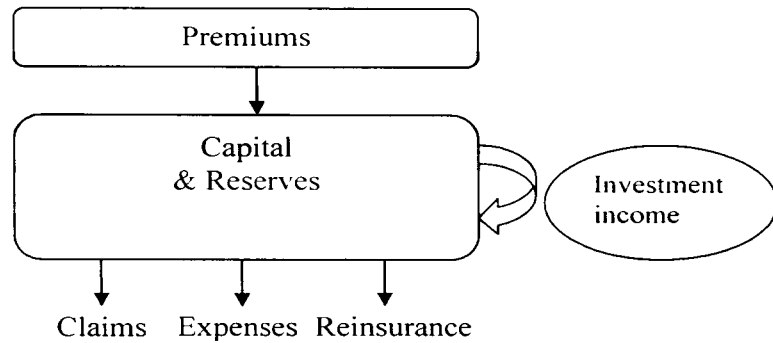
#### **2.1 INTRODUCTION**

This chapter will be explained in seven sections. The first section will explain the organization of this chapter. The second section is the foundation to life insurance. This section will briefly explain about the nature of life insurance. The third section will explain about the main types of life insurance. The fourth section will explain the concept of *takaful*. The fifth section is the discussion about the family *takaful*. The sixth section explains about family *takaful* models and the types of family *takaful* products. Section seven will discuss about the main differences between *takaful* and insurance practices. The researcher will conclude this literature review in section eight.

#### **2.2 THE FOUNDATION OF LIFE INSURANCE**

A life insurance policy contract is a legal contract between the life insurance company (insurer) and the person proposing for insurance (insured). Based on the contract, the insurer agrees to pay the insured a certain amount of money (sum insured) and any accrued additional benefits on the happening of some specified unforeseen events such as the death of the insured or his survival to the end of the contract. In return, the insured agrees to pay a regular sum (premium) periodically to the insurer for a specified term until the insured's death.

Below is an example chart of a conventional life insurance model from Price Water House Coopers 2009:



In a conventional company, the company receives premiums from the policyholders. Aside from the premiums, the company also takes fund from its shareholders. Therefore, the conventional insurance company's capital consists of money from the premiums and the shareholders' fund. With that, the company sets up its reserves and it generates investment income on the capital and reserves. The conventional insurance company also pays out claims, expenses and reinsurance from the capital and reserves.

Based on Insurance Info (2009), the main reason for life insurance is to provide income replacement to insured's immediate family after the demise of the insured which is similar to family *takaful*. The other reasons include:

- a) financing the insured's children's education,
- b) to have a saving plan for the future so that the insured have a constant source of income after retirement.
- c) to ensure that the insured have extra financial support in the event of serious illness or accident.

However, Muslim *ulama*' are on the opinion that most present insurance practices and its operations are not in line with *shari'ah*. Under an Islamic economy, as Siddiqi (1985) suggests, the insurance activities "have all practices that involve *riba*, *maysir*, and hazardous *gharar*".<sup>5</sup> This statement by Siddiqi is supported by an article by Muhammed Asraf (2008), the author stated that "when a life insurance policyholder dies after only paying part of the premium, his dependants receive a certain sum of money which the policyholder has not been informed of and has no knowledge as to how and from where it has been derived". This shows that life insurance is exposed by an amount of *gharar* that is clearly prohibited by the *shari'ah*.

## 2.3 TYPES OF LIFE INSURANCE

Currently in Malaysia, there are seven types of basic life insurance policies which are the term insurance, whole life insurance, endowment, investment-linked, life annuity plan, supplementary rider/cover, and mortgage reducing term assurance (MRTA).<sup>6</sup>

### 2.3.1 Whole life insurance policy

Whole life policies provide protection over the insured's entire life. The whole life insurance policies promise to pay the sum insured upon the early death of the insured or upon the insured reaching a specified age such as 85, 90 or 100 years. According to Insurance Info (2007) the insured will also receive the sum insured plus any bonuses if the insured suffers total and permanent disability. Since, the insurer

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<sup>5</sup> Muhammad Najatullah Siddiqi, *Insurance in an Islamic Economy*, The Islamic Foundation, Leicester, 1985, 65.

<sup>6</sup>Insurance Info. Retrieved on 27<sup>th</sup> June 2011 at 1545.  
[http://www.insuranceinfo.com.my/choose\\_your\\_cover/secure\\_your\\_future/life\\_insurance.php?intPrefLangID=1](http://www.insuranceinfo.com.my/choose_your_cover/secure_your_future/life_insurance.php?intPrefLangID=1)