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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

**A Critical Study of  
the Role and Implications of  
*Mudharabah* in Takaful**

by

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## Abstract

Most of the respondents in the survey conducted for this project paper have the impression that *mudharabah* (profit sharing) is the factor that distinguishes takaful from conventional insurance. The scholars who were interviewed, on the other hand do not think that *mudharabah* is crucial to operate takaful from the Shariah perspective. To most of them *mudharabah* is there only to give competitive advantage to the takaful operators. This project paper attempts to explain the actual role of *mudharabah* in the operation of takaful from the Shariah perspective. Many are naturally attracted to the *mudharabah* system as it offers the prospect of profit-sharing at the end of the period of takaful. This is understandable for investment linked insurance but for insurance that is purely for protection, *mudharabah* is not appropriate. Such obsession could dilute the inner beauty of takaful which is founded on the spirit of solidarity and brotherhood brought about by *tabarru'*.

This project paper also discusses what is it about insurance that is objectionable and how certain schools of jurisprudence overcome this objection to make insurance Shariah compliant. In doing so, this project paper explains the crucial role of *tabarru'* in "Islamising" insurance. This obscure word *tabarru'* is in fact the fundamental difference between takaful and its conventional counterpart.

The issue of *mudharabah* in the operation of takaful has become a contentious issue among takaful operators in Malaysia and even worldwide to the extent that it has threatened to cause division among certain sections of the *ummah*. Since *mudharabah* is not crucial to the operation of takaful (as confirmed by the scholars) then it is time for the polemic and strain over something that is merely incidental to stop.

## **Approval**

### **A Critical Study of the Role and Implications of *Mudharabah* in Takaful.**

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The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfilment of the requirements for the degree of Master of Business Administration (MBA).

**Supervisor:**

**Signature :**

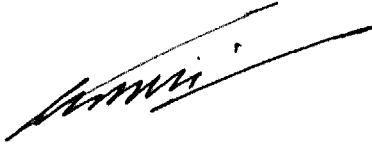
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**Date :**

## Declaration

I hereby declare that this Project Paper is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes and a bibliography is appended.

Signature :



Name : Mohd Tarmidzi bin Ahmad Nordin

Date : 5-8-2002

## **Dedication**

This Project Paper is specially dedicated to my loved ones

*Azi, Alif, Amir, Alia, Amin and Alfi*

## Acknowledgement

In 1982, my father went to Boston University at the age of 55 to do his Masters. My mother sacrificed by not following him because as a pensioner he could not afford to bring her along. He would have stayed on longer in the US to do his Phd had he more funds. Their example no doubt inspired me to do my MBA. I had no excuse to tell them that I am too old to study. I hope my children will continue with this tradition and regard learning as a lifelong pursuit.

I must also thank my wife and five children for understanding and tolerating my absence most weekends for the past 3 years. My appreciation also goes to my fellow classmates many of whom are much younger than I, whose youthfulness energised me. Two of them, Syed Murtardha and Shaik Jamil provided me with the necessary 'push' throughout the period of study especially when doing the Project Paper.

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- Sohibus Samahah Dato' Haji Md. Hashim Haji Yahya – Mufti of Federal Territory;
- Sohibus Samahah Dato' Hj. Hassan Hj. Ahmad – Mufti of Penang;
- Yang Amat Arif Dato' Syeikh Ghazali Hj. Abdul Rahman – Director General Shariah Judiciary Department Malaysia.
- Dr. Muhammad Masum Billah of the International Islamic University Malaysia
- Encik Zailan Arshad Mayban Takaful Berhad;
- Puan Anne Anthony Mayban Takaful Berhad

Last but certainly not least, I would like to thank the IIUM Management Centre especially the young and enthusiastic staff for being helpful throughout my studies there.

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# *Chapter One*

## *Introduction*

### **1.1 Hypothesis**

The application of the principle of *mudharabah* to the operation of takaful<sup>1</sup>, especially general takaful has contributed to the phenomenal growth of the takaful business since its introduction in Malaysia in 1985. One of its attractions is perhaps the prospect of profit sharing at the end of the period of takaful. This practice of rebating is something general insurance companies in Malaysia rarely do. The existence of *mudharabah* thus provides people with the most visible difference between takaful and conventional insurance. Most people probably assume that *mudharabah* or profit sharing must be fundamental to conducting the takaful business.

This perception is considerably different from the definition<sup>2</sup> of takaful that is founded on the spirit of mutual help. This definition suggests that there is more to takaful than just profit sharing according to the principle of *mudharabah*.

We are prompted to conduct this study, as we suspect many are not really aware of the spirit of brotherhood and solidarity that is so fundamental to the concept of takaful. In addition, we believe that the obligation to share profits with the participants imposes a

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<sup>1</sup> *Takaful is the term used to describe insurance that is in compliance with the Shariah or Islamic Law.*

<sup>2</sup> *Section 2 of the Takaful Act 1984, defines Takaful as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose."*

greater burden on takaful operators compared to their conventional insurance counterpart. We say this because; assuming everything else being equal between takaful operators and conventional insurers in terms of pricing, expenses, investment returns, and shareholder's expectations, etc. where would the profit that is to be shared come from? To generate this profit, the price has to be increased or the expenses reduced and so on. Whatever steps taken we suspect it would make takaful operators less competitive. In addition, there is also the extra expense to distribute the profit. This is something that the conventional insurers do not have to do. Whilst *mudharabah* is attractive to the participants, we do not think that its application is an attractive proposition to the takaful operator or their shareholders.

We do not think that takaful operators intending to provide Shariah compliant insurance services should be subject to greater burden unless, this is truly the requirement of the Shariah. Moreover, the different interpretation on the application of *mudharabah* has caused much rivalry amongst takaful operators, which we think is unwarranted.

The answer that we would like to seek from this study is whether from the Shariah perspective *mudharabah* is fundamental to the operation of takaful. If it is not, are there better alternatives to doing the takaful business that would enable takaful operators to compete on a more level playing field? To achieve this, we need to really understand from the Shariah perspective what is the factor that distinguishes takaful from conventional insurance.

A survey was conducted for this project paper to find among other things, what the ordinary people (i.e. non-Shariah scholars) think is the difference between *takaful* and conventional insurance. More than 90% of the respondents answered that it is *mudharabah* or profit sharing. All in, 100 people responded to various questions that were distributed through questionnaires<sup>3</sup>. Summary of the findings from the survey can be found in Table 2a and 2b.

In order to compare the difference between the perception of the ordinary public and the actual Shariah position on *mudharabah*, the researcher wrote to a number of scholars / academicians both locally and abroad asking them for their opinion from the Shariah perspective on the questions listed below. Only Dr. Muhammad Masum Billah of the International Islamic University Malaysia replied in writing. Attached is his written reply *ad verbatim*<sup>4</sup>.

In addition the researcher managed to pose the same questions to the following scholars in a personal interview held on the 24<sup>th</sup> June 2002:

- Sohibus Samahah Dato' Haji Md. Hashim Haji Yahya – Mufti of Federal Territory;
- Sohibus Samahah Dato' Hj. Hassan Hj. Ahmad – Mufti of Penang;
- Yang Amat Arif Dato' Syeikh Ghazali Hj. Abdul Rahman – Director General Shariah Judiciary Department of Malaysia.

The questions and the summary of their response are as follows:

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<sup>3</sup> See table 1 for a specimen of the questionnaire.

<sup>4</sup> See Table 3.

- a) Do you think that *mudharabah* is crucial (*wajib*) to the operation of takaful? All of them answered that *mudharabah* is not crucial. This means that takaful can function even without *mudharabah*. However, some of them feel that *mudharabah* is important in order to be competitive.
- b) Would you consider the operation of takaful without *mudharabah* to be valid (permissible)? All of them answered yes.
- c) Would you regard *tabarru'* to be crucial? If so how crucial is it compared to *mudharabah*? Most agreed that *tabarru'* is more crucial because protection is the primary objective of takaful compared to investment.
- d) Between the intention of protection and investment which do you think should come first when a person participates in a takaful scheme? Most said that the intention of protection should come first because for investment there are many other Shariah compliant instruments to choose from.

As can be seen, all the scholars confirmed that *mudharabah* is not crucial (or *rukun*) to the operation of takaful and that operating takaful without *mudharabah* is permissible as long as there is *tabarru'*. This is contrary to common belief. However, some of the scholars feel that *mudharabah* provides a commercial advantage to takaful over conventional insurance.

There is therefore a wide gap between the actual role of *mudharabah* in the implementation of the takaful concept from the standpoint of the Shariah and that perceived by the ordinary Muslims.

The issue of *mudharabah* in the operation of takaful has become a contentious issue among takaful operators in Malaysia and even worldwide to the extent that it has threatened to cause division among certain sections of the *ummah*. Since *mudharabah* is not crucial to the operation of takaful (as confirmed by the scholars) then it is time for the polemic and strain over something that is merely incidental to stop. After all, did the Prophet not say that differences in minor matters should be regarded as a *rahmah* (blessing)? Such differences should not give rise to major conflicts if the average Muslims learn to accept such diversity. Let us agree to disagree. Otherwise it could cause greater division amongst the *Ummah* and that would be something to worry about.

## ***1.2 Objective of the Project Paper***

The primary objective of this project paper is to critically examine the true role of *mudharabah* in the concept of takaful, specifically in terms of attempting to answers the following questions:

- Is *mudharabah* really essential for the proper implementation of the takaful system from the perspective of the Shariah?
- Will the product be less Islamic without *mudharabah*?
- Will the takaful operators be more or less competitive without *mudharabah*?
- Will *mudharabah* increase the operational cost of the takaful operator?
- Whether the decision to use or not to use the *mudharabah* system is a Shariah issue or merely a choice of marketing technique.

- Is there any difference between the modified version of '*mudharabah*' and pure *mudharabah*?
- Is there any difference between profit and surplus?
- What are the different contractual relationships between the participants themselves and also between the participants (i.e. the fund) and the operator.

In addition, this project paper will also discuss a number of problems and challenges faced by takaful operators as a result of using the *mudharabah* system. These include, but not limited to:

- Higher administrative cost in order to distribute the surplus to the participants;
- Different accounting treatment;
- Threat of liberalisation of the financial market and the disbandment of the motor and fire insurance tariff in Malaysia;
- The different treatments of management expenses under the *mudharabah* contract.

The focus of this project paper will be more on general takaful (or non-life) business rather than family takaful.

### *1.3 Methodology*

To fully appreciate the true role of *mudharabah* in the practice of takaful, we must first try to properly understand the real difference between takaful and conventional insurance from the Shariah perspective.

In fact, “what is the difference” (between takaful and conventional insurance) is usually the first question people will ask when discussing the subject of takaful. This is just like asking what is the difference between a Muslim and a non-Muslim. Physically of course, there is no difference, as both would have two eyes, two hands, etc. A convenient explanation on the difference, though not accurate, is of course the underlying contract of *mudharabah*.

Perhaps a better question to ask is why there must be a difference. The expected answer to this would be because some Muslims believe that there is something wrong about insurance that is being practised today (according to Islamic belief)<sup>5</sup>.

As mentioned earlier, there is a vast difference between what the scholars think of insurance and what the ordinary Muslims think of insurance. Thus, to appreciate really what some Muslim scholars think is ‘wrong’ with insurance, we must first understand the concept of insurance itself and have some rudimentary understanding of the Shariah.

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<sup>5</sup> Note that the researcher use the words ‘some Muslims’ because not all of them are in total agreement on this.

Once we have this understanding we can then appreciate the true role of *mudharabah* in the context of takaful.

We will attempt to explain this by taking the following steps:

- a) To understand what is it about insurance that the Shariah really object to.
- b) After that, we need to find out whether takaful is completely different from insurance or only certain aspects of insurance are objectionable of which modification is necessary to render this insurance Shariah compliant.
- c) If this is the case, we will need to find out what modifications can be done to make 'existing' insurance Shariah compliant and why.

Only after thoroughly understanding all these, can we appreciate the actual role played by *mudharabah* in "Islamising" insurance, i.e. whether it is crucial or merely incidental.

## 1.4 Objections to Insurance

The fact that there exists an "Islamic" version of insurance known as takaful suggests that Islam does not forbid insurance altogether. Compare this to gambling, for example, which is clearly forbidden in both the *Qur'an* and *Sunnah*. There is no such thing as "Islamic Gambling".

We have come to learn that in the realm of business, we can apply the established legal maxim of *ibahah* or natural permissibility to the effect that "everything is deemed permissible unless proven otherwise". In this context, a prominent contemporary



Muslim scholar, Dr. Yusuf al-Qaradawi said in one of his book<sup>6</sup> "Nothing is haram except what is prohibited by a sound and explicit *nas* from the Law-Giver, Allah *Subhanahu wa Ta'ala*." According to Dr. Qaradawi, "*nas*" is "either a verse of the *Qur'an* or a clear, authentic and explicit *sunnah*".

Dr. Qaradawi went on to say that<sup>7</sup> "The sphere of prohibited things is very small while that of permissible things is extremely vast". This gives the impression that if there is no injunction against insurance, then it is allowed (*mubah*). Muslim scholars have held that any injunction that overrules this principle of permissibility must be decisive in meaning and transmission. From information gathered for this project paper, we have come to the conclusion that there is no explicit evidence from either the *Qur'an* or the *Sunnah* that directly states that insurance is forbidden in Islam. Unlike gambling, for example, the ruling on insurance is not available ready made in the primary sources.

The next question is if there is no clear injunction against insurance why then is there any need for takaful to exist? This suggests that may be only certain aspects of insurance are not acceptable to Islam. If that is so, the next question to ask is what aspect of insurance which not acceptable? Once these aspects can be identified, then effort can be made to remove them from insurance so that what is left is insurance that is Shariah compliant.

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<sup>6</sup> Al-Qaradawi, Yusuf (1995), *The Lawful and the Prohibited in Islam* (English translation), Malaysian Student's edition 1995 by Islamic Book Trust, p. 14;

<sup>7</sup> Ibid.

To begin with, a Muslim should seek answers to these questions from the *Qur'an*. This is because Muslims believe that the *Qur'an* is the very Word of God and as such should be the supreme source of Law.

If no clear answer is found in the *Qur'an*, then the Muslim should next refer to the *Sunnah* of Prophet Muhammad SAW. This methodology of solving a legal case is in line with the following *Sunnah*:

*Mu'adz bin Jabal* who was being sent to Yemen as Governor was asked by the Prophet "How are you going to decide when asked to make a decision on a matter?" *Mu'adz* answered, "I will decide according to the Book of God (i.e. the *Qur'an*)." The Prophet then asked, "If you cannot find it in the book of God?" *Mu'adz* answered "With the *Sunnah* of the Messenger." The Prophet then asked, "If you cannot find it in the *Sunnah* of the Messenger?" *Mu'adz* answered, "I will exert myself (*ijtihad*) and decide." Then the Messenger touched *Mu'adz* on the chest and said, "Praise be to God who gives guidance to the messenger of the Messenger of God".

Opinions of scholars on insurance are varied. There are those who reject insurance completely (even *takaful*) because they are of the opinion that security should only be with Allah. At the other end of the scale are those who can accept conventional insurance because they recognise the *maslahah* or good that insurance can bring to society as a risk management tool.

It is clear that although all of the scholars based their opinion on the same primary sources i.e. the *Qur'an* and *Sunnah*, they could come to different opinions on insurance. This is understandable because as human being, it is quite natural for scholars to

interpret the *Qur'an* and *Sunnah* differently. Moreover, their levels of understanding of the concept of insurance would also be different.

This indicates that the question of the permissibility or otherwise of insurance is actually based on human interpretation of these primary sources through a process called *ijtihad*. Since it is a *fiqh* decision rather than Shariah it can be subjected to scholarly (i.e. human) debate. It is therefore not surprising to find that opinions on the subject of insurance are many and varied.

Many scholars in fact do accept the concept of insurance. It is just that many of them feel that certain practices of insurance are not in line with the Shariah. Dr. Yusuf al-Qaradawi for example, does not think that the concept of insurance conflicts with Islamic teachings. He says in one of his books<sup>8</sup>:

*"Our observation that the modern form of insurance companies and their current practices are objectionable Islamically does not mean that Islam is against the concept of insurance itself; not in the least - it only opposes the means and methods. If other insurance practices are employed which do not conflict with Islamic forms of business transactions, Islam will welcome them."*

Note that Dr. Qaradawi finds insurance useful but feels that certain practices need to be modified to bring them in line with Islamic teachings.

We need to identify the exact area(s) of objection and to systematically analyse the Shariah basis for these objections. To do this, we will revisit the 'official' *fiqh* ruling on insurance in Malaysia. Our discussions will be centred on the views expressed in the report entitled "Penubuhan Syarikat Takaful" or "The Formation of Syarikat Takaful"

by a special committee set up by the Malaysian government in 1982 to study the feasibility of setting up Islamic Insurance in the country known as the. “*Badan Petugas Penubuhan Syarikat Insurans Secara Islam di Malaysia* “ (BPPSIM). We have chosen this report because it provides a fairly detailed discussion on insurance vis-à-vis Islamic law and can be regarded as the official view on insurance in the Malaysian context. Although it was written almost 20 years ago, we believe that the official opinion on conventional insurance has not changed very much. We say this based on the fact that the Shariah screen of the KLSE still excludes conventional insurance companies from their list of ‘*halal*’ (permissible) stocks.

In a working paper entitled “*Ke arah insurans secara Islam di Malaysia*” or “*Towards An Islamic System of Insurance*” that was attached to the BPPSIM report, a number of issues were put forward to explain why insurance is “*not in line with the teaching of Islam*”. The following is a translation<sup>9</sup> of a passage from the paper<sup>10</sup>:

*“Present insurance is not in line with Islam*

*The practice of insurance presently follow the western style of management and is therefore not in line with the teachings of Islam in a number of ways:*

1. *Many insurance contracts contain usury, as it promises to pay more than the premium paid.*
2. *Insurance companies invest the premiums which they have collected, in interest bearing investments;*
3. *the western method of insurance is akin to gambling as one can lose the premium to insurance companies;*
4. *the western method of insurance contain the element of gharar and the contract is uncertain;*
5. *western insurance companies can earn profits or loss as a result of death or accident or risk to people.”*

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<sup>8</sup> Al-Qaradawi, Yusuf, *The Lawful and the Prohibited in Islam*, p. 276.

<sup>9</sup> Note that the researcher translated all quotations from the BPPSIM report appearing in this project paper from the Malay language.

<sup>10</sup> *Laporan Badan Petugas Penubuhan Syarikat Insurans Secara Islam di Malaysia (1984) Appendix C Pg. 8 para 4. (translation)*

Although we do not see why following the western style should be an issue, the paper did raise a number of objections worthy of discussion. Foremost is the presence of the following elements in the practice of insurance:

- Usury (or *Riba*).
- *Gharar* (uncertainty);
- *Maisir* (gambling);

In fact what was said is consistent with a decision made some 10 years earlier by the Majlis Fatwa Kebangsaan (or National Fatwa Council<sup>11</sup>) which deliberated on the question of life assurance on 15<sup>th</sup> June 1972. A translation of an extract from the minutes of that meeting reads as follows:

*"Decision: After a long and detailed discussion, the conference have decided by consensus that:*

*Life Insurance as presently practised by insurance companies is a fasid transaction as it is contrary to the Shariah principles of contract because it contains the following elements:*

1. *Gharar* (uncertainty);
2. *Maisir* (gambling);
3. *Riba* (usury);

*As such from the Shariah point of view, insurance is haram";*

Let us now examine in more detail, where the three elements are said to be present in the insurance contract.

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<sup>11</sup> *Laporan Badan Petugas Penubuhan Syarikat Insurans Secara Islam di Malaysia (1984) Appendix A pg. 1 (translation)*

### 1.4.1 Element of *Gharar* (Uncertainty)

Mutual consent and truthfulness of the parties to a contract is a moral obligation and a basic requirement for a valid contract in Islam. The *Qur'an* states :

*"O believers! do not devour one another's property by unlawful ways; instead do business amongst you by mutual consent."* <sup>12</sup>

*Gharar* is objected to in any transaction (not just insurance) because it is said to undermine the element of consent necessary for a valid contract. Indeed how can there be mutual consent when one party, because of inadequate information, does not have the correct impression of the material aspects of the contract.

The Prophet was reported to have forbidden all transactions involving *gharar* without defining it. In the absence of a clear explanation as to what constitutes *gharar*, scholars have had to form their opinions on the subject of *gharar* through the process of *qiyas* (analogy) based on the *Qur'an* and the *Sunnah* of the Prophet. Various types of transactions and exchanges of property practised by the *jahilliyah* (pagan Arabs) before the advent of Islam were either approved or prohibited by Prophet. These became precedents and served as broad guidelines for future Muslims. Some scholars for example, see some similarities between insurance and certain transactions that were expressly forbidden by the Prophet because of *gharar* such as the following:

- *Habal al-habalah* - sale of the offspring of a still-to-be-born animal;
- *Mulamasah* – contract which is concluded by merely touching the subject of sale;

- Bai' munabadha - a sale performed by the vendor throwing a cloth at the buyer and achieving the sale without giving the buyer the opportunity to properly examine the object of sale;
- Al-madhamin wa'l-malagih - sale of what was in the loins and wombs;
- Bai' Al-hassat – a type of sale where the outcome is determined by the throwing of a stone. For example sale of cloth where the customer is asked to toss a stone. The cloth on which the stone lands, is the one bought for a particular price.

The above contracts were forbidden perhaps because they rely too much on chance. At the time of buying, the buyers did not even know the quality and/or quantity of the item being purchased. These will only be known later, say after the stone has landed, by which time there could be dispute and ill-will. The element of uncertainty (*gharar*) in the above contracts is such that it is akin to gambling.

Note that the Prophet did not say that insurance is *gharar*. This is only the personal *ijtihad* or opinion of some scholars based on their interpretation of certain *Sunnah* of the Prophet and their understanding of insurance. Specifically on insurance for example, the BPPSIM has in their report<sup>13</sup>, identified that *gharar* is present in the insurance contract as follows and we quote:

“... it is clear that the insurance contract as practised presently

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<sup>12</sup> Qur'an (4:29)

<sup>13</sup> *Laporan Badan Petugas Penubuhan Syarikat Insurans Secara Islam di Malaysia (1984) Pg. 19 para 2.6.3.3. (translation)*

*gives rise to Al-gharar as the "Ma'kud 'Alaih" is not clear with regard to:*

- *Uncertainty as to whether or not the Insured will get the compensation which has been promised;*
- *Uncertainty as to how much the Insured can get;*
- *Uncertainty as to when the compensation can be paid."*

*The presence of only one element is sufficient to deem the contract as having gharar. As such, scholars have concluded that insurance contracts are haram (forbidden) and thus void.*

*They are void because the forbiddance goes right down to the root of the contract itself i.e. one of rukun ("Ma'kud 'Alaih"). As a condition, the "Ma'kud 'Alaih" must be clear to both parties to the contract. Because of the existence of Al-Gharar, one of the conditions has not been fulfilled and if a condition regarding a matter of principle is not fulfilled, the ruling is that the contract is void."*

Although there are many varieties of *gharar*, the BPPSIM expressed concern specifically with the *gharar* in the insurance contract from the aspect of 'non-delivery'. They are not happy that insurers are able to take what is due to them (the premium) but may or may not deliver what is due to the insured i.e. the claim. This to them, tantamount to 'unjustified enrichment'.

Although insurance practitioners would generally concede that a certain degree of *gharar* is present in the insurance contract, many would not agree with the view that the insured gets no benefit from insurance if no claim is made. To them, the insurer has fulfilled its obligation by providing the benefit of financial security derived from the promise of compensation even though no claim has been paid. The question of non-delivery therefore does not arise.